ANCHOR
Investment Management, LLC

# Q1 COMMENTARY 2019

**April 15, 2019**

| Market/Index | 2016 Close | 2017 Close | 2018 Close | 2018 Change | As of 03/31/19 | 2019 Change |
|---|---|---|---|---|---|---|
| DJIA | 19,762.60 | 24,719.22 | 23,327.46 | -5.63% | **25,928.68** | **11.15%** |
| NASDAQ | 5,383.12 | 6,903.39 | 6,635.28 | -3.88% | **7,729.32** | **16.49%** |
| S&P 500 | 2,238.83 | 2,673.61 | 2,506.85 | -6.24% | **2,834.40** | **13.07%** |
| Prime Rate | 3.75% | 4.50% | 5.50% | 1.00% | **5.50%** | **0.00%** |
| 10-year Treasury | 2.45% | 2.40% | 2.69% | 0.29% | **2.41%** | **-0.28%** |

**That's the way the ball bounces…** We started the fourth quarter newsletter by talking about the bad market we had just experienced, *"In the 4th Quarter the S&P 500 fell 14%, the Dow Jones fell 12%, and the NASDAQ fell 17.5%... ouch."* In the 1st Quarter of 2019 we have the exact opposite, the S&P 500 rose 13.07%, the Dow Jones rose 11.15%, and the NASDAQ rose 16.49%. Both results are equally abnormal and neither are particularly healthy indicators for the markets as a whole, but we like being able to report good news rather than bad.

Many interesting things have happened in the world recently, and it has made deciphering what the future holds a tricky business. Here are some key things that we have been watching and some interesting stories unfolding across the globe.

## The Inverted Yield Curve

The Federal Reserve has been increasing the Fed Funds rate in order to have tools to stimulate the economy during future times of economic distress. Typically, the yields for longer term notes will follow suit but in the last six months long term rates have actually fallen. While the yield on a 3 month note has risen from 2.23 to 2.44% (+9%), the yield on a 5 year note has fallen from 2.94% to 2.23% (- 24%), the 10 year has fallen from 3.23% to 2.52% (-22%), and the 20 year has fallen from 3.34% to 2.75% (-18%). That's right, you can now earn a higher yield on a 3 month T-bill than a 5 year note.

Why does this happen? The European Central Bank recently changed course and signaled that it would maintain interest rates below zero longer than anticipated due to economic uncertainly in Europe and the potential implications of Brexit. That caused investor demand for US debt to skyrocket. If you are a European insurance company and a European 10 year AAA rated bond is yielding 0.044%, a yield of 2.52% looks like you won the lottery.

The Federal Reserve is now reluctant to increase short term rates further and the futures markets have currently priced in a 100% chance that the Federal Reserve will LOWER interest rates this year, not because they want to but because they need to have short term rates fall in line with the rest of the yield curve. Government intervention certainly is a double edged sword and it makes interpreting the potential ramifications of this inverted yield curve difficult. But until European Quantitative Easing ends, the demand for US debt will be high and yields will continue to be relatively low.

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- Inverted Yield Curve
- High Yield Debt
- Oil Industry
- Chinese Trade Deficit

## High Yield Debt and Relaxed Bond Covenants

Contrary to what you may have read, the 2008 Mortgage meltdown was not a case of pure fraud. The underlying root cause of the problem was that from 2000 to 2008 global demand for fixed income investments doubled, from $36 Trillion to $70 Trillion. To put that in perspective, $70 Trillion was more than the total amount of the world's economic activity that year. For global investors, US Government Debt is the safest in the world and was in high demand, but at the time the US Government only had $9 Trillion of outstanding debt. When that was accounted for, global investors went looking for the next best thing, US Mortgage debt, which had very low default rates. When "credit worthy" US Mortgage debt was used up, global investors relaxed their credit standards and **demanded** more US mortgage debt of lower and lower quality. Banks and Mortgage Companies now had willing buyers for "junk" mortgage loans and proceeded to fill that need very well, but the key point is that investors **demanded** the lesser credit quality product, leading to the eventual outcome.

This phenomenon seems to be happening again in the High Yield Debt (Junk Bond) markets. Demand for fixed income investments remains very high (Since 2008 it has grown from $70 Trillion to $162 Trillion), yields on investment grade debt are artificially low, and loan defaults have reached a seven year low of 0.92%. In addition, the supply of unrated bonds issued in the 1st quarter was down 5.5% and the supply of new bank loans was down 68%. High demand and low supply, sound familiar?

Last month Moody's Investor Services noted "unprecedented flexibility" on the part of borrowers to make investments free of obligations to maintain certain coverage levels, as well as "aggressive use of investment capacity" that allow issuers to shift assets beyond creditors reach, leaving investors in "uncharted territory." In one example, because of the lax lending standards of investors, J. Crew Group, Inc. was able to borrow money against company assets and then move $250 million of those assets to a foreign subsidiary (out of the grasp of supposedly-senior bond holders), and have the subsidiary company issue $250 million of new debt using those same assets as collateral. *

While this is nowhere near the scale of the mortgage issue, it does show that some investors have decided to take on additional risk because they have fewer and fewer options. If the bonds default, they will probably have insufficient assets to use as collateral. We just hope it remains a small subset of the market. As for our portfolios, we prefer investment grade securities and, unless a client desires above market yields and are aware of the additional risks, have never held much high yield debt.

*Almost Daily Grant's "Re: ADG 4/1: Motley Crew". E-mail.

## The Oil Industry

The once almighty oil cartel known as OPEC (Organization of the Petroleum Exporting Countries), has weakened to the point that its members have lost confidence in the organization's ability to manage and control oil prices as it has done for decades. Recent political events for certain OPEC members have further hindered OPEC with sanctions on Iran and the demise of Venezuela's oil industry.

Descent among the organization has enticed Saudi Arabia and other members to seek alternative arrangements. Discussions among a 10 nation group, including Russia but not Iran, was a consideration reviewed in February.

As of September 2018, OPEC's member countries account for 44 percent of global oil production and over 81 percent of the world's proven oil reserves. OPEC has been the primary influence on global oil prices and supply for decades, until now. Over the past few years, the onslaught of non-OPEC producers such as U.S. shale oil production, has hindered OPEC's supply and price control of the global oil markets, hampering its global influence on the industry.

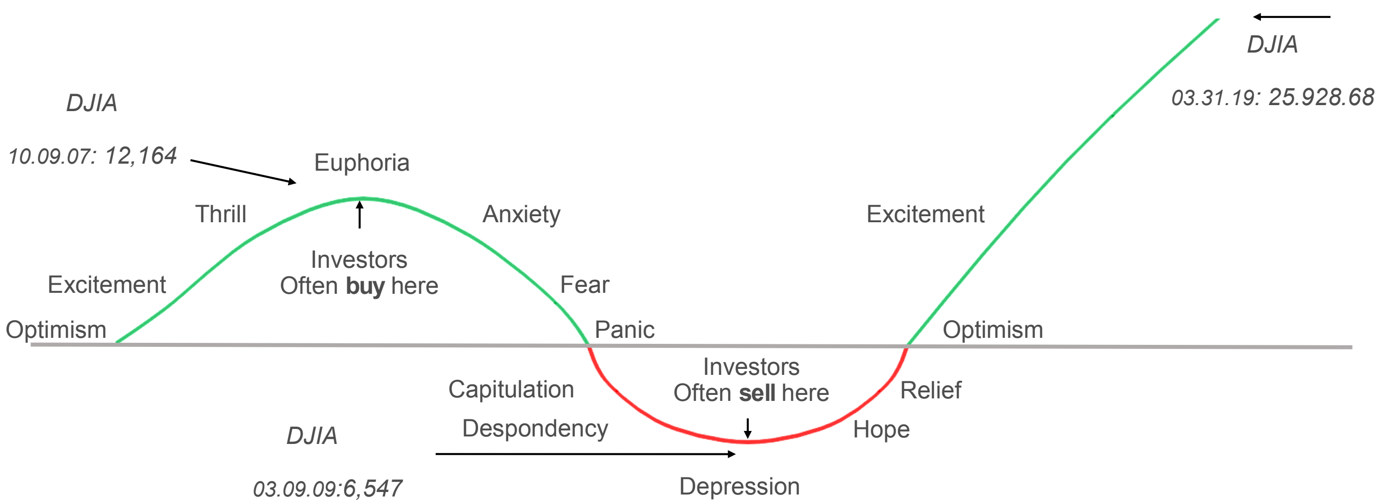
The U.S. Energy Information Administration (EIA) estimates that OPEC production in 2019 will fall by 1 million barrels per day while U.S. production will increase by over 2 million barrels per day. The US is now the world's largest producer of oil. Never count out American ingenuity!

## The Chinese Trade Deficit and Intellectual Property Rights

The US trade deficit with China has grown tremendously over the past 30 years, from nearly a trade balance in 1985 to a $375 billion deficit in 2017. China's trade deficit with the U.S. rose to the largest difference ever in the last quarter of 2018 as ongoing trade disputes continue. In October 2018 alone, U.S. exports to China were valued at $9.13 billion versus imports from China were valued at $52.23 billion, resulting in a $43 billion trade deficit for the **month**.

Over the past twenty-five years, large international conglomerates have established an enormous manufacturing presence throughout China, utilizing its cheap labor and quick turnaround times. China's manufacturing plants are among the most modern in the world, producing large capacities almost entirely for export. While China allows foreign companies to "exploit" their low cost of labor, they also use foreign-ownership restrictions to compel companies to give manufacturing secrets and technology to local firms, essentially demanding that US Companies give away their Intellectual Property. The Chinese government also supports and conducts cyberattacks on U.S. companies to access trade secrets.

As we are writing this newsletter, the Trump Administration is stating that they are making progress with the trade negotiations and they should have new announcements soon, but the holdup is Intellectual Property. They are being kind, the holdup is China's theft of our Intellectual Property. If we get a good trade agreement, and if the Chinese uphold their end of the bargain, we should be much better off going forward.




**All of us at Anchor Investment Management wish you the best this Spring and look forward to helping you reach your goals. We remain humbled by your trust and confidence and we hope to earn your continued confidence in the years ahead.**

3205 Devine Street, Columbia, SC 29205 • 803-399-9383

admin@anchorinvestmentmanagement.com