Market Review and Outlook—September 8, 2015

What a Miserable Year for Investors! Last September, this report's data table had only one red cell, a 0.60% three-month loss for foreign large-cap stocks. Every stock category had a one-year trailing gain of 15% or more. In the current table, presented below, one type of bond returned a bit under +1½% over the past year, and every other category returned less than +½%, with three lines sporting double-digit losses. What caused this?

Let's begin with what didn't cause this. This was not a dot-com implosion, a sharp decline in stock prices after investors recognized how expensive they had become. A year ago, stocks were reasonably priced—now they are a bit underpriced. This stock decline was not tied to an economic downturn. The US economy has been stronger in the past year than in the prior year. While Greece is in worse shape now than a year ago, overall the Eurozone is stronger than it was last summer. Asia and Latin America are a little weaker than last year, but only by a small amount, and there have been some successes.

The causes of investors' pain over the past year were both emotional/technical and economic. The VERY long-awaited increases in the Fed interest rate is upon us, largely expected to begin later this month. That has caused bond investors to fear tomorrow, despite the reality that upcoming higher interest rates have largely been priced into the bond market for many months.

The late August/early September sharp decline was tied to a combination of relatively minor factors. The most significant factor is that many professional investors take off from work the week or two before Labor Day. Thus the trading volume is much lower than at other times of the year, and a few sellers can drive a market down much further and faster than when everyone is paying attention. Less than 1% of the US economy is tied to exports to China, and yet the report of a further slowdown (only a slowdown, not a meltdown) of China's economy led to a disproportionate 5% drop in US stock prices. While emotionally-driven market declines are real and painful, and shown in the table, over time economic factors out-weigh short-term emotionally driven market moves. On the next page we examine what has been going on economically for the past year.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.02%	+1.44%
Intermediate Term Bond	-1.03%	+0.44%	+1.68%	+3.19%	+4.16%
Intermediate Muni Bond	+0.54%	+1.41%	+2.03%	+3.19%	+3.66%
Large-Cap Stock	-6.45%	-1.35%	+13.34%	+14.32%	+6.41%
Mid-Cap Stock	-6.69%	-2.19%	+14.12%	+14.39%	+6.91%
Small-Cap Stock	-6.54%	-2.37%	+13.06%	+14.41%	+6.66%
Foreign Large-Cap Stock	-8.98%	-7.73%	+7.22%	+6.20%	+3.76%
Foreign Small/Mid Cap Stock	-6.99%	-5.60%	+10.83%	+9.47%	+5.59%
Diversified Emerging Markets	-15.57%	-21.67%	-1.74%	-0.92%	+4.89%
Technology	-8.50%	+0.39%	+14.25%	+14.46%	+8.37%
Real Estate	-5.10%	+0.27%	+7.22%	+11.62%	+5.94%
Natural Resources	-15.95%	-30.40%	-5.02%	+0.40%	+1.84%
Equity Precious Metals	-22.65%	-43.23%	-28.86%	-20.25%	-1.36%
Moderate Allocation (60% stocks)	-5.15%	-2.48%	+7.78%	+9.05%	+5.36%

The data in this table comes from Morningstar and is as of August 31, 2015
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There are three primary factors—the sharp decline in the price of oil, the sharp increase in the value of the US dollar, and the solid and yet slow pace of US economic growth.

Last summer, a barrel of oil traded at over $110; it now trades at under $50. This has created both negative and positive ramifications, and unfortunately for investors, the negative impact shows up faster than the positive. The S&P 500 has seen its earnings fall over the past year, but if you carve out the energy sector, the S&P 500 earnings are up nicely. Oil-producing countries—Russia, Brazil, Canada—have stumbled. There are many firms, sectors, and countries which benefit from lower oil prices, but these benefits have only begun to show up. This is actually one of the strongest tailwinds for Europe's recovery, as most of Europe is dependent on oil imports.

The US dollar has strengthened about 20% over the past year. This isn't good. In economics, slow, steady change is far preferred to fast, sharp change. This has harmed US investors, who saw the returns on their foreign stocks turn negative solely due to the stronger dollar. This is hampering US companies, as they are having a MUCH more difficult time selling products and services against foreign competition with lower prices due to the strong dollar. As with most economic factors, there is a significant silver lining. Foreign companies are beginning to realize the benefits of the strong dollar, as their sales are climbing. This is a second, strong tailwind aiding Europe's recovery.

Despite the challenges of plummeted oil prices and the leaping US dollar, the continued US economic recovery is a testament both to its strong fundamentals, and the positive impact of near-zero interest rates. Despite the challenge of lower oil prices and a higher dollar, the US economy is expected to grow at a 2% level (after inflation) this year, and closer to 3% next year. Speaking of inflation, it has been very, very low, and is expected to remain well below historic levels. The Conference Board's Leading Economic Index® has been steadily rising since early 2009.

We can never protect investors from emotional moves, sharp declines and jumps. We are able to plan for them, however. Our regular rebalancing benefits from such volatility, buying more when investors foolishly sell too much, and selling when investors foolishly buy too much. At Mallard, we have developed Firewall Investing (see the April 2009 article on page 2 of http://www.mallardfinancial.com/documents/090401newsletter.pdf) program to systematically protect client portfolios when it feels like everything is crashing around you.

Our Investment Committee met last week, and agreed to several changes. One new step is that we are offering clients the opportunity to establish an 'out-of-the-market limit order' on a broad, global stock market index fund. This enables us to automatically buy more stocks whenever there is a sudden drop (5% or more) in the stock markets, even if the recovery is quick.

We are also focusing an emphasis on large-cap growth stocks, as these sectors appear to offer stronger prospects than normal, at a lower-than normal price level. We are committing an above-average weight to technology and healthcare sectors. We are reducing our allocation to natural resource stocks, and eliminating our precious metals allocation. These are both essentially an admission of defeat. We introduced precious metals about a year ago, after their prices had fallen sharply. Over the past year they merely fell further, as the table shows. Fortunately, we limited this to only 1% of clients' stocks. We are boosting our allocation to large foreign stocks, with a specific boost to European stocks. We are cutting back our use of emerging markets stocks to make room for these large-cap changes.

For bonds, we continue to view bonds as either quality or opportunity bonds. While quality bonds are more dependent on interest rates, and are expected to fare the worse when interest rates rise, in times like the past month, they also typically hold up the best during crises. We are eliminating our inflation-focused bond sleeve. The plummeted price of oil is the final nail in the coffin of our concern for inflation rising anytime soon. We are introducing a new sleeve for quality bonds—cash. Our quality bond weights are now 34% short-term, 20% intermediate-term, 5% cash, 4% long-term, and 2% emerging markets corporate bonds.

For the 35% of client bond money in opportunity bonds, we have made smaller changes. We reduced emerging market bonds (unhedged) and Asia bonds by 1% each, and boosted multisector by 2%. This leaves us with 13% high yield, 12% multi-sector, 7% unconstrained, 2% emerging market bonds (unhedged) and 1% Asia bonds. We continue to feel that this portion of clients' bond money will fare the best when rates are rising.

"Keeping your head when others are losing theirs," has been a successful investment approach. Let's commit to it!