Prepared Comments from 10/15/2014 Conference Call

Stocks cooled down in the 3rd quarter, and in the past week have fallen further. The S&P 500 is down 9% from its all-time high last month. The best investment performance this year has come from long-term government bonds, having returned over 20%. What should investors do?

I have regularly noted that stocks and stock markets are driven by two forces, economics and emotions. What has been driving stocks this year, and what does that mean for your asset allocation decisions?

The economic factor behind stocks and markets are the earnings, the profits. The S&P 500 set a record on profits for the 2nd quarter, at 22% greater than its 2007 peak. When someone notes that the markets were setting new highs and therefore must be ready to fall, remember that they are setting highs because their profits are setting highs. This is logical. This is economics.

The emotion factor behind stocks and markets are the price that investors pay for those earnings, the P/E ratio of a stock's price divided by its earnings. The US stock market's PE ratio at the end of September was 15.2, higher than the 10-year average but lower than the 25-year average. I consider the US stock market to be reasonable, neither cheap nor expensive, from a PE ratio perspective.

If the stock market's recent weakness has been driven by falling earnings for US companies, then it would be economically-driven. In this case, while there are some economic factors that cause raised concern, the bulk of the selling has been justified by emotional factors.

Let's look at the US economy. Economic growth in the 3rd quarter looks solid, perhaps 2.8%, which is greater than we have averaged during this recovery. Unemployment is now below our 50-year average of 6.1%. Car sales are above average, and should persist at this elevated level for a few years. Real capital goods order are also above average and also should continue at this level for a few years. Housing prices have partially recovered, the glut has been worked down, housing affordability remains VERY attractive, and yet new housing starts, while rising, remain below average. Housing starts should continue to grow, and to provide an ongoing boost to economic growth for many years.

The Federal Reserve Bank, the Fed, has provided significant support to our economy for six years now, not only non-stop, but at times increasing sharply. As the Fed judges that the US economy can 'go it alone,' the Fed will gradually reduce these supports. It has created such dramatic levels of support that the reduction will, over time, be dramatic. However, the Fed is committed to only remove support as the economy can handle it. This leads to a "can't win/can't lose" proposition.

When there is some short-term bad economic news, this can lead markets to improve, as it can lead investors to conclude that the Fed will leave supports in longer. Conversely, when there is some short-term good economic news, the markets can fall, as it can lead investors to conclude that the 'Day of Reckoning' will come sooner.

With the US emerging from the financial meltdown earlier than some other areas across the globe, most notably Europe, the US dollar has been strengthening. This leads to both winners and losers, advantages and disadvantages. This has hurt returns for investors who own foreign stocks. However, over time, this can help those stocks, for those companies can now better compete with US companies; the foreign companies' earnings growth rate benefits when the US dollar strengthens. In the meantime, however, this has led to investors earning more from their US stock positions than their foreign stock positions.

Let's explore whether to hold stocks, and whether to hold them below, at, or above long-term target levels. I see three factors to consider—what are the growth rates for the stock market, how cheap/expensive is that market, and what are the alternatives you have to stocks (and how cheap/expensive are they)?

Developed economies are growing at about 1.8%, and that growth is expected to rise to more than 2.0%. Emerging markets are growing at about 4% (down from closer to 5% a year ago), but are expected to see that growth rise next year. Overall, global manufacturers are fairly confident, less confident than they were earlier this year, but much more so than they were two years ago. Expected future economic growth rates are a positive factor for stocks.

Developed markets and emerging markets are both trading at prices a little higher than their long-term average. Valuations are a neutral to modestly negative factor for stocks.

Alternatives are very unattractive at this time. 10-year US government bond yield fell today to under 2%. This is incredibly overpriced, as it essentially is a 10-year guarantee of losing money to inflation. 30-year yields are under 3%. Government bond prices are quite expensive, and present a significant risk of substantial price declines in the coming years.

Commodities are a common second alternative to stocks. Gasoline in Delaware can be found at under $3 a gallon. Crude oil prices have fallen 23% in the past year. The fracking and shale oil developments have significantly boosted global petroleum supply, and our current rate of global economic growth is insufficient to 'soak up' that supply. As a result, commodity prices have been weak. As a contrarian, I find these 'bargain prices' to be attractive, but most investors continue to flee commodities. Therefore, the un-attractiveness of alternatives is a positive factor for stocks at this time.

With two positive and one mildly-negative factor for stocks at this point, we are keeping stock levels a little above long-term target levels. While the US economy and stock earnings have been the clearest story this year, we find the prices for emerging stocks to be attractive, and the upside potential for European stocks to be compelling. However these commitments require patience, for investors generally take awhile to embrace the less obvious opportunities.

On the topic of less obvious opportunities, we have, in the first time in Mallard's 18 year history, recommended the inclusion of precious metals. Here we are primarily reacting to the drastic sell-off of this asset class—they have fallen 23% annualized over the past three years, and have risen only 2% annualized over the past decade. We are using a pretty low allocation to this area, but it is notable nonetheless.

Bond investors have the most significant challenge, for the question is when and not whether bond prices will fall. There is a wide spectrum of bonds, with some that trade primarily based on their safety (government bonds), others that trade primarily on their interest rates, and others that are most affected by economic activity. Since we expect that in the coming few years interest rates will rise and prices will fall, and that safety will take a back seat to growth, we have been favoring economically-tied bonds in recent quarters. We direct 1/3rd of client bond money into these 'opportunity' bonds, and only 2/3rds in the traditional quality bonds. Over half of our quality bonds are short-term in maturity, to limit their exposure to price declines tied to interest rate increases.

With recent stock market declines, the pressing question is whether this decline is economically or emotionally driven. The economics supporting the US are very strong, and as I noted, the Fed is willing and able to keep the stimulus in place longer if we encounter a bump in the road. As such, I feel that the current market losses are largely driven by emotions.

With the recent stock market declines, year-to-date results are very modest, about a 1% gain for the average moderate allocation mutual fund. That said, that same type of fund is up almost 10% for the past year, and over 13% annually for the past three.

More importantly, the US stock market has been unusually calm for the past three years. The S&P 500's greatest peak:trough decline in 2012 was 10%, and was only 6% in 2013. While we are down from our mid-September high, the recent decline remains less than 10%. This means that 'normal' opportunities to buy on dips and sell on highs have been limited for awhile. The current stock market decline could provide the best opportunity stock investors have seen for over two years.

It is time for investors to rebalance, and this time I really mean it!

What questions do you have?

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