Prepared Comments from 10/13/2017 Conference Call

In the 13 weeks since our last call, the S&P 500 has risen 3.7%, and is up 20.0% in the past year.

US stocks did well in the quarter, gaining 3½ to 5%. Growth again outperformed value, but by a smaller margin, and mid-caps were strongest. Real estate rose under 1%, financials and health both about 4½%, technology gained over 8%, while natural resource stocks bounced back 8½%.

Foreign stocks continued to do well during the quarter, with large-caps up 5¼%, foreign smaller stocks up 7%, and emerging market stocks up 7¼%. While their longer-term results continue to badly trail, foreign stocks now have stronger 3-month and 1-year returns than most US stocks.

In the **past quarter**, most quality bonds, both taxable and municipal, earned a little under 1%. Opportunity bonds rose a little more, with taxable high-yield earning 1¾% and municipal high yield bonds gaining 1½%, while more conservative bank-loan bonds gained less than 1%.

What is behind the recent investment results?

Announced earlier this month, **US unemployment** has ticked up to 4.4%, down from 4.6% in November and 4.9% last August, and well below the 50-year average of 6.2%. Surprisingly, wage growth has actually fallen slightly over the past year, reinforcing that there is no wage inflation that has yet appeared.

The Conference Board maintains a **Leading Economic Index**, the LEI. It has again risen the past three months, and now stands higher than it has been for twenty years. The last two recessions were well-telegraphed by pretty sharp declines in the LEI. This implies that the US economy is on very solid footing for many months (quarters?).

The **US dollar** moved a little, falling 2.2% in the past three months, up 2.7% in the past year, and yet it has been in a relatively tight range for almost 2 years. The recent decline has helped boost investment returns from foreign stocks and bonds.

Inflation has been tame, under 3%, for 25 years. Most recently core inflation stands at 1.7%, which is lower than 2.1% to start the year and 2.3% a year ago. Commodity prices have remained subdued ever since 2008, and are down 2.9% year-to-date.

Oil prices have been a roller coaster this year, as they rose 20.3% during the quarter, and yet are up only 4½% year-to-date, but up 19½% during the past year. The recovery in oil prices has led to a strong recovery in energy company earnings.

The **S&P 500 earnings** are rising, aided with the recovered energy sector earnings rebound. The 5.9% boost in S&P earnings from the 1st to 2nd quarter (and up 18.7% from a year earlier) set a record, and even higher earnings are expected for the 3rd quarter. This confirms that the US stock market's level is not alarming—it is fully explained by the market's profitability.

The Federal Reserve Bank, **the Fed**, raised overnight interest rates by ¼% a third time in June, and a further increase is expected at their December meeting. Three increases are currently expected for 2018.

The Fed purchased more than $3 trillion of bonds from 2008 through 2014, to prop up the US economy. It has announced details on a very gradual glide path to selling their inventory, reaching a $20 billion monthly reduction level. This will put a damper on the bond market for many years, creating a "New Normal" for bonds, where annual returns (interest plus price movement) of 1 to 2% for quality bonds could become the norm.

Everyone is Happy—JP Morgan collects a report on purchasing manager's assessment for manufacturing across the globe. There are 18 listed figures for September, and all 18 are positive—even Greece and Brazil! While the US is solid, developed markets are even stronger, and Europe is much stronger. It is very rare that there aren't any pockets of weakness across the globe, but manufacturers are optimistic uniformly.

So what are you doing in your portfolios?

Due to the limited upside of quality bonds in a New Normal world, we continue to allocate clients stocks 2% higher than their long-term target levels. We have also taken another step from US to foreign stocks, shifting our balance from 56-44 to 54-46, reflecting this shift of leadership of economic growth beyond the US shores. We are maintaining our 70/20/10 balance of large/mid/small-cap stocks. We favor growth stocks overseas, but due to the length of the US economic recovery, we are beginning to favor value stocks within the US.

We are looking to eliminate any special allocation to natural resource stocks—the amount that we receive from broad stock funds is enough to satisfy us. Given the strong recent gains, we are trimming natural resource stocks/funds, but holding onto energy-heavy positions. We continue to maintain a real estate allocation and a modest extra emphasis on financial, healthcare, and technology stocks.

Overseas, we are shifting 2% from foreign smaller-cap stocks to emerging market stocks. We are maintaining a special 20% allocation to Europe stocks.

For bonds, since we do not see any economic trouble for several quarters, we are maintaining our 35% allocation to economically-sensitive opportunity bonds, and have added a 3% position in emerging market bonds (flexible to hold both local currency bonds and hedged back to the US dollar or dollar-denominated). Given their strong trailing returns, we have pared back high-yield taxable bonds.

Overall, despite US stock markets near record levels, we like US stocks. We like foreign stocks more, as they have less downside risk and more upside potential. We continue to expect fairly little from bonds, yet are committed to using them as ballast, as a volatility dampener, for all portfolios. They provide fairly safe money for withdrawals when a sudden sharp stock market decline rears its ugly head. We feel that our quality/opportunity approach to bonds provides the best balanced approach to this New Normal stage for bond investors.

Mallard has two home-grown strategies to aid clients. The **Firewall Investing™** system is designed to limit losses during painful downturns, however we haven't suffered any for several years, so it is patiently poised for its turn.

Our **Drop and Give Me Five™** market timing system is designed to automatically purchase stocks when the market take a quick, modest decline. Again, the steady, onward and upward stock markets this year have not yielded any qualifying declines, so the system remains ready, willing, and able.