Colchester Investment Counsel LLC

2018 Third Quarter Investment Review

US stocks rose smartly, interest rates moved higher, and international markets faced mounting difficulties in the quarter just completed. More speculative growth stocks continue to lead the advance, quite typical for bullish cycles that are in their later innings. Bond returns were generally flat, as lower prices were mostly offset by increased interest received. While rising rates hinder near-term returns, it is encouraging that our clients are earning more income from their bond investments. As for the macro picture, **the continuing recent trend of strong US economic growth and weakening foreign prospects was magnified, and this divergence has been reflected worldwide in the performance of many asset classes, including currencies and stocks. "Most overseas indices suffered losses in the third quarter (and remain negative for the year), while the major averages in the US were higher**.

Conundrums Abound

Our second quarter review pointed to the many mixed signals challenging investors, yet also to an expectation for further investment gains before the next recession and bear market unfold. On this front, little has changed in the past few months, other than that the signals are now even more mixed. Though caution lights continue to flash, stocks are likely to move higher for longer, as most every major bull market in history has ended with a final euphoric surge that has yet to occur. As for the challenges noted above, the points that follow illustrate just how many contradictory factors are currently at play:

1) **US economic conditions are far stronger than at any time in the last ten years**. The employment picture is healthy, and both consumer and small business sentiment are near record levels.

   - Despite mostly positive indicators**, the historically predictive US Treasury bond yield curve continues to flatten, not a sign of economic vitality**. Moreover, after a brief period of coordinated global expansion, trouble has returned internationally in the form of currency crises in Argentina and Turkey, and a potentially destabilizing budget impasse in Italy, the Eurozone's third largest economy.

2) While not sustainable, **corporate earnings are currently growing at a strong double digit percentage rate**.

   - Near all-time high levels, **equity valuations would seem to reflect most of the good news** evident in strong company results.

3) **Interest rates remain low** relative to historical levels and to inflation.

   - While still benign, **the Federal Reserve is raising short-term rates and, as importantly, unwinding the unprecedented stimulus instituted during the financial crisis of 2008-2009**. Additional rate increases are expected over the next two years.

4) **'The trend is our friend'** with regard to US equities; importantly, extended movements in both directions often last far longer than most expect.

   - While the most watched stock averages have been strong of late, **market breadth (the number of advancing vs. declining issues) has weakened meaningfully, and stocks with no earnings have been a major component of the recent rally**. Among the greatest current conundrums is that a number of market sectors that ordinarily perform well in strong economies (housing, semiconductors, financials) have been among the worst in 2018. And yet, the transportation and technology groups have been robust.

5) **Stock repurchases by S&P 500 companies are on pace to exceed $1 trillion in 2018**; this demand has provided a significant underpinning for the positive performance this year.

- While company boards are authorizing the buy-back of copious amounts of stock, **the executives running some of these businesses are selling the same stocks at a feverish pace**.

6) After a shaky January, and a 10% correction, **volatility has become dormant once again**.

- **The lack of volatility is curious in light of the destructive demagoguery in Washington, the coming mid-term elections (which may upset the status quo), the mounting trade frictions with China, and the Fed removing the punch bowl from the markets party, among a number of other potentially consequential factors**. Draining liquidity from world financial markets could have far reaching effects on market stability down the road. From a near term perspective, the budding trade war would be more damaging. Once thought to be simply a negotiating tactic, newly imposed tariffs will soon impact broad swaths of the global and US economies. Despite all of the bloviating to the contrary, **it is a simple fact that a trade war has never been "won". Everyone loses to some degree.**

"What, Me Worry?"

Judging by stock returns in recent years, all appears to be calm, and the future bright. From an historic perspective, the stock market has entered the best time of year (the fourth quarter) and, as stated earlier, there is reason to believe that investor enthusiasm may reach higher highs. But, we would not be doing our jobs if we did not worry, and **this movie is familiar to those of us who have followed markets for a long time**. **Remarkably, the human condition makes the same mistakes repeatedly**, often choosing to focus on current conditions when making decisions tied to longer term developments. **This is why many buy stocks when they are up, and sell when prices are down**.

Since 1962, no significant stock market top has occurred in the second half of an off-presidential election year – and it is almost equally unusual to experience one in the following year. This fact, and because **stocks appear impervious to obvious risks, has resulted in considerable investor complacency. Clearly, the markets have been remarkably resilient in the face of many obstacles**, including, as described above, tightening monetary policy, currency instability in important emerging markets, the threat of a trade war, and burgeoning inflation.

For now, no broad crisis seems imminent, and the timing of future trouble for investments in indeterminable. **Our overarching theme, therefore, is that prudence and balance are warranted. Portfolios should be allocated to take advantage of future market strength, yet at the same time be able to withstand more difficult conditions, whenever they may turn up. While more aggressive and risky alternatives are currently in vogue, quality stocks and bonds provide the profitable balance we seek**, protecting and growing your hard earned capital through market cycles.

As always, we welcome your thoughts.

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