TJIM QUARTERLY INSIGHT

Third Quarter 2021

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Flation, Duration & Valuation Bifurcation, Will We Default on our Obligation?

Flation – Historically "flation" has been used half mockingly as a short-hand for price changes – either inflation (rising prices), or deflation (declining prices). A recent news story from Reuters outlined 5 recent types of "flation" – gasflation, chipflation, foodflation, greenflation & wageflation, but recently nearly all pricing pressures are to the upside, so inflation is the concern of the day.

Gasflation – Natural Gas prices are spiking as we move away from coal and gas becomes the "base" load as the more intermittent renewables become a larger part of energy generation. Power outages in China are causing supply constraints in basic goods increasing prices. A confluence of factors is driving up gas prices in the UK – limited gas storage, lower than average production from wind, increased carbon prices reducing coal usage (increasing gas demand), reduced Russian gas supplies, and a very cold winter in Asia driving up LNG import prices.

Chipflation – If you have been in the market for a car lately, I'm sure you are very familiar with the "chip shortage", which has been constraining the supply of new cars, thus driving up the price of both new and used vehicles. Due to chip supply constraints pricing on available chips is increasing. A big reason for the chip shortage for automobiles seems to be driven by the fact that the automakers overwhelming use chips manufactured on old fabs that the chipmakers aren't keen on building out new capacity on obsolete tech. I saw a quote from Volkswagen's CEO that a $0.50 chip is keeping them from being able to sell a $50,000 car, and a corresponding but telling quote from Intel's CEO that he would sell carmakers all the 16nm chips that they want. From Fortune "the automobile is simultaneously the world's most expensive consumer good and the one that runs on the cheapest possible semiconductor chips." Another prediction from Pat Gelsinger at Intel sums this up nicely - currently semiconductors make up 4% of the cost of a car, but by 2030 this is likely to rise to 20%, which will happen as cars become more sophisticated and use higher tech chips. Interestingly, semiconductor chips are the world's fourth most traded good after crude, refined crude, and cars, so the effects of the shortage are likely to continue to be widespread. Estimates are for this mismatch in supply and demand to remain until the middle of next year.

Foodflation – Global food prices rose 30% year over year in August per the UN's Food and Agriculture Organization (FAO) Food price Index. Cereals were up over 30% YoY, dairy was up over 13% YoY, sugar notched its fifth monthly gain, and meat prices were up over 22% YoY.

Greenflation – Tighter regulations on the transition to a more environmentally friendly policy are creating supply shortages as older, higher polluting factories, vehicles and mines are either priced, fined or forced out of business. European carbon emission allowances prices have doubled this year to 65 Euros per ton. Morgan Stanley estimates that a price of 100 Euros per ton would lift European retail power prices 12%, which would increase Euro zone inflation by 0.35% YoY. Shipping rates are climbing as new ship orders are being delayed or derailed in response to upcoming rule changes on fuels. A proposed $1500/ ton tax on methane would pass through to higher natural gas prices.

Wageflation – Historically rising wages tend to have the largest impact on inflation. In the US at least, wage inflation has been muted for the past couple decades, spending most of the time below 5%, however the past 4 months we have seen prints above 10% YoY. Abundant anecdotal evidence points to the fact that it is currently very difficult to hire workers – any workers, but especially in the service industry and wages unsurprisingly are going up. This trend has likely been exacerbated by significant direct stimulus payments and the concurrent broadening and increasing of unemployment benefits.

Duration – Duration is a measure of interest rate sensitivity, traditionally used for fixed income risk measurement. Simplistically, it is a measure of how long it will take for an investment to pay back your initial investment. For bonds it has the nice convenient feature of giving you a very quick idea of what the price performance of your bond or bond portfolio will be for a given change in interest rates. If a bond portfolio has a duration of 3, and interest rates go up 1%, your bond portfolio will be down roughly 3% (duration * the opposite of interest rate move)-- conversely if rates go down 1% your bond portfolio would be up 3% in price.

In recent markets duration has been a pretty good indicator of equity performance as well. Given that future cash flows from equities are much less certain than bonds, you can't calculate a precise duration, but you can make a decent approximation. The longest duration stocks would be the high multiple stocks where most of your cash flows are expected to occur in the distant future – this would tend to be stocks with limited current earnings but high expected growth rates and presumably dividends in the (often distant) future(some high growth expectation companies also have high current earnings, just not relative to their market valuation – Amazon for instance had over 20 Billion in net income in 2020, but income pales in comparison to their 1.6 Trillion dollar market cap – absent any growth it would take 80 years of income to equate to their market cap!). In recent years these stocks have tended to do well when interest rates decline and poorly when rates rise – just like a long bond. The Nasdaq 100 or most of the growth indexes are a reasonable proxy for these types of companies.

On the other side of the coin are the low duration stocks which tend to have lots of earnings, cash flow and dividends now, and lower growth expectations, which investors are willing to pay lower multiples for, thus your payback period (and duration) are shorter. These stocks have performed better in relative terms when rates are rising and have lagged as interest rates declined. The Dow Jones Industrial Average or any of the value indexes are a reasonable proxy for these companies. In our view the synthetically low interest rates engineered by the fed to stimulate a pandemic-addled economy are temporary and have resulted in the systemic overvaluation of companies with high growth expectations, and undervaluation of highly profitable dividend paying companies with more reasonable growth prospects. We believe that as the Fed tapers and interest rates begin to normalize that our portfolios are well positioned to perform, and many growth investors are likely to be disappointed.

Valuation – Time to dust off an old word from markets past – bifurcation – cut into two. The equity market is currently highly bifurcated with some stocks trading at astronomical valuations in the top decile or percentile of historical ranges, while other stocks aren't trading that far away from long term averages. Many market pundits seek to justify the valuation gaps with term like FOMO (Fear of Missing Out) or TINA (There Is No Alternative (to stocks)), or as alluded to in the prior paragraph, with lower interest rates or lofty growth rates justifying higher stock (or other asset) prices. While looking up a "hopes & dreams" metric for measuring how much of a company's current valuation is based on future growth, I came across the following excerpt from Burton Malkiel's "A Random Walk Down Wall Street" – "What is hard is to avoid the alluring temptation to throw your money away on short, get-rich-quick speculative binges." Then he goes on to describe how a friend built a modest stake into a small fortune buying a stock called "Alphanumeric", which promised to revolutionize the method of feeding data into computers. Malkiel "begged" his friend to investigate first whether the huge future earnings that were already priced-in could be achieved given the size of the market (of course the company had ZERO current earnings). The friend thanked him but dismissed it by saying that stock prices weren't based on "fundamentals" like earnings and dividends (sound familiar?), but that they were based on hopes and dreams. His friend rushed in and bought more at $80. As you can probably guess it didn't end well– the stock plunged to $2 per share, and the friend's fortune declined to less than he originally started with. Burton's closing advice is as salient today as it was then – **"The ability to avoid such horrendous mistakes is probably the most important factor in preserving one's capital and allowing it to grow. The lesson is so obvious and yet so easy to ignore."**

Back to the "Hopes & Dreams" metric that initially sent me down this path – It is a metric devised or adopted by Bloomberg columnist, Cameron Crise. He defines Hopes & Dreams as all the valuation or market cap not captured by Book Value (Assets – Liabilities) + the Net Present Value of 5 years of net income. He then takes the "Hopes & Dreams" component to determine what % of a company's current market cap is made up of distant (i.e., 5 years out) earnings. To illustrate, I compare Intel & Amazon. Intel has a 216-billion-dollar market cap, a book value of approximately 81 billion, and net income estimates that total 97.5 billion dollars over the next 5 years (For simplicity, I used the undiscounted estimates rather than net present value). 216B – 81B book value – 97.5B earnings = 37.5B in "Hopes & Dreams", which 37.5B/216B means that just 17.4% of Intel's current valuation is based on Hopes & Dreams. Amazon has a 1.6 Trillion dollar market cap, 93 billion in book value, and net income estimates of 307.7 billion over the next 5 years. Doing the same math for Amazon, gets you to 1.214 trillion in hopes and dreams or over 75% of their current market cap. Even the hopes & dreams method is often using optimistic forecasts for the 5 years estimates (for Amazon net income estimates in year 5 are roughly 3x 2020's actual realized net income, while Intel's net income is forecast to be roughly flat).

Obligation – Hopefully by the time you read this we have resolved the issue, but as I write this congress is engrossed in a battle for raising the debt ceiling, significant spending on infrastructure and other priorities and how to pay for it. The near annual bargaining chip of the "debt ceiling" has once again come into play, and the minority party always wants to put the onus of raising the ceiling on the ruling party, so they can blame them for profligate spending. I always anticipate that this is nothing more than political theater, but if the US were to default on their obligations in a more than technical manner, there could be significant economic fallout. I am always hopeful that there are enough adults in the room to realize this and avoid any significant calamities.

The market's appetite for risk appears to be wavering, but there is little doubt that hopes and dreams are being priced into certain stocks for earnings far off into the future. In response, we continue to believe that the best way to navigate volatile markets, "flation", and achieve long-term capital appreciation is through a diversified portfolio of high-quality equities and fixed income.

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
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