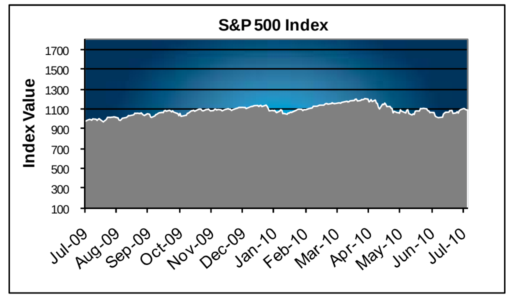
This Month in the Markets

July 2010

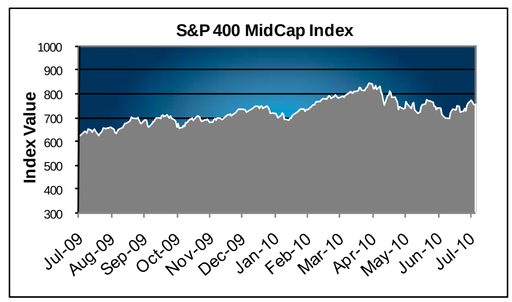
EQUITY COMMENTARY

Bounce Back

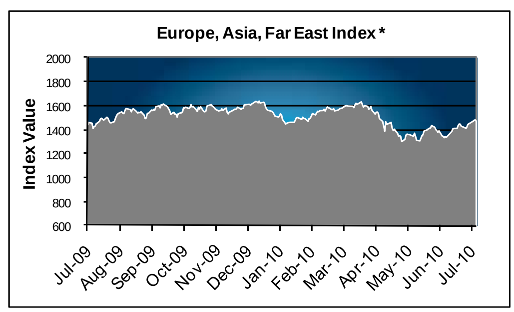
After a horrendous second quarter where many investors uttered the phrase “not again” July was a welcomed reprieve. In the United States CEOs were at odds with economists, as earnings came in well ahead of expectations while economic releases remained lukewarm. Fears of a collapse in the European economy also abated which led to a strong rebound in beaten down European companies. The Morgan Stanley World Composite Index (MSCI) closed the month up 8 percent. The market rally was broadly based with every sector outside of health care up at least 5 percent. Leading the charge were the financial and telecommunications companies up 11 and 10 percent respectively. For the year the MSCI is down 3.7 percent.



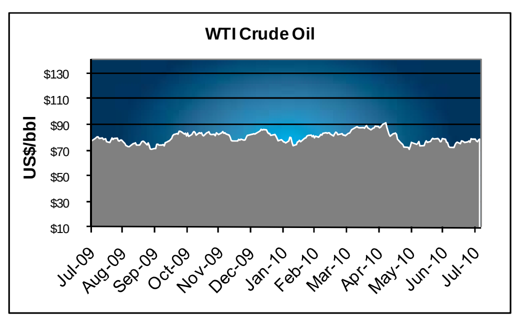
Despite softening economic data, fears of a double dip recession appear to be exaggerated. Real GDP growth for the second quarter came in at 2.4 percent over the first quarter (on an annualized basis). Versus the second quarter of 2009 the US economy grew 3.2 percent in real terms. 1 point of growth was attributed to inventory restocking while 0.7 points of growth due to government spending. Moving ahead we do not expect inventory restocking nor government expenditures to contribute to economic growth. Growth will be driven by investment spending (13 percent of the economy) particularly nonresidential investment in equipment and software which was up 21 percent (on an annualized basis) from the first quarter and 12 percent over the same period last year. Consumption was flat versus the first quarter yet up 3.1 percent from the same period last year. Going forward we expect personal consumption to grow 2 percent which is below the average of 3 percent due to continued deleveraging. We do see a slowdown in the back half of 2010 but reiterate that we do not see the economy slipping back into recession. Although many data points have rolled over we are encouraged with increases in investment demand and the resiliency of the consumer.



In the second quarter investors shrugged off a relatively strong earnings season and paid attention to economists who feared that a rolling over in much of the economic data would lead to a double dip recession. In July investors brushed aside tepid economic releases and focused on very strong earnings. Of the 254 companies in the S&P 500 that reported second quarter earnings by the end of July, 75.6 percent of them reported earnings that were ahead of analyst estimates. Average growth in earnings from the second quarter of 2009 was 55.9 percent. Excluding financial shares earnings, companies in the S&P 500 grew 41 percent from the second quarter of 2009. Analysts’ 2010 estimates for the S&P 500 earnings moved higher from the $81 estimate last quarter to $83. The S&P 500 is trading at 13.3 times 2010 estimated earnings which is about 9 percent below its long term average of 14.5 times. It could also be argued, given interest rates remain near historic lows, the fair value price/earnings ratio is closer to 18 times earnings.



While we are encouraged by the strength and resiliency of corporate America we expect that future economic growth will lag rates achieved in the last two decades as households, corporations and governments de-lever their respective balance sheets. Despite a strong July we believe that the economic news remains priced into the market. We see material upside on many quality companies that still trade significantly below intrinsic value. Given our view of slower than expected long term growth we will avoid companies whose shares are pricing in a “V-shaped” recovery. 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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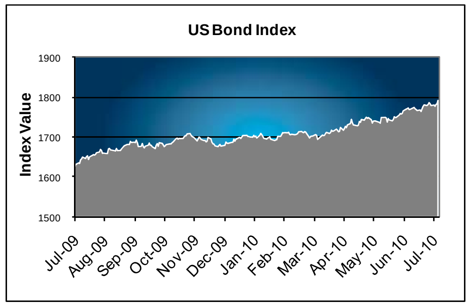
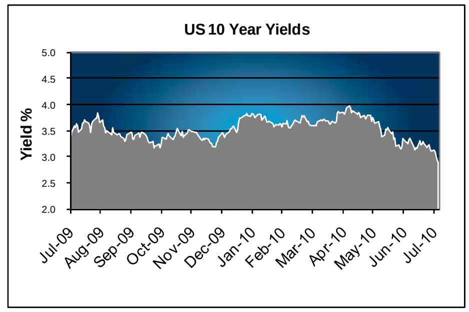
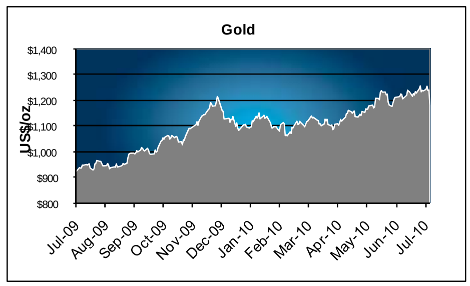
FIXED INCOME COMMENTARY

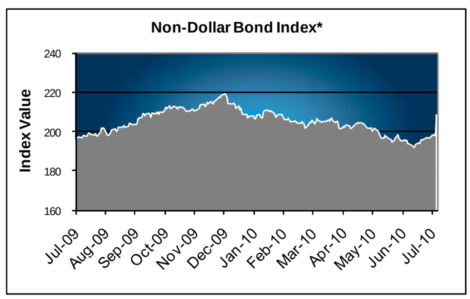
European Stress Test not so Stressful

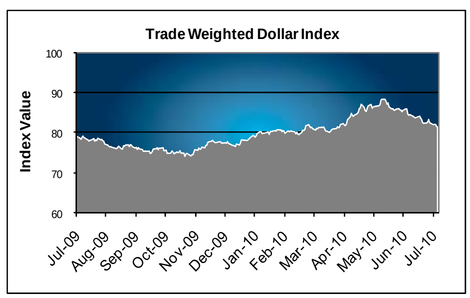
July posted a reversal of the flight-to-quality theme with corporate bonds outperforming government securities and the currency carry-trade back in fashion. The long awaited stress test of the European banks was not very stringent since it lagged rigorous criteria for a worst-case scenario. Investors took the outcome as a sign of relief nevertheless and high yielding bonds and currencies were in favor. High-yield bonds and preferred securities posted strong returns. In the foreign exchange market, the broad-weighted U.S. dollar index lost over five percent in July, while the commodity currencies were the front runners with returns of over six percent.











*Merrill Lynch Non-US Dollar Bond Index

U.S. Fixed Income Strategy

The International Monetary Fund raised its global growth outlook for this year once again, from 4.2 percent in April to 4.6 percent as of July. This compares favorably to the latest release of second quarter U.S. GDP of 2.4 percent (annualized rate). As widely expected, the growth rate slowed down after stimulus programs are winding down and the inventory cycle has stopped adding to growth. Several economic leading indictors continue to point to decent growth in the U.S. this year but have started to roll over from what seems to be their recent cyclical peak. The consumer remains the biggest component in the GDP report and an elevated and slowly decreasing unemployment rate will continue to put pressure on economic growth. Hence, it should not surprise that the latest FOMC minutes sounded quite dovish. The committee admitted that it would take some time for the economy to converge fully to trend growth. Putting a time frame on this statement, five to six years is a possibility. Indeed, Reinhart and Rogoff, authors of the book "This Time is Different: Eight Centuries of Financial Folly" found in their studies, that after financial crisis, countries experience weak growth for a long period, deficits remain high and debt as a percentage of GDP continues to rise (on average 86 percent in the major post-World War II episodes). These results are reflected in the very slow recovery of the current labor market. The recent job recovery has by far been the slowest of all revivals since World War II. High and persistent unemployment and low inflation rates have the potential to keep the Federal funds rate at close to zero percent until 2012 (if not even longer). Despite record high fiscal deficits, long-dated U.S. Treasuries have benefited from the weak labor market, low inflation and a very accommodative central bank. The spread between the ten- and two-year bonds remains at a historical high level and favors long-dated securities.

Anchor's strategy for this year has been to invest in medium- to longer-dated bonds in order to take advantage of the steep yield curve. Corporate bonds remain attractive and provide a decent yield pick-up in the current low-yielding environment. Aggregated data has shown that the balance sheets of corporations have become even more conservative. According to the rating agency Moody's, U.S. corporations (other than banks) held $1.84 trillion in cash in the first quarter. As a percentage of total company assets, cash is at its highest level in half a century. Conservative balance sheets have also been reflected in sharply falling default rates. The latest release of the global speculative-grade default rate declined to 6.1 percent at the end of June. This is a significant improvement from 11.1 percent one year ago. In fact, Moody's forecasts a continuation of the trend and expects global speculative-grade default rates to decline to 1.8 percent in the second quarter of 2011. As long as corporations remain conservative in their financial policies and while the default rate is declining, corporate bonds should be able to continue their outperformance versus government securities.

International Fixed Income Strategy

The foreign exchange market was dominated by the sovereign debt crisis and the resulting stress test of the European banks. The test itself was rather disappointing since it was lacking true stressful measures. The assumed hair cuts on bonds of potential sovereign defaults can be seen as too low and were only applied to bonds held for trading and not for securities held to maturity on banks' balance sheets – this represented just 10 percent of total bonds held by the banks. At the end, seven out of 91 banks failed and "only" EUR 3.5 billion in new capital needs to be raised. Despite the less rigorous criteria, investors seemed to find some comfort in the test and sent the euro higher.

Commodity currencies posted a very good performance in July after local central banks raised interest rates once again and the high correlation with the stock market's positive return supported the up-trend.