The Colony Group

OUR VIEW

OCTOBER 2022

For the first time since the mid-1970s investors have experienced three successive quarters of negative returns for both U.S. stocks and bonds, a tough year by any measure. The most material difference for investors is that for forty years they have expected a negative correlation from bonds when stocks sell off; however, since interest rates and bond yields hit extraordinary lows during the pandemic this has not been the case. The U.S. bond market is having its worst year in modern financial history including the high inflationary period of the late 1970s when high absolute yields provided some offset to significant price depreciation. While the absolute yield level and corresponding rates remain low in comparison to then, the recent increase in rates and yields is material as complacency around “lower rates for longer” recedes.

Market Returns

	Q3	YTD
U.S. Equity	-4.5%	-24.6%
Non-U.S. Equity	-9.8%	-26.2%
U.S. Bonds	-4.8%	-14.6%
Non-U.S. Bonds	-6.9%	-19.9%

Source: Bloomberg. Table 1

Inflation and Interest Rates

Central bank policy related to the taming of inflation is today’s critical issue impacting investor returns and risk tolerance. In our view, once investors believe the Federal Reserve and other central banks are making meaningful progress towards controlling inflation, the pressure to raise interest rates will subside, a new investment cycle will begin, and both stocks and bonds will appreciate. It takes time to tame inflation and it is paramount that more permanent components of inflation (e.g., wages) do not take root. This explains the recent change in the Fed’s script and tone expressing a willingness to sacrifice growth (e.g., jobs) to ensure inflation does not proliferate.

U.S. Dollar Strength

A second order effect of high inflation and the Fed’s response has been extreme strength in the U.S. Dollar, which has appreciated 17%[1] this year versus a basket of global currencies. The practical implications for investors, beyond the headwind to U.S. based exporters of goods

[1]Source: Bloomberg. DXY Index.

and services, is the ensuing liquidity and credit squeeze this puts on other countries. A strong dollar may be great in terms of paying for your trip to Europe, but it is stressful for the rest of the world, which inadvertently imports inflation and has higher debt servicing costs for dollar-denominated debt.

Recession Expectations Increasing

The broad U.S. Leading Economic Indicator index (LEI) has recently turned modestly negative. Some leading indicators, like the yield curve and the stock market are clearly negative, while others like manufacturing jobs, durable goods orders and building permits are decelerating, or have recently turned negative. One tangible example of the impact of higher rates on the economy is the housing market where a 30-year fixed mortgage, which at its pandemic low carried a 2.9% annual interest rate, now has a rate of roughly 7.0%.[2]

We expect the housing market will eventually reset as demand slows and home prices decline enough to bring the market back into equilibrium but this is a process that takes time and housing activity feeds through to other parts of the economy, all of which will be impacted negatively.

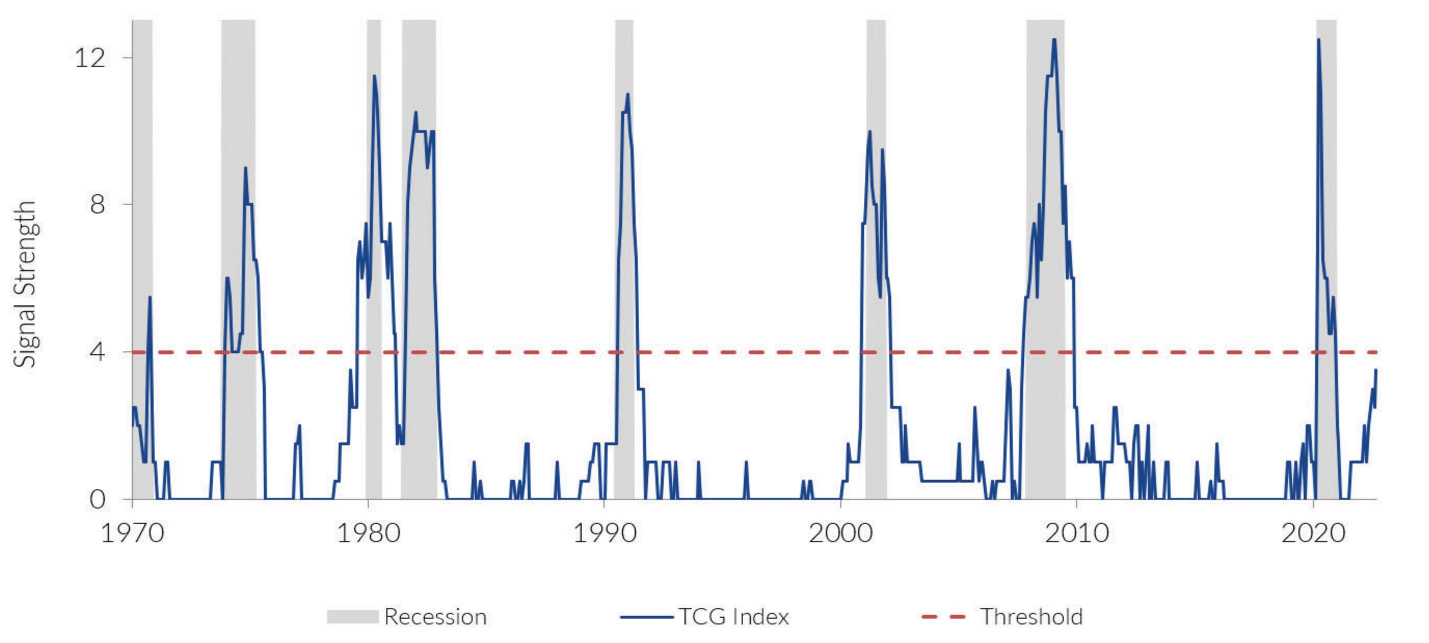
Our own proprietary tracking of a dozen domestic recession indicators (Chart 1) shows an increase in economic stress to a level that is close to, but has not reached, the threshold for the start of a recession. While it does not predict the exact timing of recessions it has a good track record of signaling the eventuality of a recession.

An Updated Report Card

Last quarter, we mentioned several signs we were looking out for to determine a favorable time to add to risk assets

[2]Source: Bloomberg as of 9/30/22.

Chart 1: TCG Recession Index



in portfolios. A current accounting shows some progress:

• Inflation – we are seeing some improvement in supply chain issues and a mild deceleration in headline inflation, although the absolute level of inflation remains high.

• Yield Curve – rates are materially higher than three months ago, and the yield curve has shifted upward while also inverting. We have not seen tangible evidence yet that the Fed will pause or stop increasing rates.

• Earnings Expectations – consensus expectations for 2023 are too high and have not adjusted for the higher cost of goods and wages, higher borrowing costs and the relative strength of the U.S. Dollar, all of which will lead to margin compression. Recently, earnings estimates have begun to move lower, which we see as a positive move toward more realistic expectations, even if the consensus still has not fully adjusted to reflect the impact of an economic slowdown.

• Valuations - lower stock prices and higher earnings this year have moved equity valuations from expensive to just below the fifty-year historical average, at 14.8x calendar year 2023.[3]

• Capitulation – the volatility index (VIX) has steadily risen since mid-August indicating increasing investor concern and some capitulation. We believe a higher level is worth watching out for as a further increase may signal broader investor capitulation and an opportunity for long-term investors.

India

Our efforts to uncover long-tailed investment opportunities leads us back to one of our favorites, the Indian equity market. It remains under-followed, under-appreciated, and a compelling long-term opportunity, especially when investors are focused on short term risks. When considering India, most investors are susceptible to the bear synopsis: economic achievement versus China has been modest; the Rupee is a "weak" currency; the economy is susceptible to higher oil prices; and the slow pace of meaningful economic reforms. While there is a degree of truth to these concerns, the contrarian view is the more appropriate conclusion, and therein is the opportunity.

• India is currently the fifth largest economy in the world, with the potential to become the world's third largest by 2030, with expected real GDP growth of 6-7% in 2022 and 2023, far faster than the developed economies of the world, including China.

• Prime Minister Modi's reforms of the past seven years are paying dividends. Tax collections are up 26% to the highest level in history, home and auto sales are strong, and retail sales are 20% above pre-covid level. The country enjoys high foreign exchange reserves, low foreign-held debt, and growing exports.

• Manufacturing is enjoying significant momentum, thanks to production-linked incentives, tax breaks and a growing desire by international firms to reorganize their manufacturing supply chain away from China (the so-called "China+1" phenomenon).

• India also has the most attractive demographic profile of any large nation or economy, a characteristic that could provide benefits for many years to come.

• The Rupee has depreciated 9% this year versus the U.S. Dollar but that is much better than developed market depreciation of the British Pound, the Euro, the Japanese Yen, and the Chinese Renminbi.

• Historically, high oil prices have created headwinds for India, but the recent fall in oil prices diminishes this issue. Inflation, currently around 7%, is lower than the United States or Europe.

The India growth story has started but it remains early days for investors who can access this market through both the public and private markets, and where active

[3]Source: Bloomberg as of 9/30/22.

management can provide meaningful excess return potential relative to the indices.

Looking Forward

Flight or fright is a normal human emotion especially when it comes to financial market turmoil. It is important to remember that markets are forward looking, and they will turn positive before the economy. Inevitably, the weaker hands in the market will capitulate and sell at the wrong time, creating opportunities for those who are willing to take a longer-term view. Our internal discussions reflect increasing investment opportunities with each passing quarter. Asset classes we are discussing include distressed credit and equity, public and private equity, agency mortgage-backed securities, and adding duration to fixed income investments, a change from our current exposure which has exhibited very low duration. Even cash yields are more attractive, with short term U.S. Treasury yields around 4%, levels not seen since before the financial crisis. In fact, the opportunity set today is clearly more attractive for investors than it was just nine months ago, even if news headlines are worrisome. It will certainly feel counterintuitive to most, but a decline in business activity and an increase in unemployment may lead to lower interest rates and higher stock prices. So, hang on, even if it feels uncomfortable.