This Month in the Markets

July 2018

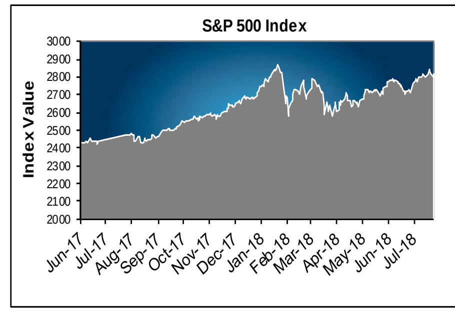
EQUITY COMMENTARY

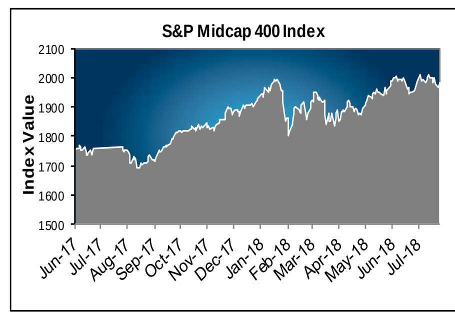
DEFANGED

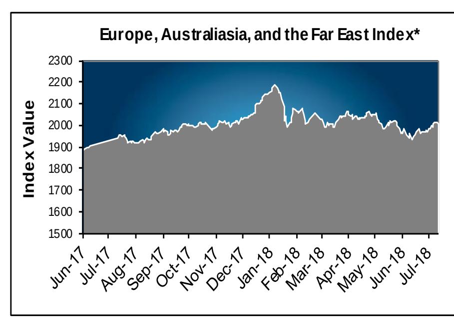
The highly touted FANG leadership (Facebook, Amazon, Netflix and Google (Alphabet)) showed some fragility in July as both the Facebook and Netflix second quarter financial results disappointed analysts (the ICE FANG Index declined 4.9% while the S&P 500 rose 3.6%). The FANG Index has risen 176% since it was launched on October 1st, 2015 compared to the 56% return for the S&P 500 Index. This outperformance has been driven by staggering profit growth of these leading technology companies. We believe that much of the strong U.S. equity performance relative to other developed markets has been driven by the U.S. leadership in New Technology. The S&P 500 has returned 175% (10.7% annualized) over the past decade versus 48% (4% annualized) for the MSCI EAFE index (Europe, Australasia, Israel and the Far East). While the law of large numbers will eventually cause the FANGs and other technology leaders to produce more moderate profit growth, it is clear that technology will continue to become a larger percentage of the overall economy. Investors who shift their investments into Old Economy sectors should recognize the important macro trends. Furthermore, when moving funds to under-performing countries, investors should analyze the breakdown of the industries in each country. We would argue that countries that have not made major investments in the New Economy will likely continue to lag growth of the U.S. going forward.

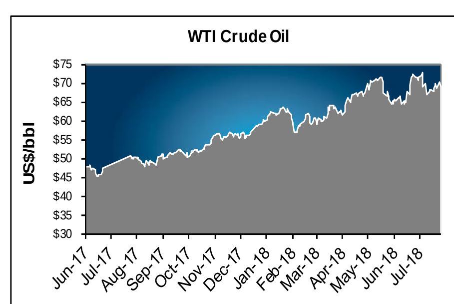
When you look at the earnings performance of the FANG shares you can understand why the U.S. markets have significantly outperformed without significant multiple expansion. Facebook, Amazon and Alphabet all have market capitalization that put them in the top 10 U.S. companies by size and Netflix is now the 34th largest company. Over the past five years their EPS have risen 1215%, 633%, 116% and 1050% respectively. While analysts expect this growth to slow modestly, the consensus growth for the next three years is 66%, 353%, 61% and 383% respectively. Even the two other top 10 tech leaders, Apple and Microsoft, are expected to grow 61% and 48% over the next three years. There are very few Old Economy companies that can produce this kind of growth and therefore we would argue that investors should not bet against technology. Anchor believes that our New Economy investments, Alphabet, Facebook, Alibaba and Naspers, will continue to add value to our clients' portfolios.

There has been a persistent call to rotate out of U.S. shares and into other markets due to the performance difference over the past decade. The reality is the U.S. markets are not expensive when you consider the projected EPS growth, impact of corporate tax changes and current low interest rate environment. The forward 12 month P/E estimate for the S&P 500 is 16.7 times and EPS are expected to rise 23.5% this year. Valuation is well in line with historical measures, especially when you consider the 10 year treasury yield is only 3%.









*MSCI EAFE Index

FIXED INCOME COMMENTARY

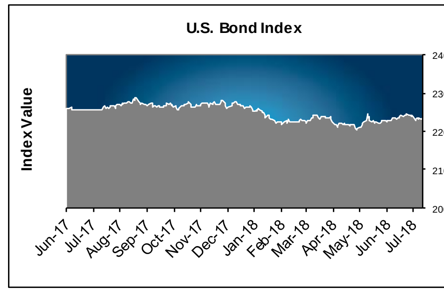
July 2018 Fixed Income Review

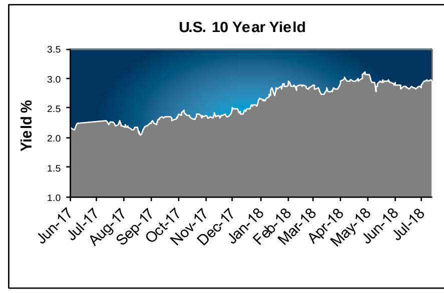
Credit markets paid little notice to July's political headlines concerning President Trump's tariffs, the basket case that is Turkey or the summit with Vladimir Putin. Export-focused industries excluded, U.S. financial markets appear to have come to terms with Trump's brash style of foreign policy/negotiations/leadership, discounting much of his rhetoric as more bark than bite. U.S. equity markets faired very well, pushing ever upwards buoyed by strong Q2 earnings, while credit spreads tightened. Indeed, there was even respite for EM government and corporate bonds which rallied in July after selling off in May and June.

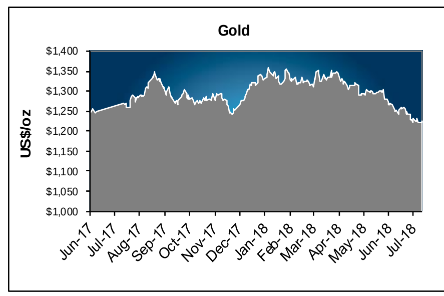
With regards to the treasury yield curve, rates across the curve were higher by approximately 10 basis points from June-end. The 2Y/10Y slope experienced some mild steepening mid-month on the back of rumors that the Bank of Japan (BOJ) would tweak its yield curve targeting strategy which had purposefully plunged a large portion of the Japanese government bond market curve into negative rates. As a result, the Japanese government 10Y bond yield rose from 0.03% to 0.08% in single day. Admittedly not a large move in absolute terms, but given the low starting point it was a meaningful one day move. More importantly for markets however, was the potential for a shifting of the Bank of Japan's policy stance from one of total monetary accommodation (negative interest rates out to the 8Y tenor of the curve, buying government bonds and ETFs) to one of less central bank control. Given the linkage of the international bond markets, this filtered through to bond markets worldwide. When the BOJ met, it did not end the yield curve targeting program, but rather stated that they will introduce forward policy rate guidance and give long-term rates greater flexibility. A minor tweak in comparison to the rumors beforehand, but nonetheless, it was a timely reminder that the environment of widespread monetary easing prevalent across the world over the last 10 years is continuing to shift to one of less central bank monetary aid.

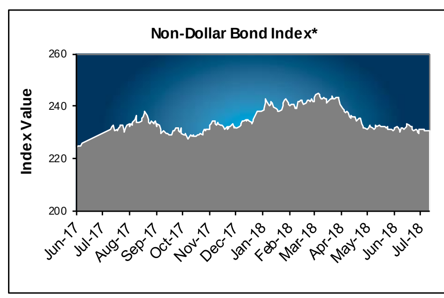
The Fed is the furthest along this path of the major central banks. It is reducing its balance sheet and has signaled a further two rate hikes to come in the remainder of 2018. This has greater relevance because the largest buyer of treasuries is taking a step back from the market at the same time as the treasury is ramping issuance to fund the budget deficit. This is one of the reasons for the Anchor bond portfolio's underweight duration position versus the benchmark. Another reason is inflation. Inflation data is essentially at the Fed's target. Meanwhile the Federal Reserve Bank of New York's underlying inflation gauge is reading 3.3% and a plethora of wage trackers are rising.

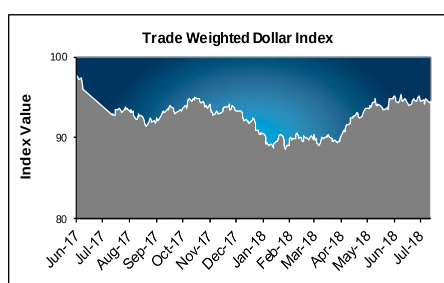
Regarding the USD, performance was a mixed bag in July as the greenback depreciated versus the euro and the loonie, but appreciated versus the yen and renminbi. The renminbi's move (-2.7%) was the most eye catching and received the most press. U.S. imposed tariffs are another headache for the world's largest exporting nation whose domestic crack-down on the shadow banking system has led to a reduction in credit and in turn rising bond yields, widening high yield spreads, and higher defaults. To combat these issues the Chinese central bank has reduced bank reserve-ratio requirements and offered increased funding for banks to support the real economy. The sharp decline in the Chinese currency has led many to speculate that the Chinese central bank has purposefully allowed this to occur to soften the impact on the export dependent economy. Given China exports to the U.S. far more than the U.S. exports to China, a tit for tat tariff strategy has limited legs… while manipulating the renminbi risks further provoking President Trump. Given the uncertainty surrounding global trade, strong U.S. growth (Q2 GDP +4.1%) and compelling interest rate differentials we are unlikely to increase the foreign currency exposure in the near-term.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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