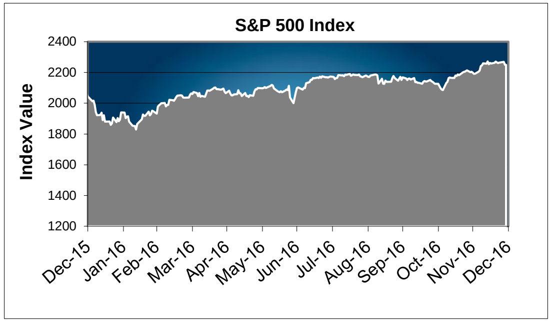
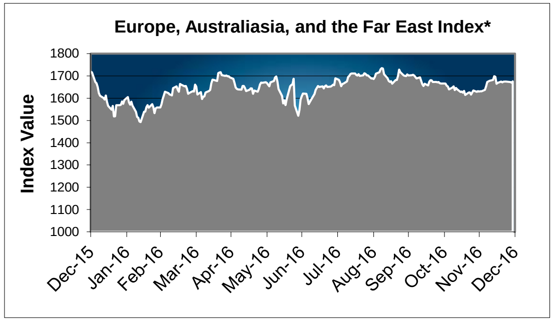
Stock Market Analysis



S&P 500 Index



Europe, Australiasia, and the Far East Index*

ANCHOR
Investment Management

Extraordinary Year

2016 was an extraordinary year highlighted by a global political revolt as anti-establishment forces demanded change across the globe. Brexit shocked many political pundits in the UK only to be followed by one of the greatest election surprises in history. Donald Trump's uncharacteristic style of shock and awe politics led to his surprising victory over Hillary Clinton in the U.S. presidential election.

Unfortunately one of the unintended consequences of globalization has been declining real wages and a widening wage gap. Many workers are revolting at the ballot box after twenty years of lower wages. This is leading to a political trend of protectionism and to anti-competitive practices. If companies cannot compete by producing goods and services at competitive prices or superior value, they will ultimately be replaced by other international competitors who do not have excess restrictions or inferior products. Simply stated, the reason many goods sold in the U.S. come from China is that Chinese companies have an almost unlimited supply of low cost labor. If those same goods are produced in the U.S. it may temporarily create some jobs but ultimately subsidies lead to lower productivity and higher costs. Unfortunately, companies will use technology and automation to lower production costs which leads to fewer jobs. One solution is not subsidies but better education and training.

Looking back at 2016, the equity market experienced a roller coaster ride driven by political changes and volatile energy prices. After the worst start in recent history, the U.S. stock market produced better returns (S&P 500 +10%) than the other developed markets, especially when adjusted for the strength in the dollar. The MSCI World Index was able to produce a positive return of 5.3% in 2016 primarily due to the Trump rally in the fourth quarter. Outside the U.S. the MSCI EAFE Index was little changed when including dividends.

The future of the EU and the euro remains in doubt due to Brexit and the continued failure to produce consistent economic growth across the region. Eight years after the global financial crisis, many European banks remain undercapitalized and reluctant to lend despite record low interest rates. In Japan policy makers appear content to allow banks and the government to borrow for nothing in the hopes this will eventually spark economic growth. It may be prudent for the Europeans and the Japanese to look at the game plan from the new Trump administration to lower regulation and reduce the size of their governments in order to end the economic malaise. Clearly, the equity markets responded well to the Trump "Hybrid Reaganomics" policies of the new Republican administration. Furthermore, lowering the U.S. corporate tax rate to 15% would make it a low tax jurisdiction. More importantly, simplifying the tax code for individuals and corporations can help bring fairness back to the U.S. tax system.

Looking forward to 2017, we continue to believe that investors need to be selective since some sectors of the market appear over-valued. The U.S. and Chinese economies will likely drive moderate global GDP growth this year, leading to reasonable profit expansion. Earnings comparisons should get easier in 2017 as the energy sector will recover if crude remains at current levels or higher. The plunge in profits in this sectors caused the market P/E multiple to climb in 2016. The strong U.S. dollar will limit profit growth of U.S. exporters but will bolster European and Asian multinationals. After a seven year bull market, finding companies that meet Anchor's quantitative upside criteria is more difficult. However, we believe our rigorous security selection process should produce attractive returns over the next five years.

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

Merrill Lynch Fixed Income Indices				Modified Duration	Macaulay Duration	Maturity WAL	Period Total Return*			
Name	Code	Yield to Worst	Yield to Maturity	To Worst	(Years)	(Years)	Quarter	1 Year	3 Years	5 Years
Global Bond	GBMI	1.6%	1.6%	6.9	7.0	8.7	-6.8%	2.1%	0.2%	0.4%
Non-USD Bond	GBXD	0.6%	0.6%	7.9	8.0	9.5	-10.4%	1.5%	-2.5%	-1.3%
US Corporate/Govt	B0A0	2.5%	2.5%	6.3	6.4	8.7	-3.5%	3.1%	3.2%	2.4%
US Government	G0Q0	1.9%	1.9%	6.1	6.2	7.8	-4.0%	1.3%	2.6%	1.3%
US Corporate	C0A0	3.4%	3.4%	6.9	7.1	10.3	-2.9%	6.1%	4.2%	4.2%
US High Yield	H0A0	6.2%	6.5%	4.0	4.9	6.4	1.9%	17.5%	4.7%	7.4%
US Hybrid Preferred	P0H0	6.1%	6.4%	11.9	13.8	96.9	-4.5%	1.8%	7.7%	6.6%

*3 and 5 year returns are compounded annualized returns

Passing the Baton

The first half of 2016 saw a massive rally in fixed income securities with the GDP-weighted developed market government bond yield dropping from 1.6% to under 0.8%. This was the lowest level on record, at a time when the long-term bonds of several developed markets posted negative yields. At the bottom, the 10-year German, Swiss and Japanese securities had a negative yield of 21 basis points (bps), 64 bps and 30 bps, respectively. The flow to safe-haven securities was due to a broad-based sell-off in the commodity space, concerns about the capital adequacy of European banks and the Brexit vote. Consequently, the Federal Reserve (Fed) was not able to follow through with its planned four interest rate hikes for the year and achieved just one 25 bps increase. At the beginning of the year lower interest rate expectations also weighted heavily on the U. S. dollar which was down versus the euro by as much as 6.5% and the yen by as much as 16.7%. However, the second half of 2016 was the mirror image of the first six months. When several supranational institutions downgraded the global economic growth forecast and the European Central Bank (ECB) and the Bank of Japan (BOJ) extended their monetary support, the economic outlook started to improve and bond yields began to rise. Nonetheless, it was the outcome of the U.S. election on November 8th which led to a significant move in the fixed income and foreign exchange markets. Defying most projections, the Republican party won all three chambers – President, Senate and House. The ensuing expectations of more government spending and the president-elect's proposed America First policies led to a significant rise in bond yields and a strong rally in the U.S. dollar. Treasury securities and the U.S. dollar finished the year with a plus of 3.1% and 3.6%, respectively. The best performance was posted by U.S. high-yield bonds which appreciated by 17.5%.

For many years the global economy was primarily supported by monetary policy but 2016 may mark the year when the baton got finally passed to the fiscal side. Central bank asset purchases will likely be much lower next year. The Fed will continue with its monetary tightening agenda and the ECB has essentially announced a tapering program from the second quarter on to the end of 2017. It will probably just be the BOJ which has to continue its large scale asset purchases. On the other hand, the proposed policies of president-elect Trump, Canada's infrastructure spending and Japan's rising budget deficit (financed by unlimited bond purchases by the BOJ) are all clear signs that more fiscal stimulus can be expected. Especially the Eurozone has room to expand government spending since after several years of austerity the budget deficit has shrunk to 0.9%. Still supportive monetary policy with the forthcoming fiscal stimulus should lead to a cyclical improvement in global economic conditions and somewhat higher inflation.

The long-term implication – or structural trend – will likely not be impacted by much by recent political outcomes and the additional government spending. Economic theory suggests that long-term growth is the product of growth in the workforce times productivity enhancements. Add long-term inflation expectations to the equation and one gets a rough estimate for the fair value of the 10-year government bond yield. In regards to workforce growth, several studies have shown that the growth rate for world population has slowed down since the 1970s and is expected to come to a grinding halt by the end of the century. The announced and proposed fiscal stimulus will not be able to change anything about this trend. In the U.S., Donald Trump's anti-immigration policy may even aggravate the slowdown in workforce growth. While this will likely keep the long-term real economic growth outlook relatively modest – the Fed estimates 1.8% - higher inflation expectations should at least ensure a better global nominal growth environment. The annual growth rate in global trade has already slowed down to zero even before the U.S. election and the protectionist measures of the incoming president will increase the cost of trade and products and lead to higher inflation. The combination of weak economic growth and potentially higher inflation has increased the risks of stagflation. The Anchor managers added Treasury Inflation-Protection Securities (TIPS) to the fixed income portfolios. TIPS benefit in a stagflationary economic environment and also represent an excellent diversifier in balanced portfolios.