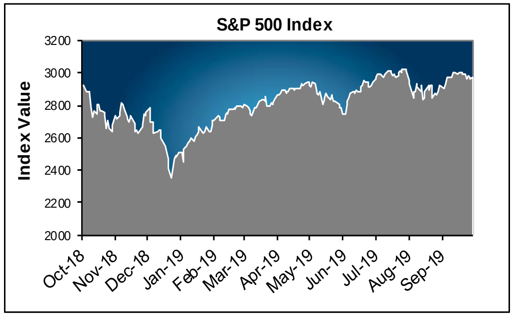
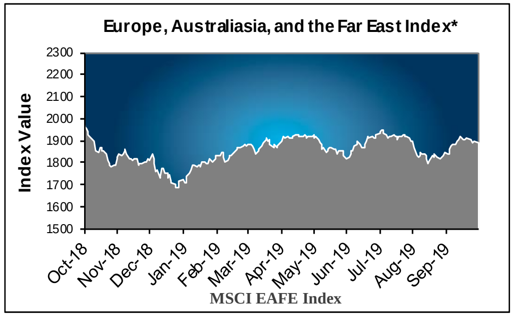
Stock Market Analysis

Hurricane season in the security markets





Political and economic headwinds across the globe kept stock investors on the sidelines in the third quarter after strong gains in the first half of the year.

The MSCI World Net Total Return Index posted a modest 0.5% gain in the quarter and has returned 17.6% in 2019. The trade war poses a significant risk to global growth as isolationism threatens the benefits of international trade. China has driven the global economy for two decades and tariffs may impact the progress of the Chinese 'economic miracle'. While some local companies may temporarily benefit from these tariffs, trade barriers make little economic sense, raising prices and hindering growth. A "trade truce" between China and the U.S. could provide a bounce to the markets but the expanded tariffs between Europe and the U.S. provides little evidence that the escalation of international hostilities will abate. The impact of the trade wars will be muted somewhat by efforts by the U.S. Federal Reserve and other central banks to lower interest rates and reflate their economies.

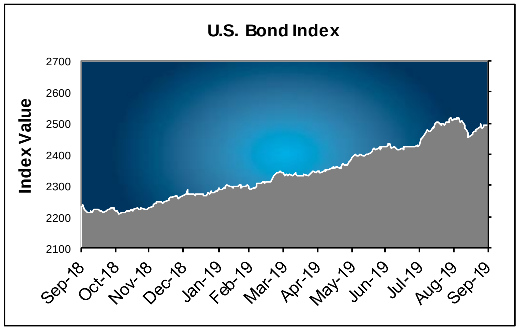
Rising healthcare costs related to changing demographics and aging baby boomers has become a major political issue around the world. Elizabeth Warren has gained support heading into the Democratic primaries. Her platform represents a major threat to the existing private healthcare system. Health insurance and pharmaceutical shares are now beginning to discount the possibility that socialized medicine could replace the current 'for profit' model. The S&P Health Sector underperformed the overall index by 15% in the first three quarters of the year. While there are some flaws in the U.S. healthcare system, there is little evidence that government run healthcare systems produce better patient outcomes and reduce costs.

Both U.S. and European bureaucrats are attacking the business models of the dominant U.S. internet companies. This has pressured the FANGs and presented us with an opportunity to add Amazon to the portfolio. Even in a period of economic stagnation, Amazon should produce mid-double digit revenue growth over the next three years. Amazon also owns the dominant cloud storage provider Amazon Web Services (AWS) which we believe is worth half the current share value of their parent. The economic moat and potential growth opportunities for Amazon's core online sales model is significant. Anchor already owns Google and Facebook based on valuation and potential growth opportunities and we now believe Amazon also represents a similar opportunity based on the current stock price.

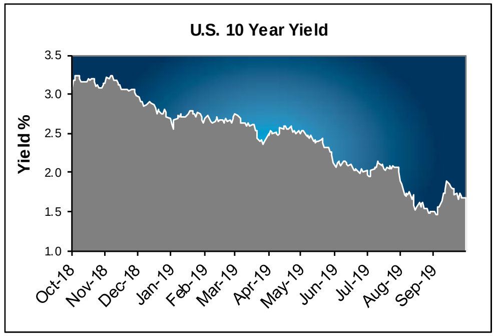
We also took profits in Disney and bought Viacom in September. The increased competition in over-the-top services requires more entertainment content. As Disney joins Netflix, Apple and Amazon in providing streaming services, independent entertainment content will become more valuable. We believe Viacom and our existing holding in Sony, will benefit for the demand of independent entertainment content. The merger of CBS and Viacom at the end of this year should give the new company the scale to compete in the growing entertainment sector. CBS will also benefit from increased advertising during the presidential race over the next 12 months. At 6 times earnings, Viacom is the cheapest company in the entertainment industry and offers investors a very compelling risk/reward profile

Fixed Income Analysis

Dissention in the Central Banking Ranks



Merrill Lynch US Corporate & Government Index



U.S. 10 Year Treasury Yield

The Federal Open Market Committee (FOMC) lowered the Fed Funds target rate 0.25% in September There was however, dissention in the ranks. Five of the committee members year-end forecast for the Fed Funds rate were at the pre-cut level. This suggests that these members saw no need for a rate cut. With a 3.7% unemployment rate and inflation close to the Fed's target (core PCE of 1.8% vs 2% target), one could make the case that the Fed is achieving their mandate. While disagreement is not uncommon, this is the largest dissenting faction in some time. On a side note, a number of European Central Bank (ECB) officials, including the head of the Dutch, French and German central banks, publicly disagreed with the ECB's September rate cut and resumption of QE. German ECB executive board member, Sabine Lautenschläger, resigned over the decision. The dissenters didn't believe lowering rates further into negative territory and further distorting the European rates market by purchasing more government bonds would have the desired effect of increasing economic growth. We agree with the dissenters…

In the September FOMC meeting, Chairman Powell said the FOMC would discuss potential balance sheet growth in the October 30th meeting. These comments were made due to the spike in repurchase agreement ("repo") rates which signaled a shortage of liquidity in the money markets. Repos, a form of short-term collateralized borrowing, are a key part of the monetary plumbing of funding markets. The spike in repo rates flowed through to other short-term funding sources, including the Fed Funds rate. As a result, the Federal Reserve Bank of New York offered (and is continuing to offer) term and overnight repo operations to ensure adequate liquidity and allow them greater control over the Fed Funds rate. These spikes in short-term funding rates have become quite common at quarter-end and year-end. However, the latest repo rate spike occurred in mid-September. Tax payment deadlines (need for cash) and a large Treasury auction (surge in collateral) were cited as the reasons for the repo rate spike, but many market commentators/analysts remain unconvinced. In truth, the repo market is far larger than the Fed Funds market; its smooth functioning is integral to banks operations. It was reassuring that the Fed stepped in quickly to provide liquidity, however it was also a red flag that a more permanent fix is needed. The Fed does not want to be the lender of first resort.

Despite the drama in short-term funding markets in September and bubbling geopolitics (escalating Hong Kong protests, U.S-Sino trade war), credit spreads were largely flat in September and Q3. Indeed, there has been considerable demand for corporate credit as evidenced by the huge issuance of investment grade debt in September, the third largest monthly issuance on record. With over $14 trillion USD-equivalent of debt globally and corporate profitability holding up, the reach for yield phenomenon that characterized much of the last 10 years has come back into play. However, we are now in the latter stages of the economic cycle. With significant geopolitical tensions, an inverted 3M/10Y yield curve, deteriorating leading economic indicators, and credit spreads at historically tight levels, we prefer to maintain a relatively conservative allocation in the Anchor Fixed Income portfolio.