

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The S&P 500 had a total return of -4.89% in the third quarter of 2022. This was the index's third straight quarter of negative returns. The total return for the year-to-date period through the end of the quarter was -23.88%.

Given the fact that S&P 500 earnings have been positive this year, the negative return represents a repricing of equity assets in relation to their earnings. In other words, price to earnings ratios have declined sharply. The two factors dominating this negative market environment for equity assets are elevated, persistent inflation and the Federal Reserve's reaction to that inflation.

The total return figure for the third quarter of -4.89% for the S&P 500 doesn't fully capture the volatility that characterized equity markets during the period. If we divide the quarter into two halves, in the first half (June 30 to August 15), the index returned a robust 13.72% while in the second half (August 15 to September 30), the total return was a punishing -16.37%. Yes, these opposing halves can largely be attributed to the trajectory of inflation, the Fed's actions, and, perhaps most importantly, what market participants think the Fed's actions will be going forward.

The Fed is in essence playing a game of chicken with the markets. Ideally, the Fed would like the markets to believe that they are stalwart believers in discipline

on inflation. They are incentivized to talk tough with the hope that if market participants believe they will act aggressively some of the air will be squeezed out of risk assets, businesses will cut back on spending, financial conditions will tighten, inflation will moderate and then they may not actually have to act as aggressively as their current posture would indicate.

Market participants, on the other hand, know that it is politically risky for the Fed to actually *cause* a recession and/or a market meltdown by raising rates too aggressively. As asset prices decline, they hope the Fed will be forced to soften their stance on inflation. In the first half of the third quarter the dominant narrative was that inflation had peaked and the Fed would soon be able to decrease the speed of rate increases and perhaps even reverse course entirely early in 2023. The market rallied. In the second half of the quarter, inflation indicators remained stubbornly high and the Fed convinced the markets that they are indeed prepared to do whatever it takes to tame inflation. Equities faltered.

EQUITY MARKET STRATEGY

Timing equity investments is famously difficult (some would say impossible) but there are some straightforward ways to think about entry points. As discussed above, equities are now significantly cheaper relative to their current earnings than they were nine months ago. It stands to reason that paying less for an

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asset is preferable to paying more. Complicating this simple rule is the fact that when you purchase equities you are not purchasing only current earnings, but you are purchasing the entire future earnings streams of a business. As the outlook for those earnings darkens the equities should be worth less. However, predicting that future earnings stream any more than one or two years out becomes increasingly difficult. Gloom about a company's (and the economy's) prospects today may turn into optimism tomorrow. We are biased towards buying more aggressively when markets have retreated aggressively. One thing you can know with complete confidence is that if one is to invest in the equity markets today they may not be buying at the bottom but they are certainly not buying at the top.

Also discussed above, we are in a period of rapidly increasing interest rates. As interest rates rise and debt financing becomes more expensive many companies will encounter balance sheet stress. An important factor in our stock selection process is a bias towards companies with strong balance sheets that can rely on profits (rather than debt) to finance operations and make ongoing investments in their businesses. Thus, the impact of rising rates on the companies in our portfolio in aggregate may prove to be muted relative to the broad market.

Finally, we would note that outside of the Energy Sector, the vast majority of equities have declined in unison. We believe our portfolio holds a number of high-quality companies that have not been spared from the downturn in the market but whose business prospects have not been significantly impaired. We will continue to add to these core positions.

FIXED INCOME REVIEW

The third quarter marked the first time since the inception of the Bloomberg Aggregate Bond Index in 1976 that both the S&P 500 equity index and Aggregate bond index have registered negative total returns for three consecutive quarters. During the third quarter, the Aggregate Bond Index generated a negative return of -4.8% and has lost -14.6% for the year-to-date period.

During the quarter short rates rose faster than longer-term maturities, flattening the yield curve. Six-month T-Bill yields rose 1.5% to 4%, two-year Treasury Notes rose 1.3% to 4.3%, ten-year Treasury yields increased 80 basis points to 3.8%, and thirty-year bond yields increased 60 basis points to 3.8%. The inversion of short rates relative to long maturities caused a hump in the intermediate part of the curve, and three-year Treasury yields of 4.3% represented the highest yields across the maturity spectrum.

After a mid-June peak in yields, bond prices rose, and interest rates fell through the end of July. Investors spent the summer wishing for a Fed pivot to easier monetary policy that has yet to come. Instead of walking back its hawkish stance and offering hope for lower rates, the Fed reiterated its determination toward tighter policy, culminating with Fed Chair Jerome Powell's August 26 speech.

Powell said, "the longer the current bout of inflation continues, the greater the chance that expectations of higher inflation will become entrenched. ... we must keep at it until the job is done. ... history shows that the employment costs of bringing down inflation are likely

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to increase with delay. ... We are taking forceful and rapid steps ... to keep inflation expectations anchored. We will keep at it until we are confident the job is done.” Akin to Lincoln’s Gettysburg address, Powell’s Jackson Hole speech was short but effective, and investors took the Fed Chair at his word. Ten-year Treasury yields rose 125 basis points within the next eight weeks.

As the Fed increases short-term interest rates, the U.S. dollar has risen in value versus other currencies. We are reminded of Treasury Secretary John Connolly addressing G-10 world leaders in Rome in 1971 when under quite different circumstances, he said “the dollar is our currency, but it’s your problem.” Whether gold coins of the Roman Empire, the Medici’s dominance in Florence, or gilts issued in pound sterling to fund British wars against France, leading economic powers enjoy favorable interest rates and strong currencies. The same is true today for the United States.

An index of the dollar’s value has risen more than 15% this year, to levels last seen twenty years ago. The dollar’s rise dampens the impact of inflation as imports cheapen for U.S. consumers. However, foreign governments and corporations must repay trillions in dollar-based debt with depreciating foreign currency-based revenue, wreaking havoc overseas. Leaders of foreign countries are struggling with the dollar’s dominance.

Another former Treasury Secretary, Lawrence Summers, suggested that supplanting dollar hegemony requires identifying a suitable replacement, and said, “you cannot replace something with nothing, when Europe’s a museum, Japan’s a nursing home, China’s a jail, and Bitcoin’s an experiment.” We do not expect a turn in

the dollar’s upward momentum while the Fed remains hawkish. The recent U.K. currency crisis may mark this cycle’s peak in yields.

While the rise in the dollar may not be apparent in our daily routines, U.S. consumers are seeing the impact of higher interest rates. The housing market has been hit by higher mortgages. Existing home prices and new home construction have fallen. The monthly cost of servicing an 80% mortgage on a \$355,000 median priced home at last year’s thirty-year mortgage rate of 3% has increased over 70%, from \$1,197 to a monthly payment of \$2,075 on a \$390,000 median priced home at today’s average thirty-year mortgage of 7%.

Higher interest rates have slowed bond issuance. Taxable municipal refinancings drove \$48 billion of taxable refundings in 2021, and less than \$7 billion so far this year. Corporate issuance has slowed, and homeowners are not refinancing mortgages, reducing mortgage-backed security new issuance.

FIXED INCOME OUTLOOK

Investors, as well as prominent global organizations, are concerned that the Fed may be raising rates too far. The United Nations, World Trade Organization, and the Organization for Economic Cooperation and Development each recently warned of recession tied to imprudent monetary policy.

We also see signs of economic slowdown. The Service portion of the Purchasing Managers Index (PMI) appears to have peaked, with prices for services led lower by drops in airfares, hotels, rental cars, internet

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services, and trucking. Apartment rents have declined two months in a row, according to CoStar. The Fed intends to reduce inflation through tighter monetary policy, and that will be difficult to accomplish without slowing employment. We believe the growth rate of inflation has peaked.

Quite a few companies have announced layoffs, including GE, Peloton, 7-Eleven, Walmart, Siemens, Facebook, Ford, and Apple. Monthly private employment gains remain strong, but recently released JOLTS (Job Openings and Labor Turnover Survey) data indicate 1.1 million fewer job openings in September than August, a precursor to reduced hiring.

Although economists strain to quantify slowdowns, every downturn has its own characteristics. Rolling recessions of the '70s gutted manufacturing centers that had enabled the Arsenal of Democracy to win World War II. Energy prices bottomed with the price of oil in the '80s. The savings and loan/real estate crisis marked the downturn of the early '90s. The pandemic of 2020 brought a brief but jarring halt to commerce everywhere. Perhaps lower corporate profits, stubbornly sticky inflation above the Fed's 2% target, but surprisingly steady aggregate employment mark the next downturn.

It has been rewarding to reinvest new proceeds in a higher interest rate environment. High quality, intermediate-maturity portfolios are generating yields above 4.5%. Investment grade corporate bond credit spreads ended the quarter where they began, at 1.6% above Treasury yields, at their widest point of the year. In an uncertain environment for many asset classes, generating mid-single digit yields in high-quality fixed income investments with intermediate maturities provides above average principal stability and reasonable income that investors have missed for many years.

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October 2022

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