Colchester Investment Counsel LLC

2021 First Quarter Investment Review

US stocks moved higher in the first quarter of 2021 due to a recovering economy, dramatically improved COVID-19 case statistics, a tsunami of liquidity and, most importantly in our view, a surge of euphoria among smaller investors. The market rise overwhelmed a number of potential headwinds, including increasing interest rates, growing inflation expectations, heretofore unimaginable levels of government debt, and the likelihood of both higher tax rates and growing regulatory burdens. Continuing a trend dating to late 2020, "value" and small capitalization stocks led the advance, while some of the perennial winners of the past decade lagged. **Short and intermediate-term fixed income returns were flat for the quarter** as income from bond holdings offset modest price declines caused by the aforementioned jump in longer-term interest rates. It should be noted that long-term bonds, which you do not own, sustained substantial price declines.

What We Know

- Thankfully, **COVID-19 hospitalizations and deaths have fallen dramatically** in recent months:
    - Better treatments, the roll-out of vaccinations, and the reopening of industries hardest hit has helped the economy and markets alike.
- **S&P 500 earnings growth will likely be outstanding** in 2021:
    - As of this writing, S&P 500 company earnings are expected to grow 28% in 2021, coming out of a recession and surging on the back of pent up demand.
- **Liquidity supporting financial markets and the economy are at unprecedented levels**. The government (Congress and the Federal Reserve) will be exceedingly accommodative in 2021, and likely well beyond:
    - **The Fed has committed to keeping short-term interest rates near zero until at least 2023**, and buying $120 billion of bonds every month. Moreover, Congress recently passed a $1.9 trillion stimulus bill, and has another $3 trillion plus in the works for later this year.
- **Stocks are as expensive, and interest rates as low, as they have ever been** (see table and chart on page 2):
    - **By most every valuation measure, stocks are excessively valued. At current interest rate levels, bonds offer modest return potential.**
- **Over 40% of the money ever printed in the entire history of the US was printed in 2020**:
    - **With the exception of World War II, there has never been anything like this period**. Stimulus during World War I, the Great Depression, and the Great Recession of 2008-2009 all pale compared with the policy initiatives related to COVID-19. Curiously, and **unlike any of the prior occasions, this liquidity injection is occurring during an economic recovery**.

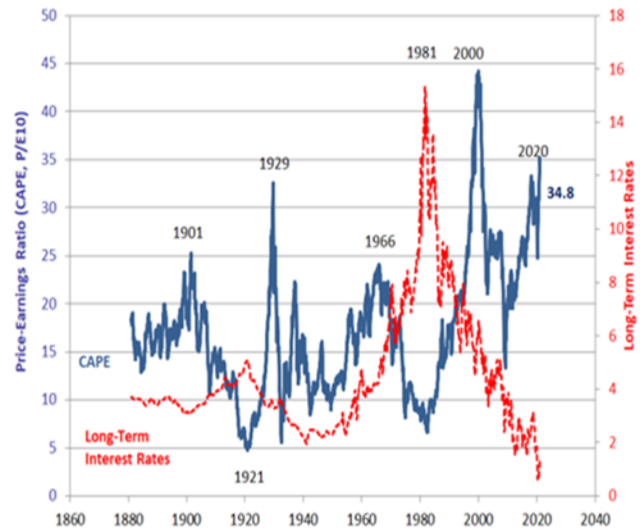
- **Investor optimism has reached the manic phase**:

  - Individual investors continue to open record numbers of new accounts. The activity in penny stocks and options trades is at all-time highs, and social media is the source of many stock ideas for this crowd. Remarkably, small investors now account for about 25% of stock market trading, up from 10% a decade ago. **Having experienced, and invested through, the crazy speculation of the dot-com bubble, this period has a similar feel. History shows that this kind of euphoria does not end well**. Indeed, for example, the NASDAQ fell 82% between the March 2000 peak and the bottom in 2002.

S&P 500 Valuations

Model Factors	Most Recent Value	Historical Percentile
Median EV to Sales (Ex-Financials)	4.0	100%
US Total Market Cap to GDP	170%	100%
EV to Free Cash Flow Margin (Ex-Financials)	48.8	100%
Median Price to Sales	2.8	100%
Median Price to Book	3.9	100%
Median EV to EBITDA (Ex-Financials)	15.0	100%
Aggregate EV to Sales	3.0	100%
Aggregate EV to Trailing 12M EBITDA	17.5	100%
Aggregate EV to 2021 EBITDA Estimate	15.9	100%
Aggregate Price to 2021 Book Value Estimate	3.8	100%
Aggregate Price to Tangible Book Value	12.8	100%
Aggregate Price to Earnings	27.9	98%
Cyclically Adjusted P/E (CAPE)	32.9	97%
Aggregate Price to 2021 Earnings Estimate	25.6	97%
Aggregate Price to Book	3.9	91%

Source: Bloomberg, Yale/Robert Shiller, John Hussman | *As of November 2020 | © 2020 Crescat Capital LLC



<u>What We Know That We Don't Know</u>

- **How long can asset prices remain unhinged from fundamentals**?

  - **Stocks and bonds (some "junk" bonds currently yield less than 4%) are priced for perfection, despite being clear to most observers that the underpinnings for these prices are not perfect**. While certainly reflective of growing risk, market bulls accurately note that valuations have been high for years, and are not a good timing tool. What has been missing until recently, and is **the single most dependable feature of the great bubbles through history, is reckless investor behavior**. A lengthy list of examples is available, but the chart that follows plainly illustrates that **'common sense' has been replaced with 'nonsense'**. Smaller investors have recently purchased as many unprofitable companies as they did in the late 1990's, but in dollar amounts three times as large. Consistent with these actions, many of these buyers admittedly believe that investing is a game.

- **How long can interest rates stay "lower for longer"? And, how high might they climb?**

  - Those who are maximum bullish on stocks these days argue that high valuations are justified by low interest rates. While the two-year note yield is little-changed since year-end 2020, the 10-year Treasury note rose from 0.9% to 1.7% at quarter end. At what point will investors move some money out of stocks and back into bonds? Will the Fed start buying long-dated bonds to control their yields?

- **How much debt can the US issue before serious consequences occur?**

  - US government money printing and spending should have their limits. **At some point, investors are likely to balk at policies that have never been successfully sustained**. The **consequences could be higher interest rates and inflation and, potentially, a challenge to the US dollar** as the world's reserve currency.

Put simply, **there is no way to pick a market top, or anticipate when a bubble will burst. Yet, all of the telltale signs are present to suggest that heightened caution is warranted**. No crystal ball is available to tell us when stocks will turn down, and it is not useful to guess. What is valuable is being prepared for a wide range of potential outcomes, and owning assets that can withstand various scenarios. **Our goal with this review is not to alarm, rather to inform, and to confirm long-term goals**. All, including us, will be delighted if our concerns are misplaced, and equities continue to be rewarding. But, clients should be equally pleased if portfolios are constructed to withstand the challenging period that may occur before too long.

At this time, your portfolios should reflect equity exposure near the low end of our agreed upon allocation range. As well, ownership of alternatives that hedge portfolio risk should be near the high end. The quality of your stock holdings is outstanding, meaning that these companies will not only survive a difficult period, but emerge even stronger in the long run. Indeed, our **clients' portfolios have never been more focused on best of breed**. Likewise, your bonds are solid credits subject to minimal risk. As always, please call us if you have any concerns about your allocation to any asset category, or with any specific investment.

If we enter a more turbulent investment environment in the near future, please remember the last two classic bear markets, those of 2000-2002 and 2008-2009. Both were uncomfortable, but also cleansing, and in each instance, portfolios recovered and prospered. Markets must expunge excess from time to time, usually about once a decade, and we are due. **Our discussions have noted regularly that markets rise two-thirds of the time, and fall the other third. It is critical to endure the latter in order to profit from the former. Owning great companies and prudently structured portfolios should mute the discomfort of down markets, and establish a foundation for solid investment returns over time.**

Please call with any thoughts, questions or concerns.

Neil S. Kenagy, CFA

Note: There were no material changes to our Form ADV in 2020. A copy of our Form ADV Part 2 is available upon request.

440 Main Street
Ridgefeld, CT 6877

www.colchesteric.com

Phone: (203) 438-0046
nsk@colchesteric.com