OBSERVATIONS

Tandem Investment Advisors | William "Billy" Little, Jr., CFA

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Financial Markets Review

It has now been one year since life as we knew it came to a screeching halt. As a society, we were forced to adapt extremely quickly to a new way of life - work from home was the norm; parents learned how to teach; masks were just another accessory; gamblers figured out that trading stocks and options could be as exciting as sports; and restaurant menus went the way of the pay phone. It is remarkable how much has changed and how much of it is likely to be permanent. However, we got some good news this past week that did not seem to get the attention that it deserves. Live Nation's CEO, Michael Rapino, announced that large scale concerts could start in mid-summer with 70-100% capacity. Pre-COVID summer pastimes are coming back! In full disclosure, I have two young children and cannot quite recall the last time I went to a concert, but that is neither here nor there. Regardless, the memories of summertime concerts are nostalgic and a sign that we are returning to what one client labeled as the "before".

Over the past 12 months, a significant amount of monetary and fiscal stimulus has been injected into the economy to get it back to, and hopefully beyond, the "before". According to Bank of America, global central banks have combined to purchase $1.1 billion of assets every hour since last March. And depending on when this piece gets published, it is likely Congress has just approved another $1.9 trillion COVID relief bill and are seeking to tee up another $2+ trillion infrastructure package in the coming months. The liquidity sloshing around is unprecedented and financial markets outside of equities, specifically the fixed income and commodity markets, have begun to price in the "after".

Last summer, on our quarterly podcast, *Tandem Talk*, we tossed around the idea of inflation being a result of the unprecedented monetary and fiscal stimulus. We have seen significant financial asset inflation since the Great Financial Crisis due largely to easy monetary policy by the Federal Reserve. However, as measured by CPI, we have not seen inflation flow through to the consumer side of the economy. Now, I have gone on record saying several times that we have experienced goods inflation for more than a decade now; it is just not being reflected in the CPI calculation. I can guarantee that just about anything you spend money on has increased in price by more than the rate of CPI, except for maybe a new television. The inflation calculation debate is for another day, but one thing we mentioned last summer was that there were two things setting up for reported inflation to be higher in the future – supply chain constraints and additional fiscal stimulus. Well, we have both.

The last PPI report came out a few weeks ago and it increased by the most in over a decade. Final demand jumped 1.8% year-over year in January following a 0.8% increase in December year-over-year prices. Last week, the U.S. ISM Manufacturing report showed the Prices Paid Index surging 4.75% from last month and 87.36% from one year ago. Below are a couple of quotes that stood out from the report.

- "Prices are rising so rapidly that many are wondering if [the situation] is sustainable. Shortages have the industry concerned for supply going forward, at least deep into the second quarter." (Wood Products)
- "Labor shortages at suppliers are affecting material deliveries and prices." (Plastics & Rubber Products)
- "Things are now out of control. Everything is a mess, and we are seeing wide-scale shortages." (Electrical Equipment, Appliances & Components)
- "Prices are going up, and lead times are growing longer by the day. While business and backlog remain strong, the supply chain is going to be stretched very [thin] to keep up." (Machinery)
- "The coronavirus [COVID-19] pandemic is affecting us in terms of getting material to build from

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local and our overseas third- and fourth-tier suppliers. Suppliers are complaining of [a lack of] available resources [people] for manufacturing, creating major delivery issues." (Computer & Electronic Products)

- "Supply chains are depleted; inventories up and down the supply chain are empty. Lead times increasing, prices increasing, [and] demand increasing. Deep freeze in the Gulf Coast expected to extend duration of shortages." (Chemical Products)

On the personal income front, household income rose 10% in January, which was the second largest increase on record, only trailing the gain in April 2020 after the government's initial pandemic relief bill. Since February of last year, household incomes have risen 13%, while over 10 million individuals remain unemployed, and 2020 GDP fell 3.5%. Assuming the House approves this next round of stimulus, personal income is likely to soar again once the March data is reported.

The stage is set for higher prices (i.e. inflation) in the near future. The million-dollar question though is whether the inflation will be transitory or lasting. Based on recent comments by the Fed Chair, the belief is that near-term price increases will be temporary in nature. For what it is worth, this is same institution that said the subprime mortgage crisis was "contained". And we all know how that story eventually played out.

Regardless of what anyone thinks might happen, interest rate markets are quickly pricing in higher future growth and inflation. The U.S. Treasury curve has steadily steepened since last summer, but more recently the steepening has accelerated. Over the past month, the 10-year U.S. Treasury yield has risen 60 basis points to 1.60% from 1.00%. In conjunction with the rise in nominal rates, the real rate has also increased over this same time period, which signals future economic growth. However, with nominal rates outpacing real rates, inflation ever so slightly remains the driver behind higher rates.

As interest rates have accelerated to the upside, the divergence between growth and value stocks has widened. Since the beginning of February, value equities have outperformed growth and momentum equities by over 600 basis points. A large proportion of value stocks are commodity-based companies that benefit when the underlying commodity goes higher and financial institutions that make money by borrowing on the short-end and lending on the long-end of the curve. On the flipside, growth and momentum stocks have been supported for several years now and very much so over the past year, by persistently low interest rates. When interest rates are low, investors are willing to pay a premium for growth, which has been a major factor in growth stocks outperforming value stocks over the past decade. When interest rates begin to trend higher, the valuation premium gets squeezed due to a higher discount rate placed on future cash flows and bonds become incrementally more attractive. It is for these reasons that we are seeing multiple compression in the momentum and high-growth pockets of the equity market.

Tandem Strategy Update

"To do nothing at all is the most difficult thing in the world, the most difficult and the most intellectual." – Oscar Wilde

Let me start off by saying that I am certainly not going to say that the "intellectual" part of the quote applies. That is for others to determine and I can promise that your take on our intellect will fluctuate as the market does. It is just part of the business.

Being an active manager and doing nothing can be very difficult. Luckily, we have an investment discipline that guides all of our actions, so it is not any one of us deciding to do "nothing". We maintain that what makes us different is the ability to be patient and not investing for the sake of investing. There must be an opportunity worth pursuing and unfortunately there have not been many over the course of the past few months to put cash to work. The opportunity that we have seen has been more in trimming current holdings than adding or taking new positions.

So far this year, we have sold 25% of our PayPal (PYPL) position in the Equity strategy and we have sold 25% of our position in Tyler Technologies in the

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Equity and Mid Cap Core strategies. Most recently, we sold 25% of our Comcast (CMCSA) holdings in Large Cap Core and Equity. And lastly, we sold 25% of our ExlService (EXLS) in Mid Cap Core. All of these sales were valuation based, triggered by our quantitative model. The only purchase was an incremental addition of CBOE Global Markets (CBOE) in the Equity strategy, since it was already a full position in Large Cap Core and Mid Cap Core.

It is yet to be seen whether the rise in interest rates brings about weakness in areas of the equity market other than just the momentum and technology names. At Tandem, we have very little exposure to this area of the market and most of the stocks selling off do not come close to meeting our fundamental criteria. Until opportunities are present in the companies that meet our criteria, we will remain patient, even if that means doing "nothing".

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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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