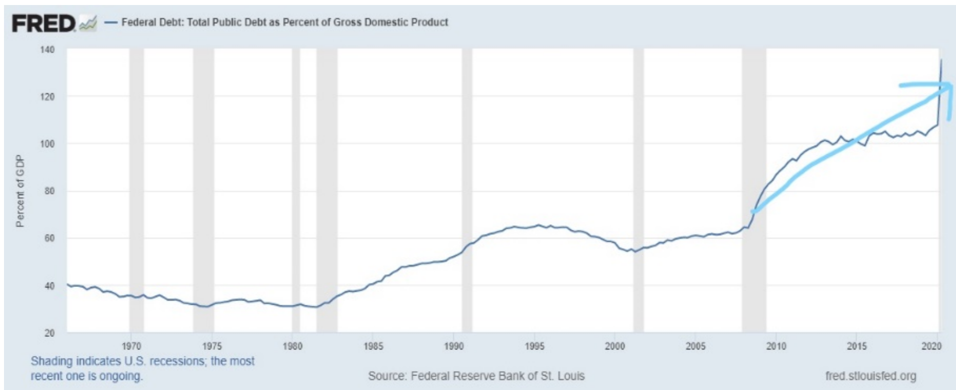
TJIM QUARTERLY INSIGHT

Third Quarter 2020

Tom Johnson Investment Management, LLC

"This time is different." A short and seemingly innocuous phrase that, when applied to financial markets, has enormous wealth destroying potential. When one hears an investor use the phrase "This time is different", the immediate response should be one of skepticism. You see these four little words are often used to make all sorts of irrational and emotion driven investment decisions. Of course we've known about this dynamic for a very long time, way back in 1933 John Templeton wrote in the *16 rules for Investment Success;* "The investor who says, 'This time is different'…has uttered among the four most costly words in the annals of investing."



Since the beginning of the Great Financial Crisis (2008 recession) governments around the world have engaged in ever loosening monetary policy. Domestically, federal debt as a percentage of GDP has risen from approximately 60% in 2007 to approximately 120% of normalized GDP by the end of the second quarter. It goes without saying that personal finances are vastly different than government finances, investors are not lining up to lend me 120% of my income uncollateralized; however it must be recognized that all government borrowing is not created equal. If an increase in borrowing results in a subsequent increase in GDP, then the debt is productive and easily serviceable. However, if the increase in borrowing does not fund new growth but instead the new borrowing is to avert some sort of a financial or human calamity, then the new debt becomes a burden as interest and principal payments become more difficult to service.

As mentioned above, this is not a purely domestic issue either. For the past decade central banks around the world have been engaging in this sort of loose monetary policy. Essentially the world has been on financial life support.

To perpetuate the analogy, the patient was doing okay, but years of life support left them with mounting medical bills; thus, susceptible to a disruption in income. Enter 2020 and the most severe global pandemic in 100 years. In June, the World Bank forecast the global economy would shrink by 5.2% this year… "with the largest fraction of economies experiencing declines in per capita output since 1870." ("COVID-19 to Plunge Global Economy into Worst Recession since World War II", 8 June 2020, https://www.worldbank.org/en/news/press-release/2020/06/08/covid-19-to-plunge-global-economy-into-worst-recession-since-world-war-ii)

With most global economies experiencing recession in synchrony, there is no bright spot to help bring the economy along while we regain our domestic footing. A global recession, coupled with a rapidly rising debt load as percentage of GDP, can result in a large rift between the growth the economy is capable of and a lower level of growth or decline the economy realizes. This rift, known as the deflationary gap in economic parlance, is kind of like Jim Brown retiring as the NFL's all-time leading rusher at age 29!

Now how would one expect the equity markets to digest the current prospects for economic growth? Well this time is truly different indeed! Because in the face of all that, the S&P 500 was up 9% in the 3rd quarter (and about 5.5% for the year).

To be clear, while it is true that the market as a whole is up 5.5% this year, those returns are not broadly distributed. Many sectors remain in negative territory, including both Oil and Gas as well as Finance, which are down 48% and 19.9% respectively. In fact, 2020 is an exceptionally narrow market in terms of stock performance. If one were to strip out the returns of the Tech sector and Amazon, the S&P 500 would be down about 3.7%.

Significant outperformance of a select few equity securities has also exacerbated the divide between equity styles. While the S&P 500 index is up 5.5%, S&P Growth index is up 20.6% while S&P Value Index is down 11.5%.

To compound the issue, one of the central tenets of diversification now has limited power to protect investors if we were to see a marked decline in the equity markets. Earlier this year, mid-February to late-March, the S&P 500 fell by about 34%. However, investors with appropriate portfolio diversification received somewhat of a salve in the form of Treasury bonds. The diversification power of government bonds, which in times of stress tend to benefit from a "flight-to-safety" trade, was on full display as the 10-year US Treasury Notes, over the corresponding period, returned about 7.65%.

Unfortunately, the landing strip for this flight-to-safety trade has become truncated. For Treasury Notes to increase in price, the amount of income the investor receives from the security must fall. In order to achieve the returns mentioned above, the yield on the 10-year treasury fell from 1.56% to 0.78.

These extraordinary market dynamics are coupled with extraordinary uncertainty regarding many economic forces. Of course, the most immediate source of concern pertains to COVID-19. What will winter and spring have in store for us? But more long-term issues include: Trade with China, the election, tax policy and the aforementioned debt garnered to stop-gap the economy while we social distance.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With very low long-term rates and very elevated equity valuations, TJIM will add positions in selective opportunities across attractively valued equities, long-term Treasuries and corporate bonds. However, our overall equity portfolio positioning will likely remain consistent with a focus on high-quality companies that we feel will be resilient to, or benefit from, changes in these economic forces. Similarly, we will maintain a lower duration than the index in our fixed income portfolios, with a lower allocation to lower A rated corporates and higher allocation to higher quality A rated corporates and Treasuries.

As always TJIM appreciates the trust you place in us, and we will continue to be 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

201 Robert S. Kerr, Suite 510 ✧ Oklahoma City, Oklahoma 73102
Telephone (405) 236-2111 ✧ Fax (405) 236-2008

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