ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY REVIEW

After experiencing sharp losses through the first three quarters of 2022, the S&P 500 rebounded with a string of strong total returns for three consecutive quarters (7.55% in the 4th quarter of 2022, 7.48% in the 1st quarter of 2023, and 8.74% in the 2nd quarter of 2023). This string of gains was broken in the 3rd quarter of 2023 with the S&P 500 retreating by 3.27%.

This modest retrenchment did little to change the overall character of the US equity markets this year. That is, the positive returns year-to-date continue to be dominated by a handful of megacap (primarily technology) companies. The market capitalization-weighted S&P 500 index (the commonly quoted S&P 500 index) had a total return of 13.06% through the end of the 3rd quarter. The equal-weighted S&P 500 index, on the other hand, had a total return of a mere 1.78%. The technology dominated Nasdaq 100 index had a total return of 35.37%.

Despite the unusually lopsided nature of equity markets this year, for some of the most important indicators, the macroeconomic environment is returning to conditions that look more "normal" or at least more stable. It's hard to overstate just how destabilizing the Covid-19 pandemic and, perhaps more importantly, the policy responses to the pandemic were for the global economy. Shutting down and subsequently trying to revive most sectors of the economy led to huge swings in GDP, inflation, and unemployment rates.

Looking at these three indicators today it would seem we have returned to something at least within the realm of the historically normal levels of volatility. Of course, this all depends on the time period we use for reference, but taking each of these three factors separately, and speaking in very general terms one could argue the waters have calmed significantly (hopefully not preceding the proverbial storm).

GDP (year-over-year) ranged from a contraction of 7.5% in the second quarter of 2020 to an expansion of 11.9% in the second quarter of 2022. We have now recorded six consecutive quarters of GDP expansion in a range between .7% and 3.6% (with the most recent reading as of June 30th of 2.4%).

Inflation (measured by the Consumer Price Index year-over-year) was measured at 0.6% in the second quarter of 2020 and then peaked at 9.1% in the second quarter of 2022. It has recently registered at 3.0% for the second quarter of 2023 and 3.7% for the third quarter. While not at the Federal Reserves target rate of 2%, it is now trending at a rate not outside of historical norms.

The US unemployment rate peaked at 12.97% in the second quarter of 2020. It then precipitously declined to 3.6% in the second quarter of 2021. It has since been stable near that level, with the most recent reading of 3.7% in the third quarter of 2023

EQUITY OUTLOOK

None of the above is meant to argue that we are in a new goldilocks era of stable markets or that the economy won't be thrown into recession due to

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known imbalances or unknown shocks. However, a more stable macroeconomic environment does have important ramifications for how we execute our equity investment strategy.

The extremes of the Covid era made it hard to ascertain the true long-term earnings power of many businesses. Individual company financial data from that period suffered from the same distorting forces as the broader economy. Supply chain disruptions, demand shocks, uncertainty around proper inventory levels, and input inflation were just a few of the destabilizing factors affecting the operation of many businesses.

Financial analysis is a quantitative discipline at its core. In our process we use metrics to understand the profitability of a business and how it compares to competitors. We look at various ratios to measure the health of a company's balance sheet and we use numerous valuation metrics to understand how attractive a security's price is relative to a company's prospects. All of this requires point-in-time data as well as looking at trends in data over time. While these trends are always dynamic and require vigilant attention, a return to a more normal operating environment improves our ability to accurately assess a great durable business from one enjoying the benefits of short-term good fortune.

Qualitative factors like management skill and competence, corporate culture, brand strength, and a company's reputation are all important to assess. In the end, however, such strengths should be reflected in corporate performance which is always measured in quantitative outcomes.

FIXED INCOME REVIEW

The world's most important asset price, the U.S. ten-year Treasury Note, fell 5.75% in price during the second quarter, as the bond's yield increased from 3.84% to 4.57%. The Bloomberg Aggregate Bond Index, which has an interest rate risk closer to a seven-year bond, lost 3.2% in the quarter. The broad index has lost 1.2% year-to-date. A loss for the full year would be the first time ever that bonds experienced negative total returns for three consecutive years.

Continued economic strength, inflation above 3%, and ballooning needs for greater Treasury issuance to finance record government spending pushed rates higher. The economy has proved quite resilient and today battles labor strikes, multiple wars, threat of a government shutdown, a weak China economy, resumption of student loan repayments, increased bank capital requirements, as well as higher mortgage rates, bond yields, and the dollar.

Higher rates have brought renewed attention to interest outlays, growing deficit spending, and increased issuance needs. In the fourth quarter of 2019, the last full quarter before the pandemic, the U.S. Treasury borrowed $381 billion. The Treasury estimates that this quarter it will need $852 billion. Next year Treasury issuance is expected to increase 46% for two-year notes, 45% for five-year notes, and 21% for ten- and thirty-year maturities. Interest costs for Treasury notes now equal national defense spending.

The House ousting its speaker for the first time in history highlights the divided government in Washington, as well as our nation's debt problem. Rational investors have worried about the nation's

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expanding deficit since the mid-1960's, when Lyndon Johnson's administration fought both North Vietnam and the war on poverty, at the same time. In 1965 total federal debt was $317 billion, about $1,660 per American. Today, total federal debt is $33.5 trillion, over $98,000 per person.

FIXED INCOME OUTLOOK

We believe that the next big move in interest rates is likely to be lower, rather than higher. Lower rates may be six to nine months away, but we have experienced most of the increase in rates for this cycle. We are less concerned about when the Fed may begin to ease short rates, as long rates will begin to fall before Fed policy changes, in part in anticipation of a change to Fed policy.

The year-over-year growth rate of inflation peaked at 9.1% a year ago. The most recent annual change registered 3.7%. Inflation should continue to fall. In September the annual growth of apartment rents declined -1.2%, the Manheim used car price index fell -3.9%, and the FAO global food price index declined -10.7%. Anecdotal signs of price cutting include Disney dropping the price of children's tickets, Tesla reducing Model 3 and Model Y prices, and major shippers UPS, the Postal Service, and FedEx dropping rates. Amazon announced free grocery delivery for orders over $100, gasoline futures indicate $0.70 per gallon price drops, and Rolex watches and beer prices are falling.

Aggregate employment remains strong. In September nonfarm payrolls increased 336,000, surpassing the 170,000 expected increase. This signal of continued economic growth pushed interest rates to new highs. Nevertheless, aggregate employment statistics are at best, a coincident, if not lagging indicator. Overall employment typically registers gains until the month the economy begins to contract. On the other hand, temporary services job data is an early warning sign of slowdown. In previous recessions temporary services employment peaked well ahead of overall employment. Temporary services jobs have begun to decline and appear to have peaked several months ago.

We continue to hold high quality taxable municipals and preferred corporate credits but have selectively reduced credit exposure. We have added to mortgage-backed positions trading at steep discounts to par. The higher rate environment represents an opportunity to invest excess cash in intermediate maturity fixed income. Historically investors who extend from cash into intermediate maturity fixed income during periods of yield curve inversion have been rewarded when the yield curve returns to a positive slope. Please contact us for more details.

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