TJIM QUARTERLY INSIGHT

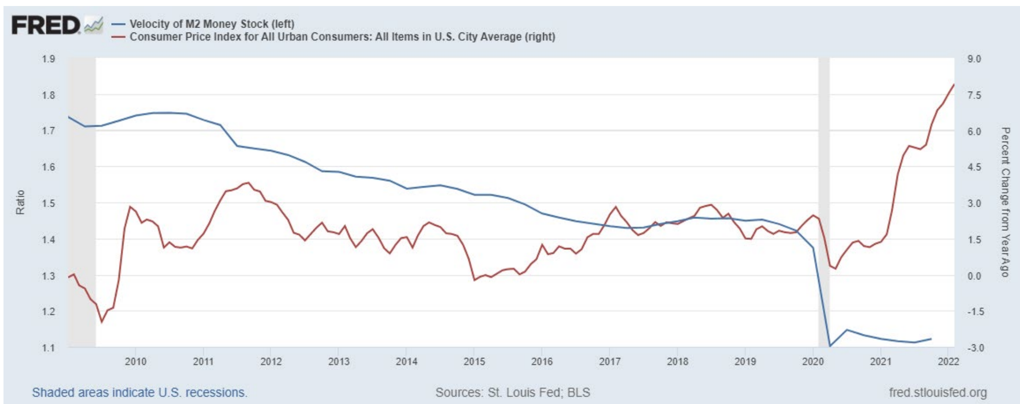
First Quarter 2022

Tom Johnson Investment Management, LLC

For the past decade plus, the Federal Reserve has taken an extraordinarily accomodative stance regarding monetary policy. The Fed Funds Rate (or the rate at which banks lend to one another) has been at or near zero for the last 13 years, rising only modestly from late 2015 until mid 2019, when the Fed put the economy back on life support, subsequently cutting the Fed Funds Rate back to zero by mid 2020.

Perhaps a more drastic and potent policy, in addition to maintaining a Fed Funds Rate of near zero, the Fed has conducted a massive bond buying program. Since the Great Financial Crisis (2008) the Fed has vacuumed up Treasury, mortage and government agency bonds. Over this period they have grown their balance sheet from roughly a trillion dollars in 2008 to the roughly $9 trillion behemoth, it is today. The theory behind this program is to increase the liquidity in the economy by increasing the total money supply, thereby supporting the economy by decreasing the cost of financing.

The Quantity Theory of Money suggests, ceteris paribus, the increase in money supply should have resulted in a corresponding increase in prices. Well, inflation remained stubbornly low; the inflation one would expect to see from such a drastic increase in money supply was neutralized by an equally drastic decline in the velocity of money. This relationship is illustrated in the below chart, with velocity as the blue line and inflation represented by the red line. Velocity essentially measures how often a dollar is spent. As a result of the decade long decline in Velocity, even though money supply increased significantly over the period, we did not see the commensurate increase in inflation that the Quantity Theory of Money would suggest.



That is, until the last two years, when a combination of global supply chain disruptions and Federal government stimulus led to inflation not seen since the 1980s. The benefits of globalization have served to suppress inflation for the past quarter century. However, over the last two years, the fragility of our global supply chains and the vulnerability of the adoption of just-in-time inventories have been brought to bear by the impact of the global pandemic.

Exacerbating our inventory woes, in a move of aggression, the scale of which has not been seen in Europe in nearly a century, Russia invaded Ukraine. Outside of the human impact of Russia's war in Ukraine, is the economic impact. The war in Ukraine has resulted in price increases in many commodities; especially oil and natural gas, for which Europe relies so heavily upon Russia. This has illuminated a vulnerability that Europe has towards Russia, and commensurate influence that Russia wields over Europe.

It does not require much of a leap to draw a similar parallel between the U.S. dependance on Asia for semiconductors. Semiconductors are of strategic importance to the U.S. as they are a critical component in most durable goods. More importantly, a reliable supply of semiconductors is paramount to our national security; nearly all of our tools of modern defense require semiconductors to operate. Is it wise to outsource

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

TJIM

this manufacturing to another superpower and potential adversary in China? Perhaps not, and with so many discussing “onshoring” plans (manufacturing more here in North America), this may be our new reality. But, just as 3 decades of globalization served to stymie inflation, a trend towards domestic manufacturing won’t come without inflation.

Another significant vulnerability is the global supply of wheat. Combined, Ukraine and Russia export about 25% of the world’s wheat exports. At particular risk is Egypt, who imports about 80% of wheat supply from Russia. A prolonged disruption in supply could cause famine in the country and lead to major social unrest.

The reality is simple, supply chain interruptions have constrained the supply of finished goods to consumers. To compound the issue, government stimulus has enhanced consumer demand. Even normally dovish members of the Fed’s Board of Governors are recognizing the need to aggressively curtail demand in order to stave off persistent excess inflation. Normally dovish Fed Governor Lael Brainard recently said, “Given that the recovery has been considerably stronger and faster than in the previous cycle, I expect the balance sheet to shrink considerably more rapidly than in the previous recovery, with significantly larger caps and a much shorter period to phase in the maximum caps compared with 2017–19.”

Market participants are taking the Fed seriously. The first quarter was rocky for equities. Hardest hit were high valuation growth stocks whose earnings are far in the future and therefor most sensitive to increases in interest rates. These, so called “growth” stocks underperformed “value” stocks, many of which actually benefit from a bit of inflation, by 8.4% in the quarter. Conversely, Energy, the worst performing sector in the S&P over the past decade but a beneficiary of recent inflation, returned almost 39% in the quarter. Information Technology, the best performing sector over the previous decade, lost nearly 9% in the quarter.

Similarly, bond market investors have begun to price in the likelihood the Fed will increase the Fed Funds rate to 2.5%. In the long term, this will create opportunities to realize higher yields on their investments. However, in the short term, investors have seen declines in the value of their current holdings. In the first quarter, the Bloomberg Government Credit index realized the second worst quarter since 1979.

Given the Fed’s current posture and these geopolitical headwinds, we believe conservative positioning remains prudent. With low long-term rates and 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 corporates and higher allocation to 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