Colchester Investment Counsel LLC

2021 Second Quarter Investment Review

US stocks marched higher in the second quarter, showing remarkable resilience in the face of considerable headwinds, including rapidly rising inflation, a more hawkish stance from the Federal Reserve, and the potential for market unfriendly tax policies. Widespread rollouts of COVID vaccines have unleashed a swift and broad reopening of the economy, supporting investor sentiment along the way. Curiously, in light of the economic resurgence, longer-term interest rates have retreated recently, leading to positive bond returns in the quarter.

What Has Changed?

The considerable evidence supporting our cautious market view with respect to risk and reward has not changed, but certain factors at play have. For one, **in the first quarter, we wrote of inflation fears and expectations, and discussed the uncertainty surrounding how markets might react were higher inflation to materialize. Today, we write that inflation has indeed emerged**, and investors are now focused on how high it will go and how long it will last. Consumers have certainly taken note of rising expenses for basics, such as gas and groceries, and even Federal Reserve Chair Powell has acknowledged that climbing prices may be more persistent than previously thought. Growing inflation should result in higher interest rates and lower price/earnings multiples for equities. Indeed, stocks came under pressure for two days following the Fed's change in perspective, but have since apparently been convinced by the "inflation will be transitory" theme.

Another "change" involves the character of the stock market itself. While "value" has outperformed "growth" since COVID vaccines were released last fall, **growth reasserted its leadership in the most recent quarter**. Lower interest rates have aided several of the dominant technology issues that largely determine the direction of the S&P 500. Less followed, but **of equal importance, the technical underpinnings of the market have deteriorated of late**. Fewer stocks are again supporting the rise in the major averages. At the end of June, just 15% of S&P 500 stocks reached new highs along with the index itself and, for the first time since 1999, a record closing high occurred with less than half of the stocks above their 50-day moving averages. Our conviction remains that market leaders in coming years will likely differ from those of the previous decade, but there will always be short-term reversals in such trends; this is why **client portfolios are designed to be "all-weather", with a healthy balance between growth and value**.

Perhaps the most considerable change that occurred in the second quarter was the direction of interest rates. After rising sharply through most of 2020, and into April of this year, the ten-year US Treasury Note yield fell back toward 1.5% as of June 30. **The head-scratching question is why interest rates would be dropping in the face of soaring corporate profits, strong economic growth, and much higher inflation**. To say that this data is inconsistent with lower interest rates is a grand understatement. Although the majority of above-noted headline indicators might suggest otherwise, **it is possible that the bond market is telling us that the recent bump in inflation will indeed be temporary. It is also equally conceivable that peak earnings and economic activity have been seen for this cycle, and that fundamental data points will weaken from here**.

What Has Not Changed?

Stocks remain expensive, investors complacent and interest rates low. Despite the myriad challenges and uncertainties of the past 15 months, market volatility is nearly as low as it was just before the COVID pandemic sent the global economy and financial markets into a tailspin. **It is a futile undertaking to predict the catalyst for the next market downturn, but no one should doubt that it will come. There are simply too many significant signs of a topping process** to ignore, including:

- **The fact that virtually no fear is reflected in current valuations or, more importantly, investor behavior**. This lack of concern leaves markets susceptible to outsized shocks on most any disappointing news;

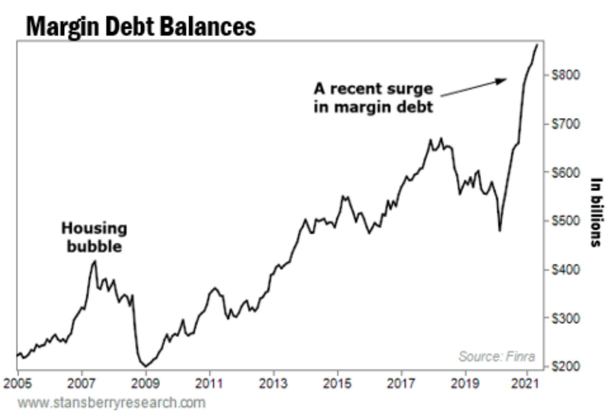
- **The heightened presence of retail investors**, many of whom are young and inexperienced, is also of concern. These individuals historically come off the sidelines very late in market cycles, and have little understanding of, or concern for, risk;

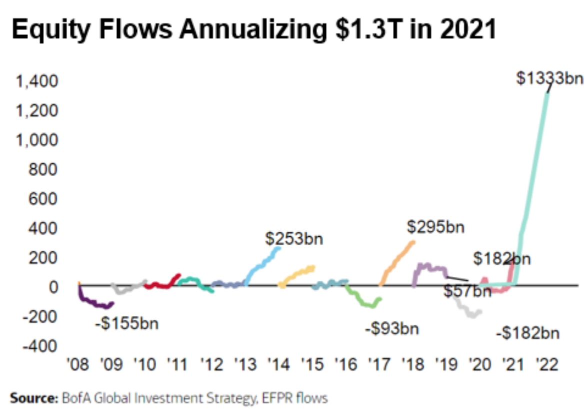
- **The risk reflected in the enormous spike in leverage** (left chart below) being used to purchase stocks reinforces the trend of reckless behavior discussed in our first quarter missive, as investor enthusiasm continues to progress along the spectrum toward ever-treacherous euphoria;

- The yield spread between safe treasury securities and the riskiest junk bonds dropped below 5% recently. **This has occurred only twice in the last two decades: prior to both the dotcom bubble and the 2008 - 2009 financial crisis;**

- **Company insiders selling stock** at a pace far greater than ever before;

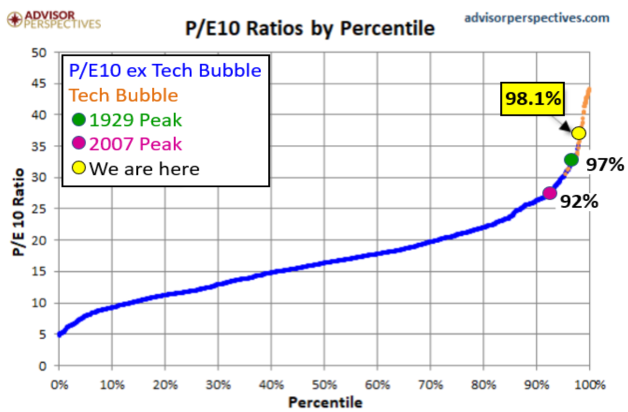
- **The Fed's unprecedented easy money policies** have spurred an historic surge into stocks (right chart below). This illustration reflects net buying of global equities in each year since 2008. Indeed, if this trend continues at its current pace, 2021 will witness greater net stock inflows than the preceding 20 years combined.

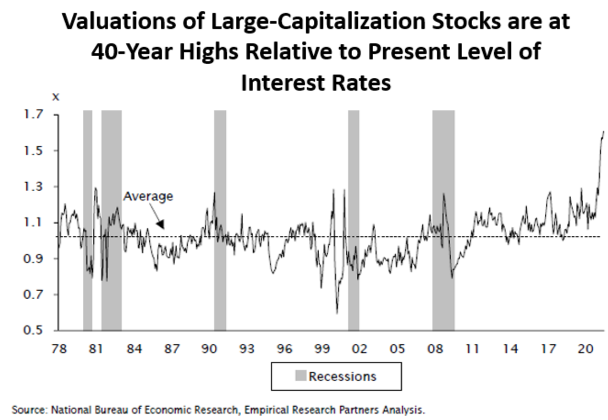




All of these elements - rampant speculation, all-time high valuations, historic fund allocations into equites, and new highs in the major averages - have been driven almost exclusively by government stimulus and central bank money printing policies. It was no surprise to see record sums of liquidity generated to meet the shocks created by the pandemic last year. It is, however, astonishing to see even larger amounts created in recent months, when the magnitude of the pandemic is now clear, and economic and employment conditions have dramatically improved.

In addition to ebullient sentiment indicators, valuation metrics are similarly stretched. The cyclically adjusted price/earnings multiple on the S&P 500 is still in the 98th percentile, and forward-looking P/E's have rarely been this extended, both on an absolute basis and relative to interest rates (see charts below). **A common narrative these days is that low rates justify current equity valuations. The right hand chart would suggest otherwise**. Remarkably, high P/E ratios become even more challenging when inflation is taken into account. Since 1871, when inflation has been 5% or higher (as is the case today), the P/E ratio on the S&P 500 has never exceeded 22. Today it is above 30. Moreover, valuations have always started to contract when inflation has topped 3%.





While there is no telling how high stocks may rise in the near term, with so many risks and uncertainties evident, it seems reasonable to err on the side of caution. Yet, **we are cognizant that the factors supporting stocks (low interest rates and a highly accommodative Fed) may continue for some time**. As the old saying goes, history does not repeat but it often rhymes, one reason why having many years of investment experience is so valuable. **Trends, especially those that seem irrational, often last far longer than expected, but the end result is always the same.**

Even more than usual, this letter has focused on the risks that confront today's investors. Similar to last quarter's review, our aim is not to alarm, rather to ensure that our clients are aware of the significant issues that we believe are important. Valuation, in and of itself, is not an effective timing tool, as investor emotions always drive these measures to extremes; however, it is valuable in assessing potential future returns. Client equity allocations, portfolio hedges, and best-of-breed securities remain consistent with our guarded market view. These are unique times in the investment arena, but adherence to our disciplined, long-term approach should provide a strong foundation to achieve solid, risk-adjusted investment returns over time.

As always, **we encourage you to call with thoughts or concerns.**

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