Colchester Investment Counsel LLC

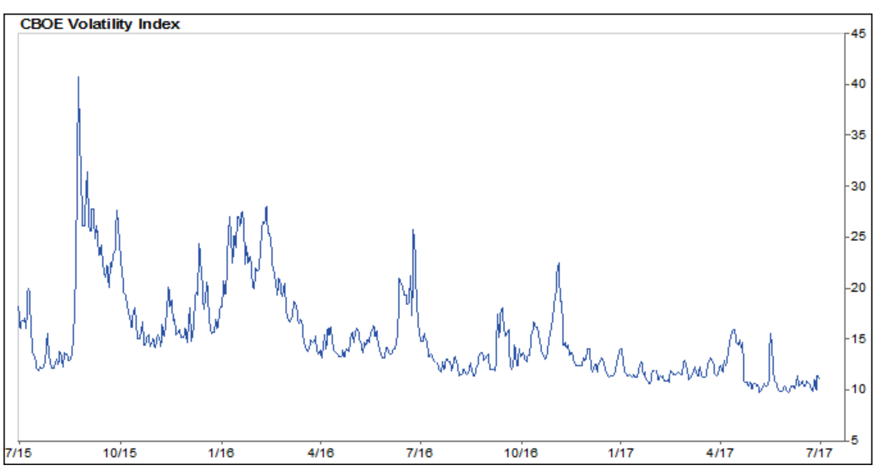
2017 Second Quarter Investment Review

Stocks continued their advance in the most recent quarter, even as economic and geopolitical uncertainty grew, and market friendly government policies have yet to materialize. Bond returns were slightly positive due to a modest decline in interest rates. In the US, equity investors favored large capitalization issues over small, ‘growth’ over ‘value’, and low over high quality. In fact, most of the characteristics present in last year’s investment landscape have been turned upside down. From an industry perspective, health care and technology have led the market higher this year, while energy has fallen due to sagging oil prices. International equities have also performed well as there appears to be light at the end of what has been a long, dark tunnel for many foreign economies.

The Message of the Market

At times, investment markets tell an understandable tale. This is not one of those moments. Tremendous uncertainty exists seemingly everywhere. For example, short-term interest rates have moved higher as the Federal Reserve has responded to improving corporate earnings and more buoyant sentiment about future economic conditions; yet, longer term yields remain very low as subdued inflation persists. Typically, a narrowing spread between short and long-term yields is indicative of a slowing economy as, indeed, some recent reports suggest. This contradicts the central banks expectation of renewed economic vitality. Uncertainty also exists outside of the financial world, as evidenced by a dysfunctional US political scene, the most powerful nations in the Middle East escalating already serious tensions, and North Korea brashly launching intercontinental missiles.

Despite these, and other considerable domestic and international challenges, stock market volatility recently hit multi-year lows and the major indices are near all-time highs. The chart below of the VIX, a key measure of market volatility known as the “fear gauge”, illustrates the muted level of volatility that has steadily declined over the past year. **With this bull market in its ninth year, the lack of meaningful volatility suggests a sense of investor complacency in what is clearly an uneven world. Coupled with frothy valuations, this environment seems too good to be true, and investors should be prepared for a more disruptive phase in the second half of the year.**



Identifying market tops is only possible in hindsight, but expecting a healthy correction is prudent. The obvious elephant in the room is timing. Investment trends often grow larger and last longer than most expect, and this one may continue to defy gravity for a time. Indeed, **there is plenty of fire power available to fuel higher prices, including from central banks around the globe. Some began buying stocks once bond yields declined to near zero**, and no longer provided a meaningful return. The world's largest central banks are on pace to purchase $3.5 trillion in assets this year, almost twice the amount of recent years. Perhaps the most disquieting example is the Swiss National Bank, which has become one of the world's ten largest equity investors. The once gilt-edged Swiss Franc is now backed, in part, by stocks and other risky holdings. This may provide comfort to some, as monetary authorities can print money to buy more securities, but what happens if/when they stop, or worse, become sellers? This is just one of many red flags waving these days.

All of this is to say that the crystal ball is cloudy at this point. There are reasons for caution short term, but we are comfortable owning high quality investments, both bonds and stocks, including industry leading companies that pay growing dividends and compete successfully in good times and bad.

What We Are Watching

There are always worrisome elements with respect to the investment backdrop, just as there are others that are favorable. Some market prognosticators are issuing dire forecasts, while others say full steam ahead. **We tend to be more measured in our outlook, always vigilant to identify potential risk, but equally on alert with regard to seeking compelling value and opportunity**. In this time of seemingly heightened, potentially market moving contradictions, there are a number of factors that bear observation, including:

- After a lengthy period of stagnation, corporate earnings have turned up in 2017. The current pace of growth is supportive of stocks, but any deterioration of either actual profitability or future expectations would provide a catalyst for a market downdraft;

- The Federal Reserve has raised short-term interest rates 3 times over the past 18 months, and the yield curve is flattening. While there is little danger of an inverted curve (short-term yields higher than long-term yields), typically a precursor to a recession, should monetary policy be perceived as too aggressive in the face of tepid economic growth, stock prices would be vulnerable;

- Much of this year's market advance has been driven by expectations of economic, tax and regulatory reform coming from Washington. If those initiatives fail to materialize, and growth does not accelerate, the market is likely ahead of itself. This does not mean a recession and bear market are inevitable, just that a meaningful correction is more likely.

While it is clear that many headwinds exist, and the aged bull probably needs a rest, we remain hopeful that the "normalization" process – proper interest rate levels, less Federal Reserve and government involvement, more focus on company fundamentals – will continue. This transition will promote a healthier economic environment, as well as a more positive landscape for investment markets over time.

As always, please let us know if you have thoughts or questions.

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