The Colony Group
Investment Outlook Series
July 2021

Our View

The second quarter was another strong quarter as global equity and bond indices generated positive returns (Table 1) despite a cacophony of market participants concerned about rising inflation, and its ultimate impact on equity valuations. Reported inflation has been scarce for years; thus, recent price spikes (e.g., commodities, health care, home prices, rents, etc.) are notable and serve as ammunition for equity market bears. However, mainstream news headlines are intended to entice a reader and sell subscriptions, and some err on the side of being extreme, extrapolating the current environment into perpetuity. Reality is likely more complex and nuanced.

Table 1: Q2 2021 and YTD Returns

Asset Class	Q2	YTD
U.S. Equity	8.6%	15.2%
International Equity	5.6%	9.4%
U.S. Bonds	1.8%	-1.6%
Global Bonds	1.3%	-3.2%

Source: Bloomberg as of 6/30/2021. Total return including dividends.

Inflation:

There are several factors impacting prices; foremost in our opinion is the supply of goods and services which is lagging demand. Qualifiers to this view are factors such as: supply chain bottlenecks that will be remediated; demand increases will likely normalize as the global economy returns to status quo; and the statistical math that relates to an annual comparison versus a devastatingly weak second quarter of last year during peak pandemic conditions. We believe investing requires a wider lens than just the present high frequency data, which leads us to conclude risk assets still have a tailwind, although we note that vigilance is required. In our opinion, this cycle will be unlike previous ones and now is not the time to become complacent, but rather to use periods of market strength to rebalance, as we have been doing.

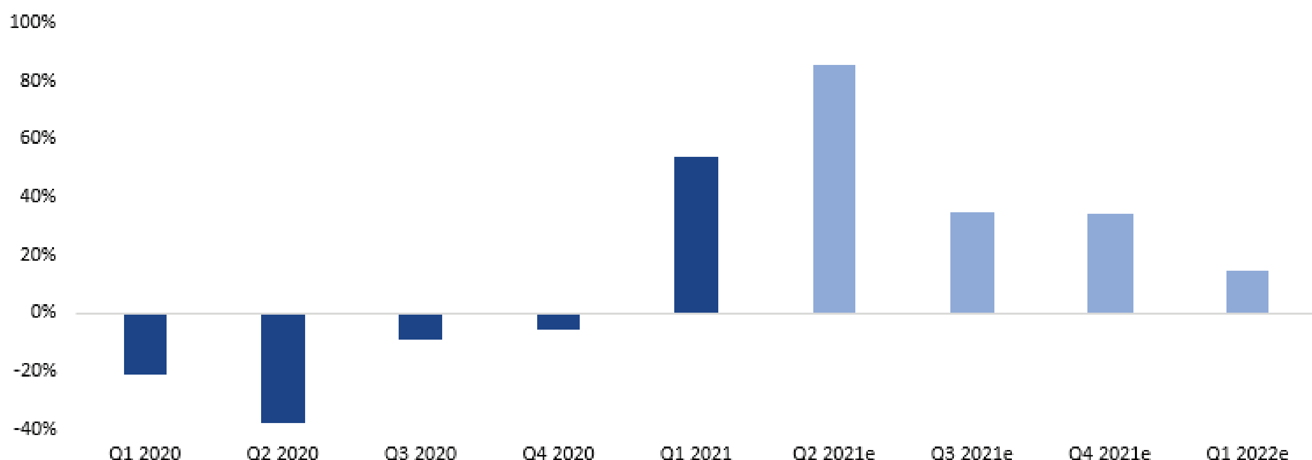
The Case for Equities:

The case for equities revolves around several key points:

- Global monetary and fiscal policy remains accommodative and is likely to stay this way if the pandemic continues to threaten economic growth. Variants of the coronavirus such as the Delta variant are proving to be considerably more infectious and have been problematic in geographies where vaccine rollout has been slow. This suggests the greater likelihood of rolling recoveries and lends support to continued policy support until vaccines have been globally distributed.

- Corporate earnings growth is accelerating rapidly and is expected to remain strong for the next several quarters and beyond (Chart 1). First quarter earnings growth for the S&P 500 was +54% compared to the first quarter of 2020. Second quarter growth is estimated to be +85%. The final two quarters

Chart 1: S&P 500 Earnings Growth Rate Y/Y



Source: Bloomberg.

of the year are estimated to achieve +35% increases. These figures are supportive of equities even as the growth rate decelerates (which it will). A similar pattern of earnings growth can be found in Asia and Europe. Asian earnings growth was not hit as hard in 2020 thus the recovery growth rate is lower than the U.S. European earnings growth was hit much harder, so the percentage increase is higher than the U.S.

• A river of ink can be attributed to headlines of impending doom from rising interest rates and a sudden end of the equity bull market. Historical data, however, shows that in the last four cycles when the Federal Reserve raised interest rates the equity market reaction was typically short lived (30-40 trading days), with declines that measured -6% to -12% (Chart 2). After that the equity market enjoyed material gains ranging from +22% to +170% (Chart 3), spanning timeframes that range from five months to over four years which highlights the risk of exiting equities prematurely.

Chart 2: S&P 500 Decline After First Fed Rate Hike[1]

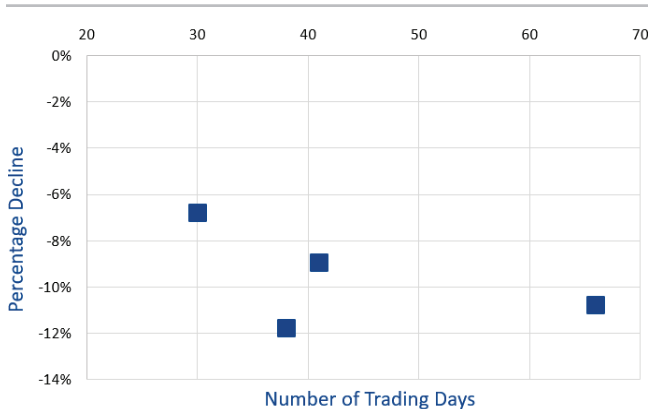
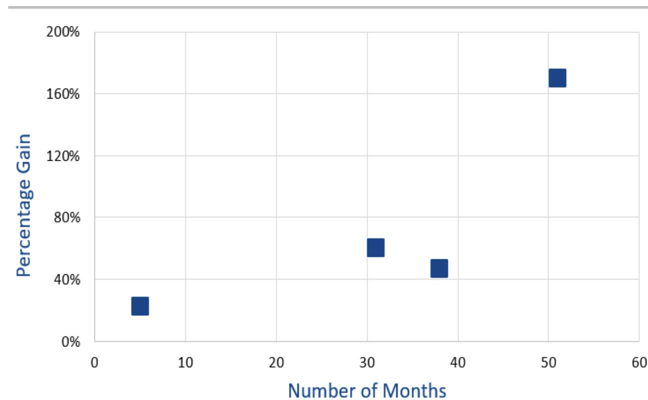


Chart 3: Appreciation from Trough Post First Fed Rate Hike[1]



The Risk for Equities:

Assessing risks, the main variables remain a negative change in the outlook for growth, policy accommodation, and/or a significant increase in corporate taxes.

• The ultimate longevity of the current cycle is an unknown. The Federal Reserve anticipates that their initial rate hike is two years away, but one must appreciate this is neither a unanimous view at the Fed, nor are their two-year forward predictions infallible. If the Fed proves to have been incorrect in their timing, or inflation appears to be stickier than expected, the market reaction will likely be to afford equities a lower multiple of earnings. Currently, the S&P 500 trades at 22.5x 2021 expected earnings and 20.2x 2022.[1] These are higher valuations than historical averages, but appropriately higher when interest rates are also near historical lows.

• If one examines the job market as a potential indicator of economic strength, 23 million net jobs were lost in the pandemic and we are still seven million jobs below the pre-pandemic peak. Many companies though indicate challenges filling openings which may suggest policy around unemployment insurance needs to change to incentivize labor to get back to work. Limited immigration, retirements, and labor mismatches make it hard to determine what a "normal" employment market should look like currently, but it appears a labor market recovery in the U.S., and elsewhere, still has some room to go before meaningful monetary policy changes are more likely. Wage growth is a sticky form of inflation and likely to be one of the factors that influences future policy shifts.

• A discussion around raising corporate and personal income taxes is on-going, but it seems unlikely that a major tax increase is the base case considering the current construct of Congress.

International Markets:

Our view has been that Asia is the most interesting investment geography outside the U.S. for investors with a long-term investment horizon. That has led us to favor India which has one of the most attractive demographic profiles and growth opportunities. Another country where we have exposure is China, although we have thought this year the Chinese market might take a pause after an extraordinary 2020. Our thought process centered on a combination of better "recovery" opportunities elsewhere, tightening credit, and increasing regulations, especially for internet and fintech companies. Nothing paints the picture more clearly on increasing regulations than the recent news related to Didi, the "Uber of China", where Chinese regulators barred new users of the Didi app only three days after its U.S. IPO. In this case the regulators' concern is data security of the app users, however, the ultimate issues are more complex. It was only a few months ago that Chinese regulators cracked down on Ant Financial just before

[1]Source: Bloomberg.

it was scheduled to launch its IPO. Before that it was a multi-billion dollar fine for Alibaba, and before that regulators barred Tencent from launching new online games for a year due to the perceived negative impact they had on children. In our opinion the signaling from China is clear as to who is in charge (the Chinese government), and where they want Chinese companies to list their shares (in China and not the U.S.).

The Biden administration has maintained a bipartisan view that China is the largest economic and geo-political competitor. As a result, it seems probable to us that China will remain in the news and the coverage likely will be negative. This does not worry us, the 19% pullback in Chinese equities from their early year peak can provide investors interesting opportunities to take advantage of short-term trading and sentiment. Today, the Chinese equity market trades at 16.4x 2021 and 14.0x 2022[2] earnings, creating a better value opportunity with interesting long-term growth opportunities. A more meaningful concern for us centers around Taiwan, if or when, China decided to take further steps related to its "One China" policy. A military conflict in the South China Sea or related to Taiwan is not predictable but would generate a significant "risk-off" event if it were to occur between the world's two superpowers.

Portfolio Construction:

We remain constructive on equities although we took some profits in the latter part of the second quarter. We continue to think market leading companies with earnings durability and high-quality franchises that are innovating make an attractive combination to own. Traditional fixed income remains unattractive in our view, providing a poor risk/reward in an environment where interest rates are more likely to increase than decrease. In the current environment, we believe cash is an asset, with zero duration it is not subject to the price risk of rising interest rates, and is a source of immediate liquidity, ready to be used by patient investors to reinvest when opportunities arise.

Innovation:

In just the last week we were reminded of the stunning breakthroughs that are occurring, this time in the field of health care and gene editing. CRISPR is a gene editing tool that has been used in conjunction with the mapping of the human genome to target specific dysfunctional genes. The allure and the promise of CRISPR is the notion that one can change any gene in the genome to improve human health. For the first time ever CRISPR has been infused into a patient's liver to edit a gene successfully. Breakthroughs like this are coming swiftly due to innovation and it is occurring across numerous economic sectors. The pandemic has taught us that the world is constantly changing, and investors should take note.

[2]MSCI China. Source: Bloomberg.

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