Information through 12/31/2019

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The fourth quarter of 2019 capped off a very strong year for equity returns. The S&P 500 had a total return of 9.06% for the quarter and 31.48% for the year. From an industry perspective, health care and technology led the market in the quarter, but all sectors enjoyed positive returns.

While markets had been flat during the third quarter amid concerns about a potential recession, fears abated in the fourth quarter and equity investors became increasingly confident.

Perhaps the most important factor relieving investor anxiety in 2019 was the U-turn in Federal Reserve rate policy. The Fed had raised rates throughout 2018 but as economic indicators weakened and the stock market swooned at the end of 2018, the Fed signaled a pause in rate increases. It then actually cut rates three times in 2019.

This signaled to investors that the Fed would not raise rates based on expected inflation. Rather, it would wait until actual sustained increases in inflation before taking action. Additionally, the Fed's course reversal seemed to indicate that the "Fed put", or its willingness to include stock market movements as a factor in rate decisions is still in play.

Renewed easy monetary policy in the U.S. brought our central bank back in line with the other major global central banks that have kept interest rates low (or even negative!) for several years. This reflects a global economic environment that continues to be characterized by slow growth and low inflation.

EQUITY STRATEGY

In the fourth quarter of 2019, we continued the repositioning of our equity portfolios that began in the third quarter. We moved from a portfolio characterized by a strong value bias to a more balanced weighting between value and growth stocks. We also continued to reduce exposure to the most cyclical sectors of the economy and conversely increased holdings in more defensive sectors.

While the economic expansion since the financial crisis has been long in duration it has been subdued in intensity. Real GDP growth in the U.S. has been averaging roughly 2% per year for ten years. It does not appear that this trend will change in the immediate future. Faster growth

ASB INVESTMENT MANAGEMENT

environments tend to be characterized by high profits in many industries. In other words, a rising economic tide lifts all corporate boats. In a more sluggish economic environment, like the current one, growth is scarce and companies that manage to steadily grow revenue and profits become relatively more valuable. We have added stocks of companies with strong growth profiles and will continue to do so as attractive opportunities arise. Our portfolios as a whole still exhibit a slight value bias but they are more balanced between value and growth stocks than they were.

The other key change to our equity strategy over the last several months has been to reduce overall portfolio cyclicality. Cyclical companies depend on robust economic growth for profits. Many actually lose money in slower growth environments and their stocks tend to underperform the overall market in recessionary periods. While we are not predicting an economic recession in the near-term we think it is prudent at this point in the economic expansion to build in protection by reducing exposure to higher cyclical stocks and sectors. We are increasing holdings in more defensive stocks and sectors. Defensive companies tend to have steady revenues that are less sensitive to overall changes in economic activity. We have reduced exposure to cyclical sectors, Consumer Discretionary, Financials and Industrials and we have added exposure to defensive sectors, Consumer Staples and Health Care.

With the portfolio repositioning that we set out to accomplish in the second half of 2019 now largely complete, we anticipate lower portfolio turnover going forward. We will continue to focus on finding the most attractive investment opportunities from across the spectrum of US large capitalization companies.

FIXED INCOME REVIEW

What a difference a year makes. 2018 went out like a timid housecat stuck in a tree and 2019 ended like a raging tiger. A year ago the stock market was reeling from a double digit fourth quarter decline, ten year treasury yields had recently fallen nearly seventy basis points, and investment grade credit spreads had widened fifty basis points. The yield curve flattened and interest rates fell, as investors gauged the probability of recession.

Speaking of recession, the decade just ended represents the first time in history that we did not have a day of recession during the period. As we embark on a new decade, last year's tumult seems far away. Today, equities are trading at all time highs after rising thirty percent over the past year. Ten year treasury yields have risen almost fifty basis points from late summer's 1.46% low. Investment grade credit spreads have retraced their

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widening and are less than ten basis points from early 2018's post-crisis tight levels.

A major difference between today and the beginning of the decade is the influence of the world's major central banks. Some wonder whether their impact on the economic cycle can continue, or is even prudent. The total balance sheet assets of the Federal Reserve, Bank of Japan, European Central Bank, and Bank of England represent 36% of their countries' GDP, an increase from about 10% in 2008. Over the past ten years, developed country central bank balance sheets have grown by almost $2 trillion more than the growth of developed country gross domestic product. Negative interest rates have caused a run on safes in Japan and Germany as banks left depositors unrewarded, prompting savers to hoard rather than invest their cash.

We learned last year that when the Fed signals higher rates and steady balance sheet reduction, recession fears increase and investor confidence diminishes. Reversing extraordinary central bank easy money policies may prove difficult. Inflation has not been a problem, so the Fed has not aggressively tightened. Should inflation reappear, rolling over large debt balances at higher rates will be costly, and potentially problematic.

U.S. Treasury total public debt has doubled to $23.2 trillion since mid-2009, yet polling data reveals that neither democrats or republicans are as concerned about public indebtedness as they were ten years ago. In fact, proponents of Modern Monetary Theory now espouse much larger deficits and massive government spending to promote full employment. They argue that a sovereign state able to issue debt in its own currency need not worry about additional indebtedness.

Environmentalists like to say, "we do not inherit the earth from our ancestors, we borrow it from our children." Never mind our children, about 53% of treasury debt matures over the next three years. Per capita public debt outstanding is at a record high and represents over $145,000 per person based on household employment. The weighted average years to maturity of marketable treasury debt is less than six years.

From a debt perspective, we are living in a flood zone that has never experienced a flood. As long as investors continue to buy treasurys and allow the U.S. to finance itself, all remains dry. Increasingly, it doesn't seem to matter whether the investor is domestic, foreign, or even the Federal Reserve itself. When skies darken and investors decide not to buy treasurys, whether next quarter, next year, or the next decade, there will be a stampede to higher ground.

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OUTLOOK

We have positioned most portfolios short of benchmark durations. Near term recession risks have subsided and global interest rates have risen from third quarter lows. Recent economic releases are mixed but generally point to a slow-growing, stronger economy, without inflation. America's longest recorded expansion continues. Geopolitical events may pressure interest rates lower as investors flee to higher quality investments. On the other hand a resolution to the trade war should help manufacturing, which has been a recent drag on growth. On balance, this early in an election year, we expect economic growth to continue and interest rates to grind higher.

Credit spreads have not been as tight as they are now since the first quarter of 2018. For multi-year periods in the '20's and '00's, when interest rates were higher, credit spreads held at tighter levels. As a percentage of total yield, the credit component of bonds is greater today than in many tight periods of the past.

We do believe that structural differences with regard to the current bond market suggest greater volatility is here to stay. Higher volatility produces higher credit spreads, and at some point this year investors will have to decide whether that moment represents a buying opportunity, or the end of the longest expansion on record. We remain cautious and nimble managing conservative fixed income allocations.

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:

Hank Murphey
Vice President,
Director of Client Services
ASB Investment 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 Investment 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

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