# Prepared Comments from 1/13/2017 Conference Call

Happy Friday the $13^{th}$! The S&P 500 is up over 5% from mid-October, and up over 20% in the past year. Note that last January began a sharp sell-off tied to oil prices and China concerns.

While US stocks did quite well in the $4^{th}$ quarter, rising 3 to 9%, foreign markets fell 2-3%. While the results of the Italy referendum weighed on foreign markets, it was the US dollar's gain of over 6% that prevented gains for the quarter.

**Oil prices** continued to strengthen, ending the year at more than $53, after having fallen to under $30 a barrel in January. Just as the financial sector collapse caused hefty losses which led the S&P's earnings to dive, the energy sector collapse in 2014 and 2015 also drove down S&P profits. The reversal in 2016 has enabled the S&P 500 to be poised to set new records for earnings, helping the US stock markets reach new records.

**US unemployment** stands at 4.7%, well below the 50-year average of 6.2%, down from 5.0% a year ago and 5.6% two years ago. **Wage growth**, at about 2.5%, is up over the past few years, and is expected to become a factor pushing US inflation upward in 2017 and beyond.

The **US Leading Economic Indicator** is has been stable in the past three months. The LEI most often declines close to a year before the US economy slows down, so it can be a very good early warning system, and it currently indicates that we have positive growth ahead for the next few quarters.

Globally, **global purchasing managers** are surveyed to find areas of strength and weakness. The overall figure is the strongest it has been in years. Europe actually has stronger figures than the US. Foreign developed markets look strong, and even the emerging markets show expected growth. The strongest areas are the UK, Germany, Spain, Ireland, Australia, and Taiwan, with Brazil the only notable trouble area.

In the **fourth quarter**, most bonds lost money. Quality municipal bonds fell 1-4%. Government bonds fell 1-11% (long Government bonds were hard hit). Taxable bonds fell ½ to 7½%. Taxable high yields actually gained over 1½%, while high-yield munis fell 5%.

**US stocks** did quite well in the quarter, gaining 4-9 ½%. Small caps and value stocks did particularly well, as did financial stocks which rose about 17%. Natural resource (energy) stocks rose about 5%, while Health stocks fell over 6%, Real Estate fell about 2 ½%, and technology fell about ½%.

**Foreign stocks** generally fell during the quarter about 2-3%. Again, value stocks outperformed sharply. Emerging market stocks fell more, about 5¼%.

As mentioned earlier, the **S&P 500 earnings** are recovering well. The estimated 4$^{th}$ quarter earnings are expected to set a record, and further records are expected later in 2017.

The Federal Reserve Bank, **the Fed**, finally pushed up overnight interest rates by ¼% in December. Increases of about ½% are expected during 2017. We view this optimistically, showing that the Fed feels that the US economy is strong enough to handle higher rates without stumbling.

The US **bond market** may be at a turning point, from "lower for longer" to "the big unwind," describing a lengthy period as interest rates gradually return to more historic levels. We do expect this, but we expect the period to indeed be lengthy. As such, we expect bond returns to be weak, but not a rout. Bonds provide two advantages today—they provide a balance to stocks which can fall sharply without notice, and they also provide protection against an economic shock (trade war with China, for instance). In both cases, the inclusion of bonds in today's portfolio is designed to improve on the portfolio's overall results.

Rising bond yields could, in isolation, lead to a sharp boost in US bond purchases, in which case the bond prices could stabilize and limit losses. This could further push the US dollar upward. We are not convinced that this will actually unfold in that manner.

Global bond investors care about more than yield, they care about the local currency and local inflation. As the US economy is much further along the recovery from the 2008-2009 financial meltdown than most developed economies, its unemployment is low and inflation is rising. Rising US inflation leads to diminished returns for global bond investors, and this can reduce demand for US bonds, and by translation, US dollars.

In this 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 expected to improve, which should lead to superior gains in high-yield bonds and other credit-sensitive bond segments in the coming quarters. We have eliminated preferred stocks and non-traditional bonds from our opportunity bonds, and have sharply increased our use of bank loan funds, which typically fare well in rising interest environments.

Should we be wrong, or premature, we maintain 65% of client bond money in **quality bonds**. In light of the 'great unwind,' we are eliminating long-term bonds. Due to our expectations of inflation rising over time, we are introducing an inflation-linked bond component to our quality bonds.

After only a few months, we have changed back our stance on stocks versus bonds from viewing stocks as fairly priced to viewing them as cheap. We don't actually view stocks as cheap, but rather we view bonds as overpriced. Furthermore, we do view some stocks as cheap; specifically we view foreign stocks as cheap. We are now running stocks at 102% of their long-term levels.

We continue to maintain a preference to **technology** stocks and, to a greater extent, **health care** stocks. We are cutting financial stocks back to and below neutral levels, locking in the gains that have come since November; we worry that the current prices of financial stocks have already factored in every piece of possible good news, and that disappointment is more likely than a positive surprise.

We continue to have confidence in our specific extra allocation to Europe stocks. The only notable change we have made in our **foreign stocks** is a reduction of our use of global stock funds, and a compensating shift towards passive (index) foreign large cap stock funds. While foreign stocks have lagged US stocks ever since the 2008 meltdown, their economies are strengthening, and their prices have substantial room for upside surprises. We expect foreign stocks to fare better than US stocks in 2017 and for several years. The fact that we are in the minority in this view actually emboldens us. When everyone agrees with an investment theme, it is invariable horribly flawed.

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% inflation-linked bonds. In opportunity bonds we have eliminated the non-traditional bonds and preferred stocks, and boosted our bank loan funds. Our balance is 10% high yield, 10% multisector, and 15% bank loan (some higher quality and some lower). We have a slight change for clients with municipal bonds.

The best **summary for the 4th quarter's investment results** is "don't rely on the headlines." Yes, US stocks did very well, but foreign stocks fell, and most bonds did poorly, some quite poorly. We feel that we are poised for a sea change, for foreign stocks to outperform US stocks, for US interest rates to begin some steady increases, and for US inflation to also rise. These changes warrant a re-examination of your portfolio.

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.

**Rebalancing** will almost certainly call for investors to reduce their record-breaking US stocks, and to replenish their weak foreign stocks. We feel that this is a good step. Please strive to resist the temptation to 'letting it ride.' Dot-com investors in 1999 came to regret this technique.

We have a new US Presidential Administration next week, new cabinet secretaries, new Congressional leaders, and new policies. This will certainly have significant economic impact. For now the markets are expecting an increased rate of economic growth, due to a combination of a increased commitment to infrastructure spending, reduced financial and environmental regulation, and simply a more business-friendly approach. This has both positive and negative investment implications (higher company profits, but higher inflation and interest rates). Global implications are less clear, but worries of increased trade disagreements been raised. This is actually one reason that smaller companies have done well in recent weeks—they are better protected from international forces.

Investors never know that the future will bring, but we still commit to invest, in order to harness the greater returns that investing into uncertainty delivers. We aim to study the range of likely outcomes, to assess likelihoods of each, and to position portfolios to prepare for each such path, always striving to place the odds in your favor. We will never be right on all fronts. We hope to never be wrong on all fronts either. For 2017, let's resolve to enjoy being right some of the time, and accept being wrong some of the time. It's going to happen anyway.

Questions?

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