Tandem Investment Advisors

Financial Markets Review

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Observations
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For much of the past few months, we have written extensively on the path of least resistance being higher in equities, regardless of the worries stacking up. In fact, we went so far as to describe the U.S. equity market as being very much like a honey badger. The tenacity and relentlessness of a honey badger to defy all odds against it was eerily similar to the narrative and direction of U.S. equities. Well, the honey badger decided it finally had enough, or at the very least, it was taking a well-deserved rest, as U.S. equity markets gave up some ground in September. The S&P 500 fell 4.76%, posting its first decline since January and its worst month since September of last year.

Concerns in the marketplace have been building for some time now and there certainly have been no shortage of them. Probably the biggest concern and easily the most discussed is inflation. Inflation has been the 800-pound gorilla quietly sulking in the corner of the room. We all see it, talk about it, feel its presence, but have chosen to brush it to the side. After all, the Federal Reserve has made their feelings well known that it is transitory and sooner or later inflation will dissipate.

The Federal Reserve is not wrong in saying that inflation will be transitory. It just depends on how you look at it. The rate of change will be transitory, and, in fact, it has already proven to be such. The month-over-month change in the Consumer Price Index (CPI) peaked in June at 0.9% and has since fallen to 0.3% in August. The year-over-year change in CPI has tracked a similar path, peaking in June at 5.3% and decelerating ever so slightly to 5.2% in August. For now, consumer prices have stopped accelerating and have started to decelerate. It is important to note that a deceleration is very different than a decline. The former represents price growth, just at a slower rate. The latter is an outright decline in

prices. Although the rate of change in CPI has proven to be transitory, the level of prices is not. For the most part, the prices you see today are likely not coming down. Case in point, just read up on Dollar Tree's most recent strategy change.

Inflation is typically not something that simply pops up overnight. The seeds of inflation were sown 18 months ago when the world economy shut down and monetary and fiscal stimulus were cranked up to unimaginable levels. We are now feeling the direct effect of too much money chasing too few goods. This is a topic we discussed in the summer of 2020 during our quarterly podcast, Tandem Talk. At the time, we talked about how you could see inflation on the horizon, but it wasn't something that would really hit us for many quarters to come. And here we are today. Inflation is being felt everywhere. Companies have been warning of commodity, wage and freight costs going higher, but it's just been talk up to this point. That is because most companies have been able to protect margins, as not all costs have returned to "normal", such as business travel. Now that we are a year and a half out from the onset of the pandemic, more "normal" business operating costs are coming back online and wages that might be tied to an inflation index are getting a boost. If the past three weeks are any indication, corporate earnings expectations are at risk of coming down.

Financial markets have become very used to "beats and raises" amongst companies for the better part of the past 12 months. The consistent upward earnings revisions have been key to supporting the equity market's historically high valuations. According to John Butters, Senior Earnings Analyst at FactSet,

"During the third quarter, analysts increased earnings estimates for companies in the S&P 500 for the quarter. In a typical quarter, analysts usually reduce earnings estimates during the quarter. During the past five years (20 quarters), the average decline in the bottom-up EPS estimate during a quarter has been 2.9%. In fact, the third quarter marked the fifth-straight quarter in which the bottom-up EPS estimate increased during the quarter, which is the longest streak of consecutive quarterly increases since FactSet began tracking this metric in 2002. However, it should be noted that while the Q3 bottom-up EPS estimate increased by 3.8% during the first two months of the third quarter (to $49.31 from $47.50), it declined by 0.9% during the month of September (to $48.89 from $49.31). This is the largest monthly decrease in the quarterly bottom-up EPS estimate since June 2020 (-1.8%)."

Companies, such as FedEx, 3M, Sherwin Williams, PPG Industries, Americold Realty, Clorox, PulteGroup, General Electric and Disney have all started to warn of missing third quarter earnings expectations due to a myriad of reasons. These include supply chain constraints, labor shortages, wage increases, shipping and freight bottlenecks and overall input price pressures not receding. Based on FactSet estimates, EBIT margin is expected to be 17.51% for calendar year 2021 and 2022, respectively. This compares much favorably to the 10-year average of 15.20%, which has been rather consistent over that 10-year period. Over the next month, as we really get into Q3 earnings season, it will be interesting to see how the dichotomy between market expectations and corporate commentary plays out. Because right now, there is a glaring disconnect between the two.

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