Market Commentary

Fourth Quarter 2018

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The fourth quarter saw the rapid return of volatility across many asset classes. After a strong third quarter for equities, US equity markets peaked in the early Fall coinciding with Federal Reserve Chairman Powell stating that the Fed was a "long way from neutral" on interest rates. From that point through late November, the S&P 500 declined 10%. During the last week of November, Powell commented that the federal funds rate was "just below" the neutral rate which set off the best weekly performance by the S&P 500 in nearly seven years. However, that week turned out to be the bright spot during the quarter as stocks reversed lower with a vengeance, turning in the worst December performance since 1931. Fears of a Federal Reserve "mistake", lingering concerns over a trade war with China, and the uncertainty of a divided government in Washington were pointed to as catalysts for the December sell-off.

The unnerving December "waterfall" declines – a series of significant daily selloffs in equity markets - were caused by the coincident occurrence of three market related phenomena. First, the forced liquidation of numerous failing hedge funds along with customer withdrawals from hundreds of other hedge funds. Second was the normal year-end tax loss selling, exacerbated by the first annual declines for US equity markets in a decade. Finally, algorithmic or computer-driven trading clicked in when certain index levels were breached. These selling pressures faced a dearth of natural buyers, causing what seemed like an endless string of negative days in equity markets. During times of panic, the steadfast long-term investor is best served by staying unemotional and remaining committed to their discipline.

During the fourth quarter, the S&P 500 declined by 13.5%, marking its worst quarterly return since the summer of 2011. This brought the total return for calendar 2018 to -4.4%. Fixed income yields halted their steady two-year rise, with the benchmark 10-year Treasury note peaking in early November at a seven-year high of 3.23%, before ending the year at 2.68%, modestly below the 3.05% yield at the end of September, but above the 2.41% rate at year-end 2017.

While 2018 was a disappointing one for equity investors, we remind you to view it in the context of the past decade. From the March 2009 lows, the S&P 500 returned an astounding 422% in the 9 ½ years through late September 2018. That works out to a 19% annual compounded rate of return! As students of the markets, we know that long-term equity returns average 8-10% annually, so after nearly a decade of returns twice the historic average, there simply had to be some mean reversion.

Economic and Market Outlook

The economy continues to show strong growth fueled by consumer spending and the continuing benefits of the 2017 tax cuts. The increased volatility and sharp declines in recent weeks are reminiscent of an economy that is on the brink of a recession, yet that is not the forecast for 2019. Earnings growth will slow from the estimated 24% growth in 2018 to mid- to high-single digits in 2019, but that is still respectable growth. The lackluster US equity market performance in 2018

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contrasted with the impressive rise in corporate earnings, resulting in a market that is significantly cheaper than it was at the end of 2017. We entered 2018 with the S&P 500 selling at 20.7x trailing earnings, and nary a whisper of apprehension about stock prices or valuations. Fast forward to the present and we find the S&P 500 selling at 15.5x trailing earnings along with a meaningful increase in investor concern. Said another way, US equities as measured by the S&P 500 are 25% cheaper than they were one year ago and are currently selling at their lowest earnings multiple since 2013.

Oil prices fell dramatically during the quarter from $73.25 at the end of September to $45.41 at year end, using West Texas Intermediate as the benchmark. The sharp decline resulted from a 180-degree change in investor sentiment regarding supply and demand. As recently as mid-September, worries of inadequate supply, bolstered by the impending sanctions on Iran saw oil prices near four-year highs. In early October, concern switched to a fear of rapidly declining global demand for oil based on expectations of slowing economic growth outside the US. The sudden and steep decline in oil prices has brought oil to a level 25% below where it was one year ago and down about 40% from its early October peak. This reduction in oil prices increases discretionary income for consumers and likely provided impetus for strong retail sales during the recent holiday season. We have been stating for several months that oil was near the top end of its price range based on the economic environment we projected and believe the fair price for oil should be in a range between $50-70 based on fundamentals of supply and demand in the global economy.

While the overall level of interest rates is quite important to equity markets, we have long opined that the Federal Reserve would not raise rates as far as many forecasts were projecting, based on the inflation rate in the economy. After the December Federal Reserve meeting, the consensus is moving closer to our viewpoint for fewer interest rate increases in 2019 and 2020.

There are a number of issues that will likely be resolved in the first few months of 2019 which should provide clarity to investors and serve to reduce the high levels of uncertainty. We believe we will learn the Federal Reserve's plan for interest rate increases during 2019, along with a resolution of the trade spat with China and an ending to the Mueller probe. Each of these may be resolved in a way that investors cheer or disdain, but simply ending the ambiguity of these should reduce overall levels of volatility.

The definition of *Perspective* is "to think about a situation or problem in a wise and reasonable way." At Tandem, we believe investing at its core comes down to perspective. Yet it is in times of heightened volatility that most investors lose their perspective and fall back on emotions. Investors despise uncertainty because it raises volatility in financial markets. Volatility is a summation of the potential risks facing investors along with their levels of fear/greed. As the amount of economic and geopolitical information available increases exponentially, many investors instinctively react to the latest information – positive or negative – and this contributes to increased market volatility.

Investors with a long-term time horizon are more likely to weather short-term volatility and market declines. We have often stated that it is both difficult and risky to attempt to time the market. While human emotion could lead investors to panic and sell when markets decline, staying invested for the long-term has historically been the smart move. The advantage of long-term investing is that it lowers volatility over longer periods of time. Short-term fluctuations seem random and unpredictable, but they are part of the normal ebb and flow of markets. In summary, volatility is

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not only an expected part of investing but used properly can enhance long-term investment results. The largest factors preventing investors from using volatility to their advantage are fear and emotion. These cause investors to extrapolate recent market results prompting them to do the exact opposite of what they should do to insure long-term investing success.

Some pundits are calling for a recession beginning during 2019. When we look at the economic data with a clear eye, we see no signs of a recession. Retailers just posted the strongest growth in holiday sales in at least six years showing the consumer is able and willing to spend. Corporations are flush with cash, helped by the tax law changes that enabled them to repatriate hundreds of billions of dollars that had been locked up overseas. Unemployment hovers near a fifty-year low and wages are seeing meaningful increases for the first time in nearly a decade. These data points tell us that the economy can continue to grow through 2019, albeit at a lower rate than in 2018. Markets are places for long-term investing and we do not believe that daily swings of 3% or more accurately portray the economic and investing climate. There is no reason to believe US stocks are worth 15% less than they were three months ago. Computer trading, driven by algorithms, have enhanced the volatility. High-frequency trading by firms that have no concerns about what security they are buying or selling adds to daily price swings.

It may feel like it is different this time, but during panics it usually does. We know from history that sharp declines in the market have almost always been excellent buying opportunities two to three years hence. If you had sold at the bottom in 2009, you would have missed the quadrupling in value that ensued over the next 9 ½ years. We are not calling this a bottom and feel that there could be more churning and violent swings. However, we strongly believe that maintaining a disciplined investment strategy through times of market volatility will provide long-term portfolio benefits.

We believe this is an opportune time to reiterate our style of investing at Tandem. Just one year ago, Bitcoin was trading close to $20,000 per unit and some clients were asking if they should add Bitcoin to their portfolios. Bitcoin was constantly in the news and many firms rushed to offer Bitcoin accounts to clients. During the Thanksgiving week a year ago, over 100,000 people opened Bitcoin trading accounts. Today, with the price down over 80% from its high, nobody is clamoring to buy Bitcoin. We have seen dozens of similar manias come and go. Investing – as opposed to speculating – is defined as buying something at less than its intrinsic (fair) value. At Tandem we analyze companies and securities to derive our estimate of intrinsic value. We look to buy companies that are selling below fair value and sell them when they meaningfully exceed fair value. Speculators – while not always acknowledging that they are speculating – buy whatever is "hot" with the assumption that they can sell it for a higher price at some point in the near future. They do not consider the underlying value of any investment. In the late 1990's the dot-com bubble resulted in anything internet related being valued at astronomical multiples of revenues since so few companies actually had earnings at that time. The housing bubble in the mid-2000's saw similar rampant speculation with houses purchased with little or no money down in the belief that owners could sell the house for 20% more a few months later. Manias come and go, with many fortunes wiped out along the way. Meanwhile, fundamental research-based investing may seem unappealing and even boring at times yet remains the best way to achieve long-term growth with superior risk-adjusted returns. We have long viewed our primary role as managers of risk, rather than managers of returns. We set prudent asset allocation targets with each client individually and review these

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targets at regular intervals. Multi-decade studies show that long-term returns are overwhelmingly derived from proper asset allocation rather than specific security selection. While asset-allocation may not be exciting, and many people may disdain it during rising markets, proper asset allocation serves to manage risk levels for the inevitable pullbacks and downturns in equity markets.

At Tandem, we have a strong investment decision making process and discipline which has worked for the past 30 plus years. The discipline is to remove human emotion by selling euphoria and buying panic. This is commonly referred to as sell high and buy low. Emotions make this discipline very difficult to execute during times of maximum pessimism. Based on what we stated above, now is the time for investors with a long-term investment horizon to cautiously and judiciously buy equities.

Portfolio Positioning

Client portfolios are positioned for continued, albeit slower economic growth after the fastest growth in US GDP in over a decade during 2018. After the sharp decline in equities, modest reductions in fixed income with proceeds moving into equities is warranted in certain cases, just as we had methodically trimmed equities during their nine-year advance. We remain focused on companies with strong balance sheets, rising earnings, and diversified customer bases which should continue to do well in the next several quarters. We favor large, multinational corporations for their global reach and diversified product offerings. We believe the bulk of the rise in short-term interest rates is in the rearview mirror with future increases tied to increases in inflation and GDP growth.

Conclusion

As we look to 2019, we see several positive factors for the economy. While acknowledging that the anniversary of the 2017 tax cuts will reduce the rate of growth for both the economy and corporate earnings, we believe both can remain at or above trend growth for several quarters. The volatility in equity markets during the last quarter was partly due to a sharp decline in expected global economic growth rates, along with slightly higher inflation expectations. Many equity markets globally declined significantly during 2018 and we believe this sell-off has brought equities meaningfully below fair value as we enter 2019.

Finally, we hope you and your families enjoyed the holiday season. We wish each of you a happy and healthy New Year in 2019. While each year begins with questions on markets and the economy, we hope we have answered most if not all your questions. The change in calendar is a good time to review your asset allocation to be sure you remain comfortable with your overall portfolio risk profile. If you have any concerns or questions on the markets or your investment portfolio, please let us know.

We wish you a healthy, prosperous and happy New Year.

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