November 2022 - Tandem Investment Advisors, Inc.

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Financial Markets Review

After a dismal August and September where the S&P 500 declined 4.2% and 9.3%, respectively, the market was due for a bounce. Over the past month, equity markets staged a bit of a comeback. Small caps led the charge, as the Russell 2000 rose 10.9%. Meanwhile, the S&P 500 and Nasdaq climbed a more modest, 8.0% and 3.9%, respectively.

The most recent recovery in equity prices looks and feels a lot like the rally we witnessed earlier this summer. In June, investor sentiment was extremely negative and very one-sided. Typically, when everyone is on the same side of a trade, the money to be made is on the other side. At the time, the fear was inflation spiraling out of control and all it took was one CPI report to calm those fears. Once peak inflation and peak Fed became ingrained into our way of thinking, the market began pricing rate cuts in early 2023. All of those people that were selling equities in June were now buying them with both hands in July and August.

Fast forward to the end of August and after another hot CPI report hits the tape, the Fed makes it very clear they have no intention of letting up with their restrictive policy. Everyone who ended up buying with both hands in the hopes of a Fed policy change in August were now relegated to selling because their thesis got turned upside down. And so, selling ensued until markets got into a dark place toward the end of September as fears of a financial market meltdown grew louder. The meltdown never happened and the sight of central banks, such as the Bank of England and Bank of Japan, intervening in their respective bond and currency markets was all it took for equities to stage another rally.

Bear markets rarely go down in a straight line. They are designed to absolutely grind you down to the point where you can't take any more and decide to throw up the white flag. It is then markets can set a credible bottom and a new bull market can commence. Right now, we get close to that utter despair moment, but end up roaring back so quickly because we have been trained to believe the Fed will come to the rescue at the first sign of trouble. The Fed very well might have our back, but it's not when the S&P 500 is trading near 3,900 and inflation is running in excess of 3 times their desired rate.

As a reminder, Fed Chair Powell made the following comments during his annual Jackson Hole speech only two months ago.

> “Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain.
>
> Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy.”
>
> *Fed Chair Powell, August 26, 2022*

Not much has changed in the economy since he spoke those words. Inflation remains stubbornly high, labor remains strong, and the economy continues to chug along as reported by the most recent 2.6% GDP report. Most of these indicators are lagging, but they do guide the Fed in their decision making. Unfortunately, if you take a deeper look into economic data points or listen to company earnings calls, the economy is slowing down rather quickly and likely headed for a recession. Just the other day, the CEO of Maersk, which is the world’s largest owner of container ships, had this to say on their earnings call.

> *“However, it is clear that freight rates have peaked and started to normalize during the quarter, driven by both decreasing demand and easing of supply chain congestion.*
>
> *With the war in Ukraine, an energy crisis in Europe, high inflation, and a looming global recession there are plenty of dark clouds on the horizon. This weighs on consumer purchasing power which in turn impacts global transportation and logistics demand.*“
>
> *Soren Skou, CEO of Maersk, November 2, 2022*

As awful as it might sound, these are the things the Fed wants to see and hear. Their best shot at bringing inflation down is through the weaking of the economy. They want and need the economy to slow and have made this rather clear to everyone. Afterall, when was the last time the Federal Reserve was proactive in setting monetary policy. The answer is… never! So, this means the Fed is going to continue tightening monetary policy until they actually see inflation lower, which will likely come at the expense of higher unemployment and an economic recession.

The “pivot” that the market wants so badly from the Fed is not coming any time soon. Fed Chair Powell even said so himself during his recent FOMC meeting’s press conference.

> *“We still have some ways to go. And incoming data since our last meeting suggests that the ultimate level of interest rates will be higher than previously expected.*
>
> *It’s very premature to think about or talk about pausing our rate hikes.”*
>
> *Fed Chair Powell, November 2, 2022*

So, the equity market rallies that occur on the back of these “pivot” narratives are unfounded and can be chalked up to just another bear market rally. Short-term interest rates are headed higher, which means equity valuations are headed lower and overall volatility will remain heightened. It’s the same market environment we’ve had for close to a year now; nothing has changed.

Tandem Strategy Update

With all of that being said, Tandem’s investment strategies are not the market. Our clients’ portfolios are made up of individual companies that have demonstrated the ability to consistently grow their revenues, earnings, and cash flows through any economic cycle. When our quantitative model signals a company to be overvalued based on these metrics, we trim a portion of the position. And, when our quantitative model signals a company to be undervalued based on these metrics, we will initiate a new position or add to it if we already own the company. If a company fails to meet this criteria, we liquidate the position from our strategies. This discipline and process allow us to do what we consistently say that we do – take advantage of opportunities. And bear markets create just that, they allow active managers like us to take advantage of opportunities to trim overvalued positions and add to undervalued positions as volatility stays high.

Over the past several weeks, we have been able to take advantage of a market that has caused certain stocks to be overvalued, others to be undervalued and an opportunity to exit a position that no longer met our criteria. We have completed the liquidation of our position in Walgreens Boots Alliance (WBA) within our Large Cap Core and Equity strategies. Earlier this year, we discussed how 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. On the flip side, we had the opportunity to begin building a new position in a REIT, which acquires, owns, and manages industrial properties in six major coastal cities. This company has a history of successfully acquiring and managing industrial real estate properties, which has allowed them to grow their dividend at a 13% CAGR over the past 11 years.

Most recently within the past few days, we have been active among a few core holdings on the basis of valuation. In our Mid Cap Core strategy, we sold a portion of our position in ExlService Holdings (EXLS) and NV5 Global (NVEE) based on an overvaluation signal from our quantitative model. In addition, we added to our Tyler Technologies (TYL) position in our Equity and Mid Cap Core strategies on our quantitative model's undervaluation signal.

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.

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