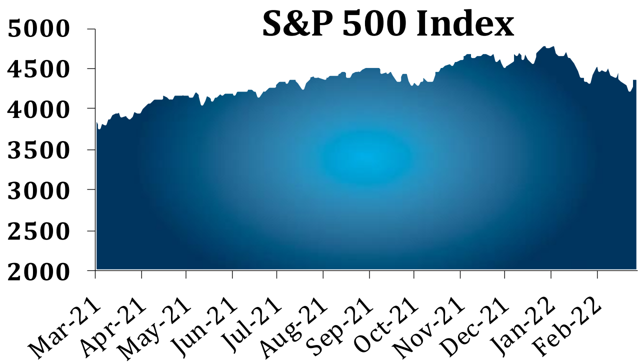
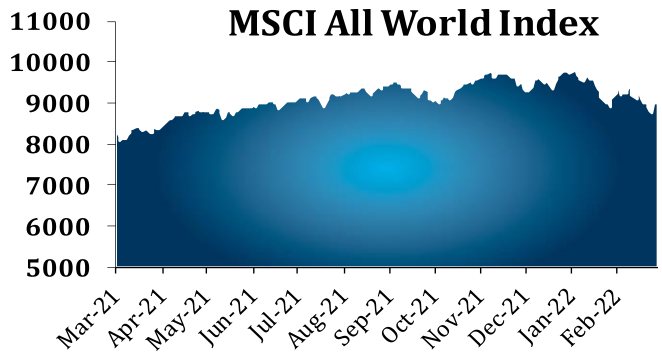
Stock Market Analysis

War Concerns and Inflation Hurt Stock Returns





After solid gains in 2021, the financial markets faced numerous challenges in the first quarter. Russia's invasion of Ukraine kindled inflationary pressures, leading global central bankers to tighten monetary policy. Commodity prices spiked, led by the energy sector. Brent Crude prices jumped 39% and natural gas prices surged 60%. The energy sector experienced strong gains in the quarter with the MSCI ACWI Energy sector gaining 20.2%. Investors sold consumer discretionary stocks on concern that higher inflation and interest rates will crimp personal spending. The MSCI ACWI Consumer Discretionary sector was the weakest sector, losing 11.5%. Rising discount rates also hurt high valuation shares, as the MSCI ACWI Information Technology sector lost 10.4%.

Anchor successfully managed the market volatility by increasing commodity stock exposure, producing strong alpha in the quarter following strong returns and alpha in 2021. **The Anchor Equity Portfolio returned -0.4% in the quarter and 15.5% over the past 12 months compared to -5.1% and 7.5% for the MSCI All Country World Net Total Return Index benchmark. The Anchor High-Quality Income Portfolio also outperformed, returning 3.1% in the quarter and 15.1% in the trailing 12 months period versus 2.8% and 7.8% for the benchmark. ***

Looking forward, we are in untested waters. Central banks around the world are attempting to fight rampant inflation by unwinding unprecedented monetary stimulus. This will be a dangerous balancing act as they want to avoid an economic contraction. Corporate margins will be impacted with companies finding it difficult to pass on higher costs. Supply chains issues persist, causing companies to carry higher inventory levels. While we believe that corporate profits will be dampened over the next several quarters, companies have already been tested over the past two years due to the Covid pandemic. Certain management teams have proved that they can gain market share and prosper in challenging periods.

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We used the March pullback, especially in European shares, to buy three companies that we believe will prosper going forward: Adidas, Siemens, and Target. At the same time, we took profits in Abbvie, which hit our target price, and ING, which we believe is vulnerable to downgrades due to the impact of the Ukraine war.

Adidas (ADS GR) engages in the design, manufacture, and distribution of athletic goods. In last month's Adidas innovation event, management was confident in their 2022 and 2025 targets despite macro concerns. They introduced 7,000 new products at the event, and they laid out their plans for strong growth over the next five years. This comfort is anchored by an upbeat view of how upcoming innovation will stimulate demand later this year, backed by what analysts state to be a strong order book. The forthcoming World Cup should help boost sales this year.

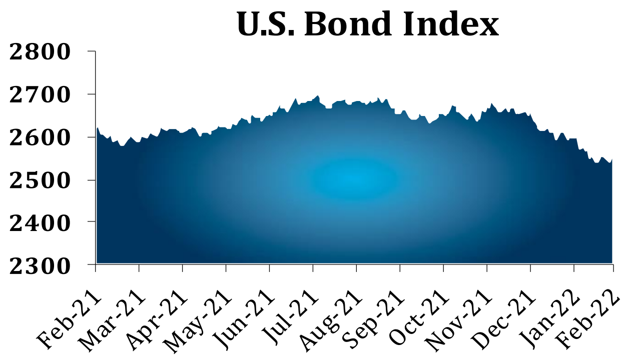
Siemens (SIE GR) should participate in several key macro themes developing today. Its major businesses involve attractive end markets, including digital industries, medical equipment, smart infrastructure, and mobility. As companies continue to invest in automation and digitization of manufacturing, Siemens will be there to offer a suite of products. The green transformation should increase revenue in both its smart infrastructure and mobility operations (think hydrogen trains). The company has a highly defensible business position that boasts units where switching costs are high, scale is significant, and its intellectual property portfolio offers recurring revenue. Despite this solid competitive position, the company also comes at a substantial discount to its peers.

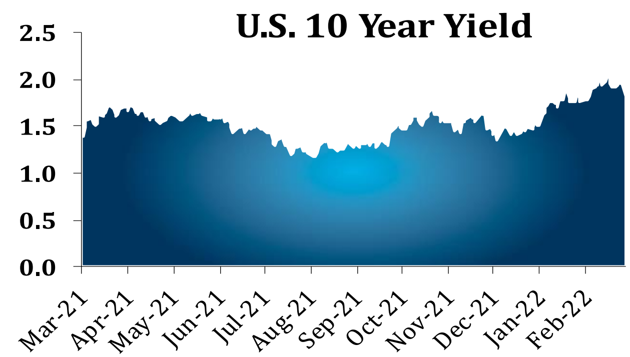
We also added Target (TGT). Americans have become increasingly accustomed to buying goods at a discount, and retail is moving to an omnichannel model. To remain competitive against the internet behemoth, Amazon, retailers need scale, distribution, sourcing, unique brands, and technology. Target has made significant investments in all these areas and is positioned well to take market share from its weaker competitors, who are shuttering stores. The $106 billion U.S. retailer reported better-than-expected fourth-quarter earnings, exceeding analyst estimates by 11%.

**Performance is based on Anchor composite portfolios after transaction and administration costs but before management fees. Past performance does not guarantee future returns*

Fixed Income Analysis

The Rise of the Rates





The first quarter of 2022 was one of the worst periods for the bond market in recent history. Interest rates rose significantly, driven by an increasingly hawkish Fed and inflationary implications of the Ukraine invasion (energy prices, agricultural impact, supply chains). During the quarter, the yield on the 2-year treasury rate rose by +1.50% to 2.33%, while the yield on the 10-year rose +0.82% to 2.33%. As the quarter progressed, market participants increasingly priced more fed fund rate hikes to come in 2022. According to fed fund futures, the fed funds rate is expected to end the year around 2.40%. For context, the fed funds rate was 0.33% on March 31, 2022, implying a significant pace of monetary policy tightening to come. This includes consensus expectation for multiple 0.50% hikes. While treasury rates rose, they did not rise in equal amounts across the treasury curve. The treasury curve continued to flatten in March, led by the short end of the curve (pricing in the expected fed funds rate increase). As a result of short-term interest expectations, the yield curve has largely inverted. For example, at the time of writing both the 2-year to 10-year and 5-year to 30-year slopes are inverted. The bond market is signaling investors' concerns that the Fed will overtighten and adversely affect the economy. Both fed fund futures and Eurodollar futures are indicating short-term rates will peak in 2023 and then decline in 2024.

The first quarter was a reminder to investors that, like equities, bonds also bare risk. Treasuries are widely perceived to be "safe" investments, almost cash-like, and generally a lower risk investment than corporate credit. This is certainly true with regards to credit risk specifically, however interest rate risk (duration) must also be considered. The duration of the Bloomberg US Treasury index (6.9 years), and the ICE BofA US Investment Grade index (7.9 years), are much higher than the ICE BofA US High Yield index (4.2 years) due to higher coupons for high yield debt. As such, treasury and investment grade bonds on an index level are more vulnerable to rising interest rates, particularly longer-term rates where the impact on bond prices is greater. Given interest rates rose materially, and credit spreads only widened marginally, high yield bonds outperformed "lower risk" investment grade corporate bonds and treasuries in Q1.

Fixed Income Analysis

At Anchor we utilize a 1-10-year laddered portfolio strategy which limits our duration risk. For example, the ICE BofA US 1-10 Year Corporate Government Index returned -4.5% (duration of 4.0 years), outperforming the ICE BofA US Corporate Government Index (duration of 7.2 years), which declined 6.25%.

With regards to credit risk, the high yield index has more credit risk than the investment grade index. However, there are nuances within this. For instance, the investment grade market contains a large percentage of BBB-rated exposure (approximately 50% of the index). The BBB-rating bucket is the lowest rating cohort in the investment grade universe. Meanwhile, the high yield index has a large proportion of BB-rated exposure (approximately 50%). The BB-rating bucket is the highest rating cohort in high yield universe. In addition, high yield universe has a large component (20%) of energy and basic industry sectors which have benefitted from the rise in commodity prices.

The Fed is in full tightening mode to tackle inflation. The Consumer Price Index (CPI) rose 7.9% year-on-year in February 2022. With the Fed due to begin reducing the size of the balance sheet as holdings roll-off, it will be interesting to see how risk assets fare in the face of this double tightening (raising the fed funds rate and reducing the balance sheet). As we wrote in prior report, this double tightening came to an ugly conclusion in Q4 2018 with falling equities and wider credit spreads. In that instance the Fed reversed the tightening course to stem the financial market stress. CPI inflation averaged 2.2% in December 2018 versus 7.9% at quarter-end. The implication is the Fed had leeway to reverse course in 2018. Given the tight labor market and elevated inflation, we would argue the fed has no such leeway at present. As such we continue to view corporate credit through a cautious lens given the elevated valuation (tight credit spreads) on the backdrop of higher energy prices, supply chain issues, and an increasingly hawkish Fed.