Prepared Comments from 10/15/2019 Conference Call

Through yesterday's close, the S&P 500 is down 0.6% in the 13 weeks since our last call on July 15th, is up 18.1% Year-to-Date, and is up 7.8% over the past year.

US stocks had a mixed quarter, with US Large stocks gaining 1.5%, US mid cap stocks gaining only 0.1%, and US small cap stocks losing 1.3%. Over the last few years it has been quite common to see growth stocks outperforming value stocks, but this quarter was a different story with value stocks gaining the most, or losing the least, across large, mid, and small cap stocks. The mixed US stock returns carried through specific sectors in the economy with winners and losers. US Financial funds rose 0.7%, US healthcare funds lost 6.3%, and US technology funds lost 1.4%.

Foreign stocks were weak over the quarter; Foreign large caps lost 1.3%, small caps lost 1.8%, while emerging markets lost 3.6%. For another quarter China continued its decline, falling another 3.6% (*All of these performance figures come from Morningstar Office®*).

Changing gears to the US bond market. In the **past quarter**, short-term taxable bonds gained nearly 0.8%, intermediate-term bonds gained almost 2%, and long-term bonds gained 5.3**%.** Municipal bonds returned between ½ to 2%, with longer-term muni's earning the most. Most opportunity bonds did fine despite the lackluster stock markets; multi-sector bonds rose 1.3%, taxable high yield bonds were up 1%, and muni high yield bonds gained 2.1%. (*All of these performance figures come from Morningstar Office®*).

Economic Measures

As of September, **US unemployment** declined another 0.2 to 3.5%. The 50-year average for unemployment is 6.2%, and the last time US unemployment was this low was in December 1969. (*GttM, slide 23, https://www.bls.gov/ces/home.htm*)

Paul and I both often mention The Conference Board's **Leading Economic Index**, or the LEI (*www.conference-board.org)*,because the last two recessions were well-telegraphed by sharp declines in the LEI for several months before those recessions began. The most recent report from The Conference Board was released September 19th, with data through the end of August. The report states in part, "The US Leading Economic Index remained unchanged in August, following a large increase in July. … The recent trends in the LEI are consistent with a slow but still expanding economy, which has been primarily driven by strong consumer spending and robust job growth."

Earlier this year US economic growth exceeded 3%, but was expected to weaken in the middle of 2019, and end the year around 2%. In the last quarter we saw some of the cooling of US economic growth, as predicted; putting the current Real GDP number at 2.3% year-on-year. (*GttM, slide 17)*

Core inflation came in at 2.4% in August, up slightly from 2.1% in June. Headline inflation is lower, at 1.8% in August, explained by gasoline declines offsetting housing and food increases. (*Source is GttM Slide 26 and www.bls.gov* Consumer Price Index Summary).

Oil prices fell to $54.07/barrel during the quarter. The price has been shockingly stable considering the increased instability in the Middle East, which has been a testament to US shale production offsetting our need for foreign energy. (GttM, slide 28).

The **S&P 500 earnings** increased in the 2nd quarter to nearly a record high. 3rd quarter results are expected to creep slightly upward toward the record set in the 3rd quarter of 2018. S&P consensus analyst estimates include year-on-year increases for the next four quarters. (*GttM, slide 7*).

The Federal Reserve Bank, **the Fed**, cut the overnight interest rates twice in the last quarter to the current 1.88%. The Fed is focused on some potential weaknesses in our still-expanding economy. There are many divergent expectations of what the Fed will do next, but since they have indicated some appetite for another small cut in 2019, I would expect that as early as this month. (*GttM, slide 29*).

Bank CD rates remain quite flat, with 3-month through 5-year CD rates between 1.8% and 1.95% through the TD Ameritrade Brokered CDs. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The US Treasury yield curve is also very flat, with 3-month Treasuries yielding 1.65%, 2 year Treasuries yielding about 1.62%, 10-year Treasuries yielding 1.77%, and 30-year Treasuries yielding 2.23%. Quality corporate yields are nearly flat, although there is a slight upward slope. The yield curve for quality municipal bond remains what we call 'normal', with short-term bonds yielding less and longer-term bonds offering higher yields. (*GttM slide 31, On the Bench, slide 33,* [*www.bloomberg.com*](http://www.bloomberg.com) *(United States Rates and Bonds)*)

JP Morgan's Global Purchasing Manager's Index for **manufacturing** is slightly negative. The global results are 49.7. Developed economies stand at 48.6, and are being propped up by emerging economies at 51.0 at the end of September. 50 would be a neutral stance for this index, so we can interpret this number to mean that globally, purchasing managers who are planning for the direction of their businesses, are on average indicating a slight deceleration. (*GttM, slide 48*)

A similar survey of the purchasing manager's assessment on **services** across the globe remains in positive territory at 51.6. (GttM On the Bench, p53)

The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p27*), is at 93.2, down slightly from last quarter, and approaching the long-term average of 85.

Investing in the face of uncertainty

The leading concern for stock investors continues to be global trade policy, for the heightened uncertainty with global trade has dampened confidence. This is reinforced with the outlook for manufacturing sector, as Joe mentioned. While global trade has had a frustrating combination of good and bad news, the lack of clarity for the future direction is preventing companies, and stock investors, from planning for long-term growth. This trade uncertainty has been with us for more than a year, its impact on manufacturers and investor confidence is starting to show up in data.

What does this mean for recession risks? Again, worries about the next recession have been raised for a while (actually for a few years), but they have been modest before this year. Part of the reason is that the December 2017 US tax cut provided a year of stimulus that boosted US company profits, and investor sentiment for much of 2018. This optimism dissipated at the end of 2018, as the trade war heated up and as the one-year sugar-high of the tax cut stimulus ran out.

We are writing history in several ways. We have been enjoying a bond market that has seen interest rates fall steadily for over 35 years. We have been enjoying an economic recovery that has lasted longer than any prior one in a century. We simply don't have any recent experiences to help us interpret the steady but very low economic growth of the past decade. The US economy is expected to slow further, but remain in the positive range. Should we worry, or celebrate? We have no guide posts.

Just as the Fed wrote its own chapter in the history books to deal with the 2008-2009 financial crisis, they are writing a new chapter to address this extended, low-growth recovery. In the past, economic challenges similar to what we are facing now were addressed with fiscal stimulus—Congress passing broad economic packages such as an infrastructure program to boost economic growth. With Congress failing to agree on much at this time, no such boosts are likely, and the Fed is in uncomfortable territory, providing monetary stimulus (lowering the Fed rate) when history suggests they should not. These are strange times.

So what are we doing?

Let's look at 4 types of investments, and their recent results. Year-to-date through yesterday, cash is up 1.6%, intermediate corporate bonds are up 7.8%, large US stocks are up 18.3%, and large foreign stocks are up 12.5%. As we noted in July, stocks had fallen sharply in late 2018, but we aren't complaining about strong 2019 gains. (*Data from Morningstar*.)

The return on cash has fallen back, and fails to keep up with inflation. Bond yields are low, and bond prices are fairly high. We are not very worried about a bond market sell-off, as that would require a strong economic environment, and that seems very unlikely. Thus we see bonds as having both limited upside and limited downside. We don't see that changing for many quarters.

We are not impressed with stocks, either. US stocks appear overpriced, not by much but a little. As noted, these are fairly unique times, however we can't help but being a bit cautious with US stocks.

International stocks appear a little cheap, although not by much. We like that they out-yield US stocks 3.5% versus 2.1%, in addition to being a little cheap. A new 'never been there' aspect of today's investing environment is that US stocks have outperformed foreign stocks for over 11 years—this is more than 50% longer than the last record (the previous one in which foreign stocks outperformed US stocks for over seven years). We don't believe that "it's different this time," however we have no idea when we will have a reversal. (*GttM, On the Bench, p41*).

We are therefore sticking to home base. We are keeping stock levels at long-term, normal levels. We are neither favoring stocks nor shunning them. We have just begun adding a modest lean into value stocks, even though they have been outperformed by growth stocks for many, painful years. We are using 55/45 as the mix of US/foreign stocks. Again, we see a lot of promise with foreign stocks to outperform US stocks, but we have no clue when that may begin.

With gains well over 20%, we eliminated any special lean into real estate a few months ago, and we have just begun keeping technology positions at a neutral level, rather than leaning into tech. We are maintaining a lean into healthcare, and a slight lean into finance.

While we are not expecting much from bonds for a few years, we are spending a lot of time making adjustments. We are maintaining our neutral stance of 80% quality, 20% opportunity bonds. This reflects our view that a recession is possible over the next year, and even without a recession, economic growth is likely subdued for the next year.

Managing clients' quality bonds is a bit tricky, given the near-inverse yield curve. Fortunately, the municipal bond yield curve is near normal, and so we have a near-normal allocation of 25% short term, 25% intermediate, and 30% long term muni bonds. Given the nearly flat treasury and corporate yield curve, for taxable quality bonds we have 35% short, 35% intermediate, and only 10% long-term.

Opportunity bonds, now at only 20% of client bonds, are 4/14/2% high yield, multi-sector, and emerging market bonds for corporate, and 3/15/2% for municipal bond accounts. We have eliminated the global bond sleeve. We have been boosting our default opportunity bond sub-sleeve, multi-sector bonds, where the fund manager can invest where they find the best opportunities.

The 2019 rebound is still active, but its pace has slowed substantially. The gains from the first half of the year have largely made up for the 4th quarter 2018 losses, thankfully. We appear to be in an even slower-growth period, with ongoing concerns over the global trade war. In this environment we are adopting a very solid, very boring, 'stick to basics' stance.

Questions?

4840-0013-2009, v. 1