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Financial Markets Review

For the third straight year, U.S. equities ended meaningfully higher. The S&P 500 led the way amongst major U.S. indices, soaring nearly 27%. The tech-heavy Nasdaq climbed 21%, while the Russell 2000 small-cap index turned in a more modest 14% return. Given everything that markets had to shake off, which was well summarized in Ben Carew's most recent *Notes from the Trading Desk*, a 27% return in the S&P 500 is nothing to sneeze at. In fact, considering everything we have endured over the past couple of years, it is mind-blowing that the S&P 500 has rocketed higher by nearly 100% since December 31st, 2019. The last time the index's 3-year return was this good was at the height of the Tech Bubble.

The numerous headwinds throughout the year were no match for the tailwinds offered up by easy financial conditions. Monetary and fiscal stimulus coupled with record corporate earnings beats was the juice equities needed to keep on marching higher. And low interest rates and subdued equity volatility continued to underpin the *TINA* and *FOMO* dynamics of the market.

As the books are now closed on 2021 and a new chapter begins, much of what drove last year's gains is starting to be questioned. Within just the first week of 2022, it came to light that the Federal Reserve was discussing QT (Quantitative Tightening) as part of their policy. And West Virginia Senator Joe Manchin no longer supported his $1.8T proposal of the Build Back Better plan he recently offered to the White House. Just like that, any hope of future monetary and fiscal stimulus started to unravel.

In all fairness, there was never an expectation of monetary stimulus, considering the Federal Reserve had already telegraphed an accelerated taper of their QE program and a path to commence hiking interest rates. However, what did surprise the market was their candor in regard to hiking rates faster than earlier anticipated coupled with shrinking their balance sheet faster than the last time they attempted to do so in 2018. As the market digested this news, U.S. Treasury yields surged. The U.S. Treasury curve steepened as the 2-year and 10-year Treasury yields soared 14 bps and 26 bps, respectively. Much of the climb in interest rates was driven by real yields, which from an economic perspective is what you want to see. Rising real yields are typically a sign of economic strength, not weakness. The initial reaction from Treasury yields is that just maybe, the Federal Reserve will be able to tamp down inflation, while simultaneously allowing the economy to expand. That is exactly what we want as U.S. citizens and consumers! However, in the meantime, financial assets will likely face a bit of turbulence before we get to the other side.

Over the past several years, one of the great underpinnings to financial assets has been the never-ending slide in real rates. As interest rates went lower and more specifically, real rates went lower, the argument for higher valuations were increasingly justified. Low rates spawned the *TINA* trade. It did not matter that we lived in an economy that could only muster 2% GDP growth, just as long as the Federal Reserve continued to back a low-rate environment. If our stocks, houses, cryptos, NFTs and baseball cards all appreciated in price, does it really matter that the economy is not growing at a robust clip? Not right now, but yes, eventually, it will come back to bite us.

In the midst of WWII, Winston Churchill famously said, “Never let a good crisis go to waste.” The COVID pandemic has exposed many human and economic vulnerabilities. It is time for one of those vulnerabilities to be addressed and changed for the better. The past several decades has been marked by a distinct shift toward globalization. Companies have never been more profitable than they are today and much of this can be attributed toward outsourcing everything from labor, manufacturing, logistics, etc.… Pre-COVID, no one ever really gave any thought to the supply chain, because everything worked and functioned properly. It wasn’t until economies around the world began locking down, that companies realized how out of touch they were with their supply chains. As consumers, we took it for granted that we could get our hands on just about anything in no more than a couple of days. Companies took it for granted that they could meet demand without much trouble. It took a global pandemic and COVID-induced economic lockdowns for all of us to realize how much we depend on other economies for some of our most basic goods.

If companies learn nothing else from the COVID pandemic, hopefully they realize the importance of staying within reach of their supply chains and bringing them closer to home. Lessons learned from the pandemic could be what drives the next generation of growth in the U.S. We don’t have to accept 2% GDP growth as the norm, but rather we should have our sights set on something bigger. Bringing much of what we sent offshore back onshore would be a step in that direction. I think everyone would be in favor of more jobs, higher wages and not having to wait 6 months to accept delivery of a dishwasher.

However, what would most definitely be good for our long-term future would likely come with some short-term pain. And who knows, maybe that is what the market is telling us during this first week of 2022. Higher real, tangible growth would lead to higher rates; higher rates would threaten lofty valuations that have been bid up because of the low-rate environment and introduce a level of volatility that we have not seen for some time. This is the scenario we have written about over the past several months and now we are living it. In times of volatility, it will behoove you to know what you own. A company that can consistently generate sales, cash flows and a profit will keep you grounded during times of uncertainty.

The time for speculation has come and gone. Now is the time for stability, certainty, and consistency. And who knows, maybe when we exit this roller coaster, we will not have let a good crisis go to waste but rather will have sown the seeds for the next wave of generational growth. One can only hope.

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> Billy Little is a shareholder, Senior 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. Mr. Little oversees Tandem's corporate financials, including business planning, budgeting, and vendor negotiations. Mr. Little also directs Tandem's quantitative and fundamental 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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