IN THIS REPORT

The Colony Group

MARKET PERSPECTIVES

QUARTER THREE 2021

Investment markets began to show signs of fatigue in September, though most asset classes were able to produce positive returns for the third quarter. Now that the recovery from the pandemic-induced recession is maturing, investors are left without a dominant theme to focus on, so they cycled through myriad uncertainties and risks throughout the quarter. Each week seemed to bring another headline for them to pivot toward: inflation, slowing growth, the COVID-19 Delta wave, political partisanship, and the debt ceiling debate, to name just a few.

U.S. equities eked out a small gain of +0.6% (as measured by the S&P 500) for the third quarter. Strong returns in July and August masked a 4.7% decline in September. The quarter saw popular technology and communication stocks continue their winning ways, while more economically sensitive sectors languished over a resurgence in COVID-19 cases.

Developed international equities finished the quarter down slightly, with the MSCI EAFE Index returning -0.4%. Emerging markets fared worse (-8.1%), largely due to an -18.7% decline in China, the largest constituent in the MSCI Emerging Market Index.

Many investors worried that China's crackdown on select technology companies and the for-profit education sector signaled increased hostility towards foreign investors. China's selloff was exacerbated in late September after Evergrande, China's largest real-estate development company, suffered a debt crisis after defaulting on a loan payment.

Bond prices largely mirrored equities during the quarter. A decline in interest rates supported solidly positive returns during the first two months; however, 10-year Treasury rates rose to nearly 1.5% in September, as investors began to discount potential Federal Reserve (Fed) tightening, causing the Barclays U.S. Aggregate Bond Index's return to be flat for the quarter. The Fed's hawkish shift at its June meeting was underscored by its statement that the "substantial further progress" threshold to begin tapering its bond-buying program is close to being met.

For the rest of this letter, we take a deeper dive into what investment markets are telling us about investors' outlooks and what is occurring beneath the surface of some equity indices.

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The Market Knows

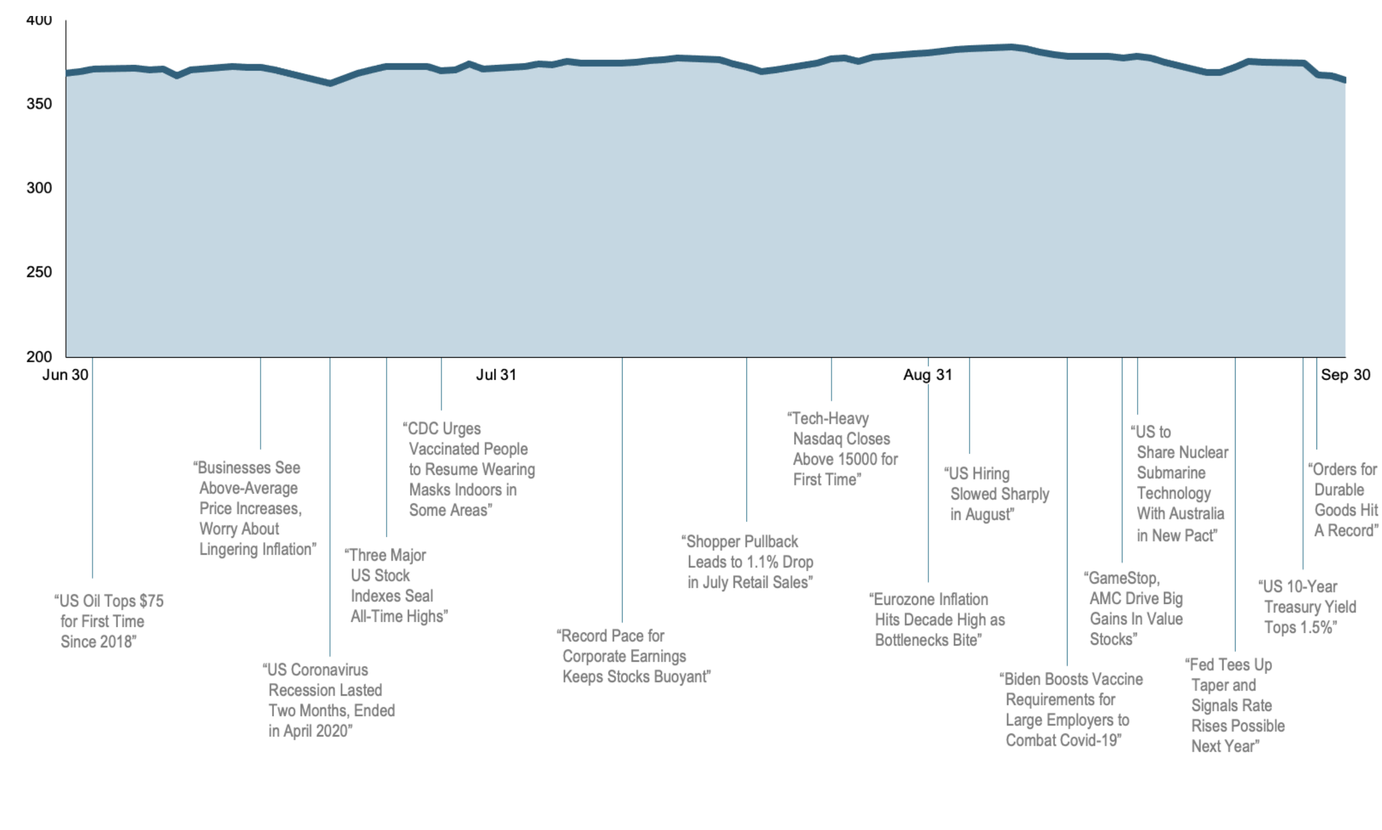
Equity markets are often a great leading indicator of future economic activity. To wit, they rallied strongly in April 2020 and once the U.S. vaccination program began in earnest, well before their impact on GDP was noticeable. Presciently, investors rewarded those companies most leveraged to an economic reopening. Travel sectors like airlines and cruise ships, and cyclical sectors like energy and industrials led the way higher, reflecting investors' expectations for relatively stronger earnings growth. Some investors were surprised that the markets did not reflect prevailing economic realities. Nevertheless, the markets sometime have a remarkable ability to not overreact to the present circumstances and instead look forward to the next set.

As the summer wore on, markets found some new things to worry about. Indeed, the Fed was turning more hawkish, and news of a more infectious Delta variant of the coronavirus dominated headlines. Facing the prospect of slowing growth, investors reallocated towards secular growth companies and businesses that benefit from work-from-home mandates. Perhaps we are witnessing another leadership change. During the last couple of weeks of September and the beginning of October, energy and financial stocks materially outperformed while some of the technology highfliers languished.

It is not only the equity markets that hold clues about the outlook for the business cycle. Fixed income and commodity markets have also been good economic prognosticators. Many traders believe that copper has a "Ph.D. in Economics," according to Investopedia, and refer to it as "Dr. Copper" because of its uncanny ability to predict inflection points in the economy. Copper topped out in May, signaling weaker growth during the third quarter, but has since stabilized. On the other hand, oil and natural gas prices have risen significantly due to supply constraints and investors' belief that the worst of the pandemic resurgence is behind us.

Given that central banks are powerful marginal buyers in many sovereign bond markets, the utility of interest rates as an economic indicator is fading. Corporate bond markets, however, remain a reliable forecasting tool. Credit spreads, which measure the additional yield an investor requires for holding relatively riskier debt, remain at historically low levels, suggesting that market participants see little risk that bond issuers will default on their obligations.

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q3 2021



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2021, all rights reserved.It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results

WHAT THIS MEANS

Markets reflect the collective wisdom of their participants. As such, their forecasting capability must always be considered.

Connecting the dots, we see a picture forming of an economy that is re-finding its footing. The hefty growth rates experienced during the start of the recovery were expected by most to fade as the recovery matures. The resurgence of COVID-19 caused growth to come in below expectations during the third quarter. The markets may now be signaling that growth will reaccelerate during the fourth quarter and into 2022.

Indeed, the U.S. is currently experiencing multi-decade lows in capital expenditures and inventories, which, as they normalize, should drive a longer, stronger business-spending cycle, the likes of which we have not seen since the dot.com era. In addition, consumer balance sheets are flush with an estimated $2 trillion of excess savings, which may support stronger than expected spending, especially considering the pent-up demand for travel and leisure activities.

How much of this outlook is already priced into the markets is an important question for investors to answer. In our opinion, the markets are not yet fully discounting a reacceleration of growth. Up until recently, equity market leadership was reflecting expectations for a growth slowdown. From our viewpoint, markets generally do not adjust instantaneously to a change in outlook, as investors are typically deliberate when repositioning their portfolios.

Beneath the Surface

Most equity markets have performed admirably through the first three quarters of 2021. Returns have been strong across sectors, countries, and regions, with most of these up double-digits or near-double-digits percent year-to-date. The S&P 500 has reached an all-time high 54 times this year, putting it on pace to fall just short of the previous record of 77 times reached in 1954 and 1995.

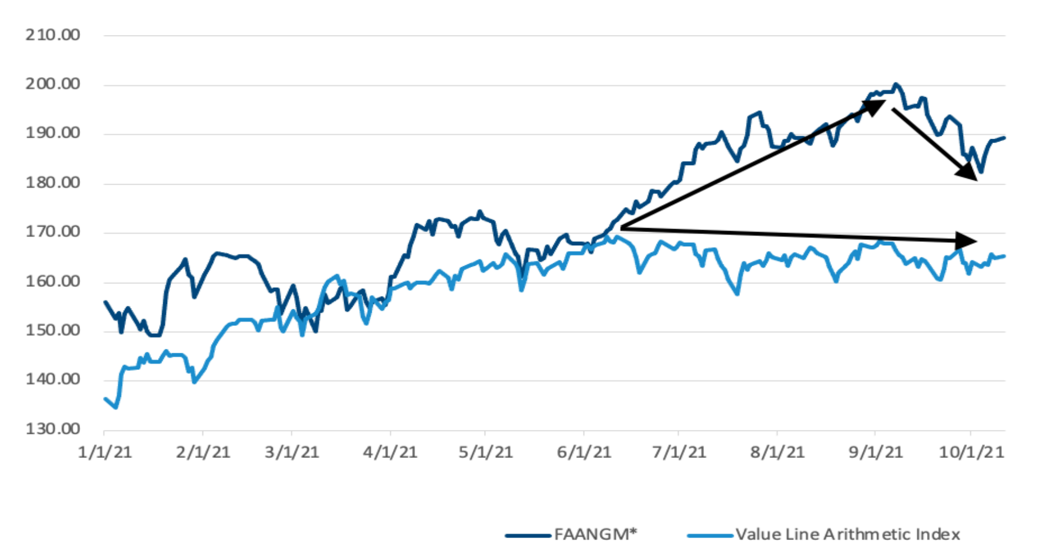
These milestones may be misleading, however. Looking beneath the surface shows a market that may not be as strong as the indices suggest. Indeed, the increase in volatility experienced in September may indicate a market that needs to catch its breath.

We have discussed in past letters the degree to which some U.S. equity indices have become overly concentrated. Remarkably, the top five names in the S&P 500 make up nearly one-quarter of the index's entire market capitalization, one of the highest readings in its history.

These five names – Apple, Microsoft, Alphabet, Amazon, and Facebook – are some of the best performers over the past several years. More recently, this concentration may be hiding pockets of weakness beneath the surface.

For those investors forecasting a correction in the near term, they point to the fact that many stocks have already reached the -10% threshold. While the S&P 500, which apportions a greater weight to the largest companies, has achieved multiple record highs, the average stock in the S&P 500 is down 11.3% from its high through quarter-end.[1] Likewise, the average stock in the NASDAQ 100 and Russell 2000 is down 12.4% and 27%, respectively, while the corresponding index is down 2.2% and 5.2%.

1 Source: Verrone, Chris, The "Index" Only One Left to Correct, Strategas - Technical & Macro Strategy, 20 Sept. 2021, p.1



Series rebased to 100 on 3/1/2020; source: FactSet

*Market-cap weighted average of Facebook, Amazon, Apple, Netflix, Google, and Microsoft

WHAT THIS MEANS

Markets do not move higher in a straight line. Most uptrends experience brief periods of consolidation or retracements. These are normal and healthy, and generally do not represent turning points.

The markets' breathtaking recovery from the pandemic lows of March 2020 has rightfully received a lot of attention. The S&P 500 is up 93% over this 556-day period, nearly 30% higher than the next strongest rebound, which occurred in 2009. During this one-and-a-half-year span, we have not had a market correction even though the S&P 500 experiences, on average, a 14% drawdown each calendar year. So to say that U.S. equities are overdue is an understatement, in our opinion. That said, given the generally positive fundamental backdrop, highlighted by low interest rates and above average growth for the near future, it seems likely that any correction will be short-lived.

Conclusion

Subsurface conditions in the equity markets suggest that a correction may be forthcoming. However, as legendary investor Peter Lynch once noted, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

A broader look at investment markets beyond equities shows that economic growth may be set to reaccelerate somewhat following a third-quarter slowdown. When we consider other elements of the economic backdrop, we become even more optimistic about the setup for the economy. Low inventories, underspending on capital expenditures by businesses, and a consumer flush with savings could yield stronger than expected growth.

It is easy for investors to be swayed by all the negative headlines. Supply chain bottlenecks are stoking inflation. Growth is slowing in China. The U.S. political system is broken and inept. The list goes on and on. Just like the nightly news, investment media have a habit of being consistently negative. It is our job to look beyond the headlines and help you to stay focused on your investment goals.

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