TJIM QUARTERLY INSIGHT

Second Quarter 2020

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I feel like I drew the short straw for who must write commentary this quarter. The past two quarters have been two of the most eventful and perplexing in the course of my 20-year career that encompasses the bursting of the tech bubble, 9/11, the great financial crisis, and the past decade driven by significant central bank intervention. I have never seen such a divergence between the economic data and the corresponding market action - the unprecedented plunge in Q1 (down almost 34% in just over a month), and the powerful recovery in Q2 driven primarily by Powell's printing press and purchasing promises, all while a pandemic proliferates. Upon pondering a plethora of points to pontificate, performing perfunctory preparation poses problems of preferred positions to pursue, I picked a plurality of primary points to present.

Pandemic – If you've seen any news coverage at all, you are familiar with the Coronavirus or Covid-19 pandemic that is plaguing the population. As of this writing, there have been over 10 million documented cases worldwide and over half a million deaths with the US approaching 3 million cases and over 130,000 deaths. In an attempt to slow the spread of the virus or "flatten the curve" if you will, countries around the world have implemented shutdowns of many businesses, churches, schools, and other institutions where people come in contact with other people. This has created considerable economic upheaval as companies have been forced to shut their doors, forego revenue and potentially layoff or furlough employees, which in turn impacts tax revenues. In addition to the many places that have been shut down, governments are urging (and often mandating) that people shelter in place, which is changing the way people work and live, and will likely have far reaching repercussions for years to come. As the US economy continues to reopen on a state by state basis, we are beginning to see a resurgence of cases, which may lead to some additional preventative measures that delay economic recovery, and at the very least impact consumer behavior. At last count there were over 250 potential vaccine/treatment candidates, but if history is any guide the road to developing and manufacturing an effective vaccine is long and arduous with an average 10 to 15 YEARS to market. Experts are optimistic that we may see an effective vaccine or treatment for Covid-19 within 12 to 18 MONTHS given the huge amount of resources devoted to it. Absent a vaccine or effective treatment many aspects of daily life will likely be altered for the foreseeable future.

Powell's Preventative Printing and the Payroll Protection Plan – Both monetary and fiscal stimulus measures have been peerless in their speed, size, and scope. The Fed's balance sheet ballooned from just over 4 Trillion in early March to over 7 Trillion by mid-May. So, it grew 3 Trillion dollars in less than 3 months. For comparison it took over 5 YEARS for the Fed balance sheet to grow 3 Trillion during the financial crisis (08-13), which at the time was unprecedented growth as the Fed balance sheet was under 1 Trillion prior to that. In addition to the magnitude of monetary easing there has been a significant broadening in scope. Historically, the Fed has primarily purchased treasuries and mortgages to implement quantitative easing, but they recently added credit line facilities for corporate loans, money market liquidity lines, the paycheck protection program, main street lending, municipal lending, central bank liquidity swaps, commercial paper lines, and the direct purchases of corporate bonds and bond ETFs. Even just the anticipation of direct fed purchases of corporate bonds has had a huge impact on corporate bond pricing and the ability of companies to issue new debt. Initially credit spreads blew out across the credit spectrum with 10-year A rated credit spreads more than doubling from early March until fed purchases were announced. Spreads then swiftly tightened about 100 basis points within 3 weeks and have continued to grind tighter since. In addition to significant monetary stimulus from the Fed we have also seen significant stimulus on the fiscal side with the Payroll Protection Plan, (one-time?) stimulus payments, and a significant short-term increase of unemployment benefits and broadening of eligibility.

Pricing – Most markets are expensive on nearly whatever metric you want to use – Stocks are expensive as a multiple of earnings or book value, bonds are expensive on absolute yield levels, credit spreads are tight and yield curves are pretty flat, Gold is nearing all-time highs, etc. However, the expensiveness on the stock side is primarily focused on the growth side of the market, where many large constituents trade at multiples north of 30x earnings, and a handful trade at triple digit multiples of earnings or huge multiples of revenue for "growth" companies that don't have any earnings, yet. On the value side of the ledger there are some compelling valuations that we believe set value up for very attractive risk-adjusted returns relative to growth over the next decade. To illustrate the point, I looked at every company within the S&P 500 that had trailing 12-month net income of at least 10 billion. There are currently 27 companies that meet this admittedly high hurdle. Of the 27 stocks, TJIM owns 15 of them across our two equity portfolios, which tend to own mostly value stocks. The 12 stocks that TJIM doesn't own tend to fall into the growth category. Collectively, the 15 stocks that TJIM owns have a combined market cap of 4.2 Trillion and net income of 296 Billion, for an aggregate Price-to-Earnings (P/E) ratio of 14.3x. The 12 that TJIM doesn't own collectively have a market cap of 6.9 Trillion and an aggregate net income of 242 Billion for a P/E ratio of 28.6x. Our mega cap stocks are trading at roughly half the earnings multiple of the "growth" names. We believe this sets us up for attractive equity performance going forward. In the short term (i.e. 1 to 2 years) valuation doesn't have a very high (negative) correlation with equity returns, but as the time horizon lengthens toward a decade there is a very significant relationship between starting valuation and 10-year forward returns with lower valuations performing considerably better.

Politics – The governing party can have a significant impact on business conditions with regulations and taxes being the primary levers. Spending priorities can change drastically depending on party – defense vs. social spending or private vs. publicly funded healthcare for instance. If recent polls are any indication, we may be looking at a drastic change in political control over the next year, which could have substantial market impacts. We are monitoring the situation and making adjustments as appropriate.

Protests – So far, significant social changes have been at least initiated by the protests – removal of symbols, statues, and media deemed to be racist or offensive. Companies are beginning to review their diversity policies in theory and practice and a hard lens is being placed on the actions of police officers, specifically in regards to interactions with people of color. This will likely have significant societal impacts for years to come.

Provisioning – The change in economic trajectory due to pandemic lockdowns was very abrupt, which led to significant provisioning for loan losses at banks. Due to accounting convention and stimulus measures the actual realized losses may not occur for another quarter or two, and the banks may have over or under provisioned. The impact on banks is still highly uncertain given the speed and magnitude of the economic recovery and the potential for more fiscal stimulus. However, this time the large US banks came into this crisis better capitalized and more liquid than they have been at any point in history and they have strong market liquidity support from the Fed.

Portfolio Positioning – As is usually the case, our stock portfolios are comprised of a diversified mix of high quality, "essential" businesses that should perform well whether we remain in lockdown or if the economy reopens quickly with a strong focus on price paid. We are holding higher than normal cash given the huge amount of uncertainty surrounding the longer lasting impacts of the pandemic and the associated shutdowns, but we are diligently searching for attractive places to put cash to work. On the fixed income side our portfolios are conservatively positioned with a shorter duration than the index and a higher than benchmark weighting in treasury securities. As opportunities have presented themselves on the corporate side, we have reallocated capital from the safety and liquidity of treasuries into the higher yields offered by high quality corporate issuers and may continue to do so if/when pricing dictates.

As always TJIM appreciates the trust you place in us, and we will continue to be prudent stewards of your capital by building diversified portfolios of high quality securities that we believe will provide attractive risk adjusted performance going forward.

Sincerely
TJIM Investment Team

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Footnote: This material has been prepared and approved for existing clients and financial consultants.

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