Information through 6/30/2021

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

For the equity markets, the second quarter of 2021 was much like the first quarter, characterized by a steady increase in prices with few interruptions. The total return for the S&P 500 Index was 6.17% at the end of the first quarter and it ended the second quarter with a year-to-date gain of 15.24%.

After a violent spike in March of 2020, volatility (as measured by the Chicago Board Options Exchange Volatility Index or the "VIX") has been steadily declining for the past 15 months. Equity markets have been relatively placid this year as much of the economic activity that was frozen during the period of COVID-19 lockdowns has begun to thaw in earnest, leading corporate earnings to make a robust comeback.

Despite the relative calm, as always, there are things to worry about on the horizon. Will nascent inflation force the Fed to become more hawkish and begin to reverse the extraordinarily accommodative monetary policy it has had in place for more than a decade? Will new COVID-19 variants disrupt the momentum of reopening economies? Will increased taxes and regulations disrupt leading companies in industries such as technology and health care? If these things come to pass will the equity markets react negatively? Have they already priced these things in? Maybe.

EQUITY STRATEGY

One of the tenets of our management process is trying to focus on things we can know with relative certainty versus relying on guesses about things that are by their nature fraught with uncertainty.

According to its own website, the Federal Reserve of the United States employs over 400 Ph.D. economists. That's a lot of intellectual horsepower. One of the tasks of these economists is to construct forecasts for things like GDP growth and inflation. These forecasts are consistently off the mark. This is not because the economists at the Fed are incompetent, but because they are trying to accomplish a task that is essentially impossible.

There are millions of variables that effect global economic activity. The vast majority of those variables are either not known or are tracked imprecisely. Nobody knows all the current variables. Forecasting the economy requires that you know all the current variables plus the future variables (which are infinite) and how all those variables will interact over time. As Yogi Berra said, "It's tough to make predictions, especially about the future".

Consequently, we try not to rely on our ability to forecast the economy or even the direction of markets (which we think is equally unknowable). Rather, we spend our

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finite time looking for assets whose characteristics we can know with relative certainty. By scouring financial data, we can find companies that consistently make excess profits relative to their peers, companies that have stellar balance sheets that allow for maximum financial flexibility, and companies whose share prices are reasonable relative to the quality of their assets.

Of course, it's impossible to avoid all forecasting. When evaluating potential investments, we have to determine the likelihood that the characteristics we find attractive about a company in the present will endure into the future. Strong brands, proprietary intellectual property, and attractive industry dynamics are some of the things that give us confidence in the ongoing fortunes of a company. But we always remain humble in our ability to see into the future.

FIXED INCOME REVIEW

During the second quarter, interest rates fell, generating positive total returns. For the quarter, the Bloomberg Barclays Aggregate Index returned 1.83%. The positive return for the second quarter partially offset the first quarter's losses, and year-to-date total returns for the Aggregate Index remain negative, at -1.60%.

The drop in rates during the quarter seemed to surprise most market participants, but perhaps an even bigger surprise than the change in the direction of rates was the shift in the shape of the yield curve. The shape, or slope of the Treasury yield curve is a meaningful indicator of the economic cycle. A flatter curve, with less spread between two and thirty year rates, indicates slower economic growth. A steeper curve, with a widening difference between two and thirty year yields, indicates economic strength, as bond investors become concerned about inflation driving longer maturity bond yields higher relative to short term yields. The Treasury curve stopped steepening at the beginning of the quarter, and after the Federal Reserve's FOMC meeting on June 16 began to flatten.

At the June FOMC meeting, the Fed discussed the tapering of bond purchases and increased its own median interest rate projections in 2023 from no rate hikes expected to two. The Fed's current quantitative easing program involves the purchase of $120 billion of Treasury and mortgage-backed securities purchases every month. In meeting notes, the Fed eliminated key phrases that kept actual tapering of monthly purchases at least six months out into the future, opening the possibility that a Fed taper decision could occur as early as September, rather than the existing market

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expectation of a December or 2023 announcement.

In the Spring of 2013, the market's "taper tantrum" witnessed ten year yields increasing 35 basis points to 3.02% by the end of the year. The slope of the yield curve steepened, as investors anticipated higher long term interest rates to accompany stronger economic growth. So far, the market's reaction to the June 16 announcement has been the opposite, with lower long-term yields producing a flatter curve.

The current level of interest rates and the contrary reaction to the hawkish FOMC statement is reminiscent of Churchill's comment regarding Russia on a BBC broadcast a month after the outbreak of World War II: "it is a riddle, wrapped in a mystery, inside an enigma." The year over year change in CPI is at a 13-year high and at 5%, more than twice the Fed's 2% target rate. Oil is at a multi-year high. According to Apartment List median national rents climbed 9.2% in the first half of the year, and although reflective of a pandemic bounce back, are higher than if they remained on their pre-COVID-19 trend. Home prices are booming, and equity markets are at all-time highs.

Economists expect 7.2% full year real GDP growth in the United States, the fastest annual pace since the economy sprang out of the steep 1981-82 recession. The global economy may record 6.9% growth this year, the highest rate of growth in over fifty years. New businesses are sprouting at the fastest pace on record. Workers are quitting jobs at the fastest pace since 2000, a sign of a confident labor market.

FIXED INCOME OUTLOOK

Perhaps the Fed is right: current inflation is transitory. As the pandemic began at the end of the first quarter last year the economy fell into a steep but quick recession. We have witnessed a similarly quick recovery. As time progresses, year-over-year changes will become less drastic as the lockdown low months of last year drop from base year-over-year comparisons. For example, Bloomberg strategists expect 4.5% inflation at year end 2021 to slow to 1.6% in the fourth quarter of 2022.

Several factors have caused the recent rise in bond prices and drop in interest rates. Although the year-over-year change in inflation recently touched 5%, the probability that this rate of change will continue at that pace has dropped sharply. The expectation of higher rates became a crowded trade, with sentiment indicators pointing to investors positioning for higher rates.

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Quantitative easing and accommodative monetary policy continue. The Fed's purchase of $120 billion of securities a month includes $80 billion of Treasurys and $40 billion of mortgage-backed securities. Data suggests that over the past quarter the Federal Reserve purchased 95% of Treasury bond issuance. The Fed is the largest direct owner of the LQD ETF, the largest investment grade corporate bond exchange traded fund.

The eventual end of massive federal fiscal stimulus leaves recession a possibility in 2022 or 2023. Although COVID-19 appears under control in the United States the Delta variant causes concern of pandemic spread overseas.

Client portfolios have benefitted from the recent rally in bond prices. We lean to the side of caution, maintain a conservative interest rate posture, and keep most portfolio durations slightly short of benchmarks. Spreads for corporate, mortgage-backed, and municipal securities remain tight. As the economic expansion continues, we remain aware that spreads have a history of trading at similarly tight levels for many years in a row. Although low nominal yields portend lower projected fixed income returns, this quarter's positive results were welcome. In addition, bonds should provide ballast in a storm for balanced portfolios should equity markets retrench.

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