Colchester Investment Counsel LLC

2019 Second Quarter Investment Review

US stocks and bonds showed continued strength in the second quarter. Equities corrected sharply in May after a torrid start to the year, but moved higher again through most of June. Fixed income returns were nicely positive, as interest rates moved lower; indeed, yields have declined dramatically and consistently since early in 2019. Surprising virtually everyone, the 10-year US Treasury note yield has fallen precipitously, from 2.8% in January to roughly 2% today. Overseas markets were generally positive as well, though returns have been more muted. With $12 trillion in negative-yielding foreign government debt, and weakening economies most everywhere, the performance of international equities continues to trail those in the US, as they have for many years.

We remain cautiously optimistic on the investment front, though increasingly feel the need to emphasize the word cautious. It seems that 'déjà vu all over again' has revisited the investment scene as asset prices have become increasingly dependent on government and central bank policies (akin to the 2009-2017 period). In our view, this trend is likely to continue. At some point, weak corporate profits growth, exploding debt, high valuations, and the inevitable recession will overwhelm policies designed to support stocks. We do not believe, however, that markets have reached this stage. While the second half of 2019 will likely be less rewarding for investors than the first, and pullbacks should be expected, the conditions necessary for truly difficult times are not yet present.

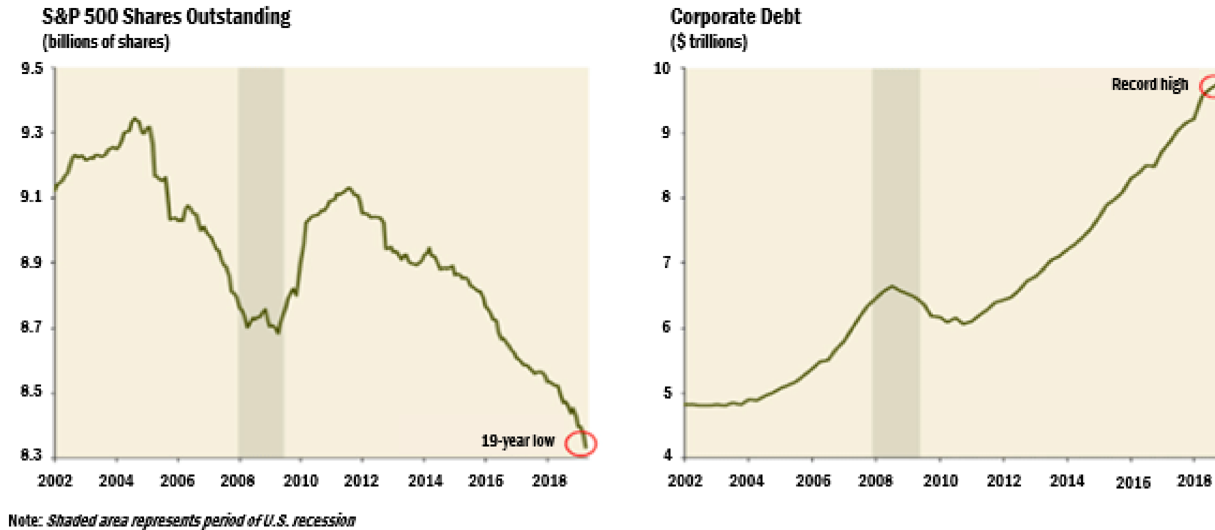
After the sharp decline in stock prices and interest rates late last year, economic fundamentals appeared questionable coming into 2019. **The Federal Reserve's surprise pivot, guiding policy expectations from restrictive, to neutral, and finally to accommodative, has underpinned the year-to-date rally in equities**. **As the second quarter moved along, a more hardline policy on trade emerged and, since then, stocks have moved primarily on trade/tariff perceptions and predictions of future Fed activities.** Much as May's stock market weakness was triggered by a renewed hawkish approach to China, the June recovery was instigated by a more dovish tone on Mexico, expectations that US/China frictions would ease, and belief that interest rates will be cut as soon as this month.

Appearing to be largely disconnected from the financial markets, **the economy is sending mixed signals, some pointing to continuation of what is now the longest economic expansion on record, and others suggesting a more reserved outlook. Near all-time high levels, stocks appear to be pointing to the former, while bonds suggest the latter**, as rates have fallen dramatically both here and abroad. **The market's reliance on policy/politics for direction is somewhat disconcerting, though the uncertainty created by the unknowable trade circumstance is tempered in the eyes of many by the perception that the Fed stands ready to be exceedingly accommodative**, following in the footsteps of the Japanese and European central banks. This means continued low interest rates (maybe negative at some point), and liquidity injections to whatever extent is necessary.

The 'cautious' element of our outlook is buttressed by numerous fundamental headwinds, including the following: 1) tepid corporate earnings, 2) indications that the Fed is prepared to embark on an interest rate reduction program from already historically low levels, 3) the world is now roughly 20% more leveraged than it was before the last financial crisis and debt loads are likely to rise from current levels, 4) the third quarter of the year is historically the least positive for equity returns, 5) company buybacks have declined markedly (see next page), reducing one of the larger sources of demand for stocks, and 6) the major averages have been driven higher by a small group of stocks; since January 2018, the S&P 500 is up approximately 11%, but more than half of all traded stocks are down over this period.

What Really Matters

Many of these headwinds have been present for the last ten years, but have had no material impact other than to drive asset prices far higher than many thought possible. **Most understand that the Federal Reserve's easy money policies have propped up the stock market since the Great Recession.** Artificially low rates made fixed income investments less attractive and equities more so. Moreover, the Fed's "quantitative easing" programs created enormous amounts of new money that ultimately made its way into stocks. **But the Fed's monetary policies had another, less understood, unintended consequence, creating an additional strong and, as it turns out, critical tailwind for the bull market.** The graphic below clearly illustrates the extent to which companies have used the Fed's low rates as an excuse to borrow heavily and buy back huge amounts of their own shares.



This would be only modestly interesting were it not for the fact that **corporations are the single largest source of demand for US stocks**. By one estimate, the number of shares associated with company repurchases is more than two times larger than ETF's (the second largest source), and six times greater than those acquired by mutual funds. **The above relationship is a principal reason why, despite the weakest economic recovery on record, the current bull market is one of the strongest in history.** The massive, price-insensitive buying on the part of corporations has contributed to equity valuations reaching record highs even as fundamentals, as measured by revenue or earnings growth, have been modest at best.

Investors are understandably wondering if trade conflicts and all of the risks associated with central bank policies will eventually lead to an unwinding of the good times. While clearly important from a tactical perspective, no one can predict the outcome or timing of these concerns. **Recognizing that the crystal ball is murky, investors should focus primarily on taking risk commensurate with their investment time horizons.** Markets will rise and fall, for reasons foreseeable and otherwise; this aspect of asset management cannot be controlled. We can and will, however, invest prudently for your circumstances, knowing that short-term uncertainties will not disrupt well-conceived long-term plans and goals.

We always welcome your thoughts and questions.

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