OBSERVATIONS - December 9, 2019

TANDEM INVESTMENT ADVISORS

Financial Markets and Economic Review

Santa Claus has come to town! The 'Santa Claus Rally" refers to a seasonal pattern that sees equity markets trade higher beginning in the back half of December through the first few days of January. This year Santa Claus took a page out of the retailers' playbook and decided to spread his Christmas spirit early. With Walmart now setting out Christmas displays on Labor Day and Black Friday sales beginning on Halloween, Santa made sure he wasn't to be outdone. The S&P 500 officially broke out to all-time highs on October 28th and hasn't looked back – rising nearly 4% since the end of October. Over this same timeframe, the Nasdaq and Russell 2000 (small caps) have climbed roughly 5%.

In *Observations* last month, we pointed out that November and December have historically been the two strongest months for the S&P 500, and I suspect this year will not disappoint. The seasonal trends coupled with the S&P 500 already being up 25% year-to-date should lead to further gains into year-end. Higher prices beget higher prices and the FOMO is real. If you haven't participated in the stock market rally so far this year, you've got three weeks to make it up. You might think this sounds ridiculous, and it is, but this is the mindset of some people. There may not be a logical or sound explanation for an increase in equities into the end of the year, other than it is likely to happen, so embrace it for what it is.

Economic data has been mixed as of late. The U.S. ISM services and manufacturing index both ticked lower in November after an October rebound. The manufacturing index continues to show a contraction, while the services sector is showing weakness as it remains in expansion territory. Consumer confidence has also been weakening over the past four months after peaking in October 2018 and again in July of this year. These negative or weakening economic reports have been balanced out by the strength in the labor market. Last week, the U.S. Bureau of Labor Statistics reported that the U.S. economy added 266,000 jobs in November. This is the greatest monthly addition since January and might prove to be a reversal in the deceleration we've seen in job growth this year. In addition, the unemployment rate dropped to a 50-year low of 3.5%.

According to FactSet, S&P 500 Q4 earnings are currently expected to decline by 1.7%, which would be an improvement from the 2.2% decline that was posted for Q3. However, looking forward to calendar year 2020, S&P 500 earnings are expected to rise by 9.7%. Current estimates have come down slightly over the past few months, but regardless, this would be a marked improvement over this past year.

As you can see, there is nothing to be overly excited or down about regarding the economic and corporate profit picture. Last month, we touched on the high valuation levels and those certainly have not changed. Equity valuations are historically high and bond yields are historically low, which has been the story for years now. This in and of itself is not enough to derail a market that is likely to slowly melt higher. The economy has slowed, but it doesn't appear to be taking another leg lower, which would be good for equity prices over the ensuing month. There is only one obstacle the market faces in the near-term – the December 15th tariffs. If these tariffs go into full effect, all bets are off. It would be a signal that the trade talks are not progressing as we've been led to believe. Volatility in asset prices would likely rear its ugly head and Santa's rally would be short lived. That is until the White House throws someone in front of a camera to let us know all is well with China and a trade deal is imminent.

Tandem Strategy Update

In October, we added two new positions to our strategies – Johnson & Johnson (JNJ) and Check Point Software (CHKP). Over the past several weeks, we've been accumulating shares in both companies to the point we now feel comfortable discussing these new purchases. JNJ has been added to our Large Cap Core and Equity strategies. And, CHKP has been added to our Equity and Mid Cap Core strategies.

JNJ has been on our watch list for quite some time. It wasn't until recently that the fundamental growth of the company started to trough and accelerate. Due to JNJ being connected to the opioid crisis and questions surrounding their baby powder, the negative headline news has created several buying opportunities over the past few months. JNJ is a huge company in the consumer products, pharmaceutical and medical devices space with a very solid balance sheet. Their ability to generate $23 billion in cash flow and $20 billion in free cash flow gives them the ability to withstand any near-term turbulence. In the meantime, the negative news flow gives us an opportunity to acquire shares at an attractive valuation.

If I had to pick one industry that might have the best future growth prospects it would be IT security and CHKP does just that. Almost everything we do today involves some sort of technology and the ability to secure that data is of the utmost importance. Over much of 2017 and 2018, CHKP's revenue and earnings growth was positive, but decelerating. The company's share price has mostly consolidated over this time period; however, when a share price remains stagnant and the company continues to grow, the result is a more attractive valuation. Once the fundamental growth of CHKP began to reaccelerate this year, we established a new position in the company and have continued to accumulate shares.

After liquidating our position in CVS last month for violating our fundamental criteria of consistent dividend growth, we had two additional core holdings get flagged as needing to be liquidated. Coincidently both companies are in the consumer discretionary space and both made the decision to replace their CEO from outside the company, which is also a fundamental violation of our investment philosophy. One of the companies has been a core holding for over 8.5 years, while the other has been in the portfolio for 3.5 years. Since our initial purchases, both companies have performed very well and currently trade close to all-time highs. These positions will be liquidated over time based on each stock's technical set up and their impact on our clients' capital gains liability.

- Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." - Ralph Waldo Emerson