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Information through 9/30/2016

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

Stocks shook off hand wringing surrounding the U.K. vote to leave the European Union, with the S & P 500 reaching an all-time high in July, and producing its best performing quarter of the year. Most of the quarter was marked by low trading volume and an almost eerie quiet, with major averages going two months without a daily move of even 1%.

The calm was interrupted in early September amid worries that global central banks might cut back their monetary elixir, then equities rallied as near term concerns were deemed overblown. Finally, stocks sold off again at the close of the month as the U.S. threatened a large fine on a major German bank, leading to speculation about its solvency and the possibility of financial contagion. Nonetheless, stocks returned nearly 4% for the quarter and nearly 8% on the year.

Technology stocks led the way, gaining 12%, which contributed to a gain of nearly 10% for the NASDAQ, its best quarter since 2013. Three of the four largest gainers in the Dow Industrials were tech stocks—Apple, Intel, and Microsoft. Many bank stocks also produced double-digit rallies, although the sector remains down for the year.

Traditional defensive sectors gave back some of their sharp early-year gains, as investors became more confident in an economic pick-up, began to contemplate higher interest rates, and incrementally re-positioned their portfolios toward higher beta, more economically sensitive stocks. The electric utility and telecommunication sectors each retreated about 7%, and consumer staples, a traditional haven in times of uncertainty, also lagged. Healthcare stocks, another popular haven, were up slightly for the quarter but remain down for the year amid the unraveling of Obamacare exchanges and ritual election year jitters as politicians threaten price controls.

Is the market optimism warranted? On the heels of a lackluster first half, U.S. economic growth is now forecast to be less than 2% for the year, with global growth about 3%. A bright spot is personal consumption, which is showing healthy growth on the coattails of an improving job market and 2-3% wage increases. Corporate earnings are expected to decline slightly, representing the sixth consecutive quarter of contraction.

Meanwhile, with stocks marching higher, valuations remain stretched. The S & P 500 trades at around 20x last twelve months earnings, representing a 25% premium to historical averages.

While hope springs eternal regarding stronger economic growth, it is the central banks upon which the markets are most fixated. Monetary authorities regularly talk about cutting back the libation, but flinch every time a weaker data point comes in, or the markets become wobbly.

If the market is to continue its march upward, one of two conditions will likely be present: either corporate profits will catch up to valuations, or central banks will remain accommodative.

EQUITY MARKET OUTLOOK

Absent policy change, there is no particular reason to believe that the U.S. economy is about to meaningfully pick up. In the first half of 2016 the economy failed to reach even its sputtering post-recession norm of 2% growth.

Improvement in corporate profits will likely be led by the energy sector, where oil prices now enjoy level year-over-year comparisons. Inventories are ample, but global energy consumption is growing and production is shrinking. Companies with relatively strong reserves and balance sheets are well positioned for higher prices. We are slightly overweight energy stocks, and also overweight the relatively small materials sector, where certain stocks are extremely oversold, with earnings turning up.

The technology sector is the largest sector and we are overweight as the proliferation of data continues. We own companies that produce the required manufacturing equipment and process and store data.

The financial sector is a larger sector that we are overweight despite currently low lending spreads. Loan volume is growing and some of our bigger holdings trade at a significant discount to book value. Cost-cutting will be augmented by wider margins should interest rates rise from historically low levels. It would be difficult for the market to continue to rise without the participation of this key group, which only recently began to outperform.

We are slightly overweight the consumer discretionary sector as the economy and job market continue to expand and wage increases may be ticking up.

We are significantly underweight most traditionally defensive sectors due to sluggish growth and historically high valuations (consumer staples) plus particular exposure to potentially higher interest rates (electric utilities and telecommunications).

Health care is a large, typically defensive sector that is overweight as demographic trends and scientific innovation increase the demand for medical products and services, and valuation is attractive.

In sum, we are positioned to benefit from a stronger economy or higher interest rates and underweight both higher yielding, and steeply valued predictable growth names.

Although it has thus far been a fool's errand to underestimate the interventionist bent of global central bankers, monetary easing may be running its course. After all, there are side effects and it is far from clear that the expected economic boost is actually being produced.

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In fact, rate hikes might actually help the economy. Savers would earn more. Bankers would have more incentive to lend. Rather than buying back stock, companies might hire more workers or increase capital spending. Lower wage earners would benefit as money makes its way back into the real economy.

Federal Reserve posturing plus the recent retreat of income producing stocks indicate that a quarter point rate hike will likely occur after the elections. If the economy at least remains steady, classic value stocks should lead on the basis of recovering earnings, discount valuations, and sector rotation.

In a market that has generally gone up, passive equity management is gaining many followers. With sharpening differentiation between sectors, and conditions ripe for an uptick in volatility, now, more than ever, skilled active managers can demonstrate their worth.

FIXED INCOME REVIEW

As the third quarter began global bond yields plunged to their lowest levels ever. By early July, the Global Aggregate Index dropped to an all-time low yield of 1.07%. Investors across the globe flocked to the safety of fixed income instruments in the aftermath of Britain's surprise vote in June to exit the European Union. After the low in yields and a brief correction in equity prices, interest rates rose steadily over the next couple of months. By the end of September, the Barclays Aggregate Index generated a 0.46% total return for the quarter and a 5.80% total return for the year to date.

The Bank of Japan fueled the early quarter rate rally with the purchase of record amounts of debt, driving even long-term interest rates into negative territory. Eventually the BOJ reversed course and, by the end of the quarter, shifted its policy to yield targeting, with an aim of keeping ten year Japanese government yields at 0%.

As Japan's central bank shifts course, there seems to be a growing chorus of investors believing that central bankers may have few options left to generate higher economic growth rates. Interest rates are near record lows but economic growth remains sluggish, which calls into question the effectiveness of additional easy monetary policy as a means to economic expansion. Expect to hear a louder call for more fiscal measures to replace monetary actions as a source of stimulus.

Beware the new term "fiscal easing." The certainty of fiscal stimulus as a means to grow the economy is not a foregone conclusion. Fiscal stimulus might only substitute government spending for private sector spending. Greater fiscal stimulus will expand the national debt. Burdening a future generation with additional debt absent a cooperative Fed deploying proper monetary policy might cause unintended consequences and an economy in which Americans are considerably worse off.

Employment remains the most important gauge of near-term economic strength. The economic expansion is aging, and while employment continues to improve, its rate of growth is slow. The unemployment rate has fallen from 10% during the financial crisis to 4.9% today, a level that the Congressional Budget Office calls "the natural rate of unemployment." Economists watch for the prospect of full employment putting upward pressure on wages as a sign of inflation. Corporate compensation as a percent of corporate GDP has spiked recently. We watch wage growth and the growth of average hourly earnings for indications of inflation, which unchecked would drive interest rates higher and wreak havoc on the bond market.

At quarter end, Inflation-adjusted real yields were higher than at the start, but declined in September after the Bank of Japan's policy shift and the Fed's September meetings. Expectations of inflation are slowly climbing, particularly after OPEC's recent announcement that major energy exporters are closer to curbing oil output.

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Market volatility increased over the course of the quarter and yet credit spreads tightened. Typically, credit spreads widen when volatility increases, but the demand for fixed income investments persists in overwhelming the strong supply of new issues.

FIXED INCOME OUTLOOK

Bond spreads are as narrow to Treasuries as they have been all year, and considerably tighter than the wide levels seen in February. Credit spreads have been tighter than current levels, but usually during periods of higher interest rates. Relative to lower yielding Treasuries, investment grade corporate bonds remain attractive. The current environment of slow but positive economic growth, steady corporate profits and stable balance sheets are supportive of a healthy fixed income credit environment.

We have long favored taxable municipal bonds in client portfolios, and yield spreads in this sector have also tightened relative to Treasuries. Investment grade municipal debt typically has greater credit stability than corporate debt, but most issues are smaller and less liquid. Holding shorter term municipals to maturity provides additional yield, but taxable munis as a source of liquidity are not as effective as corporate debt. Higher yields should reward investors for this reduced liquidity, and in the current market environment that is not always the case. As a result, we have recently been more selective with purchases of taxable munis.

Government agency mortgage-backed securities have high credit quality, but principal prepayments can be unpredictable, contributing to volatility given the vagaries of interest rate movements. High quality commercial mortgage-backed securities offer greater prepayment protection than residential mortgage-backed bonds. We expect the Fed to tighten interest rates in December, the first increase in short rates since the Fed's initial tightening last December. Given our view that interest rates will increase, we hold higher coupon mortgage-backed bonds with greater average life certainty.

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