Information through 03/31/2022

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The investment environment is always changing. This is a truism. However, for more than a decade it was less true than at most times in market history. For the ten years following The Great Recession, with few exceptions, investors operated with a remarkably stable macroeconomic backdrop.

Part of this backdrop was slow but very steady aggregate economic growth. From 2010 to 2019, US GDP growth never strayed far from an annual rate of about 2%.

Similarly, from 2010 to 2020 the US inflation rate also stayed very close to an annual rate of 2%.

With such benign inflation central banks around the world were able to maintain an ultra-dovish stance. Policy rates were maintained at levels close to (and in some cases below) zero.

Equity markets responded well to this environment. For the 13 years from 2009 to 2021 the S&P 500 had a positive return every year except for one (a total return of -4.38% in 2018). Additionally, in ten of those years the S&P 500 total return exceeded 10%, in five of those years the total return exceeded 20%, and in two of those years the total return exceeded 30%.

The investment environment is changing.

Since the onset of Covid 19 in early 2020, US GDP growth has swung from wildly negative to wildly positive. Equity markets took this volatility in stride with S&P 500 total returns of 18.4% in 2020 and 28.7% in 2021. Massive fiscal stimulus and additional accommodation from an already dovish Fed in the wake of the pandemic served as a tailwind.

However, inflation is no longer benign. Energy costs, labor costs, and lingering supply chain disruptions have led to the emergence of widespread price increases.

The Fed has abruptly changed direction as it raised rates for the first time in several years in March and it is signaling a string of additional rate hikes ahead.

While equity markets retreated in the first quarter of 2022, they did not do so in dramatic fashion. The S&P 500 had a negative total return of 4.6% for the quarter.

As the Fed has now turned hawkish and interest rates are rising, it is important to note that the Fed was completely wrong about this current bout of inflation. As inflation started to creep up at the end of 2020 the Fed called it transitory and kept rates at all time lows. There is no reason to believe that the Fed will be anymore insightful about how inflation and the economy will fair in the months and years ahead.

EQUITY MARKET STRATEGY

While we take current macroeconomic conditions

ASB INVESTMENT MANAGEMENT

seriously when considering stock selection and portfolio construction, we take our ability (and everyone else's) to forecast macroeconomic conditions with a grain of salt. The following is an example of how we incorporate current macroeconomic data into our investment process.

As has been broadly reported, a shortage of semiconductors has been one factor contributing to price increases for a wide variety of products. We also know that investment in production capacity for semiconductors is accelerating sharply driven by both private and public funds. This causes us to believe that companies providing essential tools for semiconductor production are in an enviable position.

While this gives us a reason to explore investments in such companies, we will always maintain our discipline of seeking out firms with consistently high profitability, clean balance sheets, and reasonable valuations. The latter factor is especially important when the attractive attributes of a company are well known (as is the case with semiconductor equipment makers today).

We currently have high conviction investments in two such companies. They are both currently and historically exceptionally profitable. They both have pristine balance sheets with less debt than cash on hand. Finally, they both trade at earnings multiples lower than the broad market.

While we do not know when or even if these investments will prove to be profitable for our clients, we strongly believe that adhering to our discipline as outlined above greatly enhances the *probability* that these investment will be successful.

FIXED INCOME REVIEW

Interest rates rose and credit spreads widened, driving the first quarter return of the Aggregate Bond Index to a dismal -5.93%. The Aggregate Index experienced a fifth consecutive quarter of negative total returns. The first quarter's return was the worst calendar quarter return for the index in 42 years, and third in poor performance only to the first quarter of 1980's -8.7% total return and the third quarter of 1980's -6.56% return.

Increasing inflation and a strong economy have driven rates higher. Recent jobless claims came in at 166,000, the lowest figure since 1968, and tied for the second lowest reading ever. The job market is so strong Fed Chair Jerome Powell recently described it as "tight to unhealthy." In his annual letter to shareholders JP Morgan CEO Jamie Dimon suggested that "the medicine was probably too much and lasted too long" while commenting on policymaker measures to bolster the economy during the pandemic.

The Aggregate Bond Index has never before experienced five consecutive quarters of negative returns since its

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inception in 1976. Fortunately, negative bond returns are producing a higher interest rate environment and higher returns on new investments. The yield curve flattened dramatically during the quarter as the 0.83% rise in ten-year Treasury yields failed to keep pace with the 1.60% increase in two- year Treasury yields.

The slope of the Treasury curve, the difference between short and long term rates, is often a good indicator of the economic cycle. A flattening curve headed toward inversion, with short rates rising faster than long rates, is a sign of economic weakness. A steeper curve, where long rates rise faster than short rates, signals future economic strength, with investors concerned more about the risk of holding long term bonds in an inflationary environment than the benefit of a steady fixed interest payment in a weakening or deflationary environment.

Two different measures of Treasury curve slope are currently signaling contrasting views.

- *The Two-To-Thirty Year Curve* is typically the most frequently cited measure of curve slope and portends economic weakness. Two's to thirty's flattened at the end of the first quarter when two-year note yields of 2.34% nearly matched 2.45% thirty-year bond yields.

- *The Three Month -T-Bill-to-Ten Year* Treasury note yield curve is considered a more accurate predictor of recession and remains steeply sloped, indicating continued economic strength.

While many pundits suggest a still elevated stock market is telling a story of continued economic strength that differs from the bond market's prediction of weakness, we find it interesting that the bond market's signals are incongruent.

A third curve, the *Fed Dot Plot*, reveals the consensus view of FOMC members with regard to where short rates will be in the future. Ominously, this curve indicates higher future Fed Funds rates. Coupled with the Fed's plan to reduce its record large balance sheet through quantitative tightening, it appears that the more accurate T-Bill to ten-year curve will soon flatten, if not invert, generating a clear bond market forecast of weakness.

These historically accurate measures of the economic cycle, paired with a strong sense that, regardless of inflation, the economy cannot withstand considerably higher rates without recession, soften any conviction that rates are headed considerably higher. Ten-year Treasury yields have risen 1% in four weeks. Over the near term, the strong momentum toward higher rates may have created an oversold condition.

FIXED INCOME OUTLOOK

The factors driving interest rates higher may be fully

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priced into current market levels. Although current inflation is far above the Fed's 2% target, February's 6.90% year over year increase in the Consumer Price Index may be near the cycle high. The growth of durable goods prices has declined from previous months. Wage gains show a recent peak of 6.25%, higher than three month annualized average hourly earnings of 4.5%. Recent Institute of Supply Management reports indicate an increase in the service sector and decrease in manufacturing, likely foreshadowing a shift in demand.

The worst of supply chain disruptions may be behind us. Gasoline futures are down 20% and lumber futures are off 35%, both from peaks the first week of March. Homebuilder stocks are off 29% and regional banks stocks are down 18% from recent highs. The increase in rates and much-anticipated tighter Fed policy appears to be having an impact on the economy now, even though the FOMC forecasts ten additional hikes of 25 basis points by the end of 2023.

At the end of the quarter client portfolios were positioned closer to benchmark durations, after being short duration targets for most of the first three months of the year. Corporate credit spreads are about 25 basis points wider from levels at the beginning of the year, but thirty basis points tighter than the first quarter's widest levels in mid-March. As corporate credit spiked higher in mid-March, we sold much tighter taxable municipal bonds to purchase higher-yielding investment grade-rated corporate issues.

The FOMC noted that Russia's invasion of Ukraine has not had a significant impact on financial conditions yet, but that the war has added to inflation pressures and worsened the economic outlook. The Fed's own expectations for inflation recently increased to 4% from 2.6% at the January meeting.

The Fed is likely to begin reducing the size of its balance sheet after its May meeting. It is likely the Fed will reduce holdings by $95 billion per month, comprised of $60 billion of Treasuries and $35 billion of mortgage-backed securities. Interest rate volatility and the prospect of the Fed reducing MBS holdings keeps us focused on less prepayment sensitive alternatives to MBS such as commercial mortgage-backed securities and taxable municipals.

The rise in interest rates has brought negative trailing total returns, but offers fixed income investors higher income and higher prospective returns. We look forward to prudently investing capital to capture the advantages of today's higher yields.

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