Market Commentary

Second Quarter 2021

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The second quarter of 2021 saw a continuation of the bull market in US equities that began in late March 2020. While the S&P 500 marched higher in each of the three months during the quarter, there was a persistent increase in volatility between stocks and sectors. SPACs (Special-Purpose Acquisition Companies) and Bitcoin saw significant reversals lower during the quarter, while so-called "meme" stocks with dubious business models (GameStop and AMC) continued marching higher. More importantly, investors remained laser-focused on the Federal Reserve and when the Fed will begin to raise interest rates. In our view, Fed watching has far surpassed economic data and corporate earnings as drivers of stock prices. While not necessarily unhealthy, this reliance on a single driver for stock prices removes many of the benefits of security selection as stocks can move in lockstep with each other based on consensus views of what the Fed may do next.

We have believed for several months that the combination of widespread COVID-19 vaccine availability along with an overwhelming amount of fiscal and monetary stimulus would lead to economic growth unseen in decades during the next 12-18 months. Current estimates for US GDP growth in 2021 approximate 6.5% which would be the fastest full year growth since 1983's 7.9% increase. It also compares quite nicely to the average real GDP growth of 1.7% per year the US has experienced since the 2008 recession. Early projections for 2022 show GDP growth of 3.5-4.0% which on its own would be a very strong year. With this is an economic backdrop, it is not surprising to see equities continue to march higher. What is a bit surprising – and somewhat concerning – is the types of stocks that are seeing the strongest returns. Some lower quality companies with leveraged balance sheets have been bid up on little more than speculation, increasing the risk of a less than joyous outcome by some small investors.

US equity markets moved higher during the second quarter, rising by 8.55% as measured by the benchmark S&P 500 Index, bringing the return for the first six months of 2021 to 15.25%. The index has now returned over 96% since the March 2020 lows. Fixed income yields gyrated during the quarter as investors digested positive economic news along with concerns about the Federal Reserve raising rates earlier than expected. Many times during the quarter, strong economic news would push bond yields higher and stock prices lower. This "good news is bad" phenomena would quickly reverse as yields would give up prior gains and stocks would rebound. The 10-year note ended the quarter at 1.44%, lower than the 1.75% yield on March 31 but meaningfully higher than the 0.92% yield on December 31. While the Federal Reserve made rumblings during its June meeting about possibly pulling the first hike in rates into 2022, it has been our belief since last fall that extremely strong economic growth would force the Fed to move earlier than most predict. Our previous market commentary opined, *"we believe economic and inflationary forces will combine to compel the Fed to raise rates earlier than they expect."* As students of the markets, we find it somewhat disconcerting to see forecasts of 6.5% real GDP growth, an unemployment rate predicted to drop under 5% by year-end, S&P 500 earnings growth of 35% and a Federal Funds rate near zero. Under any other circumstances, the Fed would have already begun to raise rates. It goes without saying that the unusual monthly purchases of $120 billion in debt by the Fed should have ended as well by this time. The emergency is long over, yet the Fed continues to keep emergency strategies in place. By keeping its foot on the accelerator, the Fed is endangering not only the long-term

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economy, but also its own credibility. Historically, the "bond vigilantes" would have pushed up long-term interest rates by this point, forcing the Fed to accede to market wishes. But with the Fed monetizing nearly 70% of the budget deficit, it is putting its thumb on long-term rates and doing everything in its power to prevent longer-term rates from moving much higher. The recent budget proposal from the President shows significant distortions from reality as well. Despite unprecedented fiscal and monetary stimulus, the White House budget office predicts *real* interest rates will remain negative for the next ten years! Notwithstanding predictions of full employment by late 2022, they predict inflation will never rise above 2.3% over the next decade. We understand that the President (and Congressional Democrats) need the Fed to keep interest rates very low to reduce the interest burden on the soaring debt levels. Additionally, they need the Fed to continue soaking up the prodigious supply of new issuance caused by deficit spending. When analyzing all these factors, we believe the Fed will be forced to slow or discontinue its monthly purchases of $120 billion in debt as well as begin pushing the Fed Funds rate up at some point in 2022. The last two times the Fed did this, financial markets reacted very poorly over the short-term despite the significant amount of telegraphing done by Fed governors well in advance of any changes. The Fed now has two choices – they can leave rates near zero and continue pumping liquidity into an extremely hot economy, raising the likelihood of inflation taking hold, or they can raise rates earlier than the market forecasts which would likely result in a short-term sell-off in both stocks and fixed income securities. This remains our primary macro concern currently. With all the discussion of inflationary risks, we would be remiss if we did not point out that stocks are one the best asset classes to provide protection from inflation. While bond payouts remain static, companies can raise prices to help offset their rising costs, protecting earnings growth.

Oil prices continued their move higher during the past three months, spurred by a combination of increased travel demand and 11 consecutive months of reduced US oil production. The price for benchmark West Texas Intermediate rose by more than 20% during the second quarter. After starting the three-month period at $59.16, oil prices rose steadily during the quarter before ending at $73.47. The 24% increase during the quarter brought the year-to-date gain in WTI crude above 50% and pushed prices to their highest levels since October 2018. It also moved oil above the top of our fair-value range ($50-70) for the first time in a few years. We expected energy prices to increase as the economy restarted but are uncertain if supply/demand imbalances will persist during the summer months. If supply continues to lag increases in demand, we will raise our fair-value price for oil in the coming months.

Economic and Market Outlook

The economic outlook could not be more different than it was 12 months ago. A year ago, fears of a deep and lasting recession were widespread. Concerns that a vaccine would take years to develop permeated the investment community and economic activity was tepidly starting to resume after a multi-month shutdown. Fast forward to today and we are anticipating the fastest economic growth in nearly 40 years, nearly half the US population is fully vaccinated against COVID-19, and the primary concern is an overheating economy that will force the Federal Reserve to increase interest rates faster and earlier than expected.

We still believe that the recent spike in inflationary readings are primarily transitory, reflecting the rebound from the depths of the economic shutdowns a year ago, a lack of willing and skilled workers, along with numerous and widespread supply chain hiccups. We believe inflation will run in the 4-5%

range for several months, possibly until late 2021. We also believe the Federal Reserve will tolerate this level of inflation for some time, unless and until it believes higher levels of inflation are becoming embedded in the system. As we get into September and the end of extra unemployment benefits, we will begin to get a better sense of the labor market and where wage growth will be headed in the next few quarters. This should help alleviate supply chain issues along with increasing hours and services in the hospitality industry that has been struggling to find enough workers.

The rapid and significant economic improvement is flowing through corporate income statements as evidenced by rapidly increasing earnings expectations for US companies. Three months ago, earnings estimates for the S&P 500 were $170 and $195 for 2021 and 2022, respectively. Those estimates now sit at $195 for 2021 and $205 for 2022. Our view on interest rates has long been dependent on why rates are rising. If they are increasing because of more rapid economic (and earnings) growth, that is a positive. While higher rates could affect debt levels at the most leveraged companies, these are not the types of companies Tandem has historically bought for client portfolios. In our previous commentary we wrote that US equity prices were no longer cheap. While we still believe this to be true, the excess to fair valuation has mostly evaporated with the rapid increase in earnings estimates over the past few months, with estimates rising much faster than stock prices.

Portfolio Positioning

We continued to execute modest asset allocation rebalancing during the past three months. Equities were trimmed with the proceeds invested in fixed income, maintaining preferred asset allocations in client portfolios. As previously communicated, we sold fixed income to purchase equities in the spring of 2020 after the market sell-off and have been trimming equities to fund fixed income purchases for most of the past nine months to maintain appropriate risk levels in portfolios. We wrote in our last commentary that rather than viewing this as selling winners to purchase laggards, we believe this unemotional adherence to a client's stated risk tolerance and asset allocation provides for both better long-term returns as well as subdued volatility.

We continue to believe equities can move higher during the next 12 to 18 months, although significant gains are unlikely. We are watching economic data to look for potential moves by the Federal Reserve which could cause short-term volatility. Although we do not see the catalyst for a sharp pullback, any time the market nearly doubles in 15 months, one must expect short-term selloffs for any of a multitude of reasons. One phenomenon thus far in 2021 has been the significant dichotomy in returns between value and growth names, particularly over short periods of time. When investors become focused on faster growth, higher rates, and "re-opening plays" they favor value stocks which were laggards for most of the past five years. Conversely, when there is any type of whisper of a slowing in economic growth, rates pull back and investors flock to larger growth companies that had led the market for the past several years. This back and forth is not only frustrating to watch but causes investor angst which can lead to rapid trading and poor investment decisions. We are heartened to see the sizeable increases in many dividends from companies in client portfolios and believe dividends will be an important part of total returns in the coming years.

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Conclusion
2021 is obviously a much better year than 2020 on both the human and economic fronts. Many uncertainties have been clarified in a mostly positive way, and we are in the midst of the fastest economic growth in four decades. The primary concern is if there will be an overhanging cost to all this fiscal and monetary largesse. When everybody becomes positive and euphoric, we begin to look for negative harbingers in economic data. Aside from the areas of speculation we have written about and some extremely optimistic forecasts, we believe the Federal Reserve will be the key driver of macro events for the foreseeable future. We continue to advise sticking to your individual risk tolerance and asset allocation, removing emotion from short-term investment decisions.

Finally, Tandem Investment Partners is completing its regulatory filings with the Securities and Exchange Commission (SEC). Smaller investment advisory firms are registered with the states in which they do business, as we have been. With meaningful growth in both clients and assets over the past few years, we have surpassed the threshold for SEC registration. While this requires more paperwork, reporting and compliance tasks on our end, it is due to each and every one of you putting your trust in Tandem that we have achieved this milestone. We are grateful and say, “Thank You.”

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