Market Commentary

Fourth Quarter 2019

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What a difference a year makes! In late 2018, equity prices were plummeting based on an evil cocktail of trade fears, rising interest rates and the typical year-end lack of liquidity in markets. Declines were so severe and sudden that investors collectively believed a recession just had to be imminent. In 2018, US Equities turned in their worst December performance since 1931, ending the year on a sour note and positioning investors for a fearful 2019. Fast forward 12 months to the end of 2019 – US equity markets are near all-time highs after registering their best year since 2013, and there are no quantifiable signs of a recession on the horizon.

How did markets (aka investors) get it so wrong? This requires a look back at investor psychology as the calendar turned to 2019. We are not in the business of saying "I told you so", but we would be remiss if we did not reinforce our investment discipline by listing a few points throughout this commentary that we made at the end of 2018 with the equity markets near their nadir. A year ago, the Federal Reserve chairman stated the Fed was a "long way from neutral" on interest rates. We countered "*we have long opined that the Federal Reserve would not raise rates as far as many forecasts were projecting*." In fact, rather than increasing rates in 2019 by 75 basis points, the Fed reduced rates by 75 basis points – a swing of 150 basis points from expectations. (a basis point is one-hundredth of one percent [.01%]) Even we did not see a change of that magnitude coming. Additional concerns in late 2018 were the trade spat with China along with the impending end of the Mueller probe with the possibility of political disruptions during 2019. The US and China have made progress on the trade discussions, including a reduction in some tariffs. While there is a way to go on this front, most people agree the situation is less tenuous than it was 12 months ago. Following the mid-term elections, where Democrats gained control of the House, we saw fears of endless investigations and hearings which would cripple the government. Our belief that markets do best when Congress gets out of the way was rewarded during 2019 as investigations occupied the media and the headlines but did little to affect financial markets. The Mueller report fell with a thud. After a week of headlines, the matter was behind us. Later in 2019, impeachment hearings captured our attention, yet even the impeachment of the President saw a collective yawn from the markets, based on the overwhelming assumption that the Senate is far from the number of votes needed to remove the President from office. These issues were all significant concerns to investors a year ago yet are now essentially behind us.

During the fourth quarter, the S&P 500 increased by 9.1%, bringing its total return for 2019 to 31.5%. Fixed income yields continued to rebound from their early September lows when the benchmark 10-year Treasury note traded with a yield below 1.50%. During the final three months of the year, interest rates climbed modestly with the 10-year note ending 2019 at 1.92%, higher than the 1.67% yield at the end of September, but well below the 2.68% rate at year-end 2018.

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As we wrote to you a year ago, "*During times of panic, the steadfast long-term investor is best served by staying unemotional and remaining committed to their discipline.*" 2018 ended with investor sentiment near panic levels. However, put into context, the declines in late 2018 came after 9 ½ years in which the S&P 500 more than quintupled on a total return basis. We believed the declines were overdone because we had seen little change in economic data and corporate earnings.

Economic and Market Outlook

In addition to the events we listed above, the biggest one facing investors during 2019 was the inverted yield curve. Put simply, at most times, longer-dated fixed income securities yield more than shorter-term securities. This is due to investors demanding a higher return to compensate for lending for a longer period of time. When the yield curve inverts, this means that shorter-term fixed income securities yield more than longer-term securities. The inverted yield curve is well-known as one of the predictors of a recession. During the spring and summer months while the curve was inverted, we reviewed our economic forecasts and believed it would be a short-lived inversion. We wrote in our June 30, 2019 commentary, "*we believe that declining inflation expectations are driving longer-term rates lower which is a positive. If the Federal Reserve cuts rates later this year as many expect, the yield curve should normalize with short-term rates lower than longer-term rates.*" Following 75 basis points in rate cuts by the Fed, the yield curve normalized during the latter part of 2019. Rather than foreshadowing a recession, the inverted yield curve was merely forecasting the upcoming Fed easing.

We have long stated that corporate earnings ultimately drive equity prices. There will be variations in the earnings multiple investors are willing to pay for those earnings, but over time, equity prices follow earnings. Earnings growth in 2019 is expected to approximate 7%, with subsequent growth of 5-6% forecast in 2020. We entered 2019 with the market selling at 15.4x expected earnings. After the outsized returns in the past year, we enter 2020 with US equities selling at 18.5x expected 2020 earnings. While on the higher end of historical multiples, we are not calling for a meaningful decline in equities because interest rates remain very low making bonds less attractive versus equities. Last year, amidst the panic selling, we noted, "*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.*" This was the primary reason we counseled clients to not only hold their equity positions but to add to equities if they had the intestinal fortitude, writing, "*now is the time for investors with a long-term investment horizon to cautiously and judiciously buy equities.*" We rebalanced client portfolios where necessary in early 2019 – reducing fixed income to increase equities – which benefitted overall investment performance during 2019.

Oil prices traded in a relatively narrow range during 2019 after rebounding from recession fears in the early part of the year. During the fourth quarter of 2019, oil prices climbed from $54.07 on September 30 to end the year at $61.06, using West Texas Intermediate as the benchmark. This compares with $45.41 at year-end 2018. As investors discounted the odds of a recession during 2019, oil prices moved modestly higher and are currently near the midpoint of our projected fair price range between $50-70 based on fundamentals of supply and demand in the global economy.

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Some pundits are calling for a recession beginning during 2020. When analyzing the economic data, we cannot see this occurring based on the current financial health of consumers. The consumer accounts for two-thirds of the US economy and is financially very strong with a healthy balance sheet and increasing earnings. Unemployment hovers near a fifty-year low, wages are rising at a faster rate than during the past several years and several uncertainties have been resolved. We have a partial trade deal with China, clarity on Brexit, and an accommodative Federal Reserve. Unless we are dealt an unseen exogenous shock, the economy can continue to grow into 2021 and beyond.

Portfolio Positioning

Client portfolios remain positioned for continued economic expansion with GDP growth expected to approximate 2% during 2020. Growth has outperformed value investing for most of the past decade and while there should be some mean reversion, the percentage of the S&P 500 represented by growth companies continues to increase as the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) continue to capture more investment dollars. As valuations increase, it becomes more critical to focus on companies with strong balance sheets, rising earnings, and diversified customer bases or differentiated product lines that should continue to grow in the next several quarters. We continue to favor large, multinational corporations for their global reach and diversified product offerings, particularly now that trade tensions seem to be subsiding.

Conclusion

As we look to 2020, we see several positive factors for the economy. While acknowledging that earnings growth will be challenging for many companies and industries, the expectation of a dovish interest rate policy means risk assets can continue to appreciate. After the outsized returns of 2019, we can expect pauses and even some modest pullbacks in equity prices during the coming months. 2020 returns for both equities and fixed income are expected to trail those seen in 2019. However, with decreasing headwinds for the US economy, the resolution of many uncertainties during 2019, and continued low interest rates, modest returns in line with long-term averages are possible.

Finally, we hope you and your families enjoyed the holiday season. As the calendar changes to 2020, we remind you 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 always enjoy speaking with clients.

In closing, we wish you a healthy, prosperous and happy New Year.

December 31, 2019

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