Information through 12/31/2020

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The impact of the SARS-CoV-2 virus was the dominant factor in the performance of the US and global economies in 2020. Early in the year, news of the spread of the virus was greeted with more curiosity than fear (at least outside of China), but it soon became apparent that the virus was going to become a global pandemic and the economic implications were dire.

By the end of February, COVID-19 (the disease caused by the virus) had begun to affect people throughout Asia, North America and Europe. Governments responded by restricting travel, closing schools, and shutting non-essential businesses. The economic impact was dramatic with record declines in output and a sharp rise in unemployment for the majority of global economies.

By the end of the summer, the first wave of the virus's spread had begun to abate and there was optimism that a return to normalcy would ensue. Economies began to reopen and there was a significant rebound in economic activity in the third quarter of the year.

However, global COVID-19 infections rose again at an alarming rate toward the end of the year. In many cases, the numbers were even worse than in the initial wave. Lockdowns and restrictions returned and economic activity slowed again.

The human and economic toll of the pandemic has been extraordinary. It would be absurd to argue that we were collectively better off at the end of 2020 than we were at the beginning. Knowing this, how do we reconcile the fact that equity markets ended the year with robust gains and with major indices at or near all-time highs?

During the first wave of the pandemic, equity markets reacted with a swift and deep contraction. In little more than a month (February 19th to March 23rd), the S&P 500 lost 34% of its value.

However, fiscal and monetary authorities were not idle. Stimulus came quickly and on a massive scale, dwarfing even the unprecedented support injected into economies and financial markets during the Great Recession.

In addition to the stimulus confidence was boosted by the unprecedented speed with which vaccines to combat the virus were developed, tested, and manufactured. This has led to hope of a return to normalcy as the vaccine is rolled out.

Markets rebounded strongly at the end of March and they never looked back for the remainder of the year. The S&P 500 returned 70% from the March 23rd low

ASB INVESTMENT MANAGEMENT

through December 31st.

EQUITY STRATEGY

As a core manager we try to remain agnostic to arbitrary style labels in the selection of the assets that we own. That being said, the disparity between the return of growth stocks versus value stocks was the largest in market history in 2020. The S&P 500 Growth Index outperformed the S&P 500 Value Index by 33%.

Companies in industries that benefited from lockdowns (e.g. e-commerce companies and firms providing the technology to enable working from home) naturally performed well. We own many such "growth" assets in our equity portfolios. However, we also have witnessed valuations rise quickly for highly speculative investments to levels reminiscent of the tech bubble of the late 1990s. We are avoiding these segments of the market.

We continue to search for companies that are able to produce high and sustainable profit margins even in difficult economic environments like the present one. This allows these companies to generate ample cash to reinvest in their businesses, to pay down debt, and to return cash to shareholders. We continue to be able to identify such assets at reasonable prices despite elevated overall market valuations.

Finally, we seek out companies with low levels of debt and manageable interest payment burdens. If inflation and interest rates rise as the massive stimulus works its way through the economy, those companies that are not forced to borrow at higher rates will be relatively advantaged.

FIXED INCOME REVIEW

With regard to fixed income a tumultuous 2020 was a lion that went out like a lamb. Major stock indexes ended the year near all time highs, while the Bloomberg Barclays Aggregate Bond Index returned .67% in the fourth quarter.

The current economy, with increasing COVID cases and early in the vaccination process, is positioned between two stimulus packages and two presidents. Continuing weekly claims for unemployment, which reflects hiring as well as layoffs, have decreased markedly from last summer's peak but recently flatlined. Railcar loadings and air cargo surveys are strong. Holiday spending increased almost 7%, and both domestic and foreign Purchasing Managers Index reports have increased to multi-year highs.

The pandemic of 2020 accelerated trends already in place. Mandatory lockdowns exacerbated the decline of

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traditional retailers, particularly malls. Home delivery and online services offering consumers everything from meals to medical advice mushroomed. Business casual office attire shifted to sweat pants and a t-shirt in the work-from-home environment.

The pandemic also accelerated monetary and fiscal trends. The Federal Reserve was able to quickly expand its balance sheet because of precedents set during the 2008-09 financial crisis. As the year closed, the Federal Open Market Committee held interest rates near zero and continued its pledge to maintain a $120 billion monthly pace of bond purchases. Through its forward guidance on the direction of short rates and asset purchases, the Fed has said it expects to keep interest rates at zero until the economy returns to full employment and inflation is on track to moderately exceed two percent for some time.

Recent meeting minutes emphasize that the economy is a long way from the Fed's goal of broad-based full employment and two per cent inflation. The FOMC remains, "Still far from having attained conditions consistent with the Committee's dual mandate." The Fed remains accommodative, and we don't expect a tapering of monthly purchases until early to mid-2022.

The Fed's stated intention to remain accommodative deep into any economic recovery contrasts with previous policy and extends the central bank's trend of greater transparency and activism to avoid a recession. Decades ago, a non-transparent Fed surprised investors with unexpected monetary actions, attempting to leverage perceived limited control over freely trading markets. Today's Fed offers extended forward rate guidance to limit market volatility and fallout from Fed moves.

In 1955 William McChesney Martin, the longest serving Fed Chair, succinctly summarized its role in regulating the economy when he said that the Fed, "Is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up." Today's Fed is inviting everyone to the party on social media, offering formerly contraband substances at the front door, and pouring all sorts of intoxicants into the punch. The Fed sees an inflationary hangover as no worry because it has the vaccine.

FIXED INCOME OUTLOOK

The economy is improving with a backdrop of an accommodative Federal Reserve and likely fiscal stimulus, yet ten-year Treasury rates remain below 1%. We believe rates are fundamentally too low, so we enter the new year with most portfolios positioned slightly short of benchmark index durations.

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The $900 billion stimulus package should have a big impact on the 2021 economy. $500 billion of the $900 billion is intended for consumers. If half is spent, a $250 billion lift to consumer spending in the first quarter represents a 7% quarter over quarter increase. Realizing this, consensus expectations for first quarter real GDP growth have increased from the 3% range to above 5%.

On balance interest rates are poised to rise over the near term from current levels. A strengthening economy, fueled by liquidity, is putting upward pressure on interest rates. Truck orders and the Manufacturing Purchasing Managers Index for prices are surging. Money supply has increased 25% over the past year, and consumer net worth is likely to increase 18% in the first quarter. Global quantitative easing has ballooned central bank balance sheets. A double-digit increase in U.S. nominal personal income, aided by the stimulus package, will increase GDP growth estimates.

We continue to overweight spread assets including corporates, municipals, and mortgage-backed securities. With corporate bond spreads within twelve basis points of post 2008-09 financial crisis tight levels and rates expected to rise, it may be difficult for fixed income investors to generate total returns above current coupons.

Prolonged low interest rates challenge returns for all asset classes. Increasing interest rates bring painful asset price corrections. Eventually higher rates will bring higher returns for fixed income investors. Hopefully 2021 rewards prudent investors in a more stable environment than what all of us experienced in 2020.

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