Prepared Comments from 4/7/2017 Conference Call

In the 12 weeks since our last call, the S&P 500 has risen over 3½%, and is up over 13% in the past year.

Oil prices fell 3.5% during the quarter, but have more than recovered this week, standing over $55. It remains fully recovered after its sharp decline early last year. Thus the oil sector has been beneficial to S&P earnings for the past 2 quarters, and is expect to continue to help for the next year.

Announced this morning, **US unemployment** has fallen to 4.5%, down from 5.0% a year ago, and well below the 50-year average of 6.2%. **Wage growth** has stabilized at 2.5%, but is expected to become a factor pushing US inflation upward in 2017 and beyond.

The **US Leading Economic Indicator** has risen for three straight months, and is higher than it has been in over a decade. Unlike stock market levels, a record high LEI rarely is followed by a market drop; it is designed to increase ahead of market rises. It typically begins to fall months ahead of the stock market. Thus this is a very strong sign of solid economic growth ahead of us.

Globally, **global purchasing managers** are surveyed to find areas of strength and weakness. The overall figure was high three months ago, and has risen further since. Europe is quite strong, stronger than the US, led by Germany. The natural resource recovery over the past year has enabled many countries to emerge stronger—Canada, Australia, and Russia; even Brazil is almost out of the woods. This has helped the emerging markets strengthen over the past three months.

In the **past quarter**, most quality bonds, both taxable and municipal, earned 1% or so. Opportunity bonds rose closer to 2%, with both taxable and municipal high yield bonds rising closer to 2½%.

US stocks did well in the quarter, gaining 1¾ to 5½%. Growth outperformed value and large caps outperformed small caps. Financials rose less than 2%, natural resource stocks only ½%, and real estate less than 1%, but health stocks rose over 10% and technology over 12%.

Foreign stocks were on fire during the quarter, with large-caps up 7¾%, foreign smaller stocks up 9%, and emerging market stocks up 11½%. They began the quarter so far behind US stocks that this strong performance only slightly narrowed the underperformance gap.

As mentioned earlier, the **S&P 500 earnings** are recovering well. The estimated 2nd quarter earnings are expected to set a record, and further records are expected later in 2017. (Yes, this hope has been dashed the past two quarters, but our fingers are crossed that this time it will work.)

The Federal Reserve Bank, **the Fed**, raised overnight interest rates by ¼% a second time in March. JP Morgan's Dr. David Kelly expects them to raise rates ¼% every time they meet (8 times a year) when there isn't any recent bad news, another two or three times this year, and four or so next year. I share the view that these increases are 'positive progress reports,' and indicate that the underlying economy is healthy and no longer requires substantial support.

Speaking of which, the Fed will gradually sell its trillions of dollars of bonds. This taper will take years in order to be orderly and non-harmful to the global bond market. Other central banks will follow as their regions also fully recover.

<u>The thirty-four year bull market for **US bonds** appears to be over.</u> Since it lasted so long and got so low, we are likely to face headwinds for bonds for many, many years. As the pace of interest rate increases is expected to be VERY gradual, the pain should be very minimal. Furthermore, the US is and should continue to be a core player of the global bond market—there is no reasonable scenario leading to investors abandoning their use of US bonds.

The US dollar will drive many investor decisions. The dollar jumped in 2014-2015, and remains at fairly high levels. It fell less than ½% during the quarter. If the dollar remains steady, it will be a non-issue for investors. If it falls, it could help in multiple ways. Investing in a rising dollar environment is challenging, as we saw in 2015. Fortunately, that appears unlikely.

Inflation has been tame, under 3%, for 25 years. Most recently core inflation stands at 2.2%, however wage growth can put upward pressure on inflation, as can global economic strength mentioned earlier which could lead to rising commodity prices.

The investment world had a sharp change last November, with President Trump's victory, and we made a corresponding sharp change to our stocks, and to our bonds afterwards. There have been many events during the past three months, but most have been a continuation of the expectations from January. Therefore, we are making very few investment changes at this time, other than the changes called for in our habitual quarterly rebalancing.

Given the strong global economic climate, we are keeping clients' stock levels at 102% of their long-term target levels. This is also due to the chronic headwind that bonds are facing, and the pathetically low levels of money market yields.

We continue to use a maximum level of opportunity bonds, 35% of all bond money. This has done well recently, and should continue to do well in strong economic times. We like bank loan funds, which have adjustable rates, and high-yield bonds, especially municipal high yields for high tax-bracket clients, as high yield muni bonds appear to have sold off too much late last year. For clients' quality bonds, we have a balance of short- and intermediate-term bonds, with a sleeve for inflation-linked bonds, should inflation spike suddenly.

More of the same is our stock strategy story. We maintain a 56/44 US/foreign stock level. Lately this 44% level of foreign stocks has served us well. It is about time! We have a neutral level of large/mid/small stocks, and value/growth. We have an extra lean to health stocks, and a little lean to tech stocks. We have dedicated real estate and natural resource sleeves, to protect against inflation spikes. We continue to have 20% of foreign stocks in emerging market areas, 17% in smaller stocks, and 18% in Europe, with the other 45% in large companies in large countries. After the sharp changes in December and January, we are primarily letting those changes continue to work out.

As my article in this month's newsletter notes, investors can be hampered by their own biases and beliefs. We feel that it is best to use a calm, mechanistic approach to portfolio allocation, even when emotions run high in the newspapers. The past quarter brought great gains with stocks, and so calmly rebalancing will ensure that you seal in recent profits. Don't second guess yourself. While the global economy looks fine going forward, it is never advisable to abandon your long-term plans because it feels right. Stick to your plans.

Questions?

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