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Information through 3/31/2019

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The robust rally born on December 26 continued into 2019, with the S & P 500 racking up a return of 13.7% in the first quarter. So it was that the worst December since 1931 immediately preceded the best January since 1987, and the waning days of the worst quarter since 2009 ushered in the best. All 11 sectors were higher for the quarter.

The market surge took place as fears of a global economic slowdown were assuaged by the assurance that global central banks would not overly restrict monetary flow.

The U.S. economy expanded 3.1% in 2018, grew 2.2% in the 4Q, and rose an estimated 1.4% in the 1Q.

Demand for workers continued to be vigorous, with 2.64 million jobs added in 2018 compared to 2.19 million the prior year. December's stunning initially reported gain of more than 312,000 jobs was revised down to 222,000, but then January added 311,000.

Nonetheless, consumer spending reports portray a puzzling soft patch in December (-0.6%) and January (+0.1%), failing to confirm an upbeat consumer. Retail sales (revised) were +0.7% in January, in conjunction with an initial reading of -0.2% in February. The release of data remains behind the typical schedule as a result of the government shutdown.

Then the February payroll data indicated a surprisingly small gain of just 20,000 jobs, the lowest number of additions since September, 2017 (which was impacted by several major hurricanes). However, the unemployment rate dropped to 3.8%, near five-decade lows, and the annualized rate of wage growth accelerated to +3.4%, the highest in ten years.

Oil prices rebounded 32% as continued demand growth, supply reductions by OPEC, and political disruption resulted in U.S. crude inventories again dipping below 5-year averages.

Overall inflation remained subdued, hovering around 2%.

Corporate profit growth slowed in 4Q to cap off a very strong 2018.

Contrary to the initial expectation of rising interest rates, stock prices and bond yields diverged in 1Q, with the 10-year Treasury yield closing at 2.42% compared to 2.68% at year end.

Subsequent to raising short term rates in December, to a range of 2.25-2.50%, the Fed became increasingly dovish. First came indications that they might be on hold for some time due to global growth and trade concerns. After pausing at its March meeting, downgrading U.S. growth forecasts, and further indicating that the brakes would be applied to the unwinding of its $4 trillion balance sheet, fixed income markets began to price in rate cuts rather than further hikes.

ASB INVESTMENT MANAGEMENT

Trade uncertainty continues to prevail, with negotiations ongoing between the U.S. and China.

In China the economy is growing at a lesser but still robust 6%.

The U.K. failed for a third time to approve terms of a "Brexit' from the European Union, leaving in place the uncertainty that has prevailed for the past two years.

Back in the U.S., a prominent ride-sharing company made its market debut, with strong revenue growth attracting healthy demand for the IPO shares, notwithstanding the generation of large operating losses.

EQUITY MARKET OUTLOOK

While U.S. GDP growth is temporarily slowing, it will be a surprise if the economy rolls over into a recession. Consumers comprise about two-thirds of economic activity, and should have the wherewithal to spend given the strong demand for labor, tight supply of available workers, and healthy wage gains. Indeed, consumer sentiment rose sharply in March with interviewees citing higher income expectations and the most confident economic outlook in four years.

In March, China's factory Purchasing Manager's Index rebounded to 50.5 from 49.2 the prior month, a large increase that signifies a shift from contraction to expansion, while an index of construction and services remains in expansion, and also increased, to 54.8. U.S. factory activity increased, with new orders strong.

European economies are sluggish but still in expansion.

The absolute level of interest rates remains quite low, and it would be highly unusual for a recession in the U.S. to begin with real interest rates (which subtract inflation) at such low levels.

With markets plunging in the 4Q, the Fed, under withering external pressure, may have over-reacted—not as much in its actions as in its outlook—indicating the possibility, but not the certainty, of persistently slower U.S. growth.

A number of one-offs likely contributed to the temporary economic slowing. Weather was exceptionally bad. There was a partial government shutdown. There were mid-term elections. The stock market was plunging. Then there are seasonal issues with the data, which regularly tend to understate the opening period.

The world economy is increasingly connected. China at $13 trillion represents 16% of the global economy, as does Europe. The U.S. at $20 trillion represents about 25%. At 6% growth, China remains the biggest global growth driver, the U.S. (2%+ growth) is next, and then Europe (about 1% growth).

The very public trade spat continues with the very real tariffs that accompany it. Inventory accumulation may have occurred ahead of tariff-induced price increases, followed by the subsequent work-off, and capital spending may have taken a pause as businesses await greater visibility.

Granted, an agreement on terms of trade between the U.S. and China would be a positive, but exports represent only about one-eighth of the U.S. economy.

> "By the end of the quarter, fixed income investors were divided over whether the Fed's pivot to less restrictive monetary policy presented an opportunity for greater risk taking, or implied slower future growth and greater caution."

Jobs are real. Scary headlines tend to be ephemeral, and confidence may already be bouncing back following an unusual array of difficult to analyze events. Remember, the U.S. economy alone should grow by at least $400 billion this year.

Our portfolio of large, liquid U.S. companies is positioned to take advantage of this domestic growth, and is also overweight the natural resource sectors which benefit from faster growth in China.

As always, corporate earnings bear close watching. Following the anniversary of tax cuts, which produced outsized earnings gains, few will be surprised when the more challenging comparisons produce a slower bottom-line growth rate. With EPS forecast to be reported down 4% in the 1Q, forward guidance will be key. Investors are waiting to hear tangible evidence that confirms the return of corporate profit growth, and a re-acceleration in second half economic activity to the 2%+ rate which appears to be most likely.

FIXED INCOME REVIEW

The Bloomberg Aggregate Bond Index returned 2.94% in the first quarter. In the risk-on rally, credit spreads tightened in concert with the rally in stocks, but treasury yields remained in a tight trading range through the first two and a half months of the quarter. On March 20th, the bond market broke from its narrow trading band as the Federal Open Market Committee (FOMC) met and shifted course from the direction announced at the Fed's December 19th meeting. Following Chairman Powell's quick and impactful pivot, market expectations for the number of Fed Funds hikes in 2019 changed to zero, down from three or four just a couple of months earlier.

The Fed Funds rate is the short term interest rate targeted by the Federal Reserve's FOMC. It is the key benchmark interest rate used to steer monetary policy. Unlike other market derived interest rates set by the supply and demand for bonds, the Fed sets the rate itself.

The FOMC's dot plots measure the seventeen FOMC members' expectations for Fed Funds rates at the end of the current year, the end of each of the next two years, and in the long term. The median for each time period represents the Fed's forecast of future Fed Funds rates.

Fed funds futures contracts are financial instruments traded in the open market, based on expected, future Fed Funds rates. Investors use these prices to determine a market implied forecast of Fed Funds rates. The difference between the FOMC dot plots and the market implied forecast represents the difference between the market's expectation for short rates and the Fed's own forecast.

The FOMC meets every six weeks. At the December 19th meeting, the Fed increased the Fed Funds rates 25 basis points, to 2.50%. Many years ago Fed Chairman Volker used Fed Funds rate announcements to intentionally surprise the markets, leveraging the Fed's limited monetary tools for optimal effectiveness. Since then the central bank has carried out its policy directives with increasing transparency and foresight. The Fed's tightening move on December 19th was no surprise.

Even though the Fed's rate hike in December surprised no one, the market implied path of future short rates further diverged from the FOMC's own median dot plot expectations. Interest rates traded in a narrow range for the first two months of the quarter, but that changed at the Fed's March 20th FOMC meeting. The FOMC forecast for Fed Funds at the end of 2019 dropped almost 50 basis points from 2.85% at the December meeting to 2.37% at the March meeting, but failed to keep up with the fall in market implied expectations for Fed Funds.

At the March 20th FOMC meeting Chairman Powell announced that the Fed no longer expects to increase rates for the remainder of the year and that the Fed will slow its plan for balance sheet reduction. The Fed now foresees only one additional rate hike over the next three years. The ensuing bond rally driving longer term yields to twelve month lows argued the case that the Fed erred with its December tightening. By the end of the quarter, fixed income investors were divided over whether the Fed's pivot to less restrictive monetary policy presented an opportunity for greater risk taking, or implied slower future growth and greater caution.

FIXED INCOME OUTLOOK

Although three month bill to ten year treasury note yields inverted briefly at the end of the quarter, we do not foresee a recession this year. A negative sloping treasury curve may indicate a looming recession, but we see several signs that the current record long expansion has room to continue. U.S. cyclical spending, residential investment, and motor vehicle consumption, all as a pe cent of GDP, remain solidly below warning levels of past recessions. Employment is strong, wage gains are not excessive, and inflation remains below the Fed's 2% target level.

Challenged growth overseas has weighed down foreign bond yields, so much so that Bloomberg recently reported that over $10 trillion of global debt trades at a negative interest rate. The Eurozone is weak, but the ECB remains accommodative. Manufacturing activity in China and the United States recently improved. Economic releases related to housing have exceeded consensus estimates over the past two months, with existing and new home sales rebounding off of fourth quarter lows. Homebuilder sentiment and the performance of homebuilder stocks has been strong, and mortgage applications have increased.

Our duration positioning is slightly short of benchmark indices. Corporate bond spreads are much tighter than they were at the beginning of the year and we have become more selective in our choice of credits. Mortgage-backed security yields are likely to rise with interest rates, but MBS spreads may tighten. We prefer highly rated commercial mortgage-backed bonds for the yield pick-up and reduced prepayment sensitivity.

Kevin D. Moore, CFA
Director of Equity Investments

Michael J. Stafford, Jr., CFA
Director of Fixed Income Investments

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For additional information about ASB Investment Management, please contact:

Hank Murphey
Vice President,
Director of Client Services
ASB Capital Management
(240) 482-2948
hmurphey@asbcm.com
7501 Wisconsin Avenue
Suite 1400 West
Bethesda, MD 20814
www.asbcm.com

Mike Stafford, Jr. CFA
Managing Director
ASB Capital Management
(240) 482-2977
mstafford@asbcm.com
7501 Wisconsin Avenue
Suite 1400 West
Bethesda, MD 20814
www.asbcm.com

Martin J. McLaughlin
Managing Director
ASB Capital Management-Chicago
(847) 359-8585
mmclaughlin@asbcm.com
1901 N. Roselle Road
Suite 800
Schaumburg, IL 60010
www.asbcm.com