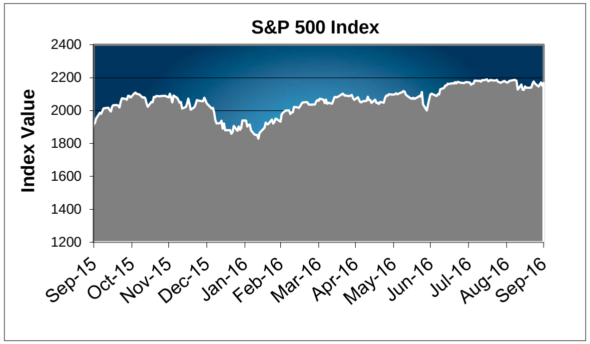
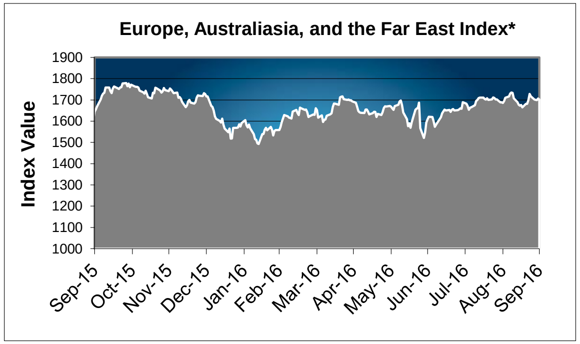
Stock Market Analysis





ANCHOR Investment Management

Reluctant Bulls

Falling global interest rates drove investors back into stocks in the third quarter despite Brexit fears, weaker U.S. economic data and concerns about the capital position of Germany's largest bank. While volatility rose in September, it turned out to be the best quarter of 2016 with the MSCI Developed Market Index returning 4.8%.

Energy exploration and production companies rallied as some unlikely allies in OPEC, including Iran, finally agreed to reduce production to stabilize the market. While this was an encouraging first step, we will have to see if the participants follow through with their promised reductions. Historically the markets applaud lower energy prices as an economic stimulus and a positive for consumer spending. Higher energy prices can be inflationary and slow economic growth. With that being said, the unintended consequences of the plunge in crude had pressured both the oil patch and financial securities. Most bankers and analysts had not modeled $30-$40 crude oil prices five years ago and the sharp decline has impacted an industry that is highly leveraged. The impact has shown up in plunging energy profits, higher bank non-performing loans and rising spreads in the high yield bond market. Investors would prefer to see some stability in the oil patch and reacted positively to the new OPEC accord.

The other major news item at the end of the quarter was related to Deutsche Bank (DB) which is Germany's largest bank (three times larger than the second largest German bank). Deutsche Bank's stock and debt were under pressure after the U.S. Department of Justice requested up to $14 billion to settle an investigation into residential mortgage-backed securities. The lender's shares plunged 48% from the beginning of the year on investors' concerns that the bank would have to raise significant capital to meet Europe's rising capital requirements. Memories of Lehman Brothers led many traders to sell the bank's shares after it was reported that some hedge fund clients had moved capital exposure out of the DB's investment bank. Fear quickly spread to the European swaps market and global financial shares all sold off. On the final trading day of the quarter the shares fell to a record low before making a remarkable 19% intra-day reversal when Chief Executive Officer, John Cryan, repeated earlier statements that he expected U.S. authorities to reduce their initial penalty. When historians look back at the third quarter it will appear to be a strong quarter for the global financial sector but the industry that is built on confidence briefly showed its vulnerability.

Last quarter we discussed how the "unhappy majority" appears to be swaying political outcomes across the world. While Brexit was the focus in the second quarter, there are some important political elections across Europe over the coming months and a historic election in the U.S. on November 8th. As more non-traditional candidates rise through the political poles we need to measure the political uncertainty that impacts our lives and investments. After failing to predict the Brexit result correctly we will not make an attempt to call the winner in the U.S. election other than one of the youngest U.S. presidents will be replaced with one of the oldest presidents on record. This will add additional risks to the market as investors evaluate the judgement of the "Leader of the Free World".

The prolonged period of low interest rates has some sectors of the market selling at significant premiums to their historical averages. It appears that there is some disequilibrium in the market caused by investors' focus on dividend yields and stability of earnings. We continue to find opportunities in select companies which provide our clients with attractive growth at reasonable valuations. We expect interest rates to remain below historical levels over the next five years which makes these stocks more attractive.

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	0.7%	8.6%	2.4%	1.9%
Non-USD Bond	GBXD	0.3%	0.3%	8.3	8.3	9.7	1.0%	11.9%	0.9%	0.8%
US Corporate/Govt	B0A0	1.9%	1.9%	6.6	6.7	8.9	0.4%	5.9%	4.4%	3.3%
US Government	G0Q0	1.3%	1.3%	6.5	6.5	8.1	-0.3%	4.3%	3.7%	2.3%
US Corporate	C0A0	2.8%	2.9%	7.1	7.3	10.5	1.4%	8.5%	5.6%	5.2%
US High Yield	H0A0	6.3%	6.6%	3.9	5.0	6.4	5.5%	12.8%	5.3%	8.2%
US Hybrid Preferred	P0H0	4.9%	6.0%	7.7	14.4	93.9	0.7%	10.5%	9.6%	7.8%

*3 and 5 year returns are compounded annualized returns

Historic Central Bank Announcement

Risk assets performed well during the third quarter despite the Brexit vote and geopolitical occurrences like the coup attempt in Turkey and terror attacks in Germany and France. Initially a blend of 10-year government bond yields (weighted by GDP) dropped to a new record low of just 78 basis points in July before it rebounded to 93 basis points at the end of the quarter. After the European Central Bank (ECB) refused to commit to more quantitative easing it looked as if global longer-dated bond yields would enter a more sustained rise. Such hope was quelled relatively quickly with the historic announcement by the Bank of Japan (BOJ) and a rather dovish outlook by the Federal Reserve (Fed). U.S. Treasuries ended the quarter relatively unchanged, while U.S. investment-grade bonds, high-yield obligations and preferred securities appreciated by 1.4%, 5.5% and 0.7%, respectively. Since the Fed reduced expectations for rate hikes somewhat, the U.S. dollar lost ground during the quarter and depreciated by 0.7% versus a basket of major currencies.

The third quarter started with fairly high expectations for an interest rate hike in the U.S. in September. Initially, incoming economic data was quite strong but lost some steam over the course of the quarter. While the employment market has remained resilient, there is still some slack left which the U.S. central bank would like to see eliminated. Although the headline unemployment rate of 4.9% appears to be low in a historical context, a broader view using the U-6 rate (which includes marginally attached workers and people employed part-time for economic reasons) tells a different story. In the past it was necessary for this rate to drop to about 9% (currently 9.7%) or lower in order to see a sustained flow through to higher wages and consumer prices. The good news is that we are close to this level and with some further patience by the central bank the inflation target may be accomplished. At the end of the quarter the odds for a 25 basis points increase in the federal funds rate was about 50/50 and the Fed guided that its decision will be data-dependent. Raising rates by a quarter percentage point should not make much of a difference outside of the possible signaling effect. More important were the latest downward revisions by the U.S. central bank regarding the long-term interest rate path. It appears that the Fed has come close to general market expectations and has now revised its long-run real GDP growth outlook from 2.0% to 1.8% and the long-run federal funds rate to 2 7/8%. Fed Chairwomen Janet Yellen's statement that the current target rate of 0.25% to 0.5% is "modestly accommodative" was probably the most significant statement from the recent Fed meeting. This is an acknowledgment that the neutral real federal funds rate (the rate at which real GDP is growing at its trend rate and inflation is stable) is actually lower than initially thought. If this rate is a not implausible 0% (some estimate even -1%) and the Fed's inflation target of 2% can be accomplished, this essentially implies that the long-run federal funds rate will top out at 2%. If this outlook proves to be true then the upside in bond yields (short- and long-dated ones) is capped to a certain extent and any sell-off in bond prices can be used to extend duration. During the quarter the Anchor managers took advantage of low inflation expectations in the markets and added further Treasury Inflation-Protection Securities (TIPS). With global central banks still being moderately to very accommodative, inflation expectations should rise in the future which benefits securities whose principal value increases with higher inflation readings. From a portfolio management perspective, TIPS represent an excellent diversifier in balanced portfolios.

Outside of the U.S. market, the latest BOJ decision was of historic proportions. The central bank made a commitment to target an inflation rate that will average at least 2% over the long-run in a "stable manner". Essentially, years of underachieving this target will be followed by years of overshooting it instead of just remaining at 2% once this goal has been reached (as all the other central banks do). The BOJ hopes that this target will be accomplished by focusing on the entire yield curve, in particular the 10-year Japanese bond yield at about 0%. The unique feature of this announcement is that it gives the government of Japan a blank check for unlimited debt issuance since the BOJ will buy the bonds in order to keep the yield curve at a certain level. This is pretty much "helicopter money" and once the government decides to take advantage of it and widens its budget deficit with fiscal stimulus, this could put a lot of downside pressure on the Japanese yen.