ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

The S&P 500 Index had yet another strong return for the 2nd quarter of 2024. The index posted a total return of 4.28%. The underlying character of that return should be very familiar to those observing the market over the past one and a half years.

Once again, market returns were driven by a handful of very large (mostly) technology stocks. The Bloomberg Magnificent 7 Total Return Index (which includes NVIDIA, Tesla, Apple, Meta, Amazon, Microsoft, and Alphabet) had a return of 16.92% for the quarter. NVIDIA alone had a total return of 36.74%. On the other hand, the average stock in the S&P 500 (as measured by the S&P 500 Equal Weighted Index) had a total return of -2.63%. That is, *minus* 2.63%.

Looking at the year-to-date period reveals a similar return structure. For the first half of 2024, the S&P 500 Index had a total return of 15.29%. The Bloomberg Magnificent 7 Index had a total return of 36.97%. NVIDIA had a total return of 149.5%. Finally, the Equal Weighted S&P 500 Index had a total return of 5.07%.

Going back to (roughly) when this phenomenon began, the S&P 500 total return for the six quarters from the beginning of 2023 through the end of the second quarter of 2024 was 45.56%. The total return for the Bloomberg Magnificent 7 Index was 183.53%. The total return for NVIDIA was 745.84%. Lastly, the total return for the S&P 500 Equal Weighted Index was 19.61%.

Looking at economic indicators, the second quarter brought solace to those hoping the "data dependent" Federal Reserve would have the numbers it needs to begin easing rates in the second half of the year. Year-over-year inflation, as measured by the CPI, eased to 3% at the end of June. The lowest rate since March of 2021. Economic growth, as measured by quarter-over-quarter annualized real GDP, slowed to 1.4% at the end of the first quarter. This was the lowest measurement since the second quarter of 2022. Finally, the monthly US unemployment rate was 4.1% as of June 30th. While this is still at the low end of the long-term historical range, it was, nevertheless, the highest monthly rate since November of 2021.

EQUITY OUTLOOK

While we usually don't like to ascribe market movements to simple factors because of the sheer complexity of understanding the motives of so many participants, it is clear that artificial intelligence, or rather the promise of the economic gains to be engendered from artificial intelligence, is an overwhelming factor in the recent equity market returns we outlined above.

While we certainly can't profess to know precisely what the impact of artificial intelligence will be going forward, we can offer a few observations on what has occurred so far.

Thus far, the winners (from the point of view of economic profits) have been the companies facilitating the build out of the infrastructure perceived to be necessary for future demand for cloud based artificial intelligence services and applications. These profits are real. Very large sums are being spent by very large and, in most cases, cash-rich companies to expand their capacity to handle the data-intensive workloads inherent in artificial intelligence

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processes. The hardware, intellectual property and services of companies that possess the necessary building blocks of this AI infrastructure are in extremely high demand. Capacity is expanding rapidly.

Clearly there is a great deal of optimism built into the share prices of many companies benefitting from this capacity expansion. Our concern is that at some point this new capacity may outstrip demand. If that were to happen, it is possible for the revenue growth rates of the companies providing the picks and shovels that are enabling the AI revolution to grind to halt. Semiconductor demand, for example, has been highly cyclical in the past. We are skeptical that the same will not be true in the future.

While we do hold companies in our portfolio that have benefitted from this trend, we are becoming increasingly concerned about valuations and future growth rates and have made portfolio adjustments accordingly.

FIXED INCOME OVERVIEW

During the second quarter Treasury yields increased, and the Aggregate Bond Index registered a barely positive 0.07% total return. The Intermediate Government/Credit Index returned 0.86% as shorter bonds outperformed longer maturities. The yield of the investment world's most important asset, ten-year U.S. Treasury notes, began the quarter at 4.20%, rose to a quarterly high of 4.74% in late April, fell to a quarterly low of 4.19% in mid-June, and finished the quarter at 4.40%.

On balance, macroeconomic factors seem to point to lower rates. Federal monetary policy impacts the economy with long and variable lead times. Investors have weathered an inverted yield curve, with 3-Month T-Bills higher than ten-year yields, for a record twenty months. Tighter monetary policy has helped reduce the growth rate of inflation, but also the growth of the economy.

Higher rates are hurting consumers. Credit card rates and auto loan delinquencies have risen. CNN recently reported the painful impact rising rates have on adjustable-rate mortgage holders, noting a $2,000 increase in monthly payments for a Texas homeowner.

Aggregate jobs growth remains steady, but the unemployment rate has increased from last year's low of 3.5% to 4.1% today. The three-month average increase of unemployment has triggered the "Sahm Rule." Like the interest rate warning of an inverted yield curve, the Sahm Rule labor indicator has always signaled a recession.

Tighter Fed monetary policy has helped reduce inflation. The year-over-year rate of growth of annual price increases has fallen from a post-pandemic high of 9.1% in June of 2022 to 3.3% today.

With falling inflation and weaker economic growth arguing for lower rates, one factor that could pressure rates higher is the rising amount and cost of financing America's $34 trillion of federal debt. Our country's outstanding marketable sovereign debt has a 5.8 year weighted average maturity, with more than one-third maturing within the next twelve months. The weighted average cost of our outstanding debt is 3.26%, in an environment where T-Bills yield 5.30% and long bonds 4.50%. Every week, as several hundred billion dollars of Treasurys mature, they are refinanced with new bond issues at higher rates. We now spend as much money financing the debt as we do on defense.

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Last year, Moody's placed U.S. Treasury debt on credit watch due to its forecast that interest expense as a percentage of tax revenue will exceed 26% in 2032, about the same level as a CCC rated bond. The nonpartisan Congressional Budget Office's estimate of this year's budget deficit recently increased to $2 trillion, from $1.6 trillion projected as recently as February. It is hard to imagine a resolution of the situation without a crisis, and the longer we kick the can down the road, the bigger the problem becomes.

FIXED INCOME OUTLOOK

Investment grade corporate bond credit spreads are tight to Treasurys but can remain at current levels for a long time, as they were during the mid-1990's. Negative cash flow growth amidst rising debt and interest expense have reduced strong interest coverage ratios, which remain above pre-pandemic levels. Many companies have responded to weaker earnings by lowering share buybacks and equity dividends, producing positive credit rating developments. The credit rating upgrade versus downgrade ratio is at a record 4.8x, and ratings agencies have upgraded over 4% of the investment grade corporate bond market on a net basis so far this year. Unless corporate bond spreads dramatically widen in a severe recession scenario, corporates will likely outperform mortgage-backed securities.

Three-month T-Bills yielding 5.38% have been above 5% for more than a year. For over fifteen years Fed policy kept short rates near zero, and T-Bills never yielded more than 2.5%. In comparison, today's 5%+ money market rates with immediate liquidity and the safety of Uncle Sam's backing seems like an easy choice. We suggest otherwise.

Whenever the yield curve has inverted and the Fed then begins to ease, on average it takes less than one month for the curve to become positively sloped. T-Bills outperform short and intermediate maturity bonds as the curve inverts, but this situation has always quickly reversed as soon as the Fed begins to ease short rates. Over multiple interest rate cycles from the 1970's, intermediate maturity bonds have outearned money market funds by more than 2% annually. We believe that rather than holding large money market fund balances, investors should invest excess cash in short or intermediate maturity bonds today, as it appears that Fed cuts are growing closer. By the time the markets is certain that the curve is returning to a positive slope, savvy investors will be better positioned to benefit from a return to a positively sloped curve.

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