Prepared Comments from 10/17/2016 Conference Call

The S&P 500 is down 1.6% from mid-July, up about 6% so far this year, and remains above three times its level from its low in March 2009.

Markets across the globe did well in the past quarter, with notably strength in China and the rest of Asia. The concern has subsided over the **BrExit**, British vote to leave the European Union, the EU. The **US dollar** has been moving sideways, which investors welcome as it becomes a non-factor.

While **oil prices** have jumped up and down over the past two years, they have been steady for the past few months, and this has led to stability, and perhaps even strength, in natural resource stocks. Core **inflation**, which excludes food and energy, has been inching up, yet stands at only 2.3%. Headline inflation is even lower, at 1.0%.

US unemployment stands at 5.0%, well below the 50-year average of 6.2%, and steady this year. Wage growth is at 2.5%, well below the 50-year average yet moving slightly upward.

The US Leading Economic Indicator is up over the past three months (up for two months, down for one), indicating that the economy is not in danger of falling into a recession.

Globally, global purchasing managers are surveyed to find areas of strength and weakness. The US is looking good, better than three and twelve months ago. The developed world is doing well, better than three months ago, but weaker than a year ago. Emerging markets look a little weak, largely unchanged from the past quarter and year. The strongest areas are the UK, Germany, and Spain, with trouble areas in Korea and Brazil.

In the **third quarter**, most bonds moved sideways, although taxable high yield bonds rose over 4½%. Stocks did well. US stocks rose 4-7%. Large foreign stocks rose 6%, smaller foreign stocks rose close to 8%, and emerging market stocks rose about 7½%. Real estate fell a little, natural resource funds rose 5%, while technology leapt over 13%. In the US, small stocks did the best, and generally growth stocks outperformed value stocks.

The **S&P 500's earnings** for the 2nd quarter were greater than the prior quarter for the second straight quarter, yet remain a little less than that of the 2nd quarter of 2015. Strong earnings gains are expected for the next few quarters, as the pain suffered by the energy sector over the past year produces very favorable comparison points. Earnings records are expected to become the norm, which supports records for stock market levels.

Since the last call, the **price of oil** has risen from about $48½ to over $51. Stability at ANY level is helpful, and compared with the past, oil has been pretty steady since April.

There have been no changes to short-term **interest rates**—the Federal Reserve Bank continues to imply that a rate increase is likely in December. The Fed is indicating that it will raise rates from ½% to 1% a year for a few years. The market, however, expects a much slower increase, with annual increases closer to ¼%.

The US **bond market** is a living contrast. The US economy is growing and largely healthy. Yet interest rates in the US continue to fall. The reason is tied to phrase "In the land of the blind, the one-eyed man is king." The US government will pay you 2½% a year for a thirty-year bond. Given that inflation is running at 2.3%, if you purchase this bond you will lock in a 0.2% annual return after inflation. That is dismal to say the least.

The global picture is much worse for bond investors. Over 70% of government bonds currently offer yields of 1% or less, and 33% of them offer yields of less than 0%. Yes, investors are buying bonds from governments in Japan and in Europe, where the government pays the investor back at maturity less than what they received. In this crazy world, a 2½% 30-year US government bond seems somewhat reasonable.

As a result, investor flows into US bonds have been strong and steady for years, and could continue. Despite falling over 3% so far this month, long-term government bond funds are up more than 9% year-to-date. Investors are rushing to obtain that 0.2% after-inflation annual return.

In light of this unprecedented environment, at Mallard we continue to max out our **opportunity bonds**, which trade more on economic growth than on interest rate moves. We have set this at 35% of client bond money for close to a decade. We continue to believe that the US economy is solid, and its slow but steady growth will continue to lead to gains in high-yield bonds and other credit-sensitive bond segments in the coming quarters.

We do recognize that we can be dead wrong, and for this reason, we maintain 65% of client bond money in **quality bonds**. It has felt foolish to hold so many dollars in bonds when bond prices are so high and yields are so low, however 1) this benefits should we be dead wrong and the US economy stumbles badly, 2) this benefits should global investors continue to favor the US bonds, due to the interest rates being low, but being higher than most global bonds, and 3) when interest rates rise, most expect the increases to be gradual, in which case the price decline would be more than compensated with interest payments.

We have changed our stance on stocks versus bonds from viewing stocks as cheap to stocks as fairly priced. We agree that bonds are overpriced, but we feel that stocks are also overpriced by some measures, and therefore **there is no longer a pronounced advantage to stocks**. While we used to overweight stocks by 2 or 3%, versus clients' long-term target allocation stock level, we are now running stocks exactly at long-term levels. We also like harvesting gains; as stocks have returned 10% or more over the past year, we feel it to be a good time to lock in some gains.

We continue to maintain a preference to **technology** stocks and to a lesser extent **health care** stocks. We feel that both sectors provide opportunities for 'breakthroughs' which can provide very positive surprises, while also recognizing that neither sector appears to be overvalued by historic measures.

We have shifted a little from Pacific foreign stocks to Diversified Emerging Markets stocks, again taking some profits off the table. Emerging stocks remain the higher-risk area for investing, but offers better apparent values and better apparent appreciation potential. We are maintaining our Europe stock allocation at 12.5% of foreign dollars.

As mentioned, we are maintaining our 65% quality/35% opportunity bond allocation. We divide our quality dollars with 3% cash, 27% short-term, 30% intermediate-term and 5% long-term bonds. In opportunity bonds we have eliminated the non-traditional bonds and introduced emerging markets bonds. Our balance is 10% high yield, 10% multisector, 5% preferred, 5% bank loan, and 5% emerging markets bonds. We have a slight change for clients with municipal bonds.

We continue to believe in several **fundamental investment principles**. Make a plan, write it down, and follow it. Focus on overall stock/bond balance. Rebalance regularly to prevent your portfolio from harboring too much, or too little risk/opportunity. Prepare for the worst when times are good.

Times appear to be solid for US stock investors. It is therefore a good time to rebalance, and to review your 'lifeboat drill.' We have developed the **Firewall Investing™** program to ensure that you don't sell investments when their prices plummet, but that all of your withdrawal needs are fully met by your dividends, interest, and bond sales while you wait for the eventual stock market recovery. We work to diversify client stock money well, and bond money well, so a fairly isolated market disturbance is muted.

Enough about investing, let's talk about next month's **elections**. In twenty-two days the country will be voting for US President, every US House seat, and a third of the Senate seats. Websites such as www.FiveThirtyEight.com, by analyzing poll data and the electoral vote system, have concluded that currently Hillary Clinton has an approximate 85% likelihood of becoming our next President. That site also concludes that there is at least a 65% likelihood of the Senate being split 50/50 (with the US Vice President being able to cast the deciding vote). These predictions have changed sharply over the past two months—these are simply the most recent figures.

I therefore conclude that for the two years beginning this January, the White House and the Senate are likely to be held by Democrats, and the US House will remain held by Republicans. This is very important, as no legislation will be possible without some bipartisan agreement. While the polls have changed sharply over the past six months, this expectation that legislation next year will require bipartisan action is unchanged. For this reason, it is very unlikely that any bold legislation will be adopted in 2017 or 2018. You can characterize this as two more years of gridlock.

That said, **gridlock** can be your friend. Stock markets do not like change, or uncertainty. It is reasonable to assume that, at least after a few weeks, the stock markets will view the November election results with a yawn. While the emotions will likely be affected by the results, there are no clear economic implications of the likely election results.

I would like to wrap up my prepared comments on an up note. JP Morgan's chief global strategy Dr. David Kelly uses the tortoise and hare story to describe the US economy. What we have, he states, is a healthy tortoise, not a sickly hare. The US economy has been chugging along, at a slow but steady pace, for more than seven years. The next year appears to be 'more of the same.' We are somewhat prepared for that, and we are somewhat prepared if that isn't the case.

Questions?

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