Colchester Investment Counsel LLC

2017 Third Quarter Investment Review

Before addressing the financial markets, we would like to offer thoughts and prayers to our clients, friends and all others impacted by the recent devastating natural disasters, and the tragedy in Las Vegas.

Stock markets around the globe marched inexorably higher during the past three months, as many of the key characteristics impacting investments for years continued unabated. After a brief spasm in August, volatility returned to historically low levels, 'growth' stocks outperformed 'value' and, despite an overwhelming consensus that interest rates should move higher, yields were virtually unchanged. Digging a little deeper, lower quality and high beta equities were the best performers, suggesting that, together with muted volatility, investors remain highly confident and/or complacent. S&P's Quality Index trailed the major averages as solid fundamentals and healthy dividends were shunned for riskier stocks that have the perceived potential for dramatic appreciation. Interestingly, the month of September, historically the worst for stocks, was the least volatile of any year since 1928. Finally, as has been the case for some time, bonds delivered modest returns. In this environment, fixed income securities will not likely provide outsized returns but should deliver safe and consistent income streams, and protect capital through adverse markets.

Some Thoughts on the Market Environment

In recent conversations with clients and friends, a few common topics and questions have often surfaced. Our thoughts and perspectives on these issues follows:

1) Why are stocks so expensive?

Stock valuations meaningfully exceed their long-term averages, and have for years, because price appreciation has significantly outpaced company earnings growth over this time-frame. Annual equity market gains have become the norm since the bottom of the most recent financial crisis, an astounding feat given that the economy has not grown more than 2%, on average, in any year since 2009; this represents the worst post-recession recovery on record. Why have investors been willing to pay up for company earnings that are growing at a modest pace? We see two primary reasons, with the first being far and away the most important: i) the exceedingly low interest rate environment has made alternatives to stocks much less appealing, and ii) the recent pickup in the US and, as importantly, most foreign economies has supported the assessment that corporate profit growth will improve and recession risk is low.

2) Given obvious and considerable uncertainties and risks, why has the market not experienced even a minor correction for well over a year?

Greater demand for stocks, a dramatically lower supply of them (half as many publicly traded companies as in 1998), together with an absence of investor euphoria partially explains the lack of a pullback. These factors, combined with the 'easy money' policies of the Federal Reserve, have provided the fuel to drive equities to record levels. The lack of investor giddiness, despite the extensive market advance, is particularly surprising and important. Stocks typically fall when public enthusiasm becomes excessive. In other words, once investors are ebullient, there are fewer buyers to support already high prices. Because of the long-standing economic malaise here and abroad, and the plethora of other concerns (including geopolitical strife, terrorism, and political dysfunction), investor euphoria has been missing from the equation. Lastly, inertia has set in with some investors, as the consistent rise in prices and lack of scary volatility, has encouraged complacency.

3) **How is it that the stock market is holding up when the new administrations reform proposals have not yet been enacted?**

After years of tough times brought on by the financial crisis, economies worldwide are generally improving or at least muddling along. Business activity is trending up, unemployment is declining, leading indicators are making new highs, and inflation is modest. These facts go a long way to explain why stocks refuse to pull back in the face of bamboozling inactivity from our nationally elected officials. Moreover, many, if not most, investors remain hopeful for tax reform, even if that means simply lower individual and corporate tax rates. This would provide a considerable one-time boost to company earnings, and make stocks more appealing.

4) **Why are interest rates staying so low and why are they below the level of inflation?**

Despite unprecedented efforts by the US Federal Reserve and central banks the world over, interest rates and inflation remain well below normal. Historically, 10-year Treasury yields are typically 2% or so higher than inflation; today they are roughly the same. There is no doubt that rates have been artificially suppressed by central bank stimulus programs. As well, with interest rates so modest, many investors are seeking income wherever it is available, providing a constant demand for bonds that, in turn, keeps yields low. As for inflation, we have too much of almost everything – retail space, manufacturing facilities, and workers to name three. Demand for money and goods has not kept up with supply. Technology allows most everything to be built or accomplished faster and cheaper. In recent months, the Fed has announced plans to gradually increase rates and reduce the amount of bonds they hold. We hope this action will normalize the fixed income world to the point where bonds are not simply safe investments, but attractive ones as well.

Looking Ahead

Compelling stock market opportunities are currently limited because of price, and it is widely recognized that a correction is long overdue. Stocks have not fallen by as much as 5% for more than 14 months. While the economic backdrop is generally supportive of financial assets, there is certainly no absence of warning signs of potential risk. Perhaps forgetting the pain of the last financial crisis, some investors are now speculating where the odds appear unfavorable. For example, Bitcoin, and other "cryptocurrencies", have soared in price in recent months. As these computer generated "coins" have zero intrinsic value, it is likely they will meet the same ignominious end as did investors in the Dutch Tulip mania of the 1600's. Additionally, desperate for securities that pay more than government bonds, some institutional investors have returned to buying synthetic CDO's (collateralized debt obligations), the very same instruments that caused the last financial crisis. Others have bought 100 year bonds from Argentina, not exactly a gilt edged credit. Finally, a well-known investment strategist was recently quoted as saying "I think the bull market could continue to forever". This level of enthusiasm is concerning, to say the least.

None of this means that investments are facing imminent retreat. We make these points simply to emphasize that, for some, complacency has set in and fairly obvious risks are going unappreciated. We intend to stick to our knitting, buying quality when it represents good value, and maintaining asset allocations that are appropriate in order to meet your financial objectives.

As always, we welcome your thoughts and questions.

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