The Colony Group

OUR VIEW

JANUARY 2024

2023 Review

Last quarter we stated (Our View Q3 2023), "There are times when the market is intensely focused on just one thing, and currently, it is interest rates." This phenomenon was on full display in November and December when Federal Reserve members remarked they may be done raising rates causing the U.S. equity market to appreciate by 15%, ending the year up 26% (Table1). Financial markets are anticipatory and focus on whether the environment is getting "better or worse" rather than if it is "good or bad." The unequivocal reaction of both the equity and bond markets in the last two months of the year indicates that the inflation picture, and interest rate environment, is getting "better."

Many economists predicted there would be a recession in 2023; in fact, the opposite occurred, nominal U.S. GDP growth exceeded 5% and the misery index[1] approached 60-year lows. Not all was good however, as a mini banking crisis in February and March offered up sizable casualties such as Silicon Valley Bank and First Republic, due to a combination of balance sheet mismanagement and eleven Fed rate increases, amounting to a 525 basis point increase in the Federal funds rate. To many investors bank failures evoked memories of the 2008-2009 financial crisis, but those concerns were short lived as regulators swooped in to minimize the risk of contagion. Instead, it was fears of sticky inflation in the late summer and early fall that led to the 10-year U.S. Treasury bond yield reaching 5%, and equity markets selling off.

Market Performance

	2023
U.S. Equity	25.9%
International Equity	16.2%
Global Bonds	5.7%
U.S. Bonds	5.5%

Source: Bloomberg. Total return. Table 1

Even so, with subsequent benign inflation data and the Fed's "pivot" in the fourth quarter, the S&P 500 ended the year a whisker below its all-time high, driven by the "Magnificent 7"[2] which contributed 60% of the S&P 500 gain. These oligopolies benefitted from their exposure to artificial intelligence (AI), the primary theme of the year. It is notable that the U.S. equity market melt-up was driven by earnings multiple expansion and not earnings growth, which is expected to be modestly negative for the year. Expanding valuation multiples, over four multiple points on trailing earnings, are rare when rates are rising, a sign of how unusual 2023 was.

[1]The Misery Index is a combination of U.S. unemployment and inflation rates.
[2]Magnificent 7: Apple, Microsoft, Amazon, Nvidia, Meta, Tesla, and Alphabet (aka Google).

2024 Preview

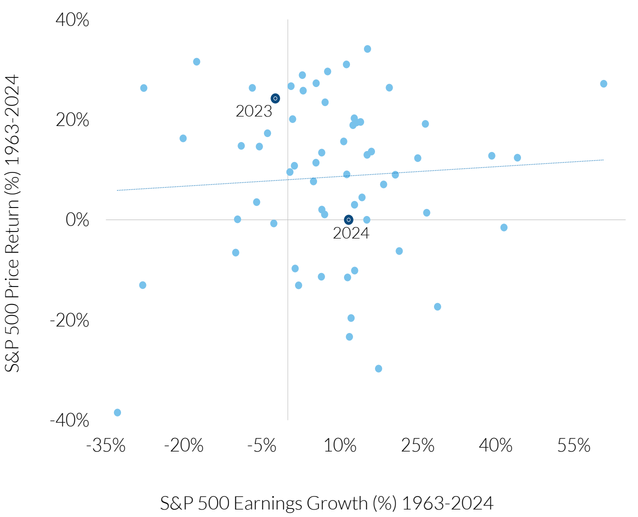
Over 60 countries expect to hold elections in 2024, impacting half of the world's population. The U.S. presidential campaign is revving up with the Iowa caucus in mid-January. While voters will have the ultimate say, there are several important court decisions which may impact the election prior to November. While the spring election in Russia is pre-determined, elections in India, Taiwan, and Mexico are all noteworthy for investors. In India, for example, Prime Minister Narendra Modi remains extremely popular in opinion polls and will likely be re-elected to a third term in office; a preferred outcome for Indian equity markets that achieved an all-time high in 2023.

With the worst of the inflation data behind us, the recent equity and bond market rallies indicate a soft landing is now the expected outcome. Equity markets tend to perform well when the Fed is on hold. Rate hikes are almost always bad news for equity markets. We saw evidence of that in the 1970s, during the GFC, and more recently in 2022. The trickiest environment is when the Fed cuts rates, leaving investors to consider the underlying reason(s) why. When rate cuts were due to an economic slowdown, recession, or from restrictive levels they were beneficial to equites, as seen in calendar years (e.g., 1982, 1985, 1989, 1991, 1995, 1998 and 2019). However, there are times when other exogenous circumstances are paramount and drive equity markets lower such as 2000-2002 and 2008.

Earnings growth is expected to be approximately +11%[3] in 2024 after a 2% decline in 2023. Growth in corporate earnings is likely if the U.S. economy experiences a soft landing and inflation continues to decline. Expanding revenues and stable/lower costs equate to better corporate margins. Of course, earnings growth does not always equate to a strong stock market in any single year (Chart 1), but it does support valuations and fuels market returns over longer periods of time.

Today, private lenders are seeing the best supply/demand conditions of the past decade and 2024 may be a year to consider additional exposure to private credit opportunities. It has been like Waiting for Godot when it comes to finding attractive credit opportunities. The banking crisis in early 2023 led to tighter lending standards from traditional lenders, such as banks. Tighter credit and the resulting higher rates make it harder to finance debt and that equates to a better yield for private lenders. A pure distressed credit cycle is not upon us yet as large corporate defaults are still rare and economic growth remains positive. However, if the global economy slows down or falls into recession, it is likely we will see an increase in defaults, credit spreads widen, and further credit tightening from traditional lenders, that would lead to better opportunities for private lenders.

Chart 1: Growth and Return Have a Modest Correlation



Source: Bloomberg.

From the Internet to AI, Innovation will be Relentless

In the late 1990s into the early 2000s there was a parabolic rise and fall of fortunes related to the advent of the internet, leading to the term "dot.com bubble." We

[3]Source: Bloomberg.

believe this term is a disservice to the ultimate result: a massive gain in productivity; commerce; and more efficient ways for businesses to operate and consumers to shop. These step functions are rarely fully understood in their early days. In 2023 we saw a few very dominant companies with global footprints and the financial capacity to invest in the future of AI be rewarded for what may evolve. Undoubtedly, some of these companies will be leaders in AI due to a combination of first mover advantage and technological excellence. However, one should not presume that the current small handful of companies will be the only winners.

We have written about innovation before (Innovation is the New Moat) and we think that the pace of innovation will only increase as AI becomes more ubiquitous, expanding beyond just a narrow technology centric world. Other beneficiaries will include healthcare therapeutics, where AI will help save time in the R&D process, aggregating and analyzing data for successful outcomes with a substantial reduction in time, trial and error, and cost. AI also should help analyze more immediate and massive challenges including carbon capture and food production options that optimize water usage for land, and better utilize our oceans. Another area of innovation that is well underway and yet still nascent is the production of less well-known clean energy options including small fusion reactors, superconducting magnets, and geothermal breakthroughs. The future is exciting with vast potential in materials science and other industries as well.

Additionally, the supply and demand dynamics for many economic minerals will radically evolve, creating new opportunities and some geopolitical challenges. Some jobs will transition or be repurposed, as has happened many times throughout history, but not without human and economic impact. Our conclusion is that the pace of change is accelerating and there will be tremendous investment opportunities as we solve and resolve the many challenges and opportunities we have before us.

Looking Forward

While financial market participants have already opined that the current inflation cycle is ending, if not over, the final script for inflation is not yet complete and we note the dispersion across final outcomes could be meaningful. A scenario where inflation reaccelerates or remains stubbornly high is likely the most negative for the equity and fixed income markets. Conversely, a soft landing may catalyze areas of the equity market that have lagged in recent years such as smaller cap companies and international equities (Table 2), the latter of which has been negatively impacted by a strong U.S. dollar.

Historical Performance

	Trailing 5-Yr	Trailing 10-Yr
U.S. Large Cap	15.7%	12.0%
U.S. Small Cap	9.9%	7.1%
MSCI ACWI ex-U.S.	7.7%	4.4%

Source: Bloomberg. Data as of 12/31/23. Total returns are annualized. Table 2