Colchester Investment Counsel LLC

2018 First Quarter Investment Review

After a furious rally in January, stocks turned tumultuous and ended the quarter slightly down. The initial pullback in February was set off by rising inflation and rate concerns, while the more recent tantrum resulted from apprehension over a brewing trade war with China. 2018 began with tremendous enthusiasm for an economic revival and for stocks that would benefit, with consumer discretionary and "technology issues leading the way. "Boring" consumer staples and most everything interest rate sensitive moved lower. Remarkably, by quarter's end, some of America's most successful and iconic companies had fallen by double digit percentages, as investors became increasingly focused on owning high-flying technology equities. Indeed, at its recent peak, technology accounted for more than 25% of S&P 500 market value, and the five largest components of the index are all tech businesses. This 'fabulous five' currently comprises 15% of the S&P, more than the entire financial, health care or industrial sectors, and also accounts for 40% of the NASDAQ 100 Index. **As reflected in the chart below, the last time technology was so impactful on stock returns was in 2000, at the height of the Internet bubble.** This concentration reflects one data point of budding excess.

In past reviews, we have noted that an unintended consequence of global 'easy money' policies since 2009 has been to encourage excessive risk taking, and investors have bought stocks for years with little concern for valuation or potential downside. With conditions changing, and the Fed no longer filling the punch bowl, it is likely that greater focus will be placed on reasonably valued investments that provide more compelling risk/reward profiles. This shift in perspective will be welcomed and is long overdue.

The Markets May Be Normalizing…

Financial conditions appear to be "normalizing", meaning that inflation and interest rates are moving higher as the economy strengthens. The US Federal Reserve has raised its benchmark rate to 1.5%, and plans further increases this year. **Business friendly policies have bolstered consumer, investor and business confidence, and most economic measures, both here and abroad, are improving.** Corporate earnings are expected to rise approximately 15-20% this year, with some of this figure being attributable to the recent tax legislation. The US dollar has weakened for five consecutive quarters, helping many American companies with global operations. **We are hopeful that "normal" is here to stay for a long while, as it should mean that strong companies are rewarded, the weak are punished, bond investors can earn a reasonable return, and attention to risk once again earns its rightful place in the investment equation.**

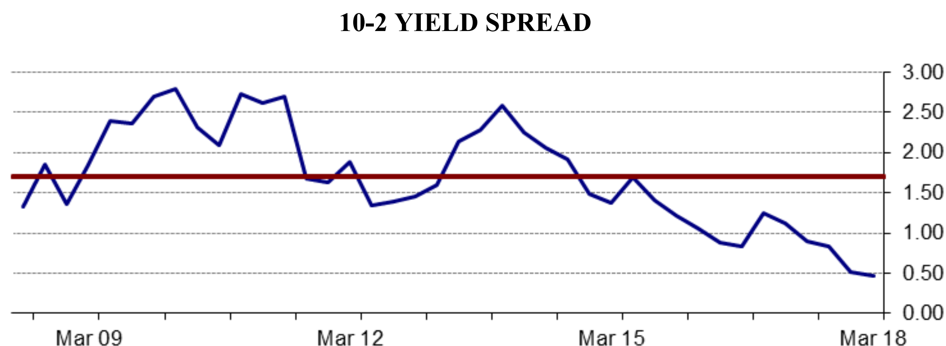
…But Be Careful What You Wish For…

Until recently, global central banks maintained interest rates at unprecedented levels that bore little connection to inflation or other key variables, and financial markets have not reflected underlying fundamentals for years. Despite substandard corporate profits, record low interest rates and the promise of sustained support from the Fed stimulated P/E multiple expansion (i.e. the prices investors were willing to pay for stocks). **It was only a matter of time before 'easy money' programs would be rolled back, and this process is now underway. Not surprisingly, the shift in monetary policy adds uncertainty, and considerable volatility has returned to the equity market.** In recent weeks, bourgeoning inflation, strong economic activity worldwide, historically high asset valuations, rising interest rates, and additional political (trade) and policy (higher rates) risk resulted in the most volatile investment atmosphere in many years. While transitioning to a more normal environment will be uncomfortable, at times, it is necessary for the long-term health of financial markets.

…And Be Mindful Of Reliable Indicators

The popular market narrative, reinforced by considerable positive data, is that 1) current weakness in stocks is simply part of the return to a more rational world, 2) the economy is solid, but not so strong as to force central bankers to increase rates too quickly, and 3) earnings are expected to be robust, justifying high valuations. **Beneath the surface, however, the bond market may be telling a different story.** The chart below shows the relationship between the yields on the 2 and 10-year treasury securities. The spread between these two typically widens when economic conditions are strengthening, and narrows during more difficult periods. This indicator has been declining for months, and is currently at its lowest point since 2007. **This development is significant for investors because recessions often follow "inversions" of the curve – when the 2-year yield is higher than the 10-year - and stock bear markets almost always result from recessions.** Such an inverted yield curve may not materialize, but it is a telltale sign that is worth monitoring.

10-2 YIELD SPREAD



After an extraordinary period of almost eerie calm, current turbulence in the financial markets may be disturbing, though should not be surprising. This is how investment markets are supposed to act, with uncertainty reflected in prices of stocks and bonds alike. **Historically, it has paid handsomely to avoid grossly overvalued assets, regardless of how exciting their stories may be, and to focus on areas of the market that offer quality at a price that provides a margin of safety.** While this discipline has been somewhat out of favor in recent years, we believe that its time tested tenets are essential to long-term investment success.

As always, we welcome your thoughts.

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