Colchester Investment Counsel LLC

2019 First Quarter Investment Review

Global stock markets roared back in the first quarter. **Despite a mostly unchanged backdrop, including softening economic conditions worldwide, a significant slowdown in earnings growth, continued trade frictions with China, and stretched valuations, equities found their footing, with the major averages completing their best quarter since 2009**. Interest rates declined during the period, resulting in positive returns for most fixed income investments.

So, What Changed...

Our 2018 year-end review welcomed the "normalization" of economic and market conditions, and noted, "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". **It turns out that we, and most others, gave the central bank too much credit**. It was less than 4 months ago that Chairman Powell suggested that the Fed would act in accordance with its mandate of promoting full employment and a stable currency, and let asset prices go where they may. Their outlook was for three rate hikes in 2019 and a consistent runoff of its $4 trillion plus balance sheet. While not new "news" at the time, the stock market rebelled, resulting in the sharp decline late last year. Then, with investors panicking and the economy softening, Powell effected a complete about-face in a matter of weeks. **The Fed's latest dictum is that rates will not be increased at all in 2019, and their balance sheet reduction will end this summer, encouraging the view that the Fed has a third unofficial mandate – defend stock prices at all costs**. Many investors now anticipate the next monetary policy move to be a reduction in rates; this was the primary change in expectations that propelled markets higher over the past three months.

The result of this dramatic policy shift has been to resurrect market conditions of the post-financial crisis era: capital markets are again heavily dependent on 'easy money', seemingly insensitive to price, and engaged in risk taking and the misallocation of capital. It is no shock, therefore, that fast growing companies are back in vogue, regardless of valuation. **For good reason, investors once again believe that accommodative policies will cushion the blow of future volatility and corrections**.

…And What Is Next?

For many years prior to 2018, when both bonds and stocks lost value for the first time since 1949, most observers wondered how these asset classes could appreciate together for such an extended period. While there are typically numerous factors that foster equity bull markets, stocks usually benefit from solid economic underpinnings, or the prospect thereof. On the contrary, higher bond returns tend to be consistent with weakening growth, as interest rates follow fundamentals lower. **After the 2008-2009 great recession, the historically weak recovery led to solid returns in financial assets, as interest rates declined and modest business activity resumed. The US economy appears to be returning to a period of mediocre growth and significant central bank accommodation**. Indeed, recent data clearly shows that global economies have slowed, and government officials are concerned not only by the prospect of lower stock prices but also by the massive debt loads carried by every major country. "Normalization", a return to healthy growth, rising inflation, and higher interest rates was the expectation. Instead, **it now appears that yields may remain unusually low, with the potential for rate decreases, further quantitative easing, and possibly other drastic monetary measures intended to prop up asset prices. Despite this turn of events, we remain cautiously optimistic about the markets for now, admittedly for reasons that are more than a bit uncomfortable**. There is no doubt that stocks are due for at least a pause or pullback after the first quarter rebound. And, at some point, investors will likely say enough to central bank manipulation. But, **if recent past is prologue, the Fed "put" (easy money measures) will be deployed at any early sign of market instability**. Until then, investors may justify higher stock valuations with lower interest rate assumptions, and defend heavy stock allocations with TINA – There Is No Alternative (to stocks), as they did for most of the last decade.

Items To Watch And Ponder

- **Interest rates**: We expect activist central banks to keep interest rates low, and liquidity plentiful. In the US, the 10-year/2-year treasury yield curve remains slightly positive. An inversion (2-year rate higher than the 10-year) has reliably signaled recessions and eventual bear markets every time since the 1970's;

- **Corporate profits**: estimates for US company profits have dropped meaningfully since the beginning of the year, though some growth in 2019 is still projected. Should, however, the budding recessions in major Eurozone economies (Italy, Germany) and the slowdown in China move stateside, it is possible that earnings growth for this year will turn negative. Equity investors would likely not take kindly to such an outcome;

- **The US Dollar**: someone recently described our currency as the 'cleanest dirty shirt in the drawer'. Despite obvious and long-standing issues, the US remains relatively strong compared with the rest of the world. As such, the US dollar should remain solid given that other major global economies remain challenged;

- **Politics**: 2020 will be here before we know it. Political pontification will promise "free stuff" (education, health care, monthly checks from the government), legislation to curb stock buybacks, notions such as Modern Monetary Theory (print money as needed), infrastructure spending, and targeted tax cuts, among other topics, in an effort to attract attention and votes. The political circus should be a side-show for investors, though policy proposals will be weighed for their potential impact on asset prices, and may result in added volatility;

- **Investor sentiment**: the minor panic that set in last December has dissipated and been replaced with an uneasy calm. Higher stock prices will do that. Yet, while credit spreads and the VIX (fear gauge) betray little concern, the market is climbing the proverbial "wall of worry", which is usually a fairly healthy sign.

In his 2018 annual letter to shareholders, Warren Buffett wrote "rational people don't risk what they have and need for what they don't have and don't need". These words ring particularly loud and true in these somewhat uncertain and tumultuous times. **Our take on Buffett's main point is that every investor should stick to a thoughtful plan, be disciplined, and avoid temptations brought on by greed**. **Consistent with this mindset, our blueprint is to grow wealth over time without taking undue risk**. In the investment 'race', the hare may look exciting, and induce the buying of story stocks that stretch the bounds of reasonable valuation. Yet the tortoise usually prevails as steady, prudent and reliable typically provide better results at the finish line with, importantly, less volatility. We counsel patience and a long-term focus during good times and bad, knowing that owning quality, income-producing stocks and bonds has historically provided solid returns in the pursuit of achieving your financial goals.

We appreciate you taking the time to read our review, and look forward to addressing any thoughts or questions that come to mind

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