Colchester Investment Counsel LLC

2019 Third Quarter Investment Review

US stocks took a breather in the recent quarter, finishing just above or below the flat line, depending on the index. Year-to-date, of course, equities have generated handsome returns. **'Defense' was the theme in recent months, as investors flocked to the perceived safety of utilities and consumer staples issues**. A brief spill taken by momentum (mostly technology) stocks in September led some to predict the beginning of the end to the dominance of 'growth' stock returns in recent years. **'Value' has underperformed growth since 2010 so a reversal of this dynamic is certainly overdue.** Fixed income securities benefited from interest rates falling meaningfully during the period, as economies worldwide softened and central bankers cut short-term rates. Equities in overseas markets were flat to negative in the quarter.

Very little has changed in the investment world since our last letter. The same complex macro headlines that have been dominating for some time – Chinese trade war, Federal Reserve policy, economic headwinds, and high valuations – remain stuck in place. This tenuous environment is likely responsible for stocks' inability to make much headway during the quarter. Bonds may be telling a more dramatic story, as rates have declined markedly in recent months. Otherwise, **the burgeoning political drama in Washington adds intrigue, but has yet to be an overriding consideration in the minds of most investors**. This will likely change as the 2020 election approaches.

Resilience…Complacency…Both?

From an investment perspective, we truly live in bizarre times. To wit, year to date, the best performers in the US stock market have been utilities and semiconductors, industries at completely different ends of the business and risk spectrums. From a big picture standpoint, the phenomenon of globalization has lost steam as populist movements reflect growing dissatisfaction with economic distress. Political gridlock, and the inability of politicians to compromise on critical issues such as debt, deficits, and entitlements, or anything at all for that matter, has spawned an era of unbridled central bank power. Originally established to maintain stable currencies and employment, monetary policy mandates have now expanded, unofficially, to include managing the economy and protecting stock markets. In order to accomplish these heretofore unattainable goals, **global interest rates have been consistently reduced for years to zero, and now less than zero, in major economic centers. In fact, $17 trillion of debt is currently priced to offer negative yields**. Beyond this astonishing figure**, a number of unintended consequences are mounting related to the zero rate policy**; one is that yields have been suppressed so much that even some European junk bonds trade at levels where investors have to pay for the privilege of owning them.

Recently, former chairman of the Federal Reserve, Alan Greenspan, said that there is no reason that the US cannot deploy negative interest rates. So, the obvious question is, have these policies worked, or have any chance of working, to repair and regenerate economic growth? **To date, the answer is a resounding no**. Japan is the poster child for this approach, as that country has been stuck in neutral for more than two decades, with a stagnant economy and the highest debt levels in the world. **The only explanation for continuing an ineffective policy is that the monetary authorities believe that they have no alternative**.

A flight to low-risk assets such as US Treasury bonds, and the virtual certainty that the Fed will continue to lower short-term rates, would typically indicate a strong belief in the marketplace that the economy is weakening and growth will be muted going forward. Moreover, additional challenges emerged in September, with oil spiking 10% after Saudi oilfields were attacked, large growth stocks experiencing a brief tumble, and "repo" rates (set by the Fed for overnight loans to banks) surging inexplicably.

Bond prices seem to have it right! Yet stock investors generally took all this in stride. Indeed, it is not a stretch to say that a market that has appreciated smartly this year, together with no material widening of credit spreads between high and low rated bonds, would appear to reflect a reasonably healthy backdrop. **Equity investors do indeed appear resilient and complacent. Like their central bank counterparts, many seem to believe that there is no alternative, in this case, to stocks**. What is clear is that there is considerable demand for safety (quality bonds, low beta, income-producing stocks) and, at the same time, risky investments, as the pursuit of meaningful returns encourages many to own overly expensive growth stocks.

Our Take

Early in 2019 we noted that the bull market in stocks was long in the tooth, ripe for increased volatility, and dependent on three things for its continued success: Interest rates had to remain low, recession must be avoided, and at least modest corporate earnings growth must continue. As we write, rates are indeed low and the economy is still expanding, but profits are not cooperating. We have also previously **noted the historical success of the yield curve in predicting recessions and bear markets**, and emphasized the importance of avoiding an 'inverted' relationship where the two-year yield is higher than that of the ten year maturity. **The 'curve' inverted for a few days during the past quarter, but is currently positive by approximately 10 basis points (.10%)**. There is very little wiggle room in this measure, and the economy is clearly weakening, but the jury remains undecided on the prospects for recession. In addition, corporate earnings have fallen slightly for each of the last three quarters, obviously a negative.

As for other indicators, they remain mixed. The US dollar continues to strengthen, a positive reflection of our economy compared with the rest of the world, but a negative for US exporters who must compete with cheaper foreign products. Recent manufacturing data was the weakest since 2009, but the consumer, a much larger and more important segment, remains on more solid footing. Some point to the recent flops of highly touted initial public offerings (Uber, Peloton), and to one that did not happen at all (WeWork) as a weak sign. In our view, this is actually a bullish development as **investors have become increasingly discerning**, demanding that companies make money no matter how exciting or favorable an organization's products or services may be. Speaking again to the issue of investor complacency, our letters have repeatedly emphasized the importance of sentiment (greed and fear). Guarded is an apt description of current investor psychology; **bear markets rarely begin with this mindset**.

This review focuses on the 'big picture' far more than usual because the dominant themes noted above are critically important to investors. There are, no doubt, numerous reasons for concern; many of them are valid, and stocks may pull back for a time. Yet, **our view is that the current wobbly environment will offer opportunities to invest in excellent companies that should provide solid long-term returns**. **We continue to believe that above average growth and/or dividend yields will attract investor attention and capital**, and our focus will be on identifying the very best companies with long track records of success, competitive advantages, and other time-honored characteristics that will enable them to thrive in good times and bad. Fixed income returns will likely remain muted for some time, as it is hard to envision interest rates moving significantly higher in the near to intermediate term. Again, however, protection of capital will be emphasized and income streams should exceed the level of inflation. **As always, your portfolios will reflect quality companies, forward thinking, and a price sensitive bias**.

We are always interested in your thoughts and questions so please do not hesitate to call.

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