This Month in the Markets

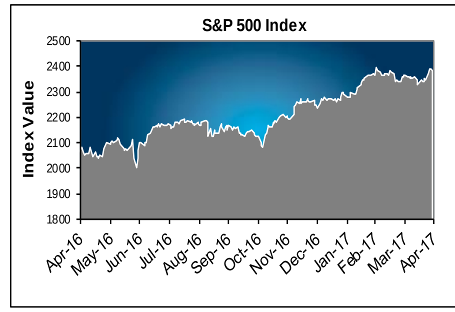
April 2017

ANCHOR Investment Management

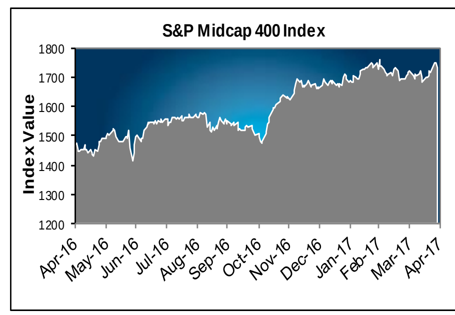
EQUITY COMMENTARY

International Markets Lead Global Equities Higher

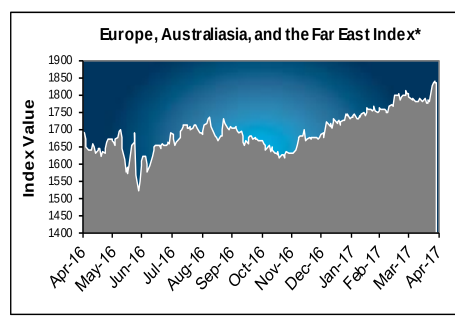
Global equities continued to move higher in April as corporate earnings strength offset some softening in economic data. Consumer discretionary, industrials and technology companies led the charge returning 2.8%, 2.6% and 2.4% respectively. Energy and telecommunication companies were again the laggards dropping 2.4% and 1.8% respectively. Overall the Morgan Stanley Composite Index (MSCI) closed the month up 1.3%. U.S. stocks underperformed international stocks with the Standard & Poor's 500 Index (S&P 500) rising 0.9% compared to the 2.3% gain of the MSCI Europe Asia Far East Index (EAFE). European shares have performed well after the demise of the euro is less likely with recent trends in elections on the Continent and investors have become less concerned about Brexit risks. .. Since the surprise victory of Donald Trump, the MSCI has risen 11.0%. The MSCI is up 7.3% year to date, with the S&P 500 up 6.5% and EAFE up 8.9% in U.S. dollar terms. The 2.4% outperformance of international markets, measured in dollars is entirely due to the recent decline in the dollar which has dropped 3.1% so far in 2017.

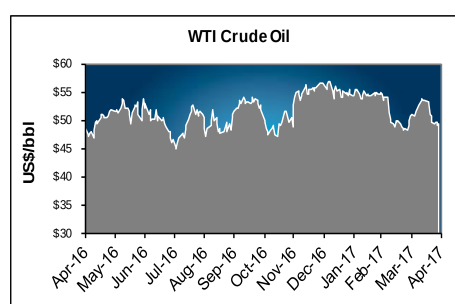


When the stock market does well we often get questions from clients about market timing. Our answer is always the same. It is very hard if not impossible to time markets. Maybe the hardest part is that you need to make two decisions: when to get out and when to get back in. This essentially means you need to overcome a series of psychological biases and be right twice. If we are invested in stocks to steadily build and preserve wealth over a long period of time then our strategy should not include trying to jump in and out of the market based on short-term concerns or performance. By attempting to be out in down periods many investors actually miss periods of exceptional returns and incur trading costs and market impact costs. It really is time in the market not timing the market that counts. Instead of trying to time the market, we value our individual positions (valuation timing if you prefer). By knowing what companies that we own and what they are worth, we essentially stick to buying companies that are undervalued and selling those that are fully valued and avoid those that are overvalued.



While the price the market is willing to pay for a dollar of earnings may fluctuate over time due to macro and emotional factors, over longer periods equity markets track corporate earnings. The collapse in energy prices and a surge in the dollar led to a perfect storm where trailing 12 month earnings for MSCI dropped 17.8% from 96.0 in Q3 of 2014 down to 78.9 as of the end of Q2 2016. The stabilization in energy prices has led to the energy sector to return to profitability which in turn has led to a large uptick in the earnings of the overall market. Since bottoming in Q2 2016 trailing 12 month earnings for the MSCI have rebounded 10.7% to 87.3. By the end of 2017, earnings for the MSCI are expected to be 109.5. If the market were to stay flat from now until the end of the year, at this level of earnings the MSCI would trade at 17.2 times. Put differently the earnings yield of the market would be 5.8% which compares quite favorably to the U.S. ten year treasury yield of 2.28%. While the overall market is not cheap, we believe that calls for an equity bubble are significantly premature as the headline valuations have been based on materially depressed earnings from one particular sector which are in the process of normalizing. At present our equity portfolio trades at 17.7 times trailing 12 month earnings and 12.9 times 2017 projected earnings compared to 21.7 and 17.2 times for the MSCI, respectively. We find the earnings yield of 7.75% based on 2017 estimates to be quite compelling.



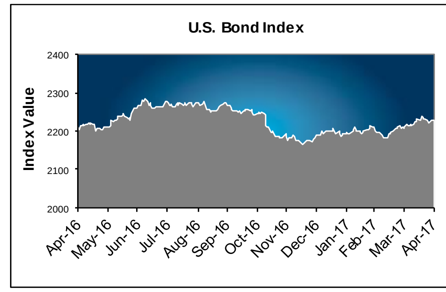


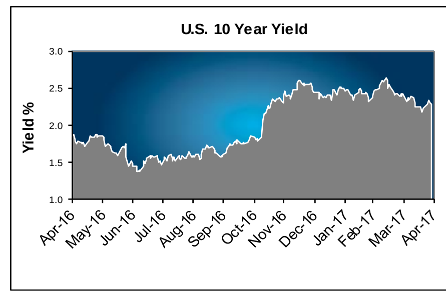
*MSCI EAFE Index

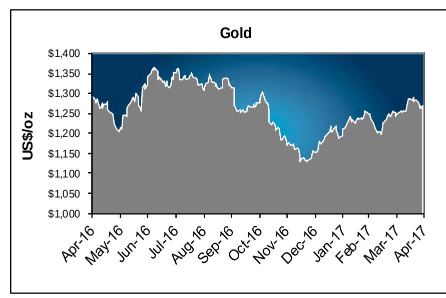
FIXED INCOME COMMENTARY

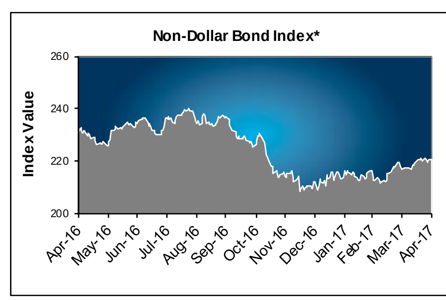
Neutral Interest Rate

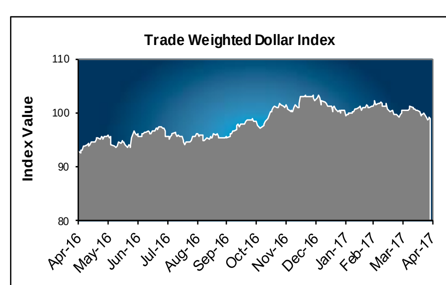
Fixed income securities extended their rally from the first quarter due to a myriad of factors. Economic data like payrolls, housing starts and auto sales have fallen short of consensus forecasts and credit growth in the U.S. has decelerated. At the same time the reflation trade has been challenged due to set backs with President Trump's proposed policies in Congress. In addition, geopolitical uncertainties like the missile strike in Syria, saber-rattling with North Korea, the French elections and bickering over Brexit have put a bid under fixed income securities. The U.S. dollar showed a strong performance versus commodity and emerging market currencies but lost ground to its European counterparts due to a repricing of political risk in France.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

For several months now soft data (i.e. professional surveys) have been encouraging and have continued to point to an economic acceleration from the second quarter of this year on. This has been reflected in the Purchasing Managers' Indexes globally and in U.S. regional surveys. Most of these data, especially the new orders index, have a strong correlation with GDP growth and point to a looming breakout to the top. So far such soft data have created a lot of hope - also referred to as "reflation trade" – and supported risk assets in a decisive way. Until now soft data have not led to a meaningful improvement in hard data (i.e. economic statistics). On the contrary, there was some slowdown in key data, with unemployment, inflation and first quarter GDP disappointing. Hard data were expected to improve once Congress and the Trump administration could agree on some meaningful fiscal policies with long-term structural improvements like a substantial tax reform. However, due to the bickering in Congress, the timeline for fiscal stimulus has been moved further out and the real impact will not be felt before next year. In this context there might be a risk that the Federal Reserve (Fed) will not be able to follow through with its plan for interest rate hikes. After the last rate increase in March it was thought that policy makers would be able to increase the target rate twice more this year, in June and September, and then announce the start of unwinding the Fed's balance sheet in the December meeting. Without fiscal policy taking over the "growth baton" from the monetary side, the future interest rate path may continue to flatten and be pushed further into the future.

The latest update to the Fed's so-called dot plot indicates that the long-run target rate is 3%. Although this number appears low from a historical perspective, it may actually be too high in the current economic environment. According to a study by the renowned Fed economist Thomas Laubach and San Francisco Fed President John Williams, the neutral interest rate in the U.S. is zero percent. (The neutral rate is the target rate minus inflation and this estimates the equilibrium where GDP is growing at its trend rate and inflation is stable.) Assuming that the Fed can fulfill its mandate of 2% inflation in the long run, this would imply a 2% Fed funds target rate in order to achieve the estimated zero percent neutral rate. A lower than expected target rate provides an anchor for the entire yield curve and has currently kept a ceiling on bond yields.

Since the Fed is the only major central bank with a tightening bias, interest rates will continue to widen in favor of the U.S. dollar. If the Trump administration is able to broker significant pro-growth reforms (e.g. tax reform, deregulation) at a time when other countries like Europe and Japan show little success towards structural reforms, growth in the U.S. will further outpace its counterparts. Rising growth will lead to higher interest rates and increased support for the U.S. dollar.