August 2021 - Tandem Investment Advisors, Inc.

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Observations
- August 2021
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Financial Markets Review

“The S&P 500 managed to climb a global mountain of worry to exceed its prior high set on January 26th. While almost every major asset class around the world seems to be coming unhinged, the domestic markets remain steadfast. And in a world of interconnectedness, it is even more surprising to see the divergence between the U.S. and the rest of the world.”

– Observations, 9/15/2018

There are many parallels between today and throughout the summer and early fall of 2018. Back then, equity markets were coming off an historically calm 2017, as “global synchronized growth” dominated the headlines. Earnings were growing at a pace not seen in several years due to corporate tax reform. However, the easy comps were coming to an end and decelerating earnings growth was on the horizon. And, while U.S. equity markets continued to climb higher, international equity markets peaked months prior and were moving in the opposite direction. The signs were pointing to a heightened probability of weakness going into the fourth quarter of 2018.

Just as cracks appeared well before the market fell in 2018, there are similar cracks forming in today’s market. There is no telling if this underlying weakness will translate into a broad-based market correction. But one thing is certain, risk is rising amongst U.S. equities. Afterall, I would be remiss to not share one of our favorite quotes.

“When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high. By contrast, when securities prices are high, as they are today, the perception of risk is muted, but the risks to investors are quite elevated.”

– Seth Klarman, Founder, CEO, and Portfolio Manager of Baupost Group

As the S&P 500, Nasdaq Composite and DJIA all made record highs last week, it is difficult to perceive any risk to the markets. Between financial conditions being the “easiest” on record, central banks remaining accommodative, and pent-up demand being unleashed throughout the economy, it makes sense why perceived risk is so low. If you do not think the perception of equity risk is low, just look at the amount of money flowing into global equity funds this year. According to Bank of America, the first half of 2021 saw record inflows into global equities. And, if the inflows stay on its current pace, the amount of money taken in by global equity funds for all of 2021 will end up being more than the previous 20 years combined. If that statistic does not scream a lack of perceived risk and an “all-in” mentality, I’m not sure what will!

Although perceived risk might be low, actual risk is rising. As we detailed back in September 2018, divergences amongst financial markets were a sign that actual risk was increasing. Today, the divergences are subtle, but nonetheless they have started to appear.

• Emerging Market equities (EEM) – down 10% since February
• International Developed Market equities (EFA) – down 3% since June
• VIX – positively correlated to the rise in the S&P 500; VIX rose 15% in July at the same time the S&P 500 climbed 2%
• Yield Curve (10-year Treasury – 2-year Treasury) – flattened 53 basis points since March with much of the move occurring over the past month
• High-yield spreads (ICE BofA U.S. High Yield Index OAS) – hit a cycle low of 302 basis points on July 1, 2021, and has since widened by 24 basis points; July 2007 was the last time the high yield spread was at or below 302 basis points
• U.S. small-cap equities (Russell 2000) – peaked in March and have since declined nearly 6%

In addition to the examples above, the rate of change in corporate earnings growth is expected to decelerate next quarter. And, we have started to see several economic indicators continue to expand, but now at a decelerating rate. The most notable is the Conference Board Leading Economic Index, which is a composite of 10 indicators including ISM new orders, building permits, average consumer expectations and weekly initial unemployment claims, just to name a few. Lastly, record high home prices have started to affect new and existing home sales, as both indicators have fallen since peaking a few months ago.

Actual risk is rising. Historically speaking, valuations are stretched, even when taking into consideration an expected earnings growth rate of 10% in 2022. The probability of a price correction is growing, but that does not mean it is a foregone conclusion. This is not a call for a drastic portfolio shift, but rather something to be aware and cognizant of when setting future market expectations.

Tandem Strategy Update

The COVID-19 pandemic brought about significant challenges to many industries, of which most were out of company stakeholders' control. For example, physical retail stores and restaurants could do very little when it was mandated that they shut down. Medical device companies were in a bind when many elective procedures were temporarily halted. I could go on and on, because nearly every company was affected in one way or another.

One of the pillars of our investment philosophy is that companies must grow earnings and revenues through any economic cycle. It could be argued that the forced global shutdown we experienced in 2020 was not an economic cycle. However, rather than picking and choosing which companies we think should get a pass for reasons out of their control, we relied on the math and let our quantitative model determine our actions. Most of our holdings have made it to the other side and are in a better place fundamentally than they were before the COVID-19 pandemic. Unfortunately, one company did not come out unscathed. And for this reason, we recently completed the liquidation of Raytheon Technologies (RTX).

Our position in RTX was the result of a merger between United Technologies (UTX) and Raytheon in April 2020. As owners of UTX, we received shares of UTX's business units, Otis Worldwide (OTIS) and Carrier Global (CARR). The effect of the merger was that the industrial conglomerate we once owned was now broken up with the legacy UTX business focusing primarily on aerospace and defense. As a whole, UTX had met our fundamental criteria and passed through our quantitative model. As separate businesses, RTX, OTIS and CARR were not able to pass through on their own. The three individual companies are more cyclical as stand-alone companies than as a conglomerate, which make RTX a much different company than the UTX business we originally purchased in 2007.

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