The Colony Group

Investment Outlook Series
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Our View

If one had spent 2020 in a news vacuum, tuning in to review equity market performance only at the conclusion of the year (Table 1), one may have assumed a good and perhaps uneventful year, although nothing could have been further from reality. 2020 was indeed unforgettable. The global coronavirus pandemic radically interrupted and influenced how the world lives, works, communicates and interacts. There have been more than 85 million reported Covid-19 cases, countless unreported cases, and over 1.8 million known deaths. The U.S. leads all countries with over 20 million cases and more than 350,000 deaths[1], exiting 2020 with more daily Covid-19 deaths than were lost on 9/11/2001, a shocking statement on the virus' human impact.

Table 1: 2020 Equity Market Returns

Asia ex-Japan	25.2%
U.S.	18.4%
World ex-U.S.	11.2%
Europe	5.9%

Note: Indices are MSCI Asia ex-Japan; S&P 500; MSCI All Country World ex-U.S.; MSCI Europe. All returns are in US$.

In March, as lockdowns forced layoffs, U.S. weekly jobless claims surged from 211,000/week to nearly 7 million/week, over 10 times higher than the previous record of 665,000/week during the Great Financial Crisis (GFC). Financial markets declined 34% peak to trough over the span of several weeks in February and March, the fastest and steepest decline ever in U.S. markets. Global GDP and earnings growth moved sharply negative, and market volatility soared as an interconnected world searched for a plan to survive and circumvent the most significant pandemic in over 100 years. Given the backdrop, the resulting human casualties, business and trade interruption, and the corresponding economic impact one might have predicted a terrible year for financial markets.

2020 however, is incomplete without noting the silver lining of human ingenuity, resourcefulness and collective action. At the beginning of the year, when the virus was still relatively unknown and thought to be contained geographically, the global scientific community began implementing a varied approach to combat the virus. One exceptional approach was a novel scientific platform that uses messenger RNA (mRNA) as a tool to provide human cells with a set of instructions to create the body's defense to fight and/or prevent disease. To a human cell this solution mimics the natural biology of an infection and uses cell machinery to develop a protective immune response. Incredibly, within a week, using a digital copy of the virus, pharmaceutical firms had developed prototype vaccines, several of which have now been approved, shattering previous vaccine development timelines. In late March, as market volatility spiked, globally coordinated financial and monetary intervention led to a reversal in financial market declines. It was the speed and size of global financial support that provided investors confirmation that investing over a longer time frame could be rewarded even as the end of the pandemic was unclear.

2020 not only serves as a useful reminder that forecasting can be imprecise, but also marks a year which may be an inflection point for specific trend reversals. For the past decade three notable trends have been: lower bond yields; lower energy prices; and a stronger U.S. Dollar. Each of these, post the pandemic's onset, are now trending in the opposite direction, which could have meaningful implications for investors who may have become comfortable, if not complacent, with the longer-term trend.

The Federal Reserve has been clear it does not expect to raise rates in the foreseeable future, thus a path to higher yields would most likely come from rising inflation expectations prompting the bond market to take matters into its own hands. As an example, only 4 of 58 sell-side estimates for the 10-year U.S. Treasury Bond forecast the current yield of 1.1% to rise above 1.5% at year end. If the yield curve were to steepen rapidly on rising inflation expectations, it would be negative for equity valuations and bond prices. Earnings growth could offset multiple contraction for equity investors, but for government bond investors there is only downside risk if/when yields rise, especially those who are long duration.

Inflation can be categorized either as structural or cyclical, and while some of the structural factors that have allowed for low(er) inflation remain in place, we have a growing awareness that cyclical inflation forces appear to be rising:

- U.S. households accumulated nearly $2.0T in additional savings deposits since the pandemic began, which equates to

[1]Source: Johns Hopkins University of Medicine Coronavirus Resource Center.

nearly 10% of U.S. GDP. Additional stimulus measures passed in late December will add to that amount, as further stimulus is more likely with the U.S. Senate now evenly split post the Georgia election results. The rollout of vaccines globally will eventually lead to the end of the pandemic, and presumably unleash a significant amount of pent-up demand (travel, recreation, services, etc.) at a time when savings rates are elevated, and the growth rate of money supply is at a 60-year high.

• Commodity prices such as energy, metals and agriculture, are rising since the early weeks of the pandemic. Oil prices, as an example, have rebounded substantial since the massive selloff in March/April. Presumably, a resumption of economic demand combined with a prolonged drop off in energy capital expenditures over the last decade could combine to allow for further price inflation.

• Inventory levels are low as companies have run operations lean during the pandemic to reduce costs and save working capital. An economic rebound would lead to both increased demand for goods but also a re-stocking of inventories at a time when the U.S. dollar has weakened (13% since the March peak[2]).This ultimately could lead to higher prices assuming corporations choose to pass on their higher costs to consumers.

The outperformance of U.S. equities over the last decade has been notable (+196.5%[3]) and has been supported by a relatively strong U.S. Dollar. Recent U.S. Dollar weakness is thus notable, and if investors' perceptions change due to a weak U.S. Dollar regime, then both the U.S. equity and bond markets become relatively less attractive to non-U.S. investors. Therefore, as investors look around the world to where they might invest, we continue to believe developing Asian equities are fundamentally attractive, and a possible beneficiary for funds rotating from the U.S.

Finally, the disruption to life, work and businesses caused by the pandemic has been unprecedented. Industries and numerous large and respected companies were, and still are, at the mercy of the pandemic, both from government mandated restrictions as well as consumer preferences. With the pace of innovation accelerating, in our opinion, it is clear there will continue to be tremendous opportunities for investors. The pace of change for companies will ultimately become a risk, or an opportunity, depending on their ability to adapt.

• *Genomics:* The speed of innovation is captured with Pfizer and Moderna developing Covid vaccine prototypes in a week using mRNA technology. Healthcare is utilizing the intersection of genomics and gene editing via the use of CRISPR technology, with artificial intelligence to create massive advances in targeted therapies.

• *Material Science:* Graphene is a carbon-based allotrope that is 100 times stronger than steel and yet lighter, flexible and transparent, the applications for which will be numerous in technology, construction, leisure goods and more.

• *Fintech:* Blockchain is allowing companies to process and record transactions and track assets in a business network, reducing risk and cutting costs for all involved.

• *Energy Storage:* Advancements in batteries are helping transition away from fossil fuel dependence. Lithium-ion battery costs have dropped 85% in the last decade, making electric vehicles and energy storage commercially viable.

While this list illuminates only a few areas of innovation, it reminds us that investing requires forward looking. 2021 will have a new set of challenges, some unforeseen, but it seems that one of the great reminders of this last year is that investing requires a longer-term time frame, and the resolve to invest in the face of volatility. Bond yields in today's market generate negative real returns, and with the possibility of increasing cyclical inflation, it appears to us that the tailwind of the last 40 years in the bond market is over. As a result, investors, with an appropriate time frame, should find compelling opportunities in equities as innovation accelerates. Some of these opportunities will occur outside the U.S., making this a good time, in our opinion, to diversify one's portfolio, with Asia remaining our preferred geography.

[2]Source: Bloomberg. U.S. Dollar Index spot rate.
[3]Source: Bloomberg. S&P 500 versus MSCI All Country World Index, 12/31/2010 – 12/31/2020.

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