Prepared Comments from 4/16/2018 Conference Call

In the 13 weeks since our last call, while the S&P 500 has fallen 3.8%, it is up 13.6% in the past year.

US stocks were mixed in the quarter, with returns ranging from -2¾% to +2¼%. Large, mid-cap, and small-caps fared the same, but growth gained while value lost. Health rose 1.6%, natural resource funds lost 4 ¼%, real estate lost almost 7%, while technology rose 5%.

Foreign stocks were also mixed, but generally a little stronger, with returns from -1 ¾% to +2.4%. Smaller foreign did better than larger, growth beat value, and emerging markets gained 2%.

In the **past quarter**, short-term bonds fell less than ½%, while longer term bonds fell more. Multi-sector bonds fell ½% while taxable high yields fell almost 1% but muni high yield lost less than ¼%.

How have economic measures done recently?

Announced earlier this month, **US unemployment** has remained at 4.1%, for the fourth consecutive month. It was at 4.5% a year ago.

The Conference Board maintains a **Leading Economic Index**, the LEI. The latest report is from March 22nd, for February. It has again risen in each of 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** fell 2.9% during the quarter, and is down 8.9% in the past year.

Inflation has returned to 2.1% in March, where it was in early 2017. Headline inflation is higher, due to strong increases in energy costs in the past year.

Oil prices rose 3% during the quarter, and is up a sharp 28% for the past year.

The **S&P 500 earnings** set records for the past three quarters, and this is expected to continue for the next year, aided by both the expected economic growth and the impact of companies using repatriated dollars to buy back substantial numbers of their shares.

The Federal Reserve Bank, **the Fed**, raised overnight interest rates ¼% during the quarter, and ¾% over the past year. Two to three more increases are expected this year. This gradual rate of increases, and the fact that they are 'well-telegraphed', has enabled the short-term bond market to react reasonably.

One nice consequent of the Fed's actions raising rates is that bank CD rates are no longer anemic. We can find a 2% yield on a 9-month CD, and 3% for a 5-year CD. While not incredible, these rates are much better than we have seen for over a decade.

As I have noted (and updated) since October 2017, *the Fed purchased more than $3 trillion of bonds from 2008 through 2014, to prop up the US economy. It embarked on a very gradual glide path to reduce their inventory, currently at a $30 billion monthly reduction level (rising to $50B/month by 4Q2018). 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 21 listed figures for February, and only one is negative—South Korea. Developed foreign markets are strongest (led by Europe), followed by Canada and 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 based on expectations of solid future economic growth.

So what are you doing in your portfolios?

Stock prices have fallen so far this year, and recently have become quite volatile. To us the leading result is that stocks are cheaper than they were three months ago. This is especially true since company's earnings have risen as their stock prices have fallen, resulting in attractive stock prices.

This good news is balanced with concerns over the very, very long economic recovery in the US, already in its 11th year. Furthermore, there is a growing consensus that 2018 will be the best year economically for a while, and that beyond we will have lower economic growth and slower company earnings growth. As a result, we are comfortable with today's stock prices, but we feel that we need to be prepared for less sunny days ahead for US stocks.

While the Fed's actions to raise rates has been holding back bond returns, and while these actions are expected to continue for several years, this is further evidence of confidence in the US economy, now and for quarters to come. The Fed is raising rates due to its conviction that the US economy is strong enough to tolerate higher rates. Additionally, the Fed's actions have already raised interest rates, making bonds a bit more attractive to investors, as I mentioned earlier in regards to bank CDs.

Since January, Mallard's Investment Committee has <u>cut our strategic stock level from 102% to 101%</u> of long-term target levels, driven by our view that the US stock market is near the end of its decade-long bull market rise. Very significantly, we have <u>boosted our level of foreign stocks to a full 50% of all stock holdings</u>, from the 48% level we used in January. We have, grudgingly, adopted a <u>greater comfort level with growth stocks</u>. We continue to prefer growth stocks overseas, as we feel that foreign economic growth has more headroom than US economic growth, and that foreign stock prices have more upside and less downside.

We continue to <u>favor Finance</u>, and to a lesser extent, Technology. We are comfortable with Healthcare, but do not currently over-weight it. We maintain a Real Estate slice, despite it providing recent losses. We have made no changes within foreign in the past quarter. We have no special allocation to energy or natural resources.

In our quality bonds, we have <u>shifted 7% out of intermediate-term bonds</u>, boosting inflation-protected bonds from 3 to 5%, and introducing an ultra-short term bond position at 5%. In taxable Opportunity bonds, we have <u>shifted 2% from multi-sector</u> into a new global bond position, and <u>shifted 1% from bank loans</u> to boost emerging markets bonds from 3 to 4%. We have not changed our municipal Opportunity bonds in the past quarter.

In January after such a strong year, rebalancing would have enabled you to seal in juicy stock gains, shifting the profits to bonds. In April, rebalancing will enable you to shift those 2017 profits back into stocks, at cheaper prices. The past three months provided a perfect example of the strength of rebalancing. Stock prices have fallen despite rising earnings. While we see rough waters ahead, we feel confident of our gameplan.

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, which was covered last week in the Wall Street Journal, is designed to automatically purchase stocks when the stock markets take a quick, modest decline. After a very smooth 2017 without any such opportunities, 2018 is shaping up to be a rocky year, which is well suited for this program to 'buy the dips.'

Questions?