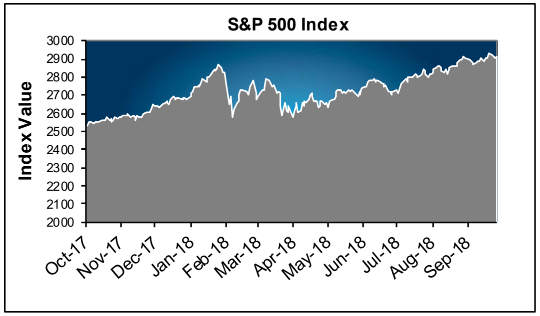
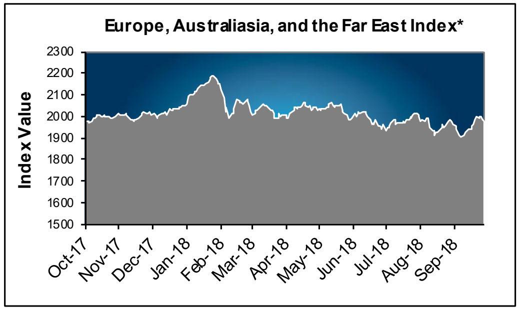
Stock Market Analysis

U.S. Trumps Other Markets





MSCI EAFE Index

The U.S. equity market continues to surprise pundits who have predicted that U.S. stocks would lag other international markets after significant outperformance over the past decade. The S&P 500 Index gained 7.0% in the quarter to drive the 4.8% return in the MSCI World Index. Returns were more modest in the rest of the World with the MSCI EAFE Index returning 1.4% and MSCI Emerging Markets Index losing 1.0%. These returns were impacted by the 5.7% appreciation of the U.S. dollar which gained for the second consecutive quarter.

A closer look at the performance of the global indices indicates that the trade wars are impacting the Chinese and Hong Kong markets with the Shenzhen CSI 300 losing 14.7% and the Hang Seng losing 7.1% in the first three quarters of 2018. It is difficult to gauge the ultimate outcome of trade negotiations but it is worth noting that the devalued Chinese Yuan will lower the impact of the trade tariffs on Chinese goods. The yuan fell almost 4.0% versus the dollar in the quarter and has tumbled 9.0% since April. This devaluation helps Chinese manufacturers' competitiveness in both the U.S. and other markets. We believe that the Chinese focus on domestic consumer spending and their emphasis on developing leadership in the "New Economy" should allow the economy to continue to grow faster than other developed economies. We have avoided Chinese exporters and have found good value in other sectors, including technology, where the major Chinese players are producing strong growth and have a wide moat in their businesses. While our over-weight position in Chinese equities hurt our relative performance this quarter, we believe that these investments will continue to produce excess returns over the long-term.

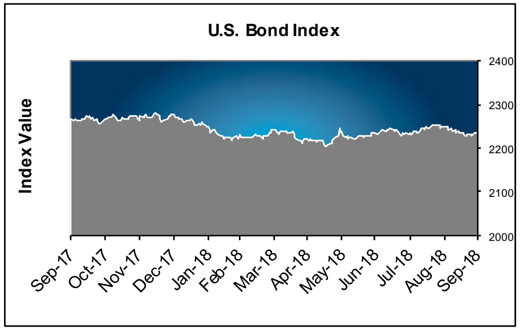
On the other hand, we remain under-weight in Europe. As we have explained in previous reports, we believe that Europe has systemic issues that impacts the return on invested capital of many European companies. The weaknesses of the euro structure have become more evident with Brexit and the recent political changes in Italy which have spooked the markets once again. The British have complained about the bureaucracy that has stymied business growth. We see that that Europeans have few solutions for under-performing economies such as Greece and Italy. Our greatest concern is that Europe is not prepared and is not participating in the "New Economy". The 7.2% gain in the S&P 500 this year has been driven by the FAANG stocks (Facebook, Amazon, Apple, Netflix, Google) with the Nasdaq Composite jumping 16.6%. Europe has watched these companies become global behemoths that now dominate their markets. Rather than creating legitimate competitors, it appears their tactic is to try to break up the competition and levy huge fines on the U.S. companies. While the relative valuation of many European companies has now become more attractive, we will remain selective when looking for opportunities in the region.

As we look forward to 2019, we expect that U.S. economic growth will likely slow, impacted by the Chinese tariffs, the strong dollar, higher interest rates and energy prices and a lapping of corporate tax rate cuts levied in 2018. The tight labor market will likely impact operating margins especially for labor intensive industries. We expect a reasonable resolution of the Chinese trade issues following the new U.S. agreements with Canada and Mexico. This would be a positive outcome for the global markets. While it would clearly benefit Chinese equities, a new Chinese trade agreement would also help U.S. retail and manufacturing industries that have been forced to absorb the trade tariffs.

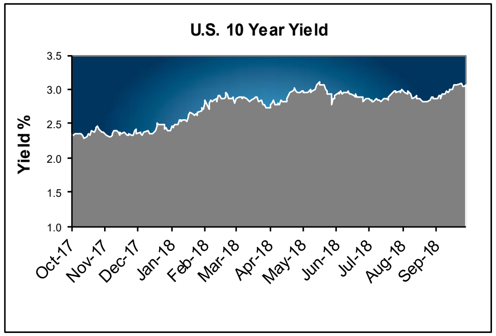
MSCIEAFE Index All stock index returns are adjusted for 30 percent foreign withholding tax.

Fixed Income Analysis

Rates Grind Higher



Merrill Lynch US Corporate & Government Index



U.S. 10 Year Treasury Yield

Geopolitical headlines were a constant theme throughout the third quarter. The Chinese-U.S. trade war escalated further as Trump enacted tariffs on another $200 billion of imports from China; China reacted by placing tariffs on an additional $60 billion of U.S. imports. Meanwhile, there were breakthroughs in NAFTA negotiations as the U.S., Mexico and Canada reached an agreement to form a new multilateral trade deal known as the U.S. Mexico Canada Agreement. Elsewhere, the Turkish central bank surprised the markets by raising its benchmark rate +6.25% to 24%, satiating market calls for higher interest rates to address rampant inflation.

Markets rallied on the back of these developments. Credit spreads tightened led by emerging markets and high yield credit, most notably. Investors piled into Turkish assets as evidenced by the +17.8% rise in iShares MSCI Turkey ETF, whose shares outstanding have almost doubled over the last two months. This indicates there is still considerable risk appetite, despite President Erdogan's stated policies. In last month's fixed income review we expressed concern for the potential for emerging market stress to flow through to U.S. markets. Despite the relief rally in September, we continue to believe this is a risk over the near to medium term. The factors we cited last month are still in effect today. As per BCA Research, excluding China, Emerging Market (EM) USD-denominated debt accounts for a record ~16% of GDP on average and almost 70% of exports. As such, a stronger USD is a real issue for the most vulnerable countries (as we saw with Turkey in August). Another important factor for EM is the slowdown in the Chinese economy and the impact of potential monetary/fiscal stimulus. It is unclear whether this will filter to EM economies. It's also worth noting that the current U.S. economic expansion is approaching the ten-year mark (one of the longest on record) and credit spreads are at tight levels historically. Given the EM risks, and the forward-looking nature of markets we feel the conservative positioning of the Anchor Fixed Income portfolio is warranted despite resilient U.S. economic data. This doesn't mean we will shun all credit exposure. We are happy with the credits we own, but rather we don't want to chase yield at stretched valuations so late in the cycle.

The Fed raised the Fed Funds rate +0.25% in September to a range of 2%-2.25% and is widely expected to hike rates again in December. In the quarter, U.S. Treasury yields rose approximately +20-25 basis points across the curve. The 10 and 30 year Treasury yields bumped up against key resistance levels on multiple occasions in the quarter. These tenors have been range bound since March of this year. Given the combination of higher Treasury issuance to fund the government budget deficits over the next couple of years, at the same time the Fed is tapering its balance sheet (meaning a major source of demand for Treasuries is scaling back its bid), we think the 10 year yield has scope to rise. Another tailwind for higher rates may come from the EU. The ECB is planning to taper the size of its balance sheet next year. Also, Draghi will step down as ECB President next year. A change in tack from the ECB's ultra-accommodative stance under Draghi, to one less accommodating (directed by a German perhaps?) could filter through to EU government bond yields. Given the global nature of the bond markets this repricing would likely filter through to U.S. Treasury yields. As such, we maintain an underweight duration stance versus the benchmark.

Lastly a word on the greenback. U.S. growth has maintained a strong course while growth outside the U.S. (in general) has slowed primarily due to the stagnant European economy and China's slowdown, along with trade war uncertainty. The Fed is expected to continue hiking interest rates, therefore, interest rate differentials should continue to benefit the U.S. Dollar relative to most developed market currencies. Having said that investor positioning has become very bullish towards the greenback which poses some risk to dollar long positions. Nonetheless we feel the U.S. Dollar will outperform in the near/medium term.