Market Review and Outlook—April 5, 2018

The 2017 Stock Market Gravy Train Stopped—With few exceptions, the table below shows losses in the past quarter. January brought broad gains, but February began with sharp losses, tied to worries that economic growth was bringing rising inflation, and would hasten the Fed in raising overnight interest rates. The markets moved sideways for six weeks and then at the end of March the markets fell again, partially due to the Fed raising the Fed rate, and partially due to fears of a trade war. Foreign stock markets faced similar patterns during the quarter.

Bonds Failed to Help Out—With these feared future and actual present interest rate increases, bonds fell during the quarter, failing to provide support to investors with balanced portfolios. Quality bonds, which are more sensitive to interest rates, fell more, especially those with longer durations, while opportunity bonds, which are more sensitive to the economy (which has been doing well), fell less.

Inflation Still Low—Core inflation has stayed in a tight range in the past year, from 1.7% to 2.2%, ending February at 1.9%. Inflation has remained low for years, and is expected to continue to remain low.

US Economic Growth is Growing—GDP growth has risen nicely, from 2.0% to 2.6%, between 4Q2016 and 4Q2017. The Tax Cut and Jobs Act of 2017 passed in December is expected to lead to higher growth in 2018 and early 2019, but then fall back towards 2.0%, due to tightness in our labor markets.

Oil's Growth has Slowed—After a 20% gain in 2017, the price of oil rose only 3% in the past quarter. It remains more than twice its January 2016 price, but less than half its July 2008 price. Bottom line—oil is volatile.

Dollar Drop—After falling 7% in 2017, the US dollar fell another 3% in the past quarter. This has many impacts, including making it easier for US companies to sell their products overseas, while boosting returns that US investors earn from their foreign stocks and foreign bonds.

Hopefully, earlier this year you cut back your stocks a bit, sealing in some of your nice 2017 gains. Now that most stocks and bonds are below their December levels, another rebalance is advisable, however it will likely be more modest than the January rebalance. While the US economic recovery is entering its tenth year, foreign economies are only in their sixth. While bonds are unlikely to provide juicy returns for a few years, the safety they provide from stock market drops should continue to justify their role in your portfolio. And the stock market seems to have choppy times ahead, providing further justification for an ongoing balanced approach.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.26%	+0.76%	+0.31%	+0.19%	+0.35%
Intermediate Term Bond	-1.31%	+1.31%	+1.27%	+1.73%	+3.80%
Intermediate Muni Bond	-1.05%	+2.12%	+1.71%	+2.06%	+3.61%
Large-Cap Stock	-0.98%	+12.82%	+8.89%	+11.72%	+8.58%
Mid-Cap Stock	-1.03%	+10.13%	+6.51%	+10.43%	+8.88%
Small-Cap Stock	-0.93%	+9.68%	+7.21%	+10.29%	+9.15%
Foreign Large-Cap Stock	-0.86%	+15.20%	+5.75%	+6.21%	+2.64%
Financials	+0.23%	+14.54%	+11.54%	+12.74%	+6.68%
Real Estate	-6.89%	-2.30%	+1.26%	+5.55%	+5.88%
Technology	+5.04%	+27.75%	+17.56%	+19.08%	+12.81%
Moderate Allocation (60% stocks)	-1.26%	+7.78%	+4.89%	+6.55%	+6.06%

The data in this table comes from Morningstar and is as of March 31, 2018
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Stocks versus Bonds. Investing always comes back to this. Should you invest in stocks or in bonds? Yes, there are alternatives (cash, commodities, direct real estate), however for the vast majority of investors, the fundamental question is how much to put into stocks, for growth, and how much into bonds, for safety.

Bonds—the good and the bad news. We have been fearing, and warning about, rising rates for years, and it is upon us. In late March not only did the Fed boost overnight rates, but they also indicated that there could be a total of four bumps this year rather than three as was expected in December. They also have begun the plan, introduced last year, to gradually reduce the mountain of bonds they purchased over the past decade to support our financial system. These sales, tens of billions of dollars a month, should continue for years, and will depress bond returns throughout.

There is some calming news. Interest rates are rising from anemic levels—the economic impact of rates rising from 1 to 4% is far less than interest rates rising from 5 to 8%. More importantly, the prior paragraph describes quality bonds, which are primarily sensitive to interest rates. These have been facing headwinds which should persist. However we also use **opportunity bonds**, which are primarily sensitive to the economy, and which can hold up much better to rising rates. These can include high-yield, floating rate, foreign, and emerging market bonds, in addition to broader approaches such as multi-sector bonds.

Ever since the 2008 economic meltdown, and its ultra-low interest rates, we have been heavy users of opportunity bonds, quickly reaching our ceiling level of 35% of bond money. Multi-sector bonds have outperformed quality bonds by more than 2% in the past year, and by almost 2% (annualized) the past three. As long as the economy keeps growing, and as long as the Fed feels that the economy can continue to handle interest rate increases, opportunity bonds should continue to outperform quality bonds. This is the reason that **at Mallard we will be boosting our ceiling for opportunity bonds to 45%, starting as soon as this July**.

Stocks—When bad news is good news. No one likes to see their stocks fall. However, long-term investors, those who rebalance regularly, benefit not only when their stocks rise, but also when they fall. Why? Because when stocks have risen, we rebalance, selling some expensive stocks, and moving the proceeds to cash and bonds. Then when stocks fall, we put those same dollars back into stocks, at cheaper prices. If you have a plan for it, you can benefit from volatility. Regular rebalancing is one such plan, and Mallard's **Drop & Give Me Five™** is another such plan.

Sometimes prices deserve to be cheap, when the underlying economy is weak. It is not, as affirmed by the Fed which only raises rates and sells bonds when there is a solid economy. US stock prices were a bit above average in January, and now are right about average. However that average is based on average times, and we do not have average times. We have very low interest rates and very low inflation, and that leads to better results from companies, and thus stocks. For these reasons stock prices deserve to be above average, and therefore US stock prices appear very attractive now.

But wait, there's more. Foreign economies are as solid as the US economy, their economic recoveries are younger than the US', foreign dividends are higher than US dividends, and foreign stock prices are more reasonable. This is why we have adopted a 50/50 balance between US and foreign stocks. As a further benefit to foreign stocks, the US dollar has fallen and indications exist that point to continued weakness in the US dollar. This is a further benefit to investing in foreign stocks, as a rising dollar harmed foreign stock returns through 2016, but for a bit more than the past year, and perhaps for a few years to come, a falling dollar helps.

2017 was an uncommonly calm year for stock investors. It was not the norm. 2017 brought very smooth growth to stock returns. We enjoyed it, but that was then. 2018 has brought us back to earth, with much more customary volatility. We have plans for clients' bonds and stocks in 2018 and beyond, and are committed to continue to "Plan your play, and play your plan."