October 2020

"Hope Springs Eternal"

The United States presidential election is foremost on the minds of investors. It is likely that the pace of legislative change will provide enough time for corporations and individuals to absorb the changes. Investors can take solace in The Constitution of the United States, which inherently provides checks and balances. This mandate has reduced the probability of sudden and extreme changes to the laws of the country during its 244-year history. The increase in the use of executive orders over the past decade has allowed for substantial changes to be made by the Executive branch unilaterally. As a result, increases and decreases in regulations have impacted a wide array of industries. Should one party be elected to hold the majority in both houses of Congress, there could be an acceleration of changes to laws that require Congressional approval such as taxes and healthcare. As always, the degree and pace of the changes will determine the broader implications, albeit positive or negative, on corporate profits.

At the onset of the pandemic in the United States, the Federal Reserve lowered the federal funds rate to 0% and simultaneously purchased treasury, agency, and corporate bonds to provide support to the economy. These actions, in conjunction with $4 trillion in fiscal stimulus, helped provide confidence to investors and liquidity to capital markets. Thus, both stock and bond markets achieved positive returns in the third quarter.

Portfolio Strategy

Fixed Income

In the current unprecedented low interest rate environment, corporations issued a record $267 billion in new investment grade corporate bonds during the third quarter. AHB taxable bond portfolios capitalized on this new issuance by identifying investment opportunities in companies with quality balance sheets, whose bonds had not previously been available at such relatively attractive yields. This new issuance has been an opportunity for taxable bond investors to increase the underlying quality and safety of portfolios during a time of significant future uncertainty. Due to the lack of visibility around the election and the pandemic, there is a range of possible outcomes for inflation and future interest rates. In this environment, an investment grade, intermediate-term maturity, laddered portfolio provides a prudent approach to insulate bond portfolios from interest and credit risk while achieving competitive risk-adjusted returns.

Municipalities have faced challenges as a result of the massive costs associated with COVID-19. The pandemic has shut down many businesses, and most severely impacted the hospitality industry which historically provided large tax revenues, particularly in cities. Fiscal aide and low interest rates have enabled municipalities to withstand the challenges stemming from the pandemic thus far.

Following the stimulus spending required for COVID-19, we would expect the US government to reduce it's deficit, increasing the probability of higher tax rates over the next several years. Investment grade municipal bonds, carefully selected, offer extremely attractive investment returns for those in high tax brackets and/or high tax states. To enhance the protection of the portfolio, we have increased the minimum underlying rating requirement for new purchases to “A” from “A-”. We continue to purchase only “essential service” revenue bonds and have more recently concentrated on General Obligation bonds as opposed to Revenue bonds. The portfolio avoids debt issues of hospitals, nursing homes, airports, stadiums, and other specific projects that are economically sensitive. Additionally, AHB municipal bond credit research has expanded the number metrics that are examined prior to the purchase of each security. The comprehensive analysis includes but is not limited to assessing the fund balance, evaluating the impact and the amount of reliance on state funding. Since property taxes are more sustainable in weaker economic periods our analysis also includes how much revenue a municipality receives from property taxes. Finally, an evaluation is necessary of the region demographics as well as the climate change exposure, specifically flood and fire.

Equities

The stock market continued to whipsaw during the third quarter and large technology stocks were the primary driver of the market in both directions. Work from home (WFH) has continued to be the new normal. It seems readily apparent that WFH is here to stay, even after the pandemic is over. Companies have accelerated their knowledge and familiarity with remote technology to communicate and manage their workforce. The awareness that WFH is possible and effective has led companies to consider lowering fixed costs such as rent, by reducing office space. E-commerce is another trend that has accelerated as a result of the pandemic. A larger number of consumers have been ordering more items online, which we expect to continue after the pandemic ends. The magnitude is difficult to measure, although increasing profits of companies such as Walmart and PayPal are examples of holdings that have benefitted from the expanding volume of online purchases. In addition, the current pandemic has compelled corporations to accelerate plans for digital transformation and we believe that many of the portfolio’s technology holdings are poised to directly benefit from this trend. We expect to continue to find more companies that will benefit from the long-term secular trend of remote work.

We are grateful for your confidence and support as we continue to make every effort to provide a high level of service while striving to meet your investment objectives. We are eternally hopeful for a resolution to the COVID-19 Pandemic. Please do not hesitate to reach out to us with any questions or comments you may have.

Wishing you safety and good health,

AHB Investment Team