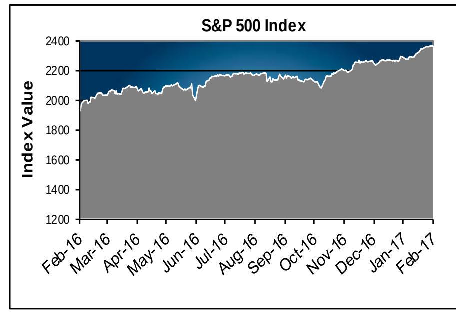
This Month in the Markets

February 2017

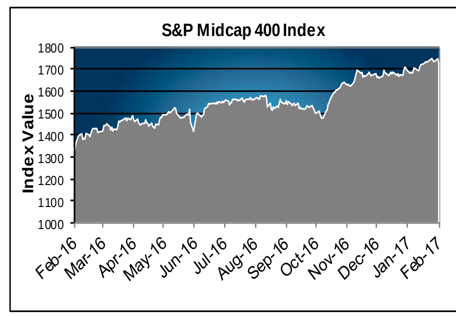
EQUITY COMMENTARY

U.S. Market Trumps Foreign Markets in Equity Rally

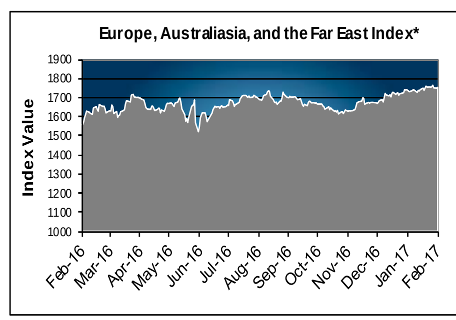
Global equities continued their charge higher in February on the back of decent corporate earnings, an improving economy and the potential for meaningful fiscal reform under President Trump. Health care and technology stocks were the best performers returning 5.6% and 4.5% respectively. Energy and materials companies were the laggards with monthly returns of -2.6% and -0.9% respectively. Overall the Morgan Stanley Composite Index (MSCI) closed the month up 2.6%. U.S. stocks outperformed international stocks with the Standard & Poor's 500 Index (S&P 500) rising 3.7% compared to the 1.2% gain of Europe Asia Far East Index (EAFE). Part of this outperformance was based on the U.S. dollar which rose 1.6% during the month. Since the surprise victory of Donald Trump, the MSCI is now up 8.7% with the S&P 500 up 10.5%. The MSCI is up 5.0% year to date, with the S&P 500 up 5.6% and EAFE up 4.1%.



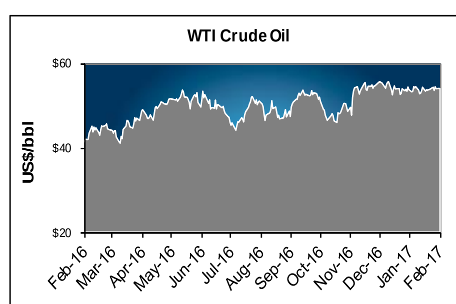
There is no question that the market has been buoyed by a shift from deflationary fears towards the reflation trade. Following the collapse in energy prices in 2014 inflation across the globe tumbled. Even core inflation which adjusts for food and energy dropped from 2.0% in May of 2014 to 1.6% by the end of 2014. Since then inflation has picked up and is back to the Federal Reserve's (Fed) 2.0% target with CPI now at 2.3%. Core Personal Consumption Expenditures, the Fed's preferred measure has increased from a low of 1.3% to 1.8%. 10 year implied inflation expectations have increased from a low of 1.2% in February of 2016 to 2.0%. While inflation is still under control, our expectation is the Fed will raise short term rates at least twice this year with an increased possibility that they will do so three times. Our portfolio is set up to benefit from higher short term interest rates. We remain overweight banks as higher interest rates have a positive impact on net interest margins while we are underweight bond equivalent equities which trade on their dividend yields.



One of the other benefits of a pickup in inflation is their impact on overall earnings and revenue growth. With reporting season nearing to a close it is clear that corporate earnings have accelerated. Trailing 12 month earnings for the MSCI were up 1.7%, the first positive reading since 2014. Q4 2016 earnings were 22.2% higher than Q4 2015. Trailing 12 month revenue growth also returned to positive territory in the fourth quarter and was up 0.7%. Q4 2016 revenues for the MSCI were 1.8% higher than Q4 of 2015. Going forward we expect corporate earnings and revenues to continue to accelerate. Earnings for the MSCI for 2017 are expected to grow nearly 25% from $85.9 in 2016 to $107.3 in 2017 on revenue growth of about 3.0%. This earnings growth should normalize the MSCI's market multiple from 21.4 time earnings to a more reasonable 17.1 times earnings.



While the recent surge in the equity markets has made finding undervalued companies more challenging, we believe there are still individual stocks that offer compelling value. We like companies that have relatively stable operating margins, high returns on invested capital and free cash flow yields after adjusting for leverage throughout the cycle. Our portfolios are made up of a basket of such names, all of which are trading below their intrinsic values. At present our equity portfolio trades at 20.7 times 2016 earnings and 12.8 times 2017 projected earnings compared to 22 and 17.2 times for the MSCI, respectively. The return on invested capital of our portfolio is 9.8% compared to 5.4% for the MSCI.



*MSCI EAFE Index

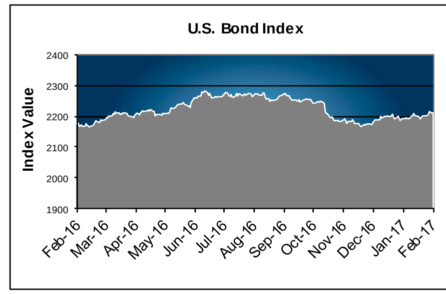
FIXED INCOME COMMENTARY

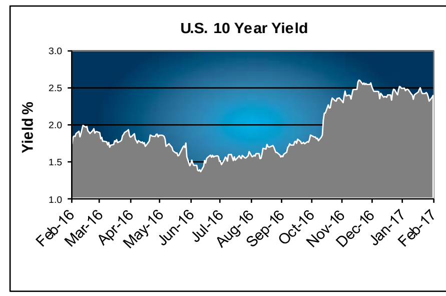
Rate Hike Nigh

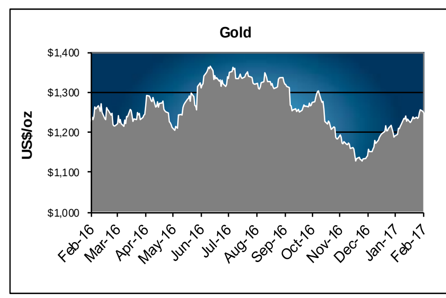
Since the beginning of December 2016, the bond market has traded in a tight trend channel with low interest rate volatility. At the end of February, yields moved to the lower end of the trading band which resulted in some moderate gains across the entire fixed income market. U.S. Treasuries finished the month with a modest gain of 0.5% while corporate bonds and preferred securities outperformed government bonds once again. The best performer was the BofA Merrill Lynch Hybrid Preferred Securities Index with a monthly return of 2.0%. In the foreign exchange market the U.S. dollar reversed some of its losses from January. The Swedish krona was the weakest of the major currencies with a loss of 3.4%, while the Australian dollar was the only currency which eked out a small gain versus the U.S. dollar.

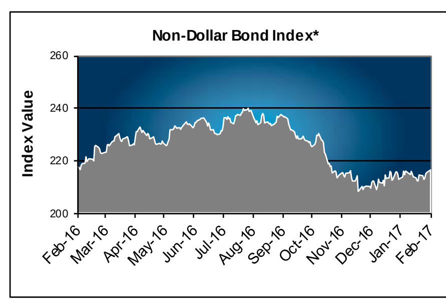
The low volatility environment in the fixed income market at the start of the year continued into February. It appears that investors are in a holding pattern due to the expected fiscal policy announcements from President Trump. Fiscal reform in the U.S. and elsewhere has been neglected for way too long and monetary policy has run its course. While interest rates are expected to remain very low and even negative in some instances in Europe and Japan, the U.S. central bank (Fed) will continue with its projected interest rate hikes this year. The big question is when the next 25 basis point hike will occur and March 15th has become a real possibility. After hawkish comments by two Federal Open Market Committee (FOMC) members at the end of February, the market implied probability for a rate hike surged to 80%. Historically, when odds have been above 70%, the FOMC has followed through with a change in interest rates. If the recent hawkish central banker statements are reinforced by a strong employment report, especially with rising wage pressure, and there is also a continued rise in inflation readings, then an interest rate hike at the next FOMC meeting will become a near certainty. According to the committee's dot plot, a total of three 25 basis point hikes are planned for 2017, while the market is expecting just two. Either way, short-term interest rates will go up this year while the outlook for longer-dated bond yields is less trivial. The U.S. yield curve (difference between the ten- and two-year government bond yields) has flattened since the start of the year and it would be a fallacy to assume that higher short-term rates will automatically cause a parallel shift in the yield curve. Short-term rates are a reflection of the cyclical economic momentum which is clearly in favor of higher rates. Relatively strong economic data and the proposed fiscal policies warrant higher short-term rates to some extent. The long-dated bond yield, however, is more a reflection of structural forces and inflation expectations. Both are still relatively muted and the dovish monetary policies by the European Central Bank and Bank of Japan have kept a lid on U.S. bond yields. The Anchor managers have therefore taken advantage of the recent sharp rise in interest rates and extended duration by adding a ten-year U.S. Treasury security to the fixed income allocation.

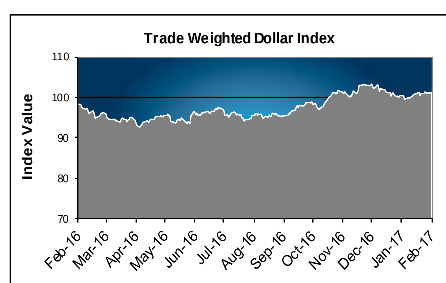
The foreign exchange market has proven to be much more volatile than the fixed income market. After a steep dollar sell-off in January some of the losses were reversed in February. Real interest rate differentials are expected to rise in favor of the U.S. and President Trump's "America First" policies have the potential to reduce the U.S. current account deficit by a serious amount. This could potentially lead to a shortage of dollar supply and bid up the greenback in the process.











*Merrill Lynch Global Broad Market, Ex US Dollar Index