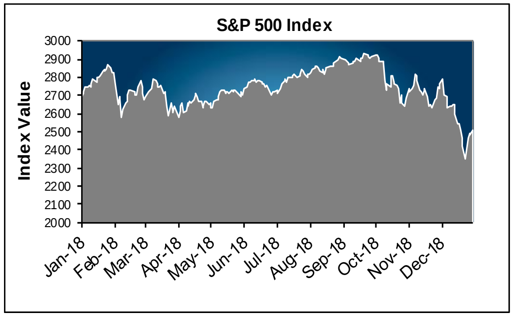
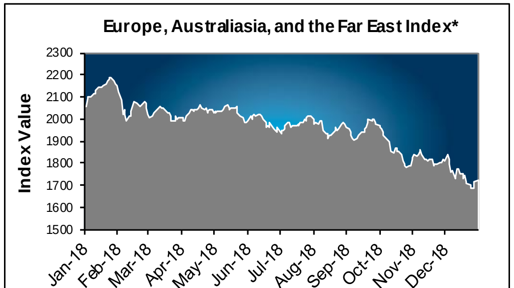
# Stock Market Analysis

## Sentiment Trumps Fundamentals




MSCI EAFE Index

**What a difference a year makes!** The stock market is forward looking and is a fairly accurate barometer at predicting future earnings and economic growth. The market also adjusts to incoming data and changes in investment risk. As I wrote the Anchor annual letter a year ago, investors were focused on the positive impact of lower U.S. corporate taxes and "synchronized global growth". The global equity markets were up more than 20% in 2017 and equity investors were euphoric. The market participants were partially correct as analysts are now estimating that earnings for S&P 500 companies rose more than 30% in 2018 ($162.5 from $123.15). This growth offset profit weakness in Germany, Hong Kong and Japan.

**So what did the market not anticipate?** The equity risk premium changes with market uncertainty and clearly political and economic uncertainty rose significantly in 2018. It is rational that the rising equity risk premium caused stocks to fall in the fourth quarter. Investor sentiment is reaching historic lows with the Citigroup Panic/Euphoria Model entering panic mode, as concerns including Brexit, trade wars, slowing global growth, the U.S. government shutdown and the possible indictment of President Trump. U.S. dollar investors were hit particularly hard as most major currencies declined versus the dollar in 2018. There was nowhere to hide as global stocks, bonds and commodities declined. Even the professionals who are paid to lower portfolio volatility had a difficult year with the HFRX Global Hedge Fund Index declining 7.0%. These highly paid investment professionals once again under-performed Anchor's Conservative and Moderate Composites which declined 4.3% and 6.2% respectively in the year (net of fees). While we are not happy with these returns we understand that the market and currency headwinds aligned to create a difficult year for investors with the MS Developed World Index producing a -8.7% return in 2018 after a solid +22.4% return in 2017.

Over the longer term, the market will reflect the future growth of corporate profits and cash flows. While a 20% sell-off in most of the major stock market indices occurs rarely and normally proceeds or occurs during a recession, there is little evidence of a significant slowdown in global economic growth on the horizon. We remind readers what Janet Yellen said, "I think it's a myth that expansions die of old age". While the economic expansion has lasted nine years there has been significant sector rotation duration the expansion and there is little evidence of the typical excesses that proceed a recession. Our team forecasts that U.S. GDP growth will slow to 2.5% from 3.5% in 2019 due to less fiscal stimulus and tighter monetary policy. We expect this slowdown and trade issues to slow global growth to 3.4% from 3.7% in 2019. Falling commodity and energy prices, along with the recent decline in long term interest rates should also help prolong the nine-year economic expansion.

Earnings will be impacted by the 40% decline in crude prices which will be a headwind for the energy sector but should benefit consumer spending and the transportation sector. U.S. earnings growth will show more normal growth in 2019 (6-8%) following the benefit of the fiscal expansion in 2018. Europe will likely see modest growth and the China stimulus program will likely benefit Asia despite U.S. trade sanctions. While the U.S. market is important for China, it is not the only market. Over the longer term, we expect that the U.S. will be forced to solve its trade issues which will be in the best interest of all global economies.

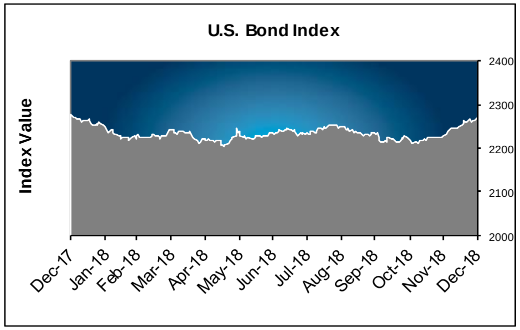
While the equity risk premium is elevated due to investor uncertainty, ignoring the current market valuation relative to the current interest rate market we believe is a mistake. The MSCI World Index sells at 13.5 times this year's EPS estimates. This equates to a 7.4% EPS yield compared to the 2.66%, 0.17% and 0.0% risk free rates in the U.S., Germany and Japan. In our opinion investors rarely get this opportunity to own stocks at a major discount and investors have plenty of cushion even if corporate profits are impacted by an economic slowdown. While it always difficult to buy risky assets when investors are in "panic mode", history indicates that this is when you achieve the best returns. At the same time, it is important for our clients to always review their long-term asset allocation to ensure it meets their bespoke risk and reward requirements.



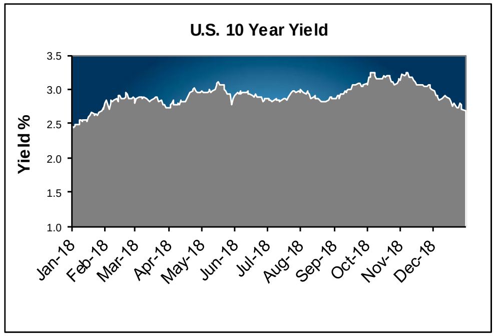
***MSCIEAFE Index  All stock index returns are adjusted for 30 percent foreign withholding tax.***

# Fixed Income Analysis

## The Return of Volatility




Merrill Lynch US Corporate & Government Index




U.S. 10 Year Treasury Yield

The low volatility environment that characterized much of the post Global Financial Crisis period ended with a bang in 2018 which negatively impacted risk assets. A major theme of 2018 which helped bring about this volatility was geopolitics. After passing tax and fiscal spending bills through Congress and the Senate President Trump turned his attention to China and its trade practices. The stand-off between China and the U.S. is more than simply a trade war – it's the world's largest economic and military power trying to stifle the faster growing challenger to the U.S.' global dominance. Even if a trade deal is reached (which is very possible within the next 18 months given the 2020 Presidential election), the underlying tensions between the two powers are unlikely to disappear. Other geopolitical events such as the U.S. government shutdown, Italian election (and other European elections), Turkey's spat with the U.S., and Brexit uncertainty also contributed to unsettled markets throughout the course of 2018.

Another 2018 theme that deserves a mention concerns central banks. While the Federal Reserve raised the fed funds rate 4 times in 2018, equally as important, Chairman Powell also showed himself to be less influenced by equity market tantrums than his forbearers (hence more volatility). Regarding "quantitative tightening", the Fed has and is reducing the size of its holdings of Treasuries and mortgage-backed securities, while the ECB has stopped buying European sovereign and corporate debt. As such two of the world's largest central banks have shifted from an easing of monetary policy to tightening monetary policy regime (at least at the margin for the ECB).

The last two months of 2018 were particularly painful for corporate credit markets. Lower oil prices have caused high yield energy names to underperform, while the market's interpretation of Chairman Powell's about turn on the neutral rate led to a widespread rerating of equities and corporate bonds. The widening of corporate credit spreads was likely exacerbated by the rise of ETF's and bank regulation that has restricted the market making abilities of banks and therefore reduced secondary market liquidity. Going into 2019, as we approach the 10-year anniversary of the U.S. economic expansion, it is likely that credit spreads will be a constant focus of news headlines as the market tries to sniff out signs of the end of the cycle. The Anchor Fixed Income portfolio is conservatively positioned. We favor holding more Treasuries than would normally be the case for the above reasons.

The Fed raised the fed funds rate four times to 2.25% - 2.50% in 2018 and the yield curve flattened as the short end of the curve (rose more than the long end). The 2-year yield rose 60 bps to 2.48%, while the 10 year yield rose +28bps to 2.68%. At the time of this writing the yield curve slope from the 1 to 8 year tenor is inverted indicating the market expects the Fed to lower rates in 2020. Fed rate hike expectations have come down dramatically over the last 2 months, largely due to Powell's comments in November and softer economic data from around the world. At the beginning of 2019 fed fund futures indicated no hikes for this year compared to the Federal Open Market Committee members median forecast for two hikes. How the rate hike dynamic plays out will likely have an impact on the USD…

In 2018, the Fed raised short term rates more than the two hikes that the market had priced at the beginning of the year. Higher interest rate differentials combined with stronger economic growth (boosted by fiscal spending) in the U.S. and bearish USD investor positioning at the end of 2017 helped the dollar outperform in 2018. Given the slowdown in developed market growth outside the U.S. and interest rate differentials, we prefer to maintain our current USD exposure. The extent of China's stimulus is still unknown and whether it will filter through to the rest of the world or just enough to support China's growth. We also think the market's pricing of short-term interest rates in the U.S. is too bearish further underpinning our USD view.