Colchester Investment Counsel LLC

2018 Fourth Quarter and Year-End Investment Review

US stocks fell dramatically in the fourth quarter, with the decline punctuated by the worst December since 1931. The equity market fell rapidly as investors became increasingly unnerved by issues that had been mostly in plain sight for much of the year: higher interest rates, a less accommodative Federal Reserve, trade frictions with China, the likelihood that earnings would peak in 2018 (for this cycle), and stretched valuations. At its worst level, well over half of S&P 500 issues were in bear market territory (down more than 20%), with the index itself falling 19.8% from its all-time high in September. The pace at which equities plunged was at least partially due to the influence of computer-focused trading strategies, an unfortunate aspect of today's investment environment. **Fixed income returns were positive in the quarter for quality securities, as yields dropped in sympathy with a 'flight to quality', and a perceived slowing in the economy.** While bond investments have generated fairly meager returns in recent years, **this asset class did its job in the fourth quarter, protecting capital and cushioning the blow from weakening stocks**.

In many respects, 2018 was a remarkable year from an investor's perspective. US stocks and bonds both fell in value for the first time since 1969. The typically volatile third quarter was more calm than any dating to 1963, but was followed by dramatic price moves in the fourth quarter, including the worst Christmas Eve performance ever, and the largest point gain on record just two days later. Historically, difficult conditions in one asset category, or geographic location, have been mitigated by opportunities elsewhere. **Last year, however, roughly 90% of all investment classes lost money, including stocks, bonds, commodities, currencies, and Bitcoin, which collapsed 75%**. Even technology stocks, including the FAANG issues, faced a drubbing toward year-end, as sky high valuations could not support moderating fundamentals, and record mutual fund/ETF redemptions compounded the selling. On the whole, foreign markets suffered the most, as a stronger US dollar took its toll on currencies and growth in developed and emerging economies alike.

Yet, by one important standard, 2018 was fairly typical. Due to the lengthy and persistent march higher following the 2008 financial crisis, some investors have forgotten that, **over long periods, stocks have corrected ten percent or more every 18 months, on average, and twenty percent or more (a bear market) every three years. Indeed, while the 2018 fourth quarter correction was uncomfortable, it was not unusual at all**. In fact, it was arguably healthy. Our recent letters have described the "normalization" of the investment markets – rising interest rates and inflation, the resumption of the economic cycle, the importance of valuation, and an appreciation for the element of risk. **With little new "news" to drive investment decisions, the seemingly forgotten emotion of fear reasserted its place, and came to the fore, for the first time in many years**. **We are encouraged that fundamentals matter again**, that quality stocks and bonds performed relatively better during the downturn, that government intervention in the markets has waned, and that investment return expectations have become more reasonable.

2019 Expectations

Lacking a crystal ball, we must emphasize that our forecast for 2019, while hopefully well-conceived, should be taken with a grain of salt. Regarding fixed income investments, with economies around the world slowing, it is hard to envision interest rates moving materially higher. **Bond returns from high grade securities are likely, therefore, to be positive, but modest in magnitude**. **As for equities, there are solid reasons to expect very different outcomes**. After the recent turbulence, **stocks may well move higher in 2019 if earnings growth only slows, as expected by the consensus, and the US economy avoids recession**. Valuations have returned to more reasonable levels, and interest rates remain low by historical standards. **Many high quality equities were down 20-40% last year, and superior companies usually right themselves over time, with their stocks following suit**.

A number of market sectors turned lower in early 2018, providing a preview of the economic slowdown which is currently in motion. These same groups, industrials being the most obvious, could well lead when conditions stabilize and equities turn higher again. Quality dividend payers, which performed poorly for most of 2018, but have been rewarding investments over long periods, could also recapture investor's attention. Importantly, **there are no systemic crises evident today, and investor sentiment has soured meaningfully, usually a solid contrarian indicator**.

On the other hand, stocks may suffer further from the aforementioned reduction in earnings expectations, the trade and tariff dispute with China, and the restrictive change in Federal Reserve policy, particularly its plan to drain liquidity from the economy and markets. The significant drop in interest rates of late is clearly not a healthy near-term sign for economic and corporate prospects. For those who find historical precedent useful, or at least of interest, all three US stock market indices endured two 10% corrections in 2018. This has only happened in 1973, 1974, 1987, 2000-2002, and 2008. All but 1987 signaled coming recessions and bear markets, and the 1987 crash was obviously not forgiving either. **Headline statistics (jobs, consumer confidence, etc.) are generally poor recession indicators. What has been helpful is the data depicted in the chart nearby**. Inverted yield curves (relationship between long and short-term interest rates) have foretold the last five recessions since the 1970's, and the weak markets that followed. While the 'curve' is not yet inverted, we are watching this indicator carefully.

Regardless of the near-term economic outcome or direction of stocks, the market tends to shift the balance of power back and forth over time. **"Growth" issues have outperformed "value" for 10 years and our view is that this dynamic may reverse. This would be a welcome shift for those of us who pay attention to valuation, and have largely shunned stocks that are popular and the favorites of momentum investors**. Avoiding expensive stocks, and owning those that offer compelling long-term risk/reward prospects requires patience and discipline, characteristics that have been lacking in recent years as zero percent interest rates encouraged excessive risk taking. We have been heartened by the new Fed Chairman, who clearly does not view propping up the stock market as part of his job description. As noted above, **the normalization process involves an element of discomfort because stock corrections are not pleasant. Yet periods when most assets decline in tandem are usually brief, and inspire a long-term perspective.** Whether the recent downdraft in equity markets ran its course last year, or if additional disruption carries over into 2019, we know that, historically, stocks and bonds have delivered solid, inflation beating returns over all meaningful periods. An investment approach focused on owning quality, income-producing securities should provide similar returns over time, while dampening volatility and mitigating permanent loss of capital along the way.

As always, we welcome your thoughts.

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