Colchester Investment Counsel LLC

2020 Fourth Quarter and Year-End Review and 2021 Outlook

2020 was a year few will forget from health, social and financial market perspectives. Covid-19 has caused considerable personal distress for so many. We continue to hope that you and your loved ones are healthy and safe.

Throughout the year, amidst the uncertainties caused by the pandemic, we stuck to our process, allowing neither undue pessimism nor optimism to influence our investment decisions. Fear and greed were on wide display, as investors panicked in the spring when stocks tanked, and then rushed back in when they approached and surpassed all-time highs. As always, we endeavored to take advantage of the sharp market decline by purchasing "best of the best" companies that were sold off along with everything else. Moreover, securities that have low correlations to stocks were added to portfolios, both as a defensive measure and because they offer strong risk-adjusted return potential. Now, by definition, with speculation rampant and asset prices having surged, we are near term cautious.

Beyond the healthcare aspect of Covid were many far-reaching consequences. Leaving policy aside, government institutions rode to the rescue to try to support our health and save the financial markets. The economy crashed in the spring, with GDP plunging by nearly one third in the second quarter. Job losses exceeded twenty million, and businesses large and small faced unprecedented uncertainties, as lockdowns forced many companies to close, some permanently. **Financial markets were roiled; stocks crashed 35% in five weeks, interest rates collapsed, with the ten-year Treasury note falling below 1% for the first time, to 0.50%, and the price of oil fell below zero at one point as demand dried up around the world.** Other difficult challenges during the year included social unrest, a record number of hurricanes that exhausted the A to Z naming practice, an absence of basic necessities for a time, and tensions surrounding the polarized presidential election.

Despite an incredibly difficult backdrop, financial assets roared back from their spring swoon. Stocks, bonds, and "hard" assets such as real estate and gold all generated gains in the fourth quarter and for the year. If ever there was a year to convince investors that the economy and stock market are different species, 2020 was it. No doubt, the economy has recovered remarkably in recent months, with unemployment now below 7%, but conditions remain challenging. Yet **stocks have never been as expensive as they are today**. While valuation will likely improve this year as earnings recover, the 'Buffett indicator' below clearly illustrates that equities are expensive, and may be foretelling another difficult period ahead, as it did in 2000 and 2007.

In a nutshell, the euphoric mood evident in equity prices is simply not consistent with the still-troubled economic and social environment, nor with worldwide debt markets that suggest a far less rosy picture. The US is the lone holdout among developed economies with positive short-term interest rates. The amount of negative-yielding debt globally now exceeds an astounding $30 trillion. From a practical standpoint, historically low rates are great for borrowers and highly indebted nations, but a significant weight to bear for pension funds, retirees and banks, never mind most investors who are used to earning 2-5% from their money market and bond holdings.

Markets look to the future, and there is no doubt that vaccines, high savings, and a healthier economy should make 2021 a better year. But these factors are not new, and are likely already reflected in asset prices. Rather, **the Federal Reserve's commitments to low rates and unlimited liquidity programs are seemingly all that matter in the current environment**, and largely explain the record level of stock prices and the run-up in assets that are hedges against higher inflation.

2021 Outlook

There is a time-honored tradition at this time of year for market participants to make predictions for the year ahead. With the disclaimer that we do not have a crystal ball, our views follow:

- **Short-term interest rates should remain low in 2021 but longer maturities (10-30 years) will rise somewhat.** This yield curve "steepening" will result from a return to economic growth, continued massive spending by the federal government, and a weakening US dollar. Bond returns are likely to be modest.

- **US stocks may be highly volatile, with sharp moves in both directions.** If the economy does not recover as expected, no one should be surprised if the Fed institutes negative rates at some point, and even becomes a buyer of stocks, if necessary, to stabilize financial markets.

- **Growth stocks, technology in particular, have seen their best days, at least relative to the rest of the market**. Economically sensitive and steady Eddie companies, most that pay consistent and growing dividends, are primed for a rebound after a long period of poor to modest performance.

- **Prices for most commodities and "stores of value" should move higher.** Energy prices could surprise to the upside as well.

- While valuation does not appear to matter at the moment – some investors appear to be willing to pay any price for a good story – this will change, probably when least expected. As a result, **index returns may well be muted for a period, while certain sectors do well.**

So, what is the basis for these hopefully well-considered predictions?

- As a practical matter, **short-term interest rates, those controlled by the Fed, are unlikely to rise anytime soon because the federal government is, for all intents and purposes, broke, and needs to avoid additional interest expense**. Yes, that is quite a statement, but it is an accurate reflection of US government finances. Incoming Treasury Secretary Janet Yellen was the former Fed Chair and no one knows this better. She is likely to work hand in glove with current Fed head Powell to keep short rates close to zero, or lower. On the other hand, a resumption in economic growth, together with unstoppable government spending and a falling US dollar, likely portends somewhat higher longer-term yields.

- **The psychology of extremes perfectly describes the US stock market in 2020.** From the peak of panic in March, prices recovered dramatically throughout the remainder of the year, rising to record levels during a period of significant uncertainty. In the near term, most of the potential good news coming in 2021 (above-noted unprecedented fiscal and monetary stimulus and vaccines to defeat Covid) has been discounted by the market. Valuation is a poor timing indicator but, as mentioned,

stocks have never been more richly priced. **Of more immediate concern is the frothy sentiment** evidenced by record margin debt (borrowing to buy equities), the momentum in high-growth stocks, one of the hottest IPO markets in history, and the surge in trading by mom and pop investors who are chasing story stocks and speculating in options. **Typically, when bullish sentiment becomes this extreme, stocks are vulnerable to a reversal.** We have seen this storyline play out many times over the years. Yet, while traditional methods of analysis suggest the market is now historically extended, a longer-term view that envisions low interest rates tempers the downside risk.

- **The so called FAANG+ companies, and big tech in general, are not only overvalued, and susceptible to the law of large numbers, but have been the beneficiaries of a wealth of good news for years.** This news is more than priced in at this point, as companies with market caps in the hundreds of billions, or even trillions, simply cannot sustain growth rates in sales and earnings that are necessary to justify current stock prices. Other recent high flyers, favorites of the Robinhood crowd, are likely to fade when their stories change, as they always do. To the contrary, while it is mildly frustrating for investors who care about risk to watch fundamentals being ignored, the pendulum will likely swing back in what we view as a more sensible and rational direction. In this light, it bears mentioning that the performance and valuation spread between "growth" and "value" stocks remains at levels not seen since the 1970's.

- **Admittedly, predicting growing inflation in commodities is not a stretch, as this trend is already in motion. Gold, lumber and other commodities moved meaningfully higher in 2020.** Supporting factors include currency printing, zero percent interest rates, and all-time high debt and deficits coming together to pressure the US dollar. Put these things on top of pent-up demand as the economy recovers and you have a recipe for increasing prices.

- Market dynamics are quite similar today to those in the late 1990's, when speculation took the place of investing. **Valuation meant nothing and greed took over for good judgment.** Timing the inflection point is impossible, particularly with the above-noted tailwind of low interest rates and unlimited Federal Reserve support but, **at some point, investors will care about risk again**. **It also seems reasonable to expect that, with meaningful income hard to come by, stocks offering solid and dependable dividend yields will attract favor.** Lastly, investing contrary to the crowd has proved successful for generations, especially when the crowd is in a euphoric state.

Your portfolio is chock full of high quality securities, and is sufficiently diversified to both weather difficult environments and prosper over any meaningful time frame. Knowing this will hopefully allow you to endure future market shocks, feel good when we take advantage of opportunities presented during these periods and, as a result, enjoy your lifestyle both before and during retirement.

As always, your thoughts and questions are appreciated.

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