Prepared Comments from 1/14/2019 Conference Call

Through mid-day today, the S&P 500 is up 3.2% so far this year, but fell 6.5% in the 13 weeks since our last call, and is down 7.2% over the past year.

US stocks did poorly in the past quarter, with losses from -11.7% to -21.7%. Small-caps and growth stocks fell the most. Financials fell 15.2%, healthcare funds lost 16.3%, real estate lost 7.2%, while technology dropped 17.6%.

Foreign stocks fell, just not as much, with large caps 12-14%, while smaller-caps lost about 16% and emerging market stocks falling only 7½%. China stocks fell almost 12% while India stocks rose about 4%. (*All of these performance figures come from JP Morgan and from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds gained about ½%, intermediate-term bonds gained over ¾%, and long-term bonds gained about ¼%. Municipal bonds returned between ¾ and 1¼%. Most opportunity bonds lost money, with multi-sector bonds falling 1½%, taxable high yields down 4⅓% while muni high yield bonds gained about ¼%. Bank loan bond funds fell 3⅓%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

Announced earlier this month, **US unemployment** rose to 3.9%, up from 3.7% three months ago but down from 4.1% a year ago. Its 50 year average is 6.2%. Wage growth has been rising, hitting 3.2% in November, up from 2.8% in August and up from 2.3% November 2017, 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 December 20th, for November. It has risen in September and November, but had fallen in October. In September it reached a 20-year high. The last two recessions were well-telegraphed by pretty sharp declines in the LEI, as reinforced by a recent article in the Wall Street Journal. This implies that the US economy remains on very solid footing for many months (quarters?).

The **US dollar** rose 2.2% during the quarter, and is up 3.6% during the past year. We had hoped that the dollar's rise would reverse, but in 2018 the opposite was the case. (*GttM, slide 29*).

Core inflation came in at 2.2% in December, unchanged from September 2018 and November 2017. Headline inflation is lower, at 1.9%, due to recent sharp energy price declines. (*Source is www.bls.gov*).

Oil prices fell sharply, 38% during the quarter, and fell almost 30% in 2018. (*GttM, slide 30*).

The **S&P 500 earnings** set records for the prior six quarters, but 4Q18 and 1Q19 are expected to fall below 3Q2018 levels before rising again. 2018's earnings strength was aided by the profit margin increase tied to the December 2017 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. Two more increases are expected this year, but this is uncertain as the weak markets in the 4th quarter can cause the Fed to slow down these increases. We appear to be quite near the end of the line for Fed rate increases. (*GttM, slide 31*).

Bank CD rates remain reasonable. We can find a 2.4% yield on a 6-month CD, and 3.0% for a 3-year CD. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The yield curve has continued to flatten, with 3-year treasuries yielding 2.5% while 30-years yield 3.0%. At this time last year the 30-year treasury yielded 0.7% more than 3-year treasuries. While a flat yield curve is often used as evidence of an upcoming recession, there are very few additional factors leading to that conclusion, and much evidence of very low risk of an imminent recession. (*GttM, On the Bench, slide 28*)

Everyone is Happy—JP Morgan collects a report on purchasing manager's assessment for manufacturing across the globe. While the average is slightly lower than three months ago, and a bit lower than a year ago, it remains at 52.0, well above the 50.0 neutral level. Globally, manufacturers are feeling comfortable, which is good news, as reinforced by the same recent Wall Street Journal article, noting few economic indicators signaling an upcoming recession. (*GttM, slide 47*)

A similar survey of plans for services is even higher, at 53.1. (*GttM On the Bench, p45*) The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p23*), at 98.3 is well above the average level of 85.7.

So what are you doing in your portfolios?

Let's look at 4 types of investments, and their recent results. In the past year through last Friday, cash is up 1.6%, intermediate corporate bonds are up 0.2%, large US stocks are down 6.0%, and large foreign stock are down 13.8%. Fortunately, the prior year was extremely good, generally returning much more than what has been lost in the past year. (*Data from Morningstar*.)

Given that the economics continue to look quite solid, both in the US and abroad, we are changing little with client stocks, keeping stocks at 102% of long-term target levels, although the reason has shifted away from avoiding overpriced bonds to favoring underpriced stocks. We are shifting the US/foreign balance from 50/50 to 52/48, largely to reduce client anxiety tied to the historically long period of US stock outperformance vs foreign stocks. We are shifting a bit from mid-cap to smaller-cap stocks.

We are shifting a bit in the bond area. We feel that the greatest risk of rising rates is behind us, and so we are shifting from 65% quality bonds to 70% quality bonds, cutting back economically-sensitive opportunity bonds. Within quality bonds, we are introducing long-term bonds at 5%, and using 12/20/33% for intermediate/short/ultra-short term bonds.

Within opportunity bonds, we are using 8/4/12/4/2% for high yield, multi-sector, bank loan, emerging market, and global bonds.

2017 and 2018 were dramatic years for investors, opposite extremes. We hope 2019 will bring less drama.

Questions??

[I read the following during the Q&A section of this call]
In the second half of 2018, with foreign stocks doing so poorly versus US stocks, many investors are questioning whether to sharply cut back their foreign stocks. I came upon a graph from JP Morgan that examines cycles of US outperforming foreign and vice versa since 1971. There have been 10 cycles, 5 with foreign outperforming US and 5 with US outperforming foreign. The current cycle, at more than 11 years, is the longest in length. At 106% it is the third greatest in the amount of outperformance. US stocks outperformed foreign by 220% in the dot-com cycle in the late 1990s, while foreign outperformed US stocks by 374% in the late 1980s. (*GttM, On the Bench, p36*)