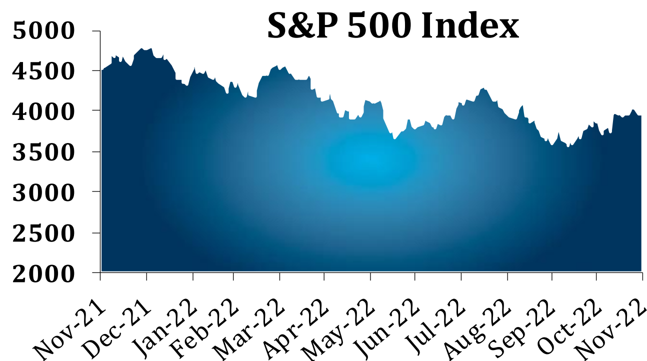
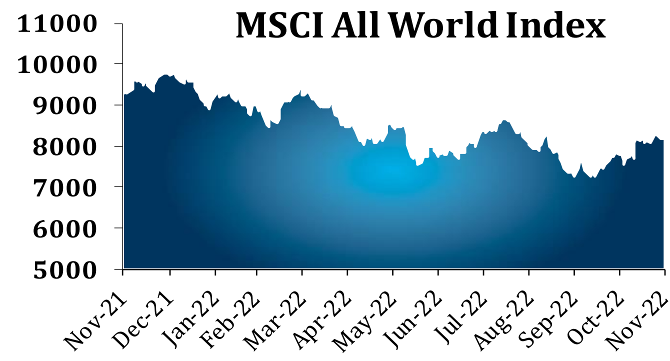
Stock Market Analysis

Look Forward





Our September quarterly equity report was titled “Capitulation?” as the 23.9% fall for the S&P 500 represented the third worst first nine months of a year since 1931. While there were plenty of reasons to be negative on the stock market with a potential recession looming, we pointed out that “the best investment opportunities occur in periods when pessimism is the highest.” In the fourth quarter the MSCI All Country World benchmark rebounded 9.5% and the Anchor Equity portfolio returned 10.9%. Despite the bounce, both major indices produced their worst annual returns since the 2008 Financial Crisis as the most anticipated recession sits on the horizon.

Central bankers significantly increased interest rates in their efforts to reduce the highest inflation rate in 40 years. The MSCI All Country World and S&P 500 Indices both lost ~18%. This drawdown implies a significant reduction in corporate profits in 2023 but several indicators point to a mild economic downturn. Importantly, recent inflation indicators have come down to more tolerable levels, supply chain issues have abated and spreads in the credit markets have returned to historical levels. While higher interest rates will be a drag on profits for more leveraged companies and interest rate sensitive sectors, long-term rates remain below historical levels. Fortunately, consumer and corporate debt levels have been reduced over the past decade and remain healthy.

Corporate margins were squeezed in 2022 after rising over the past decade, but we expect the pressure on margins to ease in the second half of 2023. Volatility will likely remain high as market participants gauge the economic slowdown, but as investors look forward, they should realize that the short-term headwinds will pass. This does not mean that we can raise the “all clear” sign, but the Anchor team believes the global recession will not be as deep as many fear and the global economy and corporate earnings should improve as 2023 progresses. Since the stock market is a forward discounting mechanism, we expect shares to continue to rebound in 2023.

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The strong U.S. dollar has been a headwind for dollar-based investors. For example, the FTSE 100 was the only major developed equity market index to have a positive return in 2022 (+4.6%) but the UK benchmark return was -6.7% when measured in U.S. dollars. The Nikkei 225 in Japan returned -7.4% measured in local currency but when you included the depreciation of the yen, the dollar loss was 18.6%. The strong dollar also pressured margins for U.S. exporters but the surge in the dollar appears to have peaked in September and we believe the headwind may become a tailwind for dollar-based investors in 2023.

Higher interest rates punished high valuation technology shares with the Nasdaq composite plunging 32.5% in 2022 which almost reached the 2008 sell-off level of 39.9%. It should be noted that the Nasdaq rebounded 45.3% in 2009 and we expect that the U.S. 10-year treasury rateshould stabilize in the recent 3.4% to 4.0% range. The central banks' aggressive actions in 2022 to quell inflation should pay dividends this year. The FANGMA tech giants will likely grow at a slower pace over the next decade compared to the past, but we believe many sectors of technology, including cyber security, e-commerce, delivery automation and cloud services will continue to present the strongest growth opportunities in the market.

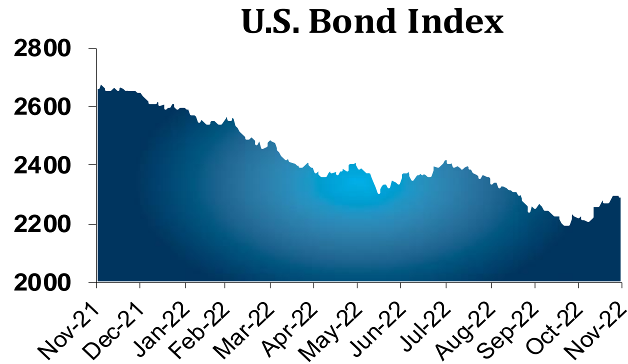
Commodity stocks benefited from higher inflation in 2022. The focus on ESG has reduced the investment in fossil fuels over the past decade and Russia's invasion of Ukraine revealed the West's dependence on less reliable energy producers. Energy shares surged in 2022 as every other MSCI sector declined. The MSCI ACWI Energy Index returned 34.2% including dividends, outperforming the broader benchmark for a second straight year. This is a reversal of recent trends, considering that in the previous decade the energy sector under-performed the overall index by 5.2% per year. Anchor remains overweight in this sector as the supply/demand dynamics remain positive.

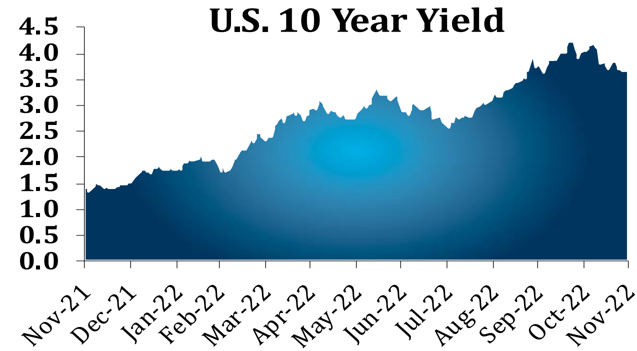
The Anchor equity portfolio composite gave back some of its 25.8% 2021 gain, returning -15.1% in 2022 compared to -17.8% for the MSCI All Country World Net Total Return benchmark. Despite the 2022 selloff, the portfolio has produced an annualized return over the past three years of +4.7% compared to +4.4% for the MSCI All Country World Net Total Return benchmark.*

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

Fixed Income Analysis

A Painful 2022





The -12.5% return of the Bloomberg U.S. Treasury Index in 2022 was the worst annual return since the index's inception in 1973. This compares to a 15.4% decline in the ICE BofA US Investment Grade Corporate Index, while the ICE BofA US High Yield Index outperformed despite declining 11.2%. Two things stand out. Firstly, the outperformance of high yield credit indicates credit spreads held in very well despite the immense interest rate volatility. Secondly, 2022 was a stark reminder that treasuries aren't "risk free." They have no credit risk; however, they are exposed to interest rate risk.

In attempting to reign in uncomfortably high inflation, caused by both a demand and supply shock, the Federal Open Market Committee (FOMC) raised the fed funds rate (upper bound) from 0.25% to 4.50% in 2022. This included 4 consecutive 0.75% hikes. It was the fastest pace of monetary tightening since Volcker was Fed Chair in the 1970/80s. The aggressive rate hikes filtered through to other markets. The 2-year treasury yield rose 3.69 percentage points to end 2022 at 4.42%, while the 10-year treasury yield rose 2.36 percentage points to 3.87%. The Bankrate 30-Year Mortgage Rates index rose from 3.30% to a high of 7.35% in November before ending 2022 at 6.66%. The dollar surged for most of 2022 buoyed by rising interest rate differentials and a superior U.S. economic growth profile.

In the December meeting, the FOMC raised the fed funds rate by 0.50% to 4.50% as expected by the market. In the press conference Chair Powell commented that he views core inflation in three separate buckets: (1) goods, (2) housing services, and (3) non-housing-related services. This was interesting because goods inflation has clearly been decelerating, while housing services inflation is known to lag the overall inflation measure (CPI or PCE). Powell expects year-on-year (YoY) housing related inflation to start declining in the second half of 2023. He expressed concern on the non-housing-related services component (~55% of the personal consumption expenditure index (PCE)), which is heavily influenced by labor market conditions. Powell cited the lower participation rate (vs pre-COVID) and the elevated ratio of job vacancies to the number of unemployed (1.7x vs ~1x pre-COVID). He also commented that wage inflation is running well above the level consistent with its 2% inflation target. As such, it's clear that Powell has turned more of an eye towards the labor market than a sole focus on inflation.

Fixed Income Analysis

In the FOMC's December Summary of Economic Projections, the median 2023 unemployment rate forecast rose to 4.6% compared to 4.4% just three months earlier. The current unemployment rate is 3.6%. The FOMC's DOT plot median forecast is for the fed funds rate to end 2023 at 5.125%, indicating another three 0.25% rate hikes. The Fed expects to continue raising rates, albeit at a much slower pace than in 2022; then keep rates elevated. It has maintained this stance despite compelling evidence that peak inflation appears to be behind us. In the 1970's inflation spiked, then fell, but then rose to a new high a few years later. Powell wants to avoid this dynamic playing out in 2023. This is why Powell is talking tough on inflation, saying the Fed will remain hawkish (as per the DOTS) even though inflation is trending lower and the FOMC's own forecasts show an expectation for the unemployment rate to rise. On the other side of the coin, markets don't think Powell will maintain his restrictive stance. Fed fund futures are pricing the Fed to raise the fed funds rate to approximately 5% before cutting rates and ending 2023 at about 4.6%. They are expecting Powell to blink and be forced to "pivot" from its restrictive monetary stance. Afterall, this is exactly what he did in Q4 2018 when push came to shove. It will be interesting to see how this dynamic plays out as 2023 progresses.

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