The Colony Group

OUR VIEW

JULY 2022

Global equity and fixed income markets were uniformly negative in the second quarter building on declines in the first quarter (Table 1). The U.S. equity market had its worst first half of the year in over 50 years with plenty for investors to worry about this year: higher-for-longer inflation; central banks raising rates; the Ukraine war; and growing concerns of recession. We may look back at this quarter and mark it as the inflection point where fears of a recession surpassed inflation concerns. One can see evidence of this in the shape of the U.S. Treasury yield curve with its relative flatness (Chart 1) and widening corporate bond spreads.

Q2 Equity Market Returns

	Q2	YTD
U.S.	-16.7%	-21.1%
Non-U.S.	-15.1%	-19.9%
Europe	-13.6%	-20.3%
India	-13.3%	-14.9%
China	+3.5%	-11.2%

Source: Bloomberg. Table 1

Equities

The significant decline in global equity prices has equated to a reduction in valuation. At the start of the year the S&P 500 was at 20.8x 2022 consensus earnings, today it trades at 16.5x earnings. U.S. equities now trade at an average multiple for the last 50 years, but there is a risk that earnings estimates for 2022 and 2023 are too high and will be revised lower. Economic growth is slowing in the U.S. which will in turn lead to a decrease in revenue growth rates. We also observe that corporate expenses are increasing via higher wages, raw material, and energy costs. Add to that a strong U.S. dollar and the potential for an increase in corporate taxes, and it becomes hard to conclude that corporate America will not experience margin compression and lower expected earnings. Despite these observations, consensus earnings estimates have not been revised lower, perhaps increasing the pressure on corporate management teams in their Q2 and full-year guidance.

Fixed Income

Investors who enjoyed a nearly 40-year tailwind for their bond investments have been startled to find bond declines that are meaningful and highly correlated to equities (Table 2). While it isn't surprising that bonds would generate modest returns from historically low levels of interest rates, the magnitude and stickiness of inflation has been the primary driver of poor bond returns. Contributing to the stubbornly high inflation numbers have been persistent supply chain issues, some caused by the Covid pandemic, and new ones caused by the war in Ukraine. Some of the supply chain issues are likely to be resolved in the near term, but many of them remain indeterminate in duration. Factors such as the move to deglobalize parts of critical supply chains adds to longer-term inflationary pressures and general uncertainty.

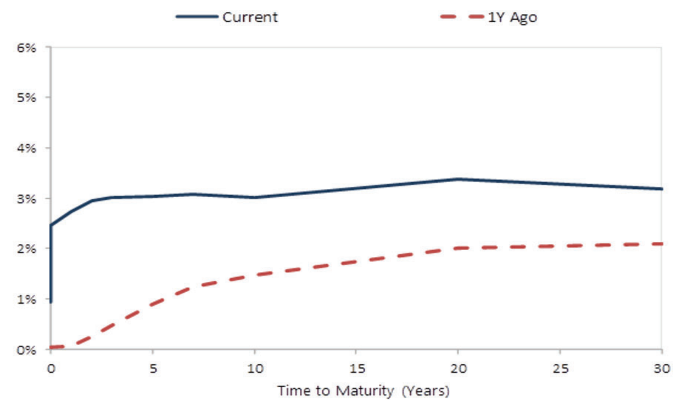
Q2 Fixed Income Returns

	Q2	YTD
U.S. Aggregate	-4.7%	-10.4%
Global Aggregate	-8.3%	-13.9%
High Yield	-10.0%	-14.0%
Treasury 20+ Years	-12.6%	-21.9%

Source: Bloomberg. Table 2

Two important issues are likely to have an impact on bond prices and yields over the long-term. The first is the advent of quantitative tightening (QT), the unwinding by the Federal Reserve of its $9 trillion balance sheet comprised predominantly of U.S. Treasuries and mortgage-backed securities. On the surface one might logically assume that QT should have the opposite impact that quantitative easing (QE) had, and thus bond yields should rise as the Fed sells its existing holdings. Realistically though, nobody knows the impact this will have on bond yields and the shape of the interest rate curve. It does, however, signal an end to excessively easy money, assuming the Fed follows through with its plan.

The second potential impact to bond yields comes from the U.S. government "weaponizing" the U.S. dollar. Treasuries have always been the safe asset to buy when the world ran into trouble. Today, foreign buyers of U.S. Treasuries may be more reluctant to buy for fear of having their assets confiscated, therein removing the marginal buyer of the asset, lowering demand, and potentially leading to higher yields.



Source Bloomberg, 6/30/2022. Chart 1

Portfolio Positioning

Market downturns are, of course, a natural part of investing, and there are several important tactics investors can implement to help manage through the current volatility:

- Quality – Stay invested in businesses and balance sheets that can self-finance their growth in any economic environment, independent of the capital markets. Excessively leveraged companies may not survive a downturn, while those with the best balance sheets and attractive business models will be share gainers.

- Geography – The U.S. has the world's reserve currency, is home to many of the best managed businesses in the world and is now substantially energy independent and a net exporter of oil and gas, in our view, an advantage in a world awash in energy sourcing concerns. We believe the U.S. also has an advantage as it is geographically distanced from its enemies. Europe unfortunately has none of these advantages. Europe's dependence on Russian oil and gas is now revealing a major strategic flaw, one that limits the European Union's policy options and makes it particularly vulnerable to inflation. An increase in interest rates to fight inflation will create pressure on the southern countries (e.g., Italy), as would a decrease in bond purchases by the ECB. Hence, Europe finds itself between a rock and a hard place. In addition, proximity to the Ukraine war also means direct exposure to refugee issues and a humanitarian crisis that cannot be avoided, a cost both economically and philosophically.

- Bond Duration – The market's perception of the risks between imbedded inflation and a recession creates a tug of war over the duration of bonds to hold. The strength and timing of that signal will likely be opaque. However, one can observe that very long duration bonds (see Treasury 20+ years in Table 2) have generated an equity-like drawdown this year, an unwelcome surprise to investors. If inflation stays stubbornly high, or we have stagflation, it is likely that long tenors/duration will continue to exhibit higher risk without the benefit of higher yields.

- Diversifiers – Investments that are uncorrelated to equities and fixed income will be valuable in the current environment, lowering portfolio risk with distinct drivers of potential returns. A true diversifier is a niche investment, hard to access, and provides uncorrelated returns in most market environments, avoiding the crowded areas of the market subject to massive swings in liquidity.

- Cash – We remain comfortable holding above average cash levels with the intent of redeploying the cash when the market offers opportunities to do so at attractive valuations.

Looking Ahead

The uncertainty of the Ukraine war, sticky inflation and rising recession risks have caused wariness for many investors. However, the market is discounting some of these risks in current prices. Despite the market's reaction to great uncertainty this year investors should be planning for the opportunities that will become available. Some potential catalysts we are focused on include:

- Supply Chain – A resolution of the supply issues created by Covid, and exacerbated by the Ukraine War, would reduce issues impacting critical industries like energy, basic materials, agriculture, and technology, and begin the process of a deceleration in inflation, relieve pressure on central banks to increase interest rates, and benefit equity markets.

- Yield Curve – When interest rates are rising rapidly the negative impact is magnified as borrowing costs rise, uncertainty around the availability of capital increases, capital projects are delayed or canceled, and the discount rate for equities increases, lowering overall valuations. As we noted, the long end of the yield curve has numerous forces impacting it; however, when a recession is imminent, yields often decline as a precursor to economic weakness. An equity market bottom will often occur during this time and before the economic data confirms a recession.

- Valuation – Bear market valuation multiples often decline below historic averages due to prevailing uncertainty. Currently, valuation multiples have rapidly approached "average" but have not reached "compelling". A meaningful reduction in consensus estimates would remove an obstacle.

- Capitulation – It is virtually impossible to predict exact market bottoms, however volatility indices provide some indication of opportune times to buy equities. Typically, an extended run for the VIX above 40 indicates significant market volatility and a shifting of ownership from weak hands to strong hands, aiming to benefit those who have time and patience.

With equity markets down over 20% many investors will resort to emotions to guide their investment decisions. The heightened concerns of recession do not guarantee a recession is either imminent or probable. While some economic data is decelerating, other indicators such as monthly payroll additions suggest an economy that is still growing. Now is not the time to use your gut or your heart, but rather one's head. We believe today's risks are tomorrow's opportunities, staying attentive and disciplined will pay dividends.

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