

TJIM QUARTERLY INSIGHT

First Quarter 2023

Tom Johnson Investment Management, LLC

The first quarter of 2023 was one of the wildest in recent memory, with the stock market experiencing significant volatility and uncertainty. The market started the year on a bullish tone, with investors optimistic about the potential for economic growth and corporate earnings. The optimistic start to 2023 is a clear reversal relative to the more sobering market conditions of 2022. In fact, every single stock in the S&P top 10 by market weight is directionally different to start the year when compared to their 2022 return. That is to say, if the stock was down in 2022 the stock is positive year-to-date, and if the stock was positive in 2022 the stock is negative year-to-date. To illustrate the point, 3 stocks in the S&P top 10 were down 50% or more in 2022, of those 3 stocks only Amazon is not up more than 50% year-to-date. Last year, Nvidia and Tesla declined by 50% and 65%, respectively. This year Nvidia is up 81% and Tesla is up 54%. By contrast, Exxon returned 87% last year, has subsequently declined by about 2% this year.

According to J.P. Morgan, the top performing equity factor from 2022, Defensive, was the second worst performing factor for the first quarter. The only factor to perform worse was Momentum. The Momentum factor is comprised of the best performing stocks for the last 6 and 12 months, as such there is currently substantial overlap between the Momentum factor and the Defensive factor. As for the worst performing factor for 2022? That distinction belongs to the Cyclical, which declined by 27%. Well, astute reader, you guessed it! Cyclical are the best performing sector thus far in 2023.

Conversely, the bond market initially struggled to find a direction during the quarter, as rising inflation expectations and concerns over rising interest rates caused yields to spike. While yields across the Treasury curve were increasing early in the quarter, fixed-income investors faced a challenging environment. As rates on newly issued bonds were rising the value of existing bonds declined. Recall, that bond prices move inversely to market yields.

However, the trend in rising rates violently reversed as losses in the bond portfolio at Silicon Valley Bank (SVB) set in motion a run on the bank's deposits. The bank, which at the time ranked among the top 20 in the US, failed over the course of 2 days from March 8-10 and set the stage for a potential banking crisis.

The onset of a banking crisis can have significant implications for investors and the broader economy. A banking crisis occurs when there is a sudden loss of confidence in the banking system, often triggered by a sharp increase in bad loans or a liquidity crunch. This can lead to a domino effect as banks begin to fail, causing panic among depositors and investors. In this case, there was no concern regarding bad loans at SVB, they simply faced a liquidity crunch as depositors were leaving forcing SVB to sell bonds at losses. Absent the decline in the deposit base, SVB could have held these bonds to maturity and received their full principal.

Typically, with a banking crisis the stock market may experience significant declines as investors become wary of the banking sector. So far, except for financial stocks, no such significant decline has materialized. In fact, the aforementioned equity reversal has only continued. In a measure of how narrow equity performance was in March, the S&P 500 was up around 3.5% for the month while the S&P 500 equal weight was down nearly a percent. This means that on average the 500 companies in the

S&P were negative, but due to the outsized performance by a select few large companies, the index overall performed quite strongly.

Perhaps the actions taken by the Federal Reserve to provide banks with additional liquidity have staved off fears of a banking crisis. The equity market seems to think so; however, the bond market would like a word. The yield on the 2-year Treasury started the year at around 4.4%. It then peaked at just over 5% on March 8th, coinciding with the beginning of SVB's failure. Since that point, 2-year yields have fallen to just under 4%. This implies the bond market is pricing in a significant likelihood the Federal Reserve will cut by year end.

With Core inflation still above 5.5%, the unemployment rate sitting at 3.6%, unit labor costs well above trend and a resilient housing market. Considering the current strength of the economy coupled with still quite high inflation, it is difficult for us to imagine a scenario where the Federal Reserve is forced to cut rates in the near term, without being accompanied by, at minimum, a mild recession. To be clear, we are not calling for a crisis or a deep recession; again, the government acted quickly to provide additional liquidity to banks. It's likely a further slowdown in lending activity would spill over into the broader economy.

The failure of SVB resulted in lower yields and therefore, ironically their failure has resulted in higher bond prices. In a way, they inadvertently "fell on the sword" for other fixed income investors.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With stubbornly high inflation and credible recession fears, TJIM will selectively add positions in attractively valued equities, treasuries, and corporate bonds. Our overall equity portfolio positioning will likely remain consistent with a focus on high-quality companies that we believe 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 remain elevated relative to recent history 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 responsible 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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