September 2023 - Tandem Investment Advisors, Inc.

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Financial Markets Review

Seasonality caught up with equity markets again this year. Historically, the two weakest months of the year for equities are August and September. So far, that historical pattern has not failed to disappoint. In August, the S&P 500 and Nasdaq posted their first monthly decline since February, as the indices fell 1.77% and 2.17%, respectively. The small-cap Russell 2000 index fared the worst, declining 5.17%.

Over the past several months, we have written extensively about interest rates, but more so about the short end of the yield curve. The yields on Treasury bills that mature between 1-month and 1-year have been fairly stagnant for the past 3 months. Short-term Treasuries yield anywhere from 5.4% – 5.5% and have been extremely popular with anyone looking for a place to park a little extra cash. These securities make up a significant portion of money market fund assets, so it’s been a wonderful alternative to a more traditional savings account at a bank. Afterall, it has been over 15 years since you could earn 5% or more on cash!

Outside of the regional bank crisis in March, the spike in short-term Treasury yields has not had a dramatic effect on equity prices in 2023. Last year, the weakness in equities was largely attributed to the dramatic rise in interest rates. As rates rose, equity valuations moved lower, especially in those companies that were considered to be most expensive – technology and more speculative companies, such as those that did not make a profit. However, this year, as the pace of rising short term interest rates has slowed, the effect on valuations and equity prices has been fairly muted. Technology companies, most notably the mega cap “Magnificent Seven”, have rebounded with a vengeance. The idea of higher short-term interest rates weighing on valuations or being in competition with equities has, so far, not really manifested itself.

With all of the talk being centered around short-term rates, there has been less attention given to long-term rates. Except for a few instances when the 10-year Treasury bond eclipsed 4% for only a few days at a time, longer-term Treasuries have remained fairly range bound. For the better part of a year, long-term Treasury yields have bounced between 3.3% and 4.0%. However, this range broke around the beginning of August when long-term

Treasury bond yields made a sustained push above 4%. In fact, for the first time since the summer of 2008, the 10-year Treasury bond's average yield has been greater than 4% over the past 50 trading days.

A sustained shift higher in the entire yield curve begs the question – what, if anything, gives? Maybe the answer is nothing, but it's hard to imagine that short and long-term interest rates that remain higher for longer will have little to no impact on asset prices or economic activity. With 30-year fixed mortgage rates closing in on 8% and home prices at record highs, U.S. housing affordability has hit an all-time low. Equities are looking ever more expensive relative to Treasury yields, as the equity risk premium, which is the extra return an investor in equities can expect to earn over 10-year Treasury bonds, is at its lowest level in over 20 years. And just over the past couple of weeks, several retailers have hinted at a weakening consumer with rising credit delinquencies.

For now, all of the talk regarding higher interest rates and tighter credit has been just that – talk. Very little has actually transpired whether it be amongst equities, real estate, or the general economy. Maybe the brief jolt of volatility in August is a precursor of what's to come, but until credit really becomes a problem and the "Magnificent Seven" begins to show weakness, the broader equity market will continue to trudge higher.

Tandem Strategy Update

For the first five months of the year, it was well documented that the bulk of the year-to-date gains of the S&P 500 came from a handful of stocks now known as the "Magnificent Seven". This includes Apple, Microsoft, Alphabet, Amazon, Nvdia, Tesla and Meta, which also happen to be the seven largest companies in the S&P 500 comprising over 27.5% of the entire index. It was only for a brief moment, but earlier in the summer, strength across the S&P 500 began to broaden out. It seemed as if the other 493 companies were finally going to catch up; however, that trend began to fizzle out around the beginning of August. Since that time, the S&P Equal Weighted Index is down roughly 4%, whereas the S&P 500 Index (market-cap weighted) is down 2%.

A hallmark of 2023 has been underlying weakness in the broader S&P 500 index being masked by strength in just a handful of companies. That weakness has shown up in the fundamentals of companies across many different types of industries and sectors. And unfortunately, a couple of our core holdings have been caught up in this weakness.

Labcorp (LH) is a health care company known for providing lab diagnostic information and testing to individuals, doctors, hospitals, and pharmaceutical companies. The business of LH took off a few years ago as testing for COVID ramped up. Since then, as COVID testing has tapered off, LH's underlying business has failed to meet our criteria of consistent growth. After initiating a dividend in May 2022, LH has failed to commit to growing their dividend, which is likely a result of the inconsistency of their underlying business. The failure to exhibit consistent growth led us to liquidate the holding, which was held in our Equity and Mid Cap Core strategies.

Dollar General (DG) is a well-known discount retailer who sells everything from groceries to basic apparel and seasonal items. DG was one of those companies that historically grew revenues and earnings through any economic cycle, whether it be an economic expansion or contraction. However, this time around, demand has waned with DG's core customers being impacted the most by inflation. And at the same time, the cost side for DG has increased with everything from wages to rents continuing to rise, which have decimated margins. The severity of the decline in earnings has caused the company to no longer pass through our screen of consistent earnings growth, which has resulted in us beginning to liquidate the position held within our Large Cap Core and Equity strategies.

Lastly, we have also started the process of liquidating **PayPal** (PYPL), which is only held in our Equity strategy. Unlike LH and DG, PYPL has continued to meet our fundamental growth expectations; however, PYPL's liquidation comes from a violation of our consistency and depth in management. PYPL recently announced the hire of a new CEO, who came from outside the business. This marks the second consecutive time PYPL has gone outside its own team to hire a new leader, which clearly violates both consistency and depth in their management team.

Source: *Source of all data is FactSet, unless otherwise noted.*

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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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