Prepared Comments from 10/12/2018 Conference Call

In the 12 weeks since our last call, the S&P 500 fell 1.2%, ended yesterday up 3.6% so far this year, and is up 8.0% in the past year.

US stocks did well in the quarter, with returns ranging from +1.6% to +9.2%. Large-caps and growth stocks did the best. Financials gained about 1½%, healthcare funds rose 10½%, real estate rose ½%, while technology rose 5½%.

Foreign stocks did worse, with large caps gaining, but less than 1%, while smaller-caps lost about 1½% and emerging market stocks falling 2½%. India and China stocks each fell 6½% or more. (*All of these performance figures come from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds gained about ½%, intermediate-term bonds gained under ¼%, and long-term bonds fell less than ¼%. Municipal bonds returned between 0 and –½%. Multi-sector bonds earned over ¾% while taxable high yields gained 2% and muni high yield bonds gained about ¼%. Bank loan bond funds earned over 1½%. Clearly, opportunity bonds outperformed quality bonds during the quarter. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

Announced earlier this month, **US unemployment** has fallen to 3.7%, down from 3.8% three months ago and from 4.2% a year ago. Its 50 year average is 6.2%. Wage growth has been steady at 2.8%, still well below its average of 4.1% (*GttM, slide 24, 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 September 20th, for August. 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 a slight 0.6% during the quarter, after having risen 3.8% during the prior quarter. We had hoped that the dollar's rise would reverse, and the first step for a rise to reverse is to stop the rise. It appears to have begun. (*GttM, slide 28*).

Core inflation came in at 2.2% in September, unchanged from three months ago and up from 1.7% a year ago. Headline inflation is a little higher, at 2.7%, due to energy price increases. (*Source is www.bls.gov*).

Oil prices (finally) fell, 1% during the quarter, but is up over 31% for the past year. (*GttM, slide 29*).

The **S&P 500 earnings** set records for the past five quarters, and this is expected to continue for the next two 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 1% over the past year. One more increase is expected this year, with two to three more expected in 2019. This gradual rate of increases, and the fact that they are 'well-telegraphed', has enabled the markets to react reasonably, up until this week. (*GttM, slide 31*).

Bank CD rates continue to rise to levels worth consideration. We can find a 2¼% yield on a 6-month CD, and 3.1% for a 3-year CD. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The yield curve has flattened substantially, with 3-year treasuries yielding 2.9% while 30-years yield 3.2%. At this time last year the 30-year treasury yielded over 1% more than 3-year treasuries. While a flat yield curve is often used as evidence of an imminent recession, there are very few additional factors leading to that conclusion, and much evidence of very low risk of an imminent recession.

Everyone is Happy—JP Morgan collects a report on purchasing manager's assessment for manufacturing across the globe. While the average is a little lower than three months ago, there is not a single country/region with a score of under 50. Globally, manufacturers are feeling comfortable, which is good news.

So what are you doing in your portfolios?

Let's look at 4 types of investments, and their past recent results. Year-to-date through yesterday, cash is up 1.1%, bonds are down 1.8%, large US stocks are up 1.6%, and large foreign stock are down 8.7%. While last year was very good for investors, so far this year it has been a bad year, especially for investors with meaningful amounts of foreign stocks.

But do you drive by staring in the rear view mirror? Of course not. Investors are not purchasing past performance. Stocks are driven by two main factors—earnings, and emotions. The market drop earlier this week was not driven by economics. None of the stated justifications were new to this week. The US economy is stronger this year and is expected to slow down a bit next year—not new. US interest rates have been rising and are expected to keep rising a few more times—not new. US stocks are (were) a little more expensive than normal, but not by much—not new.

Emotionally-driven stock market declines are just as painful as earnings-driven market declines, but have less lasting impact, as todays rebound illustrates. There is no new, bad, earnings news, in the US or abroad. Therefore, this week's declines provide two calls to action.

There is a call for diversification. The 5% two-day decline in many stock markets reminds us of how rough the road is for a 100% stock portfolio. This is why we have cash and bonds, to smooth out the bad times, even when bad times have not been seen in the rear view mirror.

There is a call for stocks. When a decline is not earnings-driven, it means that stocks are cheaper than they had just been. I call this a blue-light special. US stocks went from slightly overpriced to slightly underpriced. Foreign stocks went from a bit underpriced to meaningfully underpriced. There is this more broadly understood expectation that US earnings and growth will slow in 2019. There is no such slowdown expected overseas. That is why we are firmly committed to maintaining our strong use of foreign stocks, even though, and partially because of, this year's losses.

Speaking of losses, quality bonds have been falling this year, as interest rates have continued their steady, gradual climb. This climb is expected to continue for 9 to 12 more months. Therefore, quality bonds will likely continue to provide disappointing results. This is why we have taken two very significant stances. We have 35% of client bond money in opportunity bonds, which have been doing much better than quality bonds in recent quarters. We have also shifted our clients' quality bonds to much shorter-duration bonds. This has enabled us to minimize exposure to the typical quality bonds, which have been falling this year.

We expect to unwind each of these bond stances in the coming quarters, as the bond world performs a 180 degree turnaround, with an end to the Fed raising interest rates, and with a marked slowdown in the US economy expected. Our current stance could be painful in a year, which is why it is our current stance, and not our future stance.

2018, and especially this week, has brought a challenge to investors, but primarily to short-term investors. We work with clients who are long-term investors, focused on their future or current retirements. Even if you are already taking distributions from your portfolio, in almost all cases your portfolio has years where you are depending on it, and these years are a blessing and curse. The blessing is that, as we saw clearly and profitably over the past decade, painful market declines are invariably followed by welcome recoveries, as long as investors are disciplined and patient. The curse is that the painful market declines cause investors to question their plans, and tempt them to abandon discipline and patience.

This year's poor markets are more of a blessing than a curse. There are many superior opportunities for investors today, even more than a week ago, as long as you focus on the windshield and not the rear view mirror.

We have been busily processing our clients' **Drop & Give Me Five™** trades this week. This is a strategy we developed to buy stock dips in a disciplined manner. The last window when some of these fired was this February. There are no guarantees, but buying dips in a disciplined manner certainly feels better than buying peaks!

Questions?