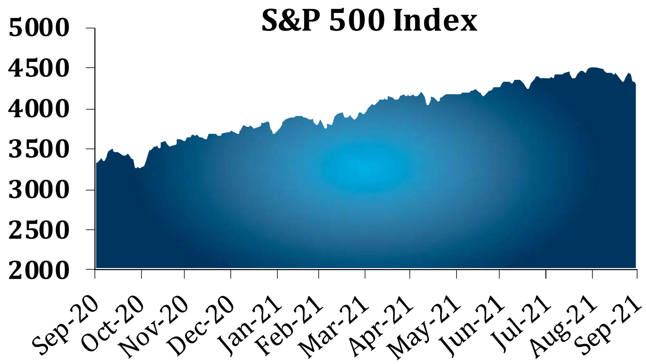
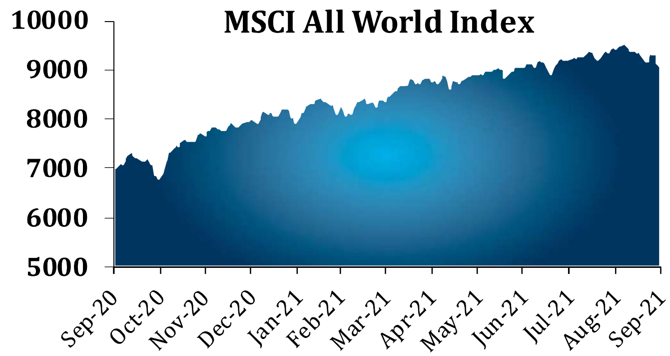
Internal

Stock Market Analysis

Finding Alpha in the Age of Delta





Making economic and market forecasts in the age of Covid is perilous. Few experts predicted that the Delta variant would create another wave of hospitalizations and deaths across the globe eighteen months into the pandemic. Unfortunately, the euphoria of reopening the economy has been tempered by the somber reality of the latest virus wave. Covid sensitive sectors have been impacted by the surge in cases in the third quarter. Travel, hospitality, and restaurants have once again seen restrictions in many countries. There also appears to be a secondary impact on the supply chains, as Covid is causing factory shutdowns and labor shortages. The Federal Reserve has described the price hikes from the supply shortage as transitory, but many economists are indicating that inflationary pressures may be more persistent. There have been two primary factors that have driven the decade-long bull market: strong profit growth and falling interest rates. In the first half of the year, earnings were driven by accelerating demand during the economy reopening and expanding corporate profit margins. The stock market stumbled in September, as it became clear that there was plenty of demand for goods but not enough supply due to bottlenecks in the delivery system. The demand for labor has also been higher than the number of people willing to go back to work, placing pressure on wages. While this is good for employment income, it pressures corporate profits. Several companies warned that the supply chain issues would impact second-half results, including FedEx, Pulte Homes, Nike, Costco, and General Motors. In this environment, it is crucial to own companies with pricing power and avoid “price takers.” For this reason, we recently exited FedEx, Oshkosh and Pulte Homes and added Freeport McMoRan and Comcast. 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 the 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 anticipate growth rates will normalize in the second half of the year; therefore, security selection and valuation are essential.

According to Bloomberg, the cost of shipping a standard 40 foot container from Shanghai to Los Angeles tripled over the past year and is up more than eight times since the end of 2019. Covid is also disrupting production in China and many other Asian countries.

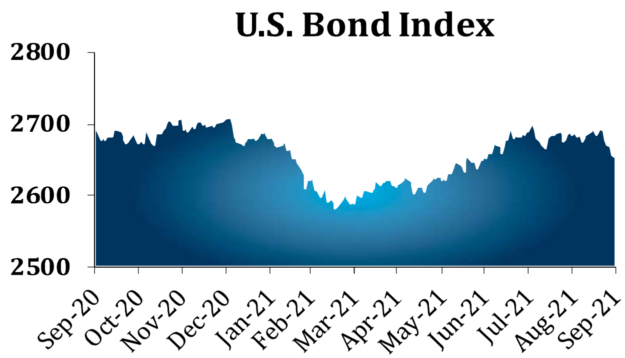
Compounding the problem, worker shortages at the ports, warehouses, and supply chains are causing long delays at U.S. and European ports. Ocean carriers' schedule reliability continues to decline, with delays of up to 30 days on the worst-hit China to EU routes and nearly 22 days on the worst-hit China to U.S. West coast routes according to container tracking data from project44, a data platform offering real-time supply chain visibility. The largest container ship company, Maersk, forecasts that global container demand growth will be between six and eight percent for all of 2021. In a recent note to customers, Maersk stated, "Continued strong demand, coupled with network disruptions has hammered our schedule reliability…. We expect Q4 to be stronger for Asia imports with network utilization remaining above 95 percent," but the carrier states that congestion in ports and supply chain bottlenecks as the "true drivers of high freight rates." The bottom line is Christmas inventories will be light, and prices will be higher.

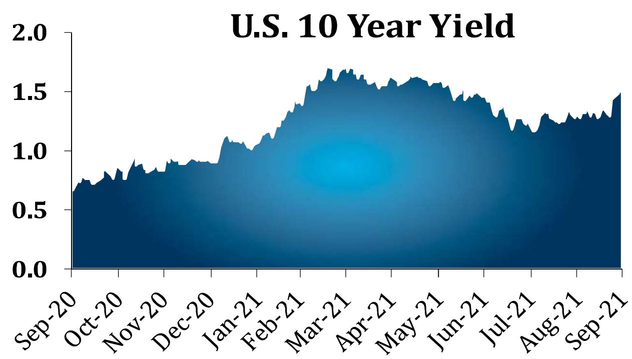
Anchor has been fortunate to manage the market volatility this year, producing strong alpha in our equity portfolio. The Anchor equity portfolio returned 0.6% in the quarter and 17.1% for the first three quarters of 2021 compared to -1.02% and 10.8% for the MSCI All Country World Net Total Return Index benchmark. While many value managers have struggled, the team is pleased that our strong discipline has achieved out-performance. The portfolios also benefited from our decision to exit the Chinese market earlier this year, when we decided that the Chinese equity market was no longer investable based on the government's regulatory actions. We remain focused on finding quality companies with business models that excel in various macro environments.

Internal

Fixed Income Analysis

Movement at the Fed





ANCHOR Investment Management

As we transition from this historic period of monetary stimulus, we think it is important to monitor how the largest central bank views the economy. Each member of the FOMC releases individual projections on a quarterly basis, for GDP, inflation, unemployment, and the path of the fed funds rate (known as the "Dot Plot"). These are not FOMC agreed-upon projections but rather individual forecasts. While not a guarantee of future rate hikes/cuts, it does provide some insight into how the FOMC members are thinking. As such, the projections are closely followed by the market. In the September release, the median GDP forecast rose +0.5% to 3.8% for 2022, while the median 2023 forecast rose 0.1% to 2.3%. The median projection for core PCE inflation rose +0.7% to 3.7% for 2021, +0.2% to 2.3% for 2022, and +0.1% to 2.2% for 2023. In addition, the median projection for the fed funds rate at year-end 2022 rose from no hikes to one rate hike, and for 3 hikes by year-end 2023 (vs 2 hikes in the June release). In the press conference, Chairman Powell noted that asset purchase tapering may be announced: "as soon as the next meeting." In the week following the FOMC release and Powell's comments, rates rose across the curve led by the 10-year and 30-year. As such the yield curve steepened, bucking the flattening trend that had prevailed for the majority of the third quarter. As such, treasury rates and the slope of the curve ended the quarter largely unchanged from Q2. It should be noted that unlike in Q1, the increase in rates was not driven by higher expectations, as evidenced by flat break-evens. Rather it was driven by higher term premiums with real rates (excluding inflation expectations) moving higher.

In other news regarding the FOMC, President of the Federal Reserve Bank of Boston, Eric Rosengren, and President of the Federal Reserve Bank of Dallas, Robert Kaplan, resigned in late September following controversial stock trading scandals. Both Kaplan and Rosengren are considered hawks (favoring tighter monetary policy than the median FOMC member). Neither were voting members in 2021. However, Rosengren was set to be a voting member in 2022. In addition to replacing Kaplan and Rosengren, there remains an open board of governors seat (permanent voting member) which has yet to be filled. Another wildcard is whether Chairman Powell will be reappointed for a second term as Chairman of the Fed. Powell was initially appointed Chairman by the republican former President, Donald Trump. Democratic Senator, Elizabeth Warren, has publicly opposed Powell's reappointment. Could President Biden use the trading scandal to oust Powell in favor of a democrat-chosen and more dovish appointment? It can't be ruled out, however, it should be noted that Treasury Secretary and former Fed Chair, Janet Yellen, has publicly supported Powell's reappointment. We expect Powell to be reappointed but note that a changing of the guard in addition to the filling of the other FOMC vacancies with doves has the potential to impact the fed's reaction function and alter the future path of the fed funds rate.

Credit spreads continued to grind tighter in Q3 on the back of strong corporate earnings expectations and reach for yield environment. The late September risk-off tone in equity markets brought on by the looming Evergrande default speculation and power issues in China did nothing to budge credit spreads. We have been wary of adding more corporate credit to portfolios as credit spreads are approaching all-time tight levels. Regarding the greenback, the dollar strengthened in the third quarter on the back of favorable growth differentials and benefitted from the late September risk-off tone. Lastly, a final word on interest rates. We still believe the most significant risk to rates is if the bond market shifts from the currently priced transitory inflation expectation to higher for longer inflation. After all, supply chain issues are rife, as evidenced by the enormous backlog of ships anchored in LA and Long Beach ports waiting to offload their goods.