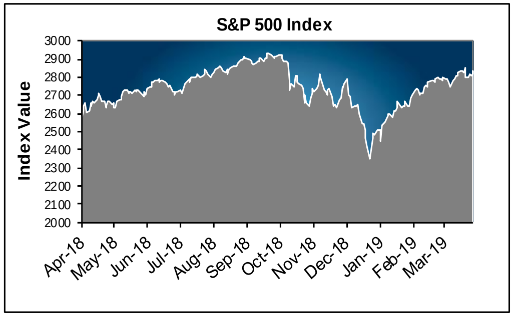
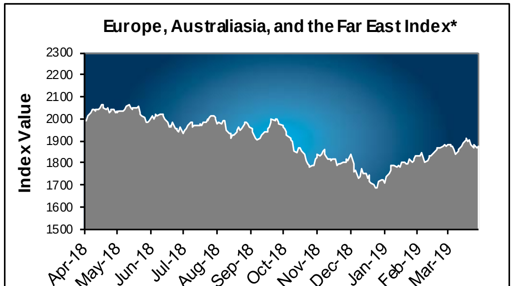
Stock Market Analysis

Investors' Fears Recede





MSCI EAFE Index

Investors returned to higher risk assets in the first quarter after a tumultuous end to 2018. **The MSCI Developed Market Index had the best quarterly return since 2009, returning 12.5%.** The U.S. Federal Reserve and ECB became more accommodative and global interest rates declined which supported equities. While global growth has slowed, we believe stock valuations remain reasonable relative to fixed income yields. A recent study produced by JP Morgan showed that the decline in interest rates is positive for stocks. According to the study which examined periods since 1950, the S&P 500 has returned 10% on average following a 100 basis point (1.0%) decline in the U.S. 10 year Treasury yield. Logic would support this concept as dividend yields become more attractive when fixed income yields fall. Lower interest rates also increase corporate profits by reducing corporate borrowing costs and reduce default rates. Unfortunately, artificially low interest rates also allow "zombie companies" to continue to operate during economic downturns causing extended periods of below average returns on capital, as witnessed in Japan over the past two decades and in Europe recently. We are also monitoring potential bubbles created by investors searching for higher returns in risky assets.

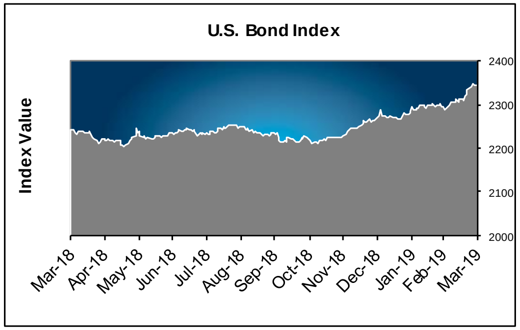
Stock selection will remain critical as cyclical and financial sectors look inexpensive but are experiencing profit pressure at this point in the economic cycle. Nine years into the economic expansion, Anchor prefers to add stocks with unique growth characteristics rather than simply focusing on valuation. During the quarter we took profits in Starbucks, Roper and Celgene and added Skyworks (SWKS), salesforce.com (CRM) and Ingredion (INGR). We described our thesis on the Skyworks purchase in last month's report.

We added salesforce.com (CRM) to the portfolio in March primarily because of its wide economic moat driven by dominance in the Customer Relationship Management market, the stickiness of its business model which leads to reliable and recurring revenues, and the company's ability to create a network effect by leveraging its robust partner ecosystem. The company enjoys a 92% revenue renewal rate and a substantial backlog of unearned revenue, leading to high barriers to entry for competitors and increased visibility for us as investors. These factors contribute to our belief that CRM is a defensive name. The company has strong growth prospects as it continues to cross-sell its products to existing customers, which both embeds the company further into its customers' core business operations and increases revenue per customer. This should allow for margin expansion and an increase in earnings moving forward.

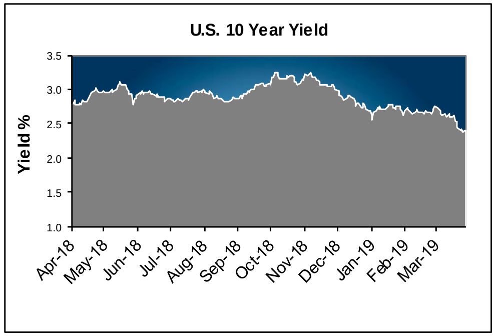
In March, we also purchased shares of Ingredion (INGR), a producer of ingredients including starches, sweeteners and plant-based proteins. Over the past year the stock has pulled back more than 35% on commodity cost and currency pressure. Our view is the market is overly focused on their legacy corn-based starch and sweetener business and is overlooking the growth potential in their growing specialty products division. At our purchase price near $95 we see plenty of upside in a name with strong free cash flow, a solid balance sheet and relatively stable margins.

Fixed Income Analysis

On the Wings of a Dove



Merrill Lynch US Corporate & Government Index



U.S. 10 Year Treasury Yield

In March, central banks across the globe, including the Bank of Canada, the European Central Bank, the Bank of England, the Bank of Japan, and the U.S. Fed, performed a full-frontal capitulation. Growth forecasts were revised down and rate hikes were pushed back/taken off the table entirely for the rest of 2019. Risk assets rallied off the back of these shifts as witnessed by the rally in high yield credit spreads and equities, while, interest rates nosedived. **The ICE Bank of America Merrill Lynch US Corporate & Government Index returned 3.26% in the quarter.** The German 10Y government bond yield turned negative and in the U.S. the 3M/10Y slope inverted for first time since the global financial crisis.

As we have stated in recent monthly reviews, the Fed has been a major driver of risk markets. The FOMC completed its hawkish to dovish capitulation in the March Federal Open Market Committee (FOMC) meeting. Rate move expectations, as per the median forecast of FOMC member projections for the future path of the fed funds rate, showed no rate adjustments for 2019 and only one hike in 2020. This compares to September 2018's median projection of 3 rate hikes for 2019 and 2 further rate hikes in 2020. In addition, the FOMC negatively revised its inflation and growth expectations. Also, the Fed announced they will end the balance sheet run-off by September-end and will thereafter reinvest maturing mortgage-backed securities into Treasuries with maturities that roughly match the maturity composition of Treasury securities outstanding. The effect will be to help suppress long-term rates; "operation twist" reborn. The Fed has completely backed off from a firm hiking bias to a dovish stance in three months and lost all Street credibility in the process… DoubleLine's Jeff Gundlach sums it up succinctly – "*Three months ago the Fed predicted totally different policy than where they are now. How can they predict 2020 policy with a straight face?*"

Central banks originally embarked on quantitative easing to further ease monetary conditions out of desperation to stabilize the financial system and kick-start economic activity. After years of this accommodation, markets have grown used to central bank support, which has artificially suppressed interest rates and forced money into higher yielding equities and corporate credit. A consequence of this 'reach for yield' phenomenon, "zombie companies" have had easy access to the debt markets and remained in business longer than would have otherwise been the case. This has led to a misallocation of resources and, in turn, negatively impacted productivity. The global central bank experimentation has distorted risk asset pricing and eroded the market's failing business clearing mechanism. Case in point, in March the European Central Bank announced a third "targeted longer-term refinancing operations" (TLTRO) where they will offer 3Y funding to European (Italian!) banks… the very banks struggling with the European Central Bank imposed policy of negative interest rates. At the time of this writing there is over $10 trillion equivalent of negative yielding debt globally. The German, Swiss, and Japanese yield curves are all negative out to 10 years…

It's worth noting the Norges Bank, Norway's central bank, raised the policy rate 0.25% to 1% in March and commented that interest rates "*will most likely be increased further in the course of the next half-year*." The NOK rallied on the back of the more hawkish than expected rhetoric given the interest rate differential implications. We expect the NOK to continue to appreciate going forward but are cognizant of other specific risk factors, including slowing global growth, Brexit, and China-US trade talks.