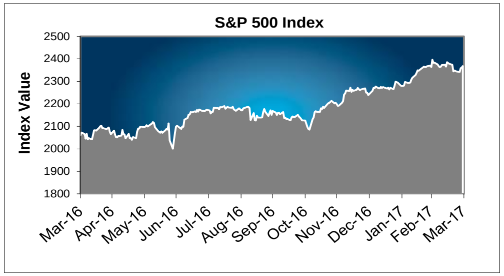
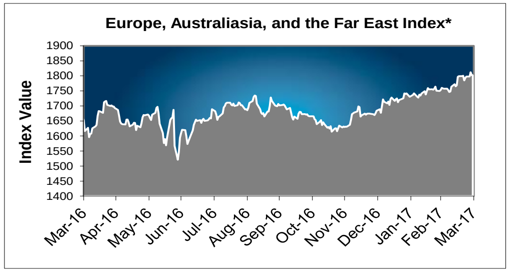
Stock Market Analysis





ANCHOR
Investment Management

Resilience

The markets have remained surprisingly resilient considering the plethora of global media reports that are focused on potential political risk and a major reversal in shares that benefited from the Trump election. The MSCI World Index produced its best quarterly gain in more than three years, returning 6.3%, led by a 12% surge in the technology sector. While some investors are concerned about a repeat of the "dot com" bubble, valuation of the tech sector and the overall market remains well below levels reached in 2000. The S&P 500 and MSCI EAFE indices trade at 18.2 and 15.3 times this year's estimated earnings per share (EPS) which compares to market multiples that exceeded 30 times during the tech bubble. Investors are supporting share prices because they are finding more attractive earnings and dividends yields in the stock market compared to global fixed income yields which remain depressed. A significant change in inflation expectations could change this scenario but we do not see significant inflationary pressures in the current environment.

In the U.S., it appears that the "ultimate" deal maker has met his match in Congress. Trump's election promises on ending Obamacare and tax reform will take longer than the new president expected. It also appears that many of his policies may get watered down. Trump leads a team of experienced negotiators with a refreshing businessman perspective on the bloated U.S. federal government system. Deregulation is a major focus which should be a positive for many industries, including banking and energy. The outlook for the healthcare sector is less clear as hospital shares rebounded after the administration was not able to gain enough support to replace Obamacare with their new healthcare proposal. Trump's program would have resulted in significant savings to the government but at the expense of 24 million Americans losing coverage. Unfortunately, it gets more difficult to reduce corporate tax rates in the U.S. unless the Republicans can find some tax savings or additional tax revenue. The Border Adjustment Tax could be the solution but there is significant opposition both inside and outside the U.S. to destination-based cash flow taxes. Ultimately, most people agree that the current U.S. system is broken and the federal government is too big. While the Republican administration will need to be patient on tackling these issues, investors remain confident that Trump's "Hybrid Reaganomics" policies will be a positive force for the stock market over the next four years. One of the biggest challenges for the new administration is that the U.S. federal debt/GDP ratio is over 100% (including non-marketable debt) compared to 33% during the Reagan era.

In Europe, the focus has been on the future of the Eurozone after the British invoked article 50 on March 29th. Concerns that other countries will follow have eased as the populous sentiments still appears to support the European Union. The Dutch election went pretty much as expected and there does not appear to be enough support in France for the anti-EU candidate, Marine Le Pen. We continue to believe that the largest issues in Europe are an undercapitalized banking system and a regulated framework that stifles innovation and investors' returns. Eight years after the global financial crisis, many European banks remain undercapitalized and reluctant to lend despite record low interest rates. It may be prudent for the Europeans to steal some of the policies of the new Trump administration to lower regulation and reduce the size of their governments. It is our expectation that growth in most of Europe will remain tepid despite significant monetary stimulus. The main exception appears to be Germany whose export driven economy is benefiting from the prolonged weakness in the euro. The 58.3 German Manufacturing PMI in March was the highest reading since 2011.

Looking forward, we continue to believe that investors need to be selective since some sectors of the market appear over-valued. The U.S. and Chinese economies will likely drive moderate global GDP growth this year, leading to reasonable profit expansion. Earnings comparisons should get easier in 2017 as the energy sector will recover if crude remains at current levels or higher. The plunge in energy company profits caused the market P/E multiple to climb last year. After a seven-year bull market, finding companies that meet Anchor's quantitative upside criteria is more difficult. However, we believe our rigorous security selection process should produce attractive returns over the long run.

MSCIEAFE Index   All stock index returns are adjusted for 30 percent foreign withholding tax.

Fixed Income Analysis

Merrill Lynch Fixed Income Indices Name	Code	Yield to Worst	Yield to Maturity	Modified Duration To Worst	Macaulay Duration (Years)	Maturity WAL (Years)	Period Total Return* Quarter	1 Year	3 Years	5 Years
Global Bond	GBMI	1.6%	1.6%	7.0	7.0	8.7	1.5%	-1.8%	-0.1%	0.6%
Non-USD Bond	GBXD	0.7%	0.7%	7.9	8.0	9.5	2.2%	-4.1%	-2.7%	-1.1%
US Corporate/Govt	B0A0	2.5%	2.5%	6.3	6.4	8.7	1.0%	0.4%	2.8%	2.5%
US Government	G0Q0	1.9%	1.9%	6.1	6.2	7.8	0.7%	-1.5%	2.3%	1.7%
US Corporate	C0A0	3.4%	3.4%	6.9	7.1	10.3	1.4%	3.4%	3.7%	4.0%
US High Yield	H0A0	5.9%	6.2%	3.9	5.0	6.3	2.7%	16.9%	4.6%	6.8%
US Hybrid Preferred	P0H0	-1.2%	6.1%	4.6	14.2	94.9	5.8%	5.4%	7.4%	6.5%

*3 and 5 year returns are compounded annualized returns

Low Volatility

The first quarter was determined by an unusually long period of very low asset price volatility. Initially, fixed income securities endured a moderate sell-off before they fought back in March and posted positive returns across the board. After the U.S. presidential election in November there have been high expectations for substantial pro-growth tax reforms. However, the retreat in bond yields and a weakening dollar would seem to indicate that some of those hopes are fading. President Trump and the Republican Congress lost some political creditability after the House of Representatives were unable to repeal and replace the Affordable Care Act (aka Obamacare). The associated savings from this reform would have helped with financing the proposed tax plans which may now turn out to be weaker and may come into effect later than initially proposed. While fiscal reforms are still expected to take shape in one form or another, monetary policy was tightened further due to a 25 basis point interest rate hike by the U.S. central bank (Fed). Despite higher interest rates in the U.S., the dollar lost ground to all major currencies since fiscal stimulus might not be as comprehensive as initially expected.

After the presidential election, the U.S. has experienced a renaissance in economic data with several time series hitting decade-old highs. Forward looking surveys are very upbeat and positive tax reforms could finally lift the so called “animal spirits” in U.S. entrepreneurs. The pickup in hiring has driven the unemployment rate to a decade low of 4.7%, which, in turn has led to a surge in consumer confidence to its highest level since the early 2000s. The massive appreciation of financial assets and real estate values over the past years has improved the consumers’ balance sheet substantially, with the asset-to-debt ratio jumping to levels not seen since the late-1999 levels. While the economic recovery has been long in duration, it has been fairly moderate in magnitude. This has had the benefit that no obvious imbalances like in prior boom periods (housing bubble in the mid-2000s, technology bubble in the late 1990s) have been created. The only missing piece during this current economic expansion remains moderate inflation and wage growth. While both have picked up from their bottoms, they have remained below average. This circumstance is one of the reasons why interest rates in Europe and Japan have stayed negative and have only increased gradually in the U.S. As long as inflation is in check, the interest rate normalization process can be expected to be gradual. Central bankers have no real experience in how to unwind the major experiment of large-scale asset purchases and negative interest rates. The Anchor managers have therefore taken advantage of the cyclical rise in bond yields and added a 10-year U.S. Treasury security to the fixed income allocations. As long as monetary policy in developed economies remains highly accommodative, long-term bond yields will be capped to the upside. What could change this assessment? If there were significant structural reforms in the U.S., Europe, etc. which generated a pickup in growth and higher inflation expectations, then it would become likely that the three-decade long bull market in bonds has run its course.

Receding political risk in Europe and disappointment about the failure to implement Trump’s policies have added pressure on the U.S. dollar. The commodity currencies performed well during the quarter with the Mexican peso leading the pack with a very strong return of 10.7%. Even the British pound eked out a small return versus the dollar, despite U.K. Prime Minister May’s official request to exit the European Union. Currently, the U.S. dollar appears overvalued based on a purchase power parity valuation basis (comparison of different inflation metrics between countries), while other models indicate further strength ahead. For example, real interest rate differentials have increased in favor of the dollar and also tighter monetary policy and a softer fiscal stance favor the greenback. Another tailwind for the dollar would be the passing of the proposed tax reforms and the potential favorable taxation of U.S. companies’ repatriation of cash from outside the country. The Anchor managers have continued to be overweight the U.S. dollar due to the higher return potential in the U.S. fixed income market and the impending legislative changes.