Prepared Comments from 7/15/2019 Conference Call

Through mid-day today, the S&P 500 is up 3.6% in the 13 weeks since our last call, and is up 7.5% over the past year.

US stocks had another strong quarter, gaining from 1-5% in that timeframe. As has been true more time than not the last few years, growth stocks gained the most. Financials rose 6.5%, healthcare funds gained almost 0.7%, and technology stocks gained 3.2%.

Foreign stocks had mixed returns over the quarter, Foreign large caps gained about 3%, small caps earned about 2%, while emerging markets returned about 1.5%. China continued its decline, falling a further 3% during the quarter (*All of these performance figures come from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds gained nearly 1½%, intermediate-term bonds gained almost 3%, and long-term bonds gained just **over 6%.** Municipal bonds returned between 1 and 2.4%. Most opportunity bonds did well, with multi-sector bonds up 2.6%, taxable high yield bonds up 2.3% while muni high yield bonds gained 2.6%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

Coming from the end of June, **US unemployment** came down slightly to 3.7%, over the past three months, as weak job creation in May was compensated by good news for April and June. The unemployment rate should always be quoted with some context, so the 50 year average for unemployment is 6.2%. (*GttM, slide 23, https://www.bls.gov/ces/home.htm*)

The Conference Board maintains a **Leading Economic Index**, the LEI (*www.conference-board.org*). The most recent report was released June 20th, with data through the end of May. 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. So to give you some numbers, March saw an increase of 0.2%, April saw an increase of 0.1%, and May saw no change.

This indicator has stalled, but the other recessions this century came after the index fell 10% or more over six months, so we still appear to have some time.

US economic growth has exceeded 3%, but is expected to weaken in the middle of 2019, and end the year at the 2% level, below the 2.7% long-term average. Our economic expansion has entered its 11th year, the longest in US history. (*GttM, slide 17, 18)*

The **US dollar** fell back 12% during the quarter, but remains up 7% 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 other short-term factors often drive short-term dollar moves. (*GttM, slide 26*).

Core inflation came in at 2.1% in June, unchanged from 2.1% in April. Headline inflation is lower, at 1.6% in June, as it is still driven by sharp energy price declines. (*Source is GttM Slide 25 and www.bls.gov*).

Oil prices fell 4% during the quarter, and stands 21% below their levels from this time last year, when oil reached a multi-year high. (GttM, slide 27).

The **S&P 500 earnings** for the 1st quarter wasn't a record, but exceeded the profits in the 1st quarter of 2018. 2nd quarter results are expected to continue this, and 3rd quarter results are expected to set a new record, however there is more choppiness in the results than the past two. S&P consensus analyst estimates include year-on-year increases for the next four quarters. (*GttM, slide 7*).

The Federal Reserve Bank, **the Fed**, has been keeping overnight interest rates as 2.38%, however a cut is expected as soon as this month, but expects them to hover around 2.5% in the long-run. The Fed is focusing less on restoring a normal atmosphere, and is instead focusing on the continued subpar economic growth rate and below-target inflation levels in the US. (*GttM, slide 28*).

Bank CD rates have flattened out, with 3-month through 5-year CD rates between 1.9% and 2.2% where we buy them. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The US Treasury yield curve is a wide U, with overnight rates over 2%, 2-3 year Treasuries yielding about 1¾%, 10-years yielding 2%, while 30-year treasuries yield 2½%. Quality corporate yields are similar pretty flat, as investors have to lengthen maturities to capture more attractive yields. Quality municipal bond yields are more normal, with shorter-term bonds yielding less and longer-term ones yielding more. While a flat yield curve is often used as evidence of an upcoming recession, the curve is not yet flat, and there is not much evidence of an imminent recession. (*GttM slide 31, On the Bench, slide 33*)

Not Everyone is Happy—JP Morgan collects a report on purchasing manager's assessment for **manufacturing** across the globe. The results have turned slightly negative (49.8) during the quarter, with Greece, Indonesia, and India with the strongest figures. The US is positive, but not by much. Emerging markets are also slightly positive, but large foreign countries' figures are weak. (*GttM, slide 47*)

A similar survey of the purchasing manager's assessment on **services** across the globe, on the other hand, reveals positive results (averaging 51.6), however these, too, have fallen in the past three months. The strongest expectations are in Europe, led by Germany. (GttM On the Bench, p52)

The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p27*), at 98.2 is well above the average level of 85.7, and down a very slight amount during the quarter.

So what are you doing in your portfolios?

Let's look at 4 types of investments, and their recent results. Year-to-date through last Friday, cash is up 1.1%, intermediate corporate bonds are up 5.4%, large US stocks are up 19.9%, and large foreign stock are up 13.8%. Granted, stocks had fallen sharply in late 2018, but I never mind strong stock gains. (*Data from Morningstar*.)

Often the leading factor that concerns investors with the US economy is limited to the US. In the current environment, the leading concern is global trade policy, and this has, by definition, global implications. This has led to lower expectations and lower corporate activity across the globe. You would expect that this would lead to lower stock prices, rather than the rising ones we have had recently. This odd behavior is due to the fact that markets don't act in a vacuum. The reduced global trade expectations have led the US and other central banks to consider steps to support the economies, and US stock investors are focusing more on the hopes of lower interest rates, and also on cases where the global trade tensions lessen (delayed implementation date, scheduled upcoming meetings, etc).

One of our overriding observations is that, even if we are wrong and the US economy enters a recession, it is likely to be quite minor. This is due to the fact that the cyclical sectors (houses, autos) are quite subdued, and, as they say, you can't fall out of the basement. While the last recession was massive, the next one could be near-painless.

We always prefer bargain prices to those just above normal, the current level of US stock prices, however US stock prices are far from excessive. We continue to view foreign stock prices as a bit attractive, cheaper than normal. Overall, stocks are near normal.

Similarly, at a high level, bonds appear to be near normal. The only caveat for bonds is that we don't expect bonds to provide the 4-6% long-term average returns we have enjoyed for 20 years. We may come closer to 3-5% annual returns for the next decade.

Despite recent results, we continue to believe that foreign stocks deserve a meaningful position in investor portfolios. 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, by more than 4 years. At 131% 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. We have no idea when foreign stocks will outperform US stocks in an ongoing basis, however we are prepared, and are being paid higher dividend yields while we wait. The recent US dollar decline could indicate that our time is upon us. (*GttM, On the Bench, p41*)

We adopted a more normal stance with stocks and bonds earlier this year, and are now making much more modest adjustments. Given this backdrop, we are changing quite a bit with client stocks, to reflect this more normal environment. We are leaving stocks at 101% of long-term target levels, as we still see both cheaper and more expensive stocks, yet expect bond results to be steady but low going forward. 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, which have been quite weak this year providing a possible bargain opportunity. Where the tax cost is modest, we continue to eliminate global stock funds, preferring purely US and purely foreign stock funds. We have re-introduced a small preference for financial stocks, however we are eliminating both US and foreign real estate emphasis from the recently lowered 1% of stock level. This follows strong trailing results, and lowered future prospects.

We continue to adjust bond portfolio strategy. With yield curves that differ between treasuries, corporate, and municipal bonds, we are adding a municipal-only element where practical. We have completed our overall bond 'return to normalcy', by further shifting quality bond allocations from 75% to 80% of overall bonds. We continue to increase the average maturity of quality bond holdings (especially municipal long-term bonds), sharply cutting the ultra-short bonds and boosting both intermediate- and long-term bonds. We now are using a 1/4/30/25/20 level of cash, ultra-short-term, short-term, intermediate-term, and long-term quality bonds. This is quite a difference from just six months ago.

Within opportunity bonds, we have 5% less to work with, and use 4/10/4/2% for high yield, multi-sector, emerging market, and global bonds for tax-sheltered and low-bracket client accounts, and 8/10/2% high-yield, multi-sector, and global bonds for high-bracket client accounts.

2019 has been quite a rebound from late 2018, however economic and profit growth appears to be slowing, so we are tempering our expectations, but continue to expect fairly steady results going forward, with some preparations for more bumps in the road.

Questions?