The Colony Group

OUR VIEW

OCTOBER 2023

The third quarter took some air out of the global equity market balloon. The S&P 500's strong return of +13.1% YTD conceals the fact that 85% of its return has been generated by seven stocks, which means the other 493 stocks contributed a modest +2% return YTD. International equities trail the U.S. but there is wide dispersion across geographies. India and Europe have been strong, while China has been a laggard. U.S. Bonds have generated a negative return of -1.2% for the year, further accentuating their meaningful decline in 2022.

Performance

	Q3'23	YTD
U.S. Equity	-3.3%	13.1%
India Equity	2.4%	8.2%
Europe Equity	-5.1%	8.1%
International Equity	-3.7%	5.8%
U.S. Bonds	-3.2%	-1.2%
China Equity	-3.0%	-7.2%

Source: Bloomberg. Table 1

The One Thing that Matters...Right Now

There are times when the market is intensely focused on just one thing, and currently, it is interest rates. It is logical, since as recently as last summer inflation was 9% and today it is 3.7%, which is still higher than the Federal Reserve's target of 2%. As we shared last quarter, this has been one of the steepest rate hiking cycles of the last 50 years. This matters because central bank monetary policy is a blunt instrument and has a lagged effect on economic activity. Remember that The Great Financial Crisis only occurred after the Fed implemented seventeen rate hikes of 25 basis points each, which broke the back of the mortgage and real estate markets, and everything linked to them. It is thought that the economy will take a calendar year to fully digest shifts in monetary policy. As a result, the economic impact of the recent rate hike cycle, which started 18 months ago, may continue for another 12 months. The Fed knows this, but also feels more strongly that it must break the back of inflation.

Discretionary Spending

One of the few pleasant surprises from the Covid pandemic was the strength of consumer spending, significantly boosted by fiscal stimulus programs intended to avoid a depression related to the initial massive loss of jobs, especially in the service economy. Despite the growth of consumer spending, the savings rate also increased. Not surprisingly, pandemic benefits are now exhausted, the savings rate has declined, and cracks in consumption are beginning to show, especially for the lower income

consumer. Credit card delinquencies and defaults and sub-prime auto loan defaults are all on the rise. Energy prices are up substantially, a gallon of gas in 2020 was $1.77, today it is $3.70[1]. A 30-year fixed rate mortgage is up five percentage points from its low in December 2020 to 7.93%[2], leading to trepidation for both buyers and sellers. Student loan repayments, frozen during the pandemic, are now re-starting after a three-year hiatus. Suffice it to say, the consumer now has less discretionary income to spend.

The U.S. government is similarly constrained with one critical exception, the ability to print money. U.S. federal debt has ballooned from the start of the pandemic from $23+ trillion to $33+ trillion. Higher debt issuance and higher rates equate to higher interest payments. Interest payments are beginning to crowd out the government's ability to fund other discretionary programs. The largest annual expenditures of the U.S. government's budget have been Healthcare 25% (Medicare and Medicaid), Social Security 24%, Defense 15%, and interest payments 7%. With interest payments poised to inflate, it will steal funding from other programs unless Congress runs even larger deficits, a polarizing topic within a severely divided Congress. Less spending by consumers and the government will increase pressure on economic growth, and the probability of a recession.

Differentiating the Opportunities in Asia

Long-term clients know our preferred international geography is Asia, although it is worth examining more specifically as this is a mammoth geographic region with 60% of the world's population and roughly fifty countries. In fact, there are just a few countries we prioritize, namely India and parts of Southeast Asia. India has one of the most attractive demographic profiles, with a democratic government that has embarked upon several particularly important reforms to increase the efficiency and output of the economy. We also have witnessed first-hand the enterprising spirit of business owners and see the country as a primary beneficiary as corporate manufacturing diversifies away from China in search of lower economic and political costs. Southeast Asia shares the advantages of an attractive demographic profile and growth prospects, and should also be a beneficiary of supply chain diversification mandates in the years to come.

China, on the other hand, is equally populous as India and far wealthier but faces several headwinds. For starters, its demographic profile is sub-optimal, in part due to the one-child policy that was in place for decades until it was officially lifted in 2013. The government is also a strict autocracy, and while some central planning can be effective, it is counter productive to have everything run through the CCP, and one individual. Additionally, the growing political divide between the west and China is leading many multi-national companies to "de-risk" their China exposure. Apple has moved some of their supply chains and manufacturing from China to places like India and SE Asia. Nike, Intel, and Tesla have all made the decision to diversify manufacturing to other parts of Asia, and in some cases to re-shore production to the U.S. or Europe. AstraZeneca, the pharmaceutical company, has decided to spin-off it is Chinese subsidiary to lessen political risk. In aggregate, the absolute level of foreign investment into China will decline on an accumulation of concerns related to tariffs, legal and regulatory compliance, technology protection, and market diversification. We believe the brunt of this shift will impact China's exporters, businesses that focus on domestic consumption (e.g., food and utilities) are likely to be less impacted and should continue to effectively serve exceptionally large target market.

Asset Allocation

Equity: While we are not warning that a recession is imminent, the risks are increasing. We maintain a "neutral" weighting to equities with our largest geographic exposure continuing to be in the U.S. The most notable change in our allocations over the last few years has been to increase our exposure to private equity, a combination of growth equity, buyout, and venture capital. Innovation within material science, life science and healthcare, as well as technology

[1]Source: Bloomberg. National average for regular unleaded gas as of 9/30/23.
[2]Source: Bloomberg. Bankrate 30-year fixed mortgage.

continue to be areas of particular focus in our research and asset deployment.

Cash and Bonds: The short end of the U.S. yield curve offers a yield of 5.5%. Holding some cash now is logical as the yield is attractive and it provides investors with dry powder to buy securities if the markets weaken. The 10-year U.S. Treasury offers a yield of 4.7% when just three years ago it was only 0.5%. We recently extended the duration of our fixed income holdings, an indication that we think we are being compensated for taking risks in certain segments of the fixed income.

Looking Forward

The market's message to the Fed in August and September was "you have done enough," but the Fed wants to retain all options. The equity and bond markets will not like additional rate hikes; but, if the Fed is done, then markets will normalize and focus on other issues besides interest rates.

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