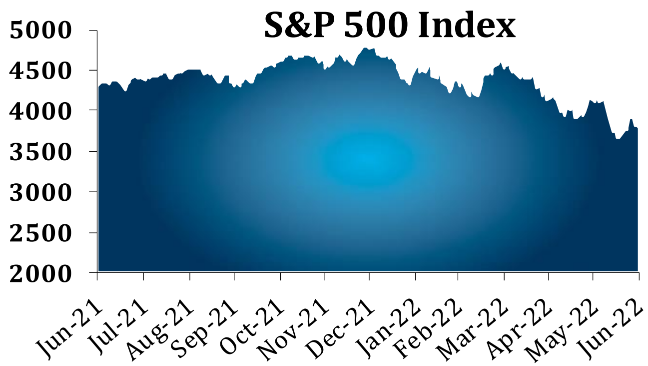
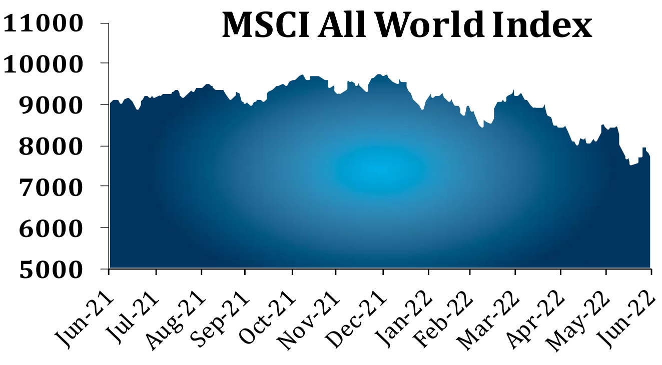
Internal

Stock Market Analysis

Fighting Inflation Has Consequences





Most investors were not around fifty years ago when Paul Volker and other central bankers battled to bring down double digit inflation following the 1970's energy crisis. It was a painful time for financial markets, but the tough central bank action led to a prolonged rally in bonds, bringing interest rates to historic lows. More importantly, developed markets have witnessed fairly stable low inflation rates for a half century. With 20/20 hindsight economists could have predicted that the tight labour markets, supply chain issues, monetary and fiscal stimulus and a rebounding global economy following Covid would stoke inflationary pressures. But the Ukraine war is what ultimately sparked the inflation flame, as the World realized that the lack of investment in fossil fuels made the World dependent on unreliable energy suppliers, such as Russia. While this period will likely hasten the move away from fossil fuels over the next several decades, we remain depend on them until then.

Rising inflation and interest rates has caused most investment asset classes to decline this year with the losses accelerating in the second quarter. According to Bloomberg, the second quarter was the worst quarter for their model 60/40 portfolio (60% equity/40% fixed income) in 35 years. The correlation of performance of asset classes has been caused by tighter monetary policy and slowing economic growth. The 10-year U.S. treasury yield has increased to 3.0% from 1.6% since the beginning of the year and from 2.3% at the end of the first quarter. U.S. CPI inflation has surged to 8.6%, the highest in 40 years, compared to 1.5% at the start of 2021. The Fed Funds rate went from 0% to 1.75% and the Fed now expects the rate to peak at 3.75% in 2024. Most investors expected a slow unwinding of the unprecedented monetary stimulus that occurred during the Covid-19 pandemic, but the sudden increase in inflation this year has caused hawkish central bankers to throw on the emergency brakes on the economy.

Stock Market Analysis

ANCHOR
Investment Management

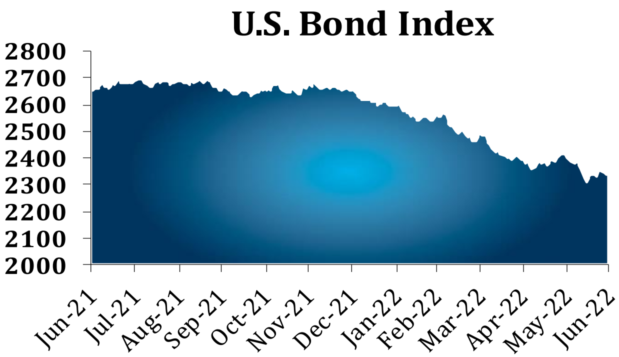
The U.S. stock market produced the worst first half returns since 1970 as the S&P 500 sank 20.6%. The losses were driven by technology and consumer discretionary shares. The MSCI ACWI Information Technology and Consumer Discretionary sectors tumbled 30% and 29.7% respectively in the first half. While Anchor successfully limited the losses in the first quarter the portfolio was dragged down in the second quarter by the broad selloff. The Anchor Equity Portfolio returned -15.6% in the first half of 2022 and -8.9% over the past 12 months compared to -19.4% and -14.9% for the MSCI All Country World Total Return Index benchmark. The Anchor High-Quality Income Portfolio continues to hold up better in the volatile equity markets, returning -2.6% in the first half of 2022 and +3.7% over the trailing 12 months period versus -3.0% and -2.3% for the SG Quality Income benchmark. *

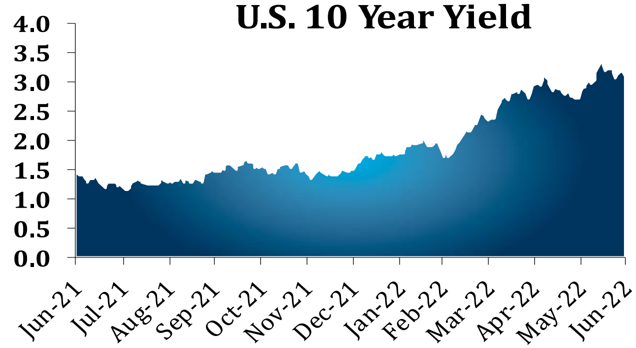
The question going forward is how deep will the economic slowdown be and how long will it last? Investors have clearly voted that it will be fairly painful for corporate profits as major international benchmarks have fallen more than 20% this year. The war in Ukraine has increased risk premiums and complicates economic scenario analysis. The bright spot as we exited the second quarter is some inflation expectation measures indicated the central bank actions are working. The U.S. Treasury 10-year yield fell from the June peak of almost 3.5% down to 3.0%. Investors will start looking beyond the impact of the tightening central bank action and focus on the eventual economic recovery. We all know the market is a forward-looking mechanism and therefore we expect that shares will recover when investors are comfortable that the worst is behind us.

**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

More Volatility





As has been the case throughout the year, volatility remained a common theme in June. The MOVE index, a proxy for treasury rate volatility, rose 26% in June to 135.5. For reference, the MOVE index ended 2021 at 77. This volatility has been plainly evident as the 10-year treasury traded in a huge 0.63% range in June. After beginning the month at 2.84%, the 10-year yield rose 0.42% over just three trading days on the back of hotter than expected inflation data, peaking at 3.47% on June 14th. Thereafter, it trended downwards driven by escalating recession fears. The 10-year yield ended the month at 3.01%. A similar theme played out in the 2-year yield, which traded in a whopping 0.87% range.

Chairman Powell has been very clear about the Federal Reserve's focus on bringing inflation back down to its 2% target. In his June Federal Open Market Committee (FOMC) press conference, he cited positive real yields across the curve, "a series of declining monthly inflation readings", and lower inflation expectations, as factors they would like to see to feel they have inflation under control. Regarding inflation expectations, he specifically cited the household survey "University of Michigan Expected Change in Prices During Next 5-10 years: Median" index (currently at 3.1%). Interestingly, market-based measures of inflation expectations over 5 and 10 years are significantly below this University of Michigan index. For example, the 5-year and 10-year break-evens (the difference between treasury and treasury inflation indexed securities of equal tenor) ended June at 2.61% and 2.35%.

Powell is maintaining a very hawkish stance, while the U.S. economy is clearly slowing. The Atlanta GDPNow Forecast is in negative territory, predicting Q2 GDP will be negative. If this does occur, it would technically mean the U.S. is in recession since there was already negative growth in the first quarter. In addition, consumer sentiment surveys and CEO sentiment surveys continue to deteriorate. On the other hand, consumer balance sheets are in good shape, and the labor market remains robust. Throw in hawkish central banks globally (except Bank of Japan), the war in Ukraine, elevated energy prices, as well as China emerging from lock-down, and you have a very complex backdrop… which brings us back to interest rate volatility…

Fixed Income Analysis

Much of the interest rate volatility we've seen in 2022 has stemmed from a high degree of uncertainty in forecasting/pricing how aggressively the Fed will hike interest rates. At the end of May, the December 2022 fed fund futures contract was trading at a yield of 2.61% (implying the effective fed funds rate will average 2.61% in December). By June 14th it had risen to 3.54% before ending the month at 3.24%. A considerable increase in fed funds expectations in just one month! This is significant because treasuries are the global risk-free assets. It's unlikely risk assets, such as corporate bonds and equities, will exhibit low volatility if the market is struggling to confidently price short-term interest rate expectations. The market doesn't like uncertainty. This uncertainty has filtered through to other asset classes. Case in point, credit spreads continued to widen in June. Credit spreads are approximately 1 standard deviation over the 10-year average. However, on a longer time frame corporate credit doesn't look as attractive. Credit spreads are at the 20-year average approximately. Spreads also remain well below periods when the U.S. economy is in recession. Given the backdrop discussed above, we are comfortable maintaining our underweight exposure to high yield credit.