Prepared Comments from 4/15/2020 Conference Call

Paul and I typically break our Quarterly Conference call into two sections. First I share a lot of dry statistics, financial and economic figures, and then Paul narrates what the investing landscape looks like based on those numbers before explaining what we're doing at Mallard to position our clients' portfolios in the current landscape.

Before I launch into the list of updated numbers, I want to touch on the big picture a little. The Covid-19 pandemic is deeply underway in the US and across the globe. Due to the nature of how this virus spreads, largely we're all living under social distancing or stay-at-home orders. Changing the way everyone interacts, does business, and frankly lives, almost overnight, has had a profound impact on market and economic valuations. From the end of February to the end of March we experienced the fastest, sharpest bear market in US history. With many people temporarily, hopefully temporarily, out of work or unable to work at this time, we expect it will take several quarters to slowly work back up to the market levels we had in mid-February 2020. The longer we have to fight the pandemic, the more damage global economies will sustain, but appropriately fighting this pandemic during this first wave of outbreak should cause less economic damage than if we have repeated, large waves of outbreaks, requiring us to be shut down for longer, in total.

Now that I've shared all that, this call isn't going to focus on the coronavirus, we'll focus on the economic and market conditions we have today, and we anticipate in the future – which admittedly has been very impacted by how we need to respond to the coronavirus.

As of 10:00 this morning, the S&P 500 is down 15.7% in the 13 weeks since our last call, and is down 4.6% over the past year.

After consistently strong quarters through all of 2019**, US stocks** have experienced a large drop in the last quarter, losing between 15 to 28%. Generally, growth stocks dropped less than their counterpart value stocks in the last quarter. Financials dropped 30%, healthcare funds dropped 7.5%, and technology stocks dropped 10.5%.

Foreign stocks had similar returns over the quarter, Foreign large caps lost about 19.5%, small caps lost 23.5%, while emerging markets lost about 22%. (*All of these performance figures come from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds lost 1%, intermediate-term bonds gained almost 2½%, and long-term bonds gained just over 2%. Municipal bonds lost between ½ and 2½%. Opportunity bonds performed as expected, losing more than quality bonds but less that stocks, with multi-sector losing 7%, taxable high yield bonds losing 9½%, and muni high yield bonds losing 7%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

US unemployment, at the end of March, was 4.4%. In the last month and a half we've had a rapid increase in unemployment largely because of the service, travel, and entertainment industries going on furlough. For some context of our current 4.4% unemployment rate, the 50 year average for unemployment is 6.2%, but we have been lower than that for over five years. (*GttM, slide 23, https://www.bls.gov/ces/home.htm*)

We always share an update on The Conference Board's Leading Economic Index (Also called the LEI). Under typical circumstances, we watch the LEI closely because we feel it is a good indicator for the direction of the markets. The last LEI data was calculated at the end of February and was not flashing warning signs of a recession at that time. Since that time we have seen steep declines and are likely in an event driven recession at this very moment. What is being indicated from the February LEI is that there did not appear to been major excesses in the market before this more recent drop, increasing confidence that the economy is not in fundamental-driven trouble once we can get to the other side of our current shut-downs. (*www.conference-board.org*).

(The **US Dollar**) From March 31 2019 to the end of 2019 on December 31st, the dollar went up in value by 12%. From December 31stt 2019 to March 31st 2020, the dollar has dropped just over 9%. Before our current market tumble, and still at this time, we see several factors that should pressure the dollar to weaken over the long-run. (*GttM, slide 26*).

Core inflation came in at 2.1% at the end of March. At the end of December it was 2.2 and at the end of March 2019 it was 2.0. Inflation is low, and appears to be staying low. (*Source is GttM Slide 25 and www.bls.gov*).

Oil prices. A year ago 3/31/19 a barrel of oil cost $60.69, by year end a barrel of oil cost $51.56. Since that time we've had both a decrease in demand for gasoline and flights, and an oversupply driven by a battle between OPEC and Russia both increasing production until one or the other concedes. This has driven recent prices for oil to historic lows. As of March 31st 2020, a barrel of oil was only $22.41. (GttM, slide 27).

The Fed, has responded seriously to the recent market drops. In fact, thinwing the kitchen sink at the problem. In addition to greatly expanding the asset purchase programs and reducing reserve requirements for the banking sector, the federal funds rate at this time is 0.13%. (*GttM, slide 31*).

Bank CD rates have dropped and remain very flat, with 3-month to 5-year CD rates ranging from 0.85% to 1.55%. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The US Treasury yield curve is shaped normally, but is even lower than the recent past. The 2yr note is yielding 0.23%, 10-years yielding 0.73%, while 30-year treasuries yield 1.35%. (TD Ameritrade Inst Fixed Income Research Section, *GttM slide 31, On the Bench, slide 33*)

The outlook for manufacturing and Services is down.—JP Morgan collects a report on purchasing manager's assessment for **manufacturing** across the globe. The results are meaningfully down at 47.6. Any value less than 50 indicates a reduction of global manufacturing. (*GttM, slide 48-49*)

A similar survey of the purchasing manager's assessment on **services** across the globe is down considerably to 37.0. We haven't seen a value predicting such a large reduction of services since late 2008-early 2009. This is largely the hot-spot of concern for global economies during our current crisis. (GttM On the Bench, p49)

The University of Michigan's Consumer Sentiment Index (*GttM On the Bench, p27*), is at 89.1. That is still slightly above the average level 85.7.

So what are you doing in your portfolios?

Let's look at 4 types of investments, and their recent results. Year-to-date through yesterday, cash is up 0.3%, intermediate corporate bonds are up 2.9%, large US stocks are down 13.5%, and large foreign stock are down 19.2%. However, when you include 2019 results, you get cash up 0.2%, intermediate-bonds up 11.5%, large-US stocks up 11.2%, and large foreign stocks down 1.8%, all non-annualized. (*Data from Morningstar*.)

Obviously the driving factor affecting all types of investments this year has been the Coronavirus, COVID-19. The dramatic decline in oil prices is often only a footnote. With the stay-at-home orders from Governors across the country, there have been sharp declines in economic activity in March and April, and record number of unemployment applications across the country. 20% or so of the US economy is fairly directly affected by these stay-at-home orders, including hotels, restaurants, bars, entertainment, and transportation, and approximately 20% of the US workforce is also directly affected (unable to perform their work from home). S&P 500 earnings, however, are not affected as directly (as these are lower-margin industries, comprising about 7% of the S&P 500).

As Joe noted, the bear market that began in February was swift and sharp, and much economic data for this time period has not percolated up yet. Unemployment is expected to climb above 10%, perhaps as high as 15%. Oil prices falling 22% lower than they have been in twenty years has no reached inflation figures yet, but has brought the industry to its knees.

Investors initially bailed out of both stocks and bonds, and by late-March stock prices had fallen 34%, more so for smaller US stocks. Fortunately there was a rebound of more than 15% by the end of the quarter, and a further rebound since then, leaving the S&P 500 about 18% below its peak level of mid-February.

Again, the damage was not limited to stocks. All but the highest-quality government bonds suffered a sell-off. The buying of US government bonds led to a critical interest rate environment, in which today no treasury bond of less than 10-years maturity yields more than ⅝%. Given that US stocks are yielding well over 2% and foreign stocks over 3%, even with the rebound of the past three weeks, alternatives to stocks are quite unattractive. While non-government bonds avoided the interest-rate slide, there is notably higher risk in corporate bonds given the unsteady economic path of the coming months, and municipal bonds are under pressure as state and local governments plan for sharply lower tax revenues.

We therefore feel that economic path for the next few months will be painful and quite uncertain. However, most analysts call for an economic rebound in 2021, sustained into 2022. This, and the flattening of the curve in locations such as New York City appears to be leading factors behind the stock market's recent recovery.

With the immediate path uncertain, but the longer-term path offering promise, we have refocused on our clients' long-term investment portfolios. We have written several analysis articles in the past weeks. We have set our strategic level for stocks at 100% of clients' long-term target levels, as we feel that the promise of the global economy recovering in 2021 and 2022, coupled with the incredibly low current level of interest rates justifies 'normal' stock allocation levels. We have shifted towards US stocks, towards larger stocks, are leaning a bit into technology and healthcare, and a little away from financial stock, while lessening our lean into value stocks. We have maintained our allocations within foreign stocks.
For taxable bonds, we have shifted towards more quality bonds, and boosted our level of government bonds. We remain fairly well spread across maturities. In municipal bonds, we have maintained our 80/20 quality/opportunity balance.

In a recent analysis, I shared the thought experiment that begins by asking when you think that US stock prices (the S&P 500 in particular) will get back to its February 2020 record levels—how many years. Compare holding onto your stocks for that time period to holding a US government bond over the same period. If you chose 10 years, you would earn 7 times more from holding the stocks. If you chose 15 years, you would earn 5 times as much from holding stocks. If you chose 5 years you would earn more than 19 times more from stocks than the US government bond.

Questions?

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