

This Month in the Markets

May 2010



EQUITY COMMENTARY

Contagion Spreads – Opportunities Emerge

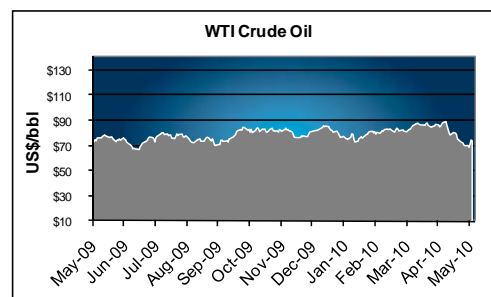
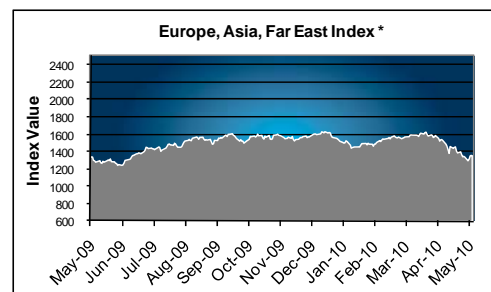
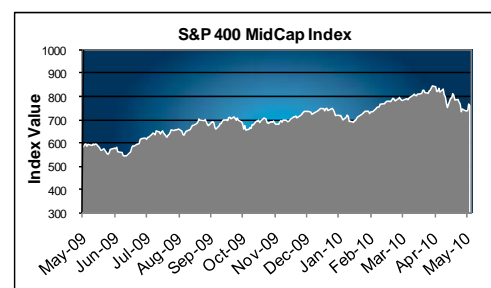
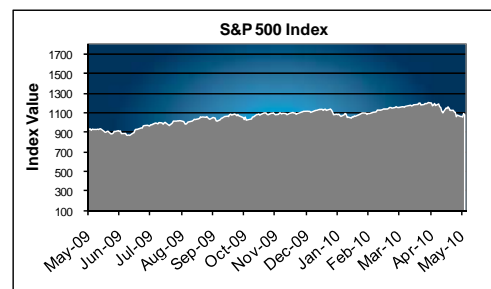
May was a tough month for equity investors. The European debt crisis garnered increasing investor focus as future stability in the region is being questioned. With the subprime financial crisis fresh in investors' minds, risky assets were sold with little concern for valuation. The Morgan Stanley World Composite Index (MSCI) closed the month down 10 percent. The market selloff was broadly based with every sector down at least 6.7 percent. Hardest hit were energy and financial shares which were down 12.6 and 12 percent respectively. Consumer staples, health care and telecom companies were the relative outperformers ending the month down 6.7, 8.2 and 8.2 percent respectively. All gains made in the first quarter were quickly erased with the MSCI ending the month down 7.6 percent on the year.

Although fundamentals have improved in the United States, concerns over European growth have intensified. The depreciation of the euro has also impacted U.S. based companies with material exposure to Europe. Over the past 4 months we have limited our exposure to domestic Europe given our concerns about weak economic growth on the Continent and our forecast that the euro will trend towards parity.

Largely overshadowed by the trouble overseas was a relatively strong earnings season. Of the 493 of the 500 companies in the S&P 500 that reported first quarter earnings by the end of May, 77.6 percent of them reported earnings that were ahead of analyst estimates. Average growth in earnings from the first quarter of 2009 was 52.4 percent. Excluding financial shares earnings, companies in the S&P 500 grew 38 percent from the first quarter of 2009. Analyst 2010 estimates for the S&P 500 earnings are \$81.

Warren Buffet often talks about being "greedy when others are fearful and fearful when others are greedy". As an investor this is easier said than done. It is human nature to want to step away when the headlines are negative and the "talking-heads" on CNBC are overtly bearish. The key to long term investment success however is separating emotion out of the decision making process and investing in good companies when valuations are compelling. Although there are certain speculative areas of the market that we will continue to avoid we view the recent pullback in the market as an opportunity to add some high quality companies trading well below their intrinsic values. There is no question that the markets can continue to trade lower. That being said we believe that after an impressive earnings season and a significant pullback, certain areas of the market offer compelling value. In general the S&P 500 is trading at 13.2 times 2010 estimated earnings which is below its long term average of 14.5 times. We see a similar story in Asia; the MSCI Asia Pacific ex-Japan Index forward price/earnings ratio is now just 10.8 times 2010 expected earnings, more than one standard deviation below the long term average of 13.7 times.

We believe that economic growth will lag rates achieved in the last two decades as households, corporations and governments de-lever their respective balance sheets but we feel that slower growth is priced into the market at current levels. We see material upside on many quality companies and remain excited about the prospects for the future. 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

Volatility Spikes

The CBOE Volatility Index (VIX) is often a harbinger for the performance of the fixed income and foreign exchange markets. The index measures the implied volatility of S&P 500 Index options. An increase is usually associated with rising government bonds and underperforming corporate bonds. The European debt crisis has been the focus for investors for several months. Concerns about sovereign defaults escalated at the beginning of May, resulting in a drop of the Dow Jones Industrial Index of almost 1,000 points and a spike in the VIX. The volatility barometer shot up to levels last seen during the financial crisis of 2008/09, the 09/11 terrorist attacks and the Asian financial crisis in 1997/98. Such negative market action resulted in a massive flight to high quality bonds, with U.S. Treasury securities posting a stellar performance. The riskier fixed income asset classes, high-yield and preferred securities, underperformed considerably in tandem with the stock market. The foreign exchange market reacted strongly to the negative news flow as well. The flight-to-safety mantra helped the U.S. dollar and Japanese yen to outperform significantly.

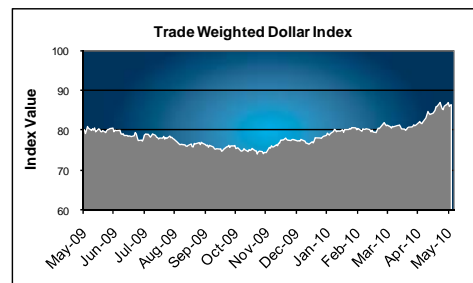
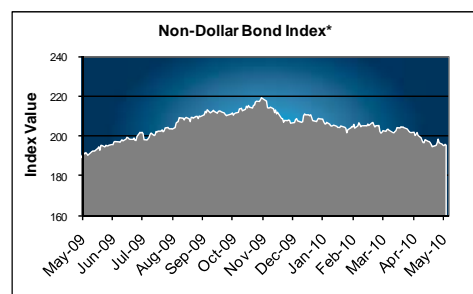
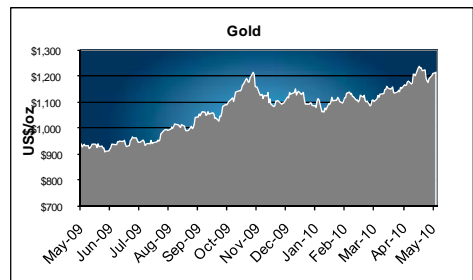
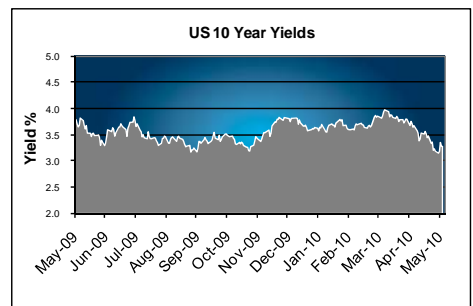
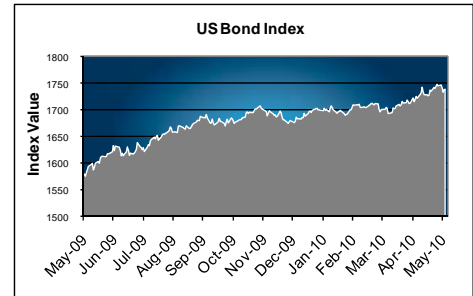
U.S. Fixed Income Strategy

After the International Monetary Fund's upgrade of world economic growth this and next year, the OECD raised its growth forecast as well. The organization expects global growth to expand by 4.6 percent in 2010 and by 4.5 percent in 2011, compared with a historic average of 3.7 percent. Leading indicators and some other economic data have already pointed to a strong recovery in the U.S. One of the most followed indicators, the ISM manufacturing index, reached a level of 60.4. Values over 50 indicate an expansion in the manufacturing sector, while figures under 44 are usually associated with recessions. The latest reading is the highest since 2004 and according to a study conducted by Deutsche Bank: this level predicts an annual growth rate of six percent for the U.S. economy. The rise in leading indicators was supported by a strong employment report. Non-farm payrolls jumped by 290,000 in April and the household survey, which is probably a more reliable report at economic turning points, suggested even stronger employment growth of 550,000.

Nevertheless, an unemployment rate of 9.9 percent and low inflation has kept the Federal Reserve from hiking interest rates. Although the Federal Open Market Committee (FOMC) raised its forecast for growth this and next year, the current economic slack and low capacity utilization rates will likely keep the U.S. central bank on hold for longer than initially expected. The Bloomberg consensus forecast has pushed back the first rate hike to the fourth quarter of 2010. In addition, the U.S. housing market has only been supported due to generous tax breaks by the government. These ended in April and it will be interesting to see whether the real estate market can keep its momentum. Early housing indicators like permits and mortgage applications have already turned down. Such uncertainty around the sustainability of economic growth, low inflation rates and a still dovish U.S. central bank will support the bond market. The recent sell-off in corporate bonds and preferred securities has resulted in attractive levels for these kinds of fixed income instruments. Both are supported by a strong earnings season and gradually declining default rates.

International Fixed Income Strategy

Most European currencies and the Australian and New Zealand dollars fell by seven to nine percent versus the U.S. dollar in May. The sell-off was triggered by increased concerns about the default of one or more European nations. The European Commission, the European Central Bank (ECB) and the International Monetary Fund reacted with a massive bailout package of EUR 750 billion for the euro zone. Shortly after the announcement, the ECB started to buy government bonds of several European nations in order to provide liquidity and bring the member state's financing costs down. The euro reacted with an initial jump up but ended the month down by over eight percent versus the U.S. dollar. The bailout package does not change much about Europe's economic misery. It has bought some time to implement prudent fiscal policies and should make it easier to refinance maturing liabilities. Fiscal restraint will lead to cuts in spending and to higher taxes. Both measures have the potential to curtail economic growth. Hence, the euro zone will lag most of the other economies this and next year and the ECB might have to keep its benchmark rate at very low levels considerably longer than other central banks. Weak growth rates and low interest rates have the potential for more weakness in the euro.



*Merrill Lynch Non-US Dollar Bond Index