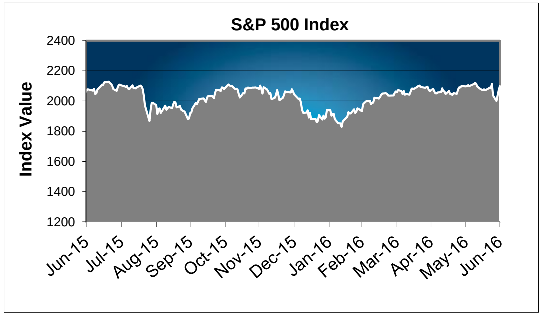
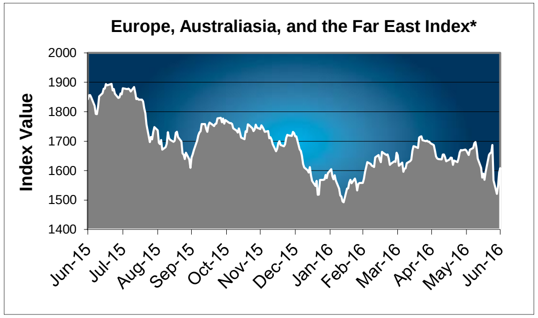
# Stock Market Analysis




ANCHOR
Investment Management

## Be careful what you wish for

The only thing that appears more difficult than predicting stock market movements is forecasting political voting results. Political polls have significant margins of error and most politicians recognize that it is almost impossible to gauge what is going on in the minds of swing voters. The “unhappy majority” appears to be swaying political outcomes across the world, and it was clear that investment professionals, David Cameron and the bookies made the wrong call on the Brexit vote. In the five trading sessions leading up to the Brexit vote, the FTSE 100 rallied 6.5% and Sterling rose 5% on optimism that the “no vote” would win the day. Most political and financial “experts” assured markets that the majority of the British populous understood the risks of exiting the EU. However, on June 23rd, many Brits woke up and asked “What have we done?”, as Sterling slumped more than 10% following the historic Brexit vote. More worrying was the concern that Britain’s exit could be the catalyst in the unraveling of the Eurozone.

Like the voting trends in Britain, there are many market calls that are unpredictable, but the major takeaway from Brexit is that there will likely be further consequences across the globe from the anti-immigration sentiment and lack of wage growth over the past two decades. The political fallout related to job and immigration reforms challenges trends in globalization which could be inflationary. While we all want cheaper goods and services, voters don’t want to see immigrants driving their wages down or watch well-paying jobs exported to low cost jurisdictions. Anchor’s opinion remains that inflation and interest rates will remain low for the rest of this decade due to weak global economic growth, demographic changes and high indebtedness. With that being said, it will be important to monitor trends in globalization and gauge wage pressures going forward.

Other Brexit implications include a possible economic slowdown or recession in the UK as business investment slows and consumer confidence falls. This impact will be offset by the decline in UK interest rates and the significant decline in Sterling, making UK goods and services more competitive. This is one advantage of having an independent central bank and an unpegged currency. The rebound in UK share prices supports the premise that UK multinationals will actually benefit from the currency devaluation and the lower cost of capital from falling interest rates. Currency concerns may also dissuade other EU countries from following the UK out of the euro but the fragile situation needs to be monitored.

The long-term impact of Brexit and the “unhappy majority” is unclear but we would expect that volatility will remain elevated and investors will likely remain risk averse in the short-term. The most difficult question for investment managers is how to achieve a reasonable return for our investors in the current environment. We have maintained that Anchor’s balanced account strategy is the best approach. Once again, bonds have proved to be a good diversifying asset class in the recent volatility. At the same time, the volatility has given us the opportunity to pick up some first class companies at reasonable prices in the first half of 2016 which should help our investors’ returns over the long term. The most recent addition is Starbucks (SBUX) whose experienced management team has produced consistently strong profit growth in the difficult economic environment. Almost 70 percent of the company’s revenue comes from the Americas but there is also significant room to grow its franchise internationally. As we look at the second half of 2016, consumer spending should benefit from historically low energy prices, inflation and interest rates. We believe the companies that we own are well positioned and attractively valued to give our investors superior long-term returns.



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

# Fixed Income Analysis

| Merrill Lynch Fixed Income Indices | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Modified | Macaulay | Maturity | Period Total Return* | | | |
| | | Yield to | Yield to | Duration | Duration | WAL | | | | |
| Name | Code | Worst | Maturity | To Worst | (Years) | (Years) | Quarter | 1 Year | 3 Years | 5 Years |
| **Global Bond** | GBMI | 1.1% | 1.1% | 7.1 | 7.2 | 8.7 | 3.1% | 9.1% | 3.1% | 2.0% |
| **Non-USD Bond** | GBXD | 0.4% | 0.4% | 8.4 | 8.5 | 9.7 | 3.8% | 12.1% | 2.0% | 0.5% |
| **US Corporate/Govt** | B0A0 | 1.8% | 1.8% | 6.6 | 6.7 | 8.9 | 2.9% | 6.8% | 4.4% | 4.2% |
| **US Government** | G0Q0 | 1.1% | 1.1% | 6.5 | 6.5 | 8.1 | 2.5% | 6.7% | 3.8% | 3.7% |
| **US Corporate** | C0A0 | 2.9% | 2.9% | 7.0 | 7.2 | 10.4 | 3.8% | 7.4% | 5.4% | 5.4% |
| **US High Yield** | H0A0 | 7.4% | 7.6% | 4.2 | 4.9 | 6.4 | 6.1% | 1.7% | 4.2% | 5.7% |
| **US Hybrid Preferred** | P0H0 | 4.8% | 6.0% | 8.5 | 14.3 | 96.0 | 3.5% | 12.0% | 8.5% | 6.8% |

*3 and 5 year returns are compounded annualized returns

## Yo-Yo

Despite record low yields the rally in bonds has remained unabated. The entire Swiss government bond market trades at negative yields, about 85% of Japanese government bonds yield below zero percent, and in Germany, only the 20- and 30-year tenors offer modestly positive yields. A GDP-weighted 10-year government bond index of the G10 members has hit a record low of 83 basis points at the end of the second quarter. The U.S. yield curve (difference between the 10- and 2-year Treasury securities) has flattened by another 16 basis points during the three-month period and is essentially a reflection of weaker economic growth prospects. In this regard, both the International Monetary Fund (IMF) and the World Bank lowered their global growth outlooks further. Both institutions cited high indebtedness, ever stricter regulation and structural issues like demographics and a lack of long-term reforms. In addition, the vote by the British people to leave the European Union boosted the bid for government bonds worldwide. U.S. high yield securities outperformed with a 6.1% quarterly return, followed by U.S. investment grade corporate bonds of 3.8% and Treasuries of 2.5%. In FX land, the Japanese yen benefited from its traditional safe-haven status during volatile market periods and appreciated by 8.3% during the quarter.

The data-dependent approach by the Federal Reserve (Fed) has resulted in a "yo-yo" decision making process. One month the committee issues a hawkish outlook, only to switch back to a dovish stance in the next month. The U.S. central bank's stubborn focus on domestic developments is much like missing the forest for the trees. As a result it has created unnecessary uncertainty in financial markets. It was the head of the European Central Bank (ECB), Mario Draghi, which called for a more global approach and coordination between the major central banks and therefore evolving monetary policy to the next level. The Fed is still the only major institution which expects to raise interest rates, while all others have and will continue to reduce rates and add to monetary stimulus. This has led to an appreciation of the U.S. dollar and a consequent tightening of financial conditions in the U.S. While the Fed expects to raise interest rates once by 25 basis points this year, capital markets strongly disagree with this assessment. The odds for a 2016 rate cut are slightly higher than for a hike and the fed funds futures market prices in no rate hike until January 2018. At the same time expectations for further asset purchases (quantitative easing) in the Eurozone and Japan have emerged and have the potential to compress bond yields even further. During the quarter, the Anchor managers have taken advantage of those favorable trends in bond prices and have extended duration twice with a nine- and ten-year high-quality corporate bond.

The outlook for the global bond market remains positive over the medium-term. After moderate growth over the past five years, the recent vote by the British people to leave the European Union will have global ramifications. The U.K. economy will likely endure a technical recession and European growth is expected to be lower by about 0.5% than initial forecast. While higher yields are capped due to strong underlying forces (demographics, disinflation etc.) in the short- to medium-term, eventually the trend to negative interest rates has to end and is not sustainable. Otherwise investors lock in negative future real returns which is not rational market behavior and will therefore not prevail in the long-run. Additionally, the recent rise of anti-establishment politicians has increased the risk of protectionism and isolationism. Both concepts are growth-repressive and inflationary and will lead to higher interest rates. Fortunately, there are many fixed income instruments to our disposal which will benefit in such an economic environment. Earlier this year, the Anchor managers invested in one of such instrument – a ten-year Treasury Inflation Indexed Security (TIPS). The rational is that long-term inflation expectations are close to record lows and just a small adjustment towards higher inflation will cause TIPS to outperform traditional fixed income investments.