The Colony Group

OUR VIEW

OCTOBER 2024

The third quarter exhibited strong performance across nearly every asset class except for commodities (Table 1). Equity markets generally like it when central banks are "paused," and we believe this has been a core factor to strong equity returns this year. In this case, the pause has led to a consensus view that the Federal Reserve, and other central banks, would implement rate cuts based on the downward trajectory of inflation and slowing economic growth.

Market Performance

Indices	Q3	YTD
U.S. Small-Cap Equity	9.3%	11.2%
International Equity	8.2%	14.7%
U.S. Large-Cap Equity	5.9%	22.1%
U.S. Bonds	5.2%	4.5%
Commodities	-7.9%	-0.5%

Source: Bloomberg. Total returns as of 09/30/24. Table 1
Indices: Russell 2000, MSCI ACWI ex-U.S., S&P 500, Bloomberg Aggregate, S&P GSCI Commodities Index. Please see important disclosures at the end of this whitepaper.

Positive Changes

Autumn is a time of change; school begins anew, the weather turns cooler, and senescence gives us autumn hues. Financial markets are indicating change as well. Beyond the noted 50 basis point interest rate cut by the Federal Reserve, the first since 2020, we have also seen inflation move from 9.1% in the summer of 2022 to 2.5% today. The yield curve,[1] which had been inverted, has now flattened; a step in the direction of the historical norm of requiring a higher yield for longer duration securities. More notable is the emergence of breadth in the equity market, with broader participation being a sign of market health. It has been well documented that a handful of global leaders have led financial markets for an extended period, but in the third quarter small-caps outperformed large-caps and international equities outperformed U.S. equities (Table 1).

Historically, lower interest rates are a tailwind for growth and are supportive of rising equity prices. Additional rate cuts are now highly anticipated, and as long as the market does not deem those cuts to be mandatory to counterbalance rising unemployment and a recession, the equity markets are likely to remain constructive. More broadly, there are positive implications as Fed rate cuts typically lead to a weaker U.S. Dollar, which can be a positive for emerging market equities and commodities, such as gold.

Chinese equities provided the biggest surprise in the quarter, vaulting from a mood of despair to euphoria. The

[1] Reference to the U.S. Treasury two-year to ten-year portions of the yield curve.

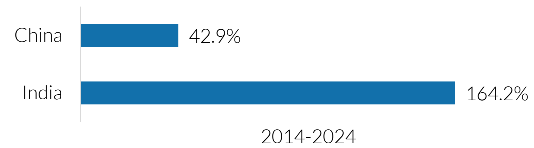
Chinese equity market peaked in February 2021 before declining 58% over the ensuing 43 months[2] and being deemed "un-investible" by a many foreign investors. The bear market in Chinese equities was extinguished with a 29% increase in the last three weeks of September following an announcement by the central government of its intentions to ease monetary policy, increase fiscal stimulus, loosen property restrictions, recapitalize the banking system, and purchase domestic equities. China has been out of favor for several well documented reasons: the domestic real estate market and bank exposure to loan losses; decelerating GDP; and a shift by western economies to diversify their supply chains to other countries. Chinese leadership apparently has seen enough and is implementing this sizable stimulus package to reinvigorate their economy and equity markets. We continue to view India as the more compelling long-term investment opportunity (Table 2) as we have noted in previous white papers we have published (The Base Case for India and India's New Growth Drivers) notwithstanding the low valuations and investor sentiment in China which should be supportive over the long-term.

What Could Go Wrong?

Over the intermediate term, we see a significant disconnect between equity and fixed income markets. The bond market is pricing in an additional 150 basis points of rate cuts between now and the end of 2025 while the equity market is forecasting +9.2% and +13.7% earnings growth in 2024 and 2025.[3] If there is a need for 150 basis points of rate cuts over the next 15 months this could suggest a weakening economy which would not be supportive of strong earnings growth. Accordingly, current earnings estimates may require a re-acceleration of economic growth and/or corporate margin expansion.

Inflation has been on a downward path for the last two years but could increase again as it is not unusual in economic cycles to see an echo effect where inflation rebounds. This is not a consensus view today and thus would be a negative surprise. Sources of reflation could include China's intended stimulus program, increases in U.S. fiscal spending regardless of which party takes the

Trailing 10 Year Equity Returns



Source: Bloomberg. Total returns 10/01/14 - 09/30/24. Table 2

White House, global monetary policy easing which is just underway, and higher energy prices with or without war in the Middle East.

Transition Points

The human eye is trained to notice motion; we focus on things that are observable and in flux. A market transition point is when breakthrough innovation is occurring but may be unrecognized or underappreciated. In the investment world there has been a vast recognition of artificial intelligence (AI), specifically large language models like GPT, and a few companies with the ability to drive capital investment with their massive balance sheets have benefitted from investor interest to date. However, there has been little investor interest in health sciences the last several years and valuation multiples in many cases are substantially below levels a few years ago. Nevertheless, biotech, genomics and life sciences are already massive beneficiaries from AI and data science tools paired with research and development initiatives. We believe the ability to expedite therapeutic research through faster sequencing of data sets and determine more probable outcomes to elevate to clinical trials means the probability of successful outcomes will increase, leading to faster time to market and more targeted therapies for hard to solve illnesses, many of which have massive end markets.

Many other industries are going through similar unrecognized changes which will likely lead to enormous transformations in areas like material science, energy, the

[2] Source Bloomberg. MSCI China Index.
[3] Source Bloomberg.

circular economy, and more. We believe many investors will be compelled to use a wider lens and an evolved investment mindset that goes beyond historical frameworks.

Portfolio Construction

We have been overweight risk assets, such as equities, and continue to think this is appropriate. International equities, including emerging markets, generally have more attractive valuations than the U.S. and would benefit from further weakening of the U.S. Dollar. Mid-cap and small-cap U.S. equities have not participated in the rally to the same degree as U.S. large-caps and have lower relative valuations, so we still advocate for exposure to the lower capitalization segment of the U.S. equity market which has lagged for several years.

We think it makes sense to have exposure to energy and commodities. A long-term movement to alternative sources of energy such as nuclear and renewable will occur but it will be difficult to transition away from fossil fuels without massive capital investment. In the meantime, traditional energy valuations are low, energy demand continues to rise, and traditional energy remains one of the few hedges for inflation and middle east geopolitical risk.

As for fixed income, we remain slightly longer in duration than the aggregate bond index with our allocation to agency mortgages where we believe we can generate additional return over treasuries. We also believe it is prudent to supplement that exposure with short duration treasuries (T-bills) or cash as a source of yield and to serve as dry powder to reinvest into riskier assets when the next opportunity emerges. T-bills are still providing a nominal yield of 4.5%, an attractive yield for those who can show patience.

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