The Colony Group

Colony Market Perspectives

In This Report

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Introduction

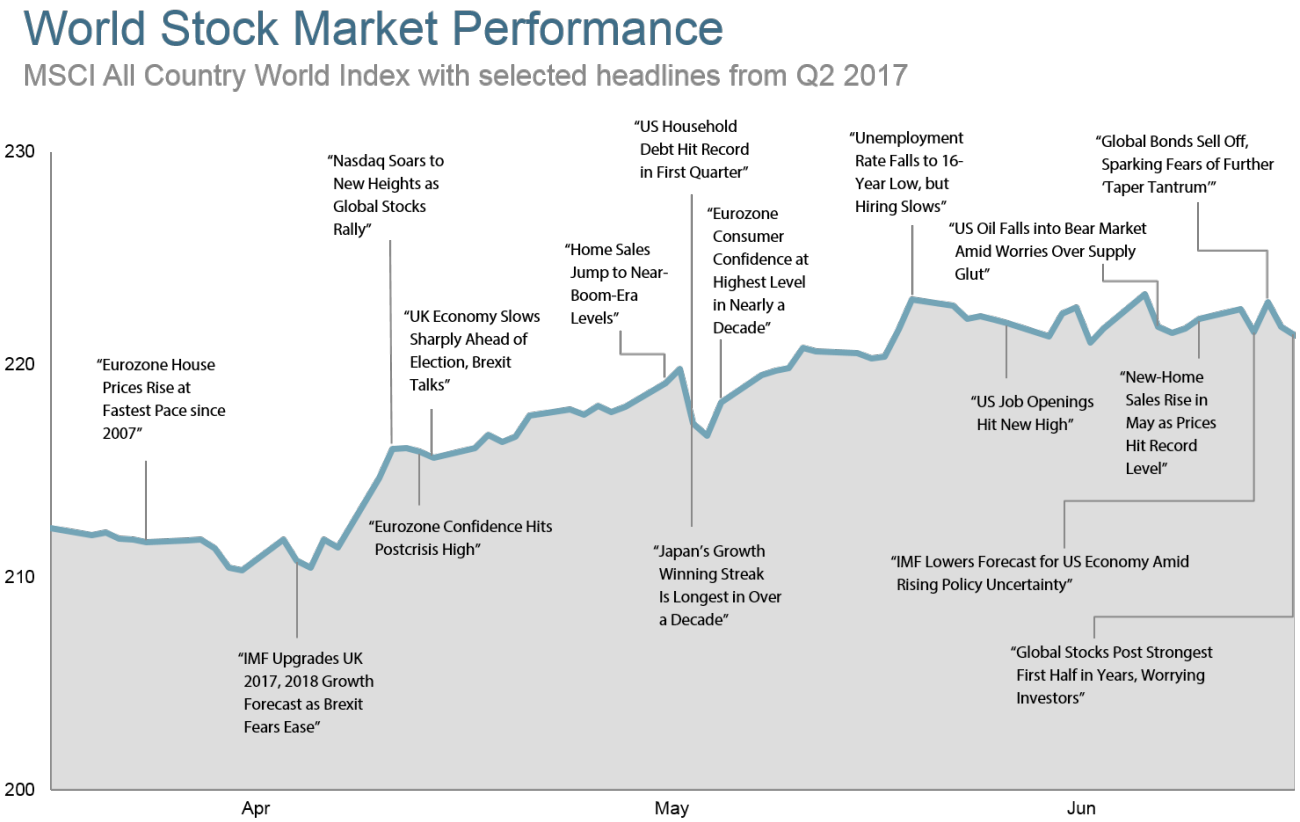
Global equity markets continued to march higher during the second quarter of 2017, boosted by strong corporate earnings growth. What was most notable about the second quarter was how tranquil the markets were. For instance, the S&P 500 returned 3.1% for the quarter while exhibiting very little volatility; there was only one day with a drawdown greater than 1.5% and none greater than 2.0%.

Non-U.S. equities outperformed domestic equities in the second quarter. The MSCI EAFE index increased 6.1% for the quarter and has returned 13.8% year-to-date. Not to be outdone, the MSCI Emerging Markets index increased 6.3% for the quarter and 18.4% year-to-date. The election in France, which saw Emmanuel Macron defeat anti-EU candidate Marine Le Pen, seemed to calm some of investors' growing concerns over political risks.

Lastly, fixed-income returned 1.5%, as measured by the Bloomberg Barclays US Aggregate Bond Index, despite the fourth Federal Reserve rate hike of the cycle in June and Janet Yellen's comment that the institution will start reducing the size of its balance sheet "relatively soon." A sell-off during the last week of June caused yields to rise as several central bank leaders were perceived to have made hawkish comments (more on this below).

Reports of Inflation's Death are Greatly Exaggerated

Inflation is defined as a sustained increase in the general price level of goods and services in an



These headlines are not offered to explain marketplace 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 2017, 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.**

economy. Rising prices reduce the purchasing power of a unit of currency. Gradually rising prices generally have a positive influence on an economy, as they support rising wages and income. Rapidly rising or falling prices, on the other hand, increase uncertainty and may cause consumers and businesses to alter their spending in ways that can be deleterious to the economy.

For some, it may seem like an eternity ago that investors last had to worry about the risks from high inflation. Over the past three decades, we have mostly experienced declining inflation rates, a phenomenon that economists refer to as disinflation. Since the end of World War II, the consumer price index (CPI), the most popular measure of inflation, peaked in the summer of 1980 at a year-over-year growth rate of over 14.5%. Since then, it has broadly declined, reaching a low point of -2.0% in the summer of 2009. While the CPI has recovered from these lows, it has largely remained below the Federal Reserve's target growth rate of 2%.

A range of factors have contributed to the recent period of disinflation. First, globalization has allowed developed countries to outsource labor-intensive production to countries with lower wages, such as China and Mexico. In addition, the output gap, the difference between an economy's maximum potential output and its current output, has remained wider than usual as capacity utilization has not fully recovered from the financial crisis. Finally, a broad increase in the supply of commodities has pushed prices sharply lower. Nowhere is this more notable than in the energy sector. Advances in technology involving the extraction of oil from shale deposits have allowed the U.S. to increase oil production dramatically, weighing down the price of oil. These conditions, which have held inflation down for so many years, seem poised to moderate moving forward.

The seeds appear to be sown for higher inflation over the coming years. We appreciate the skepticism this statement may generate following 30+ years of declining inflation. Moving forward, however, we expect a narrowing of the aforementioned output gap, which would put upward pressure on inflation.

We may be nearing an inflection point now. The unemployment rate has fallen from 10% in October 2009 to a recent reading of 4.4%, a level associated with full employment. It seems only a matter of time before full employment causes wage growth to accelerate. Additionally, the balance between supply and demand in the commodity markets appears to be approaching equilibrium. Demand is recovering along with growth in the global economy, and the plunge in oil prices that started during the summer of 2014 has removed weaker producers and prompted the Organization of the Petroleum Exporting Countries (OPEC) to reduce production. We expect that looking back five years from now, 2017 may represent the nadir for inflation growth.

What this means – An entire generation of investors has little experience investing during a period of rising inflation. Inflation-hedged investments, such as Treasury inflation protected securities (TIPS) and gold, currently receive little attention from the media outlets. Nevertheless, inflation is among the most important risks an investor must manage.

To be clear, we are not currently forecasting a period of high inflation. We expect that inflation will return after all but disappearing over the past 30 years. As a result, we are looking for opportunities to mitigate inflation risk in order to preserve our clients' purchasing power. This will likely involve adjusting our real-asset allocation, which includes investments in real estate, natural resources, and other hard assets. While there is no sense of urgency at the current moment, we are actively looking for assets that are positively correlated with inflation.

Monetary Policy Normalization

Investors are sensing a subtle shift in tone from global central bankers. The catalyst for this shift is a noticeable improvement in economic growth. Indeed, global growth accelerated throughout the second half of last year by virtue of easing financial conditions and a recovery in the price of oil. Europe and Japan, notable laggards for much of the past several years, are exhibiting more consistent economic growth. In fact, Japan reported a first quarter 2017 GDP growth rate of 1%, the fifth consecutive quarter of positive year-over-year change, which represents the longest streak in 11 years. As a result, central bankers are openly questioning the need for continued monetary stimulus.

We do not expect monetary policy to reach restrictive levels any time soon. Rather, we are suggesting that policymakers will begin the process of unwinding the extraordinary monetary stimulus put in place in the aftermath of the Great Financial Crisis. For evidence of the extraordinary nature of the current state of monetary policy, one needs to look at the assets accumulated on central bank balance sheets as part of their quantitative easing programs. Central bank balance sheets have increased by more than $7 trillion from pre-crisis levels to more than $15 trillion. In our estimation, the banks have fallen behind the curve as economic growth has outpaced the need for these elevated levels of stimulus.

Policymakers, in an effort to become more transparent regarding future policy maneuvers, have started to warn market participants to prepare for tightening. The Federal Reserve has been at the forefront of this movement, as it started the process of normalizing monetary policy earlier than the others by raising the target funds rate in December 2015 and has since bumped up the rate three more times. More recently, hawkish comments from the

European Central Bank, Bank of England, and the Bank of Canada all point to the possibility of coordinated tightening.

What this means – Monetary policy entered uncharted territory as policymakers implemented unprecedented policies to avoid a depression. These extreme policies were successful in that regard but fell short of fostering strong economic growth. Instead, the economic recovery has been one of the weakest on record.

Where monetary policy was most successful was in propping up the prices of financial assets. This helped the banking sector and broader financial system recuperate, without which the global economy would have remained depressed.

The downside to this is that prices across numerous asset types have been distorted and valuations have been pushed to elevated levels. As monetary policy shifts from accommodative towards restrictive over the coming years, this valuation premium will unwind. We expect that this process will be orderly so long as policymakers remain transparent and deliberate in the removal of these policies. Otherwise, the price adjustments could be abrupt.

Conclusion

The current recovery is the third-longest economic expansion in U.S. history. Therefore, it is unsurprising that we are shifting some of our focus to incipient late-cycle risks. As the economy transitions from early to mid to late-cycle expansion, conditions change, requiring a proactive investment strategy. We believe that managing evolving risks associated with the shifting economic cycles through a combination of prudent strategic asset allocation and anticipatory refinements to our underlying holdings is one of the most important ways in which we can help our clients grow and protect their portfolios.

Colony Spotlight

- The firm's leadership team grew to 38 Principals with the elevation of Ian Barclay, Tim Jester, Craig Jones, Jeremy Kuhlen, Bill Weydemeyer, and John White.
- The Colony Group was named to the 2017 *Financial Times* list of "300 Top Registered Investment Advisors" for the fourth straight year.
- Two grants were disbursed from the Colony Cares charitable fund. Grant recipients were the New England Center and Home for Veterans and PAWS New England.
- Over 100 clients, business partners, and friends joined us at our first Denver-area event, held at the Denver Museum of Nature & Science.

Rocky Mountain Region Managing Directors Craig Jones & Ian Barclay with Colony CEO Michael Nathanson

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