Market Commentary

Second Quarter 2020

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The world we live in has changed significantly in the three months since our last letter to you. While we traditionally analyze the economy and financial markets, we have (necessarily) added a third area of analysis – the overall "health" of the US and its population. These three areas have moved in sometimes confusing and uncorrelated directions to each other during the past quarter. When we wrote to you in early April, COVID-19 infections were rising on a rapidly increasing trajectory. We were near the point of maximum uncertainty which led to confusion, volatility, and panic in financial markets. Three months later, there are still a significant number of unanswered questions along with considerable uncertainty about the virus and its effects - both domestically and globally.

A great deal has happened during the past three months. At the forefront, the US Congress has approved approximately $2.5 trillion in COVID-related stimulus spending. Just as importantly, the Federal Reserve has acted swiftly and decisively to help reduce the economic disruption and restore order to US financial markets with a total of $4 trillion in monetary stimulus. The combination of these actions has helped put a floor under worst-case scenario projections. With both Congress and the Federal Reserve vowing to act in unprecedented fashion in coming months, we believe the long-lived depression fears have been removed from the equation. These actions help explain why equity markets have roared higher since late March, despite horrific economic data during that time.

To begin with a sobering statistic, we have lost 120,000 Americans to COVID during the past three months. It is true, the vast majority of deaths were the most vulnerable and infirmed in our population, but the sheer number is devastating. The US economy – measured by change in GDP – is expected to show a decline of anywhere from 25-50% when the data is released in late July. We have never seen a contraction as sharp and severe as that. With this as a backdrop, many are surprised by the extremely strong performance of US equities during the quarter. The benchmark S&P 500 Index rose by 20.5% during the quarter, the best quarterly return since 1998. The S&P 500 at one point rose nearly 45% from its March lows through early June before giving back some gains into quarter-end. The strong gains during the quarter brought the year-to-date return to -3.8%.

Fixed income yields stabilized during the quarter, albeit at extremely low absolute levels. Rates on the benchmark 10-year US Treasury note ranged between a high of 0.90% and a low of 0.58% during the three month period, before ending June at 0.65%, just below the 0.70% yield on March 31, but well below the 1.92% yield at the end of 2019. The Federal Reserve vowed to keep the short-term Fed Funds rate near zero for an extended period of time to assist the economy as it works to resume growth in the second half of 2020.

Economic and Market Outlook

The question we have heard most frequently is "Why are stocks moving in the opposite direction of the economy?" With the economy showing its largest contraction in history, stocks just recorded their best

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quarter in over 20 years. To begin, stocks are forward looking as investors try to anticipate where the economy and companies will be 6 to 12 months hence. Based on this, it is clear that most investors believe the worst is behind us and improvement lies ahead. A second reason for the rebound is the unprecedented amount of stimulus being pumped into the economy. As we stated earlier, we believe these actions have removed worst-case scenarios from the equation. During the waterfall declines in March, there was little tangible evidence of how bad things could get, and how long the economy would be shut down. As small parts of the economy reopen, business and government leaders learn more and are able to proceed accordingly.

There is an old mantra that says the most dangerous words in investing are, "This time, it's different." However, this time it actually is different. It is different because never before has a government voluntarily and purposely caused a sharp recession. These actions were taken in response to the health risks posed by the COVID-19 virus. Because the downturn was self-inflicted, we remain optimistic the Federal Reserve and Congress can work synergistically to help bring about a rebound. We agree the economic data will look bleak for the next few months. Unemployment is likely near 20% although it is difficult to accurately determine due to the huge number of furloughed workers that may or may not return to their jobs. Conversely, there are already data points showing we have most likely passed the trough. Home sales and housing prices continue to surprise to the upside. Consumer Confidence for June jumped from 85.9 to 98.1, well ahead of the 92.0 estimate. These and other indicators show a consumer ready and willing to spend. Because this recession was not brought about by imbalances or excesses in the economy, it has the potential to rebound much faster than previous recessions. Obviously, the trajectory of the rebound will be dependent on virus outbreaks, treatments, and vaccine development.

Oil prices moved violently at times during the quarter. based on a lack of available storage. Beginning the quarter at $20.48 for a barrel of West Texas Intermediate, oil traded as low as $6.50 before one contract declined below zero for a few minutes in mid-April due to a lack of available storage. As signs of a shorter than expected downturn combined with production cuts, oil prices moved steadily higher for the remainder of the quarter before ending June at $39.27 per barrel. This means oil followed its largest ever decline in a quarter (-66.5%) with its largest quarterly gain in history (+91.7%). This price volatility adds another level of complexity to our economic forecast. We believe the fair price range of $50-70 per barrel in a more normal environment is still accurate. To regain that level, we will need to see a rebound in both air travel as well as more normalized driving habits by Americans.

We have no real visibility into corporate earnings for the next several quarters. Nearly half the companies in the S&P 500 have withdrawn earnings guidance for 2020. We are hopeful as we get towards the latter part of the year, companies will provide preliminary guidance for 2021. At Tandem we are looking primarily at macro data and using that to determine the path of the economy along with corporate earnings. While this helps guide the overall direction, it does little to help one determine what is a "fair" valuation for either individual stocks or the market as a whole. Until we regain some sense of normalcy, calculating target prices for stocks of the market is a fool's game.

Portfolio Positioning

Client portfolios saw modest adjustments during the quarter. We made some adjustments to fixed income portfolios as we adapt to the prospect of extremely low interest rates for the next few years. Equities were strategically added to in some cases where the rapid declines of the first quarter moved

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asset allocation percentages away from desired ranges. We continue to favor growth stocks over value stocks for the next few quarters at least. We remain committed to those companies with strong balance sheets, and diversified customer bases or differentiated product lines. The rapid and significant rebound from the market lows in March reinforced our belief that market timing is a fool's game. Our last commentary counseled, "*Having been in this business for several decades, we counsel that the best thing you can do in volatile times is nothing. This is not always easy, but it removes emotion from the equation. It is seen time and again that investors reach the point of maximum pain very close to market bottoms. If they sell their equities at that point, they have significant difficulty deciding when to get back in, thinking they will get another chance to buy stock cheaply. Unfortunately, this results many times in investors watching stocks rise 10 or 20% from where they sold before they capitulate and buy back into the markets.*" Investors who panicked and sold during the selloff saw prices rebound so quickly, they were unable to get back into the markets fast enough to offset the losses they locked in when they sold.

Conclusion

We were fairly certain equities were undervalued in March, despite some calls for a multi-year depression. After the strong rebound of the past three plus months, stocks are looking more reasonably priced with future price changes dependent on continued improvements in the US and other economies.

As we look through the second half of 2020, we have the added uncertainty of a Presidential election to factor into the mix. Markets can be volatile near elections in more normal years. Adding the COVID-19 uncertainty on top of the elections and the uneven economy we project for the next few quarters results in a crystal ball even more clouded than usual. Volatility in financial markets will remain with us for some time. Investors are much less panicked than they were three months ago. As the summer goes on, economic data along with statistics on COVID will help determine if changes are needed in our strategy and in client portfolios.

June 30, 2020

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