TJIM QUARTERLY INSIGHT

Fourth Quarter 2019

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Wow! What a year it has been. If you had told me at the beginning of the year that the S&P 500 would be up over 30% in 2019, I would have told you that you were crazy. If you would have told me that the 10-year treasury would end the year with a yield under 2%, I may have questioned your sanity, but here we are.

Profit margins are near all-time highs, S&P earnings are near all-time highs, and consumer net worth is at all-time highs. We have continued the longest economic expansion since at least 1900 at over 126 months as of 12/31/19, which is vs. the average expansion of 48 months. Real GDP is trending on the lower side around 2% vs. a long-term average of 2.7%, but maybe this lower growth is what has allowed the expansion to continue for so long. Unemployment has ticked down to levels not seen since the 1960's (3.5%), and wage growth has finally begun to accelerate toward 4% where it was last seen in 2007. New hires are near 10-year highs, layoffs are near a 20-year low, and job openings appear to have peaked a year or so ago but remain near 2-decade highs. Inflation is still subdued coming in around 2%. The dollar has generally strengthened against our trading partners' currencies over the past decade, but has been punctuated with fits and starts. While oil is significantly below the peaks hit in 2008 or 2014 over $100 per barrel, it's also considerably above the bottom in 2016 of just over $26 per barrel, and seems to be moving with a generally upward trajectory over the past 3 to 4 years.

Almost every market did well – Domestic stocks, domestic bonds, foreign stocks, foreign bonds, commodities, gold, real estate, etc. The bulk of equity returns across markets were driven by multiple expansion (i.e. getting more expensive) across markets rather than fundamental improvement. In fact, across the US, Europe, Japan and Emerging markets, the US is the only market that showed earnings improvement in 2019. Every sector in the S&P 500 had a positive return with Energy coming in the laggard at up 11.8% for the year and Technology the leader up 50.3% in 2019. Of the 125 industries in the S&P 500 only 7 had negative total returns, which means that 118 industries had positive returns. Semiconductor equipment had the best total return at 97.8% in 2019 and Department stores had the worst at -28.2%. The most interesting fact to me is that the 100th best performing industry (Pharmaceuticals) was still up 12%. So even if you picked the 100th best (or 26th worst) performing sector, you still managed to eek out gains near the top of historical equity returns.

Since the great recession in 2008, households have deleveraged significantly, the US government has increased borrowing substantially, and non-financial corporate debt declined initially, but has reached a new high (all relative to US GDP). Negatively yielding debt around the world has declined from the peak in mid-2019 of around 17 Trillion, but is still considerably higher than at the beginning of the year at somewhere north of 11 Trillion vs. around 8 Trillion at the beginning of the year. Collectively central banks moved from adding liquidity at the beginning of the year, to reducing liquidity in the middle of the year to once again adding liquidity by the end of 2019. The ramp in the roll-off of the Fed's balance sheet being the driving force in reducing liquidity. Forecasts are for central banks to be adding liquidity over at least the next 2 years.

Trade – If all of the tariffs that have been proposed are implemented the US will have the highest tariff rate of all major economies on a weighted basis across all products. Exports only account for about 8% of US GDP, so we are in a position that we can implement tariffs that will have a greater impact on our trading partners where exports count for a much larger share of GDP (China at 19%, Japan at 15%, Mexico at 37%, Canada at 26%), however likely at a higher cost to consumers for finished goods. You didn't think our trading partners would just "eat" the tariffs, did you?

In past commentaries we've talked about the potential "froth" in private and venture markets, where companies that were slated to lose money and burn cash for as far as the eye could see were trading at multiple billion-dollar valuations – first in private markets then in Initial Public Offerings (IPOs). We've begun to see some rationalization of this phenomenon. Let's check in on the group of IPOs from our Q2 commentary – Uber, Chewy, Slack, Pinterest, TradeWeb and Lyft. Uber has declined from 45 to 30 (going as low as 26), Chewy declined from 34 to 30 (going as low as 22), Slack declined from 36 to 23 (as low as $20), Pinterest has declined from 27 to 18, Tradeweb is trading roughly where it was six months ago (Remember Tradeweb was the only one of these IPOs that was a profitable company), and Lyft has declined from 60 to around 43. All this while the S&P 500 is up around 8% over the same time period. When the Q2 commentary was put together the IPO basket had a market cap of just shy of 150 Billion, 18.7 Billion in Revenue and Operating Profit of -4.3 billion. As of year-end the IPO basket had a market cap of 111 Billion, revenue of 23 Billion, and operating profit of -12 billion, so market value has declined by around 25%, revenues are up nearly 24%, but operating losses have nearly TRIPLED!

This is the problem with companies that were allowed to scale rapidly with essentially unlimited outside capital – there was never a necessity to generate cash flow or profits, just a directive to increase revenues and market share, which they did with ever ballooning losses. If you were to give me access to unlimited capital, I could grow revenues essentially as rapidly as you want (while generating greater and greater losses). The easiest method that comes to mind would be to sell iPhones (or any other desirable product/service/asset) for less than it's available elsewhere (or cost). So, in my little VC incubator, I would open an off-brand Apple Store and sell the flagship iPhone at $500 per phone. I could likely sell as many as I could get my hands on. The problem is that the phones would cost me around $1000 each (assuming I pay full retail), which generates a loss of $500 per phone (ignoring overhead). So, I would be in the same situation as many of these IPOs – my positive revenue is roughly the opposite of my negative earnings. If I sold 1 million phones, I would generate $500 million in revenues and generate $500 million in losses (again ignoring any overhead expenses). I could continue to sell more and more iPhones and generate significant revenue growth coupled with increasing losses. The problem is that growth doesn't necessarily equal scale – there is no certainty that at some point size makes it a profitable endeavor.

In short, there are some silly non-economic things going on, which tends to happen when the price of money is too low, funds are too abundant, or economic growth has gone on for an extended period of time. Rather than play the central bank inspired game of hot potato, we will, as always, continue building portfolios of high-quality securities that are profitable here and now and trading at valuations that provide attractive long-term, risk-adjusted returns without heroic assumptions. It may not outperform in any given period, but we still believe this is the best way to meet long-term goals – ignoring short-term aberrations in markets, avoiding short-term fads, setting and sticking to a prudent long-term plan, and focusing on attractively priced, high-quality securities.

Sincerely
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