TJIM QUARTERLY INSIGHT

Third Quarter 2023

Tom Johnson Investment Management, LLC

We are nearly two years into the worst bear market for bonds in history. To curb inflation, the Federal Reserve has hiked short-term interest rates from zero to 5.5 percent over the last eighteen months. Long-term Treasuries haven't been spared either. Ten and thirty-year Treasury rates have both increased between 3% to 3.5%. While there is never a good time for interest rates to go up when you are an owner of bonds, it's best if it happens quickly, like ripping off a Band-Aid. Fortunately, that is exactly what has occurred.

For the last few years, TJIM fixed income strategies have maintained a significant amount of short-end liquidity. At any given time, TJIM had between 40% and 60% of the portfolios maturing within the following three years. These short-term bonds were mostly shielded from the impact of rising rates, and now those maturities have the benefit of being invested at these much higher rates going forward. All of this has led to both bond models now enjoying their highest yields in more than 15 years. Both strategies have seen significant increases in yield without materially increasing risk. Both now have the highest yields seen since 2007.

To illustrate, here is the 12/31/21 portfolio statistics of TJIM Intermediate compared to 9/30/23.

Characteristic	TJIM Intermediate Model 12/31/21	TJIM Intermediate Model 9/30/23
Yield to Worst	1.05%	5.28%
Duration	3.20	3.23
Government Weight	73%	57%
Corporate Weight	22%	39%
Cash Weight	5%	4%

TJIM model statistics only, actual client portfolios may differ due to individual account circumstances – cash flows, restrictions, tax issues, etc.

The yield on the portfolio has quintupled, but the duration is essentially unchanged. Since the end of 2021, credit spreads on A-rated bonds have also widened by about 35 basis points. Corporate debt has become more attractive, and we've responded by adding exposure to various names that we believe are resilient to economic changes, have well-structured debt, and have either liquidity and/or cash flow to self-finance for an extended period of time.

The TJIM Fixed Income strategy has also enjoyed a significant increase in yield, without taking on significant additional risk. Despite increasing duration relative to the index, overall duration has actually decreased since 2021. Similar to our Intermediate strategy, we've added credit exposure selectively as credit spreads have widened. These corporate bond additions have primarily been on the longer end of the yield curve, where investors are most compensated for taking on this additional credit risk.

Characteristic	TJIM Fixed Model 12/31/21	TJIM Fixed Model 9/30/23
Yield to Worst	1.38%	5.27%
Duration	5.92	5.63
Government Weight	69%	63%
Corporate Weight	26%	33%
Cash Weight	5%	4%

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While this all seems very nice, a question we often receive is "Why bother with longer duration bonds at all when I can get nearly 5.5% on very short-term Treasuries?" This is an excellent question. Long duration bonds carry more price risk, and they should naturally carry a higher yield to compensate for the additional risk. Currently, the yield curve is inverted, meaning the term premium for longer bonds is actually negative. This inverted yield curve has historically been a sign that the economy may soon enter a recession. Generally, rates move lower in a recession.

During the last three Federal Reserve tightening cycles, interest rates have taken the stairs on the way up and the elevator on the way down. Once interest rates move back down, owning just short-term Treasuries can present an opportunity cost. Take a hypothetical scenario of interest rates moving from 5% back to 3% over a year. A one-year Treasury total return will be 5% as promised. However, a 10-year Treasury would enjoy a nearly 20% total return over that same year. Since it is exceptionally difficult to time these market tops and bottoms, it is best to stay invested to ensure larger moves aren't missed.

The large move in interest rates has also caused significant dislocations in the equity market. While the S&P 500 continues to appear quite expensive, this is largely being driven by the "Magnificent Seven" mega-cap tech stocks. 2023 has been one of the most concentrated markets in recent memory. Nvidia, Google, Amazon, Apple, Microsoft, Meta, and Tesla have been responsible for over 80% of stock market returns year to date. As a group, they are exceptionally expensive and trade at nearly 50x earnings. With valuations at extremes and the market capitalization on this group in the trillions, it will be difficult for these past winners to continue to drive the market higher. Fortunately, we believe there are still opportunities going forward.

The 2023 focus on "mega-cap" technology stocks has largely left the rest of the market behind. Just as the recent outperformance is likely not sustainable, the underperformance of small-cap, mid-cap, and value stocks is also unlikely to be sustained.

Currently, the difference in P/E ratios between large capitalization stocks compared to mid-cap and small-cap stocks is among the highest we've seen in decades. At roughly 12x earnings, smaller and mid-cap stocks are trading at some of the cheapest valuation levels we've seen since 2008. For longer-term investors, this market repricing represents value. We will continue to look for opportunities to take advantage of these dislocations between large-cap and small-cap stocks along with growth versus value in the upcoming years.

There is plenty to be optimistic about going forward. Valuations have become more reasonable, especially when you exclude the "Magnificent Seven" mega-cap technology stocks. Interest rates have returned to long-term averages, and bond portfolio yields are the highest in decades.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. 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 by investing in corporates with attractive risk-adjusted credit spreads.

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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