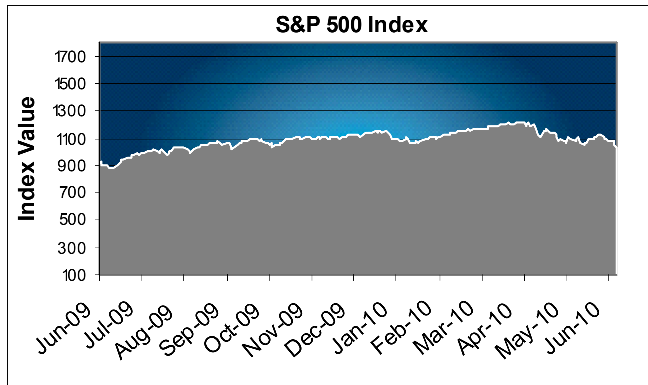
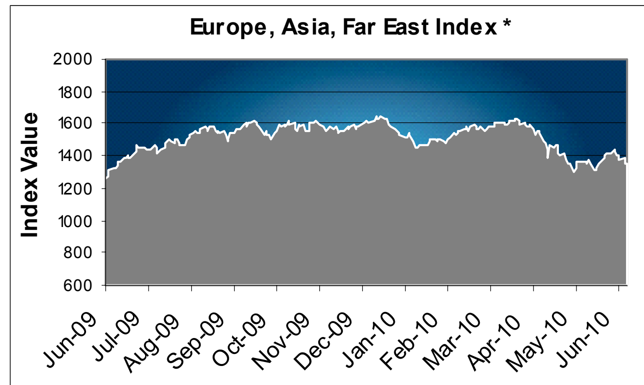
Stock Market Analysis





The Debt Hangover

After two decades of excess spending many federal and local governments are realizing that it is a lot easier to increase spending rather than raising taxes and reducing expenditure. Unfortunately for stock investors, credit fears caused many participants to push the sell button after the fifty percent gain in the S&P 500 Index over the past year ending on March 31. The U.S. benchmark retreated 11 percent in the second quarter but losses in international exchanges were magnified by currency declines relative to the dollar. MSCI EAFE Index declined 15 percent with many European exchanges losing more than 20 percent when measured in dollars during the quarter. The market appears to be rethinking the strength of the economic recovery due to the problems in Europe, new inflation concerns in China and renewed weakness in the U.S. housing market. Financial shares registered double digit losses as the European financial crisis refocused investors' fears on the risk of the global leverage bubble on international banks.

While we believe that there are legitimate concerns with the levels of government debt, we continue to believe that this leverage will mute the economic recovery and not end the rebound. Less leveraged emerging markets continue to drive global growth and provide attractive export opportunities for many multi-nationals. After a decade of negative returns stock valuations are very attractive. The historically low interest rate environment should drive investors to risky assets such as equities.

The BP Gulf Oil Disaster impacted energy shares with the MSCI Energy Index declining 15 percent. During the quarter Anchor repositioned the energy sector of the portfolio to reduce the risk to offshore drilling and increased the alternative energy weighting. We believe that the problems in the Gulf will impact the supply of energy to the U.S. and will continue to pressure energy prices higher. The disaster will likely refocus government energy policies and benefit solar, wind, nuclear and other alternative energy sources.

As we look forward to the second half of the year we believe investors need to be selective about their security choices due to the numerous "pot holes" on the investment highway. At the same time, many stocks are selling at historically low valuations which present attractive long-term opportunities for patient investors.

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											
Name	Code	Yield to Worst	Yield to Maturity	Modified Duration To Worst	Macaulay Duration (Years)	Maturity WAL (Years)	Period Total Return* Quarter	1 Year	3 Years	5 Years
Global Bond	GBMI	2.4%	2.4%	5.2	5.3	7.0	0.5%	5.4%	6.9%	5.1%
Non-US Bond	GBXD	2.3%	2.3%	6.0	6.2	7.9	-1.9%	2.0%	6.3%	4.7%
US Corporate/Govt	B0A0	2.6%	2.7%	5.3	5.5	7.7	4.1%	9.8%	7.3%	5.2%
US Government	G0A0	1.7%	1.8%	4.9	5.0	6.4	4.5%	6.5%	7.6%	5.4%
US Corporate	C0A0	4.3%	4.3%	6.3	6.5	10.1	3.6%	16.3%	7.1%	5.2%
US High Yield	H0A0	9.0%	9.2%	4.2	4.8	6.9	-0.1%	27.5%	6.4%	7.1%
US Hybrid Preferred	P0H0	7.1%	7.4%	8.5	10.7	n.a.	-0.3%	20.1%	-1.6%	0.7%

*3 and 5 year returns are compounded annualized returns

Government Bonds in Favor

The sovereign debt crisis coupled with some weaker than expected economic data led to another stellar quarter for bond investments. Due to a flight-to-quality, government bonds were the outperformers while high-grade corporate bonds also performed well. Riskier bond investments with higher correlation to the stock market, like high yield and preferred securities, posted a negative return in the second quarter. There is still a lot of uncertainty in the capital markets and many investors have parked their money in the safest of bond investments for now. Consequently the yield of the two-year U.S. Treasury security has hit an all-time low. The bond market has also received support from the recent G-20 meeting. Countries agreed on halving deficits by 2013 and to stabilize or reduce government debt-to-GDP ratios by 2016. While this is a desirable outcome in order to reduce risk premiums for weaker creditors, it also has the potential to curtail growth in the next couple of years.

Economic data in the U.S. has sent mixed signals. Leading indicators are still at high levels and point to strong economic growth rates in 2010. Nevertheless, they seem to have reached their peak in the current cycle and some of the data has started to roll over. The housing market’s recovery has paused after the expiration of the tax credits. Indeed, purchases of new homes fell to a record low and the housing confidence index posted a big drop as well. It is possible that there will be a double dip in the U.S. housing market. Besides housing, the U.S. economic recovery is on track but still appears to be fragile. The labor market is improving only gradually and hence high unemployment is constraining household spending. The Federal Reserve acknowledged the uncertainties surrounding the economic recovery with a more dovish statement. The Committee is also concerned about underlying inflation trending lower and low capacity utilization rates. Thus, the target rate will likely be kept at the 0 to 0.25 percent range for longer than initially expected. As a result, even long-dated government bonds rallied since the short-end seems to be anchored at very low interest rates for some time. The Anchor managers refinanced matured bonds in the second quarter primarily with longer-dated high-quality securities in order to take advantage of the historically steep yield curve. We have also put an emphasis on the bond ladder approach in order to reduce volatility and benefit from the steepness of the yield curve. The Anchor managers also see good value in high-quality corporate bonds. Fundamentals have improved for corporate issuers and are expected to continue to improve in the next couple of quarters. This paired with still decent yield premiums versus government securities make corporate bonds attractive.

Currencies have been quite correlated with the stock market performance and change in volatility levels lately. Due to elevated uncertainty during the second quarter many high yielding currencies underperformed and the U.S. dollar and Japanese yen were the top performers once again. The Anchor managers have over-weighted the U.S. dollar in the international bond allocation for some time. The U.S. economy is expected to post one of the highest growth rates of the G-10 economies this and next year and has the chance to be the first of the G-4 countries to raise interest rates (but probably not before 2011). Sometimes it is difficult to understand why the Japanese yen with is record high debt-to-GDP ratio and ultra-low monetary policy can post such an outstanding performance during market volatility. Japan’s government bond domestic ownership rate of over 90 percent and a positive net international investment position seem to make the currency attractive during stock market sell-offs. Nevertheless, the Anchor managers believe that the weak fundamental situation in Japan and the expected lag in normalizing interest rates will lead to an underperformance of the Japanese currency over the long term. We see more value in fundamentally strong economies like Canada, Norway and Sweden and like the high interest rates in Australia. The Anchor managers have also been constructive on the British pound as one of the most undervalued currencies and due to more stringent than expected austerity measures in order to reduce the budget deficit and cut indebtedness.