Information through 03/31/2023

ASB Investment Management

Institutional Portfolio Management Quarterly Review

REVIEW

The first quarter ended with the Aggregate Bond Index generating a respectable 2.96% total return, but it was a bumpy ride getting there.

January was smooth enough, as ten-year Treasury yields fell from 3.9% to 3.5%, and corporate credit spreads tightened from 1.3% to an average 1.15% over comparable Treasurys. In February the flat road twisted when credit spreads widened ten basis points and ten-year Treasury yields rose to a quarterly high of 4.09% in early March.

The collapse in early March of Silicon Valley Bank (SVB) rekindled memories of the 2008 Global Financial Crisis (GFC). Credit spreads exploded 40 basis points to last year's widest levels, and volatility spiked. Capital raising halted and markets nearly shuttered. The market punished regional bank issues particularly hard.

The Biden Administration acted quickly to halt additional bank panic, calming the markets. Amidst the confusion, two-year Treasury investors rode a roller coaster as yields fell from 5.07% on Wednesday, March 8th, to less than 4% on Monday the 13th, back up to 4.25% on Tuesday, down to 3.89% on Wednesday, back up to 4.16% on Thursday, down to 3.84% on Friday, and back up to 4.17% the following Tuesday, March 21.

From the Lehman default in September 2008, to the COVID pandemic in March 2020, to the collapse of SVB this past month, crises seem to develop more quickly. Washington Mutual depositors withdrew $16 billion in ten days when the bank collapsed in 2008. Silicon Valley depositors withdrew $42 billion in eight hours. Fortunately, regulators also appear to be responding more quickly as well.

So far, larger financial institutions, subjected to higher capital standards and regulatory oversight following the GFC, appear to have weathered the storm well, and in fact may have benefited somewhat. According to Federal Reserve data, the 25 biggest U.S. banks grew deposits $120 billion in the days after the SVB collapse. All U.S. banks below that level lost $108 billion over the same period, for the largest weekly drop in smaller bank deposits on record.

Let's hope the government's quick action contained the crisis, and policymakers find a way to reduce the threat of moral hazard creating even larger problems in the future.

OUTLOOK

The Fed's tightening policy has been aggressive, in an effort to control stubbornly high inflation. We believe the growth rate of inflation has peaked, and that the Fed is close to holding short rates steady. As a result, we maintain durations near 100% of index levels for most portfolios.

ASB INVESTMENT MANAGEMENT

Every tightening cycle, without exception, is marked with a financial crisis. Of course, any period's defining event is not known until after rates have begun to fall. Let's hope we have already experienced this period's inflection point.

However, hope is not an investment strategy and spreads have widened. Financial sector issues, a large component of the bond market, have been hit especially hard. We prefer the largest, most liquid bonds of institutions that were deemed "systemically important" after the GFC. Lower prices present opportunity, and we have selectively added to some positions. We have also added interest rate-sensitive housing bond positions.

We continue to like the credit quality of taxable municipal securities, although higher interest rates have slowed refinancings and reduced new issue supply.

The inverted yield curve presents an excellent opportunity for investors to invest in high quality, 1-3 year maturity, investment grade fixed. Extending from money market funds into the 1-3 year Government/Credit Index three months after the start of a yield curve inversion has generated an average of 7.7% total returns one year after the last six inversions, and 26% returns (8% annualized) three years later, dating back to 1978. Of course, past historical trends are not guaranteed to occur in the future, but we would like to discuss this opportunity with you in more detail. Please contact us for more information.

REVIEW

There are a few things that we can say with confidence about the current economic environment:

- We have inflation. While recent readings have shown a moderating trend, inflation is still at levels the US economy hasn't experienced in several decades.
- We have a Federal Reserve that is attempting to combat inflation with a fast and aggressive cycle of increasing short-term borrowing rates.
- We have a very strong labor market. Unemployment is at multidecade lows.

This continued strength in the jobs market has only reinforced the Fed's confidence that they are pursuing the correct policy in continuing to increase interest rates.

While the impact of higher rates has so far appeared to be muted in most segments of the US economy there are number of nascent trends (some admittedly anecdotal at this point) that indicate the likelihood of a weakening economy in the months ahead:

- Credit conditions are tightening. Stress at local and regional banks is leading to tougher borrowing conditions, especially for small businesses.
- After being surprisingly resilient in 2022, corporate earnings are now trending down.
- Consumer sentiment and confidence are trending down.

"Every tightening cycle, without exception, is marked with a financial crisis."

We believe the path of employment will be the key factor in determining the level of weakness in the economy going forward. While job availability remains high and the unemployment rate is exceptionally low, we have begun to see some evidence that corporations that were focused on growth are now retrenching and beginning to refocus on cost savings and profitability. This has been especially true for large technology companies that are announcing layoffs at a pace not seen since the Global Financial Crisis.

Historically, when the labor market is strengthening, it usually does so gradually over several years. When it moves in the opposite direction, however, it tends to do so with brutal speed. When one company in an industry begins to scale back hiring or begins laying off workers, it becomes politically palatable for other companies to do the same. We fear this self-reinforcing trend may be beginning now. We hope we are wrong.

OUTLOOK

Equity markets, thus far this year, have largely taken the potential for economic disruption in stride. In the first quarter of 2023 the S&P 500 Index had a total return of 7.48%. This followed a total return of 7.55% in the fourth quarter of 2022.

Counterintuitively, many market participants are actually cheering on forecasts of economic weakness. The logic is that if economic weakness leads to a cooling off of inflation and a weaker labor market, then the Fed will be able to stop raising rates and perhaps begin cutting rates. To this we would say be careful what you wish for. The direction of the economy is hard to control and even more difficult to predict. A deeper recession than forecast (aka a "hard landing") would certainly result in much weaker corporate earnings than are now being forecast, and it is difficult to foresee equity markets reacting positively in such a scenario.

While we are hoping for an economic "soft landing" we think it is sensible amidst this level of uncertainty to become incrementally more defensively positioned in our portfolios while the market remains relatively buoyant. We also stand ready to add to the companies that we think are strong long-term assets in the event of a market downturn.

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