ANCHOR
Investment Management, LLC

Q3 COMMENTARY 2022

October 19, 2022

Market/Index	2019 Close	2020 Close	2021 Close	2021 Change	As of 09/30/22	2022 Change
DJIA	28,538.44	30,606.48	36,338.30	18.73%	28,725.51	-20.95%
NASDAQ	8,972.60	12,888.28	15,644.97	21.39%	10,575.62	-32.40%
S&P 500	3,230.78	3,756.07	4,766.18	26.89%	3,585.62	-24.77%
Prime Rate	4.75%	3.25%	3.25%	0.00%	6.25%	3.00%
10-year Treasury	1.92%	0.93%	1.52%	0.59%	3.83%	2.31%

It has taken us two and a half weeks to write this quarter's commentary, primarily because of unexpected market reactions to daily news events. The Fed's hawkish stance on inflation means good economic news is bad for the market and bad economic news is good for the market. It's frustrating for everyone, but times like this are when we provide the most value for our clients. Investors who stay invested and advantageously buy cheap stocks through the tough times can do very well in the long run.

Consumer Sentiment Index

In June, the Consumer Sentiment Index hit an all-time low of 50. For context, the average is 86, November 2008 was 55, September 2001 was 81, and November 1987 was 83. We think the reading is unwarranted and driven mostly by social and political malaise rather than the economy. However, distraught retail investors tend to sell stocks, driving markets lower. The good news for patient investors is the expected returns coming out of these situations. When the Consumer Sentiment Index falls below 70, the average 6, 12 and 24 month market returns are 6%, 13% and 29%, respectively.

Personal Savings at Lowest Rate in 14 Years

With thoughts of a recession on everyone's mind you would think that people would be preparing for it by spending less and saving more. Counterintuitively, the US savings rate reached a 14-year low of 5.1% of disposable income in June 2022. Pre-Covid, the average was about 7%, and we reached a peak of 33.8% in April 2020. If a bad recession comes, some people may not be ready for it. Anchor clients who are following a good financial plan and have a solid investment strategy should be able to weather easily any storm.

Inflation

The US 12-month Inflation Rate currently sits at 8.2%, primarily driven by oil price increases in the second quarter. What may be a surprise is the monthly inflation rate has been essentially zero for the last two months due to a reduction in fuel prices. This news would be good if it continued, but we aren't betting on it. Europe's need for heating oil this winter will likely drive-up oil prices again over the next few months and OPEC+ reduced supply by 2 million barrels a day at the beginning of October. Fuel prices will likely remain high through the winter, putting upward pressure on prices throughout the economy.

The Federal Reserve has stated that they will continue to raise rates and sell bonds to fight inflation. Interest rates have risen across the board; in 12 months the 30-year mortgage rate has risen from 3.0% to 6.7%. Homebuyers who can afford a $2,500 mortgage payment could have purchased a $750,000 house last year; now they can afford only a $475,000 home. Building permits are down 14% and lumber prices have fallen 70% since March. The economy is cooling off, but we all know that it needed to re-adjust to a normal cycle.

The Rising Dollar

As the US moves to quantitative tightening to fight inflation, the law of unintended consequences is apparent and causing potentially major ramifications for the world economy. As the US has raised interest rates, the demand for US debt has risen, causing the US dollar to rise (investors must buy US debt with US dollars, so foreign investors must buy US dollars first). A rising dollar has caused a lot of problems for countries who issue US dollar denominated debt such as Saudi Arabia, Indonesia, Israel, Mexico, Colombia, and Argentina. As the value of the dollar rises, the costs to these countries to repay these loans can increase tremendously. The risk is so large that the United Nations just took the unprecedented step of recommending that the US and other developed nations stop raising interest rates due to the negative effects to developing countries. While the global community can prop up a country, we can't know what the real risk is for global banks and hedge funds with highly leveraged positions in these countries' debt. It reminds us of 1998 when the Russian financial crisis caused one highly leveraged hedge fund, Long Term Capital Management, to lose so much money it almost crippled the US financial system. As counterproductive as this may seem, a major upheaval in a portion of the market is usually needed to start a market recovery; it lets policymakers know they have moved too far off course, which is what happened in Britain in September.

What Happens When Politicians Overreach…

The British economy has had a rough time over the past few years. They are still dealing with the aftermath of Brexit, Boris Johnson finally stepped down as Prime Minister after months of scandal, and to top it all off, the Queen died. The Conservative Party elevated Liz Truss to be the new Prime Minister. She represents the free market, trickle down economics wing of the Conservative Party and sees herself as a radical who will do things that other politicians won't.

On September 23, just two weeks into her administration, her government announced massive tax cuts for the rich, but no offsetting reduction in government spending. In fact, they had increased spending by previously committing to a massive new program to subsidize high energy bills for households and businesses. She was making these moves amidst some of the worst inflation in decades and as the Bank of England, like central banks around the world, was raising interest rates. In essence, Britain now had one part of the government putting its foot on the economic accelerator and one foot on the brake. Investors immediately lost faith in the British economy and reacted by selling both U.K. government bonds and the Pound heavily. Over two days, interest rates skyrocketed and almost triggered a complete economic collapse in the UK.

The problem lay with of all things, pension funds. Pension funds invest money today to pay out more money to workers as they retire. These funds oversee trillions of dollars and have been piling into a strategy that bets on interest rate fluctuations using derivative contracts with investment banks. In these derivative contracts the pension fund must give the bank collateral, usually in the form of government bonds. Furthermore, the contracts state that if interest rates go up above a certain threshold or the collateral's price goes down below a certain threshold, then the pension fund must provide even more collateral. In this case, interest rates rose and the value of the bonds being held as collateral fell by massive amounts. Per the terms of the contracts, banks requested more bonds as collateral from the pension funds and the pension funds didn't have enough. When that happens, the banks are supposed to seize the collateral and sell them to make themselves whole. If that had happened, billions of dollars of bonds would have been dumped on the market, pushing prices down further and triggering another round of margin calls for the Pension Funds. The Funds would have had to liquidate other assets and it could have triggered a financial contagion that reverberated around the world.

It didn't happen. Luckily, the Bank of England, the UK's Central Bank, which had been selling bonds to fight inflation, stepped in and announced that they would reverse course and start buying bonds to prop up bond prices and stop the margin calls. These decisions happened in a matter of hours. The same day, Liz Truss' government announced that they would not cut taxes for the rich and that they would instead reduce spending, reversing course on her Party's entire agenda.

Outlook

There is a great deal happening in the global economy now and the markets are primarily news driven at this point. We continue to see strong companies in our portfolio, but the multiples investors will pay for stock in these companies have been reduced. It's important for our clients to know that the market has already priced in a 2023 recession and that the stock market always recovers before the economy does. We do not want to be selling stock in companies unless their outlook materially changes, and we are looking to buy stock in companies while the market is low.

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