TJIM QUARTERLY INSIGHT

Fourth Quarter 2022

Tom Johnson Investment Management, LLC

The market enters 2023 at a crossroads. 2022 was the worst year for the S&P 500 since 2008, and the worst year for bonds since 1931. Inflation began an upward spiral after fifteen years of easy money policies from global central banks. The Federal Reserve ripped the band-aid off by hiking rates at the fastest pace in decades to tame the highest inflation we have seen in 40 years. There's been plenty of debate over the precise cause of our current bout of inflation. Supply-chain backlogs coupled with loose monetary and fiscal policies likely shoulder most of the blame.

During spring 2020, these policies appeared very necessary as we stared into the abyss of Covid fear. The $2.2 trillion CARES Act passed nearly unanimously through Congress, and the Federal Reserve acted urgently to prevent financial market collapse by adding $3 trillion to their balance sheet. In December 2020, after multiple effective Covid vaccines and treatments had been approved, and the light at the end of the Covid tunnel was visible, Congress authorized an additional spending bill of $2.3 trillion, which included $900 billion in further pandemic stimulus. To further fuel fire, the Fed continued to grow their balance sheet by an additional $1.5 trillion throughout 2021. For comparison's sake, the 2008 fiscal and monetary stimulus combined totaled $2 trillion. The fiscal and monetary response to Covid dwarfed 2008, but most concerning was that the post-vaccine spending alone was larger than 2008. The system was flooded with liquidity and now the tide is retreating.

2022 has largely been a year about resetting expectations from the bubbly free money highs to a more "normalized" monetary policy. Forward P/E ratios on the S&P 500 have declined from 27 times earnings at the end of 2020 to 17 times earnings at the end of 2022. Almost all of this multiple contraction has been felt on the growth side, as S&P Growth has declined from 30 times earnings to 18 times earnings. P/E contraction was marginal among value stocks during 2022.

The greatest beneficiaries of cheap money have also been the hardest hit. The profitless tech index which tripled from 2019 to 2021 has now given back all its gains. The total market capitalization of all cryptocurrencies has declined from its high of $3 trillion to $800 billion. Most of the market leading generals of the last market cycle have been shot down from their stratospheric highs. The bubbliest growth stocks of this last cycle may not revisit their all-time highs for decades, if at all. Even with the 2022 underperformance of growth, the distance between growth and value stock valuations remains wide. The hedge fund AQR recently observed that the valuations gap remains above the 90th percentile, which is near dot.com bubble highs. For the broad market to march forward the banner will need to be carried by a new group of market leaders.

Coming to the rescue, it has been an excellent year for value stock investors. Exxon Mobil, Chevron, Aflac, Northrop Grumman, Bristol-Myers Squibb, and Merck continue to execute well and hit new highs. Value stocks broadly outperformed in 2022 and had their best relative year since the bursting of the dot-com bubble. After nearly a decade of outperformance of growth over value, this "Revenge of the Value Nerds", as investor Dan Loeb coined it, is a much welcome change.

Unfortunately, there are dark clouds on the horizon. According to the talking heads, the most widely anticipated recession of all time is scheduled to arrive on our doorsteps between Q2 and Q3 of 2023. However, it is nearly impossible to forecast a recession, and whenever consensus becomes this overwhelming, our inner contrarian is tempted to come forward. Here are some market observations that may help handicap recession odds:

Investment grade credit spreads increased during 2022, but they increased from decade lows to long-term averages. Credit spreads were higher for much of 2011-2019, in which we never experienced a recession. Junk bond spreads have also increased from decade lows, but are still well below 2011, 2016, or 2020 highs. If there are any cracks in the credit market, it is on the fringes. However, the Fed showing willingness to backstop the credit markets in 2020 may continue to distort these metrics.

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

An essential ingredient for a recession is a weak labor market. Fortunately, the job market remains exceptionally strong. Initial jobless claims as a percentage of the total labor force hit all-time lows during 2022. While we have begun to see some minor trend reversal, it is clear that the labor force shrank during the pandemic, and it seems unlikely to recover to pre-Covid highs anytime soon. This labor market strength should contribute to “stickier” or longer-term inflation. All of this is occurring while GDP is running hot at 3.2% for 3Q22 with estimates of 3.9% for 4Q22.

Another favorite predictor of a recession is an inverted yield curve. When looking at the 10-year treasury minus the 2-year treasury, the yield curve is the most inverted since the early 1980s. This indicator has had significant predictive power dating back decades. There is a strong market consensus that inflation has peaked. Longer term inflation expectations remain low at 2.2% over the next five years and beyond. The market believes that the Fed still has control of the situation, and the recent increase in Fed Funds rate from 0 to nearly 5% will be short lived. The market currently expects the Fed to pivot sometime around June 2023. The market believes that inflation will have come down softly on its own or we’ll be in a recession. The problem is, nobody told the job market, the recent quarterly GDP figures, or credit spreads about the upcoming recession.

To bring inflation back so quickly would be historically abnormal. Never before has the Fed gotten inflation under control without raising rates higher than Consumer Price Index. Indeed, Philadelphia Fed President Harker recently was quoted saying inflation is known to “shoot up like a rocket and then come down like a feather”. Once the inflation spirals, it doesn’t coil back lightly. We could be fighting this inflation battle for much longer than Wall Street wants to admit and unfortunately Washington never seems to have received the memo, as both 2022 and 2023 budget deficits are projected to be north of $1 trillion.

Fortunately, for longer-term investors, bonds have the highest yields since 2008 in both nominal and real yield perspectives. Real yields, which is the market yield in excess of inflation expectations, are the highest since 2010. Short-term treasuries yield north of 4.5%. For the first time since 2008, investors have a real answer to “TINA” or “There is No Alternative”. There finally is an alternative to equities, and as bond yields remain high, equites have some real competition in the global asset portfolio. This could continue to pressure equities going forward, but we continue to believe that a diversified portfolio of high-quality stocks trading at reasonable valuations are the best hedge against inflation.

Going forward, both equity and bond market expectations have been reset significantly. Both have returned to a degree of normalcy after years of cheap money. This market reset should significantly improve future returns in both equity and fixed income. Much has been written about the death of the 60% equity, 40% fixed income asset allocation over the last few years, but we anticipate this simple strategy is priced to generate attractive returns going forward.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With runaway inflation and credible recession fears, TJIM will selectively add positions in opportunities across attractively valued equities, 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 be looking for opportunities to increase fixed income duration as rates rise and increase corporate bond exposure to take advantage of widening credit spreads.

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

This commentary is provided for informational purposes only and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should always be made based on the investor’s specific financial needs and objectives, goals, time horizon, and risk tolerance. Past performance is not a guarantee of future results. The statements contained herein are based upon the opinions of Tom Johnson Investment Management, LLC.
Footnote: This material has been prepared and approved for existing clients and financial consultants.

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

TJIM