# OBSERVATIONS – February 1, 2020

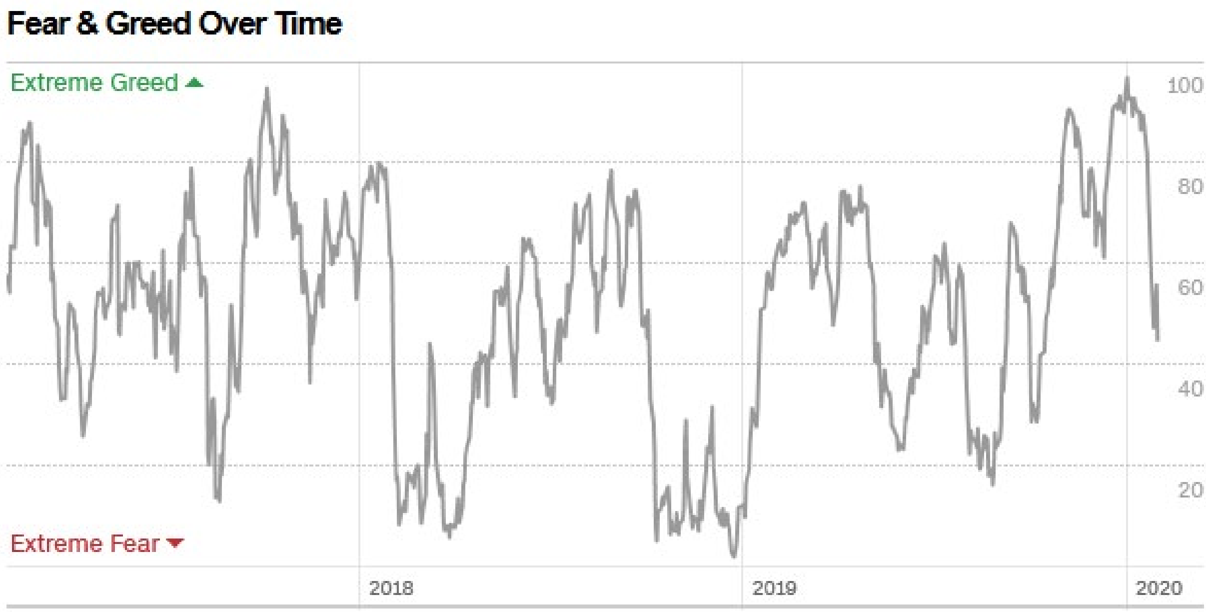
## Financial Markets Review

There is a saying in the investment community that "risk happens fast". This saying is often tied to another one when explaining the path of asset prices – "taking the escalator up and the elevator down". The trading action among equity markets this past month could not make these sayings truer.

Without rehashing everything I wrote last month, the basic premise of last month's Observations had to do with perceptual risk versus actual risk. To summarize it in the most concise way possible – actual risk is the highest when perceived risk is the lowest and vice versa. As we cruised through January, the wind was at our backs. The S&P 500 spent the first few weeks continuing its trend of the prior three months – a slow grind higher. Twenty-three days into the New Year and the S&P 500 had appreciated 3%; tensions with China had simmered down after "Phase One" of the trade deal had been officially signed and earnings season was just beginning. The expectation of a rebound in 2020 earnings growth stoked investor optimism, which powered the S&P 500 to set daily record highs. What could possibly go wrong?

Well, when numerous valuation metrics are at or near all-time highs and investor sentiment is soaring, equity prices are the most vulnerable to unsuspecting shocks. When the perceived risk is low, as it has been for a couple of months, the catalyst for a swift reversal in investor sentiment and asset prices is the actual risk that no one could've predicted. In this case, that risk was a deadly virus said to have originated from bats being sold at a market in Wuhan, China. No one would've predicted the coronavirus as the catalyst for the S&P 500 to give up all its January gains in the last week of the month. The gains built up in the S&P 500 over the course of 23 days were essentially wiped out in the matter of 3 trading days – remember, escalator up and elevator down.

As we learn more about the Coronavirus in the coming days and weeks, the economic and social effects should become clearer. Right now, we are still stuck with a lot of questions and very few answers, which is what fuels volatility in financial markets. The euphoric sentiment, seen no more than a week ago, has dissipated rather quickly – risk happens fast. I used the following chart in last month's Observations, and you can see how quickly sentiment reverses itself. This is the CNN Fear & Greed Index as of January 31, 2020.




*Source: https://money.cnn.com*

As this sell-off continues to run its course, we are likely to visit the “fear” end of the chart before this storm officially passes. Volatility, as measured by the VIX, has spiked, but it’s not off the charts. The yield curve has once again inverted with the 3-month Treasury bill yielding more than the 10-year Treasury note. The inversion of this part of the curve has predicted every recession in the past 50 years, so it is worth keeping on your radar. As the Federal Reserve started expanding their balance sheet last September, they were successful in normalizing the yield curve; however, the economic uncertainties that the coronavirus has brought us has caused the curve to reinvert.

With the S&P 500 only 3% from its all-time high, valuations still stretched, an inverted yield curve and a lack of extreme fear, this correction looks to be in the early innings. The best thing for a continuation of the current bull market is for fear to grip the market, volatility to spike, equity prices to sell off enough to reset valuations and the coronavirus to dissipate before taking too many more lives and halting worldwide economic growth. Uncertainty and volatility breed opportunity. If the future is anything like the past, opportunities are on the horizon.

### Tandem Strategy Update

It was one of those months where sometimes doing nothing is better than doing something. As the S&P 500 continued to plod higher throughout much of the month, we found ourselves turning over every rock looking for an opportunity to invest our clients’ cash. However, with valuations as high as they are - pretty much across the board in the high-quality companies we seek to invest in - our quantitative model has not given us the green light to part ways with that cash. As mentioned in the prior section, the current sell-off in equities appears to be gaining steam, so it may only be a matter of time until we put some cash to work again.

I would be lying if I said we did absolutely nothing within our strategies over the past several weeks. Back in the fall, two of our core holdings announced the hiring of a new CEO – Tractor Supply (TSCO) and Nike (NKE). Part of our fundamental discipline is that companies hire their CEO from the inside rather than going outside the company to find that next leader. Typically, when a CEO is hired from outside the company, the Board of Directors and shareholders are looking for a change in culture. Sometimes this is warranted, and much needed for a company to execute a turnaround. However, we are ultimately looking for consistency in a company's culture, business and results, which comes from consistency in management. We view the hiring of an outside CEO as a fundamental change in the business and our discipline calls for the liquidation of those companies from our strategies, which is what we just recently wrapped up with TSCO and NKE.

- 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*