Market Commentary

Second Quarter 2023

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The second quarter of 2023 saw surprising strength in US equity markets against a backdrop of modestly weaker economic data. Equities, as measured by the benchmark S&P 500 Index, rose by 8.7% during the quarter, bringing the YTD total return for the index to 16.9%. We admit to being surprised by the rapid increase in equity markets over the past few months during what we would describe as a turbulent period. The US came very close to defaulting on its debt, three banks collapsed in a matter of days, corporate earnings have continued to disappoint, and bonds/money market funds provide tempting alternatives to stocks. Also concerning is the significant concentration of returns in a handful of high-tech growth stocks while the broader market muddles along.

Fixed income yields moved higher, rebounding from the flight to safety yield declines throughout March during the short-lived banking turmoil. The benchmark 10-year US Treasury note ended June yielding 3.85%, up from 3.49% at the end of March, but nearly equal to the 3.88% at the start of 2023. Once again, larger moves were seen in the shorter end of the Treasury yield curve. For example, the 1-year Treasury bill jumped from a 4.64% yield on March 31 to 5.41% on June 30. The 2-year Treasury note began the quarter yielding 4.06% and rose steadily during the quarter before ending June with a yield of 4.87%. These ultra-safe short-term yields are quite compelling compared to the past two decades.

Economic and Market Outlook

The Federal Reserve remains the key variable on most investors' radar. While it is near certain they are approaching the end of their tightening cycle, the cumulative effect of the most rapid rate increases in decades is less clear. As the full effects of 500 basis points of Fed tightening work through the financial system, the consumer is showing continued signs of retrenching. Conversely, the labor market continues to surprise most pundits, with job gains running well ahead of expectations for several months running, although jobless claims have been moving higher over the past few months. At the mid-June Fed meeting, the FOMC voted to keep the Fed Funds rate steady at a range of 5.0-5.25% but released their quarterly projections which surprisingly call for two more 25 basis point rate hikes during 2023. As recently as mid-May, interest rate futures showed a consensus for two or more rate *cuts* during the second half of 2023. Investors have meaningfully adjusted their expectations and are currently looking for short-term rates to end the year near their current levels. We think the Fed would like to be finished with their rate hikes sooner rather than later, and thus by projecting two more hikes, the markets may do some of the Fed's work for them by pushing short-term rates higher, slowing overall demand. Regarding the question if this was a pause in hikes for a single meeting or a stoppage for a longer period, we think Chairman Powell may have tipped his hand when he slipped during the press conference and referred to the pause in hikes as a "skip" before saying "no decisions" about future rate moves have been made. This leads us to believe that unless we get economic reports that show surprising weakness, the Fed will likely raise rates by another 25 basis points at their July meeting. The Fed moved their forecast of 2023 GDP growth up from 0.4% to a still lackluster 1.0%, while they nudged their forecasts for unemployment lower and for inflation a bit higher when compared to their March

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forecasts. While headline inflation has fallen for 11 consecutive months from 9.1% to 4.0%, the Fed's preferred measure of Core PCE has remained stubbornly high at 4.6%. We have long believed the move from 9% to 5% would be far easier than the move from 5% to 3% or below. Taking the current economic data as a whole and believing the effects of monetary policy are both long and variable, the odds of a modest recession are meaningful.

Earnings estimates for S&P 500 companies have slowed their decline after being reduced to a level near 2022 earnings of $218. While estimates began the year looking for an increase of 5%, they have fallen to $220 with the chance for further reductions following the release of second-quarter earnings results in July and August. Importantly, consensus forecasts are for the recently ended quarter to mark the bottom in earnings, with gains expected in the last two quarters of 2023 followed by further gains next year. If these estimates come to fruition, equities could justify some of their recent move higher. We still believe the much higher interest expense many companies face, along with higher input costs and wage demands will pressure margins. If we assume no earnings growth in 2023, the S&P 500 is selling at about 20x forward estimates, above the 10-year average of 17.2x. Looking out 12-18 months, we can see an improving economy, declining interest rates, and earnings about 10% higher than 2023's level. On that measure, US equities are selling below 18x estimates, not far from their long-term average.

Turning to oil markets, the price for benchmark West Texas Intermediate (WTI) began the recent quarter at $75.67 and traded in a narrow range for most of the quarter as geopolitical tensions ameliorated and demand stayed firm. WTI ended the quarter at $70.46, down a modest 6.9% during the quarter and 12.2% lower for the 6-month period. Our estimate for the fair value of oil remains in the range of $70-$90 per barrel with risks based on geopolitics and economic concerns.

Portfolio Positioning

US equities remain slightly above fair value, with pockets of more extreme valuations found in NASDAQ's largest technology stocks. In fact, the recent spurt of Artificial Intelligence (AI) euphoria among several companies reminds us of the first wave of internet speculation following the 1995 IPO of Netscape. For the next few years, anything remotely related to the internet saw valuations skyrocket before it all ended in tears during the 2000-2002 dot com bust. While we do not see the same level of extreme valuations as a quarter century ago because many of the companies being bid up are already established and profitable; that does not mean the lofty valuations these companies have attained are warranted by fundamentals.

We do not often discuss individual stocks unless it is to make a specific point. Tesla has seen its market cap increase by over $200 billion in just the past seven weeks based on AI mania along with several auto manufacturers agreeing to standardize their electric vehicles to utilize Tesla's charging stations. While both are good news for Tesla – the magnitude of the stock jump boggles the mind. For example, analysts believe the increase in EVs utilizing Tesla's charging stations could add $150-$200 million in annual earnings to Tesla *by the year 2035.* Even putting a 50x multiple on those additional earnings more than a decade hence, the value of the company would increase by about $10 billion. Yet it has risen by over 20 times that amount. Chipmaker Nvidia has nearly quadrupled in price since October and sells above 200x trailing earnings based on their report of "high demand" for their chips by AI related customers. These are the signs of speculative froth that concern prudent investors.

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We expect a challenging second half for equities as some of the expected full year returns for 2023 were likely pulled forward. In fact, the 31.7% return for the NASDAQ YTD marks the best first half performance since 1983 during the initial personal computer mania. Tandem believes in sticking to high quality investments with below market valuations, continuing to remain defensive until clearer signs of a growing economy are evident. We have always believed that foregoing some upside in rapidly rising markets is a fair price to pay for aggressively protecting against large declines in portfolio value during bear markets. Said another way, investors win more by losing less.

Conclusion

We would describe the Fed's holding rates steady at the June meeting as a "hawkish" pause with at least one more rate hike likely at the July meeting. There are those who believe the Fed is bluffing – telling markets to expect more rate hikes, while they internally believe they have done enough to force inflation lower as the previous hikes work their way through the system. We have been less focused on the absolute level of Fed funds as we believe the Fed is either done or nearly done in this hiking cycle. Rather we are looking at the effects of 500 basis points of rate hikes on employment, banking, and other areas of the economy. Short-term treasury yields over 5% are a compelling alternative, particularly when there is reduced confidence in corporate earnings and the ability of the US consumer to continue spending. Consumers have burned through most of the surplus savings built up during the pandemic. Recent earnings reports from retailers across the spectrum showed a retrenching consumer – a trend we believe will continue through the remainder of 2023 at least. The Supreme Court decision blocking student loan forgiveness could crimp disposable income for many in the 25-49 age range as loan payments resume after a long hiatus.

The volatility in both equity and fixed income markets during the past 18 months is the result of interest rates being normalized after 15 years of being held artificially low. There is always pain when financial markets are forced to take their medicine, but it results in a more normalized market where strong companies outperform weaker ones. Unsustainable business models are punished, and investors flee more speculative investments. While we went a long way towards cleansing speculation from the system in 2022, the first half of this year has partially reversed that trend, leading to our cautionary stance.

In closing, we ask that you inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments. We always enjoy communicating with our clients and are happy to answer any questions you may have.

June 30, 2023

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