This Month in the Markets

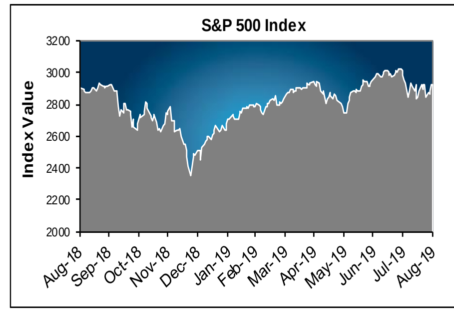
August 2019

ANCHOR
Investment Management

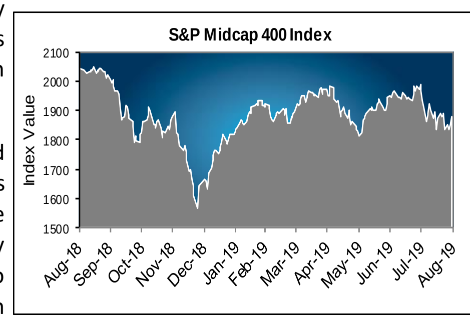
EQUITY COMMENTARY

Eating the Seed Corn

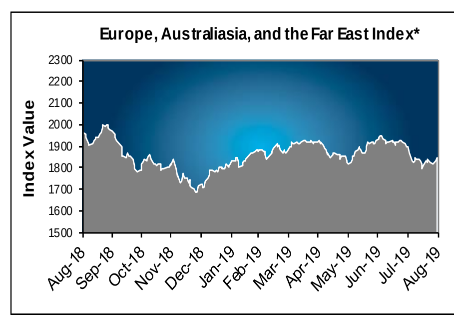
Equity markets retreated in August. The MSCI World Net Total Return Index fell 1% in the month with the U.S. market posting negative 1.6% return while the MSCI EAFE Net Total Return index slid 2.6%. The MSCI Emerging Markets Net Total Return Index dropped even further on Chinese trade posturing and Hong Kong civil unrest, posting a 4.9% decline. The utility sector recorded strong counter cyclical gains, rising 3.2%, as global trade concerns increased and interest rates declined. The MSCI World Energy Net Total return index continued its weakness, falling 7.4% on macroeconomic growth concerns and the slide in energy prices.



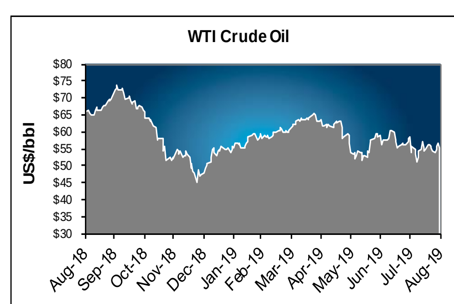
It has become less clear if China will make a trade deal with the Trump administration. If the Chinese believe that they could create economic dislocation in advance of Trump's run for reelection and knowing they subscribe to a "100-year view", it is becoming less of a probability that they will hammer out a deal in advance of November 2020. They may delay the negotiations if they believe an economic slow-down dramatically hurts Trump's bid for reelection and therefore increases the odds the Chinese can begin discussion on the trade front with a less acrimonious adversary post 2020.



If there is indeed a slowdown to come, what is the strategy? Typically, one would overweight or increase exposure to the less cyclical areas of the stock market, such as consumer staples and utilities. The problem, at this juncture, is that these sectors have already seen a surge in popularity on the back of yield and seekers and low volatility zealots. The S&P 500 Utilities Sector Index, for example, trades at a price earnings ratio of ~21 times – far in excess of the market in general and 20 year high! "Hiding out" in this defensive sector could turn out to be an "expensive" form of insurance when one considers the high valuation is also being applied to a sector growing at low single digits and offering its lowest yield in ten years as well. The consumer staple sector also appears over-valued after rising 18% in the first eight months of the year. We have eaten the seed corn before the harvest, and little remains to be planted after any potential drought in terms of traditional options. The solution is companies that benefit from slowdowns, companies that are not as cyclical as perceived (companies with stable recurring revenues and pricing power), and companies heavily discounted for non-economic reasons that will rebound once "clarity or perceived" risk lifts.



We added Berkshire Hathaway to the portfolio in August. Berkshire has been one of the most well studied companies in America with its legendary leader Warren Buffet. Many investors don't appreciate the advantage of the company's long-term thinking that avoids the pressures of other publicly trading companies. The solid balance sheet allows the investment team to step in and take advantage of market dislocation as we saw during the Financial Crisis. While Warren's investment track record has not been perfect, the investment philosophy of finding good management teams that run businesses with a wide mote has been very successful. Berkshire's 25-year average annual return has been 11.6% compared to 9.6% for the S&P 500. We believe that any future market turmoil will offer Berkshire opportunities many can only dream of.



*MSCI EAFE Index

FIXED INCOME COMMENTARY

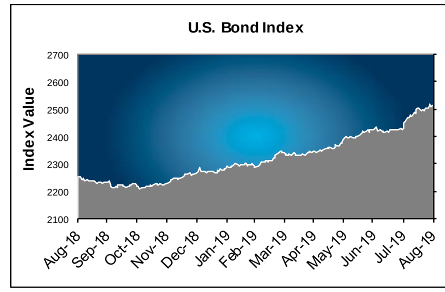
Lower Rates Abound

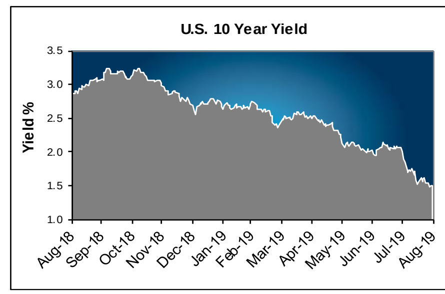
August was a volatile month for markets due to the further ramping of rhetoric regarding U.S. and China trade. However, there are other dark clouds lurking that could have far reaching consequences for markets including the Hong Kong protests, Brexit, and the budding Japan/South Korea trade dispute. Taken together these situations have caused significant uncertainty for markets. As a result, in August we saw volatility rise while interest rates fell precipitously, and the USD strengthened.

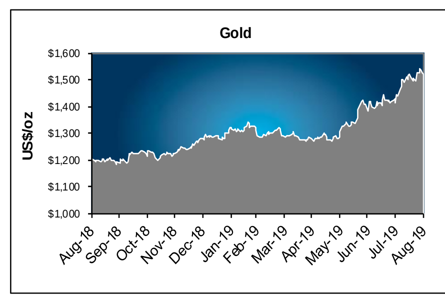
Given the interwoven nature of global supply chains, the trade war has contributed heavily to the slowdown in global growth and uncertainty. As of the end of September, 17 central banks have lowered their benchmark interest rate. Indeed, at the end of July the Fed cut the fed fund's rate by 0.25% commenting it was not the beginning of a rate cutting cycle, but a "mid-cycle adjustment" … an insurance cut against the uncertain outlook. This is very much at odds with market expectations of 2 cuts by year-end. Indeed, rates on the long-end of the Treasury curve fell by 0.5% in August, outpacing rate declines in the short end of the curve. As a result, the 2Y/10Y slope further inverted, historically a recession indicator over the next 12-18 months. It should be noted that consumer confidence remains very upbeat, as evidenced by consumption's strong contribution to Q2's GDP (2.0%). There is a clear disconnect between consumer/labor market strength and what interest rates are indicating going forward…

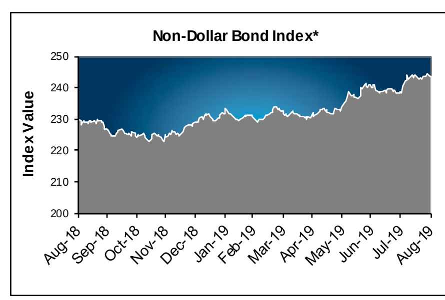
Moving on to Europe, in August the ECB set the stage to reintroduce its bond buying program (aka quantitative easing), as growth and inflation (actual and expectations) continue to disappoint. The ECB's benchmark interest rate stands at -0.4%. And according to the incoming ECB President Christine Lagarde, the ECB has not yet "hit the lower bound on policy rates." Translation, the ECB will not hesitate to lower their benchmark rate deeper into negative territory. It's a truly ludicrous notion for central bankers to believe that forcing already negative interest rates further into negative territory will kick start growth. Case and point, Germany's GDP contracted -0.1% in Q2 despite the entirety of Germany's sovereign yield curve now yielding less than 0%... or better yet, check out Japan and see how well it has worked out for them.

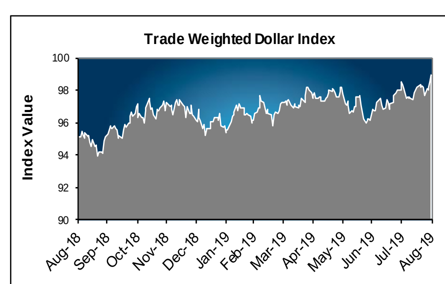
As of the end of August, there was USD-equivalent $16.8 trillion of negative yielding debt across Europe and Japan. The U.S. 30-year Treasury yield has fallen to a record low (1.93% at the time of writing). Debt markets are pricing in a low growth, low inflation world. While no one can predict the future, the risks are asymmetrically skewed against bond investors, especially longer duration bonds, if market conditions don't follow the path priced in. As such, we continue to favor a conservative tilt in the Anchor Fixed Income Portfolio.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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