This Month in the Markets

August 2018

EQUITY COMMENTARY

Summer Stories

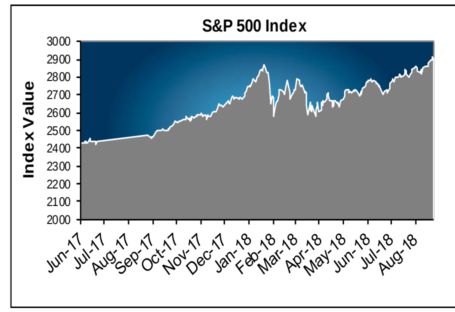
A relaxing August summer it was not. Unfortunately, there was no shortage of macro news stories to digest. The U.S. reintroduced trade sanction banter, Turkey crumbled under pressure from political uncertainty causing the collapse of the Lira and the selloff of the Italian bond markets spooked Italian equity holders. Most major equity markets sold off on this news. MSCI EAFE Net Total Return Index slid 1.9% and the MSCI Emerging Markets Net Total Return index fell 2.7% the geopolitical issues and the escalating trade war pushed increased uncertainty and drove dollar assets higher. The lone and exceptional performer was the S&P 500 – it continued its lonely climb by returning 3.3% on the back of strong U.S. corporate earnings and solid economic fundamentals. The strength in the U.S. market drove the MSCI Developed World Index higher with a return of 1.2% for the month and 4.6% year-to-date.

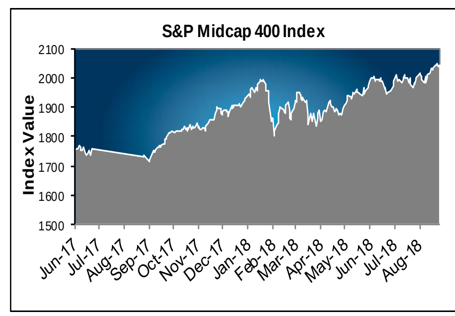
The energy industry was the worst performer declining 3.5%, pressured by the rising U.S. dollar and global growth uncertainty brought on by the trade wars. The top performing sector was the MSCI World Technology which climbed 6.5% which saw large gains in some semiconductor stocks and hardware names. World growth markets beat value, the later rising 3.1% while value fell 0.4%.

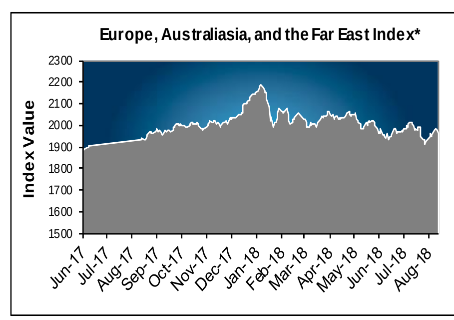
Dave & Buster's Entertainment was the biggest gainer in the portfolio during the month overall, rallying more than 18% after they launched new virtual reality games driving improved same restaurant spending. Lazard Ltd. slid 10.6% in the month on concerns about its emerging market exposure at their investment management division.

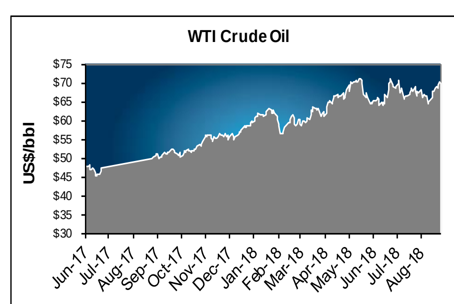
We made a few changes to the equity book in August. We sold our position in Rolls Royce as it achieved our target price after the company released more positive news on its turn around and a solid quarter. At the time of the sale we felt all the positive news was being factored in – our approximate $1 in free cash flow per share forecast looked increasingly likely but trading at 14 times this number expected in 2022/23 we believe the market had priced in a great deal of the good news. We used proceeds to pick up a name we have owned in the past – Celgene. We feel Celgene has been punished excessively. At our purchase price we feel the market is giving little to no value for its extensive pipeline of new drugs – some of which we feel are in cutting edge areas of medicine, such as CAR-T therapy. Its blockbuster drug Revlimid comes off patent in 2023 but we believe it will generate significant cash flow over the next five years and its product pipeline will drive future growth.

We also sold Omega Healthcare Investors and bought Manulife. Omega generated an 8% dividend yield and rose 11.3% in August and was up over 32% from its recent low reached in February. The shares hit our target price and we found more long-term opportunity in shares of Manulife – a stock trading at less than 8.9 times this year's consensus EPS estimate and sporting a solid 3.76% dividend yield. Many investors have avoided global life insurance companies due to concerns about historically low global interest rates impacting their long-term liabilities. Global life insurance companies have learned to adapt to changing financial markets and Manulife has plenty of experience in managing interest rate risk and demographic changes. The company has significantly diversified its business beyond life insurance. Manulife is the largest Canadian life insurance company in its domestic oligopoly market and it has taken the profits and experience in its domestic market to grow in North America and Asia. Over 30% of its core earnings are outside of North America and management is focused on growing its wealth management and insurance business in Asia. Return on equity has improved over the past decade with its operating ROE is expected to rise to 12.4% this year







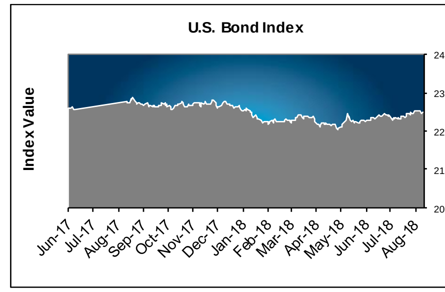


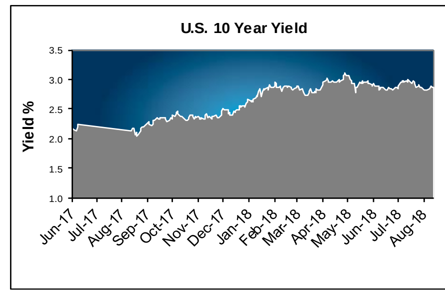
*MSCI EAFE Index

FIXED INCOME COMMENTARY

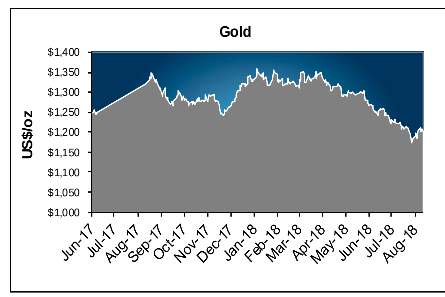
Cold Turkey

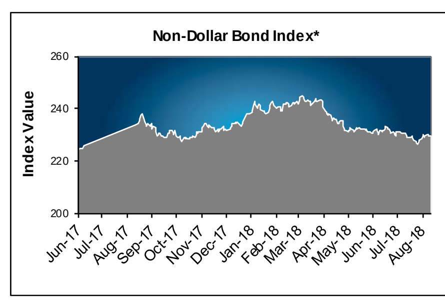
The growing trade wars pose an increasing threat to global economic growth. While President Trump reached a trade deal in principle with Mexico, the US and Canada could not come to an agreement. There has been no movement in the USA-China trade issues, as both countries are refusing to give any lee-way to reach a deal. Venezuela is still in chaos, South Africa is officially in recession, the IMF is on Argentina's doorstep, and Turkey/US relations soured dramatically. As a result, EM currency's depreciated, EM stock markets fell, and EM credit spreads widened. Despite the sell-off in EM, high yield credit spreads were relatively subdued and US equity markets reached record highs. Thus, US markets came through August largely unscathed. Although the Anchor Fixed Income portfolio does not own any EM sovereigns or corporates, the risk is if the EM sell-off filters through to developed markets risk assets.



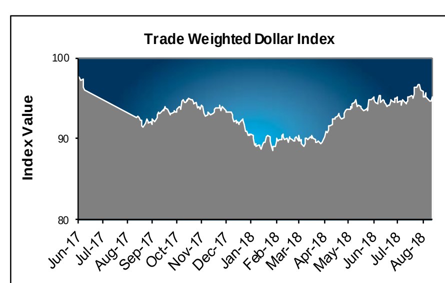


In July Turkey's President, Tayyip Erdogan, won another 5-year term as Turkey's President. One of Erdogan's pre-vote promises was to take more direct control of monetary policy; one he made good on by appointing his son-in-law the minister of treasury and finance. The lira sold-off as a result. In early August the situation worsened dramatically when already shaky foreign relations with the US soured over Turkey's arrest of a (US citizen) Christian pastor. Trump then doubled tariffs on Turkey (steel to 50% and aluminum to 20%), and in return Erdogan called on Turks to boycott US electronics, trade their gold for lira, and struck an agreement to buy a Russian-made missile defense system, taking Turkey (a NATO member) closer to Russia. In Erdogan's 15 years in power he has employed a policy of low interest rates and cheap credit to spur growth. At the cost of rising inflation, the policy has achieved strong growth however it was funded by a considerable amount of foreign currency debt (53% of GDP). Thus, a depreciating Turkish lira makes it more expensive for Turkey (and its banks/companies with foreign currency debt) to meet its debt obligations. Both S&P and Moody's downgraded Turkey's sovereign debt and its largest banks in August. Turkey's inflation is rising (+18% YoY); hiking interest rates is desperately needed. However, Erdogan refuses to let the central bank increase interest rates to arrest the currency's decline and restrain inflation because it would lead to a biting recession. Erdogan is not battling just Trump, but the market as well. The Turkish lira fell -33% versus the dollar in August alone (-72% YTD!) and the yield on 10Y Turkish government debt increased +270 bps to 20.7%.





Although Turkey accounts for only 1% of global GDP other emerging market (EM) currencies have also sold-off (Venezuela, South Africa, Argentina); specifically, countries with large amounts of non-domestic currency denominated debt (external debt) have fared the worst. In addition to EM currency weakness, EM stock markets have fallen, and EM credit spreads have widened. Prolonged USD strength would continue to bite as EM USD-denominated debt sits at a record 16% of GDP. Contagion among the EM space going forward will likely be heavily influenced by the extent of China's stimulus, specifically the potential economic benefits throughout the world. Continued widening EM interest rate differentials versus the USD would signal that contagion is spreading.



*Merrill Lynch Global Broad Market, Ex US Dollar Index

As mentioned above we do not own any EM sovereigns or corporates. We continue to favor the USD in the current environment and our bond portfolios remain conservatively positioned. This has been the case all year as we believe we are likely nearing the final innings of the economic expansion and credit cycle. If there proves to be a meaningful sell-off from the EM space that filters into US credit markets it may give us the option to add credit at attractive levels, however this is not our base case at present. Given the heightened geopolitical rhetoric/risks (trade-war, Italian budget release, potential US government shut-down, ECB's grasp on the EU bond market, and US mid-term elections to name a few), in addition to historically tight credit spreads we continue to favor a conservative stance.

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