Market Commentary

Fourth Quarter 2015

Fredric P. Lutcher, CFA
Managing Partner

Thomas J. D'Auria, CFA
Managing Partner

Equities rebounded in the fourth quarter of 2015, with the S&P 500 benchmark rising by 7.0% during the last three months of the year. This brought the total return for the benchmark index to a meager 1.38% for the full year. In fact, when backing out dividends, the S&P 500 had a return of -0.73%. The fourth quarter of 2015 saw the first move to raise interest rates by the Federal Reserve (Fed) in nearly a decade. While long overdue in our opinion, we believe market watchers can finally stop worrying about zero interest rates and begin to focus on fundamentals again. We note Chair Yellen went out of her way to discuss what it would take to see further rate hikes – specifically, higher inflation and lower unemployment. Clearly, this is not the start of series of rate hikes in rapid succession. In fact, current estimates by the Fed governors (the "dot plot") are for three to four hikes in 2016 which would bring the Fed Funds rate to approximately 1.25-1.50% a year from now. At Tandem, we believe interest rates will move up even more slowly than the Fed currently projects, and are looking for two interest rate hikes in 2016. The yield on the benchmark 10-year US Treasury Note rose slightly to 2.27% on December 31, 2015; modestly higher than the 2.06% yield on September 30. The US dollar consolidated its gains after a very strong advance.

Economic and Market Outlook

Most asset classes performed in a lackluster fashion and a majority of mutual funds again trailed the benchmark performance. While 2015 saw minimal changes in the major equity and fixed income indices, these results mask a turbulent year below the headline index numbers. There were a number of headwinds that held back equities in 2015, specifically a rout in commodity prices, a very strong US Dollar, fears of a hard landing in China, weaker than expected economic growth globally, and a Federal Reserve that was on hold until the last two weeks of the year.

Investment returns in this bifurcated market were extremely diverse with outsized gains from four technology-related stocks skewing overall index returns. If your portfolio didn't include the double- and triple-digit percentage gains from the "FANG" stocks - Facebook (up 34%), Amazon (up 118%), Netflix (up 134%) and Google (up 44%), it is likely your performance trailed the benchmark index. While the S&P 500 returned 1.38%, the average stock in the index declined by 4.3% during the year. The four "FANG" stocks comprise only 5.5% of the S&P 500 yet taking out only those four stocks reduced the S&P 500 return to -2.1% for 2015. During 2015, while the S&P 500 Index did not change much, the internals tell a much different story. Energy and Materials declined by 21.5% and 8.7%, respectively.

Earnings estimates for the S&P 500 show growth of less than 1% for 2015 versus the prior year. While the sharp decline in oil and commodity prices gets the most notice for weak earnings growth, we point out the role of the strengthening dollar during the year. Approximately $100 billion in earnings was wiped away by dollar appreciation. This alone took about eight percentage points away from earnings growth in 2015. The dollar does not need to decline to reverse this earnings hit, but merely to stabilize at current levels. With our forecasts of flat to slightly higher oil prices along with dollar stability, it is not a challenge to see earnings growth of 8% or more in 2016 with only modest GDP growth.

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

© 2015 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.

In our last commentary we discussed the negligible difference to the economy of a change of 25 basis points in short-term interest rates. To add some numeric context to the discussion, a 25 basis point increase means a jump of about $5 in the average monthly car payment and about a $35 increase in a mortgage payment. This is more than offset by the average household monthly fuel savings of $150 from lower energy prices. Obviously, if rates were to rise meaningfully, we would see some changes in consumer behavior due to higher payments for housing, auto loans, etc. Banks and money market funds will be slow to raise rates paid to consumers, and we expect only about a third of the recent rate hike to show up as higher interest payments.

The global decline in commodity prices that began in mid-2014, and the continued strength of the US dollar through 2015 leads us to the expectation for minimal inflation in the near future. While the “headline” unemployment rate hovers near 5% (seen as a possible trigger for continued Fed rate hikes), the U-6 rate of unemployment – which counts those working part-time purely for economic reasons along with those not looking for work but who want and are available to work – is approximately double the 5% rate. Our expectations are for a very slow increase in interest rates by the Fed.

Fears of a hard landing in China have subsided a bit, although they remain elevated. We have long believed that China is undergoing a deliberate change in its economic composition, shifting from one that is primarily manufacturing and export driven to one with more domestic consumer demand. As demand for raw materials declines, we see a converse increase in demand for both services and consumer goods – iPhones, name brand clothing, etc. This process is never painless, but it does explain why overall Chinese growth has been slowing as the multi-year process continues to unfold.

Portfolio Positioning

At Tandem, we continue to believe large-cap multi-national companies are the best investments for the current political and economic climate. While growth has far out-paced value during the past several quarters, 2015 saw the long-term outperformance of small-cap stocks come to an end. Volatility will remain elevated for the foreseeable future as all asset classes adjust to the first rate tightening cycle in a decade. In fixed income, we continue to hold relatively short-term maturities that will better withstand the volatility in the current interest rate environment.

Clients with taxable portfolios may have seen tax-loss selling towards year-end as we endeavored to take tax losses where prudent for client portfolios. These were done without changing asset allocation or sector positioning.

Conclusion

After the most telegraphed interest rate hike in history, investors may be asking, “What’s next?” 2016 will play out with cross currents of interest rate changes, a Presidential election, and the eighth year of a sub-par economic recovery. We expect fixed income to muddle along with total returns similar to the coupon yield on most securities. With forecasts of a high single-digit increase in S&P 500 earnings, we see the potential for a total return on equities approximating the long-term average of about 10%.

As we look to 2016, we wish each of you a healthy, joyous and prosperous year. Please contact us if you have any questions or comments.

December 31, 2015

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

© 2015 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.