Market Review and Outlook—October 11, 2016

Despite the Noise The national Presidential election has dominated the news cycle for the past three months, obscuring very solid investment results. These results have coincided with brightening expectations for the global economy, including developed foreign countries in Europe and beyond.

Future expectations for earnings in the US are very strong. US consumer confidence has remained above average levels for more than two full years. There is reason for that. Unemployment remains at very low levels, wage growth is just beginning to pick up, housing affordability remains historically cheap, and consumer balance sheets are 20% greater than their previous peak nine years ago. Capping it off, inflation has been very low for almost a decade. As a result, the S&P 500 is expected to earn record profits by the end of this year, if not early next year. This is what is behind the double-digit stock market gains from the past year.

Bonds have been the icing on the cake. While they largely moved sideways this past quarter, over the past year bonds have been posting great returns, largely due to substantial investor purchases. The investors who have been feverishly buying bonds are disregarding the high prices and low yields, and are producing still higher prices and still lower yields. This hasn't been in a vacuum, however. Many foreign central banks have set negative interest rates to stimulate their economies. In this global environment, the skimpy US interest rates appear less absurd. We know that rates will rise, however we expect that it will be over a pretty long time period, dramatically limiting bond investors' losses when rate increases begin and then continue.

Sectors have been strong. This past quarter saw a slowdown in real estate, but the three sectors we list below all have one-year gains of 16% or more. Emerging market stocks similarly are up over 15% in the past year.

The past quarter's strength in stocks has increased the need for investors to rebalance their portfolios. **This could be a good opportunity to seal in some of your gains**. While we don't see storm clouds ahead, you make hay while the sun shines, and it has been sunny.

Despite the incessant news on the Presidential election in November.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.03%	+0.06%	+0.03%	+0.02%	+0.98%
Intermediate Term Bond	+0.98%	+5.27%	+3.72%	+3.44%	+4.53%
Intermediate Muni Bond	-0.24%	+4.80%	+4.47%	+3.80%	+3.87%
Large-Cap Stock	+3.80%	+12.03%	+8.75%	+14.71%	+6.34%
Mid-Cap Stock	+4.93%	+10.51%	+6.69%	+14.34%	+6.79%
Small-Cap Stock	+6.97%	+13.05%	+5.57%	+14.53%	+6.63%
Foreign Large-Cap Stock	+6.19%	+6.53%	+0.53%	+7.13%	+1.72%
Real Estate	-0.89%	+16.66%	+12.72%	+14.56%	+5.47%
Natural Resources	+5.01%	+18.66%	-4.93%	+1.64%	+1.00%
Technology	+13.10%	+21.04%	+13.20%	+16.20%	+9.28%
Allocation (50-70% stocks)	+3.11%	+9.07%	+5.41%	+9.22%	+5.16%

The data in this table comes from Morningstar and is as of September 30, 2016.
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Investing is weird. It isn't like a vacation. With a vacation you plan it out, perhaps sun and sand for a week, and plan for some overdue relaxation. You arrive and get sun, sand, and relaxation.

Investing is messy, and rarely goes according to plan. This time last year emerging markets stocks had fallen almost 15% year-to-date. Bonds had gains of less than 1%, as most investors expected bond yields to rise in the coming quarters. What has happened over the past year? Emerging market stocks are now UP over 14%, and bond have gained about 5% as their yields have fallen even further. That is sort of like planning a beach vacation and arriving in the Alps.

The good news is that you can invest like going on vacation. You can buy a one-year CD, know what you are getting, have FDIC insurance, with no surprises. The bad news is that inflation runs at twice the rate of 1-year CD interest rates. Investing is messy.

It is often noted that "past performance is not necessarily indicative of future results." The table displayed earlier has 55 entries, eleven asset class with five trailing returns per asset class. The same table a year ago included 15 losses. Three months ago there were 11 losses. Today there are three. This is one reason that I use the bungie cord analogy. In many cases past losses lay the groundwork for future gains, and large past losses can lead to large future gains, such as we have just seen for emerging markets. The harder you pull a bungie cord, the stronger it will rebound.

The best time to invest is when it feels the worst. The strongest US stock gains were earned immediately after the market bottom of early March 2009. Yet no one wanted to invest then.

Human nature leads us to want to not invest when it is the best time, and to want to invest at the worst time. This is why the average investor over the past twenty years has earned just over 2% annually, about the same as inflation, about 3% less than foreign stocks and bonds, and 6% less (annually) than US stocks. So what is an investor to do? Mallard has always recommended the following: 1) choose a long-term asset allocation level of stocks, and stick to it, 2) diversify your stocks and your bonds, and 3) regularly rebalance. How has this done? **Consistent 60/40 and 40/60 stock/bond allocation approaches have earned more than 6½% annually over the past twenty years**. It is hard to do, but it is well worth it.

At the risk of jinxing us, **this is turning out to be a good year for investors**. Given that we have had two big investing scares already this year (oil/China fears in January/February, and the failed BrExit referendum vote in June), many investors feel pretty beaten-up. Yet the average 50-70% stock fund has returned more than 6% in the first nine months of 2016, pretty good for nine months that have felt awful.

Some of this good fortune is due to **solid results from bonds**. High-yield bonds have returned over 10% this year, as have long-term corporate bonds. Our generic 'opportunity bonds' proxy, the average Multi-Sector Bond fund has gained over 7½%. Our generic 'quality bond' proxy, the average Intermediate-Term Corporate Bond fund has gained almost 6%.

When returns are good, we are cautious, and we are cautious at this time. But we are not rejecting our long-term approach. Despite fine trailing returns, we are keeping stocks at long-term target levels. We continue our broad approach to bonds, with 65% in quality bonds and 35% in opportunity bonds—there is a place for both. Consistency is rewarded, and we are dedicated to combining discipline and patience to ensure consistency in our investing. Even when it's messy. Especially when it's messy. It's weird that way.