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ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

Stocks, now more than eight years into a bull market, marched still higher, setting new records ten years after the start of the financial meltdown. The S & P 500 returned +3.09% for the quarter and +9.34% for the first half, with the technology group still leading the way and volatility quite low by historical standards.

The strength of the indices has some solid underpinnings as the economy keeps growing, albeit slowly, and corporate earnings show healthy advances. The labor market remains firm. Although the number of job gains has moderated, the unemployment rate is near a 16-year low at 4.4%. Moreover, monetary policy remains accommodative even after recent rate hikes, and inflation has yet to assert itself. Hence, with few viable alternatives, stocks continue to receive a bid.

There does, however, seem to be a growing disconnect between the equity and fixed income markets. The stock market, with its steady advances, may be assuming further economic growth and respectable earnings gains, making historically stretched valuations look more reasonable. Yet fixed income yields remain low as if bond market participants are skeptical of the economy and dismissive of the prospect of rising inflation.

Yields are low in spite of four hikes in the Fed Funds rate, including three within six months. The Fed and investors must surely be scratching their heads as they contemplate why a tight labor market has not led to meaningful upward pressure on wages. Healthy pay raises would go a long way toward taking inflation above the 2% target of the Fed. However, there are other contributing factors, such as energy prices which once again dropped following a strong rebound from the cataclysmic lows of early 2016.

Then again, equity markets may not be as convinced of a pending pick-up in the economy and inflation as the averages indicate. Equity strength is relatively narrow, led by growth stocks, which typically outperform during periods of meager economic activity, as investors pay up for the scarcity value of firms that can expand absent a strong economic tailwind. Indeed, even within the technology sector, a handful of high-flying stocks have accounted for much of the gains. Finally, all other things being equal, low-interest rates and subdued inflation mean that investors are willing to pay up for future business expansion.

The rise of passive investing plus the increasing presence of computer-driven algorithmic trading also surely contribute to stock market strength as well as suppressed volatility. When new money flows into an index, all index components are purchased, but especially those with the largest market capitalizations, and with no differentiation regarding company fundamentals. Meanwhile, trend following computer programs often look for stocks that are rising and add to upward momentum. The reverse is true when stocks are going down, with share price weakness leading to further selling.

Of course, fundamentals, both negative and positive, have a habit of intervening and abruptly altering trend lines and conventional wisdom, turning winners into losers and losers into winners.

EQUITY MARKET OUTLOOK

It is certainly possible, and perhaps the most likely scenario, that status quo will continue in the markets.

Yet, among the myriad macro-economic risks that face investors, a few stand out: economic slowdown at home, overly aggressive monetary tightening, rising interest rates, economic slowing overseas, particularly in China, and geo-political drama. Any of these, or a computer-generated event, could shatter the market calm.

While it remains a close call, the economy is likely to pick up, led by a strong job market, improved balance sheets, and renewed business and consumer optimism. Although the prospects are unclear, any pro-growth policy initiatives would incrementally help.

The Federal Reserve finally seems committed to unwinding years of accommodative monetary policy, and a strong June jobs report gives cover for further increases, and perhaps a reduction in the size of its balance sheet over time.

Global yields rose at mid-year as a number of Central banks overseas voiced the same thoughts. Note that at this stage it is just talk, and also that tighter money does not imply that policy will actually be tight, just not as loose as previously.

Other factors always bear watching, but it is monetary policy that presents the biggest risk to markets. Stocks have tripled in this bull market, even as the economy inched forward at 2% per year. Much of the divergence is the result of a flood of money, which needs a home, and very low-interest rates, which make equities relatively attractive. The duration and magnitude of the recovery,and muted market volatility has bred, in some cases, a sense of complacency and even greed.

Is the latest rise in yields a harbinger, or yet another head fake? When interest rates rise, higher multiple stocks suffer most because for them the markets are pricing in earnings that are further out, and which now must compete with higher current yields. Trend followers who own, and often overweight the most popular names, could be in for a jolt.

If interest rates rise because the economy is improving, classic value stocks, typically more correlated to the economic cycle, can offset the opportunity cost of higher current yields by generating significantly higher earnings in the near term. And, more conservative valuations can offer a cushion should markets become choppy.

Our strategy differentiates by having high active share compared to a market index rather than indexing and by overweighting names with strongly favorable reward/risk characteristics. Favored stocks at discount valuations include big banks, whose much-improved balance sheets allow the return of large amounts of capital to shareholders, and high-quality energy names, featuring strong resource portfolios, increasing production and lower costs.

Other favored investments have greater earnings power than generally appreciated. We are participating in the proliferation of data via memory producers, which enable computers, cell phones, cloud computing, artificial intelligence, the internet of things, and self-driving cars. Biotechnology manufacturers continue to invent products that extend and improve quality of life.

If market trends change and there is a stampede out of crowded trades, a refuge away from the main action can be found in a portfolio of firms poised to deliver stronger, more sustainable growth rates than widely expected.

FIXED INCOME REVIEW

U.S. interest rates ended the second quarter just a few basis points lower than where they began. The low volatility environment of broad financial markets was also true of interest rates. Ten year U.S. treasury yields traded in a tight range over the course of the quarter, ranging from a high of 2.42% to a low of 2.13%. Even though interest rates rose over the period, the Aggregate Bond Index generated positive total returns of 1.45% for the second quarter.

During the quarter the shape of the US Treasury curve changed more than the level of rates, continuing the flattening trend started at the beginning of 2014. The spread between two and thirty-year Treasurys narrowed from 1.75% at the beginning of the quarter to 1.45% at quarter end. The shape of the Treasury curve is often a good predictor of the economic cycle, with a flatter curve signaling a weaker economic outlook.

Immediately after the 2016 election the Treasury curve steepened on expectations that a unified government might push through tax cuts, infrastructure spending and a repeal of the ACA, spurring economic activity. In early 2017, disagreement among policymakers led to a delay in legislative action that would impact economic growth. Even though there has been no meaningful progress on the major issues, however, business confidence of leaders of both large companies and small businesses has surged.

Earnings growth picked up at the same time as business confidence. S&P 500 trailing twelve-month earnings were negative for six consecutive quarters through the third quarter of 2016, bottoming at -4.4% growth in the second quarter of last year. Earnings growth of large U.S. companies increased 5.1% for the first quarter of 2017, commensurate with double digit increases of 20% for European companies and 25% for Japanese firms. For bond investors, the upsurge in global earnings provides additional coverage for creditors but also indicates stronger economic growth.

To combat the financial crisis of '08 the Federal Reserve first lowered short term interest rates to 0%. Over the next five years, the Fed dramatically expanded its own balance sheet through quantitative easing, purchasing Treasury and mortgage-backed securities in the open market, to lower interest rates and spur a self-reinforcing recovery. The Fed began to raise short rates gradually in 0.25% increments beginning in December 2015, again late in 2016, and two more so far in 2017. The Fed Funds target now has a range of 1.00 – 1.25%, and the Fed has maintained its tightening bias. We are concerned that the Fed began tightening rates before beginning to reduce the size of its balance sheet, in reverse order of its implementation.

The Fed entered unchartered territory with the balance sheet expansion, and unwinding of the Fed's purchases could yield unintended consequences. The velocity of money has slowed coincident with the increase in the Fed's balance sheet, perhaps indicating the Fed's quantitative easing strategy is counterproductive to the Fed's goal of growing the economy. The Fed intends to gradually reduce its balance sheet, and the current proposed schedule requires almost seven years of steady asset sales to bring the balance sheet back to its 2007 size.

At seven and a half years the current economic expansion is quite old relative to most periods of growth. One fear is that a typical economic slowdown with interest rates so low will tempt the Fed to reverse any program of balance sheet reduction, with ever expanding Federal Reserve balance sheets becoming a permanent feature of future monetary policy. The duration of the Fed's balance sheet is about 5.7 years, indicating that the market value of the Fed's $4.4 trillion of bonds falls about $250 billion

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for every 1% increase in interest rates, introducing another risk.

Separate from the Federal Reserve, the U.S. Treasury's debt ceiling of $19.9 trillion expired on March 15. To avoid default short term measures were authorized, but absent legislative action the Congressional Budget Office projects the government will run out of money before the end of October. Half of U.S. Treasury debt matures in the next three years and the weighted average coupon of U.S. debt outstanding is 1.79%. The expense of refinancing trillions of treasury debt and marking to market the Federal Reserve's multi-trillion dollar portfolio present risks of higher interest rates which we expect will garner more attention in the popular press over the next few quarters.

FIXED INCOME OUTLOOK

Fed policy remains a self-described "accommodative," and we maintain a maturity posture slightly shorter than benchmark indexes in most portfolios. Corporate spreads are tight but have been tighter, particularly relative to historically higher interest rates, for multi-year periods in the past. Spreads will widen, at least temporarily if not in expectation of weaker credit conditions, when market volatility increases. The cash flows of mortgage-backed securities are interest rate dependent and we prefer higher coupons with less extension risk in a rising rate scenario.

We have used the recent period of tight spreads and low volatility to reduce exposure to several riskier higher yielding credits. Volatility has trended lower for most of the year. We want to protect portfolios if volatility increases, providing a better opportunity to add incremental yield and more attractive relative value.

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