The Colony Group

OUR VIEW

JULY 2023

The first six months of 2023 are evidence that financial markets are anticipatory. Central banks are still raising rates, but investors have pivoted to a future where rate hikes stop, or reverse. Even with higher interest rates this year global bond markets have generated positive total returns, +2.1% in the U.S. and +1.4% globally.[1] U.S. equity market returns by market capitalization and style (Table 1) clearly show 2023 has favored the largest growth companies. It is extraordinary that seven[2] companies are responsible for 73% of the S&P 500 index return, while 493 companies generated 27% of the total return. To further emphasize the narrow breadth of the U.S. equity market, the market cap weighted S&P 500 is +16.9% YTD versus the equal weighted S&P 500 index return of +7.0%.

US Equity Market

	Growth	Value
Large	29.0%	5.1%
Mid	15.9%	5.2%
Small	13.6%	2.5%

Note: Russell style indices, total return through 6/30/23.
Source: Bloomberg.

Table 1

In the U.S. the Federal Reserve continues its tough talk on inflation and willingness to raise rates so that inflation does not become entrenched. As a result, there could be a few more rate increases but it may not matter much, investors already sense an end to the rate hike cycle. The bigger question now is whether there will be a soft or hard landing.

Soft Landing

The case for taking equity risk is that inflation will continue to decelerate (e.g., Japan, India and the U.S.) to targeted levels and economic growth will remain positive, even if it slows. In the U.S., labor markets remain strong while wage growth is slowing, rent increases and other inflationary costs are decelerating which will lead to easing cost pressures and corporate margins stabilizing. Earnings expectations have begun to trough after a year of incremental cuts and there is no apparent sign of distress in the traditional credit markets where bankruptcies are very low and credit spreads are narrow. This goldilocks scenario equates to a positive environment to invest in equities, especially in globally dominant companies.

Less-than-Soft Landing

The Fed has raised rates five percentage points in the last 16 months and the lagged effect of rate increases means the Fed, and other central banks, could go too far without knowing it. The current tightening cycle is the fastest and steepest since the Volcker era. Is it safe to assume nothing will break?

[1]Source: Bloomberg.
[2]Source: Bloomberg. Apple, Microsoft, Nvidia, Amazon, Alphabet, Salesforce & Tesla.

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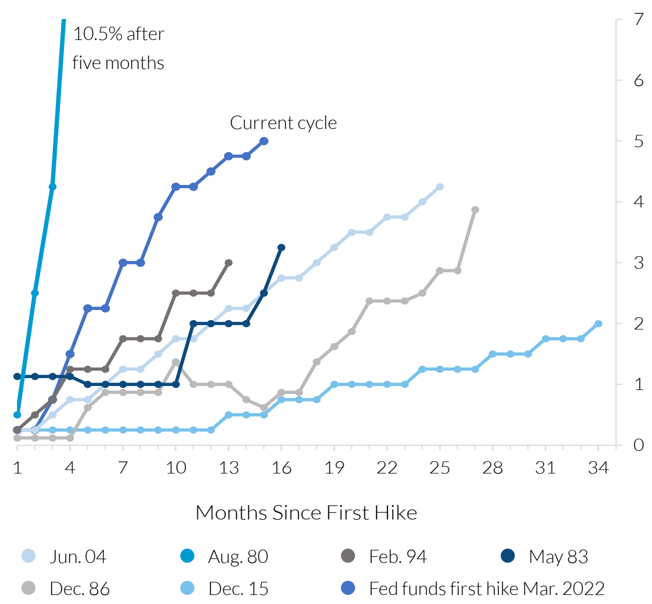
Chart 1: An Aggressive Fed Cycle



Source: Pantheon Macroeconomics.

Unsurprisingly, the supply of money has been contracting for a year. This year's banking crisis has led to further tightening in bank credit which is impacting corporate access to loans for capital expenditures, inventory, growth initiatives, and refinancings. Higher rates also mean the aggregate debt service cost of the U.S. government is increasing which could crowd out more productive uses of government revenue which gets recycled through the economy with a beneficial multiplier effect. Labor markets, while still robust, show signs of being late cycle as unemployment claims tick up and wage growth decelerates. Consumers are also showing signs of slowing spending as borrowing costs rise and pandemic era policies like student loan payback holidays expire.

Energy

One sector of the global economy that has gotten modest investment attention relative to its importance to world economic growth, innovation, and government policy is the energy sector. In 2022 energy was the best performing U.S. sector (+64.2%[3]) in a sea of negative returns. Six months later, fears of global oil and gas shortages due to the Ukraine War have proven to be largely unfounded. This, coupled with a middle east peace dividend between Iran and Saudi Arabia and strategic petroleum reserve releases has led the price of oil to decline 12%[4] this year. Complacency about the delicate balance of supply and demand is high, in part driven by narratives that misunderstand and underestimate the multi-decade duration of the transition to energy alternatives. Alternative energy options (e.g., battery powered cars, wind, solar, etc.) are occurring, but accelerated investment will be required to keep up with steady increases in energy demand (over 1% per year for several decades) and to catalyze the transition away from carbon intensive fuels. The looming issue for the world is that the conventional global energy supply is at peak levels, with tight inventories, and production from the rest of the world is declining.

Exacerbating the situation is the rapid aging of the U.S. shale oil revolution[5] which put the U.S. back on the map as energy independent and the marginal supplier of oil. A relative lack of investment in new supplies in the last decade has been driven by a clear message from investors to energy executives requiring free cash flow to be returned to investors rather than reinvested for growth opportunities.

We are close to an inflection point. Either the world needs to invest more in its energy transition or in conventional oil and gas. The ultimate catalyst for the energy transition would be a sustained increase in prices for traditional fuels. Either way, conventional and alternative energy is likely to provide interesting private and public opportunities. As an example, public midstream energy infrastructure offers a high single digit dividend yield, strong cash flows, low valuations, and a potential hedge if oil and gas prices rise. In addition, one does not have exploration and production risk, and there is little threat of substitution for pipelines and storage.

[3]Source: Bloomberg. XLE Total return.

[4]Source: Bloomberg. WTI 1st Contract as of 6/30/23.

[5]U.S. conventional production declined 50% in the four decades prior to the shale oil revolution. Shale oil production rapidly spiked to 10 million barrels per day, an amount that rivals Saudi Arabia's daily production.

Asset Allocation

Equity: This year's U.S. debt ceiling debate has been resolved and valuation multiples have expanded as corporate earnings have been flat. The passing of a material risk and the lower opportunity for reward near-term leads us to maintain a neutral position in equities. We continue to focus on companies that can self-fund their growth and thrive in any environment. Internationally, India continues to be our favorite long-term equity market.

Bonds: After a disastrous 2022, Bonds have not yet resumed their negative (or low) correlation to equities. However, rising yield levels suggest the relationship will eventually re-emerge. The short end of the U.S. yield curve now offers a yield greater than 5%; therefore, holding cash is an attractive option when coupled with patience as opportunities to redeploy capital become available and we are looking for opportunities to extend duration. Corporate credit spreads do not yet compensate investors for the additional risk being taken and the continued absence of a credit default cycle has led to some complacency. However, our managers have identified some select opportunities that provide attractive risk-adjusted returns, and we expect the emergence of a new distressed cycle at some point.

Looking Forward

The biggest risk to investors appears to be central bankers forcing a hard landing by raising rates too far. There is an argument to be made that the Fed should pause now and observe what the lagged effect of its rate hikes will be. However, since inflation rose far more than central bankers anticipated they do not want to appear indifferent to the impact of sticky inflation and they appear comfortable going too far rather than not far enough. After all, if they go "too far" they have a known policy response–lower rates. The landscape of risks and opportunities feels balanced, and with this in mind, a neutral allocation to equities makes sense as we remain vigilant for the next opportunity.