

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

After a modest total return of 2.65% in the 4th quarter of 2025, the S&P 500 index ended the year with a robust calendar year total return of 17.86%. This followed two even more impressive years, with total returns of 25.00% in 2024 and 26.26% in 2023.

It's been an impressive three-year run, which, as we have written in previous notes, has been largely driven by a small subset of large-capitalization stocks fueled by investor enthusiasm around advances in artificial intelligence (AI) technology. However, the character of the bull market began to change toward the end of 2025 with more participation from stocks outside of the "Magnificent Seven" and the technology sector in general. In fact, for the year, only two of those seven stocks (Alphabet and Nvidia) actually managed to outperform the total return of the S&P 500 index.

Investors seem to have developed at least a modicum of skepticism regards to the massive scope of spending on the infrastructure required to run AI processes and the prospects of this spending reaping competitive economic profits in the near future. However, regardless of this recent, modest retrenchment in sentiment, equity valuations remain significantly above historical averages and, thus, still vulnerable to disappointing earnings or other economic shocks.

While the macroeconomic background appears to be relatively benign (according to the spotty data that is currently available), labor market weakness is an area we will be watching closely in the coming months as there are signs of a slower pace of hiring. In a consumption-dependent economy, job security is a key driver of

growth, if that security is threatened, we would expect a downturn in general economic activity to result.

EQUITY OUTLOOK

Discipline is, by definition, difficult to maintain. This year was challenging (like many others) and it was important to stick to our strategy and avoid the temptation to seek out easy gains in the low-quality and/or overpriced assets that dominated market returns for much of the year.

We are pleased that our consistent strategy of constructing a low-volatility portfolio of high-quality assets was rewarded this year and we think we are well positioned going forward as the market environment continues to evolve.

FIXED INCOME OVERVIEW

Positive returns in the fourth quarter helped investment grade bonds generate positive results for a third straight year. For the full year, high quality fixed income indexes generated mid-single digit returns, and the Bloomberg Aggregate earned 7.30%.

In 2025, beginning in mid-September, the Fed eased short term interest rates three times, all in twenty-five basis point increments. The accommodative policy action pushed T-Bill yields to 3.65% at year-end. For the

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full year, two- to three-year Treasury yields fell about seventy-five basis points, and seven- to ten-year Treasury yields fell about fifty basis points. Contrary to the move lower for shorter maturities, thirty-year Treasury yields rose seven basis points. Lower short-term rates and higher long bond yields increased the slope of the curve, or difference between two- and thirty-year Treasury yields, from fifty basis points to more than 1.35% at the end of the year.

The slope of the Treasury curve is typically a good indicator of overall economic conditions. A year ago, Wall Street forecasters feared lower earnings, restrictive tariffs, higher unemployment, and recessionary economic conditions. The flat curve at the beginning of the year warned of economic weakness that never materialized. The recent steepening of the curve indicates investor confidence in continued economic growth. Going into the new year positive sentiment abounds, recession risk has receded, and every Wall Street firm predicts another year of market gains.

The Fed lowered short-term rates because of weaker employment data. Long bond yields have remained stubbornly higher because of investor concerns regarding inflation and the increase in the federal debt.

During the fourth quarter the social, economic, and investment issues surrounding Artificial Intelligence (AI) that have dominated equity markets since the coining of the term “Magnificent 7” in 2023, became pertinent to fixed income investors with a dramatic increase in tech company bond issuance to fund capital expenditures. There are widespread expectations that the trend continues into 2026.

AI can pass the bar exam better than the average law school student, interpret X-rays better than the average doctor, and write code faster than the typical programmer. Like most major innovative technologies AI will likely bring a better standard of living for all and come with costs we have yet to comprehend.

What gives us pause is the massive need for corporate debt to satisfy the hyperscalers’ funding of capital expenditures. We don’t know the amount of debt particular companies can incur before investors say “no mas,” and how much total debt the market can absorb without pushing all credit spreads wider.

FIXED INCOME OUTLOOK

Over the long term, rational economists make good arguments both for higher and lower interest rates. A peak in the ratio of workers to consumers may signal an end to the cheap labor costs of the past few decades that have enabled exporting countries to profit and importing countries to buy cheap goods. China alone will lose over four hundred million workers before the end of the century. The United Nations projects that by 2030 the world’s population aged sixty-five and older will exceed those aged 15 to 24. Apart from Africa, youth will account for less than 12% of the population in every region of the world. These demographic certainties could push rising wages to cause higher inflation. In addition, conventional wisdom suggests that growing global government indebtedness will increase borrowing needs and drive rates higher.

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On the other hand, the disinflationary forces of the past few decades may continue to pressure rates lower, including globalization and technological advancements. Aging savers demanding stable fixed income cash flows may overwhelm younger generations willing to incur debt.

Over the short run, heading into 2026, monetary stimulus to fight slower growth, and even fiscal stimulus that boosts output faster than debt increases, represent countervailing forces we expect to drive interest rates lower. We expect fiscal stimulus from tax relief to surprise consumers and avoid recession, but not to reignite higher inflation. Accommodative Fed policy in a softer job market will push short maturities lower, and the yield curve steeper.

Most investors commonly describe incremental spreads over Treasuries for both corporate and securitized assets as tight. Demand for fixed income assets has driven prices higher and spreads tighter, even amidst near record supply of new issues. New issuance of U.S. investment grade corporates surpassed \$1.6 trillion in 2025, second only to 2020's \$1.8 trillion of new debt. Consensus expectations are for another big year of new supply for corporate debt, around \$1.5 trillion. Higher capital needs for AI projects and expectations for the funding of mergers and acquisitions are the primary drivers.

2026 will bring a new head of the Federal Reserve. We are a bit surprised so many savvy people have expressed interest in the job, given the challenges the Fed will face. Inflation remains stubbornly above the Fed's 2% target while unemployment has increased. Fighting weakening employment trends with lower rates risks reigniting higher inflation. Raising short rates risks an acceleration

of slower employment trends. Nevertheless, the current environment is more friendly for bond investors than the zero interest rate years that succeeded 2008's financial crisis.

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