Prepared Comments from 7/17/2017 Conference Call

In the 14 weeks since our last call, the S&P 500 has risen 4.2%, and is up 13.8% in the past year.

US stocks did well in the quarter, gaining 1¾ to 3%. Growth again sharply outperformed value and large caps outperformed small caps. Real estate rose a little under 2%, financials rose about 3½%, health stocks rose almost 7% and technology jumped 6%, while natural resource stocks fell 4%.

Foreign stocks continued to do well during the quarter, with large-caps up 6¼%, foreign smaller stocks up 8¼%, and emerging market stocks up almost 6%. While their longer-term results continue to badly trail, foreign stocks now have stronger 3-month and 1-year returns than US stocks.

In the **past quarter**, most quality bonds, both taxable and municipal, earned 1½% or so. Opportunity bonds rose a little more, with taxable high-yield earning 1¾% and municipal high yield bonds gaining almost 2¼%, while bank-loan bonds gained less than ¾%.

What is behind the recent investment results?

Announced earlier this month, **US unemployment** has fallen to 4.4%, down from 4.9% a year ago, and well below the 50-year average of 6.2%. While this low level is good for US households (and companies which rely on the consumer), this presents a big challenge to the US economy as there is little room for the workforce to grow our economy further.

The Conference Board maintains a **Leading Economic Index**, the LEI. It has risen the past three months, and now stands higher than it has been for 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** has moved a little, falling 2.9% in the past three months yet up 2.7% in the past year, and yet it has been in a relatively tight range for 2½ years. The recent decline has helped boost investment returns from foreign stocks and bonds.

Inflation has been tame, under 3%, for 25 years. Most recently core inflation stands at 1.7% ½% less than in February, and wage growth has failed to exceed 2 ½%, well under its 50-year average of more than 4%. Commodity prices have remained subdued ever since 2008.

Oil prices were flat during the past quarter, and had fallen 3.8% in the past year, but have since recovered 4.2% to $48.47 a barrel. In the past year and change, oil has provided an overdue, stabilizing force on the US economy and stock markets.

The **S&P 500 earnings** are recovering well. While the earnings from the last three quarters were much higher than in the prior year, we aren't setting new quarterly records until the 2nd quarter figures are finalized. Then further records are expected. One of the reasons is the relative stability of oil prices—the 2015 plummet in prices was a real body punch to S&P 500 earnings and has taken many quarters to recover.

The Federal Reserve Bank, **the Fed**, raised overnight interest rates by ¼% a third time in June. The Fed estimates a brisker rise than the bond market believes—time will tell.

So how has that affected stock and bond results?

The baton may be in the process of being passed from US stocks to **foreign stocks**. We don't necessarily worry about record-setting stock prices, as long as the stocks' earnings are also setting records. They are, largely, in the US, however the ratio of price to earnings, the P/E ratio, is starting to look a bit too high. This doesn't mean that US stocks will fall shortly, just that the odds are worsening for further good US stock returns, and the risk of the next downturn being more painful has increased.

The footing overseas appears stronger. For the first time in six years the US lags the rest of the world in a major manufacturing index that looks at upcoming orders. Surprisingly, the leading region at this time is Europe, which has reached an apparent sweet spot, with very supportive (low) interest rates, central bank backing of local banks, falling unemployment, strengthened consumers, and reasonably priced stock markets. The US enjoyed this sweet spot a few years ago, and investors benefited handsomely. It could be time for investors to benefit from European stock holdings.

Given the strong global economic climate, at Mallard we are keeping clients' stock levels at 102% of their long-term target levels. This is primarily due to the challenges facing the bond markets for the next several years, with downward pressure on prices and upward pressure on yields.

For the first time in several years, we are adjusting the US:foreign stock balance, shifting 2% from 56/44 to 54/46, reflecting this view that the US has passed its sweet spot, and that there are better valuations and promise in foreign stock markets.

US bond investors have little to hope for other than more sideways moves. Bonds did fine in the 2nd quarter, rising about 1½%, yet almost every indication is that bond investors will be facing steady headwinds for many, many years. The Fed in June provided some guidance on their program to gradually unload their massive bond portfolio over several years, providing some of those headwinds. However, there is no clear reason for bond prices to plummet. The most likely path is for the bond market tire to have a steady leak. European banks should follow suit, however this could be five or more years from now.

Within our quality bonds, we cut back inflation-linked bonds this month, due to the diminished inflationary pressures noted earlier. We slightly boosted short-term bonds. We see very little to like in quality bonds, with treasury bond yields ranging from 1.2% for one-year bonds to 2.3% for 10-year bonds. There simply isn't enough yield to justify locking up money for a long time into quality bonds today.

We continue to use a maximum level of opportunity bonds, 35% of all bond money. Opportunity bonds, our label for bonds which trade more on their economic ties than on interest rates, and thus should continue to do well in strong economic times, while quality bonds do best when the economy is under pressure. Opportunity bonds include subclasses such as high-yield, bank-loan, and multi-sector bonds. We have shifted a bit from high-yield to multi-sector bonds this month, due to our view that taxable high-yield bonds may have 'gotten ahead of themselves.'

It is time to consider your US:foreign stock balance. The typical US investor has only 26% of their stocks from overseas. At Mallard we are now recommending a 46% foreign weight. In contrast, 64% of global stock and bond markets are outside the US, while 78% of global economic activity is outside the US.

We always have uncertainty in the markets. It is uncomfortable for the current economic expansion to be 8-years long and counting, the third longest in over a century. However, this is also the most gradual recovery in 70 years. There is no compelling reason to bet against stocks (both US and foreign) at this time. While there is no reason to be excited about bonds at this time, they should continue to provide stability to investor portfolios, even with the headwinds.

Therefore, we maintain our never-ending recommendation of regularly-rebalanced, globally diversified investment portfolios, with the risk matched to your individual circumstances. While the daily headlines can cause great stress, this doesn't shake our confidence of long-term investing foundations such as these.

Questions?
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