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Information through 3/31/2017

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY MARKET REVIEW

The rally of economically sensitive sectors took a breather in the first quarter with growth and momentum stocks outperforming classic value stocks which would be expected to benefit from fiscal stimulus and regulatory rollbacks. The market remained buoyant, however, with the S & P 500 returning 6.07% in its strongest performance since the closing stanza of 2015.

Technology led the way, advancing 12%, headlined by the 24% gain of Apple which tacked on an astounding $145 billion to its market value. Familiar large cap momentum names were also prominent, with Facebook, Amazon and Netflix all gaining more than 18% for the quarter. Conversely, financial stocks lagged after running up sharply in the prior two quarters along with industrials.

The rotation took place as the Trump honeymoon was unusually short-lived amidst intra-party disarray and external resistance. By March, the long promised GOP dissolution of Obamacare was very much up in the air, bringing with it uncertainty about the timing and viability of other agenda items such as tax reform.

The Federal Reserve hiked interest rates an additional quarter point and the market yawned. The U.K. began the formal process of withdrawal from the E.U., with other countries contemplating the same, and the market similarly appeared disinterested in this once scary spectacle. Indeed, average daily price moves for large capitalization U.S. stocks in the quarter were the lowest in 50 years.

In some ways, the reflation thesis remains intact. Manufacturing activity, as measured by the ISM reached 57.5 in March and its recent readings would normally be compatible with a 4.5% level of GDP growth and rising prices. The unemployment rate remains well below 5%, wages are increasing, and housing prices are now recovered to all-time highs. The Fed-preferred measure of inflation, PCE, clocked in at +2.1% in March, the highest annual level in five years, while the CPI recently registered a +2.7% year-to-year reading. Business and consumer optimism poll at high levels.

Even so, first quarter expectations for economic growth were yet again lowered as consumer spending remains uninspiring, long-term interest rates retrace some of their gains, and cyclical stock prices are stuck in idle.

In order for economically-sensitive issues to regain their mojo, two things must likely happen. The economy must maintain the slightly brisker pace that led up to the elections, and some of the Trump growth initiatives must be successfully implemented. While both are still plausible, optimism has lessened, along with the margin for error.

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The need for economic pick-up is heightened by the somewhat daunting valuation of the market, which at around 18x expected earnings is the loftiest in more than 12 years and approaching the peak level of valuation relative to GDP reached in 2000.

Still, there is some basis for optimism, as S & P 500 earnings are expected to grow 9% in the first quarter, and 8% for the year. A corporate tax cut is a wild card that might expand the typical profit margin by one percentage point of revenues, and double the estimated EPS growth rate.

EQUITY MARKET OUTLOOK

Investors face a key question: Is the reflation trade still intact? The U.S. Federal Reserve was, after all, waiting for economic growth to pick up enough to be viewed as sustainable before continuing to hike short-term interest rates. After it did so, interest rates fell by 30 basis points over the next month and more economically dependent stocks lost some altitude as the market gravitated toward growth. What gives?

The first part of the higher growth/ higher inflation scenario remains unaltered. Signs of economic expansion persist, although at uninspiring levels. Progress continues to be made on the employment and wage front, manufacturing data are strong, and inflation measures are ticking up.

The second piece, related to fiscal policy, is comparatively dicey. The content of prospective policy, its efficacy, and its timing are all unknown, with the outcome of forecasts subject to the whims of political maneuvering. Notwithstanding the initial GOP healthcare flop, talks continue in the House, and, of course, the Senate will eventually weigh in as well. Tax reform is now regarded as a late 2017 event, and the timeframe for any infrastructure program is also pushed out.

Hence, it seems that the recent market rotation was more related to a recalibration of expectations for policy--and some profit-taking by shorter term participants--than any dramatic change in economic conditions or outlook. The most likely outcome still seems to be steady, but muted growth, rising inflation, and rising interest rates, all of which should favor cyclical stocks more than growth stocks.

The ASB Large Cap portfolio remains tilted toward the reflation trade. Our multi-factor process encompasses both macro-economic analysis and bottom-up fundamental analysis of individual securities. The most reasonable assumption about the economy is status quo (slow growth, but picking up slightly). Policy developments, largely unknowable, do not alter the base case macro forecast, although they do widen the range of potential outcomes.

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Rather, it is bottom up fundamental analysis that tilts the scales toward value. In the slow growth, falling interest rate, and money printing environment following the 2008 financial crisis, stocks more than tripled. Of the stocks comprising our overweight positions, many never fully participated in the run-up, while others, notably in the resource sector, sold off steeply in 2014-15 and have recently begun fundamental recovery. Notably, stocks that fit the reflation theme began to outperform even prior to the election boost.

Slow growth and low interest rates typically favor more expensive growth stocks, since the ability to produce rapid earnings gains in that environment is scarce, and investors are willing to pay up given the lack of compelling alternatives. We may now face the opposite situation, although risks to the economy cannot be dismissed. Currently prevailing growth plus the chance of stimulus provide opportunity to profit while less demanding valuations offer a margin of safety should volatility re-emerge.

FIXED INCOME REVIEW

While the financial markets are rarely boring, the words mellow and muted come to mind when describing fixed income activity in the first quarter. Ten-year Treasury yields traded within a 30 basis point band, compared to the greater than 100 basis point swing of the second half of 2016. The Barclays Bloomberg Aggregate Index posted a 0.82% total return for the quarter. Bonds across the entire yield curve generated slight positive returns for the quarter, and longer maturities outperformed shorter bonds.

The slope of the yield curve is often a good predictor of economic activity. During the first quarter the spread between two year notes and thirty year bonds flattened modestly from 1.88% to 1.75%. Following the brisk rise in rates immediately after November's election, many investors considered the modest flattening an indication that President Trump's economic policies may meet more resistance than initially expected.

The FOMC raised short term rates 25 basis points to a 0.75% target in March, after raising rates in December for only the second time of this tightening cycle. The year began with strong momentum fueled by post-election optimism that regulatory reform, lower taxes, and infrastructure spending would accelerate economic growth. After the Republican majority failed to pass healthcare legislation, investors began to doubt passage of other presidential policy choices, such as infrastructure spending, corporate cash repatriation, lower taxes, and regulatory reform. Toward the end of March this shift in policy expectations drove Treasury yields to the lower end of this year's narrow trading band.

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The economy has averaged an addition of 225,000 jobs per month over the past three years and unemployment is 4.7%. GDP growth has averaged 2.1% over the same period and few strategists expect a slowdown before 2018. Measures of consumer confidence and small business sentiment have spiked like the stock market. Weaker data points including slower vehicle sales, rising auto loan delinquencies, slower real income growth, and slower growth of retail sales (excluding gasoline) suggest that any uptick in activity is unlikely to generate higher inflation any time soon.

FIXED INCOME OUTLOOK

Credit spreads are tight but they have been even tighter for prolonged periods in the past, for example, most of the 1990's. Today's tight spreads occur in an environment of seemingly rational rather than over-exuberant merger activity. Even though balance sheet strength and corporate creditworthiness may have peaked, earnings are increasing in an economically favorable environment for corporate profitability.

Fed Chair Janet Yellen executes the current tightening policy within a long-term trend of low rates for a longer period of time. Global forces of disinflation dominate secular economics even if rates experience a cyclical bounce. We remain short of benchmark durations while the Fed tightens, conscious that higher rates will bring better fixed income investment opportunities when tighter policy gives way to slower economic growth and lower rates improve bond returns. Until then, we continue to favor corporate and municipal spread assets over Treasuries, investing where relative value opportunities offer the most favorable risk reward tradeoff.

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April 2017

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