TJIM QUARTERLY INSIGHT

Fourth Quarter 2018

Tom Johnson Investment Management, LLC

There is currently a lot of uncertainty in the market which leads to many questions. Will the Fed hike or cut rates in 2019? How many times? Will central banks around the world continue to shrink their balance sheets (i.e., take liquidity out of the system)? Will tariffs spark a worldwide trade war? Will we dip into recession? Will currency moves continue to wreak havoc with corporate earnings? It's usually comforting to look at the certainty of numbers and statistics to get an idea of what history suggests we should expect. The S&P 500 finished the fourth quarter of 2018 down 13.52% including dividends, and hopefully the storm is over now.

By turning back the hands of time we can see that since 1871 the market has been down more than 10% in a quarter 37 times. For our analysis we'll ignore all of the minor setbacks. That works out to about 2.5x per decade or just over 6% of the time that the market has quarterly double-digit declines. The average decline in these down low quarters is 16.5% and the median is down 13.87%. The worst decline was 40.35% in 1932 during the great depression. Q4 of 2018 falls near the middle of the distribution as the 22nd worst quarter out of 37. Now that we've quantified where we stand, what happens after the storm? Roughly 64% of the time the market is positive in the next quarter for an average of 4.4% vs. positive 66.5% of the time for an average of 2.56% over the full period (3/31/1871-12/31/2018). So, after a bad quarter we have similar odds of being positive as in any given quarter, but considerably higher average returns. Looking at one quarter's return is fairly short-sighted and frankly doesn't provide much useful information. What about the full year following a double-digit decline? Again, we see a similar pattern – similar odds of being positive (72.2% vs. 71.9%), but higher average returns (13.5% vs. 10.8%). Twelve months is still probably too short of a period to accurately judge equities, so let's look at the next five years. Equities are up 94.4% of the time over the next 5 years after a double-digit decline quarter for an average of 12.62% vs. up 89.34% of the time for an average of 9.35% across all markets. So, the odds of being up increased 5% and average returns increased over 3% per year. This impressive increase in return potential is enhanced by realizing that the only 2 periods where 5-year returns were negative after a double-digit decline occurred during the Great Depression, which is an economic and market environment we don't anticipate repeating anytime soon. We admit, even the "Great Recession" of 2008 was a trifle relative to the tribulations of the Great Depression. The certainty of numbers from history is a nice aid to put fears into perspective, but we do have to remember the maxim often attributed to Mark Twain "History doesn't repeat itself, but it often rhymes." Assuming the market rhymes with the past now is no time to exit and it's better to hold on.

Entire period 3/31/1871-12/31/18 Stock Market Returns

	Quarterly Returns	Annual Returns	5 Years Annualized
Average	2.56%	10.82%	9.35%
Median	2.88%	10.69%	9.30%
Best	77.37%	135.21%	33.60%
Worst	-40.35%	-62.19%	-17.22%
Count	591	588	572
% of time positive	66.50%	71.94%	89.34%

Double Digit Stock Market Declines and their Aftermath

	Down Quarter	Following Quarter	Following Year (4 Qtrs)	Next 5 Yrs Annualized
Average	-16.50%	4.43%	13.48%	12.62%
Median	-13.87%	5.43%	15.87%	14.51%
Best	-10.14%	77.37%	135.21%	33.18%
Worst	-40.35%	-27.07%	-62.19%	-9.90%
Count	37	36	36	36
% of time positive	0.0%	63.9%	72.2%	94.4%

*Based on quarterly data from www.irrationalexuberance.com for periods from 3/31/1871-12/31/78

Based on S&P 500 quarterly total returns from 12/31/1978-12/31/2018

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Aside from market history and statistics, we have an additional tool to handicap future equity performance – valuation. It takes a longer horizon of about 10 years before valuation becomes an accurate divination tool, which is unfortunate for short-term oriented investors, but this “time arbitrage” is what allows for superior risk-adjusted performance for diligent investors. Current market valuations have gotten considerably more attractive over the past year due to tax cuts increasing earnings and recent price declines reducing multiples. The S&P 500 is now trading at around 17x trailing earnings and 15.7x forward earnings, which is in line with historic norms and at a pretty steep discount to the 23x it traded at earlier in 2018. TJIM’s portfolios are positioned even more favorably from a valuation perspective with both equity portfolios trading around 13x trailing earnings and 11x future earnings with TJIM Core’s dividend yield at 2.8% and TJIM DSI’s dividend yield at 3.7% vs. 2.1% for the S&P.

In reality, volatility tends to “cluster” with the good days interspersed with bad days, so while the prognosis for grinding out positive long-term equity returns is favorable, it may be a bumpy road getting there.

While the equity decline got all of the press in the quarter, there were pretty significant changes in bond markets as well. Throughout most of the year interest rates across the treasury yield curve rose all the way to 3% and beyond (2 years and shorter never quite got there), but toward the end of October a sharp reversal happened with all of the treasury curve now trading below 3% from a low of 2.39% at the 2 year to a high of 2.91% at the 30 year. From the beginning of 2017 until the peak at the end of October rates rose 0.98% at the 2-year scaled to 0.65% at the 30-year, so the curve flattened slightly as is typical in a Fed tightening cycle. Since October, rates have declined roughly 0.5% across the yield curve with 0.6% declines at the 5 year and 10 year. The most significant driver of the rise in interest rates had been the Fed with the fed funds target increasing from 1.5% at the beginning of the year to 2.5% at the end of the year. Expectations for future rate hikes in October were an 85% chance that rates would be higher by year end with roughly equal probability of 1 or 2 hikes at 30% each, and probability of a 3rd hike at 15%. With the drastic changes in interest rates, the market now expects zero rate hikes in 2019 with a 50% probability of a rate hike by year end, and the yield curve is humped with the highest yield at the 1 year until you get out to 8 years to maturity. Given the high level of uncertainty regarding future interest rates and the relatively flat yield curve our fixed income portfolios remain conservatively positioned with a duration considerably shorter than the index, and a significant amount of short-term liquidity (over 40% of TJIM bond holdings have a duration less than 2 years) that we can redeploy if/when opportunities arise.

Over the same period investment grade credit spreads have widened. They widened from the beginning of the year until the middle, then tightened through September, and have widened pretty significantly since the low in September. Corporate credits are beginning to look like an opportunity, and we are taking a hard look at increasing our exposure in this space.

As always, we believe a portfolio of attractively valued, high quality securities that is properly diversified across stocks and bonds with an asset mix that is appropriately matched to risk tolerance is the best strategy for meeting long term goals across volatile markets. We just want to thank you for your trust in our firm, and we will continue to diligently, and prudently manage the investments that you have placed in our care. We wish you a prosperous new year, and as always, we welcome any questions.

Sincerely
TJIM Investment Team

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