ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The impact of the Covid-19 pandemic on the US economy has been shockingly acute. In the first quarter, GDP shrank 5% from the same quarter in 2019. However, the economic lockdowns implemented to contain the virus were not yet in place in most of the country until mid-March. It was the second quarter that bore the brunt of the economic contraction. Official data is not yet available, but the Atlanta Fed estimates that second quarter GDP will contract by a previously unfathomable 35.5%. Of course, the pandemic is by definition a global phenomenon and economies across the world have been negatively impacted. The IMF estimates that global GDP growth for 2020 will contract by an unprecedented 4.9%.

Equity markets have reacted in two stages. A sharp fall in the first quarter, followed by a sharp recovery in the second quarter. The net result thus far, would appear to be a benign (given the dramatic circumstances) loss of 3.09% for the S&P 500 in the first half of the year. However, the underlying disparity in equity market performance have never been as stark. In the first half, the S&P 500 Value Index had a total return of negative 15.52% while the S&P 500 Growth Index had a positive return of 7.92%. That difference is largely the result of the stock performance of a handful of megacap technology companies. The Nasdaq 100 Index, with heavy weights in the largest technology firms, had a positive return of 16.89% in the first half. These megacap technology companies dramatically outperformed in the second quarter. If we simply look at the performance of the largest four constituents of the S&P 500 in the second quarter, the market impact becomes clear. Microsoft had a positive return of 29.40%, Apple returned 43.84%, Amazon returned 41.50% and Facebook was up 36.13%.

There are many possible reasons for the dominant performance of these companies. One is simply momentum. They have performed well for several years, becoming ever larger constituents of equity indices, which has led to increasing flows of passive equity investment dollars into their shares. Many active managers have had to play catch-up and add to these positions or risk underperforming their benchmarks. The fundamentals of the companies are strong. All produce copious amounts of cash from operations and have no problem raising debt (in many cases for stock repurchases or dividend payments) at extremely low interest rates. Additionally, as a group they have been fortuitously positioned for pandemic conditions given their key roles in ecommerce and providing the infrastructure that facilitates work from home and the accelerated movement of corporate IT solutions to the cloud.

ASB

INVESTMENT MANAGEMENT

EQUITY STRATEGY

The market dominance of a small group of megacap technology companies has masked the underlying weakness of the shares of firms in most other sectors and industries. While we will continue have a stake in some of the leading technology firms, we think the most attractive opportunities in the coming months are likely to be in areas that have lagged the broad markets such as the industrial, energy, financial and real estate sectors, all of which were down sharply in the first half of the year.

Given the massive dislocations we have seen in the real economy, we will be vigilant in our search for attractive assets. Companies that are producing positive free cash flow with industry leading profitability will be our primary targets. It will be essential that these firms have balance sheets strong enough to endure potentially difficult macroeconomic conditions for several quarters going forward, if not years. Additionally, we will avoid firms that are highly dependent on policy decisions (e.g. government aid) to survive in the current economic environment.

FIXED INCOME REVIEW

The second quarter rebound in securities prices didn't represent so much a dead cat bounce as a starved cougar pouncing on unsuspecting prey. After perhaps the most vicious quarter ever, corporate bond yields recovered almost as quickly as the equity markets, which experienced the best quarter in over twenty years. Although Treasury yields were stable, the rebound in corporate credit carried the Bloomberg Barclays Aggregate Index to a total return of 2.9% for the quarter and 6.2% year-to-date.

The Barclays investment grade corporate spread index began the year at 93 basis points over Treasurys and widened to 373 basis points at the market lows of March 23rd. The corporate rally continued as spreads began the second quarter at 272 basis points, and closed the second quarter at 147 basis points over Treasurys. Even though corporate credit spreads retraced 70% of their first quarter move, spreads ended the quarter 54 basis points or about 60% wider, from where they began the year.

The move tighter in spread assets drove positive total returns. Treasury yields were less volatile and ended the quarter where they began. The difference between the high and low yield for the current ten year during the second quarter was only 0.33%, considerably less volatile than the 1.47% disparity of the previous quarter.

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Global government stimulus deployed to fight the pandemic has been massive and swift. Last year the Congressional Research Service reported that the U.S. Government spent $4.1 trillion in current inflation adjusted dollars fighting World War II. In just a few weeks the combined pandemic spending of the U.S. Government and Federal Reserve exceeded $6 trillion, with more help on the way.

The nonfarm payroll figures released the first Friday of every month have been the most important economic statistics of the past several years. The data offers investors clues as to whether the overall economy is contracting or expanding. The figures released during the second quarter for the March, April, and May month-end periods so differed from expectations, which themselves varied greatly, that the data seemed irrelevant and untimely as investors quickly absorbed more recent Coronavirus headlines. For the first two months of the year monthly gains in nonfarm payrolls averaged 232,000 jobs. March and April losses totaled 2.3 million and 20.8 million jobs respectively, but were followed by gains of 2.7 million and 4.8 million in May and June.

The worst four week sum for unemployment claims during the 2008-09 Great Financial Crisis was 2.64 million, representing less than 1% of the population. The most recent peak four week sum for the pandemic was 23.16 million, representing 7.1% of the population.

The $600 weekly additional CARES Act unemployment benefit is set to expire at the end of July. Between 21 million and 30 million Americans are currently receiving unemployment benefits. Unemployment payments vary depending on the recipient's income and rules that vary from state to state, but the average weekly payment over the past year was $342 according to the Department of Labor. The loss of the $600 weekly benefit represents between 3% and 4.3% of total GDP, depending on the number of actual recipients. When the $600 CARES Act payment expires on July 31, a meaningful source of liquidity will be pulled from the economy.

The Bureau of Labor Statistics announced that 6.3 million Americans have dropped out of the labor force since February. The BLS also said that nearly 5 million workers who were likely on temporary layoff in May were inadvertently labeled "absent from work," a category that includes workers on vacation. This error may have reduced the official unemployment rate of 13.3% in May and 11.1% in June, by as much as 3%. It is difficult to sort through the rapidly changing headline numbers. We suspect that government stimulus will fall short of satisfying the unprecedented need for

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unemployment support, and that it is likely to take much longer than previous recessions to reach former levels of peak employment.

FIXED INCOME OUTLOOK

When asked recently about the low level of treasury yields one pundit referred to bond investing as a low return, high risk endeavor. We believe that the low level of interest rates portends low returns across all asset classes. A ten year corporate bond trading at an average spread of 93 basis points at the beginning of the year yielded 2.84%. Today, the yield of that bond has fallen 70 basis points to 2.14%, but the corporate spread component now comprises 70% of the total bond yield, versus 32% at the beginning of the year. A properly diversified portfolio of creditworthy corporate bonds should achieve much higher returns than Treasurys in today's environment.

Over the next few years the markets are likely to experience bouts of both unexpected deflation and inflation, contributing to volatility in interest rates. We believe the forces of deflation represent a more immediate concern. The Fed has committed to supporting low interest rates for a prolonged period of time. Coronavirus recovery may take longer than any of us would hope for, but it appears unlikely we will repeat a full lockdown of the economy. The most likely recovery is a muddle through scenario in which businesses directly related to unnecessary social gatherings suffer, but most industries thrive in a low growth environment. This deflationary environment will add to the multi-decade trend of low growth in prices, interest rates, rents and wages.

We have all become accustomed to a new way of life where inconveniences have become respectful habits. Someday soon sights of masked graduates, empty ball fields, and background sounds of barking dogs on conference calls will be distant memories. It will be fun to dine out again, but today's uncongested highways will be missed. Please reach out to us if we can assist you in any way.

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