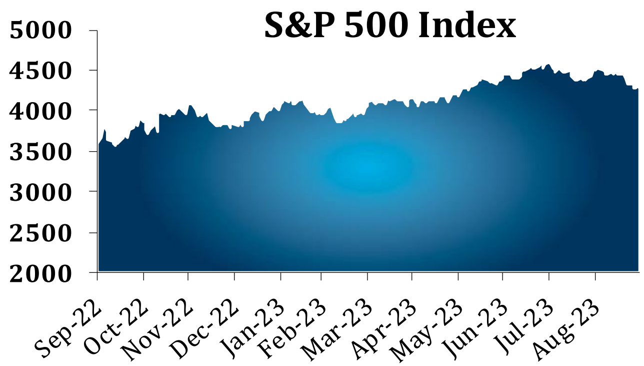
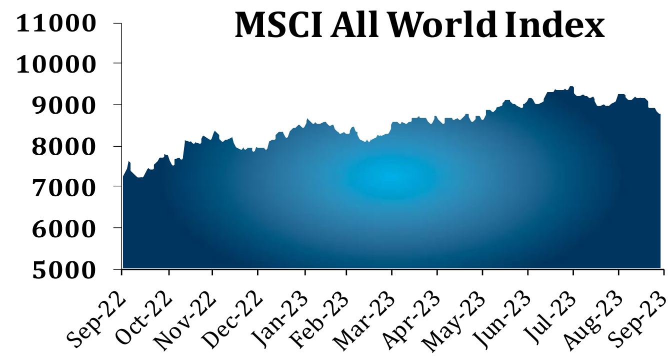
Public

Stock Market Analysis

Headwinds Cause a Profit Recession





Global central banks have insisted that they will keep short-term interest rates elevated long enough to wring out inflation. Unfortunately, this tight monetary policy is the equivalent of a tax on consumers and corporate profits. The 35% jump in crude oil price since June further pressures household spending, and the strength in the dollar will mute foreign earnings for U.S. multinationals. Investors feared that these taxes on earnings would persist longer than initially expected, and equities experienced selling pressure in the third quarter. In the U.S., the S&P 500 operating earnings fell 3.0% in the first half of the year based on Bloomberg data. International companies have been more challenged by inflationary pressures, and the MSCI ACWI operating earnings slid 10.4% in the first half of the year. The current headwinds and margin pressure has challenged the post-COVID rebound in consumer discretionary and industrial profits. While profitability will remain under pressure this year, analysts expect profit growth to rebound 10.2% and 8.9% next year for the S&P 500 and MSCI ACWI indices, respectively.

Despite these challenges, markets are forward-looking, and central banks have successfully reduced inflation pressures. One of the Fed's preferred inflation metrics, the US core PCE Index (excluding food and energy prices), declined to 3.9% in August, the lowest increase since late 2020. While Fed governors have made it clear that they will hold off on rate cuts this year, the direction from here is eventually lower. Several sectors have already felt the impact of the economic slowdown in 2022, and the earnings comps will get easier next year. We also believe artificial intelligence innovation will cause significant productivity and growth opportunities over the next decade. While it is difficult to forecast all the AI applications, it is clear it will improve technology, healthcare, research, and other human services. Reports have claimed that AI will hurt employment, but many experts predict that AI will be labor augmenting, rather than labor substituting, increasing productivity.

Stock Market Analysis

The higher interest rates and the rising cost of capital have hit the financial sector particularly hard. After a decade of low interest rates, the Fed hiked rates by 5.25% in 16 months. Historically, periods of rapidly rising rates cause unanticipated strains, as we witnessed during the Great Financial Crisis (GFC) and regional banking meltdown this year. It is a credit to the capital rules implemented following the GFC that the global banking sector has withstood the historic interest rate shock. While there have been losses absorbed by investors, this has fortunately not turned into a significant credit event as we saw during other downturns. We anticipate banking earnings will be depressed for the rest of 2023 before slowly recovering in 2024. Interest rate sensitive sectors usually are the first companies to recover after an economic downturn and we anticipate that investors will start looking forward to this recovery and lower interest rates once that they are comfortable that the worst of the economic downturn is behind them.

There was profit taking in the third quarter, but the equity markets produced double digit returns year-to-date. The U.S. equity market has performed better than global market indices, primarily due to the large technology sector, with investors focused on artificial intelligence (“AI”) related shares. The S&P 500 Index produced a 12.6% return in the first nine months of the year. The breadth of the market was weak with the cap-weighted index performance driven by tech “mega caps”. The broader indices such as the Russell 2000 equal weighted index declined by 4.4% year-to-date.

The Anchor Equity Composite rose +0.2% in the third quarter and returned 15.4% in the first three quarters of the year, compared to -3.2% and 10.3% respectively for the MSCI ACWI benchmark. The portfolio has produced an 11.9% annualized return over the past three years compared to 7.3% for the benchmark. This year higher interest rates, the strong US dollar and weak market breadth hurt the performance of global quality dividend strategies. The High-Quality Income Portfolio Composite returned -4.5% in the third quarter and declined -1.8% in the first nine months of 2023 compared to -2.0% and +1.7% respectively for the SG Global Quality Income benchmark. The portfolio has produced a +7.7% annualized return over the past three years compared to +5.65% for the benchmark. *

**Performance is based on Anchor equity composite portfolios. Returns include changes in unit value, reinvestment of all distributions, investment management fees, execution, custodial and other charges. Investment results are best judged over the long term. Performance should be evaluated with consideration of the client’s specific goals and investment objectives. Past performance is not necessarily indicative of future results. Returns for indices or benchmarks are provided in U.S. dollar terms and solely for informational purposes. These indices or benchmarks are non-managed indices that do not accrue advisory or transactional expenses. Benchmarks are based on the client's selected asset allocation and are calculated in U.S. dollar terms. The Anchor Equity Portfolio benchmark uses the MSCI AC World Total Return Index. The Anchor High Quality Income Portfolio benchmark uses the SG Global Quality Income (USD) Index.*

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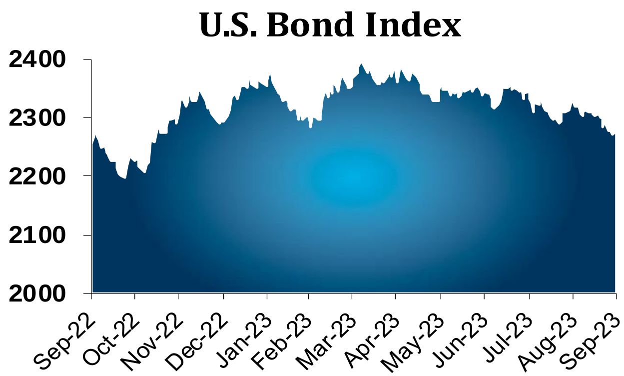
Fixed Income Analysis

Connect the Dots



ANCHOR Investment Management

The Federal Open Market Committee (FOMC) met in September, leaving the Fed funds rate unchanged. Chair Powell stuck to the rhetoric of "higher for longer" which he has been reiterating for most of the year. This stance was further supported by the Fed's updated Dot plot– each member's projection of the path of the fed funds rate over the next two years and their estimate of the longer run Fed Funds rate. The median estimate for year-end 2024 (YE24) rose from 4.6% in June to 5.1%, while the YE25 median rose from 3.4% to 3.9%. The long-term median dot was unchanged at 2.5%; there was an increase in the number of dots above the median though not enough to move the median estimate. The FOMC also updated their Summary of Economic Projections in September. These are each individual member's projections for GDP growth, unemployment, and inflation for the next few years and over the long run. The median projection for Personal Consumption Expenditure inflation (PCE) and core PCE (excluding food and energy) are expected to decline each year before reaching the Fed's 2% target (exactly) by YE26. Meanwhile, the median unemployment rate projection fell from 4.1% in June to 3.8% for YE23 and from 4.5% to 4.1% for YE24 and YE25. These projections, in conjunction with positive real GDP growth forecasts of 1.5% (up from 1.1%) for 2024 and 1.8% in 2025 and 2026, reflect the very definition of a soft landing. In the press conference, Chair Powell repeatedly tried to emphasize the difficulty of forecasting and said the Fed would remain data dependent.

On top of resilient economic data (big JOLTS job openings, strong consumer spending), the market took these forecasts as evidence of the Fed's intention to stick to the higher for longer stance by pushing rates higher through to the month-end. This was led by rates at the long end of the curve. The 2Y yield rose 0.18% in September to 4.86%, while the 10Y rose a considerable 0.46%, ending the month at 4.57%. The 30Y treasury rose by a whopping 0.48%, long-end rates are far less influenced by near-term expectations of the fed funds rate but rather by longer-term expectations (such as inflation), the degree of uncertainty around these expectations, and investor positioning.

Fixed Income Analysis

Uncertainty rose in September as proxied by the “term premium” - the extra compensation investors receive for investing in longer-dated bonds versus continually rolling over short-dated bonds. The term premium is only knowable ex-post (because you don’t know the future path short-term rates will take). The New York Fed’s estimate of the term premium in September moved sharply higher, from -0.52% to 0.10%. Using net non-commercial net positioning in 10 year and 30 year treasuries futures as a proxy for investor sentiment towards bonds, both are notably short which indicates that investors remain bearish bonds. We are not technical traders, but we note that the 10-year treasury broke through a long-term resistance level, which likely played a part in the big move.

The Goldman Sachs Financial Conditions index moved sharply into restrictive territory due to the increase in interest rates and falling equity prices. Ultimately, higher longer-term rates assist the Fed’s monetary tightening efforts: The higher long rates go the more restrictive monetary conditions will be, which in turn should further slow the economy (that is itself helping to drive rates higher). We’ve already seen banks reign in lending to conserve capital, while excess savings from multiple government handouts are being run down. Thus, while bonds are very much unloved now, forward returns are looking more and more attractive. For one, given the level of rates, there is a much larger cushion to absorb rates moving higher before incurring an unrealized loss. Also, if the Fed overtightens and causes a recession, there is ample opportunity for appreciation over and above the bond's yield to maturity. We ended Q3 slightly underweight duration versus our benchmark and underweight high yield credit vs. our neutral allocation.

ANCHOR
Investment Management

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