Information through 9/30/2024

ASB Investment Management
Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

The third quarter of 2024 was yet another strong one for the S&P 500 index. The total return for the quarter was 5.89%. However, unlike so many of the preceding quarterly periods the return was not dominated by a handful of megacap technology stocks nor by the technology sector more generally.

In fact, The Bloomberg Magnificent 7 Total Return Index actually trailed the S&P 500 slightly with a total return of 5.43% and the S&P 500 Information Technology sector returned only 1.61%. Further evidence of a broadening of the market was the fact that the equal weighted S&P 500 soundly beat the market cap weighted S&P 500 with a total return of 9.59%.

Participation from additional companies and sectors for the past few months of the current equity bull market would appear to be a healthy development. However, if we don't just look at the quarter in isolation but look at longer periods the dominant drivers of the returns of the current bull market have changed very little.

For the year-to-date period through the end of the third quarter, the S&P 500 had a total return of 22.08%. The equal weighted S&P 500 had a total return of 15.16% and the Bloomberg Magnificent 7 index had a total return of 44.40%.

The trailing year return for the S&P 500 was 36.33% versus 28.80% for the equal weighted S&P 500 and 62.55% for the Magnificent 7. Over the trailing two year period, the divergences are even more stark with the S&P 500 having a total return of 65.77%, the equal weighted S&P 500 returning 46.32% and the Magnificent 7 index living up to its name with a return of 161.22%.

Yes, the market has broadened recently, but it is not yet broad. Looking at more meaningful time frames makes that clear.

EQUITY OUTLOOK

There are a number of reasons that investors are feeling optimistic and that returns have been so strong in US markets over the past two years. An often-predicted recession has yet to arrive. Inflation is moderating. The Federal reserve has begun to lower interest rates. There is a perception that we are on the cusp of another revolution in information technology.

However, over the long term it is corporate earnings that drive stock market returns. What investors are paying for those earnings has increased significantly over the past two years.

At the end of the third quarter of 2022 the price to earnings ratio of the S&P 500 was 17 times. At the end

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of the third quarter of 2024 it was 26 times. That's an increase of over 50%. Thus, the bulk of market returns over the past two years were due to the price investors were willing to pay for stocks increasing rather than corporate earnings increasing. Another way of looking at it is that investors are optimistic about company earnings in the future.

As has always has been the case, the future is uncertain. Although it has become more challenging, even at current market price levels we continue to be able to identify companies with solid profits and prospects at reasonable prices.

FIXED INCOME OVERVIEW

The longest anticipated easing of short-term interest rates that we could ever remember occurred on September 18th, when the Federal Reserve announced a 50-basis point lowering of the Fed Funds target rate range from 5.25% - 5.50% to 4.75% - 5.00%. All expected the Fed to ease on the 18th, but pundits were split between a 25 and 50 basis point cut. The Fed went big and cut rates 50 basis points, but contrary to investor expectations, long term interest rates rose. From the 18th to the end of the month, the price of ten-year Treasury notes fell over 1%, and thirty-year bonds almost 3% in value.

Interest rates did fall during most of the third quarter, in anticipation of the Fed easing short rates. The Aggregate Index generated a 5.2% total return for the quarter. The quarter's positive results offset first half losses, producing a 4.44% year-to-date return for the Aggregate Bond Index.

During the quarter, ten-year Treasury yields fell 62 basis points, and thirty-year bonds 44 basis points, but the bigger drop in rates occurred at the front end of the yield curve. Six-month T-Bills declined 92 basis points, one and two-year yields 112 basis points, and three-year yields fell 100 basis points.

The easing on September 18th brings an end to the "Fed pause," which began at the last Fed hike in short rates on July 26, 2023. Typically, periods of a Fed pause, the time between the last hike and first ease, are favorable times for investing in higher risk assets like equities, and the past year was no exception. Its during easing cycles that investment results have historically been more challenging.

The Fed eases interest rates in response to economic weakness, producing a strong investment environment for high quality, fixed income investments like longer maturity Treasurys. Ten-year Treasury yields were lower three months after the first ease in 7 of the previous 10 first rate cuts dating back to 1980.

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FIXED INCOME OUTLOOK

The drop in shorter term Treasurys steepened the slope of the yield curve. The 3 Month T-Bill to ten-year Treasury spread has been negative for two years, the longest period of yield curve inversion on record. Historically, inverted curves have had a perfect record of predicting recessions. Primarily for this reason most economists predicted last December that the Fed would ease rates five to seven times by now, to avert an economic slowdown. Long and variable lags to monetary policy were reasoned to warrant more aggressive easing.

The markets, as measured through futures contract pricing, expects seven additional cuts of 25 basis points over the next twelve months, including a total of 75 basis points of cuts before the end of the year. These predictions may be a bit aggressive. We expect one or two additional cuts of 25 basis points before year end.

We expect shorter maturity bond yields to continue to fall, and the yield curve to become more positively sloped, giving us a preference for five to seven-year maturities. Credit spreads are tight, the economic cycle may be turning, and we are more cautious when investing in corporate bonds. We have invested in more securitized mortgage and asset-backed securities and expect these sectors to perform well as the yield curve steepens.

A record amount of cash sits in money market funds, where investors attracted to yield levels they have not seen for over twenty years may have become too complacent. One to three-month T-Bill yields have fallen 50-60 basis points since the beginning of September. For investible cash targeted for long-term investing, investors should consider extending out of money market funds into intermediate maturity bonds as soon as possible to earn higher returns over the longer term. We believe the yield curve will become positively sloped and money market fund rates will drop much faster than most expect.

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