Market Commentary

First Quarter 2021

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The first quarter of 2021 saw an increase in volatility in several financial markets. Although the equity index returns for the full quarter were relatively modest, the indices mask a good deal of turbulence beneath the surface. During the first three months of 2021 we witnessed a rapid rise in longer-term interest rates, continued speculation in SPACs (Special-Purpose Acquisition Companies), Bitcoin and some companies with fading business models such as GameStop and AMC. Many Wall Street professionals have professed surprise at some of these phenomena. We believe the mixture of commission-free trading, user-friendly trading apps, three rounds of pandemic-related checks to consumers, and a large pool of unemployed people with ample free time combined to set the stage for these events.

US equity markets continued moving higher during the first quarter, rising by 6.17% as measured by the benchmark S&P 500 Index, which brought the index total return from the March 2020 lows to 80%. The S&P 500 currently sits 20% *above* its pre-pandemic peak. While most investors focus primarily on equity price levels, the past quarter cannot be properly analyzed without beginning with the US Treasury market. Fixed income yields moved higher during the quarter as investors reacted to positive news on the COVID vaccine. Rates on the benchmark 10-year US Treasury note moved significantly higher during the quarter as investors digested the expected strong economic growth in 2021 as well as the $1.9 trillion stimulus bill passed during the quarter. The 10-year note ended the quarter at 1.75%, meaningfully higher than the 0.92% yield on December 31, and near its highest level since the pandemic began almost 13 months ago. While the Federal Reserve again reiterated its commitment to keep the short-term Fed Funds rate near zero through 2023, we believe economic and inflationary forces will combine to compel the Fed to raise rates earlier than they expect. Additionally, the Federal Reserve has committed to purchasing $120 billion per month of Treasury debt and mortgage-backed securities. We well remember previous market disruptions when the Fed even mentioned slowing or discontinuing the purchase of Treasuries. This is something that will come into focus earlier than late 2023 in our opinion. Debt service remains a concern, although Treasury Secretary Yellen noted that the federal government's interest burden is lower than it was in 2007, even as the ratio of debt to GDP has almost tripled in that time frame. If interest rates, particularly on the front end of the curve were to rise noticeably from current levels, debt service could take an even larger portion of the federal budget.

Oil prices continued their move higher, as anticipation of increased demand from consumer travel pushed prices back to the mid-point of our fair-value range. The price for benchmark West Texas Intermediate rose by almost 20% during the first quarter. After starting the three-month period at $48.52, oil prices peaked near $67 in early March before pulling back to end the quarter at $59.16. This 22% increase during the quarter brought oil prices close to their year-end 2019 level of $61.06. As we have written several times, our fair price for oil in a "normal" economic environment is in the range of $50-$70 per barrel. With oil prices in the middle of that range currently, we will be watching supply changes to see if an adjustment is warranted.

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Economic and Market Outlook
The first quarter of 2021 gave us confidence that a very strong economic rebound will continue through 2021 and into 2022. In fact, current estimates are for 2021 real GDP Growth to approximate 6% which would be the strongest full year reading since 1984. The continued easing in lockdown restrictions is driving rehiring in many industries, particularly the hospitality and restaurant industry which was very hard hit. The Unemployment rate in the US declined to 6.2% in February, with the Fed expecting it to decline below 5% by year-end.

The biggest change in economic and market forecasts over the past 6-12 months has been the 180 degree turn from fear of a depression to concerns of an overheating economy accompanied by runaway inflation. While we were never in the depression camp, always believing the Federal Government and capitalistic tendencies would combine to do what was necessary to get the economy back to a growth trajectory, we are also not overly concerned about significant levels of inflation becoming embedded in the economy. That said, we have gone nearly 25 years since Core inflation (total inflation less food and energy which are always volatile) has surpassed 3% on an annual basis. In fact, the Federal Reserve has spent the past decade attempting to get core inflation to sustainably reach 2%. We expect the combination of a rebound in hiring, extremely low short-term interest rates, and the flood of $6 trillion in pandemic spending will drive inflation modestly higher in the coming months. As we anniversary the worst months of the pandemic lockdowns, we expect to see short-term inflation jump noticeably, likely surpassing 3% for a few months, although this is likely transient and will probably subside by late summer. Fed Chair Powell has said the central bank would view inflation as the result of one-time price changes rather than the start of sustained inflationary pressures requiring the Fed to tighten monetary conditions. Inflation running between 2 and 3% would be welcomed by the Federal Reserve as they work to reduce excess capacity. In fact, we think it would be difficult to see sustained inflationary pressures while the economy is working off the output gap (difference between where the economy is and where it should be).

The significant improvement in economic forecasts will flow through to better-than-expected earnings growth for many companies. The outlook for corporate earnings has improved steadily since last summer and we now forecast S&P 500 earnings to approximate $170 in 2021 with a further increase to $195 in 2022. These forecasts are dependent on expected continued progress on vaccine implementation as well as continued low interest rates. Higher than expected interest rates would be the result of faster than expected economic growth. This could affect the more leveraged and weaker companies to a disproportionate extent. As we wrote in our previous commentary, *"we believe some of the expected returns in 2021 have been pulled forward into 2020. Although there is room for further advancement in US equity prices, we do not expect to see prices rise as much as earnings during 2021."* We continue to believe that equity prices are no longer cheap, and some areas of the market are above fair valuations. This brings us to another discussion point that investors miss frequently. At Tandem, we have long written about our disdain for market timing. It is extremely difficult to judge both when to sell and (more importantly) when to buy back in. At times when valuations seem ahead of themselves, we tend to adjust asset allocations modestly and/or to make internal portfolio adjustments, selling overvalued securities and buying or adding to undervalued securities. In fact, we can think of a sole occurrence where we counseled widespread selling of equities solely due to market valuations. This happened in late 1999 as the dot-com bubble was nearing its peak. Market timing has destroyed portfolios for decades and will continue to do so. A year ago, near the market bottom, we wrote, *"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*

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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." This encapsulates our resistance to market timing, preferring to make internal portfolio changes rather than significant changes to portfolio asset allocation and risk tolerance.

Portfolio Positioning

During the first quarter of 2021, client portfolios saw a continuation of modest asset allocation rebalancing. The sharp rise in equity prices during the last 12 months pushed equity weightings in client portfolios above target levels, necessitating some modest reductions in equities with funds added to fixed income holdings. Some may view this as selling winners and adding to laggards. Rather, this is one of Tandem's bedrock principals of trimming outsized gainers and adding to those with lesser gains as an unemotional method of reducing overall portfolio risk.

We believe equities can move higher during 2021, albeit at slower levels than over the past 12 months. Companies and industries that have been laggards for years have been leading the market higher thus far in 2021. This rotation is healthy and helps reduce some of the speculation in many stocks. As total-return investors, we view dividend growth as a sign of a healthy company and believe stocks with growing dividends could lead markets over the next several months. We remain wary of the increasing signs of speculation in some areas of the market along with an overall upturn in the appetite for risk by many investors.

Conclusion

2021 looks to be a much better and brighter year than 2020. We have seen a large number of questions and uncertainties resolved and the main issue we are focused on is how fast the economy will grow this year. While we at Tandem have been very positive since the depths of the pandemic last March, we now are growing concerned with the overly optimistic forecasts by some and the increasing signs of speculation in certain areas of financial markets. As your risk managers, we adjust client portfolios to each client's individual risk tolerance and strongly advise you to stick to your chosen asset allocation rather than trying to time the market by injecting emotion into the investing equation.

As always, we invite you to contact us if you have any comments or questions about your investments. We always enjoy dialogue with our clients.

March 31, 2021

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