

This Month in the Markets

January 2010



EQUITY COMMENTARY

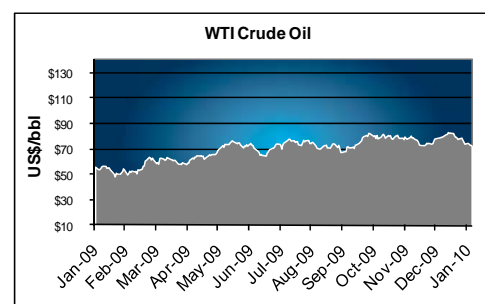
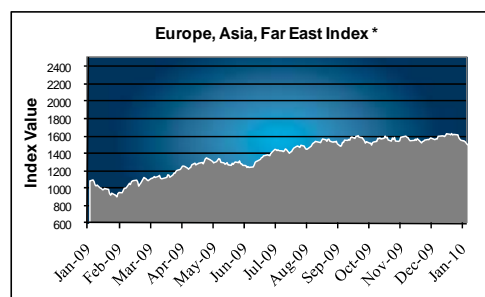
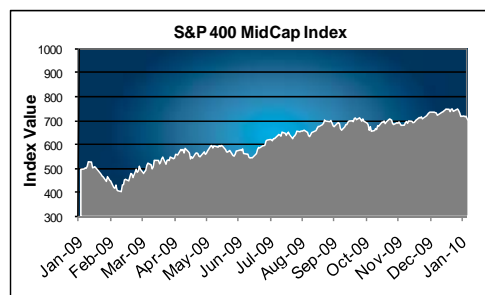
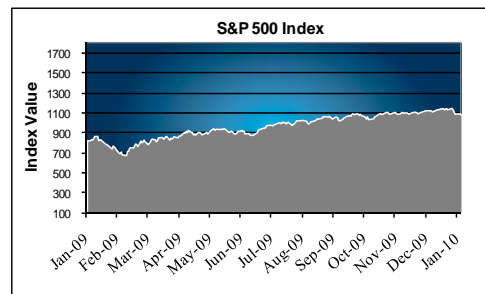
Off To The Races – Maybe Not So Fast

2009 was a bounce back year when equities rallied 70 percent off of their March lows and nearly 30 percent for the year. The severely oversold condition in March was pricing in a near depression scenario. The significant infusion of capital by governments throughout the world succeeded in avoiding an implosion of the financial system. As a result fear was replaced by optimism that the worst was in the rear view mirror. Heading into 2010 the focus has shifted towards the sustainability of the recovery and the prospects for growth given the deleveraging that needs to occur both at the household and government levels. January started off well for stock investors with commodity related companies surging in the first week of the month. The rally was short lived as equities gave up all of their early gains and then some. The Morgan Stanley Composite Index (MSCI) ended the month down 4 percent. The fall was broad based with all major sectors showing negative returns. Leading the way to the downside were the materials, telecom and information technology sectors losing 8, 7 and 6 percent respectively. Health care and staples were the outperformers down just 1 and 2 percent respectively.

The biggest wildcard going forward remains China. The Chinese led the way in 2009 with a stimulus package that represented a whopping 14 percent of GDP and posted GDP growth of 9 percent for the year. Investment in infrastructure was the primary driver of the growth. The Chinese also imported record levels of commodities to restore inventory levels that had depleted during 2008. One of the risks of injecting significant capital into an economy prone to bubbles is creating just that – a bubble. In January the Chinese government attempted to put the brakes on their overheating economy by restricting lending activities. As the largest driver of global GDP growth investors began to worry about the impact this behavior would have on global growth going forward. On the news investors sold assets that were levered to China. Worst hit were the commodities who benefited greatly from the Chinese stimulus and restocking efforts of 2009. Going forward the focus will clearly be on the sustainability of the Chinese growth engine and the ability of the Chinese government to properly regulate growth. For domestic demand to become the key driver of Chinese growth, the key will be how effective the Chinese government will be in their plans of improving the incomes, and hence purchasing power, of the Chinese farmers in rural China as opposed to the elite in the coastal cities.

Earnings season got off to a good start in the US. With just under half of the companies in the S&P 500 reporting, 77 percent of those companies reported profit that exceeded analyst estimates. This compares to just 60 percent of companies who beat estimates in the fourth quarter of 2008. Earnings in the fourth quarter of 2009 were up 140 percent from depressed levels a year ago. If you exclude the strong rebound in financial profits from depressed 2008 levels, earnings were up nearly 15 percent on a year over year basis. The S&P 500 is now expected to post earnings of \$77 in 2010 which would represent 34 percent growth from the \$58 earned in 2009. While we see this outcome as possible we are less convinced that the road to recovery will be a smooth one. In an environment where historic profitability may not return as quickly as many market participants anticipate, higher quality companies should continue to outperform.

Although we are not calling for a W-shaped reversion we recognize that the current recovery will likely take longer than past economic rebounds. With a deleveraging consumer and large government deficits, we believe that economic growth will lag potential for the next several years. This is not to say that we do not see substantial value in certain areas of the market. Shares in many quality companies are still trading at attractive prices. Our focus will continue to be on buying higher-quality, stable-growth names with low earnings risk, strong franchise values, resilient free cash flow generation, dividend sanctity and solid balance sheets.



*MSCI EAFE Index

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FIXED INCOME COMMENTARY

Volcker Rule

The Chinese government announced measures to curb lending after posting a 10.7 percent growth rate in the fourth quarter of last year. Since China is seen as one of the most important contributors to global growth in 2010, the recent announcement led to some uncertainty amongst global investors. While stocks came off their recent highs, funds were shifted back into fixed income instruments. The Merrill Lynch U.S. Corporate & Government Master Index advanced by 1.6 percent in January. Rising risk aversion between currency investors supported the U.S. dollar and the Japanese yen since both currencies are considered as “save haven” investments.

U.S. Fixed Income Strategy

In January global growth was revised upwards and the U.S. GDP numbers for the fourth quarter of 2009 surprised to the upside. Both, the World Bank and the International Monetary Fund raised their forecasts for global growth for this and next year. China is seen as the biggest growth generator, expected to grow about ten percent in 2009. In addition, the U.S. growth numbers for last quarter were posted at a strong 5.7 percent annualized rate. While this has been the fastest growth for six years, the breakdown of the data is less encouraging. Inventory rebuilding contributed 3.7 percent to the headline number. Lately, inventories fell below the sales rate and the buildup in inventories were needed in order to reestablish a “normal” inventory-to-sales ratio. Rising inventories might have the potential for a positive contribution to GDP for another one or two quarters, but its impact on the headline number will diminish.

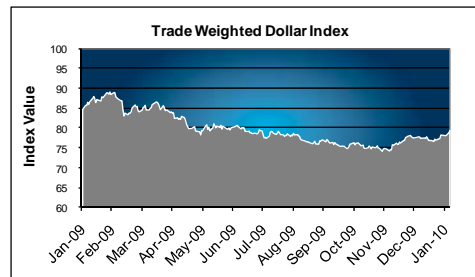
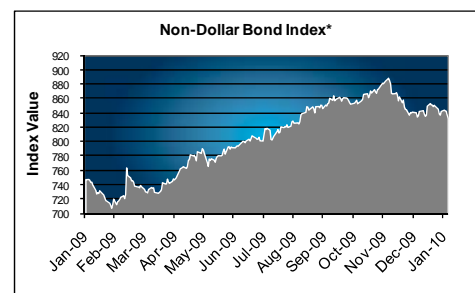
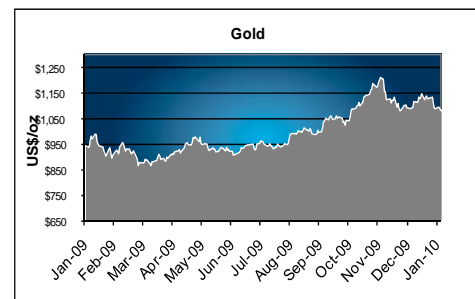
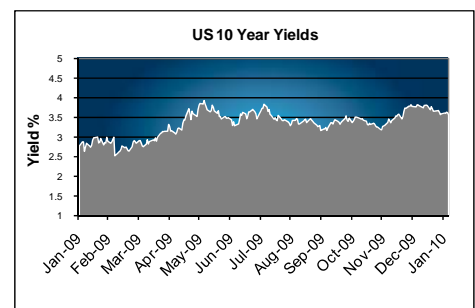
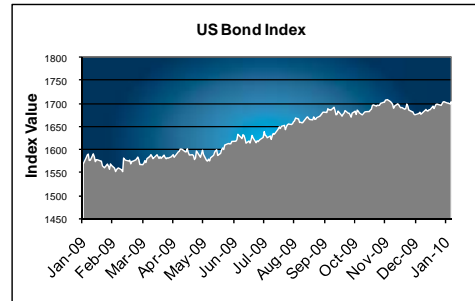
In our September issue we pointed out that the housing market leads the general economy by about three to five months. Recently the housing data for December, the month after the first expiration of the housing tax credit, was posted. The rush to take advantage of this credit before the deadline led to a rebound in housing activity until the end of November. The December data was disappointingly weak, with falling sales data and the National Association of Home Builders Market Index remained at a very depressed level. The extension of the housing tax credit until April of this year should be able to support the housing market for now. Without this government support U.S. real estate sales would probably be much weaker than they already are. 2010 will be another big test for the U.S. housing market since many adjustable-rate mortgages (ARM) are due to reset.

Financial bonds might be the big beneficiaries in the corporate bond segment this year. President Obama is working on stricter regulation for banks and is trying to de-risk financial institutions by separating the commercial from the trading business. This is also referred to as the “Volcker Rule”, named after former Chairman of the Federal Reserve Paul Volcker. European countries are looking into similar regulations, in order to reduce the riskiness of banks and hence reduce the likelihood for further financial crisis in the future. It is also possible that financial institutions will have to operate under higher capital requirements. This would provide financial bond holders with an extra safety cushion. Thus, the Anchor Manager believe that upcoming stricter regulation for the financial industry warrant an overweight position of financial bonds within a fixed income allocation.

International Fixed Income Strategy

The U.S. dollar started on the strong side and was only outperformed by the yen. The Japanese currency usually benefits from an environment of higher risk-aversion, which was clearly the case in January. Nevertheless, the Anchor Managers believe that the yen has become an overvalued currency and the lack of interest rate support makes it hardly attractive. The extreme accommodative monetary and fiscal policies in Japan will eventually lead to a weaker yen.

The euro suffered from an increase in default risk of one of its member countries. Greek bond yields rose to a record risk premium versus the German government bond benchmark. While Greece represents only two percent of the European bond market, bigger countries with high deficits like Spain and Portugal might soon move into the spotlight and put further pressure on the euro. The Anchor managers see more value in the other European currencies, namely the British pound, Swedish krona and Norwegian krone.



*Merrill Lynch Non-US Dollar Bond Index