Colchester Investment Counsel LLC

2017 Fourth Quarter and Year-End Investment Review

2017 was a remarkable year for the financial markets. **Stocks worldwide marched inexorably higher, completing the 9th consecutive year of positive returns.** The fourth quarter was strong, capping off a year with each month in the plus column, the first time that has ever occurred. **Equally unusual was the lack of market volatility**, with the S&P 500 index now in the midst of its longest stretch without as much as a 3% pullback. **Underlying the advance was 1) a rebound in corporate earnings growth, spurred by a synchronized global economic recovery and 2) an expectation that tax and regulatory reform would augment business profitability.** It is unheard of for most every asset class to appreciate simultaneously but this was indeed the case last year, not just in the US, but virtually worldwide. In short, markets are not supposed to go up on a daily basis, but that is, seemingly anyway, what transpired in 2017. **From an investor perspective, this scenario was near ideal.**

Bond returns were modest compared with stocks, but were positive as interest rates remained low. While monetary authorities have reduced the flow of cheap money, ample liquidity remains available across the global financial system. **Fixed income yields remain absurdly low, relative to inflation**, exemplified by the trillions of foreign government debt instruments still yielding less than 0%, and European junk bonds offering only 3%. **Short-term yields rose in the US, as the Federal Reserve increased its benchmark rate several times, but longer maturities barely budged.** There are important cross currents impacting bond prices. With short-term rates rising and long rates steady, the yield curve has 'flattened', often an indicator of a pending economic slow-down. However, inflation is showing signs of picking up, which should push yields higher. **Our view is that current yield levels do not provide enough return to merit assuming much price risk. Once bond yields are significantly higher than prevailing inflation, we will extend maturities to earn more reasonable returns.**

2018 Outlook

For the first time in a decade, the US is experiencing accelerating GDP growth. Unemployment is low and consumer confidence is at a 17-year high. Many believe that 3-4% growth is achievable in 2018, based on regulatory reform and lower taxes in the US, and continued recovery in economies worldwide. This view is buttressed by the fact that for the first time since 2013, the economies of most every major country are expanding. Earnings should grow nicely in 2018, and interest rates are expected to rise gradually as credit conditions "normalize". Economic conditions are favorable, market momentum is clearly positive and, as the saying goes, the trend is our friend.

With the backdrop encouraging, stock prices setting new records, and volatility at historic lows, it seems there is little to worry about. Indeed, **the vast majority of Wall Street prognosticators are focused on the bright side and predicting clear sailing ahead. As always, despite the developing enthusiasm, we strive to assess future prospects objectively and dispassionately**, and to consider all potential market environments. From our perspective, there are many risks for investors to eye warily: political turmoil in the US, China's considerable debt challenges, always present fragility in the Middle East, the unstable leader in North Korea, and the potential for higher interest rates and unruly credit markets as the Fed unwinds its unprecedented monetary experiments. These issues have been apparent for some time and, theoretically, have been accounted for in the asset price discovery process. As a result, from our angle, the more pressing and pertinent questions are whether all the "good news" is priced in to said asset prices, and are signs of late cycle excess setting the stage for an investor comeuppance.

Therefore, **in our view, the most significant concerns for prospective stock returns are 1) valuations are historically high and 2) investor speculation has returned**. While not a good timing tool for identifying exact market tops and bottoms, valuation is a wonderful measure of future returns, and an accurate indicator of risk and reward. In short, stock markets purchased at 10X earnings have always been richly rewarded, while those entered at 20X far less so. The current price/earnings multiple is near the top of this range, and yet understates the degree of market overvaluation, as accounting chicanery has allowed some companies to manipulate their reported income in a favorable light. More reliable indicators are Price/Sales and Total Market Value/GDP (see chart below). Remarkably, the multiple of sales at which stocks are trading is 40% higher today than it was in 2000, just prior to the unwinding of the dot com bubble. As convincing, **the total value of all stocks, relative to the size of the US economy, also provides clear evidence that current prices offer little margin of safety should the positive environment become less favorable**.

Of equal concern is the recent and rapid change in investor sentiment from cautious to exuberant. Our October 2017 letter stated that "the lack of investor giddiness, despite the extensive market advance, is particularly surprising and important…investor euphoria has been missing from the equation." That psychology has changed quickly, as no price seems too high for certain assets these days. Indicators of market sentiment now reflect extreme optimism on the part of mutual and hedge fund managers (they were fairly cautious in the summer), and show that individual investors are returning to the stock market after having been scared off for years by the 2008-2009 market melt-down.

While emerging public euphoria is reason enough to get our attention, there is also anecdotal evidence that suggests a bubble is brewing. Most notably of late, the 'action' in Bitcoin and its cryptocurrency brethren has been breathtaking. In recent months, fortunes have been made and lost in a matter of days with these speculations, despite the inability to reasonably assess the underlying value of these "coins". More indicative that we may have entered a melt-up phase in the market, a number of stocks have soared recently based solely on changing their company names to include a cryptocurrency association. Our favorite example of this is Bioptix, a maker of machinery for the biotech industry. Having traded near $4 for the last three years, and as recently as October, the company's stock reached $46 in December after a name change to Riot Blockchain (blockchain being the technology underlying Bitcoin). Same business, new name, 1000% increase in stock price. Similar outcomes were experienced for other public companies that announced business strategy shifts to areas related to blockchain. Long Island Blockchain (formerly Iced Tea) is another example – tea to Bitcoin, hmmm. This is the stuff from which bubbles are made…and eventually burst.

In sum, a combination of rich valuation, low volatility, and budding euphoria seems like a recipe for at least a market correction. There are no rules concerning timeframe of course, but a retreat is long overdue. Stocks may well defy gravity for a while longer – markets are all about fear and greed, and the latter emotion is in full control these days. This presents a challenge for Investors who, like us, remember the last two crushing bear markets (which began at similar valuation levels) and wish to sleep comfortably. **It is increasingly difficult to find high quality stocks that are meaningfully undervalued, and this is a tell-tale sign to be careful.** Your portfolio is full of outstanding companies bought at prices that offered compelling opportunities at the time of their purchase. While momentum and high spirits may drive markets higher for some period, we are delighted to hit singles and doubles, knowing that your portfolio will be sturdy both in good times, like now and, more importantly, during the inevitable periods of challenging conditions.

We wish you a very happy and healthy 2018 and, as always, welcome your thoughts and questions.

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