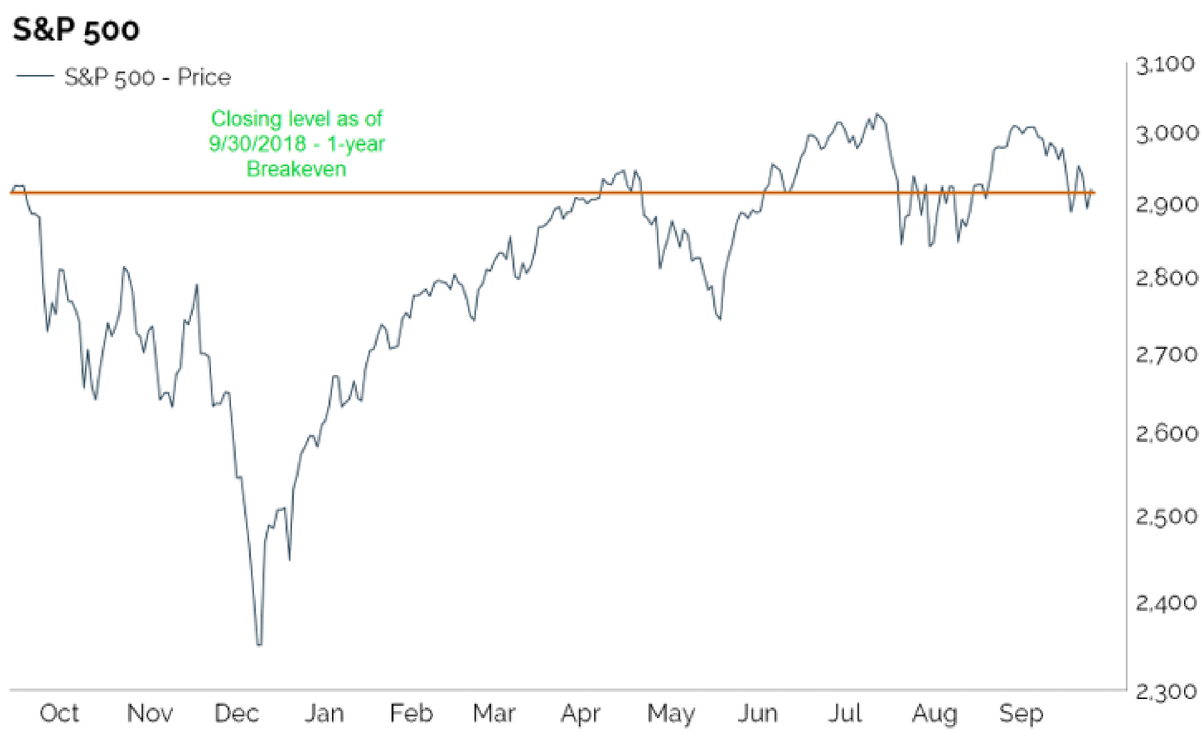
TANDEM INVESTMENT ADVISORS

Financial Markets and Economic Review

The Shakespeare quote that started off last month's edition of Observations could've once again commenced this column. In fact, one could argue the "sound and fury" has intensified over the past couple of weeks leading to a slight downside move in the S&P 500, which has brought us back to where we stood 12 months ago. As you can see in the chart of the S&P 500 below, the "sound and fury" that has caused us to dip below the breakeven line and above the breakeven line has ultimately "signaled nothing".



Source: Factset

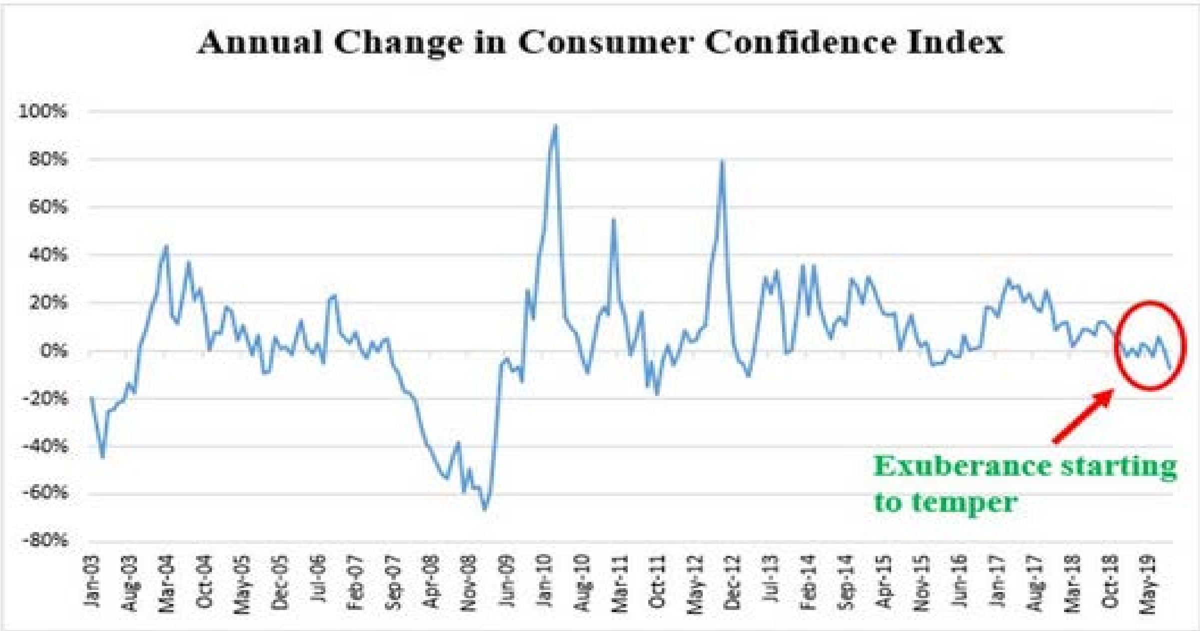
Much of the "sound and fury" as of late has to do with an increase in expectations that the U.S. economy will fall into a recession by the end of next year. According to a recent WSJ article,

> *"A Duke quarterly survey of chief financial officers in September showed that nearly 70% expect the U.S. to enter a recession by the end of 2020. Optimism among finance chiefs stands at its lowest level in three years, with a less-than-1% increase in capital spending expected over the next 12 months. That compares with an expected 5.7% increase in September 2018."* - Ira Iosebashvili, WSJ

The most important takeaway from that passage is not the 70% that expect the U.S. to enter a recession, but rather the actions these chief financial officers are taking – a less than 1% increase in capital spending. It is their actions that should be most concerning, because any recession that may materialize will ultimately be self-fulfilling. The more that individuals hear of corporations pulling back the reins, the more likely consumer spending will also suffer. All of this is a vicious cycle that leads the U.S. economy down a path toward a recession.

Recently, the economic data is starting to confirm the actions of the surveyed chief financial officers. The U.S. ISM manufacturing PMI survey fell below the expansion/contraction threshold of 50 for the second month in a row. In September, the reading was 47.8, which marked a ten-year low. You might recall in 2015 when the U.S. experienced a manufacturing recession and corporate earnings recession, but the overall economy never officially fell into a recession due to strength in the services sector. Well, we are in a similar place today. I will touch on corporate earnings shortly, but the services sector of the economy remains in expansionary territory as evidenced by the latest U.S. ISM non-manufacturing PMI survey. The non-manufacturing number remained above 50; however, it badly missed estimates and the general trend has been declining for a year now.

The data hasn't all been that bad. The unemployment rate remains at a 50-year low with the most recent jobs report showing a slowing, but continued growth in payrolls. Retail sales are strong, and housing data looks to be firming up after a sharp decline in mortgage rates over the past 12 months. At the end of the day, the U.S. economy is going to rise, or fall based on the consumer. Consumer data continues to hold up quite well, but cracks are starting to appear. As seen in the graph below, year-over-year change in consumer confidence has now turned negative.



Source: Conference Board, Consumer Confidence Index through September 2019, Forbes – Randy Brown

None of this should come as a surprise to anyone who reads this column and all of our other commentary - ***The TANDEM Report*** and ***Notes from the Trading Desk***. Over the past year, in some form or fashion, we've touched on the slowing economic environment, the deceleration in corporate earnings and the risks all this pose to financial markets. Nothing has changed, except for the attention the media is now giving to the weakness here in the United States. If a recession were to hit our shores, this would be the most telegraphed recession of all-time, which could end up being what keeps equity markets afloat. As we found out in 2015, the equity market may just see right through any economic weakness.

Corporate Earnings Review

Earnings season is always an important time, because it gives us some insight into how each of our companies are performing. A single quarterly report, either good or bad, does not define a company, but rather it sheds light on the positive or negative trends the business may be experiencing. We've highlighted for over a year now, the deceleration in S&P 500 sales and earnings growth. And based on current estimates, this trend looks to be headed lower. According to Factset, S&P 500 revenues for Q3 are expected to increase 2.7%, which would be the 5th quarter in a row where sales growth was lower than the prior quarter. On the earnings front, expectations are for S&P 500 earnings to decline by 4.8%. If the estimates hold true, it would be the 3rd straight quarter of not only a deceleration in growth, but rather an outright decline in earnings growth. Technically, one could consider this to be an earnings recession, which we last experienced in late 2015/early 2016.

Looking further ahead, S&P 500 estimates are a bit rosier. Beginning in Q4, the S&P 500 is projected to have revenue growth and earnings growth of 3.6% and 2.6%, respectively. Estimates progressively get even better the further out you look into the future. Current estimates for calendar year 2020 have the S&P 500 growing revenue at 5.7% and earnings at 10.5%. For the S&P 500 to realize double digit earnings growth next year, the CFOs that were polled need to become more optimistic and ramp up capital spending. And, consumer confidence needs to quickly reverse its downward trend. Otherwise, current estimates are too high and will be revised down over the coming quarters.

Tandem Strategy Update

As volatility has increased, so has our activity on the composite level. Astute readers of this column will likely have picked up that we've been net sellers of equities over the past few months. Our quantitative model has started to signal an increasing number of companies that continue to trade at historical valuation levels, while their fundamental growth has begun to decelerate. Over the past several weeks, we have trimmed our holdings in the following stocks based on these signals.

- Brown & Brown (BRO)
- Ecolab (ECL)
- ResMed (RMD)
- Stryker (SYK)

All these securities fundamentally meet our criteria, which is why we only sold 25% of our position in each company. On the other hand, we have one core holding that is in the process of being liquidated after not meeting our dividend growth criteria. Once we have completed liquidating the position, we will explain in further detail why this company no longer meets our fundamental requirements.

Lastly, we were able to take advantage of the market sell-off and put a little cash to work during the first few days of October. We added to our position in Expeditors International (EXPD), which was first bought on the composite level over four years ago. This company specializes in 3rd party logistics, which has somewhat suffered throughout the recent trade spat. EXPD has fallen roughly 15% from all-time highs, is attractively valued and their fundamentals appear to be troughing after decelerating for several quarters. In addition, we recently established initial positions in two new companies. One of these companies is also in the 3rd party logistics industry and the other is a software security firm. As we fill out our position in each of these companies, we will provide more detailed information about them.

-Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson