Tandem Investment Advisors

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Observations
- November 2021
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Financial Markets Review

U.S. equity markets got back on track in October as all major indices clawed back their losses and then some from September. The S&P 500 gained 6.9% and closed at an all-time high. Not to be outdone, the DJIA and Nasdaq also ended the month at all-time highs, climbing 5.8% and 7.3%, respectively.

As equities powered higher with general ease, there was a rotation under the surface that bears watching. In the first half of October, the reflation trade was en vogue. Delta variant cases had peaked and begun to subside, which lead investors back into the re-opening and economic growth plays. Energy, materials, and financials drove equity markets higher as the yield curve steepened, with value outpacing growth.

However, as the month progressed, and most notably in the last week of October, the script flipped. The equity landscape was one we became very accustomed to pre-COVID. Growth stocks outperformed value, small caps lagged, and the yield curve flattened as expectations for economic growth waned at the same time global central banks were beginning to take away the punch bowl.

Mark Twain famously once said, “History never repeats itself, but it often does rhyme.” There are a lot of interesting parallels between today and the 2017-2019 period. Prior to the September pullback in equities, the S&P 500 went nearly a year without a 5% drawdown.

There are only a handful of times in history when the market went that long without pulling back with 2017 being the last time. And when the calm finally subsided, it gave way to significant volatility shocks.

Many might not recall, because it feels like an eternity ago, but 2018 was a roller coaster of emotions. In the first quarter of 2018 alone, the S&P 500 rallied 7%, fell 12%, rallied 10% and fell 9%. At the time, the 12% drawdown from an all-time high was the fastest on record. The volatility experienced in the first quarter was only a preview of what was to come later in the year, as the S&P 500 plummeted roughly 20% from peak to trough in the fourth quarter. However, within five months, everything that was lost in 2018 was ultimately recovered. 2018 through 2019 was our first real taste of swift declines being met with record fast recoveries. That market dynamic may have been suspended since the initial COVID drawdown and subsequent recovery in 2020, but I suspect it is about to make a strong comeback.

There are a few catalysts that could spark a wave of volatility over the next year, the biggest of which are centered around the actions of global central banks. There is a growing sense that inflationary pressures may not be as transitory as initially thought. Rather, inflation may be a little stickier and more persistent. A shift from transitory to persistent would likely cause central banks to act more aggressively to fend off inflation by reducing monetary accommodation faster than expected. Increased volatility in central bank policy will lead to increased volatility in financial markets. In fact, increased volatility is already being felt in fixed income markets, as measured by a 45% rise in the MOVE Index since mid-September, which is a VIX for the U.S. Treasury market. The U.S. Treasury yield curve, along with most curves around the world, has flattened significantly. In October, the 2-year yield increased 20 bps, the 10-year increased 2 bps, the 20-year decreased 3 bps and the 30-year decreased 15 bps. The entire curve has flattened considerably with the back end now inverting, as the 30-year yield is lower than the 20-year yield. The recent moves in the Treasury yield curve are signaling fear of the Fed making a key policy mistake – raising rates into an economic slowdown – which was a similar worry in 2018.

Tandem Strategy Update

So, does this mean all hell is about to break loose? Absolutely not. But what it does mean is that emotions are likely to run high for some time. In periods of excessive volatility, there will be times of exuberance and FOMO and there will be times of utter despair. There used to be a saying that the market takes the escalator up and the elevator down. If there is anything we have learned over the past few years, it is that each correction and recovery is happening increasingly faster.

So, that saying should be more like taking the elevator up, escalator to new highs, elevator down, elevator up, escalator to new highs, elevator down, rinse and repeat. It is hard for me to see the market changing its stripes, which leads me to believe that 2021 was the year of the escalator, making 2022 the year of the elevator.

If I am correct with this assumption, it would behoove you to stay liquid and nimble. To stay liquid, your assets need to be converted into cash without compromise to its principal. For the most part, stocks are liquid. However, if you are fully invested and the market declines, more than likely you are selling a stock low to buy another stock that has fallen. That works if the stock purchased outperforms the stock sold when the market recovers. Ideally, you would not want to be forced to sell in order to buy. That is when cash on hand is an important asset to your portfolio. In the same vein, you do not want your cash locked up in a “cash alternative” trying to squeeze out a little extra yield with the risk of the principal declining. That would defeat the purpose of staying liquid, which is making sure you have the resources available to take advantage of opportunities.

To be nimble requires an investment process that removes emotion. In periods of elevated volatility, emotions will undoubtedly run high and increase the probability of making the wrong decision at the wrong time. Volatility has an innate ability to bog down the thought process and cloud your ability to make rational decisions. An investment process that can remove your feelings in times of stress is imperative to staying nimble in a fast-moving market.

At Tandem, we take liquidity and the ability to be nimble very seriously. The cash sitting in a portfolio is there for a reason. First, we have identified more stocks to sell than to buy. We do not have a mandate to be fully invested and we do not believe you should be invested for the sake of being invested. Second, cash is in the portfolio to be deployed at opportunistic times. While cash is in the portfolio, we will make sure our clients are getting the best yield they can on the cash, but we will not put the principal at risk. Lastly, to stay nimble, we have built an investment process that relies on math instead of human intuition. The math guides our actions and allows us to execute during highly emotional times. If we are close to re-entering an “elevator” type market, then you will be well served relying on math and logic over your gut.

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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

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