TJIM QUARTERLY INSIGHT

Third Quarter 2018

Tom Johnson Investment Management, LLC

For most of the past decade inflation has remained consistently and stubbornly low. In only two of the past forty quarters has inflation (as measure by Core Personal Consumption Expenditures) exceeded the Federal Reserve's (Fed) stated inflation target of 2%. This past decade, inflation has remained low despite extraordinary monetary stimulus by the Fed to achieve the goal of 2% inflation.

The Fed tried to shake up the economy and employed a zero interest-rate policy, keeping their target interest rate at essentially 0% from 2009 until 2016.

The Fed has twisted; referring to "Operation Twist", a policy in which the Fed bought longer-term bonds and sold short-term bonds in order to lower long-term interest rates and subsequently spur borrowing for things like housing and heavy machinery.

The Fed has shouted; when the Fed announced the third round of Quantitative Easing, Quantitative Easing involves the Fed buying Treasuries in order to increase money supply in the economy and thereby decreasing the cost to borrow, they explicitly conveyed their inflation target by announcing the program would last until unemployment fell below 6.5% or inflation rose to 2.5%.

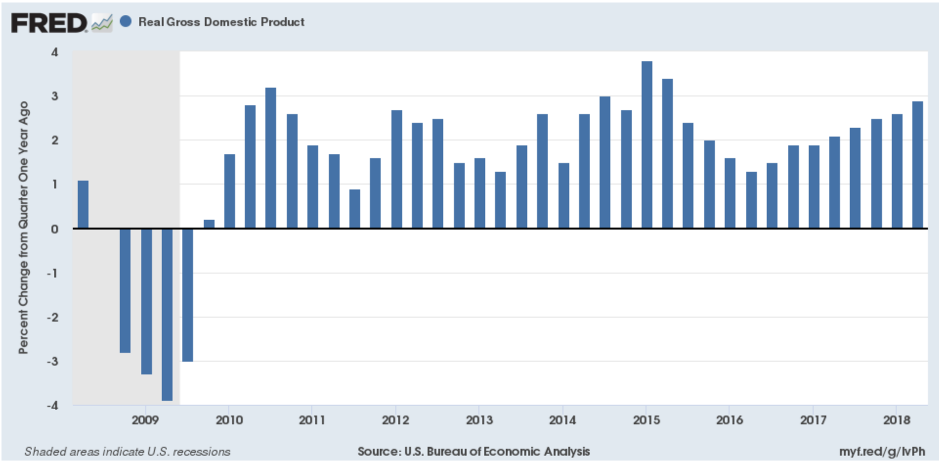
The Fed tried to shake it up with "Quantitative Easing" (QE). The Fed conducted three rounds of QE, and as a consequence increased their balance sheet from roughly $1 trillion in 2008 to a peak value of $4.5 trillion. Additionally, over the same time period, the total money in circulation (as measure by M2 Money Stock) increased from $8 trillion to over $14 trillion.

The Quantity Theory of Money suggests, all else equal, the increase in money supply should have resulted in a corresponding increase in prices. Well, this view turned out to be quixotic; the inflation one would expect to see from such a drastic increase in money supply was neutered by an equally drastic decline in the velocity of money. Velocity essentially measures how much a dollar is used. So inflation remained tame as this new money went largely underutilized.

Paradoxically while the Fed is currently tapering the above-mentioned monetary stimulus, we are now starting to see signs of inflation in multiple aspects of the economy. From 2012 to 2015 the rate of inflation mostly declined, but since that nadir in 2015 (when inflation grew at just ~1.3%) the rate of inflation has steadily increased. Finally, for the first time in six years, in the second quarter of 2018 inflation exceeded the 2% target set forth by the federal reserve.

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

Not surprisingly, as inflation has increased since 2015, so has growth in real GDP. A couple of quarters after the bottom in inflation, real GDP growth was a mere 1.3%. As of the second quarter, GDP growth had climbed to 2.9%. Growth in the neighborhood of 3% represents one of the healthiest numbers in the post-financial crisis era. But more important than the current rate of GDP growth is the trend in GDP growth. Whereas, for much of the post-financial crisis era, acceleration in GDP growth had been consistently followed by growth deceleration. Over the last couple of years GDP has steadily increased without any major setbacks. One final point on GDP, with the recent tax cuts, higher commodity prices and strong labor market, conditions are favorable for continued growth.



As mentioned, the labor market also looks to be quite strong. The unemployment rate, at 3.7%, is the lowest it's been since 2000. There are some caveats to this to be sure; for instance, labor force participation is still low and, when adjusting for inflation, full-time employees are making about as much as they were in 2009. However, the labor market is no doubt tight and that should bode well for future economic growth and inflation.

With the economy strengthening, the Fed has begun the process of tightening monetary conditions. They have increased the Fed Funds Target three times this year, and the market projects a good chance for a fourth increase in December. They have also begun the process of reducing their balance sheet (i.e. reducing the amount of money in circulation); as mentioned, the Fed's balance sheet peeked at about $4.5 trillion while this year the balance sheet has been reduced by about $250 billion bringing the total balance down to $4.2 billion.

While no one can be sure how the removal of such accommodative policies by the Federal Reserve will affect economic growth, if growth and inflation remain strong, we should continue to see interest rates rise. Ultimately, with interest rates likely to climb higher over the coming years, TJIM has been positioning our equity and fixed income portfolios with GDP growth, the interest rate environment and Fed policy in mind.

We appreciate your trust in our firm, and as always, we welcome your questions and comments.

Sincerely
TJIM Investment Team

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