Market Commentary

First Quarter 2015

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The first quarter of 2015 saw increased volatility across many asset classes – equities, fixed income, currencies and commodities. However, the increase in volatility resulted in muted returns for both equities and fixed income over the full quarter. The benchmark S&P 500 index rose by a scant 0.9% during the quarter on a total return basis. The yield on the benchmark 10-year US Treasury note again dropped below 2%, yielding 1.94% on March 31, down from the 2.17% yield at the start of 2015. The US dollar rose sharply versus most major currencies, continuing the strength that began in the second half of 2014. Many commodity prices continued the decline which began in mid-2014. One of the most watched commodities – oil – saw prices gyrate between $45 and $55 a barrel during the quarter, ending the period at $47.60, down from approximately $54 three months earlier.

Economic and Market Outlook

The buzzword for most of the quarter was "patient". Would the Federal Reserve remove that word from its guidance at the March Federal Open Market Committee meeting and if they did, what would it mean for investors? The Fed seemed to confuse markets by removing the word "patient", but then Chair Yellen said during her press conference that the Fed would not be impatient. This resulted in new highs for the major equity indices, a rally in bond prices and a sharp decline in the US dollar. Stepping back from the chaos, we believe Yellen is trying to telegraph that while the Fed may raise rates at some point in the not too distant future, they are not committed to raising rates at every meeting once they begin. During the 2004-2006 rate hike cycle, the Fed raised rates from 1.00% to 5.25% in almost a straight line. Clearly, this will not be the case during the upcoming cycle.

We have frequently written about the risks in longer-term fixed income securities. This issue is even more pervasive in international government bonds. Last quarter we pointed out how the very low US Treasury yields in fact are much higher than the yields of European sovereign debt. This spread has continued to widen with investors happy to buy European debt at yields approaching or actually going below zero. There is currently approximately $1.5 trillion dollars in outstanding European sovereign debt with negative nominal yields. The German 10-year Government bond has had a negative real yield for several months now. With governments around the world trying to spur higher inflation, we believe that the first sign of inflationary pressures will crush these bond prices. This type of investing is like hunting for pennies on a busy interstate highway.

While the stock market has provided investors with solid inflation-adjusted returns for the past 75 years, it has not done so without volatility. Fluctuations in stock prices (volatility) are one factor investors must accept to invest in equities. Capital market theory and experience show that stocks provide higher returns than bonds over the long term. To earn those higher returns one must acknowledge the risk and volatility of the stock market. Many people become uncomfortable with investing and look to become traders when volatility increases. Human nature compels them to not want to ride out the volatility. Unfortunately, the most likely results are either trading losses or missed appreciation potential due to selling and then being fearful to buy back what was sold. We counsel our clients that we are investors – not traders. We look at the long-term and invest for the same.

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A prudent investor is one who invests in strong, growing corporations for the purpose of participating in the future growth and expansion of these entities. Most traders have no affinity for the stocks they purchase. Rather they are simply buying pieces of paper and holding for a few minutes, hours, or days speculating on the outcome of one or more events. We observe that after all of the stock market's volatile daily squalls during the first quarter of 2015, the S&P 500 is close to the same level it ended 2014. One recent analysis concluded that traders during this period have lost significant amounts of money.

The price of oil continues to be one of the most discussed factors over the past several months. Those who predicted a rapid rebound in oil prices have been proven wrong and the current discussion is focused on what a floor price for oil might be. While it is a fool's game to try to determine a "fair" price for a globally traded commodity with numerous demand and supply factors, we continue to examine the positive effects for consumers and spending. Thus far, the increased discretionary cash flow has not found its way into increased retail sales. We believe this shows that consumers continue to work on deleveraging and paying down debt, still bearing the scars of the recent financial crises. We see volatility in many asset classes remaining at higher levels than over the past several years. Volatility, while quite normal, tends to frighten investors who would prefer asset prices move in a straight line.

Portfolio Positioning

With the bull market now in its seventh year, we are more cognitive of potential risks and overall valuations than in the past few years. At Tandem, we have always believed in forgoing a bit of the upside gains in favor of fiercely protecting on the downside when markets move against us. Again, this goes counter to human tendencies that focus on greed. Our focus on strong companies with fortress balance sheets may lag markets that are moving steadily higher, but during volatile times, the benefit of this portfolio strategy becomes increasingly evident.

Conclusion

While we are not calling for the end of the secular bull market, we do believe that the vast majority of the P/E multiple expansion is now behind us. This means that earnings growth will be necessary to propel equity indices to new highs. 2015 will likely be a year of sub-par earnings growth due to the rapid strengthening of the US dollar. At Tandem, we believe it is prudent to look through this temporary hiccup in earnings growth as long as the dollar does not continue to increase at its current rate. We believe this to be the prudent course. An improving economy will lead to better earnings growth, and ultimately, higher stock prices. Volatility will stay at elevated levels as we await the first move by the Fed, which may not come until late in 2015 or even early 2016. It is imperative to focus on asset allocation and stay true to our disciplined process, avoiding unnecessary risk where possible and seizing opportunities where available.

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