Prepared Comments from 4/15/2019 Conference Call

Through mid-day today, the S&P 500 is up 12.4% in the 13 weeks since our last call, and is up 8.4% over the past year.

US stocks did very well in the past quarter, rising from 11 to 18%. Growth stocks gained the most. Financials rose 10%, healthcare funds gained almost 13%, real estate gained over 16%, while technology gained close to 20%.

Foreign stocks gained, just not as much, with large caps and small caps both up 9 to 13%, while emerging market stocks gained over 10%. China stocks gained almost 21% while India stocks rose only about 4½%. (*All of these performance figures come from JP Morgan and from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds gained about 1½%, intermediate-term bonds gained over 3%, and long-term bonds gained close to 6%. Municipal bonds returned between 1 and 3¼%. Most opportunity bonds did well, with multi-sector bonds up over 4%, taxable high yield bonds up over 6% while muni high yield bonds gained over 3%. Bank loan bond funds gained over 3½%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

Announced at the beginning of this month, **US unemployment** for March is unchanged at 3.8%. For context, the 50 year average for unemployment is 6.2%. March saw notable job gains in health care and in professional and technical services. While employment in construction showed little change in March (+16,000), it has increased by 246,000 over the past 12 months. (*GttM, slide 25, https://www.bls.gov/ces/home.htm*). [no comment on wage growth]

The Conference Board maintains a **Leading Economic Index**, the LEI (*www.conference-board.org*). The latest report is from March 21st, with data through the end of February. It fell 0.1% in December, had no change in January, and rose 0.2% in February. The 6-month August to February values show an increase of 0.5%. This predicts that the economy will continue expanding in the near-term although the pace of growth could decelerate by year end.

Reminder that we watch the LEI closely because the last two recessions were well-telegraphed by sharp declines in the LEI for several months before those recessions began.

The **US dollar** rose 19.2% during the quarter, and is up 27.2% during the past year. There are several factors that should pressure the dollar to weaken (including the substantial trade deficit and federal budget deficit, and the impact of foreign interest rates rising while US rates are stable), however they have not produced that impact yet. (*GttM, slide 27*).

Core inflation came in at 2.1% in February, unchanged from January. Headline inflation is lower, at 1.5%, which was true last quarter too and still from recent sharp energy price declines. (*Source is GttM Slide 26 and www.bls.gov*).

Oil prices rose a sharp 33.9% during the quarter, but remain 8.5% below their levels from this time last year. (GttM, slide 28).

The **S&P 500 earnings** set records for six of the seven the prior quarters, but 4Q18 saw a decline. S&P consensus analyst estimates increased earnings per share for the next four quarters. (*GttM, slide 7*).

The Federal Reserve Bank, **the Fed**, have been sticking with overnight interest rates as 2.38% with a stated long-run goal of 2.75%. The Fed has taken their foot off the pedal some, revising their plans to slow down increases going forward while shrinking their balance sheet. (*GttM, slide 29*).

Bank CD rates remain reasonable. We can find a 2.1% yield on a 6-month CD, and 2.55% for a 3-year CD. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The yield curve has had a slight inversion, which means the 1-yr bonds are yielding higher than longer time frame bonds. At the moment 1-year treasuries are yielding 2.4%, with 3-year treasuries yielding 2.2%, and 30-years yield 2.8%. At this time last year the 30-year treasury yielded 0.6% more than 3-year treasuries, which yielded 0.3% more than 1-years. 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 32*)

Not Everyone is Happy—JP Morgan collects a report on purchasing manager's assessment for manufacturing across the globe. The results have spread out over the past quarter, with the US, UK, Greece, Brazil, and Russia with the best figures. The Euro countries and Korea and Taiwan are below 50.0, the neutral level. (*GttM, slide 48*)

A similar survey of the purchasing manager's assessment on services across the globe reveals very positive results (averaging 53.7), with the exception of the UK and France, which come in around 49.0. Fortunately, services make up much more of the global economy than manufacturing. (GttM On the Bench, p50)

The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p23*), at 98.4 is well above the average level of 85.7, and largely unchanged during the quarter.

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 1.8%, intermediate corporate bonds are up 3.9%, large US stocks are up 8.8%, and large foreign stock are down 4.1%. The bond and stock results are far better than they were in January, due to the recovery enjoyed since late December. (*Data from Morningstar*.)

We appear to be in an odd economic arena—a normal period. The economy is growing, but at a modest pace. Interest rates are expected to remain largely where they are for awhile; neither large increases nor decreases are forecast. US stocks are priced similarly to their average level. Core inflation has been largely unchanged for 25 years.

There are certainly economic risks, chief among them the inability of the US economy to grow at much more than a 2% level, ongoing trade wars, continued uncertainty on Brexit, and several geo-political hotspots across the globe. However there are also apparent opportunities, including foreign stock markets which are 8% cheaper than normal and 21% cheaper than US stock markets, overall foreign stocks yield 3.5% while US stocks yield only 2.1%, foreign economies that are expected to grow faster than the US economy, foreign central banks are on track to raise their interest rates in a vote of confidence in their underlying economies.

In the second half of 2018, with foreign stocks doing so poorly versus US stocks, many investors have questioned whether to sharply cut back their foreign stocks. JP Morgan has a graph 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 125% 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, p39*)

Given this backdrop, we are changing quite a bit with client stocks, to reflect this more normal environment. We are cutting stocks from 102% to 101% of long-term target levels, as stocks are less of a bargain than they were in January, and bonds appear at less risk of rising yields and falling prices. We are maintaining the US/foreign balance at 52/48, expecting that, over time, the US dollar will be driven cheaper, providing a substantial tailwind to foreign stock holdings, coupled with higher growth rates, higher dividend yields, and lower prices for foreign stocks. We are maintaining a relatively heavy allocation to smaller-cap stocks. Where the tax cost is modest, we are eliminating global stock funds, preferring purely US and purely foreign stocks and stock funds. We no longer have any extra emphasis on Europe stocks. We are also eliminating any preference for financial stocks, and we cut our US real estate emphasis to 1% of stocks from the prior 2% level.

We are shifting even more in the bond area. With this apparent 'return to normalcy', we are shifting quality bond allocations from 70% to 75% of overall bonds. We are increasing the average maturity of quality bond holdings, cutting the ultra-short bonds and boosting the long-term bonds. We now are using a 1/19/30/15/10 level of cash, ultra-short-term, short-term, intermediate-term, and long-term quality bonds. This is sharp change from three and six months ago.

Within opportunity bonds, we eliminated the entire 12% allocation to bank loan funds and reallocated the percentages to now use 8/10/5/2% for high yield, multi-sector, emerging market, and global bonds. Given our expectation that interest rates will not be rising much further, bank loan funds offer very little appeal at this time.

2019 is turning out to be quite different from 2018, thankfully. The outlook for the rest of the year is 'steady as she goes.' We would welcome less drama.

Questions?