ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

In the first half of 2021 US equity markets marched upward with unusually low volatility. That pattern continued into the third quarter of the year into July and August. Things changed in September, however, with an uptick in volatility and a down trend for equity markets. The S&P 500 lost 4.65% for the month but still ended the quarter with a small gain of .58%.

Through the end of the third quarter the total return for the S&P 500 was 15.91%. This follows a total return of 18.39% for calendar year 2020. To put it mildly, those are robust returns given the fact that they occurred in a period that included the deepest global recession since World War II.

As the global economy continues to recover in fits and starts from its medically induced coma, the side effects are becoming more apparent. The most prominent has been a disruption to global supply chains which is impacting a broad number of industries. For example, shortages of semiconductors have stalled automobile production, shortages of thermal coal and natural gas are crimping energy supplies in Europe and China, and consumer goods are stuck in container ships in long queues outside of major ports that are unable to handle the volume of traffic.

While adjustments will be certainly be made going forward, it is likely that this disruption will persist for several quarters and many companies are likely to have unhappy earnings surprises for investors as they struggle with supply chain bottlenecks.

EQUITY MARKET STRATEGY

As we navigate the unique market environment created by the wake of the Covid pandemic, we think it is more important than ever to stick to our discipline of searching out companies with exceptional profitability and the strong balance sheets that will allow them to weather a period of heightened uncertainty.

Another tenet of our management process is that we will always prefer the largest opportunity set possible from which to select the most attractive assets. One way that investment managers often limit their opportunity set is to self-identify as growth managers or value managers. We think these labels are arbitrary and unnecessarily limit a manager's ability to find the best opportunities in the market by effectively cutting their opportunity set in half.

Moreover, we think these style biases often lead to poor investment decisions. Value managers, for example, can be seduced by companies with low price to earnings multiples, ignoring business models that may be seriously impaired. Growth managers, on the other hand, may significantly overpay for assets that have been bid up due to investor excitement about potential future earnings that may never materialize.

To be sure there are periods when value stocks outperform growth stocks (and vice versa). Last year, for example, the S&P 500 Growth Index outperformed the S&P 500 Value Index by a whopping 32%. This year, on the other hand, the two indexes have had nearly identical returns. However, we believe that just like forecasting macroeconomic outcomes or market returns, determining in advance whether value stocks or growth stocks will outperform is fraught with uncertainty and a distraction from the discipline of building a portfolio of attractive assets regardless of how the market labels the style of the companies.

FIXED INCOME REVIEW

The minimal difference in Treasury yields at the beginning and end of the quarter belied the midsummer volatility of yields in between. Ten-year Treasury notes yielded 1.47% at the beginning of July, and note prices rose 2.75% over the next five weeks as the Delta variant surge caused many to question the sustainability of the economic recovery. Yields fell to a low of 1.17% on August 3rd. From the early August low in yields, Treasuries gave back all of the price gain through the end of the quarter, when the ten-year closed at a yield of 1.49%, about the same level as the beginning of the quarter. Given the small change in interest rates, the Bloomberg Aggregate Bond Index earned a positive total return of 0.05% for the quarter.

During July the spreading Covid Delta variant accelerated fears of weaker economic growth, and Treasury prices rose, driving yields lower. Even though Treasury yields bottomed the first week of August, it was not until after the September 22nd FOMC meeting that yields abruptly spiked higher. At that meeting, the Fed signaled it would begin reducing its monthly purchases of over $120 billion of Treasuries and mortgage-backed securities as soon as November. Over the past 21 months, these purchases have caused the Fed's balance sheet to grow by more than $4 trillion to a total of about $8 trillion. FOMC members also indicated that the Fed might increase short term interest rates sooner and faster than previously anticipated.

The Fed has maintained the narrative that the recent uptick in inflation is transitory, but we are not so sure. Over the past eighteen months domestic M2 money supply has increased $5.3 trillion, while the total money

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supply for the United States, the Eurozone, and China was up 10% over the past year to $74 trillion. Changes in money supply lead changes in economic growth by one to two years. The 13.2% year-over-year increase in domestic money supply is occurring at the same time that inflation is evident everywhere.

A year ago, deteriorating demand was the number one reason for revenue shortfalls cited by CEOs on quarterly earnings calls, and today it is supply shortages. Shortages are disrupting sales and driving prices higher not only of semiconductors for cars, but also Halloween decorations, tennis balls, rental cars, chicken wings, toilet paper, furniture, bacon, construction equipment, pool chlorine, and oxygen.

Big salary, wage and benefit increases are being announced every week. Deere has a union contract in the works, while Amazon is paying $3,000 signing bonuses and Walmart is looking to hire 150,000 employees for the holidays. Three of the nation's largest employers in Walmart, Amazon, and Target recently announced free college tuition benefits for employees. Truck and rideshare drivers are in demand, and Fedex has had to divert packages as the labor shortage impacts service levels. Layoff announcements are at record lows. The Conference Board's Consumer Confidence Jobs Survey is at a record high last seen in 2000 at the peak of the internet bubble.

Owners' equivalent rent comprises one fourth of CPI. Home prices have soared and historically have led rents. Surveys of apartment rental increases are at record highs. Housing cost increases have yet to impact CPI, and when they do will more than offset price declines of higher transitory items like hotel rooms and rental cars.

Commodity prices are surging, particularly for energy. West Texas Intermediate Oil is approaching $80 per barrel, a seven year high. The increase in the price of natural gas has created crisis conditions in Brazil, China, and Europe.

FIXED INCOME OUTLOOK

Higher bond yields reflect stronger growth and more inflation. We expect economic growth to support higher interest rates. We have positioned most portfolios short of benchmark index durations to preserve capital in a rising rate environment. We remain overweight spread assets, especially municipal, commercial mortgage-backed, and corporate bonds. Credit spreads are tight, particularly for short and intermediate maturity bonds, but stronger economic conditions create a favorable

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environment for corporate creditworthiness.

Stagflation, or the prospect of higher inflation in a slowing economy, is an increasing concern. Supply chain problems are likely to continue. Toyota recently announced it will produce 40% fewer vehicles in October due to shortages prompted by unpredictable Covid infections at various suppliers and tighter semiconductor supplies. Eventually, as supply bottlenecks ease, production and transportation disruptions will ease, creating a firmer footing for future higher real growth.

Although higher rates reduce fixed income total returns, investing new cash at higher yields is welcome. The stability of fixed income relative to other asset classes with stretched valuations like equities will prove valuable over the next several quarters as the Fed tapers asset purchases and considers tighter monetary policy.

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