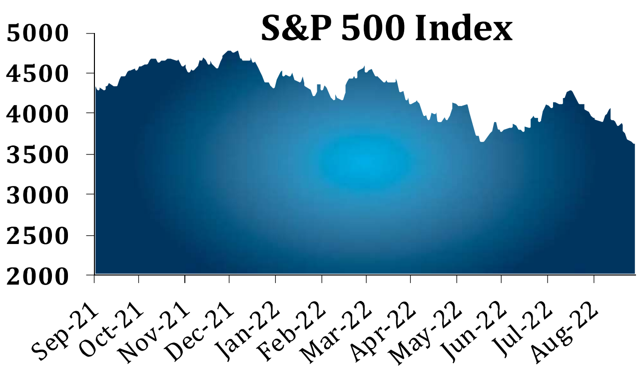
Stock Market Analysis

Capitulation?



In July, investors attempted to take advantage of the 20% pullback in the stock market, and the equity market rallied 10% in the first six weeks of the third quarter. But central banks around the world took a more hawkish than expected stance to fight inflation, which again, pressured risk assets. As a result, it has been one of the most painful nine-month periods for investors. At this stage, the question is whether the recent selloff is capitulation, or is there more pain ahead? Our major advice to clients is to not change their long-term allocation. We are confident that the stock and credit markets will recover, but it is impossible to know the timing. Anchor's team does not believe in market timing since this has historically caused investors to realize losses when the markets decline and miss market recoveries. As we saw following the early days of the Covid crisis, stock market recoveries can be swift. Equity markets historically started their rebound more than six months before the economic data improved, so waiting for economists to give you the green light is not a good strategy. The best investment opportunities occur in periods when pessimism is the highest.

As we have discussed in previous reports, most investors were not around fifty years ago when Paul Volker and other central bankers battled to bring down double-digit inflation following the 1970s energy crisis. The lesson from that period was for central banks to take decisive action when inflation is elevated. After years of loose central bank policy to bolster the economy, it is a quandary for many investors who don't understand why the same central bankers seem eager to stymy economic growth. The Russian-Ukraine invasion complicates the situation, increasing energy insecurity, fueling inflationary pressures, and adding to the market volatility. While this period will likely hasten the move away from fossil fuels over the next several decades, we remain dependent on several unreliable regimes to supply fossil fuels as this transition occurs.

Internal

Stock Market Analysis

The S&P 500 Index posted the worst September in two decades, and the -23.9% return during the first nine months of 2022 is the third worst 9-month period since 1931. So, what is driving the losses? There is an old reliable adage on Wall Street, "Don't fight the Fed". During the past six bear markets, bottoms formed when the Fed was lowering rates. The recent selloff occurred when Chairman Powell made it clear that the Fed Funds Rate would move higher, and the hiking cycle would last longer than the market anticipated. We believe this news is now priced into the market. The central bank's "Dot Plot" indicates that the Fed Funds Rate will peak at 4.6% in 2023 and then decline to 3.9% in 2024 and 2.9% in 2025. Assuming the Fed confirms this stance at the next meeting, the market will likely look forward to the period of declining rates. This is what happened prematurely in July, but unfortunately, the central bankers raised their Fed Funds forecasts. We don't think that they will repeat this miscalculation going forward since the economy is already feeling the impact of previous Fed action. By no means do we think that stocks will experience a smooth recovery because corporate profits will be pressured by higher rates, inflation, slowing economic growth and a strong dollar. But at one stage, the markets will look at the other side of the hill.

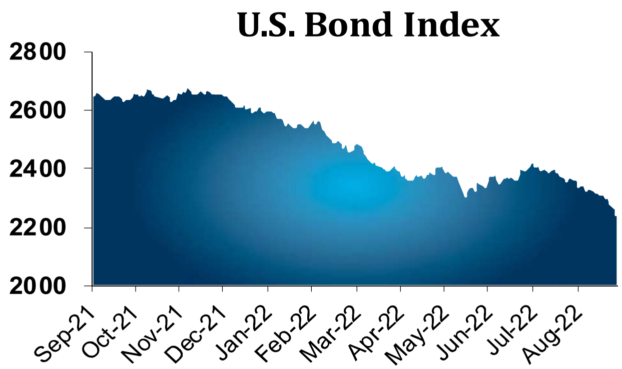
The Anchor Equity Portfolio returned -8.9% in the third quarter and -23.0% in the first nine months of 2022 compared to -6.6% and -24.8% respectively for the MSCI All Country World Total Return Index benchmark. The Anchor High-Quality Income Portfolio has held up better this year, returning -9.6% in the third quarter and -11.9% in the first nine months of 2022 compared to -11.5% and -14.9% respectively for the SG Quality Income benchmark. *

**Performance is based on Anchor composite portfolios after transaction and administration costs but before management fees. Past performance does not guarantee future returns*

Internal

Fixed Income Analysis

Surging Treasury Rates



Inflation fears caused global central banks to life rates aggressively in September. This included the U.S. Federal Reserve (+0.75%), European Central Bank (+0.75%), Bank of Canada (+0.75%), Norges Bank (+0.50%), Sweden's Riksbank (+1%), and Swiss National Bank (0.75%). These policy rate hikes were accompanied by interest rates moving higher along yield curves. The German 10-year rate rose +0.57% to 2.11%, while in the U.S. 10-year yield ended September at 3.82%, +0.64% higher. The Move Index, a proxy for treasury rate volatility, exploded higher in September reaching a year-to-date (YTD) high and in touching distance of the level reached in March 2020 (peak fear from unknown global pandemic). Currency volatility spiked in September also as proxied by the JP Morgan FX Volatility Index, which also reached a 2022 high. On this note, the dollar rose to a 20 year high as proxied by the DXY index. The index rose 6.7% during the quarter and 16.8% in 2022.

Rising inflation and interest rates caused most investment asset classes to decline this year. Unfortunately, investors experienced the worst returns in the bond market in recent history with the BofA Corporate & Government Bond Index declining 15.2% year-to-date. The shorter duration of Anchor's 10-year laddered bond strategy has reduced losses (Anchor's 1-10 year benchmark is down 9.7% year-to-date). These losses are unrealized since we intend to hold the bonds until maturity. We also look forward to replacing maturing bonds with much higher yielding debt due to the increase in rates.

Fed hawkishness and uncertainty surrounding the stickiness of inflation have been major contributors to market volatility. Inflation is well above the central bank's 2% target. The latest reading of the Fed's preferred inflation measure, the Core Personal Consumption Expenditure (PCE), remains over three times their target. In addition, the latest Consumer Price Index figures reported in September showed month-on-month pricing pressure. On the back of this, the central bank raised the Fed funds rate another 0.75% in September. This was the third 0.75% hike in a row, bringing the total increase in the fed funds rate (upper range) to 3.25% this year. These rate moves have filtered through into other market determined interest rates including mortgage rates. The Bankrate.com US Home Mortgage 30 Year Fixed National Average Index has more than doubled in 2022 and ended the third quarter at 7.06%. The Goldman Sachs Financial Conditions Index has moved steadily higher in 2022 and is now in restrictive territory. This compares to deeply accommodative territory and a near record low at the beginning of the year.

Internal

Fixed Income Analysis

As a result of Fed tightening, various leading indicators of economic growth are rolling over. For example, the Institute of Supply Management (ISM) US Manufacturing Purchasing Managers Index (PMI) is sitting just above the contractionary territory threshold. The New Orders component is already in contractionary territory and trending downwards. Meanwhile the labor market has held-up well. Initial jobless claims (reported weekly) have remained subdued. The latest JOLTS Job Openings figure (released at the time of writing) missed expectations to the downside; the first such decline since March 2020. As a result, the ratio of job openings to unemployed persons fell from 2x to 1.7x; lower month-on-month (MoM), though still well above the prevailing pre-pandemic levels. Meanwhile, consumer spending has remained resilient as evidenced by August's +0.2% MoM inflation adjusted consumer spending on services as reported by the Commerce Department. To summarize, leading indicators are slowing, inflation remains uncomfortably above target, and the labor market might be showing the first signs of cooling.

In the first three quarters of the year, the rise in treasury rates has driven most of the unrealized losses in corporate bonds. Put differently, the rise in the (credit) risk-free rate component has been the issue for corporate bond holders. Credit spreads, compensation for the company's credit risk when owning a corporate bond, have widened overall, but the pace and scale have been quite orderly. Notable weakness has been isolated to the lowest rated companies – namely CCC-rated and B-rated high yield bonds. In addition, banks have recently had difficulty offloading some high profile leveraged loans (Citrix for example) due to a lack of investor appetite. In past periods when interest rate volatility has reached current levels (March 2020, Global Financial Crisis, dot com recession), credit spreads were materially wider than current levels. Having said this, companies are generally in good shape and took advantage of the 'reach for yield' environment of 2020 and 2021 to refinance and term out debt maturity schedules. Perhaps this time will be different and credit spreads will remain resolute? It's a topic that we continue to debate internally. Our positioning relative to our neutral allocation is overweight investment grade credit, underweight high yield credit, underweight non-USD, and overweight treasuries.