Market Commentary

Third Quarter 2014

Fredric P. Lutcher, CFA
Managing Partner

Thomas J. D'Auria, CFA
Managing Partner

Equity markets once again confounded the skeptics during the third quarter of 2014, setting fresh record highs before pulling back in the final days of the quarter. The benchmark S&P 500 index rose by 1.1% during the quarter on a total return basis. This brings the year-to-date total return to 8.3%. The benchmark 10-year US Treasury note yielded 2.49% on September 30, essentially unchanged from the 2.52% yield at the start of the quarter. During the quarter, the yield on the benchmark note dropped as low as 2.30% before rebounding during September.

Economic and Market Outlook

The Federal Reserve is just weeks away from the end of its QE tapering. Despite the slow removal of this extraordinary level of buying power, interest rates are now meaningfully lower than they were at the start of 2014, running counter to popular wisdom. While most investors want to focus on stock prices, we believe a longer than normal discussion on fixed income is prudent at this time. During the past several years, the Federal Reserve has not only artificially held down interest rates, but also indirectly has dampened volatility in the credit markets. While we cannot say with precision when interest rate will begin to climb, we can say unequivocally, that a 10-year Treasury note yielding less than 2.5% is not likely to be a good investment. Real rates on the 10-year note – when factoring out current inflation trends – is about 25-50 basis points. This is significantly below long-term averages. While total returns on fixed income securities have been quite positive thus far in 2014, we point out that as rates on the 10-year note declined from 3.0% to below 2.4%, an investor buying current Treasury notes has seen his income on new purchases decline by more than 20%. Historically, fixed income investors have gotten burned by reaching for the highest yielding securities rather than looking at the macro landscape. With this as a backdrop, there is not a large amount of upside to being "long" in fixed income, while there is a significantly higher downside risk. We at Tandem have remained relatively short in our maturities as we are unwilling to take on meaningful principal risk for a relatively small increase in current yield.

There are a number of non-financial flash points that have the potential to swing markets over the coming months. These include tensions in the Eastern Ukraine, ISIS and the ongoing battles in the Middle East, and concerns over a potential ebola outbreak. While none of these directly affect the US economy at the current time, they have the potential to sway investor sentiment if the outlook on one or more of them worsens.

On the economic front, the two major concerns we are focused on include the possibility of a "hard landing" for the Chinese economy and a deeper than expected recession in Europe. While many lament the sluggish growth in the US economy, we note the much better than expected 4.6% growth in real GDP during the second quarter. This is well ahead of the 2.0% average we have seen since the recession ended in 2008/2009. We noted in our last commentary the risk of higher oil prices and its negative effect on consumer spending. This works both ways and with the decline in oil prices of over $10 in the past few months, consumers have more disposable income and could be primed to increase their discretionary spending further. Additionally, the recent strength in the US dollar makes imported goods cheaper for US consumers.

TANDEM
INVESTMENT PARTNERS

29 Emmons Drive, Suite A-5
Princeton, NJ 08540
Tel 609-452-2100
Fax 609-916-1280

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628
Fax 928-458-7100

112 W 34th Street, 18th Fl
New York, NY 10120
Tel 631-766-3764
Fax 609-916-1280

The continued strength in equities has US stocks selling at their approximate fair value based on interest rate levels, earnings expectations and the current inflation rate. While not priced for perfection, we believe the downside risk is greater than it has been in several years. Modest returns over the next 12 months are expected. Volatility has increased recently, which is not necessarily a negative. Long periods of extremely low volatility breed complacency. This in turn sets investors up for an unexpected negative surprise which can cause a sharp short-term decline in equity markets. The adage that "stocks climb a wall of worry" has been evidenced during the past several months. We believe that two 40%+ declines in equities in a decade have investors still gun-shy and many have yet to return to equities in a meaningful way. It has now been more than three years since the last 10% pullback in the major US equity indices. There will be a pullback, and while it may cause concern for investors, we counsel that the market functions as a "two steps forward, one step back". Lately we have taken several steps forward meaning the time for a needed step back is coming.

Portfolio Positioning

Lately there has been a clear divergence in the performance of large-cap stocks versus small-cap stocks. Also, growth and value have shown signs of diverging. While we are not saying that one style of investing will always be in favor, we believe the divergence shows that investors are once again beginning to focus on the levels of risk they are taking. This is healthy and allows for outperformance of stronger, financially sound companies versus more speculative ones. We remain focused on higher-quality, financially strong companies and industries and shy away from leveraged companies and industries with low returns on capital.

Conclusion

Stocks rarely move in a linear fashion. We can point to the great bull market from 1982 through 1999. There were several market pullbacks of varying degrees during that period, including the infamous "crash of 1987". Yet, none of the pullbacks interrupted the 17-year bull market for very long. That bull market was driven by rising earnings and falling interest rates, along with some P/E multiple expansion. The period since the early 2000's has been more macro driven, with a great emphasis on the Federal Reserve and its impact on stock prices. As the Fed ends its QE and begins to push interest rates higher to more normalized levels, fundamental investing should rise to the fore again. When a pullback happens, we plan to use it as a chance to invest in companies and areas of the market that are enticing but had previously been too expensive. Bull markets do not end because of their duration, but rather because of outside shocks like rising energy prices or rising interest rates.

This is our first communication with you as the "new" Tandem. In closing, we thank you – our clients – for the trust you place in us at Tandem Investment Partners. We fully understand that without you, we do not have a business. Each of us believes in striving to earn your trust and loyalty every day. If you have any questions or comments, please do not hesitate to call or email us.

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Princeton, NJ 08540
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