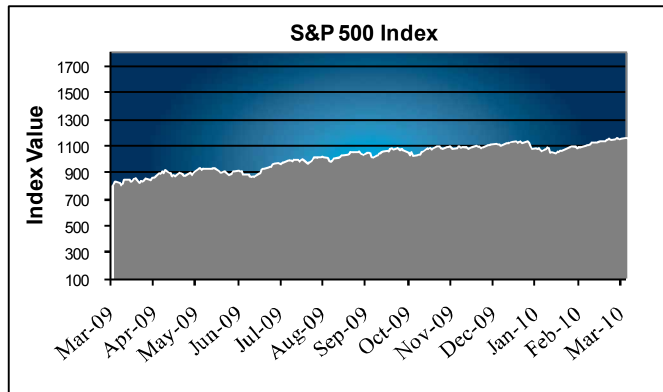
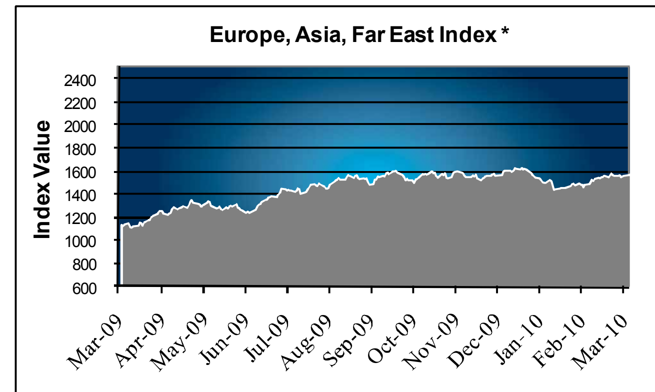
Stock Market Analysis





Cleanse and Refresh

Most economists focus on the negative impact of a recession on economic growth but I would argue that a recession is the free market system's method of cleansing corporate inefficiencies and forcing companies to be more productive. While the process is often painful with job losses, corporate failures and investment losses, usually companies are forced to provide higher quality goods and services at lower prices. This certainly appears to be the case in 2010 as we emerge from recession with productivity reaching a record high. Leaner and more competitive industrials and financials will likely report strong earnings growth over the next three years as economic growth rebounds. Investors recognized this potential in the first quarter and as result the finance and industrial sectors led the MSCI World Index to an eighteen month high.

At this point in the economic cycle the "perma-bears" return to hibernation and the analysts start scrambling to adjust their earnings trends to the positive economic reality. While there are certainly some headwinds and hangovers lingering from the financial crisis, we remain focused on the opportunities presented by the global economic recovery. The MSCI World Index has rebounded 72 percent from the March, 2009 low but the global equity benchmark would have to climb an additional 40 percent to return to the 2007 high. Shares are certainly not as cheap as they were a year ago but many high quality companies remain well below their historical valuation multiples after a decade of weak equity returns. Anchor continues to find under-valued companies that have strong balance sheets and attractive cash flow generation.

While corporate balance sheets continue to be healthy and most financials have significantly improved their capital ratios, we remain concerned about sovereign debt risk. Unfortunately, it is far more difficult for governments to cleanse themselves of bad habits during a recession. To the contrary, many countries have accumulated dangerously high levels of debt over the past two years as they were forced to bail out failing financial institutions and instituted stimulus packages to prop up their domestic economies. While these trends often occur during a recession, the current ratio of government debt relative to GDP in several countries could lead to the next financial crisis. It is particularly disturbing that many developed nations have the highest debt ratios. The elevated levels of borrowing will lead to rising taxes and slower economic growth, as a best case scenario and sovereign default(s), as the worst case scenario. Anchor remains focused both on the currency impact of this problem but also the impact on corporate tax rates and corporate profitability.

Note: Past performance does not guarantee future returns. Equity performance is based on Anchor's equity composite portfolio.
All stock index returns are adjusted for 30 percent foreign withholding tax

* MSCI EAFE Index

Fixed Income Analysis

Merrill Lynch Fixed Income Indices				Modified	Macaulay	Maturity	Period Total Return*			
		Yield to	Yield to	Duration	Duration	WAL				
Name	Code	Worst	Maturity	To Worst	(Years)	(Years)	Quarter	1 Year	3 Years	5 Years
Global Bond	GBMI	2.8%	2.9%	5.2	5.3	7.0	-0.2%	10.3%	6.5%	5.0%
Non-US Bond	GBXD	2.5%	2.5%	5.8	5.9	7.8	-1.7%	12.0%	6.7%	4.7%
US Corporate/Govt	B0A0	3.1%	3.1%	5.2	5.4	7.5	1.7%	7.9%	5.8%	5.1%
US Government	G0A0	2.3%	2.4%	4.7	4.8	6.2	1.1%	-0.4%	6.0%	5.2%
US Corporate	C0A0	4.6%	4.6%	6.2	6.4	10.0	2.7%	24.8%	5.7%	5.2%
US High Yield	H0A0	8.4%	8.6%	4.1	4.8	7.0	4.8%	57.2%	6.5%	7.7%
US Hybrid Preferred	P0H0	6.8%	7.2%	8.2	10.8	n.a.	5.3%	57.6%	-2.1%	1.2%

*3 and 5 year returns are compounded annualized returns

Sovereign Credit Crisis

In the first quarter bond and foreign exchange markets were heavily influenced by sovereign credit risks. Country defaults were usually a phenomenon seen in South America, Africa or smaller countries in Asia and Europe. This decade started off with a fundamental shift in evaluating sovereign credit risk. The so-called Emerging Markets have recovered strongly from the financial crisis of last year. Their balance sheets are relatively strong since Emerging Markets were not directly involved in the global banking crisis and hence did not have to bail out major financial institutions by increasing their debt levels. On the other side, the G-10 group of countries were the most effected by the crisis and it took major financial efforts to avoid a total collapse of the financial system. The bailouts came at a hefty price, namely soaring budget deficits and rapidly increasing debt levels. The Congressional Budget Office (CBO) has forecast that the debt-to-GDP ratio of the U.S. will rise from 40 percent at the end of 2008 to 90 percent by 2020. Similar projections have been made for the U.K. and the euro zone.

So far, the G-10 group has been able to issue enough debt to finance their budget deficits and repay maturing debt. This has been different for smaller and less reputable countries. Greece, for example, has received a lot of media attention regarding its very elevated debt level and astronomical budget deficit. Investors have been reluctant to buy Greek debt which has sent its bond yields to record highs. Other European countries and the International Monetary Fund were forced to announce a rescue plan for the Hellenic Republic in the event that Greece's increased default risk will shut it out of the capital markets entirely. While Greece represents only two percent of the euro zone, fears have arisen that other countries – like Italy, Portugal and Spain – could be the next victims.

The Anchor managers will continue to overweight corporate versus government bonds. Corporate bonds outperformed government securities once again with high-yield bonds the clear forerunner. While global default rates are still at historical high levels, the trend is encouraging. The rating agencies have forecast a drop from over 12 percent to under four percent by the first quarter of 2011. Following the financial crisis, companies have become more conservative. They have restructured their balance sheets, by reducing outstanding debt and refinancing short-term obligations for longer-dated securities. Dropping debt-to-equity ratios and the build up in cash reserves bode well for corporate bonds. Within the corporate bond sector, financial fixed income securities still look attractive. Policy makers around the globe have worked on de-risking financial institutions. It is likely that banks will have to operate under higher capital requirements. The risk premiums of financials bonds are still the highest in the corporate bond universe. The cheap valuation plus the proposed regulatory framework for de-risking the balance sheets of financial institutions lead to the potential for further outperformance of the financial sector of the bond market.

In the foreign exchange market, the Anchor managers will continue to overweight the U.S. dollar in the international bond portfolio. The euro is hardly attractive since the euro zone has to deal with the situation in Greece and fears about rising default risk in Portugal, Spain and Italy has weighed on the euro's sentiment. There is more value in peripheral European currencies, like the Norwegian krone and the Swedish krona. Both economies have strong fundamentals and are expected to grow faster than the euro zone in 2010. The Anchor managers still like the two commodity currencies Australian and Canadian dollar. Both economies benefit from a strong external sector and Australia offers the highest bond yields in the G-10 group.