Information through 3/31/2024

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY REVIEW

The first quarter of 2024 was yet another strong one for U.S. Stocks. The S&P 500 recorded a total return of 10.55%. This followed a total return of 11.68% for the fourth quarter of 2023. Year-over-year (the end of the first quarter of 2023 through the end of the first quarter of 2024) the S&P 500 recorded an impressive total return of 29.86%.

Equity market returns and macroeconomic conditions do not always move in lockstep, however, for the past several quarters, market strength and economic strength have been concurrent.

Macroeconomic strength has been apparent in both the labor market and aggregate production statistics. The U.S. unemployment rate has been below 4% since January of 2022. This is a level of employment that compares favorably with the best job market conditions in history. Meanwhile the broad U.S. economy, as measured by real GDP growth, has also been relatively robust of late, with 4.9% and 3.4% growth in the third and fourth quarters of 2023 respectively. While we don't have the real GDP growth figures for the first quarter of 2024 yet (the complex calculation of GDP growth takes several weeks after the quarter to be reported and then is subject to multiple revisions) there is nothing obvious that would indicate that a significant slowdown occurred in the first quarter of the year.

More worrisome for equity market investors is the fact that the deceleration that we saw in inflation last year (from a CPI measurement of 6.5% at the end of 2022 to 3.4% at the end of 2023) seems to have stalled with the latest measurement of year-over-year inflation growth of 3.5% at the end of the first quarter of this year.

Disaggregating the "reasons" for equity market movements is difficult most of the time and nearly impossible some of the time. Nevertheless, we would posit that it is likely that at least some of the recent strength in equity returns was due to the perception at the beginning of the year that the Federal Reserve was likely to soon "pivot" from increasing short term interest rates to decreasing those rates. This perception was reinforced by commentary from Fed officials themselves. Recent inflation readings that show inflation stuck stubbornly above the Fed's 2% target may derail the timeline for reducing rates and will likely be a headwind for equity markets.

EQUITY OUTLOOK

While we need to take into account the macroeconomic environment in which the companies in our portfolio operate in order to accurately assess their prospects and the quality of management execution, the core of our process does not differ from one economic cycle to the next.

Portfolio managers often speak of both the art and science of their investment strategies, and we can describe our process in those terms as well. Although our goal is to generally lean more heavily on the "science" and try to rely less on the "art".

On the science side of the ledger, we try to objectively assess the quality of a prospective (or current) investment through the use of financial metrics in three broad categories: profitability, balance sheet strength, and valuation. We view profitability as the ultimate measure of the success of a business. The metrics we rely on include operating margins, net margins, and free cash flow margins.

Profitability can be viewed as a company's offense, while the strength of the balance sheet can be viewed as the company's defense. The balance sheet indicates a firm's

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ability to weather difficult business conditions and a its ability to finance its business from cash generated from its operations rather than depending on debt markets or equity infusions. Here we look at a several debt ratios, and cash on the balance sheet relative to the company's capital expenditure needs.

Finally, when we identify a company with attractive profit margins and a strong balance sheet, we have to be sure we are making our investments at a time when a company's shares are attractively or at least reasonably valued. Here we use standard metrics such as price to free-cash-flow, price to earnings, price to book value, and price to sales.

While we rely heavily on the objective characteristics above in selecting investments, we also don't want to be completely dogmatic in our approach and we leave some room to deviate based on assessments of more subjective qualities like brand strength, management quality, and future growth prospects.

We also leave open the possibility of making opportunistic investments in companies that may not meet our quantitative criteria but are either too cheap to ignore or are likely to benefit from a significant change in future business conditions. For this we have to rely upon the "artistic" skills we have gained from experience evaluating thousands of companies over many market cycles.

FIXED INCOME REVIEW

Ten-year Treasury yields began the year at 3.88%, having fallen over 1% in the fourth quarter from last year's 5% peak. Investors began the new year expecting rates to continue to fall. Most expected that the Federal Reserve's next move would be a cut in short-term rates, as early as March. Contrary to consensus expectations, yields rose.

During the first quarter, ten-year Treasury yields rose 32 bps, and the Aggregate Bond Index recorded a -0.78% negative total return.

Bond prices plummeted with the release of January's blowout employment report, sending yields higher by 30 bps over the next two trading sessions. Nonfarm payrolls increased 353,000 and the Bureau of Labor Statistics revised the previous month's payrolls higher, far exceeding expectations.

In mid-February, the BLS released inflation data. Consumer prices (CPI) rose only slightly more than expected, but three days later the BLS announced a 0.6% rise in the Producer Price Index (PPI), its biggest gain in a year.

The bond market rallied until early March's release of February payrolls. Another remarkable month of job gains surprised the market and ten-year yields climbed to the first-quarter high of 4.32%.

Given last year's double digit returns and the strong start to the new year for riskier asset classes, it is hard to believe that one year ago all were lamenting three of the four largest domestic bank failures ever. As one pundit put it, commenting on the turnaround in market sentiment, "the only thing we have to fear is no fear."

Employment gains are strong, the rate of inflation has declined, and equity indexes seem to trade at new all-time highs every week. We fear that the country's debt load could disrupt the present favorable investing environment at some point over the next several quarters.

It took the United States 232 years to accumulate its first \$10 trillion of debt, ten years to accumulate our second \$10 trillion of debt, less than five years for the third \$10 trillion, and four months for the most recent \$1 trillion. The interest cost on this debt now rivals our spending on

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defense. One third of this debt comes due within three years. We finance 21% of it with Treasury Bills, almost $6 trillion of which we must roll over and re-finance as they mature over the next twelve months. Even if we avert a crisis, the need to refinance this massive debt load may weigh on markets, pressure rates higher, and crowd out more productive investment opportunities.

FIXED INCOME OUTLOOK

We believe the economy is fragile, weaker than recent market returns imply. The payroll statistics released the first Friday of every month are the most important macro-economic factors driving market returns. Yet, monthly payroll data is at best a coincident, if not lagging indicator of economic strength.

Once unemployment increases, the recession is already upon us, even if many months pass before the National Bureau of Economic Research signals the slowdown's start. Since World War II, there has never been an instance when the three-month moving average of the unemployment rate has risen by more than 0.3% without a recession occurring. Recent recessions have ended or mostly run their course before the NBER has determined a start date. Thank goodness the National Hurricane Center holds itself to a different standard.

Many inflation periods experience a second upswing, like those of the United States in the mid-and late- '70s. Chair Powell and the FOMC know this and want to ensure they subdue inflation before they begin to cut rates.

We may have seen the peak in economic activity for this cycle. Tighter Fed interest rate policy operates with a long lag period, typically twelve to eighteen months, and higher interest rates and inflation have begun to impact consumers. We expect an easier Fed policy with lower short-term rates to steepen the yield curve later this summer, toward the end of the second quarter, if not the third quarter.

Demand has quickly absorbed new issue bond supply. The additional yield spread of corporate or mortgage-backed securities over Treasurys is slight, and signs of macroeconomic weakness will widen credit spreads. Cognizant of the trade-off between higher yielding investments and less risky securities, we are more selective when assessing relative value. We remain nimble, particularly with longer duration bonds that are more sensitive to price movements.

With a flat yield curve and higher rates for intermediate maturity bonds that we have not seen since before the Great Financial Crisis of 2008-09, we see an attractive opportunity to extend from cash into intermediate maturity two-to-five-year bonds. If the Fed does lower rates, the short average maturity of money market funds will quickly drive cash returns lower. When the Fed begins to ease, we believe today's intermediate bond yields will have looked attractive.

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