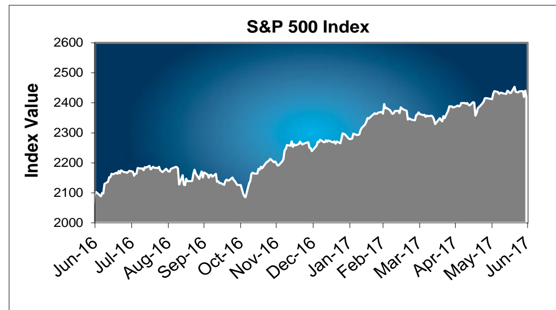
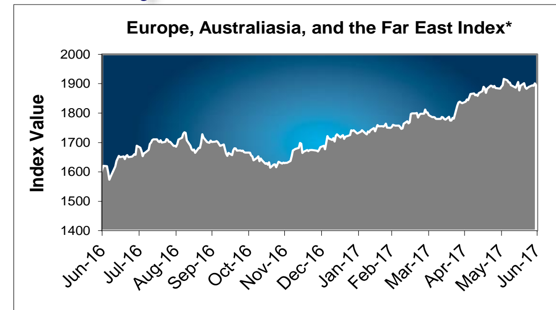
Stock Market Analysis





Where do we go from here?

After the 17.1% return for the MSCI World Index over the past 12 months some of our clients are now asking what would derail the bull market. As we have stated in previous reports, market timing can be perilous and our team focuses on discovering under-valued securities. Market corrections and bear markets are normally driven by a sharp rise in inflation/interest rates, an economic downturn or a major credit event. Political events such as Brexit can impact local markets but normally do not affect the overall flow of funds into global equity markets.

Our investment team believes that inflation will remain tepid and global interest rates will hold below historical levels for the balance of this decade. While there are some specific areas of concern in the credit markets and overall global debt levels need to be monitored, we believe regulators and central bankers have learned valuable lessons from the recent financial crisis. Bank capital levels and leverage ratios are sound and the use of derivative securities to increase gearing has been reduced by new regulations.

While several sectors of the equity market appear more expensive, we continue to find specific under-valued securities in the current environment. Low interest rates make equities which are producing superior profit growth more attractive. While recent stock market performance has improved, the 10-and 20-year returns of most of the major global market indices are below the long-term historical average returns. Investors have focused on the surge in FANG (Facebook, Amazon, Netflix and Google) stocks but not all stock indices have produced this level of performance. Over the past decade emerging markets and developed markets in Europe, Australasia and the Far East have posted low single digit annualized returns, significantly under-performing the U.S. markets. During the same period, the Russell 1000 Growth Index has produced an annualized return of 8.9% compared to 5.5% for the Russell 1000 Value Index. Market rotation will continue and opportunities remain in individual shares in the lagging groups.

The MSCI World Index recorded its best first half year return in almost 20 years, returning 10.5%, led by a 17.4% surge in the technology sector. While some investors are bringing out charts 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 18.7 and 15.4 times this year's estimated earnings per share (EPS) which compares to market multiples that exceeded 30 times during the tech bubble. Unlike the run that we saw two decades ago, many tech companies have produced impressive profit growth and have multiples that can be justified based on their profitability, growth rates and the low interest rate environment. Anchor clients benefited from strength in technology and healthcare shares during the first half of the year where the equity portfolio had over-weight positions.

Technology innovation is impacting most sectors of the economy. The rapid changes resulting from technological advances is leading to productivity gains but is also causing job losses, margin pressure and deflation in some industries, including media, travel, retailing and food services. The internet improves price discovery for consumers and businesses but pressures the bottom line of manufacturers and retailers. Shares of many brick and mortar retailers have collapsed as they try to compete with the mammoth Amazon and other online retailers. Amazon's announced purchase of Whole Foods in June raised further investor concerns but indicates that a hybrid omni-channel retailing model may evolve over the next several years. We believe the current market dislocation will cause opportunities for nimble management teams who take advantage of technological innovation to provide products and services at competitive prices. Anchor has invested in several rapidly growing global internet leaders that are gaining market share but recently has also taken a position in Target which we believe is positioned well in the new omni-channel retail market.

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***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	7.1	8.8	2.4%	-2.3%	0.0%	0.9%
Non-USD Bond	GBXD	0.7%	0.7%	7.9	8.0	9.5	3.3%	-4.1%	-2.4%	-0.3%
US Corporate/Govt	B0A0	2.4%	2.4%	6.5	6.6	8.9	1.8%	-0.6%	2.7%	2.3%
US Government	G0Q0	1.9%	1.9%	6.3	6.3	8.0	1.4%	-2.4%	2.2%	1.4%
US Corporate	C0A0	3.2%	3.3%	7.1	7.3	10.5	2.5%	2.3%	3.5%	4.1%
US High Yield	H0A0	5.7%	6.1%	3.7	5.0	6.3	2.2%	12.8%	4.5%	6.9%
US Hybrid Preferred	P0H0	-2.3%	5.9%	3.0	14.4	94.0	4.0%	5.6%	7.6%	6.9%

*3 and 5 year returns are compounded annualized returns

Economic Expansions Do Not Die Of Old Age

Very low asset price volatility persisted in the second quarter and supported risk assets. The financial market shrugged off various geopolitical and macro news such as the French and British elections, the sharp drop in crude oil prices, U.S. President Trump's spat with former FBI Director Comey and the Russia probe. Even the 25 basis point interest rate hike by the U.S. central bank (Fed) and its guidance for winding down its massive balance sheet did not have much impact. During the quarter the Organization for Economic Cooperation and Development (OECD) increased its forecast for world output from 3.3% to 3.5%, but lowered the outlook for the U.S. economy from 2.4% to 2.1% this year and from 2.8% to 2.4% next year. In a similar fashion, the International Monetary Fund (IMF) reduced the growth prospects for the U.S. by two tenth of a percentage point, citing problems ranging from an aging population to low productivity growth. The weaker outlook paired with receding inflation risks helped the fixed income market to perform well. While U.S. Treasury securities added 1.4% during the quarter, corporate bonds and preferred securities outperformed government bonds once again. In the foreign exchange market the euro was the best performer of the major currencies with a quarterly return of 7.3%. The performance was driven by receding political risks in Europe and the potential end of asset purchases by the end of this year.

The double growth downgrade by the OECD and IMF was a slap in the face for the U.S. economy. Nearly half a year has passed since Donald Trump's inauguration but notable reforms have been absent. The recent attempt to advance the health care reform was postponed once again. The revamp of the Affordable Care Act is critical for getting the tax reform started since changes to the former are intended to pay for the latter. For now the U.S. economy has muddled along with average growth in the low 2% range. The soft data (surveys) is still pointing to a pickup in growth but hard data like payrolls, housing starts and auto sales have disappointed. In fact, the Citi Economic Surprise Index for the U.S. has hit a new cyclical low and is at its lowest level in six year. The good news is that such an extreme reading has often proved to be a counter indicator since it has reduced expectations and has set up for more positive surprises in the future. The U.S. economy is suffering from low workforce growth and weak productivity readings. Both are the main determinants for GDP growth. While the former input factor is likely to be as good as it gets at the current state of the business cycle with the unemployment rate at 4.3% and below the estimated non-accelerating inflation rate of unemployment (NAIRU). Productivity growth, on the other hand, has a lot of potential to increase, subject to rising capital expenditures. While such a rise has not really been observed yet, several leading indicators point to a strong rebound in the investment cycle which in turn would lift GDP growth. Once there is clarity about a possible tax reform the investment cycle will most likely accelerate.

Disappointing inflation readings in several developed economies have supported the rally in bonds. The sharp drop in crude oil prices of 9% has added to the concerns that inflation will not rise enough to meet central banks' targets and consequently monetary policy will remain accommodative for longer than expected. We have long been in the camp that the three decade old bull market in bonds remains intact and that any cyclical sell-off can be used for extending duration. Although the Fed's monetary tightening process has increased interest rates for short-dated maturities, the long-dated bond yield has dropped. This is a typical behavior during monetary tightening cycles since less accommodation has the potential to reduce growth prospects and inflation expectations. A flat yield curve is eventually a harbinger for a recession but since the spread between the 10- and 2-year U.S. Treasury securities was 92 basis points at the end of the quarter, there is still a long way to go before an economic slowdown should be expected. While the current economic expansion has been the third longest since 1945, the saying goes that expansions do not die of old age. In fact, if the U.S. Congress is able to approve a substantial tax reform then its effects would likely be felt from 2018 onwards and counter tightening in monetary policy.

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