Prepared Comments from 7/15/2020 Conference Call

Good Afternoon, I'd like to thank everyone for joining this Quarterly Conference Call. I know Paul and I have been looking forward to this call because there is a lot of new and useful information to share since our last conference call on April 15th. For today's call we will follow our typical agenda where I share a laundry list of information, and Paul follows with putting the investing landscape into focus and explaining what we're doing at Mallard to position our clients' portfolios. My last housekeeping matter is to remind everyone that since the start of the economic slowdown in March, Paul and I started hosting regular weekly check-in calls, every Thursday at noon, where we discuss the economy, markets, and Covid-19. Details to join those weekly calls are on the homepage of our website, www.mallardfinancial.com.

So let's get started, as of 10:00 this morning, the S&P 500 is up 15.9% in the 13 weeks since our last call, is down 0.1% year-to-date, and is up 7% over the past year.

In February and March of this year, as fears about the novel coronavirus were at their peak, US stocks plunged losing between 15 and 28%. Clearly we have regained almost all of those losses and have returned to pre-crisis levels from the beginning of this year. But that's broadly measuring across US stocks, not all sectors have experienced that average level of recovery. Generally, growth stocks dropped less and gained more than their counterpart value stocks so far this year. Some examples of sectors with very different returns since the beginning of the year include: Financial funds dropped 24%, healthcare funds have gained 7.5%, and technology stocks gained nearly 18%, those are all YTD figures.

Foreign stocks have moved in similar directions to US stocks so far this year, but declined a little further and recovered about the same, still leaving them behind US stocks slightly when measuring since the beginning of the year. Over the last quarter, Foreign large caps gained a little over 16%, small caps gained a little over 20%, and emerging markets gained 20.5 (*All of these performance figures come from Morningstar Office®*).

In the **past quarter**, short-term taxable bonds gained 3.8%, intermediate-term bonds also gained 3.8%, and long-term bonds gained 8.8%. Municipal bonds gained between 1½ and 3%. Opportunity bonds did well in the quarter, with multi-sector bonds gaining 7¾%, taxable high yield bonds gaining 8½%, and muni high yield bonds gaining about 3¼%. (*All of these performance figures come from Morningstar Office®*).

How have economic measures done recently?

In March **US unemployment** was 4.4%. In April unemployment was 14.7%. As of June the unemployment rate is down to 11.1%. For context the 50 year average for unemployment is 6.2%. (*GttM, slide 26, https://www.bls.gov/ces/home.htm*)

The Conference Board's Leading Economic Index (Also called the LEI) is a good indicator for the direction of the markets. The latest LEI figure increased 2.8% in May, following a 6.1% decline in April, and a 7.5% decline in March. It was reported that the "improvement in unemployment insurance claims is responsible for about two-thirds of the gain in the index. The improvements in labor markets, housing permits, and stock prices also buoyed the LEI, but new orders in manufacturing, consumers' outlook on the economy, and the Leading Credit Index™ still point to weak economic conditions. The breadth and depth of the decline in the LEI between February and April suggest the economy at large will remain in recession territory in the near term." (*www.conference-board.org*).

(The **US Dollar**) The last quarter the US dollar has been declining in value, but not yet in a significant way. The value of the US Dollar index has generally been steady between 90 and 100 since 2015. 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. It has been suggested by several leading economists to anticipate the value of the dollar declining sooner rather than later based on the estimates of numerous other developed economies handling the outbreak of Covid-19 better, which is anticipated to hasten the economic recovery of those countries compared to the US. (*GttM, slide 30*).

Core inflation is at its lowest level in the last year, coming in a 1.2% in May. The 50-yr average for core inflation is 3.8% (*Source is GttM Slide 29 and www.bls.gov*).

Oil prices. Oil prices hit rock bottom prices in March, and have almost doubled since that point. Even with the price of a barrel of oil doubling in the last few months, oil is still on the cheaper side of historical levels. As of July 14th 2020, a barrel of oil was $40.29. (GttM, slide 31).

The Fed reacted quickly to the economic and market downturn in February and March. They greatly expanded their asset purchase programs and reduced reserve requirements for banks. They also dropped the federal funds rate to 0.13% and forecasts expect that low rate to continue for at least the next year. (*GttM, slide 32*).

Bank CD rates have dropped following that interest rate decline, and are frankly dismally low. 3-month to 10-year CD rates are all under 1%, ranging from 0.15% to 0.95%. (*Source TD Ameritrade Institutional Fixed Income trading desk.*)

The US Treasury yield curve is shaped normally, which means that longer term notes yield more than shorter term notes. What is amazing at this time is how low **all** of the yields are, no matter the length of time on the term. 2yr treasuries are yielding 0.07%, 10-years yielding 0.58%, and 30-year treasuries yield 1.31%. (TD Ameritrade Inst Fixed Income Research Section, *GttM slide 35, On the Bench, slide 29*)

The outlook for both manufacturing and services are still down.—JP Morgan collects a report on purchasing manager's assessment for **manufacturing** across the globe. The results are a figure of 47.8 for June. Any value less than 50 indicates a reduction of global manufacturing. In June, France was the only developed economy in the world with positive manufacturing momentum with a value of 52.3. (*GttM On the Bench, slide 44,*)

A similar survey of the purchasing manager's assessment on **services** across the globe is recovering a bit, rising to 48.0 in June. Across all developed and emerging economies tracked by the survey, China was the best market with positive services momentum with a value of 58.4, with France and Spain slightly over 50. (*GttM, 7/14/2020 slide 53*)

The University of Michigan's Consumer Sentiment Index is a measure of consumer confidence and the stock market. As of June, the index is at 78.1, below the average value of 86, indicating lower than average consumer confidence. (*GttM On the Bench, p22)*

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 ¼%, intermediate-term core bonds are up 6%, large US stocks are down 3%, and large foreign stocks are down 8%. However, when you include 2019 results, you get cash up 2%, intermediate-bonds up 15%, large-US stocks up 25%, and large foreign stocks 12%, all non-annualized. (*Data from Morningstar*.)

While I will focus on US experiences, as we are speaking of a global pandemic and the economic impact, most of these observations apply globally. 2020 has been the year of COVID, with a very sudden halt of much of the economy starting in March, coinciding with a sudden and sharp crash of stock markets. This was led by massive unemployment claims, and was coupled with massive financial support from the federal government, and the Fed. Congress and the White House swiftly passed over $2 trillion of relief, comprising 11.8% of the US GDP.

While COVID affected every corner of the economy, it focused on restaurants, hospitality, and travel, which makes up about 20% of US employment, and about 20% of the economy, however it makes up less than 20% of profits and wages. You can view the 12% of federal relief as paying for a bit over six months of 'shut down' of these highly-affected industries. We are approaching the end of this grace period.

The gameplan to addressing this pandemic has been to shut down the most vulnerable industries, build up the resources to address rising cases and to strive to reduce new cases. This is not a one-way street, it is designed to begin, exist, and end. Re-opening is a critical phase to this approach. As I have noted in the past, in the US we have had 50 laboratories regarding the pace of shutdowns and reopening—we call these laboratories 'states.' Each state has had a different path, and differing results.

Surprising most investors, the markets fell for a relatively short amount of time (about a month), as investors changed their focus to 2021 and beyond, AFTER COVID is largely behind us (post-vaccine). There is a lot of justification for this swift rebound—we found that there are steps which can slow and almost halt new cases, we have built up nearly adequate amounts of PPE, we have discovered treatments and developed protocols to assist COVID patients. In addition, early indications suggest that the pandemic, like most, morphs over time, becoming less lethal but more transmissible.

Given this additional data and progress, economic life beyond COVID has come into focus, and it appears to be fairly similar to 2019, before COVID, and stock markets have largely returned to 2019 levels.

We certainly do not know the pace of the medical research efforts to discover, manufacture, and distribute COVID vaccines, nor do we know the pace of either the economy or stock and bond markets over the coming months. We do, however, expect that over time, a vaccine will be found and distributed. We also expect stock market earnings to return to and, eventually, exceed 2019 levels. With a largely-recovered economy, we expect the Fed to gradually back out the substantial support it has provided, permitting bond yields to rise from their near-zero level. Again, we don't know the timing, but these are the directions we see.

While this is much less uncertainty than we faced in March and April, it is substantial. For this reason, we are adopting a fairly conservative approach, driving down the middle of the lane. We are keeping stock levels right at 100% of their long-term allocation target level; we are neither leaning into stocks, nor leaning away. Within stocks, we are shifting (just a little) into foreign stocks, setting a goal 57/43% US/foreign stock balance. This reflects our assessment, mentioned by Joe earlier, that the US is encountering more problems controlling its COVID case growth, and that its economic recovery will be slower than in many other areas of the world.

Bonds are very challenging at this time, with yields at very, very low levels. We have set our quality/opportunity bond balance to 75/25, leaning into opportunity bonds a bit, based on our expectation that gradual reopening will lead to irregular, yet largely consistent levels of people returning to work, which drives economic growth. Economic growth most directly benefits stock investors, and opportunity bond investors.

We have looked closely at interest rates in quality bonds, and for taxable bonds, have a 3/20/27/25% balance of cash, short, intermediate-, and long-term bonds. For municipal bonds, we have selected a 3/17/28/27% balance. We have streamlined our opportunity bonds a bit, with a 15/10% balance in municipal bond portfolios, of high-yield/multi-sector bonds. For less tax-sensitive portfolios, we are using a 13/12% level.

Let’s state the obvious. This is a Presidential Election year. While there are polls and pundits sharing many predictions, we stand by our observation that 1) markets generally dislike uncertainty, and 2) the uncertainty about the elections will be resolved in about 4 months. We also note that dramatic legislative action requires the same party to control the White House and both chambers of Congress. This is uncommon, but is certainly possible this November. We and many others were surprised at the results in November 2016, and we made several significant changes after the election. Especially if the results in November differ from the consensus leading up to the election, we will likely make additional significant changes after November, however if the results come in close to consensus levels, it is less likely that notable changes would follow the election.

We don’t feel that any additional changes (aggressive or conservative) are warranted at this time, given the November elections.

While we are pleased that most investors have largely recovered the bulk of dollars they lost on paper in February/March, we still face much uncertainty. We are therefore adopting a largely unexciting ‘nothing special’ stance, and continue to watch COVID, the economy, and the markets closely, and remain ready to make mid-course corrections are they appear warranted.

Questions?

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