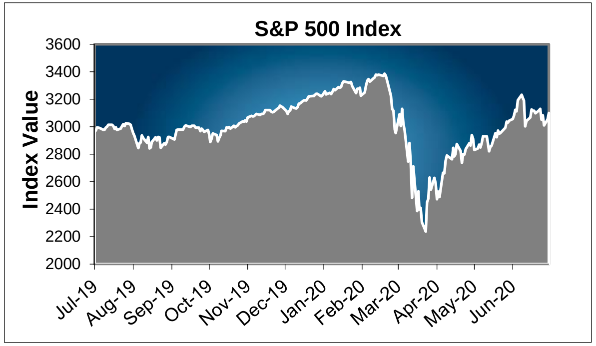
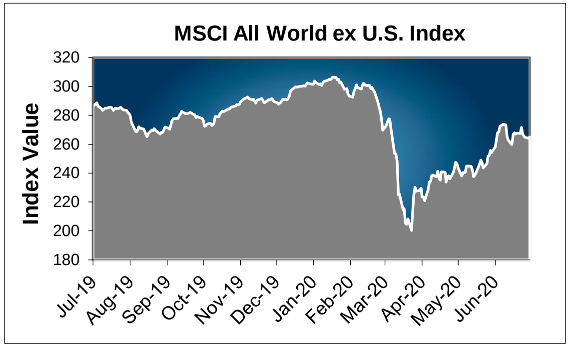
Stock Market Analysis

Market Rotation





ANCHOR
Investment Management

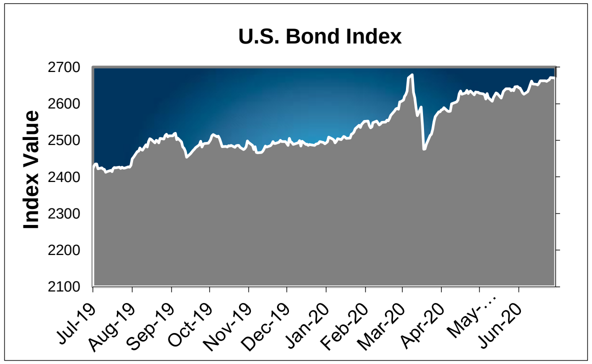
We have discussed the narrow breadth in the stock market leadership this year due to investors' uncertainty about the potential economic recovery. The focus has been on the stocks that have benefited from work from home, online retailing, fitness, gaming, and other entertainment trends. The question that many experts are asking is, do these companies deserve to sell at historically high premiums relative to other stocks, and what happens to the market if their valuations compress? Their out-performance relative to the broad market produced a distorted impact on the market indices. This can be seen in the market weightings of the S&P 500, which is dominated by the large technology names (Amazon, Apple, Google, Facebook and Microsoft). These five stocks now represent 22.5% of market cap weighted S&P 500 Index and are up 40% on average in 2020. The strong performance explains why the S&P 500 index is up 4.1% this year while the average company in the benchmark is down 6.3%. The same five names are the largest weightings in the MSCI All-World Index, representing 11%, followed by the Chinese technology behemoths, Alibaba and Tencent. The distortion in the market cap weighted indices has impacted Anchor relative performance since Anchor’s stock positions are equal weighted. Over the past three years Anchor’s equity composite has produced an average annual return of 4.5% (excluding management fees), compared to 1.8% for the MSCI All Country World Equal Weighted Net Total Return Index. This compares to the equivalent market cap weighted MSCI AC index which returned 7.1% annually over the same period.

In September, we started to see the impact of rotation out of the market leaders but unfortunately, the result was a selloff in the overall market with the MSCI All-World Index falling 3.4% led by a 10.3% decline in Apple shares. It was notable that MSCI All Country World Excluding the U.S. Index and the S&P 500 Equal Weighted Indices outperformed in the month, but it did not erase the underperformance of most stocks in the quarter or the year. We believe that we will witness broader market participation once a COVID-19 vaccine is approved, and as investors begin to l focus more on a general economic recovery. It is our opinion that the economy will continue its slow rebound over the next 12 months.

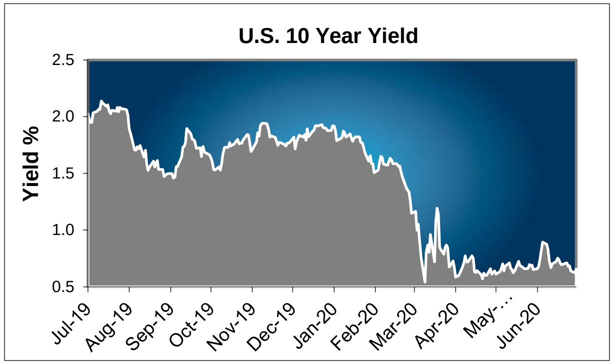
The COVID-19 pandemic past a grim milestone in September with over a million reported deaths worldwide from the virus. Active cases have continued to climb across the World over the past two months, but deaths have declined modestly. Three percent of the reported cases have died, down from the 10-15% rates seen in Western Europe in the second quarter. The actual infected mortality rate has declined with increased testing and it is estimated to be less than 1% according to the CDC, since many asymptomatic cases are not included in the reported case count. The average age of new cases has declined, explaining some of the decrease in mortality and hospitalizations. The U.S. surpassed 200,000 deaths and represented 20% of the global total as many individual states are reporting rising cases. Some European countries are in the midst of a second wave and case counts are higher than the first wave. The pandemic has produced a prolonged negative impact on many industries and accelerated trends to online retailing, entertainment and fitness. COVID-19 has also impacted the trend toward urban living and virtual offices. Many employees have learned that they prefer to work and live in the suburbs rather than commuting or living in cities. During September, we bought Pulte Homes in our regular equity and balanced accounts. The pandemic has convinced many millennials to finally settle down and buy a house in the suburbs. The work from home trend has forced demand for larger homes and Pulte is positioned well to meet the demand. Low interest rates are also allowing renters to take advantage of home ownership in the U.S. Pulte is well positioned to meet demand in their communities across America.

Fixed Income Analysis

Bondanza!



Merrill Lynch US Corporate & Government Index



U.S. 10 Year Treasury Yield

Aided by historically low treasury rates and the Fed's programs to support markets, companies have clamored to raise cheap funding. They have found the welcoming arms of investors hungry for yield. As a result, bond issuance has soared since March 2020. as investment-grade issuance has set a monthly record for each month, except for July. Companies have built up liquidity reserves and/or taken the opportunity to refinance debt, locking in historically low coupons. According to CreditSights and Dealogic, 29% of Q2 and Q3 U.S. investment-grade new issue proceeds were used to repay/refinance debt. Indeed, the duration (a measure of interest rate risk) of U.S. investment-grade corporate debt index is at a record high, evidencing company's ability to refinance and push out maturities. The refinancing activity has been even brisker in the high yield market. According to Barclay's, 87% of September's high yield issuance was to refinance debt, even higher than the very elevated 78% in August, and 57% from January-July. Calendar 2020 already holds the record for annual high yield issuance despite having another quarter remaining in the year. Despite the Fed's support programs, there will undoubtedly be further bankruptcies (and bond defaults), namely in highly levered energy companies (shale) and retailers. Nonetheless, many companies will come through this COVID-19 era with larger debt loads. This will be offset by more significant liquidity buffers, more manageable debt maturity schedules, and potentially lower interest expenses.

After continuing Q2's strong performance into July and August, risk markets took a small stumble in September although it was not a significant correction. The yield to maturity of the U.S. investment grade corporate credit index remains at historic lows. Treasury rates barely moved in the month, staying in the tight range that has prevailed since June. The U.S. dollar rose in September, with currencies giving up some of the gains of the prior two months. Despite the pullback, the dollar weakened in Q3 as proxied by the 3.6% decline in the DXY index. The more cyclically sensitive currencies (EUR, SEK, NOK, AUD) rose the most versus the greenback. High yield credit spreads widened in September in tandem with the equity market correction given their close correlation. Indeed, in late September the iShares Iboxx High Yield Corporate Bond ETF experienced the largest weekly outflow since February. Despite this, high yield credit performed well in Q3, driven by robust returns in July.

The pullback in the riskiest cohort of the corporate debt market was not a huge surprise, given the last five months of gains. After all, we are now in profit protection season among hedge fund managers keen to lock in the year's gains to ensure their compensation. However, other risks are festering in the background, including the lack of a fiscal deal, a potential contested election, and rising COVID infections in certain countries/regions (the U.K. for example). The longer these risks linger, the greater the potential for higher volatility, all else equal. Hopefully, the chaotic behavior exhibited in the first Trump-Biden debate is not a foreshadowing of what is to come in Q4… Longer term, we believe corporate credit should perform better than treasuries as global economies and company profits continue to recover.