IN THIS REPORT

Political Regime Change | 2
Will the U.S. and China's battle for hegemony lead to a new world order?

Market Regime Change | 3
How sustainable are budding signs of change within both the economy and markets?

MARKET PERSPECTIVES

QUARTER ONE 2021

Investment markets were able to move past the U.S. elections in January despite an attack on the U.S. Capitol building and a contentious U.S. Senate runoff election in Georgia. As January turned to February, investors became more optimistic due to the continued rollout of vaccines and another large stimulus package. Equities rose, setting a succession of new record highs.

This optimism worked against the markets starting in mid-February, however, as market participants began to worry that reopening economies would stoke inflation. Interest rates surged higher with the U.S. 10-year Treasury Bond yield rising by 83 basis points (one basis point equals 0.01%) to 1.74%, its largest gain since the fourth quarter of 2016. The increase in yields, which rise when bond prices fall, caused most fixed-income sectors to post negative returns, with the Bloomberg Barclays U.S. Aggregate Bond Index returning -3.4% for the quarter.

Despite a pickup in volatility, equity markets produced solid returns for the quarter. The S&P 500 generated a +6.2% return, outperforming non-U.S. stocks, which rose +3.5% as measured by the MSCI ACWI ex-USA Index. Otherwise, the leadership change, which began at the end of last year, continued during the quarter, with both value and small-cap stocks outperforming their growth and large-cap peers.

Investor risk appetite also seemed to expand during the quarter. Most notably, stocks such as GameStop (GME) that were touted by retail investors on social media experienced both enormous gains and wild fluctuations in price (The Rise and Fall of Speculative Stocks Explained). Cryptocurrencies such as Bitcoin also appeared to be the objects of speculation.

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Political Regime Change

The rise of China over the past 20 years has caused profound changes to the geopolitical landscape. The country's rapid growth since joining the World Trade Organization in 2001 has the country poised to become the largest economy in the world by as early as 2028, according to the U.K.-based Centre for Economics and Business Research.

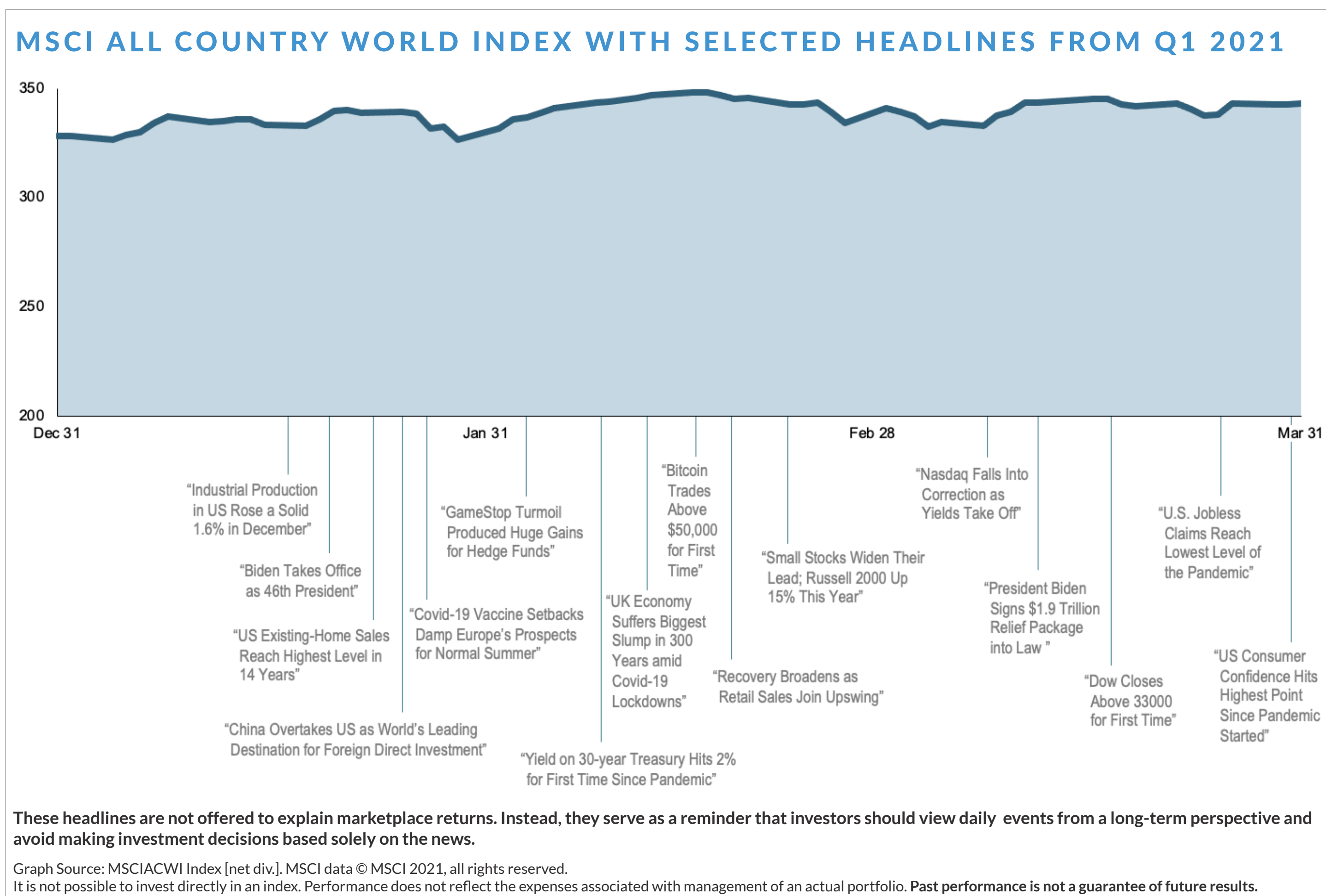
President Donald Trump used the threat from China's ascent to U.S. authority as part of a broader effort to transform the Republican Party. As he was pushing the Republican Party to shift, progressive Senators, such as Bernie Sanders and Elizabeth Warren, were attempting to shift the Democratic Party as well. Progressives used growing wealth inequality, which has intensified over the past few decades, to increase their sway over the party. While President Joe Biden is considered a moderate by many political commentators, the influence of the progressives is meaningful and seems likely to increase.

With both major political parties migrating towards their ideological extremes, it has given rise to historically high levels of partisanship that has consequently contributed to an increase in populist and nationalist sentiment. Both parties have enacted mammoth fiscal stimulus programs over the past several years that appealed to their bases, regardless of the fiscal consequences. Moreover, they continue to use serious issues, such as China, COVID-19, economic inequality, and climate change, to justify further unfunded spending to an extent that the world has never seen.

Political regime change is not limited to the U.S. A wave of immigration from less developed countries into Europe has given rise to nationalist sentiment across the continent, creating challenges for ruling parties in Germany, France, and the U.K. In addition, China's increasingly provocative behavior in the South China Sea has caused countries such as Japan, South Korea, and Taiwan to revisit existing defense alliances and accelerate military spending.

After it is all said and done, the pandemic may prove to be the tipping point for a new world order. Supply shortfalls in personal protection equipment and pharmaceutical raw materials during the early phase of the pandemic and, more recently, a shortage of semiconductors are causing countries to reevaluate their supply chains and trading partners. Furthermore, China's early and aggressive efforts to contain the virus in their own country were largely successful, putting the country in a strong economic position relative to the rest of the world. Many believe that these factors may accelerate the retreat from globalization, which may have started during the U.S.-China trade war.

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q1 2021



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: MSCIACWI 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

China and the U.S. appear headed for a larger confrontation, leaving the rest of the world to choose sides. At this stage, it is unclear how this battle for hegemony will progress, but it is causing many countries to rethink their strategic alliances. Investors will need to follow these developments closely over the coming years.

Investment markets abhor uncertainty, and the changing geopolitical landscape is causing volatility to rise. While it is still early, there are signs of change to the world order of the past 20 years. How all this gets sorted out will go a long way towards determining how investment markets perform over the decades to come.

Market Regime Change

Trading in investment markets over the past twelve-plus months has been extraordinary. The rapid-fire responses to both the emergence of the novel coronavirus and the inevitable economic recovery were breathtaking. Indeed, the drawdown in equities as the world started to become aware of the oncoming pandemic was among the fastest declines ever. Likewise, the subsequent snapback, thanks to an aggressive monetary and fiscal policy response and the medical community's rapid development of effective vaccines, was the fastest recovery from a bear market in history.

Starting in November of last year, we began to see budding signs of change within both the economy and markets, reversing multi-year trends. For example, inflation has perked up of late after lying dormant for decades. Also, value stocks have materially outperformed growth stocks after an unusually long period of underperformance. Investors are right to question the sustainability of these recent trend changes.

The global economy has generally experienced disinflation since former Federal Reserve Chairman Paul Volcker effectively curbed inflation during the 1970s and early 1980s. Since peaking at 14.8% in March of 1980, inflation has decelerated to 1.2% in 2020, owing largely to innovation and globalization. Globalization, which started in earnest with China's admittance into the World Trade Organization in December 2001, enabled companies to outsource manufacturing to low-cost nations, putting downward pressure on prices. As we outlined in the preceding section, the trend towards globalization now appears poised to reverse, potentially removing a major obstacle to rising prices.

When combined with the current staggering level of global stimulus in the world's economy, it appears likely that inflation will accelerate over the coming years. This is not to say that we forecast a return to a 1970s level of inflation. Instead, we see rising inflation on a cyclical basis as the global economy recovers, which could grow more meaningfully if economic growth stays above par for longer than is expected.

We previously noted that value stocks have outperformed growth stocks since the third quarter of last year. This follows a 14-year period of substantial outperformance by growth stocks. How is such a long streak possible when most academics postulate that value stocks generally outperform growth stocks over long periods of time?

Since the Great Financial Crisis, global economic growth has been below average. Not surprisingly, value stocks, which are concentrated in economically sensitive sectors such as industrials, energy, materials, and financials, have underperformed during this period as growth was scarce. Contrarily, value stocks' recent period of outperformance has been sparked by expectations of stronger growth from the reopening of the economy.

Interest rates have also contributed to growth stocks' dominance over the past several years. In our recent blog post, Positioning a Portfolio During Rising Interest Rates, we explained how rising interest rates have a greater negative impact on "Star Growers" versus "Cash Cows," euphemisms for growth stocks and value stocks respectively, because their future cash flows are worth less in today's dollars. The declining interest rate environment over the past 30 years, coupled with slow economic growth, has been an ideal environment for growth stocks. The environment may be changing in favor of value since rates are unable to move much lower as the Federal Reserve seems committed to keeping interest rates above zero and economic growth is poised to accelerate.

WHAT THIS MEANS

It is unclear how sustainable these still-nascent leadership changes are. Indeed, rising inflation and outperformance by value stocks are historically consistent with the initial phases of a bull market. Nevertheless, some pundits have suggested that inflation may run hotter over the next several years as central banks and policy makers commit to resuscitating the global economy. Investors may need to prepare for the possibility of an extended period of above-average growth. Assessing these types of risks is one of our most important roles as investment managers.

Conclusion

It is not uncommon for a crisis to lead to changes to the status quo. For example, the Roaring Twenties ended with the Great Depression, and the Great Financial Crisis marked the end of a period economists refer to as the Great Moderation – a period of reduced volatility in the business cycle that, according to former Federal Reserve Chairman Ben Bernanke, was the result of greater central bank independence.

It is possible that similar upheaval may follow in the wake of the pandemic. While it is premature to forecast major changes at this point, we have highlighted above some potential causes and effects that we see occurring today. While investment markets have plenty of experience in navigating these types of secular change, not all investors do. Therefore, we remind clients that what worked for investors over the past ten years may not be the same as what will work over the next ten years.

COLONY INSIGHTS & EVENTS

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