Information through 12/31/2024

ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

The S&P had a positive total return of 2.39% for the 4th quarter of 2024. The 25% total return for the calendar year 2024 marked a second consecutive strong year for the index.

We have written in detail over the past several quarters (perhaps ad nauseum) about the fact that the returns of the market capitalization weighted S&P 500 index have largely been driven by a small handful of index constituents. We have represented these stocks using the Bloomberg Magnificent 7 Total Return Index (BM7). The price momentum of that index, and thus a high level of market concentration, continued into the last quarter of the year.

For the fourth quarter of 2024 the BM7 had a total return of 15.89% vs. 2.39% for the S&P 500. For the full year the BM7 had a total return of 67.34% vs. 25% for the S&P 500. For the trailing two years, the BM7 has had a total return of 246.42% vs. 57.82% for the S&P 500.

Two salient factors continue to support this extraordinary market environment: benign economic conditions and the promise of a computing revolution driven by artificial intelligence.

Throughout the year, economic indicators were remarkably resilient. Inflation moderated, output was stable, and employment remained healthy.

But the narrative that has truly excited investors has been the transformational promise of Artificial Intelligence. So far, the market has chiefly rewarded a handful of large companies either building out AI computing capacity or those providing the technology and tools to do so. Many of these companies now trade at valuations that reflect extreme optimism.

For the massive investments being made to build out AI computing capacity to be worthwhile, AI driven applications will have to prove to be useful for a wide range of commercial applications.

EQUITY OUTLOOK

While we have made portfolio investments that have benefited from the AI boom, we think much of the space is now overvalued.

Going forward, we will be keeping a close eye on companies outside of the technology sector to see whether they can prove to be generating positive returns from their investments in AI tools.

If indeed, companies begin to successfully and profitably integrate AI tools that improve their productivity, that should become apparent in their financial statements. In other words, the proof will be in the pudding.

While we always search for companies with attractive profitability metrics, we also look closely at margin trends. This may become an increasingly important part of our process if, indeed, AI begins to transform a variety of business models.

ASB INVESTMENT MANAGEMENT

FIXED INCOME OVERVIEW

Interest rates rose during the fourth quarter, causing a negative total return of -3.19% for the Aggregate Bond Index. The quarter's results partially offset strong third quarter returns, and the index registered positive returns for the calendar year, up 1.25%. Shorter maturities outperformed. The Intermediate Government/Credit Index returned 3%, and Three-Month T-Bills returned 5.25% for the year.

During the fourth quarter the Treasury curve returned to a positive slope after a long two-year inversion. The Fed lowered the Fed Funds target rate in two regular intervals of twenty-five basis points on November 7th and December 18th. At the end of the year, three-month T-Bill rates had fallen to 4.32%, 28 basis points less than 4.60% ten-year Treasury yields and forty-nine basis points less than 4.81% thirty-year Treasury yields.

Three-month T-Bill yields have fallen over 1% from the 5.40% area they traded in last spring. During the quarter T-Bill yields continued to fall as the Fed lowered short term rates, but the market responded quite differently to longer maturities. Rather than following Fed rates lower, maturities one year and out increased in yield, and prices fell. The 66-basis point increase in thirty-year yields to 4.78% corresponds to an eleven point drop in price.

The expansion of the U.S. economy continued as the Fed eased, and investors became increasingly concerned that the Fed may be spiking the punch bowl with lower rates, risking letting the party get out of control when caution toward inflation is necessary. At the beginning of the quarter the futures markets implied investor expectations of seven or more additional rate cuts and 3% short rates by the end of 2025. Expectations shifted so dramatically that by the end of the quarter investors expected only one or two cuts and short rates close to 4% at the end of the new year.

FIXED INCOME OUTLOOK

Investors entered the past two years expecting strong fixed income returns amidst lower interest rates. That did not happen, and this year the consensus seems less optimistic. Even though the Fed has begun to ease interest rates, the market fears the Fed has acted prematurely. Investors enter 2025 concerned that continued economic growth and an inflationary environment will dampen fixed income returns.

Spreads are tight and incremental yield above Treasurys is difficult to achieve through investment in high quality bonds. Investment grade corporate spreads averaging eighty basis points above Treasurys hover near multi-decade lows. Although spreads appear tight relative to recent levels, we remember the period after the real estate recession of the early nineties until the internet bubble burst in early 2000 when investment grade corporate bonds traded at even tighter levels than today's prices, with little volatility, for a prolonged period.

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In today's tight-spread environment we are cognizant of the additional risk investors must incur to earn additional income. We remain overweight spread assets but prefer A-rated companies over riskier BBBs.

We expect the Treasury curve to continue to steepen and prefer to hold concentrated maturities in the five-to-seven-year range rather than evenly distributed maturities from 2 to ten years. As the curve steepens, portfolios with concentrated intermediate maturities should outperform portfolios with a broader range of maturities. Proactively managing security maturities is another way an actively managed bond portfolio can increase returns versus more static, buy and hold strategies.

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