TJIM QUARTERLY INSIGHT

First Quarter 2024

Tom Johnson Investment Management, LLC

Is the market beginning to return to rationality? A lot of the baseless runups in asset prices such as various crypto-currencies, NFTs, and Meme stocks have dissipated. Meme stocks are continuing their return to sanity. Gamestop (GME) and AMC have gradually slid back toward reality with GME declining from over 80 to 11 and AMC from over 200 to now at 3. The rise was built on not much more than hype– no growth, no fundamentals, minimal cash flows, etc. However, many assets with underlying fundamental strength that are exhibiting strong near-term growth are still trading with euphoric valuations. The valuations may prove to be justified *if* the recent stellar growth can continue for an extended period, but history shows that investors often grossly overpay for recent growth that proves to be unsustainable and the downside can be significant when disappointments occur. I recently heard Nassim Nicholas Taleb say that shortages are always followed by gluts – the specific quote "I've seen gluts not followed by shortages, but I've never seen a shortage not followed by a glut". We believe this is what we are currently dealing with in AI related infrastructure. The demand for AI compute has been insatiable, but eventually supply from Nvidia or even their competitors will catch up with demand and likely overpower it bringing expectations back to rationality. However, the current cycle may go on longer than we anticipate and there is potentially still money to be made until the momo is nomo (momentum is no more).

We believe that recent demand for all things Artificial Intelligence (AI) is a mix of real potential and hype. There will almost certainly be some significant innovations driven by AI's adoption. However, at this point nearly all the money is being made at the "picks and shovels" level, with Nvidia, Super Micro Computer, Vertiv, and Dell Corp being major beneficiaries as companies scramble to buy up and install AI servers. The pace of innovation is mind blowing if you have been monitoring the improvement in generative AI tools from human like writing, text to photorealistic images, to short text prompts to full videos. Frankly, if you haven't already, I encourage you to play around with some of the free tools such as ChatGPT or Gemini. It will give you a glimpse of how useful and or disruptive this tool could eventually become, but also the challenges with hallucinations (where it just makes things up), abnormal picture generation (AI seems to have lots of issues generating hands with correct fingers), its problems with simple math, and the significant potential to be used for nefarious purposes – election tampering, scam perpetuation, etc.

Moving away from the hype and toward the mundane, there are still plenty of opportunities to invest in high quality companies at attractive prices. Custody banks can currently be purchased at a discount to money center banks when they historically trade at a significant premium. They are generally less credit sensitive and should benefit from higher short-term rates. Pharmaceutical companies are trading with low PE ratios, high dividends, and strong growth prospects. Technology companies outside of the Magnificent 7 should be direct or indirect beneficiaries of the continued expansion of data centers and "compute", while trading at significantly cheaper valuations. Large integrated energy companies are trading at attractive valuations with good dividends and strong growth prospects. Industrial and materials companies are continuing to benefit from a strong economic backdrop. Even while broader markets are somewhat expensive it is still possible to build a high quality, diversified portfolio at very attractive valuations.

On the fixed income side of the ledger, bonds are flattish to slightly negative year to date – the Bloomberg Government Credit Index is down -0.72% YTD at quarter-end and the Bloomberg Government Credit Intermediate Index is down -0.15%, but given yield levels around 5% and absent runaway inflation, we anticipate that bonds will still print a positive total return by year-end. The yield curve is still inverted – it will likely normalize over the next year or two. How it normalizes is important – short-rates down (good for bonds), long-rates up (bad for bonds), a combination of both (depends) or short-rates down more than long-rates (good for bonds) or long-rates up more than short-rates (bad for bonds). Credit spreads have continued to grind tighter as the broadly expected recession hasn't materialized, yet. Currently, the treasury yield curve is inverted with the 2-year yield higher than any other point on the curve, but the corporate yield curve bottoms at 4 years and steepens out to the 20-year. While the opportunity set in corporate bonds is currently narrower than it has been, there are still a handful of relatively attractive credits. We have built our fixed portfolios to take advantage of both high short-term rates (with a treasury overweight on the short end), and the steeper credit curve (by overweighting corporates out on the longer end). For the longer duration fixed portfolio, we have also overweighted the 20-year portion of the curve due to it having a higher yield than both 10-year and 30-year treasuries.

Higher rates are both a blessing and a curse serving as a boon to savers and a burden to borrowers. They are putting pressure on commercial real estate borrowers, specifically office buildings, as work from home is simultaneously pressuring occupancy. We have seen a significant but contained spike in net charge-offs on commercial real estate, but given the large capital bases, huge liquidity pools, and diversified business models, the losses are manageable for the large banks, but could pose problems for smaller, less-diversified lenders where the loans are larger relative to their capital base. We are monitoring the situation closely, looking for both opportunities and threats.

Inflation has been trending in the right direction (down) but may be reaching a stickier point that takes longer to decline. Measures of economic activity appear to be slowly ticking up. Employment remains strong. As of right now, we anticipate that the Fed doesn't have to do anything immediately and will likely cut rates slower than the market anticipates. The market has slowly been coming around to our way of thinking with the yield curve now pricing in 3 or less cuts, down from as many as 6 earlier this year.

As always, TJIM appreciates the trust you place in us, and we will continue to be prudent 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

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