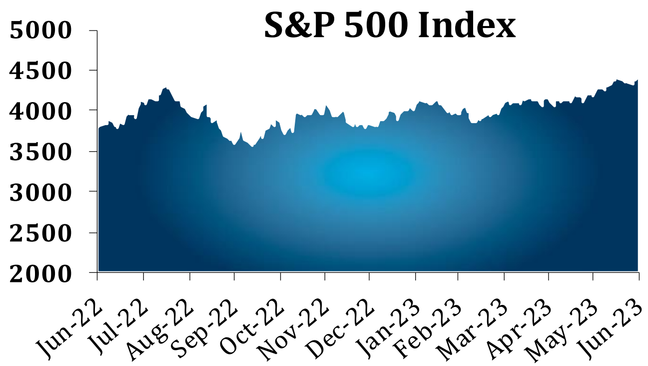
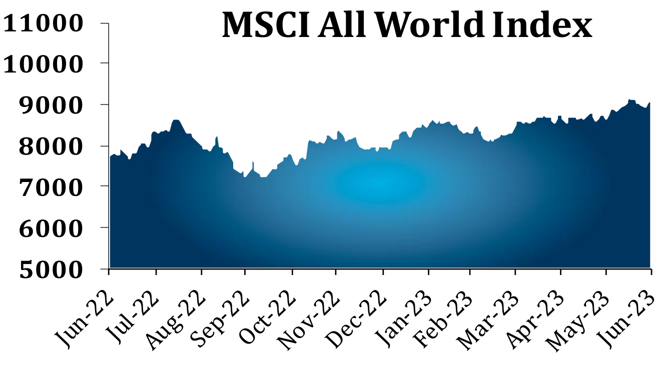
Internal

Stock Market Analysis

Economic Resilience





Not many experts would have predicted that equity markets would produce double digit gains in a period of record increases in central bank interest rates and persistent inflation. While it is premature to give the green light to the global economy, economists have been surprised by the resilience of consumer and corporate spending in this period of tight money. Excess Covid savings and rising wages have offset the impact of rising prices and lending costs. The markets are also forward looking, and central banks have indicated that their tightening cycle is almost over. Short-term rates are expected to gradually decline from current levels over the next three years. The stabilization of the banking sector in the second quarter also calmed fears of a systemic banking crisis. The U.S. equity market has performed better than global market indices, primarily due to the large technology sector, with investors focused on artificial intelligence ("AI") related shares. The S&P 500 Index produced an 8.7% total return in the second quarter and 16.9% in the first half of the year (3% better than the MSCI ACWI Index).

The breadth of the market was weak with the cap-weighted indices performance driven by tech megacaps. The Nasdaq Composite surged 32.3% in the first half of the year while broader indices such as the Russell 2000 or S&P 500 equal weighted indices were only up 7.2% and 6.0% respectively. The "Big Seven" (Apple, Microsoft., Alphabet, Amazon, Meta Platforms, Nvidia, and Tesla) drove the major indices as analysts forecast a strong recovery in their earnings this year after their profits slumped in 2022.

Looking forward, data shows signs inflation is moderating, and we believe central banks aggressive tightening will ring out the damaging impact of higher prices. There are clear opportunities from the artificial intelligence revolution. While many investors fear a repeat of the tech bubble two decades ago, no one will deny that the internet changed our lives.

Stock Market Analysis

Most of us use Google, Amazon, Facebook, Instagram, Messenger and iPhones in our daily lives. Families can now make video calls to loved ones around the World with a simple internet connection. We have invested a portion of the portfolio in growth stocks that should participate in the new AI revolution. Our research indicates that there will be significant innovation caused by AI which should transform the way individuals and businesses use the internet. We now have instantaneous access to computer power using machine learning languages that matches and, in some cases, exceeds the capacity of the human brain. The full impact is still not understood but it is clear we will see numerous implementations of AI in our lives over the next decade. This should improve productivity and our standard of living.

While we believe AI should benefit corporate profits, it is important to make rational assumptions when valuing individual company prospects. There are elements of the market that appear over-extended, but most stocks have not participated in the tech-surge. We continue to find under-valued companies which should perform well when investors look past the economic downturn and the market breadth improves. We believe that in the current market environment it is important to be selective and conduct thorough research into what you own.

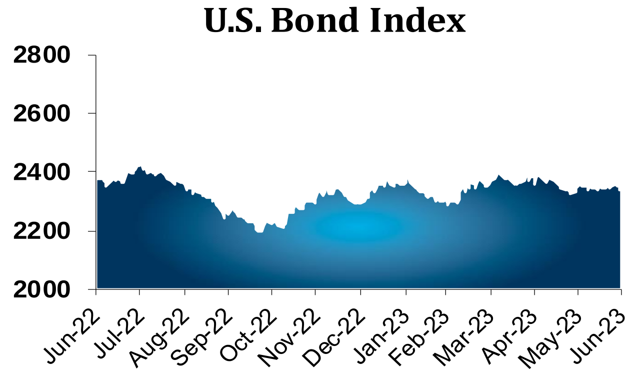
The Anchor Equity Portfolio Composite returned 6.8% in the second quarter and +15.1% year to date compared to 6.2% and 13.9% respectively for the MSCI All Country World Total Return benchmark. Despite the 2022 selloff, the portfolio has produced a +13.7% annualized return over the past three years compared to +11.2% for the benchmark.

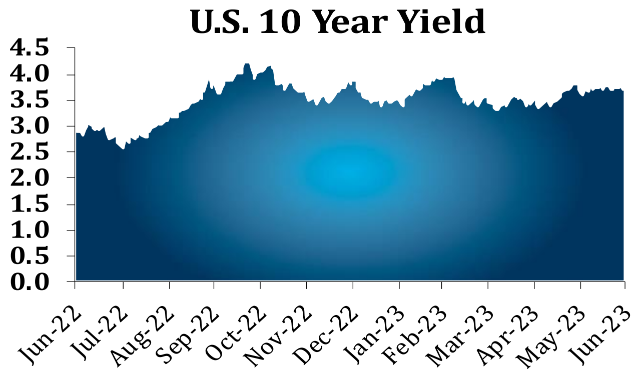
The Anchor High-Quality Income Portfolio held up much better than the major global stock indices during the 2022 market selloff, falling only 0.6% compared to -2.9% for the SG Global Quality Income benchmark and -17.4% for the MSCI All Country World Total Return benchmark. The HQ Composite returned 0.4% in the second quarter and 2.9% in the first half of 2023 compared to -1.0% and 3.7% respectively for the SG Global Quality Income benchmark. The portfolio has produced an annualized return over the past three years of +10.7% compared to +7.1% for the benchmark. *

**Performance is based on Anchor equity composite portfolios. Returns include changes in unit value, reinvestment of all distributions, investment management fees, execution, custodial and other charges. Investment results are best judged over the long term. Performance should be evaluated with consideration of the client's specific goals and investment objectives. Past performance is not necessarily indicative of future results. Returns for indices or benchmarks are provided in U.S. dollar terms and solely for informational purposes. These indices or benchmarks are non-managed indices that do not accrue advisory or transactional expenses. Benchmarks are based on the client's selected asset allocation and are calculated in U.S. dollar terms. The Anchor Equity Portfolio benchmark uses the MSCI AC World Total Return Index. The Anchor High Quality Income Portfolio benchmark uses the SG Global Quality Income (USD) Index.*

Fixed Income Analysis

Central Banks Continue To Hit The Brakes





In June we saw a swath of central banks raise rates in an effort to extinguish inflationary pressures. The Reserve Bank of Australia and Bank of Canada were the first to kick-off the interest rate hiking party. Both central banks had paused hiking rates earlier in 2023, preferring to give time for the monetary tightening of 2022 to filter through to their economies. Given the highly valued housing markets and floating/adjusted rate dominance of mortgage debt in both countries, both central banks were wary of overtightening. These actions were followed by hikes from European Central Bank (0.25%), Bank of England (0.50%), the Swiss National Bank (0.25%), the Norges Bank (0.50%), and the Riksbank (0.25%), with each citing some combination of unexpectedly resilient consumer and/or labor markets and the potential for this to underpin inflation above their targets. In general, the guidance was to expect more hikes going forward. The Bank of Japan (BOJ), however, left rates unchanged in June. The BOJ is the only central bank still employing yield curve control, whereby it caps the 10Y Japan government bond yield at 0.50%. The BOJ reiterated the need for patience as it is unconvinced that current price pressures will prove durable. Headline Inflation in Japan (3.2%) has been above the BOJ's 2% target for the last 13 months; core inflation (4.3%) has been over 2% since September 2022. As a result, the yen has weakened versus the dollar by ~10% this year, due to widening interest rate differentials; at 144 JPY/USD is nearing the 150 JPY/USD low reached in 2022.

As was expected by the market, the U.S. Fed left the fed funds rate unchanged in June, though they did provide an updated "Summary of economic expectations" and an updated Dot plot. The 2023 year-end expectation for the unemployment fell to 4.1% from 4.5% (March expectation), while GDP growth is now expected to come in at 1% versus the 0.4% expectation in the March report. Indeed, these improvements were reflected in the Dot plot. As a reminder, the DOT plot is comprised of individual Federal Open Market Committee (FOMC) member's expectations for the path of the fed funds rate at year-end 2023, 2024, 2025, and longer-term.

Fixed Income Analysis

The median FOMC member fed funds rate projection for year-end 2023 rose from 5.125% in March to 5.625% in June. This implies two more rate hikes in 2023. Indeed, in the press conference, Chair Powell said, “A strong majority of committee participants expect that it will be appropriate to raise interest rates two or more times by the end of the year.” At the time of writing, fed fund futures are pricing in an 85% change of a 0.25% hike in the July 26th FOMC meeting, however for that to be the final rate hike of the year.

Chair Powell’s worry is that a too resilient economy will allow inflation pressures to remain intact, even though inflation data is clearly trending lower. At the time of writing, Truflation’s gauge for US inflation is 2.22% year-on-year (YOY), compared to 4% for headline Consumer Price Index (CPI). As a reminder, the Truflation inflation rate is calculated by a private company which updates its myriad of inputs daily to give a real-time inflation gauge. Turning to government reported inflation figures, we see that the so called “super core inflation” (inflation rate excluding food, energy, and housing/shelter components) continues to fall, both on a YoY and 3-month annualized basis – Super Core CPI was 2.9% and Super Core PCE was 3.8% on a 3-month annualized basis as of the June data. Chair Powell has cited the super core measure as an important metric to watch given its influence on wage growth and as a guide for inflation pressures. On that matter, the labor market has clearly been more resilient than Powell expected. The total job openings (as reported by the Bureau of Labor Statistics) are 1.8x the number of unemployed. This metric has been above 1.7x since the beginning of 2022, compared to ~1 pre-COVID. Weekly initial jobs claims haven’t shown a material uptick, and while continuing jobless claims have risen from the lows of 2022, they remain at levels that point to a tight labor market. Chair Powell is likely to continue talking tough on the ‘higher for longer’ mantra for rates as long as the labor market holds up. The risk to this approach is employment has historically been a lagging economic indicator.

The Conference Board Leading Economic Index remains on its downward trend, while purchasing managers’ indices (PMIs) are also weakening. All three U.S. manufacturing PMIs are in contractionary territory, while we are seeing mixed signals from Services PMIs. Taking this and stubbornly hawkish central banks into consideration, we continue to prefer conservative positioning with respect to credit risk. We don’t view the risk-reward trade-off in high yield bonds as attractive at this point, however we remain overweight investment grade credit. We anticipate increasing duration (interest rate risk) as we move into the second half of 2023.

ANCHOR
Investment Management

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