July 2023 - Tandem Investment Advisors, Inc.

T tandemadvisors.com/observations/july-2023
July 13, 2023

Financial Markets Review

After months of extremely narrow market leadership, strength in equities finally began to broaden out in June. It has been well publicized that much of the market's advance this year has been driven by a handful of the largest technology focused companies, while all other companies have muddled along. However, over the past month, this trend has shown signs of reversing. For the first time since January, the Russell 2000 posted a positive monthly return, climbing 7.95%. The other major U.S. indices also posted impressive performance in June with the S&P 500 and Nasdaq advancing 6.47% and 6.59%, respectively.

The economic and market narratives have remained relatively consistent throughout the better part of 2023. Overall, the economy has held up rather well, supported by a resilient and strong labor market. Inflation has slowly come down leading to calls once again for a soft or even no landing in the economy. The idea is that the economy will avoid any type of meaningful contraction, while inflation drops to the Fed's target of 2% and stays there. The strength in equities is pointing to this goldilocks scenario playing out. On the other hand, the extreme inversion in the Treasury yield curve suggests a recession is all but inevitable. In the meantime, the battle between which market will be proven correct wages on.

However, there is one battle that has been of great interest to me and that is between the Federal Reserve and market expectations surrounding the path of interest rates. Over the past year, every time the equity market swoons, the market begins to price in Fed rate cuts. And, once equities recover, those rate cuts are priced out. One thing is certain, the Fed has been pretty consistent in their messaging the entire time. Nearly one year ago at the Fed's annual meeting in Jackson Hole, WY, Fed Chair Powell stated the following:

"Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy.

We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done." – Fed Chair Powell, August 26th, 2022

Last week, Jay Powell had this to say at a conference hosted by the Bank of Spain:

"A strong majority of committee participants expect that it will be appropriate to raise interest rates two or more times by the end of the year… Inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go." – Fed Chair Powell, June 29th, 2023

After pausing in June, the Fed looks committed to raising interest rates at their next meeting in a few weeks and then possibly again in September. Market expectations are finally aligning with what the Fed has been saying all along – that interest rates will keep moving higher until inflation has moved back to their 2% target. The market is pricing in another 50 basis points of interest rate hikes in 2023, while moving out the date of the first cut into 2024.

Yields on Treasury bills continue to edge higher, while, just last week, the 2-year Treasury note breached 5% for the first time since right before the regional banking crisis in March. In fact, according to John Authers of Bloomberg, the 2-year Treasury yield just traded above 5% for only the 65th day since the beginning of 2001. For much of this century, the 5% level on the 2-year Treasury note has proven to be a headwind for the equity market and that continues to be the risk going forward.

There is no line in the sand that says a 5% yield on Treasury bills and notes has to weigh on the equity market, but there are a couple of reasons it does. The overarching reason is that higher yields on Treasuries naturally become competition for the incremental dollar that might otherwise be invested in equities. Currently, the earnings yield on the S&P 500 is lower than that of the entire Treasury yield curve going out to the 2-year note. This is one of the first times this has happened since the Tech Bubble in the early 2000s. What this ultimately means is that an investor in the S&P 500 is paying more for a dollar of earnings than they would be by holding a Treasury bill or note to maturity. Thus, the expected return or yield in the S&P 500 is lower than that of short-term Treasuries, which makes Treasuries a more attractive investment option.

Given then that Fed plans on continuing with interest rate hikes and the market has come around to believing them, it is fair to think that the second half of the year might not be as smooth sailing for the broader equity markets as it was during the first half of the year. That's not to say an immediate decline is on the horizon, but rather choppiness or an increase in market volatility should be expected.

Tandem Strategy Update

As has been the case for several months now, our transaction activity at the strategy level continued to be subdued in June. The vast majority of the companies we own across our three strategies remain entrenched in what our quantitative model deems to be "fairly valued". When a company is at this valuation level, we remain patient and vigilant.

Patience can often be a difficult discipline for an active investor, but it is a supremely important trait if you want to be opportunistic with your capital. Oftentimes, the best thing to do is nothing. As a bottom-up manager, who focuses solely on the individual companies in the portfolio, there is no reason to buy and sell just for the sake of trading or based on what the market may or may not be doing. The direction of the market is ultimately independent of our decision to incrementally buy or sell a particular company held within our strategy.

Earlier in the year, we found more opportunities to reduce our exposure in a few companies; however, as interest rates have crept higher and all focus has been diverted toward technology companies, there have been a few scattered opportunities to add to our existing holdings over the last quarter. In June, the only transaction we made at the strategy level was to add to our position in Terreno Realty (TRNO) across our Large Cap and Mid Cap strategies. TRNO is a real estate company that acquires, owns, and operates industrial properties in six major coastal U.S. markets. The types of properties include warehouse/distribution, flex, research and development and trans-shipment. TRNO's focus is to purchase industrial real estate in areas where there is growing demand but limited or shrinking supply. This strategy has worked well for TRNO since they became public in 2009, as seen by their consistent growth in revenues, earnings, and cash flows. And due to their strong fundamental growth, TRNO has been able to grow their dividend at a compounded annual growth rate of 12% over the past 10 years.

As interest rates likely continue drifting higher, more opportunities, such as TRNO, will pop up. If we are correct in thinking that interest rates will be a formidable competitor to equities over the ensuing months, then patience should be rewarded.

Source: *Source of all data is FactSet, unless otherwise noted.*

Written By: William "Billy" Little, Jr., CFA

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.