July 2022 - Tandem Investment Advisors, Inc.

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Financial Markets Update

A new economic and financial market narrative was not what market participants were looking for in June. Over the past couple of weeks, the inflation story has morphed into a growth slowdown story. The increasing chatter of an economic recession drove U.S. equity markets lower, as the S&P 500, Nasdaq, and Russell 1000 each fell over 8% this past month. The slowing economy narrative was clearly highlighted by the sector performance within the S&P 500. Although all sectors finished in the red, the least cyclical sectors held up the best with Healthcare, Consumer Staples and Utilities having declined 2.84%, 2.87% and 5.13%, respectively. The more economically sensitive sectors paled in comparison, as Financials, Materials and Energy led the way lower by 11.07%, 14.08% and 16.99%, respectively.

Alongside equities, other financial markets have begun to hint at an economic slowdown outweighing inflationary concerns. WTI crude oil declined for the first time since November, falling 8%. Industrial metals, such as copper and nickel, which tend to ebb and flow with economic activity, declined nearly 15%. And not to be outdone, Treasury yields declined, as the curve flattened dramatically after the huge spike higher in interest rates around mid-June. The 10-year U.S. Treasury hit a cycle high of 3.48% on June 14th and has since fallen nearly 70 basis points.

As worries of an impending recession have grown, inflation expectations priced in by the market have begun to deviate from reported inflation and consumer expectations. The May CPI report came in hotter than expected, soaring to a new 40-year high at 8.6%, which dismissed any notion of "peak inflation". And throughout last month, several consumer sentiment surveys sank to new lows, as the majority of consumers expected price increases to far outweigh wage increases over the ensuing year. However, market expectations for future inflation and ultimately the peak of the federal funds rate target have come down rather meaningfully over the past few weeks. At one point, the market was expecting the Fed Funds Rate to top out at 4% and now those expectations have moved to a peak of 3.3% by early 2023, followed by 50 basis points of interest rate cuts through the end of next year.

The big question looming over investors for the second half of 2022 and beyond is how much of a slowdown in growth is priced into the markets. Last year and into the beginning of 2022, we tirelessly wrote and spoke of the risks inherent in equity valuations. At the time, valuations were at historically unsustainable levels and the probability of a correction in valuations was significant. As equity prices have fallen over the past 6 months that correction has taken place and valuations are now, at the index level, much closer to being fairly valued. Some individual companies are attractively valued, while others are still overvalued. But the market as a whole is trading much closer to the historical norm.

However, valuations are not just based on price, but rather, price relative to some fundamental aspect of a company. That fundamental piece could be revenues, earnings, or cash flow, to just name a few. If price is held constant and the expectations for the fundamental data move lower, the valuation will increase. Vice versa, if expectations move higher, all else being equal, the valuation will decrease. To bring this back to the current environment, according to FactSet, EPS for the next four quarters for the S&P 500 is expected to be $232. At a level of 3,800 on the S&P 500, the P/E is 16.3x. This P/E multiple is a little above average, but generally has historically been considered to be fairly valued. If those earnings expectations rise or fall 10%, then the price of the S&P 500 must also rise or fall a similar amount to stay at the same fairly valued level. And that is the conundrum the market faces today. The risk to equity prices has shifted away from valuations and toward earnings.

Since the start of the year, Wall Street analysts have continued to increase their full-year 2022 earnings estimates. Most of the increase has come directly from the Energy sector; however, earnings expectations ex-Energy have still managed to hold up fairly well. The resiliency in future expectations is a bit perplexing given the recent weakness in many macroeconomic data points, the dour consumer, and the rise in negative commentary from corporate executives. Companies, big and small, have come out to warn investors about continued supply chain issues, inventory gluts, shifts in consumer spending, the impact of a stronger U.S. dollar and inflation in general. And some of these companies are beginning to announce layoffs to combat rising expenses and falling demand. At this point, the risk is that analysts are behind the curve and ultimately need to adjust earnings lower to match corporate expectations. Otherwise, there will be a slew of earnings misses this quarter and for quarters to come. These next six weeks will be critical to figuring out where the market is likely to go from here.

Tandem Strategy Update

A different month, but the same result, with market volatility continuing throughout June. I apologize to any regular readers of this piece, as I probably sound a bit repetitive when discussing updates to our strategies. You've heard me say countless times that volatility breeds opportunity. In a bear market, swift rallies provide opportunities to trim positions that might be overvalued or no longer meet our criteria. And extreme selloffs provide opportunities to add to core holdings or establish new positions at attractive valuation levels. Well, just like most months so far this year, we had the opportunity to both buy and sell this past month.

In our Large Cap Core strategy, we added to Hormel Foods (HRL), which has been a core position for some time. We also established five new positions in the strategy – Amphenol (APH), Church & Dwight (CHD), Mastercard (MA), Roper Technologies (ROP) and Verisk Analytics (VRSK). Each of these companies have a long history of consistent revenue, earnings, and cash flow growth. In addition, all five companies have been able to pay and consistently grow their dividend, which has been sustained through the growth of their core fundamentals.

In our Equity strategy, we added to Ansys (ANSS) and Intuitive Surgical (ISRG). Both of these were positions that we established earlier this year.

In our Mid Cap Core strategy, we added to Akamai Technologies (AKAM), Hormel Foods (HRL) and Lab Corp (LH). In addition, we established two new positions in Church & Dwight (CHD) and Ansys (ANSS). As a refresher, one of the criteria that differentiates Mid Cap Core from our other two strategies is that a company must have a market cap under $20 billion at the time of our initial purchase.

As markets staged a rally off the May lows, we were able to take the opportunity to either fully liquidate or begin the liquidation process of a couple core holdings that no longer met our criteria of consistent fundamental growth. Within all strategies, we liquidated Ecolab (ECL). ECL was never able to fully recover from the COVID pandemic as a reduction in demand hit their top line at the same time costs were mounting from increases in commodity costs and disruptions in their supply chain. In Large Cap Core and Equity, we started the liquidation process and have sold all but a small fraction of our position in Walgreens Boots Alliance (WBA). WBA started to stumble just before the COVID pandemic, but the company did just enough to continue meeting our fundamental growth criteria. It wasn't until more recently that WBA succumbed to rising costs, which dented margins and impaired earnings and cash flow. These factors prevented WBA and ECL from making it through our quantitative model, which is the first step a company must pass to be established or continued to be held in the portfolio. Once a company can no longer meet the first step in our quantitative process, it must be liquidated.

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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. 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

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