Tandem Investment Advisors

February 2022 - Tandem Investment Advisors, Inc.

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February 3, 2022

Observations -
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Financial Markets Review

The inevitable has become reality. For months, we have spoken and written about the likelihood of the markets being on the precipice of entering a new volatility regime. I do not mean to belabor the point, but the comparison we have been making to today’s environment is that of 2017-2018. After coming off an historically low volatile period in 2017, 2018 was ripe for fireworks. All you needed was a catalyst to ignite the tinder and get asset prices moving again.

At that time, the economy was humming along, the unemployment rate was low, the Federal Reserve began raising interest rates and shrinking their balance sheet. And to top it off, a bit of macroeconomic uncertainty hovered over the market with threats of a trade war with China. Largely driven by fiscal stimulus, in the form of corporate tax cuts, earnings were growing in excess of 20% and equity valuations were at cycle highs.

Those economic and market conditions sound all too familiar. If you just substitute the Chinese trade war with heightened Russia/Ukraine tensions, then there are many similarities between today and 2018. The most recent Q4 GDP report showed the economy expanding by 6.9%, and the unemployment rate is back below 4%. With a third of S&P 500 companies having reported earnings this quarter, the expected Q4 earnings growth rate is hovering around 24%, which would mark the fourth consecutive quarter of 20%+ earnings growth. And, as we rolled into 2022, equity valuations were not only at cycle highs, but many were at or near all-time record highs. At the same time, the Federal Reserve has signaled the commencement of a tightening cycle to combat inflation.

Just to be clear though, monetary tightening hasn’t even begun yet. The Fed’s balance sheet is still expanding, albeit at a decelerating pace and the Fed Funds rate remains at the zero bound. However, Fed Chair Powell has made it clear that interest rate hikes are coming and specifically stated that “the balance sheet is substantially larger than it needs to be and there’s a substantial amount of shrinkage in the balance sheet to be done.” Between the recovery in economic growth and the Fed’s desire to tighten monetary conditions, interest rates on the short end of the Treasury curve have soared higher. The 2-year and 5-year Treasury note yields have risen roughly 45 basis points since the start of the year. While the long end of the curve has been a bit more subdued with the 10-year and 30-year Treasury bonds climbing 30 and 20 basis points, respectively. And, not to be forgotten, the U.S. Dollar Index has appreciated nearly 2% over this same timeframe.

What this all points to is that inflation is likely to come under control and economic growth will moderate. If inflation expectations were out of control, the U.S. dollar would be depreciating, not appreciating. And the flattening of the yield curve has always been a precursor to a slowdown in future economic growth. None of these are bad things. In fact, snuffing out inflation would probably be welcome by all! What this does mean is that valuations are not justified at these levels. According to FactSet, the 2022 earnings estimate for the S&P 500 is $223, which equates to a forward P/E multiple of roughly 20x. Given a more restrictive Federal Reserve, current level of interest rates, path of real rates and money supply (M2) growth decelerating from historically high growth rates, a P/E multiple in the 16x-18x range can easily be justified. Afterall, that is the valuation range we traded around throughout 2016 to 2019 during a similar policy and interest rate environment.

The increased volatility and recent decline in equity prices is a correction in valuations. The economy is not staring into the abyss and on the precipice of a massive contraction. We are not on the verge of a financial crisis. Rather, the punchbowl is being taken away. That’s what this is about. The S&P 500 returned 42% from the February 2020 peak to the January 2022 peak. Over that same time, GDP has grown by 10% and forward-looking S&P 500 corporate earnings estimates have increased by 25%. Multiple expansion explains the excess between the S&P 500 return and corporate earnings growth. And multiple expansion was driven by the actions of the U.S. government and Federal Reserve, which dwarfed that of any prior crisis.

Now that some of those policy actions are being reversed, it is fair to assume that multiple expansion gives way to multiple contraction. And multiple contraction can happen in a few ways. It can be through price alone, which is what we have experienced this past month. Or it can happen over time as the economy and corporate earnings grow into the multiple. Either way, as the equity market digests the gains of the last two years, it will do so through volatile and choppy price action.

Tandem Strategy Update

It feels as if volatility has only returned since the start of the year, because the market has been down more days than it has been up. The reality is that this new volatility regime began around Thanksgiving, and over the past two months, there have been more 5%+ drawdowns than at any point during the prior 14 months. However, as we have mentioned in the past, volatility should not be associated with just a down market. Intertwined within those 5%+ drawdowns have also been three different 5%+ moves higher in the S&P 500.

We have often said that volatility begets opportunity, and we are starting to see those opportunities come to fruition. An increase in volatility and an increase in our strategy activity is very much positively correlated. Over the course of the past few months, we have established three new positions in Jack Henry & Associates (JKHY), MarketAxess Holdings (MKTX) and Visa (V). In addition, after trimming our positions last year in PayPal (PYPL) and T. Rowe Price (TROW) on a valuation sell signal from our quantitative model, we have been able to add back to these positions on recent weakness.

Although our strategy activity typically picks up as volatility increases, it should not be assumed that cash is invested based solely on what the market is doing. For example, after the S&P 500 corrects 10%, we often get asked if we see tons of buying opportunities. The answer is yes and no. Yes, there are typically more buying opportunities than there were when the market was higher. But just because the market is now 10% lower doesn't mean the companies we seek to invest in are down that much. During market corrections, some companies will bottom before the market, some coincide with the market and others will bottom after the market. We are a bottom-up manager, so market trends may serve as a guide, but they do not dictate our actions. At the end of the day, our actions are still based on the individual company rather than the overall market.

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Billy Little is a shareholder, Vice President and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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