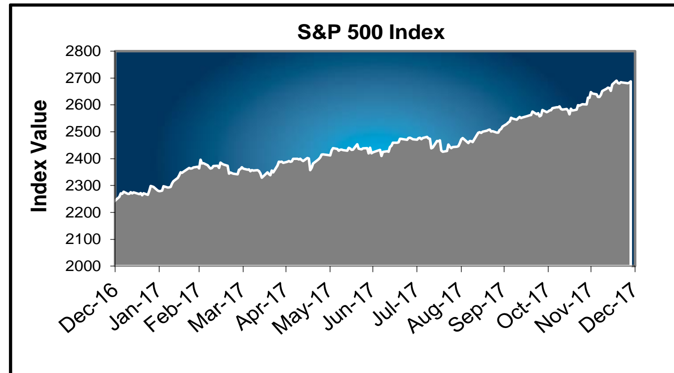
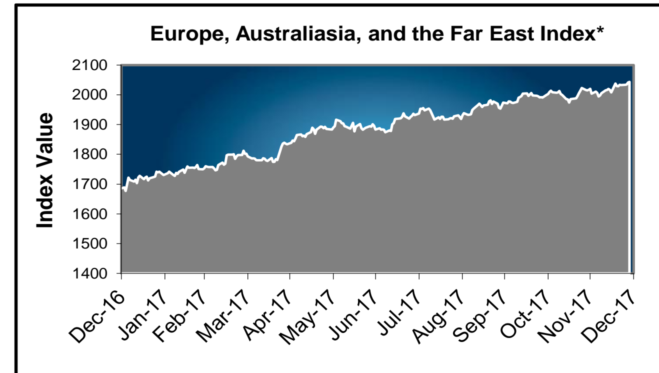
Stock Market Analysis





Speculation or Anticipation

After the strong market rally in 2017 it is normal for investors to ask whether we are in a speculative bubble or anticipatory bull market based on improving fundamentals. Accelerating global economic and profit growth drove strong gains in all the major developed and emerging equity indices in 2017. The MSCI World Index returned 21% for the year with broad double-digit gains across most bourses, led by a 36% jump in the Hang Seng Index. The International Monetary Fund raised its forecast for global economic growth to a healthy 3.6% in 2017 and 3.7% in 2018. Consumer and business confidence in the U.S. and Germany are near record highs. The lagging Japanese economy also saw improvement and China continued to have the fastest growing major economy with an estimated 6.8% growth in 2017. U.S. dollar based investors also benefited from the broad appreciation of other currencies versus the greenback. The Bloomberg U.S. Dollar index produced its biggest annual decline in fifteen years giving back 9.8% following four years of gains. While the Republican tax changes should stimulate economic growth in the largest global economy, currency investors are concerned about the impact of the tax cuts on the growing U.S. budget deficit.

The question on many investors' lips is whether the 21% gain in the stock market in 2017 will lead to losses in 2018. We have consistently stated that market timing will have a negative impact on long-term investment returns. Historical statistics support our argument. The average long-term return for retail investors in equity fund is only 4%, compared to 10.2% for the S&P 500 Index (through 12/31/2016), according to a 30-year DALBAR study. This under-performance is primarily due to retail investors' poor market timing and lack of participation during market rallies. Annual returns of greater than 20% are not uncommon in the equity markets with the S&P 500 Index eclipsing 20% returns one out of every four years since 1930. The index produced a 9.3% return on average the following year, according to Bloomberg data analytics and had a positive return **75% of the time**. We recognize, however, that the prolonged period of low interest rates around the world is causing increased speculation. The surge in blockchain related shares is a clear indication that rational behavior can be replaced with FOMO (fear of missing out). Furthermore, the growth in ETF based investing has many investors blindly making decisions without understanding the underlying valuation of what they own. This trend will continue to produce opportunities for disciplined security selection. We believe Anchor's qualitative and quantitative stock selection process gives our portfolio managers an advantage in evaluating risk and finding under-valued companies around the globe.

Accelerating profit growth in technology shares drove the MSCI World Technology sector 37% higher during 2017. While some analysts are making comparisons to the dot-com bubble, the sector continues to gain a larger slice of the economic pie. Unlike the 1990's, many of the leading technology companies are producing strong double-digit profit and free cash flow growth. The rapid expansion and evolution of digital technology is transforming industries, including retailing, transportation, advertising, publishing and entertainment. Investors are fleeing other industries where they anticipate that "the Amazon effect" will spread, including healthcare and pharmacy distribution. Amazon's purchase of Whole Foods suggests that the internet behemoth believes that a combination of online and brick and mortar distribution is likely the long-term retailing model. Alibaba has made similar acquisitions over the past two years with $8 billion in investments in Chinese physical stores. The significant outperformance of the traditional retailers in the fourth quarter after three years of negative returns indicates that investors believe that consumers will not completely abandon traditional shopping venues. We believe that the omni-channel model will likely be the future of retailing and companies that lead the industry transition will survive the technology disruption and gain market share. There will likely be an acceleration of acquisitions of under-valued traditional retail chains by the internet leaders as they monetize their recent relative gains and expand their physical footprint.

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

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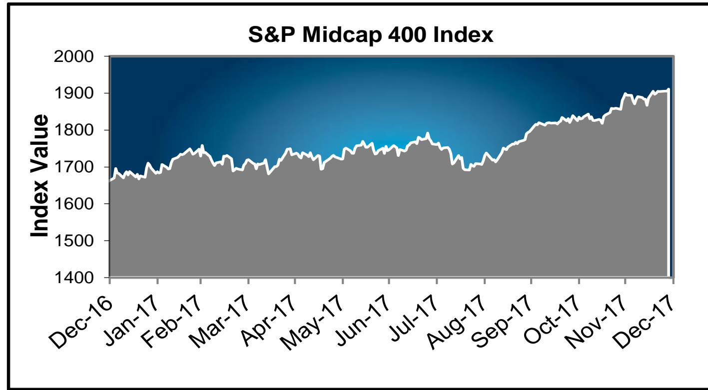

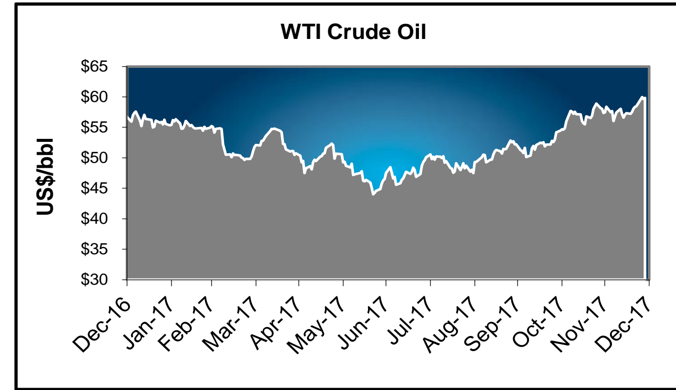

Looking ahead to 2018, it is important to understand that investing is multidimensional. While technological innovation is a major factor for consideration for many industries, there are several other major impacts on stock performance. One of the most significant influences on security valuation is the risk-free interest rate since it impacts the cost of borrowing and the overall cost of capital. Long-term government yields remain near historical lows. The combination of strong global growth, low interest rates and benign inflation is rare and should continue to be supportive of stock valuation. While we are witnessing a synchronized global expansion, inflationary pressures remain under control. Wage increases would normally occur at this stage of the economic cycle, but productivity gains, automation and globalization are dampening pressure on employee income. Unemployment rates have fallen in many developed economies but this is not leading to wage pressure. It is our expectation that inflation and interest rates will remain low for the rest of the decade but we will be monitoring inflationary pressures in 2018. One of the greatest risks to financial asset values at this stage would be a meaningful and unanticipated spike in inflationary pressure. The grand quantitative easing (“QE”) experiment has lasted longer than many experts had expected and consequently, we are in unchartered waters as central banks try to reduce the size of their balance sheets. We believe that central banks will raise short-term interest rates gradually due to high debt levels and demographic challenges. This environment remains supportive for equity prices assuming no Black Swan events disrupt the bullish sentiment.

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	1.7%	1.7%	7.0	7.1	8.8	1.0%	7.2%	2.1%	0.9%
Non-USD Bond	GBXD	0.7%	0.7%	7.9	8.0	9.5	1.6%	10.7%	1.8%	-0.2%
US Corporate/Govt	B0A0	2.6%	2.7%	6.6	6.7	9.0	0.5%	4.2%	2.5%	2.1%
US Government	G0Q0	2.2%	2.2%	6.4	6.4	8.1	0.1%	2.7%	1.5%	1.3%
US Corporate	C0A0	3.3%	3.3%	7.2	7.4	10.6	1.1%	6.7%	4.0%	3.5%
US High Yield	H0A0	5.8%	6.2%	3.8	5.0	6.4	0.4%	7.5%	6.4%	5.8%
US Hybrid Preferred	P0H0	-2.5%	6.0%	2.6	14.5	92.9	0.8%	11.9%	7.2%	6.7%

*3 and 5 year returns are compounded annualized returns

Euphoria

Asset price volatility was very muted during 2017 despite some notable economic and geopolitical events. Several terror acts, North Korea’s missile tests, investigations into the U.S. elections and monetary tightening was not able to derail capital markets. Instead, investors took heart from receding political risk in Europe, tax reforms in the U.S. and robust corporate earnings around the globe. Rising economic indicators worldwide and upgrades to global growth from international think tanks supported the positive sentiment. Risk assets outperformed government bonds for the second year in a row, with the BofAML Hybrid Preferred Securities Index leading the pack with a stellar 11.9% return. Government bonds posted a positive performance during the year advancing by 2.7%. The biggest surprise was the sell-off in the U.S. dollar which lost nearly six percent versus a broad basket of currencies. The delays in the tax reform and stronger than expected growth elsewhere weighted negatively on the greenback.

The general economic mood in the U.S. and globally can be described as very optimistic. Several leading indicators are at or close to record highs and signal robust growth for this and next year. For the first time in a decade global research institutes like the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) upgraded their assessments for global growth. It is also estimated that the median output gap (difference between the actual output of an economy and its potential output) for 20 advanced economies will shift to a surplus in 2018, which would be the first time in a decade. While growth expectations are euphoric, the missing piece of the puzzle is the still muted inflation rates in developed economies. This might appear somewhat counterintuitive since the slack in the U.S. employment market has been absorbed and the unemployment rate could potentially drop to 3.5% next year. This rate would be a full percentage point below the estimate of the non-accelerating inflation rate of unemployment (NAIRU) and a tight labor market should – in theory – create wage pressures. There have been several developments which have kept inflation low nevertheless: in Europe, for example, the unemployment rate ex-Germany is still about 6% above where it was 2008 and it will take several years before this imbalance will be absorbed. In addition, globalization and technology have reduced workers’ bargaining power. Another reason for low wage growth – and consequently low consumer price inflation – is due to low productivity growth which has curtailed the scope for wage gains.

Anchor’s economic outlook for 2018 is for the global expansion to continue and for inflation to slowly accelerate while the global slack in the employment market will be absorbed gradually. The recent fiscal stimulus in the U.S. might be ill-timed since the underlying economic developments are relatively solid and do not require any further support. Moreover, the tax plan is not a game changer since it is estimated to increase U.S. real economic growth by a mere 0.8% over a ten-year time horizon, whereby most of it will be front loaded into the first two years. At the same time the debt-to-GDP ratio is forecast to rise by six percentage points which will make a budgetary rebalancing even more complex in future years. While most economic indicators and forecasts are upbeat, there is one segment in the market which does not trust the euphoria. The U.S. yield curve flattened a whopping 73 basis points to 0.52% during the year. Although short-term interest rates rose significantly in 2017, the long-dated bond yield finished the year slightly lower than where it was at the end of 2016. A flat yield curve usually occurs at the end of an economic expansion and can indicate lower growth and inflation ahead. The current level of the U.S. yield curve is not concerning yet but we will watch this pricing indicator together with the change in the Conference Board U.S. Leading Index closely in order to get a good read on the economic outlook.

The consensus outlook for the U.S. dollar is for an ongoing weakness. Although our purchasing power parity (PPP) valuation for the U.S. dollar is negative, positioning indicators show that the recent sell-off is stretched. In addition, the market prices only two rate hikes by the U.S. central bank in 2018 which could turn out to be too pessimistic. Any upside surprise on this front would widen interest rate differentials in favor of the U.S. dollar.

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