



MARKET PERSPECTIVES

► QUARTER TWO 2021

The bull market is alive and well as the S&P 500 posted its strongest first-half-year gains since 1998. However, last winter's optimism over the development of effective vaccines and an economic reopening has given way to anxiety over inflation, employment, and decelerating growth. This phenomenon is impacting the bond markets more than the equity markets thus far as signs of decelerating economic growth, which emerged in June, caused long-term bond yields to move lower during the quarter.

Inflation continues to be a primary focus of investors as they debate the sustainability of its recent uptick. Federal Reserve (Fed) Chair Jay Powell has repeatedly proclaimed that the increase in inflation is transitory, caused by supply-chain bottlenecks and comparisons against prior-year, depressed pandemic readings (sometimes referred to as base effects).

Equities were generally higher during the quarter, propelled by stronger than expected earnings growth and lower interest rates. Lower rates helped growth stocks outperform value stocks after materially underperforming them during the

previous two quarters. The latter are still outperforming year-to-date, however. The U.S. outperformed international and emerging equity markets due, in part, to a faster vaccine rollout in the U.S. than most other countries.

Bonds partially recouped first-quarter losses despite higher-than-expected inflation and slightly more hawkish Fed commentary. Corporate bond credit spreads, which measure the incremental yield a corporation must pay investors relative to safer government bonds, declined to historically low levels, driving higher returns from that sector of the fixed-income market. The recent decline in yields, following the end of the quarter, is a warning for investors who believe interest rates can only head higher as the economic recovery gains traction.

Investment markets appear to be transitioning into the next phase of the cycle. These types of transitions often lead to choppy trading. Indeed, the second year of a bull market typically experiences more muted returns relative to the first year's returns, although they are generally positive. We explore this transition more deeply in the remainder of this letter.

Colony Investment Leadership Team



BRIAN KATZ, CFA

*President of Colony
Investment Management &
Chief Investment Officer*



**RICHARD D. STEINBERG,
CFA**

*Chief Market Strategist &
Co-Chair, Colony Investment
Management*



**JASON BLACKWELL,
CFA, CAIA®**

Chief Investment Strategist

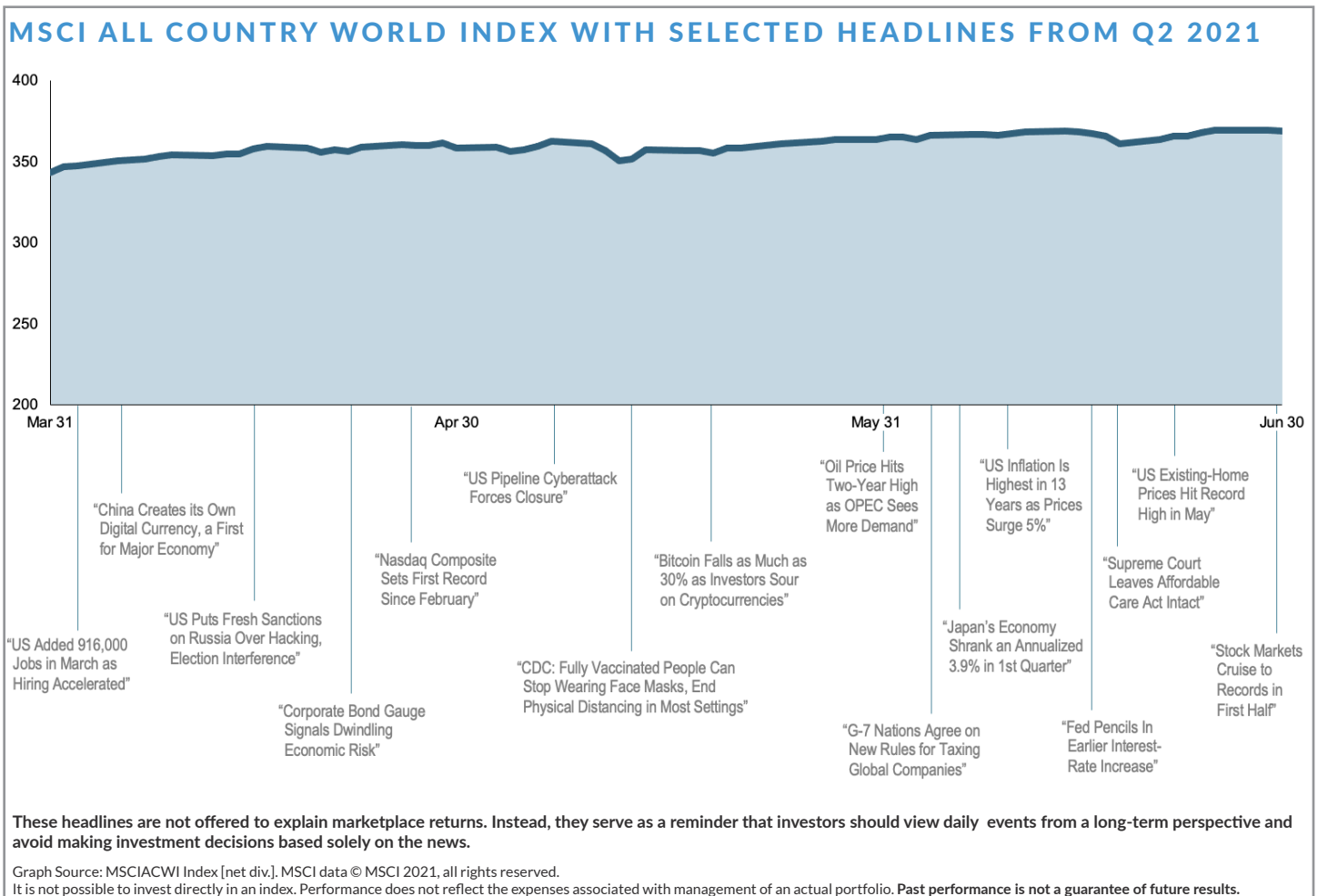
Peak Everything

The pandemic and resultant lockdowns caused one of the sharpest economic declines in history. Business cycles often behave like a stretched rubber band that is pulled downwards from the middle; the snapback is generally proportional to the force with which it was pulled. As such, the strong pace of economic growth experienced during the first half of 2021 should surprise no one. We believe we are near an inflection point that should see segments of the investment markets, fiscal and monetary policy, and the economy normalize relative to the extremes experienced over the past 18 months.

During the spring of 2020, authorities shut down a large portion of the U.S. economy to slow the spread of COVID-19. This caused one of the sharpest quarterly economic contractions in history, second only to the Great Depression. It was understood that once the lockdowns were eased, economic growth would recover at a pace that mirrored the declines. As we have now moved past the anniversary of the low point of the economic contraction, year-over-year comparisons should become more difficult, causing economic growth to normalize moving forward. We have started to see emerging signs of this. Indeed, personal income, personal spending, home sales, automobile sales, manufacturers and non-manufacturers Purchasing Managers Index (PMI) readings, and money supply growth all have reached near-term peaks and are trending lower.

While this scenario was to be expected by investors, it has occurred earlier than some investors thought and is causing increased volatility in the markets. This is normal around inflection points, which are only known for certain with hindsight. Typically, there is a subset of investors that expect the trend to reestablish itself. This may create controversy amongst investors as they reconcile their dueling outlooks. We expect volatility to continue until consensus on the outlook for the markets is achieved.

One reason why economic growth is cresting is that monetary and fiscal policy are passing the point of peak stimulus. As states were locking down their economies, policymakers unleashed a tidal wave of stimulus programs to keep individuals and businesses afloat until a medical solution to the pandemic became available. The amount of stimulus and liquidity generated by these programs were unprecedented. Many of these initiatives are set to lapse shortly, creating a headwind for the economy when compared with the previous year. While the Fed may not raise interest rates anytime soon, other stimulus measures have been phased out, or, in the case of their bond buying program (a/k/a quantitative easing), may be tapered before year end. These reflationary policies have provided support to risky assets over the past 18 months. Policymakers expect to pass the baton to the private sector, as the economic reopening offsets the decrease in stimulus. Of greater concern to investors are



rising short-term interest rates, something the Fed has said it would not do for another couple of years.

We are also beginning to see peaks forming beneath the surface of the economy and markets. For example, earlier in the pandemic, many consumers spent a significant amount of their government stimulus checks on goods, such as laptops, home improvement supplies, and leisure wear. Now that restaurants, bars, concert venues, and movie theatres are reopening, consumers are redirecting their spending towards the service sector. This may lead to important leadership changes across equity sectors and their constituents.

Value stocks received a great deal of attention from investors during the fourth quarter of 2020 and the first quarter of 2021. During that span, value stocks substantially outperformed growth stocks for only the second time in more than a decade. It is commonplace for value stocks to outperform growth stocks during the early phases of an economic recovery as the rising tide of economic growth lifts all boats, especially those that are more pro-cyclical, which are generally concentrated in the value-stock universe. For the past month, however, there has been a noticeable shift in investor preference back to growth stocks. Whether this is the market consolidating previous gains or a sustained change in leadership remains unclear. Nevertheless, it is consistent with peaking economic growth.

We would be remiss to not discuss inflation, which has become a hot debate on Wall Street. Inflation has spiked due to a combination of supply shortages, the economic reopening, and base effects. The Fed has maintained that the acceleration in inflation will be transitory. There are emerging signs that they may be right. Forward-looking, market-based measures of inflation, as inferred from the Treasury Inflation Protection Securities (TIPS) market and consumer confidence surveys, have declined recently.

The trend reversal in inflation sentiment is encouraging investors to align themselves with the Fed's outlook. Interest rates have retraced some of the increases experienced in February when economic reports were surprisingly strong. The 10-year U.S. Treasury yield rose to a closing high of 1.74% at the end of March, up from 0.93% at the start of the year. It has since declined to below 1.30% as the Fed repeats its transitory mantra and recent economic reports have come off the boil.

WHAT THIS MEANS

As we transition into the next phase of the recovery, we believe investors should expect an increase in volatility. Most economists foresee growth normalizing as the economic reopening matures. Many investors mistakenly base their forecasts solely on the most recent data points. As a result, the recent slowdown in some economic numbers has some investors downgrading their growth expectations.

Slowing growth is not the same as slow growth, however. Policy stimulus may be peaking, but interest rates should remain lower for longer, if the Fed is to be believed, and there does not appear to be an appetite to curtail government spending in Congress. Moreover, consumers remain flush with cash, with household savings estimated to be \$2.5 trillion above trend, according to BCA Research, which is equivalent to almost 17% of annual consumption. Surveys show that consumers are eager to travel and spend on experiences that they were unable to access during the lockdowns. Finally, it is possible that we have a long sought-after jump in capital spending by businesses, perhaps driven by the onshoring of supply chains, which were exposed as a weak link during the pandemic. In conclusion, there are many reasons to expect the economy to post above trend growth over the next several years after more than a decade of subpar growth.

Investors are not comfortable with uncertainty and, unfortunately, cycle inflection points generally are a breeding ground for uncertainty. This explains why we expect a bout of volatility as market participants recalibrate their outlooks.

Stocks may continue to generate stronger returns than other asset classes. According to FactSet Research, analysts expect earnings per share for the S&P 500 to grow 37.4% in 2021 and 11.5% in 2022. That could translate into strong gains for stocks if valuations remain constant or even contract a little.

The business cycle is transitioning from the recovery phase to the expansion phase. Historically, this phase is still rewarding for investors. Nevertheless, these transitions are generally not smooth.

Conclusion

As we contemplate the second half of 2021, we are cautiously optimistic. A combination of strong growth and low interest rates are constructive for risk assets. Most bear markets coincide with recessions. We believe the probability of a recession occurring over the near-term is low.

We are also mindful that slowing growth in the U.S. could be offset by stronger growth outside the U.S., Europe (excluding the U.K.), Japan, and the developing markets are only just catching up to the U.S. with administering vaccines. As a result, these regions have been slower to reopen their economies. If growth accelerates into the second half of the year outside of the U.S., it may support an elongated cycle globally.

We are passing the easy part of the market cycle. The cycle is not over, in our opinion, but we expect markets to become more nuanced moving forward. We could see increased volatility and leadership changes across and within the investment markets. It is important not to confuse the volatility caused by this transition with the end of the bull market.

COLONY INSIGHTS & EVENTS

We invite you to read our latest [Our Perspectives, Your Possibilities](#) newsletter dedicated to helping you stay up to date with the latest news about the markets, upcoming webinars, and how we strive to make an impact in the communities we serve. For more market-related insights, visit [News & Insights](#). We look forward to staying more connected and sharing our collective knowledge to give you the tools to move towards your vision of a wealthy life.

Don't miss listening to our [Seeking The Extraordinary](#) podcast, hosted by Michael Nathanson, as he explores the undiscovered world of the extraordinary.



Colony Market Perspectives is prepared by The Colony Group, LLC. Sources include BCA Research, Strategas Securities LLC, and FactSet Research. The Colony Group considers these sources to be reliable; however, it cannot guarantee the accuracy or completeness of the information received. This newsletter represents the opinions of The Colony Group, contains forward-looking statements, and presents information that may change due to market conditions. It is general and educational in nature and is not intended to be, nor should it be construed as, investment advice.

In accordance with SEC regulations, we request that clients contact us in the event that there have been any material changes in their financial circumstances or investment objectives, or if they wish to impose any reasonable restrictions on the management of any accounts or modify any existing restrictions on the management of their accounts.

In Florida, The Colony Group is registered to do business as The Colony Group of Florida, LLC.