Colchester Investment Counsel LLC

2019 Fourth Quarter and Year-End Investment Review

US stocks surged in the fourth quarter, capping a terrific year in which all of the major averages returned in excess of 20%. Many of the issues that had spooked investors in late 2018 were resolved favorably in 2019; most importantly, the Federal Reserve not only reversed course and lowered interest rates but ended the year furiously pumping liquidity into the financial system. In addition, fears of recession faded as the year progressed, and the on-again off-again trade negotiations with China simmered around the holidays, providing at least modest signs of progress. **Consistent with lower interest rates and a steady economy, fixed income returns for investment grade securities were quite respectable, up in the mid-single digits**. Surprising most market observers, interest rates declined dramatically through August, with the 10-year treasury falling to 1.43%. From that point, they crept slowly higher through year-end as economic angst moderated. Finally, most asset classes (stocks, bonds, commodities and currencies) across the globe reported modest to very handsome gains in 2019, unlike the prior year in which returns were predominantly negative.

Viewed through a near-term lens, daily market volatility picked up in 2019, as each presidential tweet about trade negotiations seemed to generate an outsized reaction. Eyed, however, from a somewhat longer-term perspective, equities continued higher in a methodical, almost grinding manner, extending the current bull market that is already the longest on record. **While investor sentiment obviously improved from the gloom of late 2018, numerous concerns provided the proverbial "wall of worry" for stocks to climb**. Given the brutal 2008-2009 bear market, it is understandable that many investors become nervous when the market makes new all-time highs. Two modest declines during 2019, in April/May and July/August, fostered considerable consternation. Indeed, **a number of high-profile investment firms have been calling for a meaningful correction for some time, yet, for various reasons, equities remain remarkably resilient**. Plenty of fodder exists for bulls and bears alike.

On the One Hand…

- **The most important factor underpinning the stock bull market is worldwide central bank policy, particularly that of our own Federal Reserve**; interest rates are historically low and money printing is back in fashion. Chairman Powell has stated that the Fed will not be raising rates again unless inflation surges, and the Fed added $400 billion to the financial system during the final four months of 2019.

- After "inverting" for 6 days last summer, the US Treasury yield curve steepened considerably by the end of the year. **A "normal" yield curve, when short-term rates are lower than those with longer maturities, is viewed as healthy for both economies and financial markets alike**.

- **Together with the very reliable yield curve indicator, most recent economic data and stock market activity suggests that a recession is not coming anytime soon**. Employment and wage growth are strong, and both financial and industrial stocks have been solid in recent months, relative to the market as a whole. All of this points to a reasonably healthy backdrop for investors.

- **Trade friction with China has become less bad**. A "phase 1" deal will reduce/eliminate potentially crippling tariffs, at least for some period, and should, together with accommodative Fed policies, restore a degree of confidence in the business community. **Most observers expect global growth to resume in 2020, reversing the downtrend witnessed over much of the past two years**.

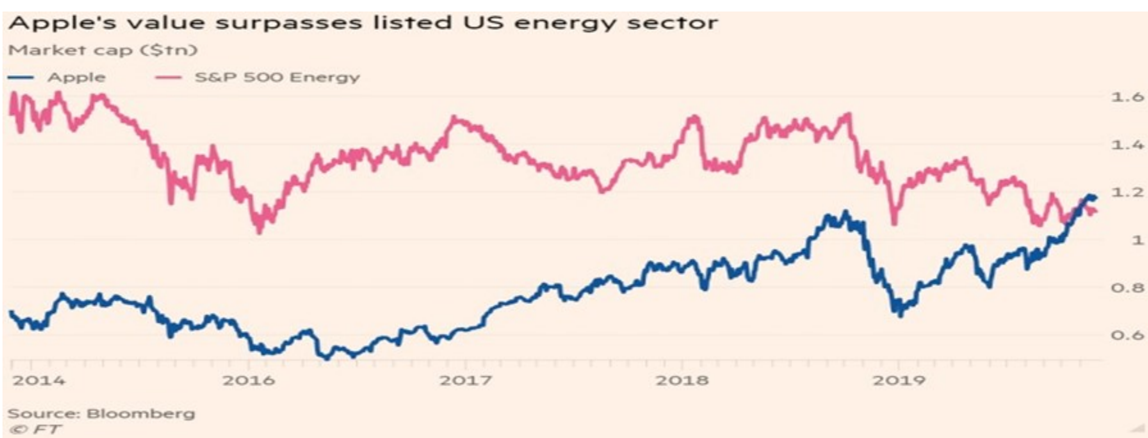
…But on the Other Hand

- **Corporate earnings declined in 2019 from the prior year**. In fact, the number of companies currently making money is the lowest since the days of the dot-com bubble. Previous letters have noted that profits have basically gone sideways for many years while, concurrently, the stock market has continued to rise. This illustrates that **the primary factor driving this bull market is P/E (price/earnings) multiple expansion** which, in turn, has been largely attributable to easy money policies.

- Since 2013, dividends and stock buy-backs for US companies have exceeded free cash flow. Companies have increasingly borrowed to fund the shortfall, but they cannot spend more than they make indefinitely.

- While few seem to care, **the mountain of debt continues to grow**. The US national debt now exceeds $23 trillion and, rather than reducing leverage as usually happens during economic expansions, many companies have added to their borrowings. For its part, the Fed is conducting repurchase ("repo") operations at a pace 10 times larger than that during the period leading to the 2008 financial crisis. This is clearly not normal and is likely a sign of some sort of duress.

- **Stocks are either expensive or exceedingly expensive, depending on which measure is used. This is particularly true of the technology sector**, which provided stunning returns in 2019. The P/E ratio of the tech group is currently in the 99th percentile of all P/E ratios over the past 10 years. Seven of the largest ten stocks in the world are US technology companies, with the top five names in the S&P 500 (1% of the constituents) accounting for 16% of the index market cap, a concentration that has not occurred since 1999. For those who appreciate visual presentations, **the chart below is, frankly, astounding**. It shows that the value of Apple's stock is worth more than the entire US energy sector. One can argue the merits of each, but **it seems fair to say that over the past several years the pendulum has swung rather excessively toward technology and "growth", and away from energy and "value"**.



Our Take on 2020 and Beyond

Each January brings on the annual rite of unveiling prognostications for the new year. For some, this can be an exhaustive process as we recently learned that one of the large Wall Street banks has a "Futurist" who is charged with predicting how 28 economic, social, political and sundry other forces will impact investment returns. It will probably not surprise you to learn that **Colchester prefers to keep things more simple, relying on time honored trends and concepts**. For instance, 100 years of history shows that owning quality, dividend paying stocks, through market cycles good and bad, is a rewarding approach to growing wealth. Over that same period, investment grade bonds have provided steady streams of income and the return of one's original investment. Over any meaningful future period, there appears to be no reason why this should change.

As for 2020, our best guess is that volatility will be more pronounced since, for no other reason, equities are starting from a much higher valuation point, leaving less room for hiccups of any kind. It is also stating the obvious that 2020 is a presidential election year; fireworks should be expected, and different market sectors may gyrate along with the prospects of the various candidates. **While intermittent pullbacks should be anticipated**, **equities may well continue higher, riding the seemingly never-ending wave of Federal Reserve largesse**. Predicting how long technology issues will continue to dominate the major averages is unknowable, though we would be remiss to not identify the considerable outperformance of "growth" stocks over the past decade, and suggest that this phenomenon could/should shift at any time. **The consensus expects interest rates to remain low and we would agree. Fixed income returns, therefore, are likely to be modest**. **But predicting short-term events, and their timing, is inherently difficult, and this is why we take the long view**, purchasing reasonably valued quality companies that typically thrive due to one or more competitive advantages.

There is an old adage that says markets rhyme but do not repeat. Stocks rise and fall for many of the same reasons over time, and buying when they are cheap and selling when dear most often delivers solid returns. Over the long term, stocks will prove to be rewarding investments. Yet, the table below (thanks to strategist Louis-Vincent Gave) illustrates that underneath the rising long-term trend, the course of individual stocks (as well as industries and sectors) will change. In short, the biggest and best companies over any given ten-year period have a hard time sustaining their superior performance over following decades. For this reason, **we try to avoid falling in love with stocks that have performed well, and generally favor a contrarian approach** – buying quality companies when they are out of favor – as this philosophy has proved consistently successful.

The top 10 stocks by market cap seldom make it to the end of the next decade

1980	1990	2000	2010	2019 - June
IBM	NTT	Microsoft	Exxon Mobil	***Microsoft (US$1.035trn)***
AT&T	Bank of Tokyo-Mitsubishi*	General Electric	PetroChina	***Amazon (US$936bn)***
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	***Apple (US$913bn)***
Standard Oil	Sumitomo Mitsui Banking*	Cisco Systems	BHP Billiton	***Google (US$766bn)***
Schlumberger	Toyota Motor	Wal-Mart	Microsoft	***Facebook (US$538bn)***
Royal Dutch	Fuji Bank	Intel	ICBC	***Alibaba (US$421bn)***
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	***Tencent (US$412bn)***
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson (US$371bn)
General Electric	UFJ Bank*	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase (US$360bn)
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Exxon Mobil (US$320bn)

* Merged entities

Investment vigilance and discipline, together with a constant focus on your evolving financial goals and requirements, are the foundation of our advisory process. **We are sensitive to the fact that this bull market is growing longer in the tooth, and the next difficult period is closer on the horizon**. Prudent asset allocation, well-considered position sizes, alternatives that hedge equity risk, and quality securities will be the underpinning of portfolios that should grow steadily over market cycles, and hopefully allow you to rest easy when the inevitable bumps are presented.

As we enter this new year, Colchester is celebrating 20 years as an independent investment advisory firm. Our growth over the last two decades has occurred exclusively by word of mouth, and we would be most appreciative if you will think of us when the opportunity arises to introduce family and friends who may benefit from our services.

As always, please let us know if you have questions or thoughts. We wish you and your loved ones a happy and healthy new year!

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