TJIM QUARTERLY INSIGHT

Third Quarter 2022

Tom Johnson Investment Management, LLC

It has been a rough start to the year. The S&P is down nearly 24%. The Bloomberg Government Credit bond index is down over 15%. When markets are down these two asset classes don't normally move in tandem, so we haven't seen the full benefits of diversification this year. So far, this year has been the worst year for bonds – ever – primarily due to rates starting near zero. It's also the 2nd worst start for a balanced 60% equity / 40% fixed income portfolio since the great depression. While TJIM's conservative positioning has reduced the downside and placed us ahead of all our benchmarks on a relative basis YTD, we haven't avoided being negative for the year.

Rising interest rates have been the primary driver of declining asset prices. The discount rate for valuing essentially all assets has increased. Higher discount rates should lead to lower asset values, whether it be stocks, bonds, or real estate. A move to a more "normal" interest rate environment is causing some rationalization – investors can't continue to assume that companies will be able to borrow near unlimited amounts of money at near zero rates. Start-ups and prior highflyers must show some sort of path to profitability and cash flow as they won't be subsidized by venture capital indefinitely. We have seen overly optimistic earnings estimates moderate significantly as the effects of stimulus and the pandemic reopening wear off.

On the bright side - we have gone from TINA to TARA – There Is No Alternative (TINA) to stocks to There Are Reasonable Alternatives (TARA). Depending on the day, investors can now get over 4% buying US treasuries of various maturities, and even 5% is easily achievable in high quality corporate bonds. To achieve similar yields last year required taking significantly more risk by investing in long maturities *and* below investment grade quality. The further you went out on the risk scale last year – the more you have been punished this year – it reinforces the old Raymond Devoe, Jr. quote – "More money has been lost reaching for yield than at the point of a gun."

The Fed is raising rates at the most aggressive pace since the early 80's when Paul Volcker was Fed chair. The fed funds rate has gone from essentially zero to 3.25% this year with another 1.25% anticipated. The market currently swings wildly based on the anticipation of an eventual Fed "pivot". However, Fed governors and their language have remained hawkish even in the face of declining stock and bond markets. At this point we believe that the Fed's credibility is at stake, and they must continue tightening and/or remain restrictive until we see inflation back near their 2% target.

On top of the Fed raising interest rates, they have also begun to shrink the balance sheet, which in contrast to quantitative easing (QE) has become known as quantitative tightening (QT). They began QT in June by not reinvesting the proceeds of maturing bonds (runoff) at an (intended) pace of $17.5B in mortgages and $30B in treasuries per month and reached maximum runoff of $60B in treasuries and $35B in mortgages per month in September, which will continue for somewhere in the vicinity of 20 to 26 months from here (based on Powell's initial guidance of 2 to 2.5 years). In our opinion, this really is the big wildcard. We have seen multiple cycles of federal reserve rate hikes, but we have never seen the significant unwinding of the balance sheet that we will see over the next two years. At the $95B monthly run rate, we should see the fed balance sheet decline over 1 trillion dollars per year and somewhere in the vicinity of $2.5T overall. We did see the fed shrink the balance sheet back in 2018 from roughly $4.5T to $3.8T, but after equity markets retreated significantly the fed reversed course, stopped raising rates and began buying again by late 2019. A similar pivot is what markets seem to be anticipating on big up days, but we expect it is unlikely to come until inflation has been objectively vanquished.

A potentially useful, but admittedly grossly overly simplistic way to gauge the potential impact of QT on markets may be to see what happened during quantitative easing (QE). When QE began in 2008, the total market cap of US stocks was around $15T (as represented by US exchange listed holdings) and US investment grade taxable bonds were around $11T (as represented by the Bloomberg US Aggregate bond index). The Fed balance sheet was just under $1T at the time. By the end of 2021 the market cap of US listed stocks had grown to $54 trillion, and bonds had grown to $27 trillion. So, the market cap of US securities grew from $26T to $81T, while the Fed's balance sheet grew to near $9T. Simplistically for every $1T in Fed balance sheet growth we saw 6.8x growth in securities markets ($55T/$8T = 6.8x). Since year-end the stock market capitalization has declined to $40T, and bond's market cap has decreased to $24T for a total value of $64T, or a decline of $17T from year-end. Coincidentally (or not?), taking the QE/QT multiplier of 6.8 times the $2.5T anticipated balance sheet decline works out to $17T. I realize that there are so many other factors that impact market size – growth, ROE, new issuance, population growth, new businesses, bankruptcies, etc., but for the last decade plus the Fed really has been the dominant factor. Has the market already discounted the full impact of QT? Time will tell.

There is still a very long laundry list of things to worry about – rising rates, QT, inflation, recession, war in Ukraine, European energy reliance on Russia, China/Taiwan relations, supply constraints, strong dollar, high yield debt, emerging markets, housing prices, etc., but most of these are widely known and followed, so absent significant unanticipated outcomes these probably don't pose any greater risk than normal. The two issues that we anticipate have the most potential to surprise to the downside are housing prices (the change in mortgage rates from sub 3% to north of 7% is hardly reflected in current home prices), and the significant potential for sizeable markdowns in private assets, which thus far have not had nearly the valuation adjustment that public market assets have. Given that most of the price adjustments have been due to changes in the risk-free rate, we don't see how investors and auditors can justify not putting similar if not greater mark-downs on private assets whether it be private equity or venture capital, especially when most of the mark-ups that occurred were due to greater and greater valuations paid rather than improving fundamentals.

Going forward – bonds are more attractive than they have been in nearly 15 years based on yield to maturity. Stock valuations are more attractive than they have been in over a decade. On top of a "reasonably" priced market TJIM's stock portfolios currently have one of the most significant discounts to the market we have seen in our near 40-year history and are trading near the lowest absolute valuations ever. We own a broadly diversified portfolio of companies that are paying very attractive dividends. Bargains abound in very high-quality profitable companies with strong cash flows. While there is probably continued elevated volatility in the near term as the market bounces between euphoria and despondency, we believe that our portfolios are as well positioned to generate both absolute and relative long-term returns as they have ever been.

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

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