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Information through 03/31/2018

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

Any expectation of a repeat of the tranquil equity markets of 2017 was quickly dispelled in 1Q 2018. Stocks initially moved to all-time highs as the economy continued to grow, but not at a pace that caused widespread fear of inflation. Optimism regarding tax cuts also helped, as, contrary to custom, corporate earnings estimates actually moved up to +19% for the year, from +12% previously, while the annual revenue growth forecast was bumped up a point to +7%. Earnings grew at about 15% during 4Q, the fastest pace since late 2011.

Upon further review, investors found a number of things to fret about, with the self-reinforcing result being the collapse of outsized bets on low volatility. The Dow tumbled 9.4% from its January 26 peak. Now, rising economic growth was seen as leading to rising inflation and more aggressive Fed tightening. The tax cuts were feared to add too much fuel to the economy and price levels. Plus, expanding the deficit would lead to further debt issuance (supply) and cause interest rates to go up even more, while a weakening dollar could raise prices of products denominated in dollars, particularly commodities like oil.

Then the February jobs report came out: more than 313,000 new jobs, upward revisions, and decent wage growth of +2.6%, but lower than the prior month. Markets rallied sharply on the ‘Goldilocks’ scenario of strong jobs, contained inflation, greater workforce participation, and more hours worked.

After recovering about two-thirds of the decline, the market sell-off resumed into the close of the quarter. President Trump announced tariffs against overseas steel and aluminum producers, leading to Chinese retaliation. Additionally, the technology sector—long a market leader—began to falter. Facebook sold off dramatically amid disclosure of the misuse of its customer data by a related party. There were tragic mishaps involving “self-driving” vehicles. Finally, President Trump began hectoring online retail giant Amazon, raising the specter of heightened taxation or regulation.

In March, the Federal Reserve hiked short-term rates 0.25% to a 1.50-1.75% range, while upgrading its view of the economy and the job market, but leaving inflation expectations unchanged.

Elsewhere, the posture of the European Central Bank also became less accommodative, reflecting its own pick-up in growth.

The S & P 500 declined 0.76% after accounting for dividends for the 1Q, its first quarterly loss since 2015, and had nine weekly moves of more than 2% up or down. The dollar was down for the 5th straight quarter and oil

ASB INVESTMENT MANAGEMENT

was up for the 3rd straight quarter.

Despite the late sell-off, consumer discretionary was the best group, led by Amazon. Traditional retailers also benefitted from strong holiday sales and the prospect of tax cuts. Technology was next, followed by healthcare. Telecom, energy, consumer staples, and materials fared the worst. U.S. stocks lagged their global counterparts, and mega-caps were outpaced by smaller caps.

EQUITY MARKET OUTLOOK

During the Winter Olympics, one of those absurdly long cross-country ski contests had become a two-man race. Both of the leaders knew that changing into skis with a fresh coat of wax would increase their efficiency but also cost valuable time. As the Finn stopped with 10 kilometers to go, the Russian surged onward, opening up a seemingly large lead. Undaunted, the Finn pursued doggedly, conserved energy while gliding downhill on his more efficient skis, narrowed the gap, then burst past his laboring opponent to win the Gold.

During March Madness basketball, a coach beseeched his team, "time is the friend of truth." What he meant was… 'your shots are not falling right now. Keep playing strong defense. You are good shooters. You are getting good shots. Keep taking them. They will fall…' The next game the three-pointers rained down and his team proceeded with a strong run in the tournament.

Investing is like that, too. To paraphrase, 'Time is the friend of Fundamentals.'

Right now, the macro-economic fundamentals are solid, with decent economic growth, a strong job market, rising wages, tax cuts, robust corporate earnings, and the Fed looking to bump up rates only gradually. A bi-partisan $1.3 trillion spending blowout will increase Federal spending by $300 billion over two years, and further balloon the deficit.

During 2018, corporate quarterly EPS are estimated to increase 18%, 20%, 21%, and 20%. With the immediate one-time boost from tax cuts rolling off, there is a very real possibility of peak growth rates this year, if not peak earnings.

So, after a long economic and stock market run, stocks could continue upward on earnings growth, or could correct on concerns that the end of the cycle is in sight. In fact, we have already seen both scenarios play out early in the year. With little near-term likelihood of a clear resolution, expect volatility to remain elevated.

Likewise, the jury is still out on the inflation rate. Economic growth and increased spending could drive prices higher. Or, corporations flush with cash could increase capital spending, increasing the supply of goods, and driving prices lower.

Fortunately, our bottom-up stock picking discipline guides us toward companies with fundamentally vibrant long-term and near-term growth outlooks.

Yes, there are security and privacy concerns associated with data, but its relentless proliferation will continue thanks to the cloud, artificial intelligence, virtual reality, the internet of things, and more. We own a significant investment in leading producers of memory chips.

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Global growth, and burgeoning production of electric vehicles, will increase the demand for commodity building blocks. Yes, economic fluctuations and fears of a trade war with China can cause short-term sell-offs, but the long-term outlook remains favorable. We are overweight copper and other materials.

Worldwide oil demand continues to grow, with oil prices increasing 7.5% in the first quarter to $65 per barrel, and liquefied natural gas demand over the next 20+ years forecast to grow 4-5% per year. Energy companies are forecast to produce the fastest near-term growth, yet the stocks lagged in 2017 and the 1Q of 2018. We remain overweight energy.

Though markets remain turbulent, we believe favorable outcomes can still be achieved over time by employing a disciplined investment process and investing in fundamentally strong companies.

FIXED INCOME REVIEW

Volatility returned to the markets like a school yard bully back from spring break and investors struggled to find any place to hide to start the new year. The S&P 500 and Barclays Aggregate Bond Index both registered losses in the same calendar quarter for the first time in nearly ten years. The Barclays Aggregate investment grade fixed income benchmark returned -1.46% for the quarter.

Short interest rates rose more than long rates and the treasury curve flattened. The difference between two and thirty-year treasury yields narrowed to 0.70%, from 0.85% at the beginning of the year. Investments in high quality fixed income now yield more than 2% across the entire maturity spectrum, even in very short-term instruments.

Continued strong employment gains and lower tax rates increasing both corporate confidence and earnings expectations drove interest rates higher. After January and February's steady rise in rates and amidst a backdrop of higher equity market volatility, investors seemed to realize that for the first time since 2008 two year Treasurys have a higher yield than the S&P 500. In March Treasurys rallied, but credit spreads continued to widen.

Economic activity remains robust. The Institute for Supply Management recently reported the overall economy grew for the 107th consecutive month. The New Orders Index remained above 60 for the 11th straight month and the Customers' Inventories Index is at its lowest level of the past seven years. The Backlog of Orders Index has grown for 14 consecutive months and registered its highest reading since 2004.

Corporate earnings are strong. Earnings of S&P 500 companies rose 15% year over year in the fourth quarter of 2017. Strategists expected a similar increase in the first quarter, before tax cuts. Analysts now expect corporate tax cuts to propel the year over year increase in first-quarter earnings to 25%.

Inflation has increased but not rapidly, leaving the Fed committed to additional rate hikes. 2.5% inflation on top of 4% real GDP growth would result in 6.5% nominal GDP growth. High nominal GDP growth, 0.75% of additional Fed rate hikes and $420 billion of Federal Reserve balance sheet reduction by the end of the

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year are arguments for gradually higher interest rates.

FIXED INCOME OUTLOOK

We are more cautious with regard to both the near-term direction of interest rates and credit spreads than at any time in several years. Most portfolio durations remain short of benchmark indexes. The Fed continues to tighten short-term rates but recent shifts in market sentiment and technical investor positions weaken our conviction that rates will rise with the same momentum in the second quarter as in the first.

Credit spreads have widened about thirty basis points from early February lows. The passage of the tax act heralded the repatriation of large corporate short-term investment funds. The absence of reinvestment, noted overseas selling, and redemptions from exchange-traded funds as interest rates rose, contributed to wider credit spreads.

We usually like the taxable municipal sector for its credit quality and diversification features, and most of our portfolios have allocations much larger than benchmark indexes. As credit spreads widened in the first quarter, particularly in two to three-year maturities, taxable munis performed well. As the difference between muni and corporate yields widened we became sellers of high priced municipals, preferring the relative value of Treasurys and corporates.

The new issue market often offers clues to the direction of overall credit spreads. During the quarter, we became increasingly reluctant to participate in expensive new issues. As credit spreads have widened we have noticed an increase in new issue concessions, and have again become selective investors in new deals, especially large financings of acquisitions. These transactions typically offer greater liquidity from larger companies determined to pare down recently expanded balance sheets. The landscape is challenging, but higher yields have increased the reward for discerning fixed income investors.

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