TJIM QUARTERLY INSIGHT

Second Quarter 2022

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The second quarter was a weird quarter. Well, not just a weird quarter, but a continuation of a peculiar couple of years. Let's face it, the Coronavirus pandemic has brought to light some strange biases in our society. Of paramount importance for this letter is some quirky investor behavior. Over the period investors have seemed less and less concerned with measurable things like cash flows, book value and cash conversions cycles, and more and more mesmerized by the promises of some futuristic utopia brought on by new technologies, decentralized finance, and…Bored Ape NFTs (non-fungible tokens)?

In May famed technology investor Cathie Wood said, "*Within 6-12 years, breakthroughs in AGI* (Artificial General Intelligence) *could a* (sic) *accelerate growth in GDP from 3-5% per year to 30-50% per year. New DNA will win!"* Confoundingly, statements like this are often met with optimism from investors who fear missing out (FOMO). To be clear 30-50% GDP growth is nowhere near an attainable target, none-the-less her fund has realized roughly $325 million in inflows since this statement.

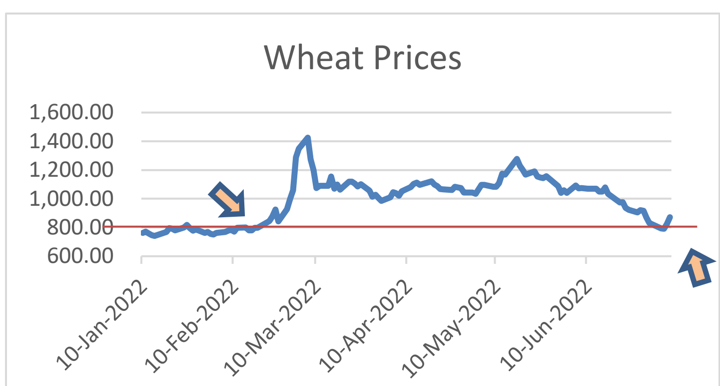
What will ultimately cause the unwinding of remaining excesses? One potential source could actually be fixed income. With the rise in rates there is now an alternative to equities. While the last couple of quarters have been painful for bond investors, higher yields make the future risk/reward for fixed income considerably better from this point forward.

Two years ago, in the depths of the pandemic, the 5-year treasury yielded just over a quarter of one percent. A quarter of a percent to lend the US government money for 5 years is the lowest interest rate going back to 1962, possibly an all-time low.

To illustrate the benefit of higher yields, consider a scenario where an investor puts one-thousand dollars in this 5-year Treasury and rates subsequently increase by one percent over the course of the next year. After one year the bond would be worth $963 and the investor would have realized about $3.00 in income. Good for a total value of about $966 on the $1000 investment, or a total return of about -3.5%.

As of this writing, the 5-treasury has risen from the aforementioned 0.25% to over 3.0% (wahoo!). Consider the same 1% rate rise scenario, but with this much higher starting yield. From this yield the picture looks much more mild; rather than being down 3.5%, our investor is only down about one half of one percent.

In another weird turn of events prices of many commodities have recently fallen sharply. All while consumer prices are soaring. Perhaps falling commodity prices will be a harbinger of falling consumer prices, or perhaps the rout will be short lived and we will see higher commodity prices in the future.



Take, for example, the recent price action in the wheat markets. Russia continues their invasion into Ukraine, explicitly cutting off food supplies. Counter intuitively, while this invasion affects two of the largest wheat exporters in the world (combining for 30% of global exports), wheat prices are actually lower than their pre-invasion levels. Post Ukraine invasion wheat futures spiked from just above $900 to over $1400 and

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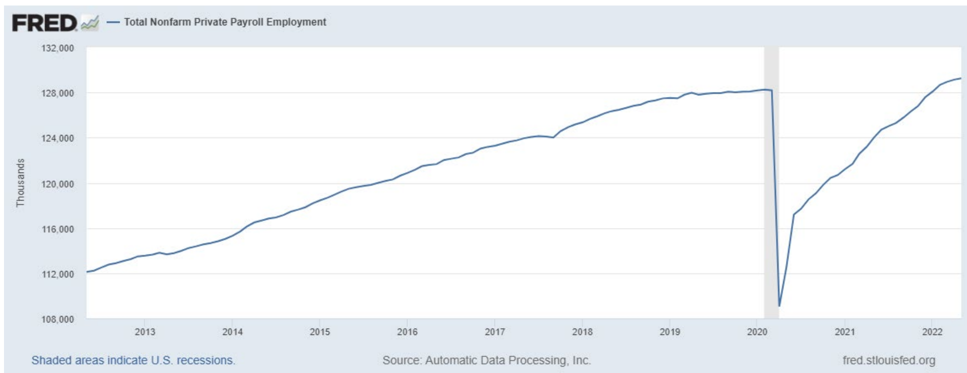
have subsequently fallen back to just below $900. Now, if you are like me and you need food for survival, $900 is not all that comforting considering the 5-year pre-pandemic average was about $475. However, the trend is favorable and we hope to see it continue.

Despite the negative headlines, the economy appears to still be on decent footing for the moment. GDP growth has significantly declined, but some of that is due to base effects from last year's exceptional GDP expansion. Job growth continues to be strong with employers adding an additional 372,000 jobs in June. The unemployment rate remains quite low at 3.6%. Even prior to the June additions, the economy has essentially closed the gap on the pandemic job losses to return to the pre-pandemic trend (see below chart through May).



The strength of the labor market is likely a good indication that the Federal Reserve has some runway to further raise rates without significantly impacting their mandate of maintaining the maximum rate of *natural* employment.

It might be useful to define the word "natural" as it pertains to employment. Maximizing *natural* employment is not the same as achieving an unemployment rate of zero. This rate represents how low the unemployment rate can go with a fully functioning economy. Even when the economy is fully functioning the unemployment rate would never reach zero, there are all sorts of structural reasons why certain cohorts may be temporarily out of work (skill set obsolescence, relocation, family planning, etc.). So, economists consider some rate of unemployment to be unavoidable, this is the natural rate of unemployment and can be thought of as the maximum unemployment rate irrespective of cyclical economic factors such as recession.

With quantitative tightening and federal funds rate hikes on the horizon, we think rising rates from here is a likely scenario. But what rates and by how much are important. We will likely take some prudent steps to take advantage of higher rates and wider credit spreads while also maintaining an eye to Federal reserve actions and economic conditions. Rates across the yield curve are not likely to move in lockstep, perhaps some parts of the yield curve may come down from here if the domestic economy enters a deep enough recession.

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

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