# ASB Investment Management
## Institutional Portfolio Management Quarterly Review

### EQUITY MARKET REVIEW

The third quarter of 2020 saw a continuation of positive momentum in equity markets from the pandemic-induced lows of late March. The S&P 500 index had a total return of 8.93% for the quarter, bringing total returns for the year through September 30 to a positive 5.57%.

Unprecedented liquidity from global central banks in the form of interest rate cuts and asset purchases as well as trillions of dollars injected into the economy via fiscal support has given investors the confidence to reenter risk markets in a substantial way.

Markets have also been spurred (in fits and starts) by positive news around potential vaccines and therapies to treat Covid-19, but the timing of any treatment for the broad population remains unclear.

The brunt of the economic pain from pandemic related closures and restrictions continues to be felt by smaller businesses dependent on face-to-face interactions with customers. Many large, multinational, transportation and hospitality companies have also experienced severe impacts.

On the other hand, the richest and most powerful companies in the world are seemingly only getting richer with an acceleration in the growth of already thriving businesses like e-commerce and cloud computing services.

This has increased the extreme bifurcation in the markets that was already apparent at the end of the second quarter. Through the end of the 3rd quarter, the S&P 500 Growth Index returned a positive 20.60%. The S&P 500 Value Index returned negative 11.47%. This adds up to an astounding 32.07% spread between the performance of value and growth stocks.

### EQUITY STRATEGY

Equity markets, generally, are not cheap. Higher valuations can in part be explained by the tail-wind provided by low interest rates but we are now seeing valuations of some individual companies that are reminiscent of the excesses of the tech bubble of the late 1990s.

While we are avoiding investing in companies with unreasonably high valuations we are finding opportunities is companies with strong balance sheets and attractive growth profiles.

We recently invested in a software company with several strong gaming franchises that is benefitting from the acceleration in trends toward home consumption of

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entertainment. The firm also has an additional near-term catalyst from the launch of two new gaming consoles in November which should further drive gaming software sales.

In the health care space, we recently invested in a fast growing biotech firm with a suite of potential cancer therapies in stage three trials. Unlike many firms of similar size, this company is self-funding from cash flow generated by its current products and has very little debt.

At the other end of the spectrum, we think there are a large number of value stocks that have been punished severely by markets but that should prove to be attractive investments as the economy continues to recover.

Finally, given the prospect of low interest for the foreseeable future we have continued to decrease exposure to interest rate sensitive banks and instead we have purchased attractively positioned assets elsewhere in the financial sector such as asset managers and auto insurers.

## FIXED INCOME REVIEW

During the third quarter, Treasury yields remained remarkably stable and the Bloomberg Barclays Aggregate Index generated a 0.62% total return. As the quarter progressed, Treasury yields experienced little volatility, ending the quarter within basis points of where they began.

Years from now, it is likely that Fed Chairman Jerome Powell's speech on August 27th will stand out as the interest rate highlight of the last several years. In his speech, Powell emphasized a shift in Fed policy aimed at maintaining rates at low levels for a prolonged period of time, regardless of near-term inflation fluctuations.

The Fed seems to be waiting for a bus which will never come because the route has changed. Try as it might, the Fed has been unsuccessful in its goal of creating inflation. The Fed wants to create inflation to avoid deflation. Should deflation take hold, and consumers and businesses respond by delaying purchases in expectation of lower prices in the future, a self-fulfilling downward economic spiral would be more difficult for the Fed to correct than a general rise in prices. The nominal value of our vast debt is easier to pay off with less valuable dollars that have lost real purchasing power. By keeping wage increases below inflation, businesses can lower real employment costs without increasing unemployment.

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stimulus, and yet inflation remains below the Fed's two percent target. Aggregate demand has not increased. Even $1,200 stimulus checks and zero per cent interest rates have not fueled broad-based inflation.

Many fear we have reached a tipping point after which additional debt required to fund monetary policy loses effectiveness. Additional debt contributes to existing deflationary tendencies by mortgaging the future. The velocity of money, the rate at which money circulates through the economy, has dramatically declined in tandem with the explosive growth of the Fed's balance sheet. The Fed's low interest rate policy has forced a misallocation of capital that penalizes savers, allows unprofitable companies to thrive, and creates excesses in asset prices that lead to bursting bubbles. Additional debt no longer creates demand, and low rates are a necessary condition for repayment of the debt.

Fiscal and monetary policy to fight a Depression-like economic decline from the pandemic has been extraordinary. Additional stimulus is a political football with the outcome uncertain. Chairman Powell recently commented, "Too little support would lead to a weak recovery, creating unnecessary hardship for households and businesses. By contrast, the risks of overdoing it seem, for now, to be smaller. Even if policy actions ultimately prove to be greater than needed, they will not go to waste."

Recent stimulus seems to have worked. Former Fed Chair Ben Bernanke won Time's Person of the Year Award in 2009. In similar fashion, we will soon be reading Keynesian inspired pundits giving Jerome Powell and the Federal Reserve an "A" for fighting the pandemic. We are not as confident that after all of the grades are in, our children will be as generous.

Stimulus does not come without a cost. Most developed economies have sacrificed future economic growth in exchange for a less painful contraction today. 900 PhDs work for the Fed, but no one at the Eccles Building is suggesting a policy of restraint today to preserve greater growth tomorrow.

Last quarter we discussed an alphabet soup of shapes of various recoveries: L, W, V, even a square root sign. As summer came to a close, a "V" shaped recovery took hold. Stimulus checks enabled the payment of rents, groceries, and credit card bills. Auto sales rebounded. Low mortgage rates and pent-up demand brought a boom to housing. At this point, the easy part of the economic bounce is over. The economy is still adding jobs, but momentum is slowing.

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## FIXED INCOME OUTLOOK

The low level of rates keeps us cognizant of the money that can be quickly lost investing in high quality fixed income instruments. At 0.70%, a mere rise of 70 basis points in ten year Treasury yields would result in a 6.5% price drop, nearly ten times the bond's annual yield. An inflation scare could cause a bond sell-off at any time. As a result, even though we expect interest rates to remain low for an extended period, our portfolios are positioned slightly short of their benchmark indexes.

We remain overweight corporate, mortgage-backed, and taxable municipal bonds for the additional yield spread they generate over Treasuries. Investment grade corporate spreads have tightened considerably since the lockdown lows of mid-March, but are still over 40 basis points wider than where they began the year. This 0.40% spread over Treasuries for the average corporate bond represents 1.5 times the yield of a five year Treasury.

As we approach the first year of a new four year presidential cycle, fiscal restraint may resurface, further endangering the government assisted recovery. This may threaten creditworthiness. Today there is a wide disparity between "A" rated corporates expected to maintain investment grade status even in a weaker environment, and lower rated "BBB" rated bonds at risk of downgrade to high yield should the economic backdrop deteriorate.

Low interest rates have changed the risk-reward dynamic of fixed income investing. High quality bonds offer principal stability relative to more volatile asset classes. The general low level of rates portends lower future returns not only for fixed income instruments, but investments across all asset classes.

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*October 2020*

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