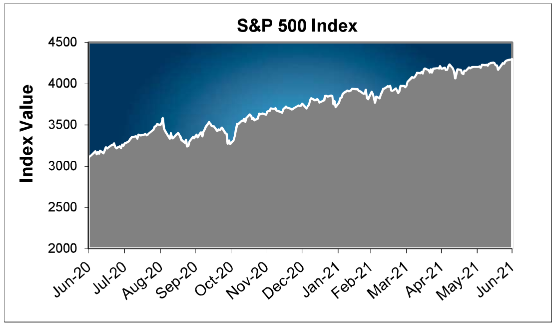
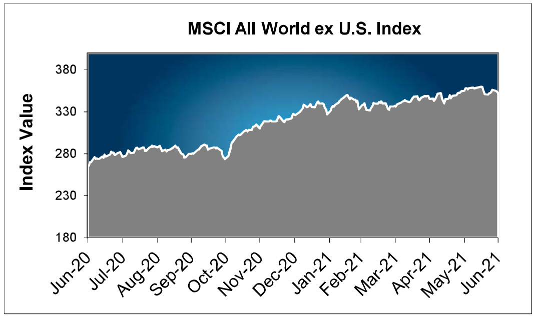
Internal

Stock Market Analysis

Where do we go from here?





ANCHOR
Investment Management

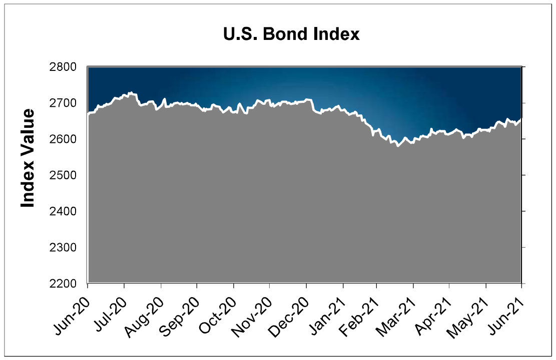
It has been a heck of a journey over the past 16 months. Investors have ignored the impact of the COVID pandemic and driven stock indices to new records. The S&P 500 Index closed the quarter at a record high. The MSCI All Country World Net Total Return Index produced a 7.5% return in the second quarter and 12.5% in the first half of 2021. Some investors are concerned that there is risk in the equity market after the MSCI benchmark has doubled over the past five years. While equity valuations have risen, monetary and fiscal stimulus, persistently low-interest rates, and the prospects for sharply higher corporate profits have buoyed the equity market. The market is discounting a strong earnings rebound during the reopening of the global economy, following the successful vaccination program in many developed markets. This does not mean that there are not some excesses in the financial markets. Periods of low-interest rates and monetary stimulus have historically increased risk-taking, so there appear to be some speculative bubbles both in the stock and bond markets.

We believe that stock selection is critical in this period. Anchor's equity portfolio produced a return of 7.7% in the second quarter and 16.5% year-to-date, outperforming the MSCI ACWI benchmark by 0.4% in the quarter and 4.7% in the first half of the year (excluding management fees). The gains in the quarter were led by technology and healthcare shares. Energy has been the leading sector in the first half of the year, with the MSCI energy sector surging 26.5% as crude prices rose 55%. The Anchor equity portfolio has benefited from our overweight position in this sector. The decision to add companies that benefit from an economic recovery has contributed to the portfolio performance. We also believe that quality companies with a solid economic moats and high returns on invested capital will continue to produce superior returns.

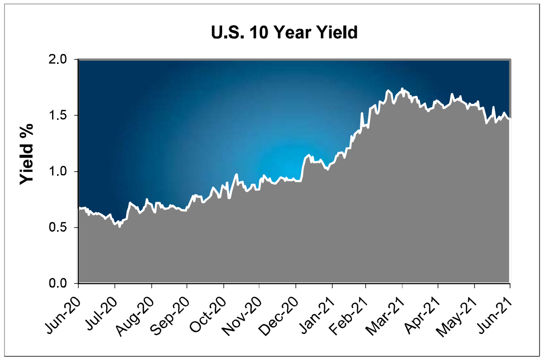
Some market participants are concerned about the rise in inflationary pressures, but we agree with comments from most central bankers that this pressure appears transitory. A close look at the employment data indicates there remains plenty of slack in labor market, which will limit persistent wage pressure. With that being said, we are in uncharted water on central bank policy, and our team is monitoring inflationary pressures as monetary policy is normalized. As we enter the second-quarter earnings season, we expect strong profit growth with easy comparisons to last year. We expect growth rates to normalize in the second half of the year; therefore, security selection and valuation are essential.

Fixed Income Analysis

All Eyes on the Second Half of the Year



Merrill Lynch US Corporate & Government Index



U.S. 10 Year Treasury Yield

After rising in the first quarter, Treasury rates trended lower in the second quarter despite significant year-over-year inflation prints and a feverish media inflation narrative. The ten-year treasury yield declined -0.28% in the second quarter, ending June at 1.47%. The U.S. dollar was a bit weaker in the period as per the 0.9% decline in the DXY index. This was driven by a decline in interest rate differentials and the Euro area reopening, which has lagged that of the USA (the euro appreciated 1.4% versus the US dollar the quarter). Meanwhile, credit spreads continued to narrow with investor appetite for corporate credit strong as we remain entrenched in a reach-for-yield environment.

Anchor positioned fixed income portfolios with an overweight in corporate credit since April of last year. After a very strong run over the past 12 months, we are planning to reduce the corporate credit exposure. This will be achieved by replacing maturing and called bonds with treasuries. Simply, put, valuations are stretched, and the risk-reward trade-off is no longer attractive. For example, many bonds are trading near to or even through their call prices. In addition, credit spreads of the lowest-rated cohort of the corporate credit market (CCC bonds) are at the tightest spreads since 2007. Absolute yields of the investment grade and high yield bond indices are near record lows and almost two standard deviations below the long-term average. While credit spreads can remain depressed for long periods of time, they will not remain so indefinitely. Corporate bonds are typically traded over the counter and are not as liquid as stocks. As such, when sentiment sours, volatility can rise very quickly (especially if there is a market-wide rush to the exit door). It is impossible to say when a correction will occur, but we prefer to be patient instead of chasing yield at unattractive levels. We successfully used this strategy last year and believe that adding some “dry powder” with liquid treasuries is prudent at this time.

Every quarter the Fed releases projections from members of the Federal Open Market Committee (FOMC) expectations for the path of the fed funds rate (“Fed dots”), as well as forecasts for GDP growth, inflation, and unemployment rate. Each prediction is the member’s own; the forecasts are not debated and are not meant to be viewed as a unified FOMC opinion/forecast as not every FOMC member is a voting member. However, given the Fed’s use of forward guidance to inform the market of its thoughts on monetary policy, the dots and projections are closely followed by the bond market in particular. In the June fed fund rate projections there was a notable increase in forecasts for a rate hike by year-end 2022 (5 dots versus 3 in March 2021), and the median projection was for at least two rate hikes by year-end 2023 (compared to zero hikes as of March 2021). In addition, the median estimate for inflation (Personal Consumption Expenditure or PCE) rose to 3.4% YoY from 2.4% in the March release, while the median projection for 2021 real GDP

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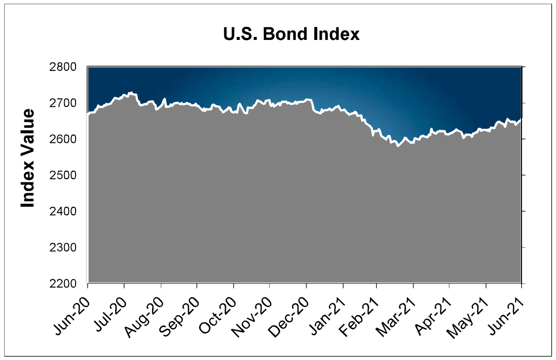

Merrill Lynch US Corporate & Government Index

U.S. 10 Year Treasury Yield

growth rose 0.5% to 7.0% YoY. In the June 16th, press conference Chairman Powell was keen to downplay the importance of the individual forecasts and interest rate projections, however, the market largely ignored his remarks, interpreting the release as a more hawkish tilt. Treasury yields in the 2Y-5Y part of the curve rose. This portion of the yield curve is most sensitive to changes in fed funds rate expectations. As a result of this move and the decline in longer tenor treasury rates, the yield curve flattened in Q2 (the 2Y-10Y slope fell -0.38% to 1.22%), with the majority of the flattening occurring post the June FOMC meeting.

As we move into the second half of 2021, we have a FOMC that appears less dovish on the margin; however still believes inflation will be “transitory.” As we pointed out last month, the inverted breakeven curve and low long-term treasury rates indicate the market agrees with the Fed’s inflation view. With YoY inflation base effects set to decline going forward, we’ll get a better sense of just how transitory (reported) inflation actually is. If inflation remains elevated and above market expectations, we could see another increase in treasury rates and a change in stance from the Fed. This could have flow through to risk assets, including corporate credit. In addition, the market is awaiting asset purchase tapering plans from the Fed. Considering the markets' reaction to the 2013 tapering announcement, this is another potential risk to the bond market. An announcement is widely expected within the next three months.