Prepared Comments for 1/13/2020 Conference Call

In the almost 13 weeks since our last call on October 15th, through Friday's close, the S&P 500 is up 10.1%, is up 1.1% Year-to-Date, and is up 25.8% over the past year.

US stocks had a strong quarter, with US Large stocks gaining 8.1%, US mid cap stocks gaining 7.1%, and US small cap stocks gaining 8.0%. Over the quarter, growth stocks gained slightly more than their counterweight value stocks, but they performed closer to each other than they have for the last few years. Most US specific sectors moved in tandem to drive the strong overall US gains. US financials funds rose 8.1%, US healthcare funds rose 18.6%, and US technology funds rose 11.9% during the quarter.

Foreign stocks also saw a strong quarter; Foreign large gained 8.4%, small caps gained 10.8%, while emerging markets gained 10.3%. (*All of these performance figures come from Morningstar Office®*).

Now for the US bond markets. In the **past quarter**, short-term taxable bonds gained 0.6%, intermediate-term bonds gained only 0.1%, while long-term bonds gained 0.2**%.** Municipal bonds returned between 0.5 and 0.6%. Most opportunity bonds did well; multi-sector bonds rose 1.3%, taxable high yield bonds were up 2.3%, and muni high yield bonds gained 0.8%. (*All of these performance figures come from Morningstar Office®*).

Economic Measures

Since our last conference call in October of 2019, **US unemployment** has remained low at either 3.5 or 3.6%. The 50-year average for unemployment is 6.2%. (*GttM, slide 23, https://www.bls.gov/ces/home.htm*)

The Conference Board maintains the **Leading Economic Index**, or the LEI (*www.conference-board.org)*. The most recent report from The Conference Board was released December 19th, with data through the end of November. The index was unchanged in November, "following a 0.2 percent decline in both October and September." The report states in part that the "Strength in residential construction, financial markets, and consumers' outlook offset weakness in manufacturing and labor markets."

The average GDP growth this expansion has been only 2.3%. Earlier last year US economic growth exceeded 3%, but cooled down through the middle of 2019, and end with a year-on-year percent change at 2.1%. Economic growth is expected to remain stable around 2% in 2020. (*GttM, slide 17 and www.conference-board.org)*

Core inflation came in at 2.3% in November, down slightly from 2.4% in August. Headline inflation is lower, at 2.0% in November. (*Source is GttM Slide 26 and www.bls.gov* Consumer Price Index Summary).

Oil prices rose slightly to $61.06/barrel during the quarter. There are heightened concerns over a potential oil shock resulting from the increased tension and military action in the Middle East, but this risk is being closely monitored, and there have not yet been any concrete signs of price fluctuations. (GttM, slide 28).

The **US dollar** fell 3.0% during the quarter, but is up 4.7% over the past year. (GttM, slide 27).

S&P 500 earnings dropped slightly in the 3rd quarter compared to the prior quarter. The next 4 quarters are expected to continue the overall trend of creeping upward (*GttM, slide 7*).

The Federal Reserve Bank, **the Fed**, has signaled no plans to cut the overnight interest rates in 2020 by maintaining the stated target range of 1½-1¾%, following their ¼% cut at the October meeting, which leaves the current rate at 1¾%. (*GttM, slide 29*).

Bank CD rates are starting to slightly spread out compared to how flat rates were at our last conference call. 3-month through 5-year CD rates range from 1.55% to 2.0% through the TD Ameritrade Brokered CDs. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The US Treasury yield curve is steepening a little, with 3-month Treasuries yielding 1.25%, 2 year Treasuries yielding about 1.52%, 10-year Treasuries yielding 1.79%, and 30-year Treasuries yielding 2.28%. Quality corporate yields have also moved away from being so flat, and have steepened slightly. The yield curve for quality municipal bonds remains relatively unchanged from previous quarters and close to what we call a 'normal' yield curve (*TD Ameritrade Institutional Fixed Income trading desk , GttM slide 31, On the Bench, slide 33, www.bloomberg.com (United States Rates and Bonds)*)

JP Morgan's Global Purchasing Manager's Index for **manufacturing** has shifted to slightly positive. The global results are 50.3. Developed economies stand at 49.6, and are being lifted by emerging economies at 51.0 at the end of November. 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 manufacturing businesses, are on average indicating a slight decrease in manufacturing in developed economies, and a slight increase in manufacturing in emerging economies. (*GttM, slide 48*)

A similar survey of the purchasing manager's assessment on **services,** rather than manufacturing, across the globe remains in stronger positive territory at 52.1. (GttM On the Bench, p54)

The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p27*), is at 99.3. This is up from last quarter, and higher than the long-term average of 85.7, indicating strong consumer confidence at this time.

2019 and 2020

After a blockbuster year for investors in 2019, we look out at 2020 both grateful and uncertain. 2019 was a very schizophrenic year, beginning amidst turmoil that led to a 4th quarter of 2018 with losses of 10-20% for most stock markets. Two top concerns a year ago were the slowing US economy and the global trade tensions. True to expectations, US economic growth slowed in 2019, and while trade talks appear to finally be in a productive direction, there are no concrete resolutions for trade. The overall concerns were so pronounced that the Fed lowered rates twice in 2019, which typically is done to provide necessary supports to a crippled economy.

Yet the markets had their best year for stocks in many years. It sounds odd, but a good way to get a strong year for stocks is to have a terrible 4th quarter of the prior year.

Regardless, welcome to 2020. There are many concerns, the US elections this year, gridlock in a divided Congress and White House, a sharp escalation of tensions in the mid-east including the US assassination of a senior Iranian government official. While we have had several positive developments, there remain many steps necessary to end the global trade tensions that have arisen in the past three years.

While the past several years have, on the whole, been good for investors, the post 2008 recovery has been uneven, with income inequality widening. Most recently this has been improved by continued low unemployment, and, finally, signs of meaningful, yet still fairly low, wage growth. Jobs make a lot of difference, as the consumer confidence figures just quoted by Joe reflect.

As portfolio managers, we constantly scan the horizon for risks and opportunities, and for good values and overvaluations. We are very mindful to pay the most attention to the windshield, and not the rear-view mirror. This approach is well-rewarded in periods such as the last fifteen months. If we had focused on the losses in late 2018, we may have been tempted to 'go to cash,' which could have led to clients missing out on the strong 2019 gains.

So what do we see on the horizon? We see continued, very low real economic growth, with slightly higher growth expected overseas. We expect interest rates to remain low, however we expect that there is a greater risk of rates rising (hurting bond returns) than falling this year.

I mentioned valuations—just as stocks were cheap this time last year, after a brutal 4th quarter of 2018, stocks appear a bit overpriced now, after a strong 2019. Stocks appear cheaper overseas than in the US. Foreign stocks have dividend yields of 3.3% while US stocks yield only 1.9%. Foreign stocks are priced at 14.2 times their earnings while US stocks are priced at 18.2. Cheap/expensive variations can and do persist for extended periods of time, however we are mindful that risks appear greater in the US than abroad for stocks at this time.

Obviously the Presidential election results will not be known for 10 or more months, nor will the Congressional balance. It appears very likely that both leading parties will control at least one of the three levers of power—White House, Senate, and US House—and therefore we do not expect the markets to be significantly disrupted by the results. We are hopeful that the current global trade tensions continue to be gradually resolved. We face a notable risk should this path to progress be blocked. As of today, the Middle East tensions appear to be fairly stabilized. We hope that stability and improvement unfold as the year progresses.

Given this lengthy backdrop, what do we doing for our clients at this time? We are tapping on the brakes for stocks. We are holding stocks at 99% of long-term levels, reflecting our caution regarding current stock prices, both in the US and abroad. This is the first time we have been under 100% for many, many years. We have a neutral stance to the US stock market as it relates to large vs small stocks, however we are maintaining a lean into value stocks, again due to our concerns over stock valuation. We have removed any leans into specific stock sectors, with no special above-normal allocation to, for instance, finance, healthcare, real estate, and technology.

Overseas we have shifted a bit from large foreign to smaller foreign stocks. Here we feel that the 'opportunity set' favors an increase to smaller foreign stocks. At this time we are aiming for a 60/20/20 level of large foreign stocks, smaller foreign stocks, and stocks from developing markets.

In bonds, we continue to maintain our 'home base' level of 80% quality bonds and 20% opportunity bonds. This reflects our view that 1) we don't expect a recession in 2020, but 2) we could be wrong. If a recession surprises us, 80% of clients' bonds should hold up very well, providing a welcome hedge.

Within quality bonds, we are using a fairly even balance of short, intermediate, and long-term bonds, and we do this for both taxable and municipal bonds.

Within opportunity bonds, we made no changes in January, emphasizing multi-sector bonds while maintaining a pretty low level of specific high-yield and emerging market bonds.

That was a lot—if you are still with us, let’s open this up for questions.

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?

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