ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY REVIEW

The fourth quarter of 2023 capped off a very strong year for the S&P 500 Index. The total return for the quarter was 11.68% resulting in a total return for the year of 26.26%.

U.S. equity markets were dominated by the spectacular returns of a handful of very large technology companies in 2023. Because the S&P 500 index is weighted by the size of its member companies (as measured by market capitalization) these companies had an enormous influence on the returns of the index. Seven of these companies (NVIDIA, Meta, Amazon, Alphabet, Tesla, Microsoft, and Apple) became known colloquially as the Magnificent Seven. Bloomberg has created an index including only these companies called the Bloomberg Magnificent 7 Total Return Index. That index had a total return of 107.01% for the year.

There are several ways we can get a sense of the impact of these stocks. One is to look at the returns of the S&P 500 Equal Weighted Index. Naturally, this index gives each member of the S&P 500 an equal weight and, thus, equal influence on the return of the index. The total return for this index was 13.84% for 2023, a bit more than half the return the capitalization weighted index. We can also look at the total return of the S&P 500 without the Magnificent Seven. That return was 9.99% in 2023.

Wall Street forecasters are prone to recency bias (to be fair, so are all of us). Recency bias refers to the tendency to give more weight to the most recent events or data and, thus, underweighting the importance of all previous historical data. This makes sense as our recent memories are more vivid and accessible than older memories. The problem with this is that it can result in sub-optimal decision making.

Calendar year 2022 was a difficult one for equity investors. The S&P 500 had a total return of negative 18.13%. Going in to 2023 the mood on Wall Street was gloomy. Equity investors had just taken a beating and forecasters expected the beatings to continue. The Federal Reserve was in the midst of aggressively raising interest rates (The Fed Funds Target Rate) and recession in 2023 was almost assured.

Yet, with 2023 now in the history books we know that the S&P 500 had a total return of 26.26% for the year and a recession never materialized. The unemployment rate remains under 4%, near historical lows. The market now expects that the next move for the Federal Reserve will be to lower the Fed Funds Rate. The mood on Wall Street has improved markedly and optimism is rife. Let's see how they do forecasting the economy and markets for 2024.

EQUITY OUTLOOK

As discussed, the S&P 500 Index had very strong returns in 2023 greatly enhanced by the returns of some of the largest companies in the index. There are a couple of things that passive investors in the index should keep in mind at this point.

The first point concerns diversification. As the price of a stock rises relative to other members of the index, it becomes a larger weight in the index. In 2023 we saw companies that were already amongst the largest in the index significantly outperform the index as a whole. This makes future returns of the index even more sensitive to the performance of these stocks going forward. Thus, investors seeking stock diversification through indexing are getting less of it than they were a year ago. Not only has stock concentration increased but so has industry concentration. The Magnificent Seven are all to a greater or lesser degree technology stocks (although they may be

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technically classified as belonging to a sector other than technology). Thus, the correlation of the returns of the largest stocks in the index is likely to be relatively high going forward.

The second point concerns valuation. If you believe that an individual stock can be undervalued or overvalued at a particular point in time and you would prefer to buy larger positions in undervalued stocks than in overvalued stocks, you are by definition doing the opposite in a capitalization weighted index. If a stock is overvalued, it has a higher market cap than it "should" have. If it is undervalued, it has a lower market cap than it "should" have.

As active equity investors part of our strategy is trying to manage both concentration risk and valuation risk. Certainly, doing so successfully is difficult, but we believe that having our hands on the wheel is always important, but especially so at this point in time.

FIXED INCOME REVIEW

The bond market was saved from a third consecutive year of losses by a tremendous fourth quarter in which the Bloomberg Aggregate Bond Index increased 6.8%. Through October the Aggregate Index declined -2.8% year-to-date but rallied in the last two months of the year to generate a 5.5% return for the full year.

November's 4.5% gain was the best month for the bond market in 35 years. December followed with a very strong 3.8% return. Let's hope the Santa Claus rally did not pull good results for the New Year from 2023.

In a tumultuous year the bond gods displayed a sense of humor, as the world's most important reference rate, the yield of the U.S. Treasury 10-year note, ended the year at the same level it began, 3.88%. The point-to-point similarity belies a 1.70% swing in rates from April's 3.3% low, spiking to a 16-year high in October at 4.99%. An investor unfortunate enough to have bought in April and sold in October would have realized a 14-percentage-point loss.

In November, Treasury Secretary Yellen and Fed Chair Powell came to the rescue. The Treasury announced continued high issuance of T-Bills, rather than increasing longer maturity bond financings. Although financing record liabilities with short maturity instruments may be a policy mistake over the long haul, over the short-term, investors were excited that large, long bond financings would not pressure rates higher. The bond market was at its low for the year, and from that moment forward prices rallied.

A few weeks later, Fed Chair Powell began his press conference by saying, "...Inflation has eased from its highs, and this has come without a significant increase in unemployment. That's very good news..."

Over the next two days 10-year Treasury yields fell 20 basis points and prices rose almost 2.5 percentage points, cementing the cause for a Fed pause.

FIXED INCOME OUTLOOK

Last year we pointed out data in graphs we likened to "always slides." The data demonstrated recessions always following inverted yield curves, post-inversion equity market rallies always disappointing, the level of Leading Economic Indicators always indicating contraction, and a pessimistic consumer confidence diffusion index at levels always predictive of recession. We can't promise it will happen again in the future, but each indicator has always predicted an economic slowdown. Unprecedented stimulus-fueled liquidity has delayed but will not avert, a recession.

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Total job openings are high but have been falling for three quarters. Temporary employment, which has peaked several quarters before the past few recessions, peaked in 2022. Many point to continued strength of aggregate employment as a sign of continued growth, but aggregate employment is, at best, a coincident economic indicator. Once overall employment begins to weaken, the recession will already be upon us.

Unlike the National Hurricane Center, the National Bureau of Economic Research (NBER), the nation's arbiter of economic growth, will not warn us of a recession. The NBER does not determine a recession has begun until the economy is deep into it, if not already over.

When Paul Volker chaired the Federal Reserve, the Fed often surprised the market with its actions, levering perceived limited powers to achieve its full intention. Through the tenures of Greenspan, Bernanke, Yellen, and now Powell, the Fed has become increasingly transparent, telegraphing its moves through communication. Powell's mid-December press conference signaled a pause in short term rate hikes.

The consensus outlook seems to be "the economy is slowing but is not susceptible to a deep recession any time soon." The pricing of futures contracts implies that the market expects at least five quarter-point rate cuts in 2024 and a 70% chance of a 0.25% rate cut in March.

We place a higher probability than most that the economy is more susceptible to a severe contraction, but we also sense the Fed may maintain short rates at current levels for a longer period, past the March meeting date. The Fed keeping short rates at current levels could be the unintended nudge that pushes the economy into recession. We anticipate that market expectations will swing rates both higher and lower than conditions warrant, like last year. Eventually, as the weather heats up and spring turns to summer, we expect the economy will cool down, and rates will be lower than where they are today.

As a result, we are nimble with our interest rate positioning. We expect to be longer than benchmark duration targets in most portfolios for most of the year. Credit spreads are tight within the context of the past two years and are certain to widen should the economy contract. When viewed over the past several decades, spreads have been tighter for prolonged periods of time.

We most likely are in a "Fed pause," when the Fed keeps short rates at current levels. This is usually a good period for investors. The past nine pause periods dating back to 1974 have averaged 100 trading days, and have been, on average, a positive period for investors in general. It is the easing cycles, the period between the first Fed rate cut and the market low, that investors fear. During these periods risk assets underperform, and investors seek the haven of high-quality fixed income instruments. We expect to be there before the end of the year. In the meantime, please reach out to us at any time, and best wishes for a happy and healthy 2024.

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