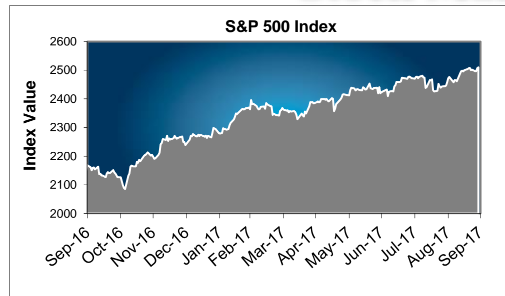
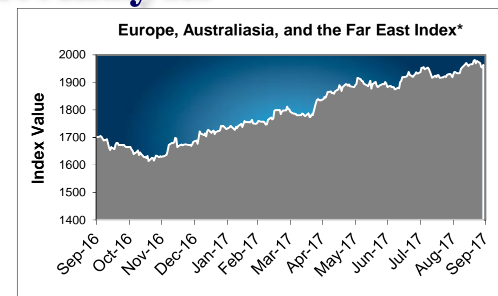
Stock Market Analysis





Top value investors thrive when human emotions impact investment decision making. They often pick up bargains that other investors have discarded. Anchor uses quantitative disciplines to search for under-valued securities. Investing is multidimensional and the marketplace is constantly evolving so it is important to combine computer power with the portfolio manager's experience. Every once in a while, we run into an investment market that no one has seen before and it becomes more difficult to measure risk.

The biggest challenge in financial modeling today is the extended period of quantitative easing ("QE") around the globe and other creative measures used by central banks. While there are plenty of pundits who have dire forecasts about the end of central bank stimulus, no one has experienced the reversal of the central bank actions on the scale that we have witnessed. Quantitative tightening and tapering are inevitable but there is significant risk with slow global growth, democratic challenges and record outstanding government debt. While we do not know the ultimate outcome of central bank action, we assume that QE is a policy that is now in every central bank's tool box. Most economists believe that this policy can minimize the impact of economic downturns but there is no consensus on the long-term impact of these actions. What we do know, is that traditional recessions cleanse the marketplace by eliminating weaker competitors. This cleansing can be painful and result in significant investment losses but also eliminates weak competitors and makes the market more efficient.

The prolonged downturn in Japan and Europe was primarily caused by inefficient financial institutions being bailed out by QE and zero interest rates. Regulators have raised banks' capital ratios to reduce risk to the financial system but this has resulted in less lending ultimately prolonging the period of slow economic growth. Furthermore, it has taken many years to reduce non-performing loans ("NPL") and under-performing assets from the European and Japanese financial systems. In the U.S., the banks and regulators tackled the NPL issue following the financial crisis, helping the banks to get back into the business of lending and growing the U.S. economy. This has resulted in higher profits and better performance of the U.S. equity markets. Despite the financial crisis, the S&P 500 Index has produced a 7.4% annualized return over the past decade versus 3.8% for the Nikkei 225 Index and 3.3% for the Bloomberg European 500 Index. Many value managers are now touting European and Japanese shares due to their under-performance. The question is whether this is a prudent move?

It is clear that the European and Japanese economies have improved. Both countries have averaged 1.1% real GDP growth (YOY) over the past five years compared to 2.1% for the U.S. In Japan this measure rose to 1.4% YOY in the quarter ending in June. In Europe real GDP growth accelerated to 2.3% YOY in the latest quarter compared to U.S. real GDP growth of 3.1% (YOY). While improving, all three growth rates are below the 3.5% OECD estimate for world GDP growth this year. The question is what is "the new normal" for these economies? We believe that European and Japanese growth will improve but demographic, regulatory and debt challenges will mute the economic recovery. Technology leadership will help the U.S. economy expand faster than the G10 but Trump's immigration and trade policies could negatively impact growth. On the other hand, tax changes, infrastructure spending and deregulation could stimulate U.S. growth in the short-term.

Anchor has increased exposure to faster growing economies in Asia. While Chinese growth comes with risk, the transition from an industrial to a consumer based economy appears to be making progress. Consumer lending is growing significantly from low levels relative to other large economies. Banks are reducing lending to industries with over-capacity and are becoming less dependent on state owned enterprises. Anchor recently invested in China's second largest bank, Chinese Construction Bank H shares which should grow with the Chinese economy, continue to produce a 15% return on equity and sells at 5.7 times earnings per share. The H shares pay a 5.3% dividend which is expected to rise by 5% to 8% over the next three years. At the same time the Chinese are leading technological development in areas including artificial intelligence, communication, automation and the internet. Anchor clients have benefited from an investment in Alibaba thanks to its leadership in the rapidly expanding internet in China.

We believe Anchor's quantitative stock selection process gives our portfolio managers an advantage in evaluating risk and finding under-valued companies around the globe.

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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										
				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	1.6%	1.6%	6.9	7.0	8.6	1.5%	-1.4%	1.4%	0.6%
Non-USD Bond	GBXD	0.7%	0.7%	7.8	7.8	9.3	2.4%	-2.6%	0.2%	-0.7%
US Corporate/Govt	B0A0	2.4%	2.5%	6.4	6.5	8.8	0.6%	-0.4%	2.8%	2.1%
US Government	G0Q0	2.0%	2.0%	6.2	6.3	7.9	0.2%	-2.1%	2.2%	1.3%
US Corporate	C0A0	3.2%	3.2%	7.1	7.3	10.5	1.2%	1.9%	3.9%	3.5%
US High Yield	H0A0	5.5%	6.0%	3.6	5.0	6.3	2.1%	9.2%	6.0%	6.4%
US Hybrid Preferred	P0H0	-2.1%	5.8%	2.6	14.5	96.1	1.4%	6.0%	7.8%	6.7%

*3 and 5 year returns are compounded annualized returns

Moderate Growth Path

Besides a little flare up in asset price volatility in August the third quarter turned out to be remarkably calm for financial markets. The looming crisis with North Korea led to some flight to safety and supported government bonds. Corporate bonds and preferred securities benefited from a decent earnings season, low asset price volatility and a stable macroeconomic environment. Global growth was revised higher by several supranational institutions, whereby the upgrades of most regions came on the heels of a downgrade to U.S. growth expectations. Monetary policy remained very accommodative despite small rate hikes in the U.S. and Canada and a slightly more hawkish European Central Bank (ECB). The current growth environment can be characterized as “muddle through”, indicating that it is not too strong for causing excesses nor too weak for leading to deflationary tendencies. The moderate growth path has kept inflation rates contained in most developed markets, has kept event risk from changes in monetary and fiscal policies under control and asset price volatility low. However, the foreign exchange market has been much more erratic and the weakening of the U.S. dollar continued in the third quarter. There are not necessarily any major economic issues in the U.S. but rather other economies have experienced a slightly better growth spurt which has allowed them to catch up with the U.S. The dollar’s sell-off this year can also be traced to the inability of Congress and White House to get meaningful reforms passed. There will be a last ditch attempt to get some sort of tax relief written into law by December before 2018 becomes an election year with the focus shifting to other topics.

Economic indicators have been buoyant in most countries and surveys point to further improvements. The Organization for Economic Co-operation and Development (OECD) estimates that global growth will pick up from 3.0% in 2016 to 3.5% this year and 3.6% in 2018. The Eurozone is expected to post its fastest growth in a decade. Those forecasts are supported by expectations that central banks will remain very accommodative with monetary policy and that at least some countries (e.g. U.S. and Japan) are in the process of providing more fiscal stimulus. In regards to monetary policy, a very loose stance remains justified since most central banks have failed to lift the inflation rate to its mandated target. The U.S. economy is getting close to generate some higher inflation readings since the unemployment rate is estimated to have dropped below the non-accelerating inflation rate of unemployment (NAIRU - refers to a level of unemployment below which inflation rises). However, inflation is a lagging indicator and it often takes time before higher readings form. Until then the Federal Reserve (Fed) will pursue a cautious monetary policy. Expectations for a 25 basis point rate hike in December are a coin toss. Although the market is pricing a two-third chance for an increase, historically the Fed hiked rates once expectations exceeded 70%. In Europe, the ECB is still working on its communication when and by how much to taper its asset purchases and is consequently far away from adjusting interest rates. The same holds for Japan which is stuck close to deflation despite record amounts of asset purchases. Not even the monetization of the budget deficit has led to any meaning full improvement in the inflation rate. Our expectation is that the bull market in bonds will continue until structural changes will cause economic growth and inflation to rise on a sustainable basis. Over the past years only minor adjustments to fiscal and monetary policy were pursued which have kept global growth at its moderate growth path.

The U.S. dollar endured a major rally after the presidential election in November of last year. The rise reflected high expectations for Donald Trump as a pro-business president and that his agenda would lead to rising capital expenditures and repatriation of dollars to the U.S. Fading hopes of such and improving economies elsewhere have gradually eroded the dollar’s value during the course of the year. The biggest beneficiaries were the European currencies, led by the euro and the Swedish krona. Both currencies appreciated by about 12 percent year-to-date. Since there is another attempt to get tax reform passed in the U.S., and if successful, it could turn the misfortunes of the dollar. Especially repatriation flows would be supportive for the greenback.

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