Prepared Comments from 7/16/2018 Conference Call

In the 13 weeks since our last call, the S&P 500 bounced back 4.5%, ended Friday up 5.9% so far this year, and is up 13.9% in the past year.

US stocks did well in the quarter, with returns ranging from +1.6% to +8.5%. Small-caps and growth stocks did the best. Financials fell about 1%, healthcare funds rose 6%, real estate jumped almost 8%, while technology rose over 5%.

Foreign stocks were not so strong, losing from 0.7% to 8.9%. Growth stocks also did best overseas, while emerging market stocks did the worst (Latin America funds lost over 22%). Foreign stock returns were harmed by the 3.8% rise in the US dollar during the quarter. (*US Dollar changes from 6/30/2018 JP Morgan Guide to the Markets®, GttM, slide 29, https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets*).

In the **past quarter**, short-term taxable bonds gained about ¼%, intermediate-term bonds fell ¼%, and long-term bonds fell 1¼%. Municipal bonds all gained under 1%. Multi-sector bonds fell ½% while taxable high yields gained ½% and muni high yield bonds gained about 1 ¾%. Bank loan bond funds earned almost ½%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

Announced earlier this month, **US unemployment** has fallen to 3.8%, down from 4.1% three months ago and from 4.3% a year ago. Its 50 year average is 6.2%. Wage growth is slowly rising, standing now at 2.8%, still well below its average of 4.1% (*GttM, slide 25, https://www.bls.gov/ces/home.htm*).

The Conference Board maintains a **Leading Economic Index**, the LEI (*www.conference-board.org*). The latest report is from June 21st, for May. 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** rose 3.8% during the quarter, after having fallen 6.6% during the prior three quarters. The recent rise is attributed to the recent trade war turmoil, and is expected to resume a downward path. (*GttM, slide 29*).

Inflation rose to 2.3% in June, up from 2.1% three months ago and up from 1.7% a year ago. Headline inflation is higher, due to very strong increases in energy costs in the past year (over 30% for fuel oil). (*Source is www.bls.gov*).

Oil prices rose 12% during the quarter, and are up almost 60% for the past year. (*GttM, slide 30*).

The **S&P 500 earnings** set records for the past four quarters, and this is expected to continue for the next three quarters, aided by the profit margin increase tied to the December federal tax law change, the benefits of share buybacks, coupled with solid economic growth due to favorable consumer confidence, financial stability, and employment. (*GttM, slide 7*).

The Federal Reserve Bank, **the Fed**, raised overnight interest rates ¼% during the quarter, and ¾% over the past year. Two more increases are expected this year, with more expected in 2019 and 2020. This gradual rate of increases, and the fact that they are 'well-telegraphed', has enabled the short-term bond market to react reasonably. (*GttM, slide 31*).

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 6-month CD, and 3% for a 3-year CD. These rates are much better than we have seen for over a decade. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

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 20 listed figures for June, and only three are below 50—South Korea, Brazil, and Russia. Canada comes in first, followed by the US, followed by a tie with EuroZone and the category of Developed Markets. The category of Emerging Markets comes next, followed by the entire global economy. All of these countries/regions/categories have scores well above 50 as of June. These figures continue to be 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?

While US stock prices have risen so far this year, their profits have risen more. As a result, they appear to offer better values now than they did in January, or a year ago. Foreign stocks continue to look like even better values, given that they have not enjoyed the 9-year straight rebound that US stock markets have. For this reason, and for the reason that interest rate increases are expected to continue, hampering future bond returns, we have added a little more emphasis on stocks versus bonds.

Interestingly, the uncertainty that results from global trade disputes provides a positive influence. Really. Without any storm clouds, the economic world would look picture perfect at this time, and that could lead to excessive speculation, sharper Fed interest rate increases, higher inflation, and a recession coming sooner. The international anxiety serves as a beneficial calming influence on the global economy, strange as it sounds.

The Fed's actions to raise rates have 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 April, Mallard's Investment Committee has restored our strategic stock level to 102% from 101% of long-term target levels. We have maintained our level of foreign stocks to a full 50% of all stock holdings, a level we established earlier this year. We have adopted neither a growth stock nor a value stock lean.

We continue to favor Finance, and to a lesser extent, Healthcare and Technology. We have cut back US real estate from 3% of stocks to 2%.

We have made one minor and one major change to our foreign stock strategy. We have shifted 1% from foreign small-cap to emerging market stocks. We have also shifted 11% of foreign stocks from Europe-specific to broadly foreign stocks. This last step was taken in recognition that we have accomplished what we sought to do—we invested early in Europe's recovery, and suspect that the 'easy money' has already been made there. For this reason we are sharply cutting it back, returning to a more normal level of Europe stock exposure.

In bonds, we made a change on paper but not in practice yet. We have never allocated more than 35% of bond money to opportunity (economically-sensitive, higher-risk) bonds. Last quarter we agreed that we would permit our committee to allocate up to 45% to opportunity bonds, however we have chosen, for now, to maintain the 35% level. One main reason that we don't boost opportunity bonds further is the risk of a trade-war driven recession. While not a likelihood, it is enough of a possibility to warrant caution.

We have made no changes to the opportunity bond weights since April, but we have some big changes in our quality bonds. With interest rates steadily rising, with inflation near the Fed's target levels, and with CD rates much higher than they were a year ago, we identified the following changes. We have eliminated our inflation-protected bonds (5% position). We do not see likelihood of sharply increasing inflation from this level, and we have other holdings to provide some upside when inflation does rise a little. We cut 10% from intermediate-term bonds and we cut 10% from short-term bonds. The freed-up 25% is used to purchase bank-CDs, currently in thirds between 6, 18, and 24 months of duration. We expect to maintain this CD sleeve while 1) the CD yields are reasonable, and 2) quality bonds, with their prices subject to swings based on interest rates, come with the real risk of producing returns less than the guaranteed CD yields.

After the past quarter, since US stocks rose and foreign stocks fell, our US/foreign stock balances are out of whack. We look forward to the impact that our disciplined rebalancing approach provides to our client portfolios. We feel that it is time to unwind much of our 'Europe stock bet.' Finally, we are in the process of shifting 25% of clients' bond money from quality bond funds into bank CDs, to stability a portion of their bond money, which is the portion of their portfolio clients look to for stability. We feel that these changes will position our clients' portfolios to best handle the many possible economic and market forces we encounter in the coming months.

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 earlier this year in the Wall Street Journal, is designed to automatically purchase stock funds when the stock markets take a quick, modest decline. After a very smooth 2017 without any such opportunities, 2018 provided a drop in early February which triggered our 'buy the dips' program. We have not yet fully recovered to January's pre-dip levels, but we are closing the gap, and looking for the next dip buying opportunity.

Questions?