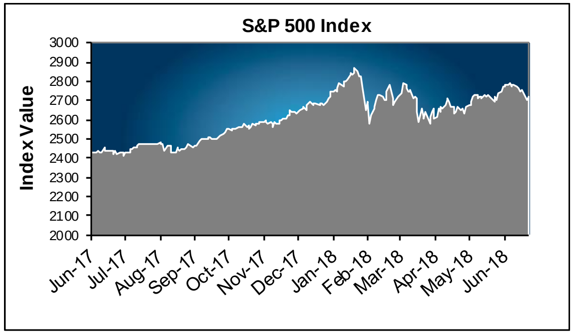
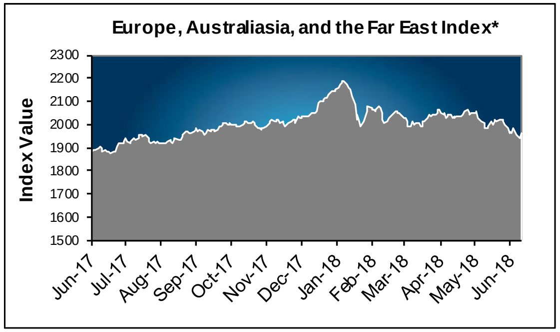
# Stock Market Analysis




ANCHOR
Investment Management

## Quandary

The definition of Quandary is “a state of perplexity or uncertainty, especially as to what to do; dilemma”. While the U.S. and global economic data remains reasonably strong, most investors are uncertain about the outcome of rising political rhetoric related to a possible trade war. President Trump’s negotiating tactics elevate market participants’ apprehension. Unfortunately, uncertainty is increasing volatility and higher investment risk is causing stocks to fall in the short term. Most of our investment time horizons are longer than the normal political cycle and therefore it is important to gauge the longer-term impact of the current trade talks.

Global equity funds had the largest outflow in June since the 2008 Financial Crisis according to market research firm TrimTabs. Rising short-term interest rates are also attracting risk averse investors into money market funds. The good news on rising cash levels is that investors traditionally reinvest the cash when uncertainty abates and elevated cash levels are normally a bullish signal.

Despite the June equity outflows, the MSCI World Index returned 1.71% in the second quarter and 0.44% in the first half of 2018. The question is whether there is too much complacency in the stock market after a 10% annualized return for the MSCI benchmark over the past five years or is the fundamental outlook supporting current valuations. We believe that it important to look at the details of the benchmark’s performance. The S&P 500 Index is a good proxy of the U.S. component which represents almost 57% of the MSCI index. The U.S. benchmark has returned 13.3% per year over the past five years compared to 6.1% for the rest of the benchmark (MSCI EAFE Index). Much of the U.S. out-performance has been driven by double-digit earnings growth helped by a strong economy. S&P 500 Index earnings are expected to rise 21.4% this year spurred by the Trump corporate tax cuts. The estimated compounded annual growth rate of the index’s operating earnings per share over the next full business cycle (typically 3-5 years) is 13.4% based on Bloomberg consensus estimates. The Price/Earnings ratio of the U.S. benchmark is expected to decline to 17 based on analyst forecasts from 21.7 at the end of 2017 and down from the 10-year median of 17.9 times. Therefore, the market does not appear over-valued on this metric.

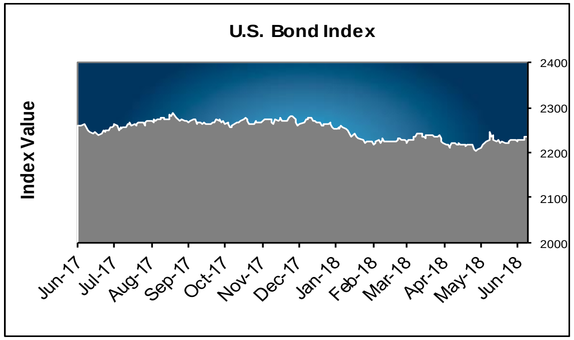
The ‘bear’ equity market argument is the current economic cycle is growing long in the tooth and that analysts’ U.S. profit estimates are too optimistic. The economic data does not seem to support this hypothesis with strong U.S. employment, personal income and ISM manufacturing data. While trade war talks may impact global consumer and business sentiment, we assume that it is in everyone’s interest to implement fair trade and a reasonable compromise will likely be achieved this year. More importantly investors must consider the impact that the new technology revolution is having on productivity and global economic growth. Information technology and the internet have changed our lives forever. Global earnings growth is primarily being driven by the innovative companies that dominate global indices (Amazon, Alphabet, Apple, Facebook, Microsoft, Alibaba, Tencent and Samsung). These companies are very profitable and have plenty of ramp to continue to grow unlike the tech bubble of 2001 when many of the new internet companies were unprofitable. We have discussed the power and the dominance of Google and Facebook and we continue to believe that the regulatory environment is actually helping the dominant names and making it more difficult for new companies to compete with them.

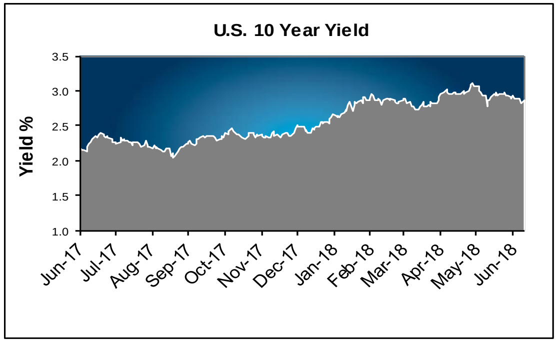
While we own several new media stocks we felt that the market volatility during the quarter presented us with an excellent opportunity to buy a traditional entertainment powerhouse at a significant discount to intrinsic value. Disney is one of the most valuable conglomerates in the world with leading businesses in media entertainment, hotel and cruise ships. Key assets include its theme parks (six locations globally), cable networks (Disney, ESPN, ABC, A&E), film studios (i.e. Disney, LucasFilm, Marvel, Pixar) and consumer products. Investor sentiment has been negative on concerns that Netflix, Amazon, and other social network companies are transforming the media landscape and that this will cause margin pressure in Disney’s key media distribution and content businesses. We believe that entertainment content will always be valuable and new media represents new opportunities to distribute Disney’s market leading content. The company uses its brand loyalty to expand its profitable merchandise, theme parks and cruise ship businesses. The potential battle with Comcast to acquire Fox has kept buyers on the sidelines but we like Disney with or without Fox assets.

*Anchor Investment Management Ltd. is Licensed to Conduct Investment Business by the Bermuda Monetary Authority*

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

# Fixed Income Analysis




## Greenback Trumps the Competition

Geopolitics were a constant theme in April and May and it was no different in June. Trump enacted tariffs in mid-June on $50 billion of imports from China, who in-turn announced tariffs of their own on imports from the USA. While this situation is ongoing, the topic of migration remains in focus in the EU, and especially so in Germany where it could threaten Merkel's coalition government.

Despite the geopolitical headlines and uncertainty surrounding trade, U.S. high yield (CCC-BB) credit spreads held up well in the quarter, while investment grade (BBB-AAA) credit widened modestly. Given the increase in volatility that we have seen since February 2018, it would be reasonable to expect high yield credit to have underperformed investment grade. However, high yield credit has been buoyed by its lower duration (shorter maturity) profile, low default rate outlook, and subdued issuance (less supply) year-to-date making high yield exposure an attractive proposition. The geopolitical stress can be seen in the emerging markets (EM) space as both EM corporate and government debt have noticeably underperformed USD high yield credit, driven by wider credit spreads and the appreciation of the greenback.

In mid-June, as was widely expected, the Federal Open Market Committee (FOMC) raised the fed funds rate range from 1.50%-1.75% to 1.75%-2.0%. It also lowered the year-end 2018 unemployment rate forecast from 3.8% to 3.6%, increased the GDP forecast from 2.7% to 2.8%, and increased the inflation forecast from 1.9% to 2.1%. Given that inflation and the unemployment rate had already reached the Fed's year end targets, it was not a surprise that the forecasts were adjusted. There was also a shift in median expectation for the path of the fed funds rate for 2018 which moved from 3 hikes to 4. We have maintained a shorter duration in Anchor's laddered fixed income portfolio to reduce interest rate risk. We have also been reluctant to add credit risk to the portfolio due to tight credit spreads as investors are not being paid to take risk.

The ECB also met in June where President Draghi announced that the ECB would end its asset purchase program by YE18, however will continue to reinvest maturities. Offsetting this somewhat hawkish statement, Draghi announced the ECB will not raise interest rates until at least the end of summer 2019. The contrasting actions by the central banks demonstrates how much farther along the monetary tightening path the U.S. is compared to the EU.

Regarding currencies, the U.S. dollar had a very strong quarter as evidenced by the 5.0% rise in the U.S. Dollar Index (DXY). The greenback's strength was broad based as it appreciated versus the Euro (-5.2%), Sterling (-5.7%), Japanese Yen (-4%), Chinese Renminbi (-5.2%), Canadian Dollar (-1.8%), and especially emerging market currencies South African Rand (-13.7%), Turkish Lira (-13.9%), Brazilian Real (-14.7%). This strength was driven by the divergence in economic data between the U.S. and the rest of the world, as well as favorable interest rate differentials which have come back into focus. President Trump's hardline rhetoric/stance on trade and the likelihood for further U.S. rate hikes, should continue to support the greenback in the near term. For this reason and low global interest rates, Anchor remains underweight non-dollar bonds versus our benchmark.

*Anchor Investment Management Ltd. is Licensed to Conduct Investment Business by the Bermuda Monetary Authority*