Colchester Investment Counsel LLC

2018 Second Quarter Investment Review

The major US stock averages rebounded in the second quarter, though to varying degrees. Technology issues continued to lead, while small capitalization equities benefited from strength in the US dollar, and the perception that their domestic businesses are protected from trade friction with China, Europe and other nations. Conversely, higher quality and value oriented stocks lagged, as consistent earnings and dividend yield have taken a back seat to 'growth' for the moment. **With regard to fixed income, investment grade bonds were virtually flat on a total return basis**, with tax-free securities slightly higher and taxable bonds down a bit.

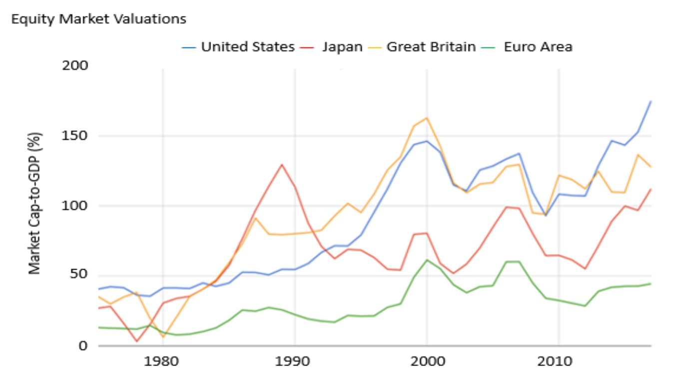
Transitions Are Often Bumpy

After a long and generally steady multi-year move higher, **the stock market has been on a roller coaster ride thus far in 2018. The broad headlines are mostly favorable**: the US economy is strong, unemployment sits at a 40-year low for all demographic groups, and second quarter earnings are expected to rise 19%. **Yet, concerns are mounting and volatility has increased; rising interest rates, a burgeoning trade war, and the notion that earnings and economic activity may be peaking have provided cause for investors to be somewhat nervous**.

While the Federal Reserve has raised short-term rates, longer maturities have fallen of late, and the yield curve has narrowed further. The "curve" is not negative, historically a strong signal of a looming recession and equity bear market, but the continued compression is unsettling.

Partly due to the strong US dollar, most international stock indices are down this year, despite being much cheaper on numerous valuation metrics (see chart).

This illustrates that US stocks are not simply expensive relative to their own history, but are extremely pricey when compared with other world markets. Since price paid is the most important factor in ultimate investment returns, this visual is compelling and our conviction in high quality foreign stocks remains strong.



The bouncy action in stocks is consistent with the transition now underway to more "normal" economic conditions. Among other attributes, normal means interest rates being 2-3% above inflation, levels not seen in a decade. Normal anticipates the potential for recession, as downturns are key elements of economic cycles. Normal also suggests higher volatility, and not the one way road to riches that some have come to expect. With the equity bull market in its 10th year, historically quite extended, all investors should be prepared for setbacks that restore balance to the risk/reward equation and set the stage for the next leg higher.

Though currently lofty valuations may result in modest intermediate-term returns, it is reasonable to expect further gains before the next recession and bear market.

While the presidential cycle has not been kind to investors in the summer of year two (where we are now), it is worth noting that the fourth quarter of midterm election years and the first quarter of the following year have been positive 87% of the time for the S&P 500. Strong earnings growth and only modest bumps in interest rates should allow stocks to move higher again, once current trade spats are resolved.

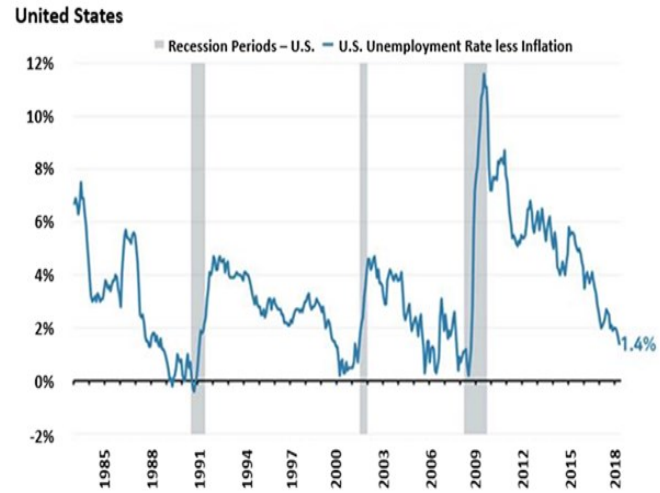
Another reason for optimism is that, due in part to cash being repatriated from overseas, 2018 will mark the first year that corporate America will return in excess of $1 trillion to shareholders between stock buybacks and dividends. Significantly, while the process has begun, only a relatively small suggesting that far more is on the way. Admittedly, we are assuming that the President and his advisors are familiar with the names Smoot and Hawley (of Smoot, Hawley tariff infamy), and will not allow the current disagreements to morph into a damaging trade war.

The Cracks are Growing

Mixed signals abound in the US credit and equity markets. While spreads between corporate and treasury bonds have tightened, signaling that corporate balance sheets are mostly solid, the yield curve continues to narrow and long-term rates (more sensitive to economic activity and inflation) have softened of late, suggesting that the economy may not be as strong as advertised. Likewise, most US equity averages have continued higher in 2018, but are increasingly dependent on the performance of a small group of technology stocks. In the 'all you need to know' category lies the 2018 performance of the Dividend Aristocrats Index, a group of highly successful companies whose dividends have grown for at least 25 consecutive years. Of the 50 stocks in this elite group, only 17 are up year-to-date; remarkably, 18 have fallen by more than 10%.

The tumultuous first half of 2018 for equities lends credence to the notion that investors have largely discounted the good news on tax cuts, global growth, and generally supportive financial conditions, and that more uncertainty is on the horizon. Again, the facts are compelling – despite the steady to slightly higher stock indices, every S&P 500 market sector has declined at least 10% at some point this year, with some down closer to 20%.

As for the flattening yield curve and lower rates, the 'money supply' is not growing, the 'velocity of money' (the rate at which funds move through an economy) is at its lowest reading since 1949, the year-over-year change in bank credit is down, and gross federal debt as a percentage of GDP is almost double the average since 1952. **All of these indicators are threats to economic expansion**, despite the current headlines being quite positive. Indeed, the following chart plots the difference between the inflation and unemployment rates. As the economic cycle ages, the gap shrinks. While not yet at levels witnessed prior to the last two recessions, we are definitely getting close.



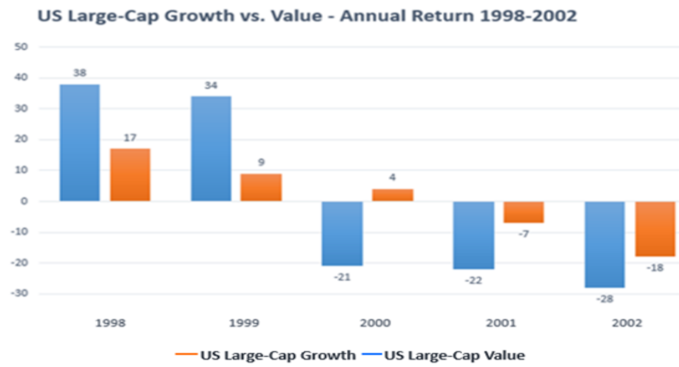
A Familiar Picture

The question is what happens from here? With the obvious caveat that we do not have a crystal ball, our best guess is that we are in the late innings of this favorable period, and we should be starting to prepare for what follows. **The current market environment has a lot in common with the years 1998-2000**. No two historical moments match identically, of course, but the parallels with the conditions of 20 years ago are unmistakable, including: 1) an unusually long economic expansion that began with tepid growth rates, and eventually reached full employment with high consumer and small business confidence readings, 2) a Federal Reserve that tightened policy, but not at a pace that noticeably restrained risk taking by companies or investors, 3) a rather flat yield curve that is moving toward inversion, 4) wobbly emerging markets due to strength in the US dollar, 5) 'growth' and technology shares dominating the stock market amid talk of a new era, while a bevy of companies considered to be "disrupted" struggle, and 6) a media merger frenzy featuring a purchase of Time Warner.

The most glaring similarity to the late 1990's is the dominance of technology in the stock market, with portfolios (these days passive ETF focused) concentrated and risky, investors excited and stimulated, and the notion accepted that tech is really immune to late-cycle pressures that trouble other investments. At the end of the last century, investors had to own the Four Horsemen (Microsoft, Intel, Cisco Systems, and Dell), regardless of their sky high valuations and the ever present risk that conditions regularly change, particularly in technology. Those names have been replaced today by Facebook, Amazon, Netflix and Alphabet (Google), along with a few others. **As with the earlier group, each of these companies sports a riveting story to match valuation levels that have never before been sustainable**. In keeping with historical precedent, the higher the stocks rise, the more interest they draw.

The flows into tech funds of late have been nothing short of astounding. The FANG stocks (noted above), together with a relatively small number of additional issues, have been market darlings for some time, and it is understandable why investors are so enamored with these fast growing companies. What is somewhat surprising is that these technology leaders are finding their way into non-technology funds, including consumer discretionary, retail, media and entertainment, internet and social media. **The inclusion of tech titans in non-tech funds demonstrates the extremes of the current mania in this part of the market, the same sort of greed that has driven every speculative period throughout history.**

With this as prelude, we believe that a repeat of the early 2000's could well unfold, and feel fairly sanguine about this because of the chart in the next column.



Unlike the bear market of 2008-2009, when virtually everything declined sharply, the 2000-2002 market was largely a tech bust phenomenon. **Many quality stocks held their own quite nicely** during this period, and we would suggest that **the same is possible in this cycle**. As noted earlier, a large number of industry giants are being ignored, or worse, just as they were in 1999. They all share the same qualities: excellent businesses, reasonable valuations, above average dividend yields, and an ability to weather any storm. A repeat of the scenario illustrated above would be well suited to our investment philosophy, in harmony with the 'normalization' process and, most importantly, consistent with the goal of growing your capital and income over time while controlling risk.

As always, we welcome your thoughts.

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