Information through 3/31/2025

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

In the first quarter of 2025 the total return of the S&P 500 Index fell 4.28% after six consecutive quarters of positive returns.

One factor contributing to investor caution was uncertainty about the current administration's approach to trade issues, namely implementing tariffs on the United States' global trading partners. While candidate Trump and then President Trump strongly signaled his intention to use tariff increases as a major policy tool, equity investors seemed to shrug off the potential implications of such policies until they became more imminent and concrete.

Complicating matters further is the rapidity with which the administration has signaled changes to its tariff policies. This has led to a significant increase in equity market volatility.

This same policy uncertainty also greatly complicates matters for the Federal Reserve, with its dual mandate to support employment and keep inflation under control. It is unclear what tariffs will mean for each of these mandates. Tariffs clearly and immediately increase costs, which is inflationary as long as the same amount of goods and services are purchased, but they also may lead to decreased economic activity which would harm the job market and could eventually lead to lower inflation. Thus, the Fed has to decide whether to keep rates high to fight the potential inflationary impact of tariffs, or to lower rates in anticipation of potential economic weakness from tariffs.

This lack of certainty around the impact of higher tariffs (as well as a lack of clarity around what tariff policy actually will be) is not just a problem for the Federal Reserve. It is also a problem for companies trying to navigate this uncertainty.

Businesses are reticent to make investments and to hire workers when they feel unsure about their future operating environment. Some public companies have already decided to stop issuing forward guidance on revenues and earnings, with many specifically sighting uncertainty about tariff policy and the potential impact of tariffs on their companies specifically and the economy more generally. This is unlikely to bode well for economic growth going forward.

Given the amount of attention we have devoted in prior letters to the extreme market concentration in the S&P 500 and impact of the Magnificent Seven ("Mag 7") specifically, we would be remiss in not mentioning the reversal of fortunes for these and other technology stocks in the first quarter.

As mentioned above, the S&P 500 retreated 4.28% in the first quarter of the year, but the S&P 500 Technology Sector fared significantly worse, falling 12.79% in the quarter. Things were even more dire for the Mag 7 (measured here by the Bloomberg Magnificent 7 Index) with those stocks dropping 15.98% in the quarter.

One factor affecting the sector is that investors are still waiting to see economic returns on the significant investments that have been made in the infrastructure necessary to run data- and energy-intensive artificial intelligence applications. The longer investors have to wait to see tangible financial results from these capital expenditures the tougher things may become for stocks that have benefited from the extreme optimism that has propelled the shares of AI-related companies over the past several years.

EQUITY OUTLOOK

Tariff uncertainty also complicates the work of equity analysis. Very few, if any, companies would not be impacted to some extent by the implementation of broadly higher tariffs. Thus, an ongoing assessment of what those impacts might be for current and potential investments is important.

However, uncertainty in equity investing is always present. Anticipating the future is a difficult pursuit even in benign market environments. We believe our investment approach is as relevant now as it has ever been.

The three key factors we seek in potential investments are: companies with high and consistent profitability, companies with strong balance sheets, and companies trading at valuations commensurate to our assessment of their prospects.

Of these three factors, profitability is the one most likely to be directly affected by tariff levels. Companies that can maintain above average margins in the face of increased tariffs will be of great interest to us.

As we have moved from a regime of extremely low interest rates to higher rates, balance sheet resilience has become even more important. Companies that don't need to borrow to fund their operations will be advantaged over those that must acquire new debt or roll over existing debt at higher rates to fund their businesses.

Finally, valuation, while seeming ignored in some parts of the market over the past several years, has suddenly become a more relevant factor to investors recently. While we think the price you pay for an investment is important in any market environment, it becomes particularly important when the overall market is expensive relative to history, as it continues to be.

FIXED INCOME OVERVIEW

The "Trump Bump" of the fourth quarter became the "Trump Slump" in the first quarter, but high-quality bondholders benefitted amidst falling interest rates. The Aggregate Index generated a 2.78% return, and the Intermediate Government/Credit Index earned a 2.42% total return for the quarter. Ten-year Treasury yields fell from 4.57% to 4.21%, and two-year Treasury note yields fell from 4.24% to 3.89%.

Volatility increased in the quarter, resulting in wider bond spreads relative to Treasurys. The average spread over Treasurys for the investment grade corporate bond index widened thirteen basis points, to 0.93%.

Before the turmoil of the tariff news, some economists believed that immigration restrictions would lift inflation more than tariffs. Tariffs will increase the cost of doing business in America, but in a loosening and still tight labor market, a reduction in the supply of workers may drive wage costs higher.

The administration has fired the first shots of a trade war, and the April 2nd tariff announcements will be more burdensome than first expected. When compared to tax hikes the initial tariff proposals represent 1.6% of GDP, larger than any tax increase in recent history. Maybe the administration will soon declare victory and weaken proposed high tariff rates in the future. In either case, uncertainty is causing executives to delay corporate plans and foreign trading partners to re-think their relationship with the United States.

The relationship between tariffs and inflation is difficult to predict. A review of periods of higher tariffs in the past is inconclusive. Higher tariff rates may slow business investment, creating deflationary recession conditions. On the other hand, if tariffs aid the administration's goal

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of re-industrializing the country in a tight labor market, inflationary conditions may persist. Most are convinced higher tariffs mean higher prices. Nevertheless, the initial market reaction of lower equity and higher bond prices suggests a deflationary, weaker economic growth environment in the near term.

The prospect of stagflation, a low growth economy with higher prices, puts the Federal Reserve in a difficult spot. Raising short rates risks dampening growth, while lowering short rates risks higher inflation.

Aggregate employment statistics remain strong, and the labor market remains a key support for economic growth. So far, there don't appear to be any signs of contagion from federal government job cuts infecting headline employment growth. Over the past two years U.S. Government and government-related sectors like education and healthcare contributed 73% of job creation. The Quits Rate has fallen and may be an early indication of a softening employment outlook. The presumption is that workers do not quit unless for a better opportunity, and fewer good opportunities are available.

Investors worry about the strength of the U.S. consumer, as both consumer confidence and sentiment register declines. Uncertainty regarding policy has grown, and real consumer spending has stagnated.

FIXED INCOME OUTLOOK

Initial estimates put the overall weighted-average new tariff rates at 29%, the highest in over 100 years. For perspective, the highest U.S. weighted-average tariff rate of the past 100 years was the 20% level of the Smoot-Hawley Act in 1930. Prior to the announcement, many expected a weighted-average tariff rate of about 12%, far below the 29% current estimate. The higher figure shocked the markets.

Lower interest rates and oil prices are exactly what the administration has said it wants. Equity prices are a secondary concern. Treasury Secretary Bessent, a brilliant investor before entering government service, has warned of a detox period and said, "Over the medium term, which is what we're focused on, it's a focus on Main Street. Wall Street's done great, Wall Street can continue to do fine, but we have a focus on small business and consumers."

We had hoped that market volatility preceding the April 2nd tariff announcement would represent a "buy the rumor, sell the news event," signaling a peak in policy uncertainty and a near term high for credit spreads and low for equity prices. Hope is not an investment strategy, and because of the higher-than-expected tariff announcements we remain cautious, expecting policy uncertainty to produce higher volatility for the next several months. We favor higher quality bonds, less cyclical issuers, domestic over foreign credits. In volatile times like these, the income and safety of high quality bonds offers greater certainty in an uncertain environment.

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