ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

Two and a half years have passed since the emergence of a viral outbreak that was destined to become a global pandemic.

Several times in those two and a half years, sanguine market participants have thought the effects of the pandemic were on the wane and a return to something like a "normal" environment was imminent. Such hopes have been dashed repeatedly.

It is not just the direct human toll of the virus that has been stubbornly persistent, but the effects of the policies enacted to combat the pandemic that will seemingly be with us for some time to come.

Lockdowns, workplace and school closings, and extreme fiscal and monetary responses have all had lingering impacts. Global supply chains have not fully recovered and labor market shortages have disrupted many industries. Inflation, recently considered a relic of the past in most advanced economies, has come roaring back causing central banks to scramble to reverse the course of more than a decade of ultra-easy policy actions.

Market participants are now reacting as if they no longer believe in a quick recovery from all of these displacements. Interest rates have risen dramatically, and equity markets have pulled back significantly.

The S&P 500 hit an all-time high on January 3rd of this year and then declined 23% to its recent bottom on June 16th. The total return of the S&P 500 for the first half of 2022 was down 19.97% with most of the damage coming from a 16.11% decline in the second quarter. Equity markets around the world have moved more or less in sync with the US with similar sharp declines in both developed and emerging market indices.

EQUITY MARKET STRATEGY

With the large number of variables at play as well as the potential for exogenous shocks (such as the war in Ukraine) it is difficult to accurately predict the exact direction of macroeconomic conditions. Furthermore, equity markets often do not move in concert with the broader economy.

What we are able to do with more confidence, however, is take advantage of price movements when they make high quality assets available at attractive valuations. As equity markets have declined this year such opportunities have become increasingly prevalent.

We have added to several existing positions that we continue to think are very attractively positioned in their industries as well as adding a few new positions that we have admired but found too expensive in the past.

ASB
INVESTMENT MANAGEMENT

As always, we seek out companies that have been able to consistently produce high profits without relying on excessive debt to do so. Thus, the excess profits these companies are able to produce are the result of valuable assets and uniquely positioned products and services rather than excessive leverage.

This combination of characteristics is even more important in an environment characterized by rising interest rates and persistent inflation. Higher borrowing costs are deemphasized as a factor that threatens our portfolio holdings and goods that consistently garner higher margins are less susceptible to the threat of substitution for more commoditized products that can result from inflationary pressures.

FIXED INCOME REVIEW

The rise in interest rates produced the worst start of the year for the Bloomberg Aggregate Bond Index since its inception in 1976. The index generated a negative total return of -4.7% for the quarter, and -10.3% for the year-to-date period. U.S. Treasury ten-year yields have risen from 1.50% at the beginning of the year to 2.35% at the end of the first quarter, to just over 3% at the end of the second quarter.

So far this year average investment grade corporate bond spreads have increased from 93 to 158 basis points. The yield of an average ten-year maturity investment grade corporate bond rose from 2.93% at the beginning of the year to 5.08% at the end of the second quarter. That much of a rise in ten-year yields corresponds to a price drop of 16.5%. About two-thirds of the price drop is attributable to the increase in "risk-free" ten-year treasury rates, but the other one-third of the price decline is due to the increase in corporate bond spreads. Daily market volatility, easily measured by the VIX (Volatility Index), or "fear gage," has a strong correlation to movement in credit spreads.

Market prices discount investor expectations of future unknowns, not merely the facts of the past, which makes investing difficult. In today's environment, fixed income investors are especially caught between a rock and a hard place. Fears of an impending recession argue for lower rates while tighter monetary policy to reduce inflation argue for higher rates.

The Federal Reserve's job is also difficult, as central bankers seek a balance of low inflation, sound money, and maximum employment. The Fed must contend with a market anticipating every move, as investors seek to capitalize on any perceived Fed slowness to act. The Fed's 900 or so PhD's are well informed, but collectively do not have any additional insight into economic activity than the rest of us. We suggest that the consumer on Main Street may currently be more cognizant of the fragile state of the economy than professional economists or Wall Street elites.

As recently as early June, both Bank of Japan head

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Haruhiko Kuroda and U.S. Secretary of the Treasury and former Chair of the Federal Reserve, Janet Yellen, apologized for inflation. Nikkei reported that during a lecture Kuroda "apologized for saying that households are becoming more accepting of price rises." Addressing the topic of whether inflation is temporary, Yellen commented, "Both Powell and I could have used a better word than transitory. There's no question that we have huge inflation pressures. Inflation is really our top economic problem at this point." She also commented to CNN, "I was wrong a year ago about the path that inflation would take. There have been unanticipated and large shocks to the economy that have boosted energy and food prices and supply bottlenecks that have affected our economy badly that I didn't at the time fully understand."

Sometimes it's easy to criticize the Fed because policymakers seem distant from Main Street concerns. In the book The Lords of Easy Money, Dallas Fed President Richard Fisher and at the time a voting member of the FOMC (Federal Open Market Committee), discusses the economic impact of incredibly low interest rates with Fed Chair Ben Bernanke. Fisher notes that the CEO of Texas Instruments had told him the company would use low interest rates to repurchase shares and that the easy money policy was not going to create a single job. The comment was too much for Bernanke, who replied, "President Fisher, I do want to urge you not to overweight the macroeconomic opinions of private-sector people who are not trained in economics."

FIXED INCOME OUTLOOK

On July 27, the Fed is likely to hike short term interest rates 75 basis points, bringing the Fed Funds target rate to 2.25%. The FOMC sees a "significant risk that elevated inflation could become entrenched if the public began to question the resolve of the Committee to adjust the stance of policy as warranted." Currently the FOMC points to strong employment and a commitment to return inflation to a 2% long-term target.

Fed Funds have exceeded CPI (Consumer Price Index) during each of the past eight recessions dating back to 1974. Today, Fed Funds are almost 7% less than CPI. Either the economy weakens, and inflation subsides, or the Fed continues to increase short rates to control inflation. Over the near term, we believe the Fed will continue to hike short-term interest rates.

Today's inflation has many causes, marked by supply shocks, worker shortages, and war-fueled oil price increases. Another cause of today's inflation is the extraordinary expansion of the nation's money supply to fight the pandemic. For at least fourteen years the money supply as measured by M2 less currency grew at a steady 6% rate. The current pandemic-era growth of money supply represents a $4.1 trillion gap above trendline growth. It is difficult for asset prices, including bonds, to increase in price with a Federal Reserve determined to control inflation by reducing this multi-trillion-dollar gap.

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We believe higher short-term rates are on the horizon, and that it is unlikely we have seen the peak in long term rates for this cycle. We are increasingly uneasy that the Fed is hiking into a recession. Employment remains strong, but contractors are shelling out $175 to fill F-150s, and commuters $50 to fill a Prius. Over the past year the monthly mortgage payment for a median priced single-family home has increased 65% from $1,600 for a 3.13% thirty-year fixed rate mortgage on a $375,000 home to $2,650 for a 5.8% mortgage on a $450,000 home. Housing affordability is the lowest since 2006.

Fortunately, as rates have risen, so too has the prospective return of fixed income instruments.

Spencer C. Smith
Director of Equity Investments

Mike Stafford, Jr. CFA
Director of Fixed Income Investments

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For additional information about
ASB Investment Management, please contact:

Mike Stafford, Jr. CFA
Managing Director
ASB Investment Management
(240) 482-2977
mstafford@asbcm.com

7501 Wisconsin Avenue
Suite 1400 West
Bethesda, MD 20814
www.asbcm.com

Darryl A. Keeton, CIMA®
Director
ASB Investment Management
(240) 482-2948
dkeeton@asbcm.com

7501 Wisconsin Avenue
Suite 1400 West
Bethesda, MD 20814
www.asbcm.com