Prepared Comments from 1/12/2018 Conference Call

In the 13 weeks since our last call, the S&P 500 has risen 9%, and is up 22½% in the past year.

US stocks did well in the quarter, gaining 3½ to 5½%. Growth again outperformed value, but by a smaller margin, and both large- and mid-caps did well. Healthcare stocks rose only ½%, real estate rose only 2%, while technology rose almost 6% and energy/natural resources gained 7%.

Foreign stocks continued to do well during the quarter, with large-caps up 4%, foreign smaller stocks up 5%, and emerging market stocks up 6%. While their longer-term results continue to badly trail, foreign stocks led US stocks in 2017.

In the **past quarter**, short-term bonds fell ¼% or less, other quality bonds earned under ½%, while opportunity bonds earned ½ to 1%.

What is behind the recent investment results?

Announced earlier this month, **US unemployment** has fell to 4.1%, down from 4.4% in August, and from 4.6% last November. Amazingly, wage growth actually fell very slightly over the past year, despite our super-low unemployment level.

The Conference Board maintains a **Leading Economic Index**, the LEI. It has again risen the past three months, and remains higher than it has been at any point in the past 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** jumped around this past quarter, but is down 7% from a year ago. This has juiced the 2017 returns for foreign stocks and bonds.

Inflation has remained tame, and core inflation (excluding food and energy) stands at 1.7%, down from 2.1% a year ago, although headline inflation (including energy which jumped in 2017) rose from 1.7% to 2.2%.

Oil prices jumped 15% during the quarter, and 20% for the year. This has had a dramatic impact on earnings from the oil sector specifically, and for the entire S&P generally.

The **S&P 500 earnings** set records for the past two quarters, and this is expected to continue all year. Most of this is thanks to the energy sector, however this year's expectations are based more on expected stronger GDP growth this year, while expectations beyond December are less rosy.

The Federal Reserve Bank, **the Fed**, raised overnight interest rates three times in 2017, including last month. Three increases are expected this year, but if economic growth comes in as strong in 2018 as some are projecting, a fourth 2018 boost is possible.

As I noted in October, *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 December, and only two are negative—Indonesia and South Korea. Developed foreign markets are strongest (led by Europe), followed by the US, and then emerging foreign markets. These figures are very hopeful, and lead us to strengthen our conviction that stock prices in the US and abroad are well-justified, given expected economic growth.

So what are you doing in your portfolios?

Due to price pressure that rising interest rates bring, we remain unenthusiastic about future returns for quality bonds and therefore we continue to allocate clients stocks 2% higher than their long-term target levels. We have also taken a second step of shifting from US to foreign stocks, shifting our balance from 54-46 to 52-48, almost 50/50, reflecting this shift of leadership of economic growth beyond the US shores, and reflecting the fact that US stocks, if not expensive, are at least not cheap.

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 favoring value stocks within the US.

We are <u>eliminating any special allocation to natural resource/energy stocks</u>—the amount that we receive from broad stock funds is enough to satisfy us. 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 emerging markets, adding 1% to foreign smaller-cap stocks and the other 1% to foreign large caps. We are maintaining a special 20% allocation to Europe stocks. At this time, we are <u>eliminating our use of frontier emerging market stock funds</u>, a subset of emerging market stocks which we have concluded are too haphazard in their results to justify continuing to hold.

For bonds, we have a single change, and this is only for higher-tax bracket clients. For their portfolios, we are shifting 15% from high-yield to multi-sector muni bonds. The reason is that municipal high-yield bonds had a selloff about 5 quarters ago, and we rushed in to boost our holdings at these sale prices. The prices have recovered, so we are restoring our more normal levels.

As I noted last quarter, *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.*

Every year that stocks do well at the start, earning “a year’s worth” of gains in just a few months, we naturally consider cashing out for the rest of the year, to eliminate the risk of the seemingly-inevitable pullback. This temptation was substantial in 2017, and yet 2017 was a year without even a 4% pullback—the stock markets’ upward climb was remarkably steady, and “Nervous Nellies” would not have fared as well as “Steady Eddies.”

Our concern at this point is two-fold. While US economic growth is expected to be strong this year, this is almost certainly priced into today's record-setting stock markets. When will US stock investors begin to consider the likely economic slowdown in 2019 and beyond? Granted, that slowdown could still remain near the low, yet steady, rate of economic growth from 2009 through 2016.

The second concern is that while foreign stock markets are cheaper, and appear to provide more attractive upside potential, they have regularly been more volatile than the US stock markets, and their results can become victims (or beneficiaries) of the seemingly-randomness of movements in the US dollar.

Such concerns can lead a person to avoid investing in stocks. However, over the past decade, which includes the financial meltdown, stocks outperformed bonds by a strong margin. Furthermore, now does not appear to be a very good time to load up on bonds!

Uncertainty is the investor's constant, and this is absolutely the case at this time. We use broad diversification to address the range of economic and profit outcomes, and we use regular rebalancing to ensure that we seal in profits and purchase assets when they are cheaper. Together these two strategies have been able to provide a far smoother investment path than the vast majority of alternatives. The 2017 investment results and 2018 outlook appear to very clearly recommend this one-two strategy of diversification and rebalancing.

Questions?