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*Information through 3/31/2015*

# ASB Investment Management
## Institutional Portfolio Management Quarterly Review

### EQUITY MARKET REVIEW AND OUTLOOK

The equity markets were essentially flat for the first quarter amid questions about the strength of the economy, the future direction of interest rates, and the growth rate of corporate earnings. Notably, with many major equity indices having already reached all-time highs, the NASDAQ also came within an eyelash of taking out levels achieved more than 15 years ago during the peak of the tech bubble, before falling back.

In the U.S., expectations of a significant pickup in growth steadily waned. Fourth quarter 2014 GDP was revised lower, to 2.2%. Meanwhile, a stream of economic indicators began to come in on the weaker side. Among the disappointing data points were measures of industrial production, business spending, capacity utilization, housing, retail sales, and the regional Fed surveys.

In the midst of this, the job market stood mostly alone as a beacon of economic acceleration. For January and February, the trend continued as the unemployment rate dropped to 5.5% and the 12-month average of jobs created rose to more than 250,000 per month. However, even that came to an abrupt halt with the March report, which showed just 126,000 jobs created and downward revisions for the prior two months.

This presents a rather awkward situation for the Federal Reserve, given that a strengthening economy and job market were among the primary rationales for removing the word "patient" from its outlook for interest rate hikes.

After setting the table for finally hiking rates, a slowing economy and job market were not on the Fed's wish list. Getting it right this time is paramount, as two prior attempts to throttle back the money printing resulted in swift market corrections, followed shortly thereafter by the virtual printing presses whirring back to life.

Globally, there is not enough strength to pick up the slack. Europe remains sluggish, with the question of what to do about Greece once again moving to the forefront. China continues to slow. Russia and other oil producers are faced with shrinking revenues, and there is rising geopolitical turbulence, particularly in the Middle East, which adds to uncertainty.

A prerequisite to equity markets continuing to rise would seem to be either a pickup in economic growth or yet another delay in raising interest rates. Over long periods of time, it is typically earnings that drive stock prices, as a growing pool of earnings persuades investors to value a company at higher levels.

However, lower interest rates can also drive valuations higher, as lower yields on fixed income investments make alternative returns available in equities relatively more compelling. This can lead investors to bid up the price (PE ratio) that they are willing to pay for a given level of earnings.

Indeed, in recent years multiple expansion spurred by easy monetary policy has, more than earnings growth, driven market gains.

### EQUITY INVESTMENT STRATEGY

The near-term prognosis for corporate earnings is not inspiring. First quarter earnings are now expected to drop 6%, followed by declines in the second and third quarters as well.

In addition, little tailwind will be provided by first quarter GDP, perhaps once again affected by poor weather.

The rising value of the dollar also hurts earnings for a significant number of multinational companies that receive a large portion of their earnings overseas.

The dollar rose about 10% in the first quarter compared to other major currencies and is up around 25% versus the euro in the past year. The strength of the dollar makes U.S. products less competitive by raising the price for overseas customers. It also reflects relative weakness in the rest of the world, where there is less wealth to spend on U.S. products.

The dramatic retreat in oil prices over the past several months will also be felt as energy companies receive lower product prices and report lower earnings. Capital investment and employment are also being curtailed in response to production cuts and lower return on investment. Excluding the energy sector, S&P 500 earnings would be up slightly.

Regarding monetary policy, the Fed has signaled that it would like to begin the process of raising interest rates from the extraordinarily low levels of the past several years. While it maintains that its policies have been successful, a long period of subpar economic growth would tend to indicate otherwise. Even the Fed must privately be cognizant of the potentially deleterious side effects of its continued medicine.

Until recently, strengthening economic data provided cover for the beginning of an exit strategy. However, now it looks as though there may be further delays. It is difficult to ascertain what this means for equity markets.

The Fed policy of 'lower for longer' on interest rates has certainly been a successful one for investors. Yet, federal debt levels are higher and interest rates must also eventually rise. And the more that stocks appreciate, the greater the divergence between valuations and the underlying fundamental characteristics of economic and earnings growth. The long anticipated "handoff" from easy money to economic growth always seems to be further down the road.

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In a nod to these challenging fundamentals, we continue to be conservatively positioned overall. Despite a recent drag on performance, we remain overweight the energy sector where production cuts, summer driving season, and some increase in demand due to lower prices should soon improve the supply/demand balance.

At the same time we continue our practice of identifying and analyzing individual securities with attractive reward/risk profiles. While these opportunities are becoming scarcer in a rising market, any inclination toward bearishness is tempered by the reality of a Fed that is likely to continue to take its time in raising interest rates.

## FIXED INCOME REVIEW AND OUTLOOK

For fixed income markets, 2015 opened in a *Groundhog Day*-like time loop, repeating 2014's first quarter pattern. As in 2014, investors began 2015 with broad expectations that interest rates would rise and stocks would outperform bonds. The consensus proved wrong again, as interest rates fell and the Barclays U.S. Aggregate Bond Index returned 1.61% for the quarter, outperforming equities.

Divergent central bank policies emerged as a major theme in the first quarter of 2015.

In January, President Draghi of the European Central Bank began to fulfill his pledge of two years, to "do whatever it takes" to save the euro, by embarking on the ECB's own brand of quantitative easing. At the same time, U.S. central bankers publicly discussed raising U.S. short rates from the 0% level that has held for more than six years.

The ECB initiated a trillion-euro effort, which will extend well into next year, with an initial monthly purchase of 52 billion euros of private and government debt. European sovereign debt yields are negative out to seven years, and German-backed ten-year bonds yield less than 0.20%.

Although most investors don't expect Fed rate liftoff until September, the differing central bank policies created a dramatic rise in the value of the dollar versus the euro and other major currencies. A sharply higher dollar, along with deflated energy prices, have resulted in lower corporate earnings estimates in the U.S.

For many reasons, domestic economic growth may continue, prolonging an already-aging economic expansion. Rail car loadings, hotel revenues, and mortgage applications have increased from recent lows. The Economic Cycle Research Institute's gauge of leading indicators has risen, along with private company business surveys and purchasing managers' reports. Vehicle sales, auto production, and furniture buying also recently have increased.

Nevertheless, the important monthly jobs report for March came in much weaker than expected. The headline gain of 126,000 new jobs compared to a 245,000 expected increase and a 280,000 average gain for the previous six months. In addition, the strong initial 295,000 gain reported in February was revised downward.

The March report also showed a rise in part-time workers and a decline in both average weekly hours worked and labor force participation. The decline in participation cast a negative impression on the unemployment rate's lack of change.

After digesting the March employment report, investors perceived that when the Fed does begin to raise rates, the pace of increases is likely to be what New York Fed President William Dudley termed "shallow." The past several strong years of market gains amidst low interest rates and higher valuations may be setting investors up for a year of low capital market returns in a sluggish, but positive, macroeconomic environment.

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**FIXED INCOME INVESTMENT STRATEGY**

Thus far, 2015 has witnessed increased volatility across asset classes, including the MOVE Index, a common measure of Treasury option volatility. This followed a prolonged period of low volatility, attributed by many to the Fed's easy monetary policy.

Investment-grade corporate spreads have continued to track high-yield spreads, which respond to the price of oil. When oil falls, credits tied to the energy sector drop in price. When oil rises, those credits rise in price. The impact of oil has been most profound in the high-yield sector, where energy issues comprise 15% of the market.

In January, investment-grade credits widened 10 basis points to their widest spread of the past 18 months, and then tightened 20 basis points as oil rebounded from the mid $40's to the low $50 per barrel range at the end of February. In March, the price of oil dipped again and so did corporate credit. The first quarter ended with credit spreads about where they began the year, as oil rebounded from the quarter's lows.

Investment-grade corporate spreads are more volatile, but also more attractive than their levels for most of 2014. We favor corporate and taxable municipal over lower-yielding residential mortgage-backed securities and Treasuries, particularly those with shorter maturities. Residential mortgage-backed securities trade at tight or negative option-adjusted spreads, and we remain underweight the sector.

We have increased weightings to commercial mortgage-backed securities, and prefer the sector to residential mortgages as a result of larger option-adjusted spreads, higher convexity, and the ability to increase return by rolling down a positively-sloped yield curve.

The near-term direction of interest rates is uncertain, and we remain slightly short, or close to, most client benchmark durations.

Kevin D. Moore, CFA
Director of Equity Investments

Michael J. Stafford, Jr., CFA
Director of Fixed Income Investments

April 2015

**For additional information about**
**ASB Investment Management, please contact:**

**Ronald F. Perrone, CFA**
Client Services
ASB Investment Management
(240) 482-2907
rperrone@asbcm.com

7501 Wisconsin Avenue
Suite 1400 West
Bethesda, MD 20814
www.asbcm.com