

## Market Review and Outlook—October 7, 2015

*[These comments come from Kenny Beach, who has been with Mallard for about two years and who serves with Paul Baumbach and Ryan Flurie on Mallard's Investment Committee. The comments on the back page are from Paul.]*

Boy what a rough ride we have had in recent weeks. Practically all stocks, foreign and domestic, finished the quarter firmly in the red. The guessing game continues and I am sure you are tired of the endless commentary and pontificating about when the Federal Reserve will make the move to raise short term interest rates. Whatever the Fed does, it does. We cannot change that. A few clients have contacted us inquiring as to what are we going to do in this up and down choppy market. We are going to continue to do what we have always done; maintain widely diversified portfolios, tailored to your risk tolerance, and constructed to weather the good days, as well as the bad. See the article on **Drop and Give Me Five™**, a new tactic you can implement that may help turn this volatile market into an “opportunity” market. As unpleasant as lower stock prices are, the current market creates opportunities for improvement.

In taxable accounts we can trim holdings, which are overvalued or unattractive, with much less of a tax cost. In previous months we found it very difficult at times to trim some holdings with large embedded gains. This was a good problem, but a problem nonetheless, when a large portion of a sell trade was going to have to be shared with the government by virtue of our tax code. In some accounts we will move more quickly this fall to move out lower rated securities since the tax cost will be considerably less now that the market has settled down, or should I say bounced down, to a new lower level.

For persons with the fortune, or misfortune, to have incurred year-to-date taxable gains, we will harvest losses, likely from some of your more recent purchases, which will offset some if not all of those taxable gains. Even if your account does not have realized gains we may harvest losses that can be used to offset future realized gains.

If you are in the accumulation phase of your financial plan, the market drop gives you the opportunity to buy your chunk of the world's income producing companies at a lower price than before. **For you the world is on sale.**

If you are drawing down assets, take solace in the fact that a reasonable portion of your portfolio is in bonds. Although this will not be the case forever, high quality bonds of all maturities are holding up quite well and providing your portfolio with stability while contributing some minor income. Today's market provides a much needed reminder why bonds are held in your portfolio.

| Category                                | 3 Months | 12 Months | 3-Yr Avg | 5-Yr Avg | 10-Yr Avg |
|---|----------|-----------|----------|----------|-----------|
| <b>Fidelity Cash Reserves</b>           | +0.00%   | +0.01%    | +0.01%   | +0.01%   | +1.42%    |
| <b>Intermediate Term Bond</b>           | +0.32%   | +1.46%    | +1.58%   | +3.15%   | +4.29%    |
| <b>Intermediate Muni Bond</b>           | +1.29%   | +2.02%    | +2.02%   | +3.35%   | +3.78%    |
| <b>Large-Cap Stock</b>                  | -7.53%   | -2.48%    | +11.28%  | +11.68%  | +5.97%    |
| <b>Mid-Cap Stock</b>                    | -9.14%   | -2.41%    | +11.74%  | +11.19%  | +6.39%    |
| <b>Small-Cap Stock</b>                  | -10.90%  | -1.11%    | +10.38%  | +10.94%  | +10.94%   |
| <b>Foreign Large-Cap Stock</b>          | -10.34%  | -8.06%    | +4.62%   | +3.30%   | +2.91%    |
| <b>Real Estate</b>                      | +1.37%   | +8.58%    | +8.60%   | +11.19%  | +6.18%    |
| <b>Natural Resources</b>                | -20.00%  | -31.55%   | -8.92%   | -3.19%   | +0.17%    |
| <b>Technology</b>                       | -7.69%   | +0.41%    | +12.95%  | +11.18%  | +7.85%    |
| <b>Moderate Allocation (60% stocks)</b> | -5.60%   | -2.51%    | +6.41%   | +7.33%   | +5.08%    |

*The data in this table comes from Morningstar and is as of September 30, 2015*

*Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect, transactions in securities, or the rendering of personalized investment advice for compensation.*

**There is a reason that stocks outperform bonds over time. Stocks occasionally fall.** The table on the other page shows that over the past decade bonds have returned a bit over 4% annually, while large US stocks have returned about 6%. Over a decade, that 2% gap made the difference between a 52% gain and a 79% gain. While the 79% gain looks great, it comes at a cost. Stocks on average fall one out of every three quarters, and one out of every three years. Despite, or actually because of, these occasional declines, stocks have outperformed bonds over time. Stock investors put up with a lot of turmoil and grief. On average, the market will decline over 14% from peak to trough each year. This year the decline is less than average, but it still feels pretty bad. Experienced investors take such declines in stride, and work hard to ‘be greedy when others are fearful.’ This is fairly easy to say and fairly difficult to do. Yet it is critical to strive to follow this guideline.

Stocks fell this quarter, and are down over the past year. The chart has a lot of red figures in the left two columns, illustrating these losses. The biggest losses came from the energy sector, down a shocking 20% in three months, and down over 30% in the past year. This has ripple effects, and led many commodity-rich countries, especially those in emerging markets, to suffer. While the energy sector makes up less than 15% of the S&P 500, the S&P 500’s earnings have declined over the past year solely due to this sector’s sharply fallen earnings.

The second significant factor is the sharp increase in the value of the US dollar, versus other major currencies. It is up almost 18% in the past year, an astoundingly sharp rise. This has a short-term and a longer-term impact. The quick impact is that returns from foreign stocks suffer. The dollar rise alone is ‘to blame’ for the 8% loss in foreign stocks over the past year—it is surprising that the loss isn’t greater. The longer-term impact is very positive for foreign companies. Larger foreign companies compete with US companies, and a stronger US dollar leads to increased sales by foreign companies, and sharply stronger dollar levels lead to sharply higher sales, and ultimately profits.

The third factor has been the slowdown in China. While China was credited with single-handedly reversing a global recession in 2009, concern has mounted this year that it would lead us downward as its official growth rate falls, and its unofficial growth rate falls even further. There are two notable silver linings. Even pessimistic growth figures are well ahead of most of other countries’—while analysts’ 4% estimate is much lower than China’s official 7% figure, it is well ahead of the US’ 2.2% annual rate since 2010. Importantly, China’s central bank is in an enviable position of having tremendous resources which it can use to head off further slowdowns, to avoid a ‘hard landing’ and recession.

Which brings us to our central bank, the Fed... Surprising most people, the Fed in September decided to NOT raise the Fed rate. We have been ‘at zero’ for an incredible seven-plus years. This has led to a 0.01% average annual return from money market funds for the past five years, as noted on the chart. If you have a stroke, you are admitted to the ICU. Eventually you are stabilized and move to a standard room. The Fed has judged that the US economy needs to be in the ICU a bit longer. This judgment has been widely criticized, as most analysts feel that the US economy is pretty solid, and that it is well past time to get us ‘off zero.’ Many analysts expect (and hope) that the Fed will finally begin to raise the Fed rate at its December meeting.

Whenever the stock markets fall, we look to ask the important question—“was the stock market decline caused by worrisome fundamental reasons, in which case we hold on for a bumpy ride, or for emotional reasons, in which case the odds are good that we now face a buying opportunity?” In all matters in the investing world, we are working with uncertainty—what could appear as an emotional sell-off could in fact turn into a fundamental, economic slowdown.

The Leading Economic Index® hasn’t declined in the past three months. Unemployment continues to fall, while vehicle and housing sales continue to increase. Gas prices have declined sharply with oil prices, putting more dollars in consumers’ pockets. While a global manufacturing index fell a bit in the past three months, it remains at an expansionary level. We feel that the likelihood is that the selloff has been emotional, and provides a buying opportunity, not only in the US, but globally. We are making adjustments, but our overall view is that stock markets offer compelling value.

As Kenny noted, there are good reasons to hold bonds, even when we are worried about significant headwinds in coming quarters. We have adjusted both our quality and our opportunity bond sector weights, in several cases streamlining to four quality (cash, short-term, intermediate-term, and long-term), and three opportunity sectors (high yield, multi-sector, and unconstrained). We continue to advise a 65/35% quality/opportunity balance, to provide a balance prepared for both continued economic growth and a slowdown, and prepared for both stable and for rising interest rates.