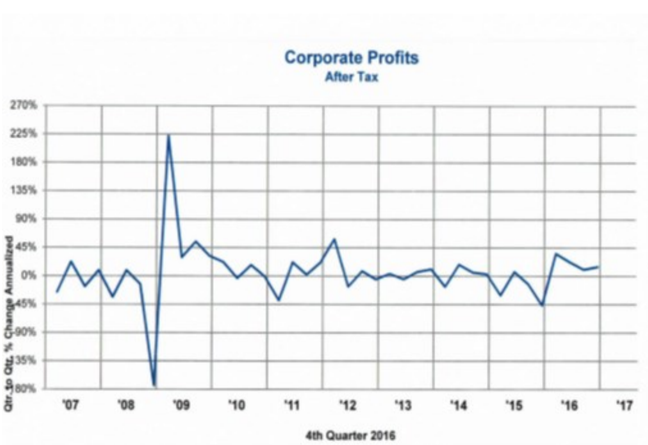
Colchester Investment Counsel LLC

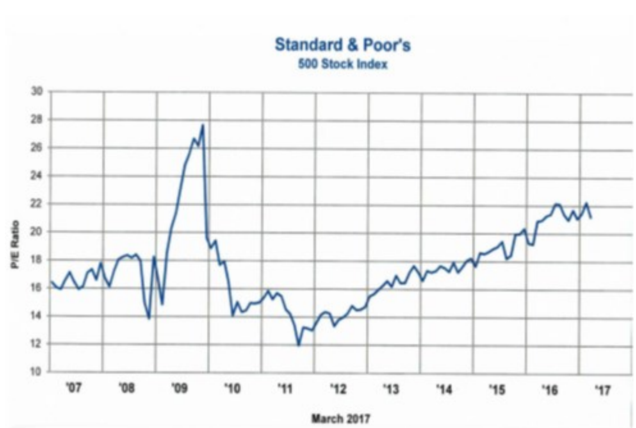
2017 First Quarter Investment Review

Rising interest rates, economic policy uncertainty, US political intrigue, North Korean nuclear threats, unpredictable presidential tweets, and seemingly ever present high valuations could not stop the stock market's upward march over the past quarter. Nor has age done much to sap the energy from this bull market as **the current upswing recently commenced its ninth year, a stretch of longevity rarely experienced**. On average, stocks correct 20% or more once every three years. Yet, despite persistent challenges facing the US and global economies, a decline of this magnitude has not occurred since the financial crisis of 2008-2009. **More recently, a wave of post-election enthusiasm for policies that should be business and investor friendly has buoyed asset prices. Time will tell if this optimism is justified.**

While equities have advanced nicely thus far in 2017, quality bond returns have been only slightly positive as interest rates have generally stabilized following the sharp rise late last year. With anticipation high regarding possible pro-growth economic initiatives, the financial markets are now awaiting the outcomes of policy decisions that will most certainly impact asset prices. **Remarkably, this past quarter was the least volatile period for stock prices since 1965, despite what seems to be significant breaking news on almost a daily basis.** It is, of course, troubling that investment markets can be so influenced by the machinations of politicians. For example, the recent failure to pass health care legislation injected doubt about future policy measures into the investment equation. **Indeed, it appears that a market inflection point may be developing, one that could have significant repercussions based on the success or failure of government driven policymaking.**

The stock market is discounting future strength in profits; in fact, in the quarter just completed corporate earnings are expected to have grown 10%, the best showing since 2011. However, questions remain as to the sustainability of the recent uptick in economic activity. 'Soft' data, mostly sentiment indicators such as consumer confidence and business optimism, are at high levels not seen since 2000. 'Hard' data, on the other hand, including actual measures of economic activity such as retail sales and capital spending, have yet to follow suit. **The charts below tell the tale. Business profitability has stumbled along for many years, yet investors have been willing to pay increasingly more for a mediocre profit picture.**





Reasons to be Cautious…and Optimistic

The present economic and investment landscape contains a number of paradoxes that are likely to resolve, one way or another, in the not too distant future. They include the following:

- The current stock bull market is one of the longest in history despite one of the worst post-recession periods of corporate earnings growth. Stock gains have mainly come from expanding price/earnings multiples and not increased business profitability. This disconnect cannot last indefinitely.

- Enormous expansion of US government debt has occurred in recent years, while at the same time the value of the US dollar has strengthened and interest rates have remained at historically low levels. Ordinarily, debt growth of this magnitude would cause concern for the currency and lead to higher than normal fixed income yields; this has not happened in the current cycle.

- From an international perspective, the US remains the perceived safe haven as evidenced by global inflows of capital during periodic times of global stress. This status continues today despite the appearance of seemingly debilitating dysfunction in the US political/governing system. In short, the US, in many respects, is the best house in a challenged global neighborhood.

Most recent indicators reveal that investor concern has been replaced with confidence and even complacency. As noted, Wall Street's fear gauge, a measure of volatility, currently sits at its lowest level in many decades. Yet, while low interest rates and animal spirits may drive equities higher for a time, it is fair to suggest that a sell-off will occur if profits do not rise meaningfully to justify well above average valuations. **The bottom line is that whether one believes in the economic turnaround thesis, or remains unconvinced, it is clear that earnings growth will be the key factor if the bull market in stocks is to be sustained.** Our hope is that tax cuts and regulatory reform, designed to jump-start a sluggish economy, will be enacted to the benefit of workers, businesses and investors alike.

Many market pundits are vociferously calling for the long awaited correction or 'bear' market. They may well be right, though virtually all major bull markets end when euphoria is the dominant emotion and this is not the case today. While current conditions do not suggest a major decline, we anticipate heightened volatility due to the considerable headwinds noted above. Of course, **uncertainty is why a long-term investment approach is critical to successfully growing your money over time. While never easy, those who endure significant market downdrafts, and hold or add to positions, not only recoup paper losses, but end up with larger portfolios as recoveries take hold**. This is why we should be conservatively postured when stocks are expensive, and aggressive buyers when they are on sale. As well, with respect to fixed income, we should own short-term instruments when interest rates are exceedingly low, and move out on the maturity spectrum some as rates rise. Recently, it seems that much has changed in the world, yet the time tested approach to wise investing remains the same. We will endeavor to follow these tenets with full confidence that solid investment returns will be our reward.

As always, please call with any thoughts.

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