Information through 06/30/2023

ASB Investment Management

Institutional Portfolio Management Quarterly Review

REVIEW

The S&P 500 had a total return of 8.74% for the second quarter of 2023. This was the third quarter in a row of strong returns following the 7.48% return in the first quarter of the year and the 7.55% return in the fourth quarter of 2022.

What is driving these gains in the S&P 500? Perhaps it's important macroeconomic factors such as low unemployment, resilient consumer spending, and easing inflation. The much-anticipated recession that has been just over the horizon for more than a year has yet to arrive. Some now believe it may never come. Perhaps there is also a bit of irrational exuberance in the mix (artificial intelligence comes to mind). Whatever the reason, equity markets have been strong with much of that strength coming from a powerful rally in the largest technology companies in the index.

The consensus reasoning (in hindsight) for the strong equity markets in the decade after the Great Financial Crisis was that it was largely the result of the extremely easy monetary conditions fostered by the largest global central banks. Low interest rates meant that there was no alternative to stocks with bonds offering very low (in some cases negative) yields.

Additionally, it is reasoned that these low interest rates meant that the discount rate for future company earnings was very low, thus, stocks should trade at higher earnings multiples. Such conditions were especially favorable for companies with the greatest prospects for future growth.

Interestingly, the current rally in growth stocks is occurring when these conditions have reversed. As interest rates have rapidly increased, there is an alternative to stocks. The 10 year US Treasury Bond is trading at its highest yield in 13 years. An inverted yield curve means that cash in money markets and short term bonds are yielding even more. Of course, the discount rate on future company earnings has also rapidly increased which should depress the earnings multiples of growth stocks.

OUTLOOK

If we were to think of the S&P 500 index as a fund manager, it would be having a truly extraordinary year.

This manager is not afraid to take bit bets on big companies. And those bets are paying off handsomely. The top seven positions in the S&P 500 index at the end of the second quarter were: Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla, and Meta. The total returns for those stocks in the first half of the year were respectively: 49.72%, 42.66%, 35.67%, 55.19%, 189.54%, 112.51%, and 138.47%. Thus, the returns of each of these stocks dwarfed the S&P 500 total return of 16.88%.

Of course, when a manager's largest positions do this well relative to the overall market, then they become even bigger positions and the manager takes

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on additional concentrated stock risk. But the index is constrained as a manager as it cannot reduce this risk. It cannot sell high. It has to let it ride. Anyway, this manager is not concerned with fundamentals or valuation so it tends not to worry about things getting out of hand.

We don't think it is wise to chase highly valued growth stocks at this point. Many defensive stocks have not only been left out of the current rally, but they have become even cheaper. In a sense, the price of insuring the portfolio with the ballast that these kinds of companies offer has gone down, while market risk has increased. We believe this has made a strategy of reducing holdings in expensive growth stocks and increasing allocations to defensive positions increasingly attractive.

REVIEW

The rise in interest rates during the second quarter did not offset the benefit of tighter credit spreads, producing negative total returns for investment grade fixed income investors. The Bloomberg Aggregate Bond Index returned -0.84%.

The nearly 1% rise in two-year yields, versus only 21 basis points for thirty-year yields brought the inversion of the Treasury curve to extreme levels not seen since the early 1980's. During the second quarter the difference between two-year notes yielding 4.90% and thirty-year bonds at 3.86% increased from 0.38% to 1.04%. The market has not experienced an inversion this severe since the all-time peak in rates when Paul Volcker chaired the Federal Reserve.

Cash continues to accumulate, and many investors are attracted to the 5% yields of money market funds. Smart investors buy their straw hats in the winter, and now is a prudent time for fixed income investors to consider investing cash savings in intermediate maturity bonds, rather than holding cash in a money market fund. With average maturities in the 15-to-60-day range, money market fund yields will quickly fall when the Fed reverses course. Since the late 1970's, three months after the initial Treasury curve inversion, it has always paid to extend bond maturities. For each of the past six inversions, T-Bills averaged 5.05% annualized returns over the following three years, versus 7.8% for 1-to-3-year bonds, which never experienced a loss.

OUTLOOK

Although the Fed appears poised for two more twenty-five basis point rate increases before the end of the year, we believe that the next big move in longer maturity interest rates is likely to be lower, not higher. Federal tightening measures require time to impact economic activity, typically twelve to eighteen months. The Fed first pushed short term interest rates above zero per cent in March of 2022, sixteen months ago. This tightening cycle has been the most aggressive ever, increasing short rates higher and more quickly than any previous tightening cycle.

By some measures, particularly aggregate employment, the economy's growth remains robust. Employment is a coincident indicator, and typically grows right up until the month that a recession begins.

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Policymakers flooded the economy with liquidity during the pandemic, and total money supply is still above its long-term trend line of growth. However, the rate of change of money supply has never been more negative. From World War II up until the pandemic, the annual change of M2 money supply consistently grew in the mid-single digits, only briefly approaching zero percent growth, but always staying positive.

During the pandemic M2 money supply growth exploded, briefly nearing a 30% year-over-year growth rate. The massive growth of M2 helps explain the stock market's 28% return in 2021. M2, which has never experienced a negative growth rate, is now declining at a 4.5% pace. Interest rates are likely to fall in an economic environment weakened by less liquidity.

The declining rate of inflation also argues for lower interest rates. One argument for higher rates points to stubbornly persistent core CPI that recently dropped to a 5.3% annual increase, down from 9.1% peak growth last fall. Prices for shelter and used vehicles accounted for 88% of this core CPI growth. Pandemic volatility of car lease rollovers distorted vehicle data and contradict auction results revealing falling used car prices. Rent growth has slowed, and a record number of newly constructed apartments are coming online this year. After almost a year and a half of higher short term interest rates, car and home buyers are beginning to feel the pinch of higher financing costs.

The shape of the yield curve is a time-tested predictor of economic strength. Today's inverted curve warns of a slowdown. Lastly, the Leading Economic Indicators Index has never been this low without a recession occurring.

Our macroeconomic perspective keeps us cautious regarding reaching for too much yield. We are interested in high quality, low coupon mortgage-backed bonds trading at steep discounts. Most portfolios are slightly above benchmark duration targets, and we expect to extend maturities.

Higher rates have increased prospective returns for fixed income investors. It has been a long time since investment grade fixed income offered investors reasonable income with the hope of mid to high single digit total returns. Investors wary of the risk of other asset classes now have a better choice than the low-rate environment of the recent past.

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