The Colony Group
Investment Outlook Series
October 2021

Our View

The U.S., China and India represent some of the largest economies and populations in the world and are important areas of focus for our investment portfolios. Each country has had notable negative headlines this year. However, in each case, we think there are reasons to be invested as patience and preparation are necessary tools to harvest the next investment opportunity.

U.S.

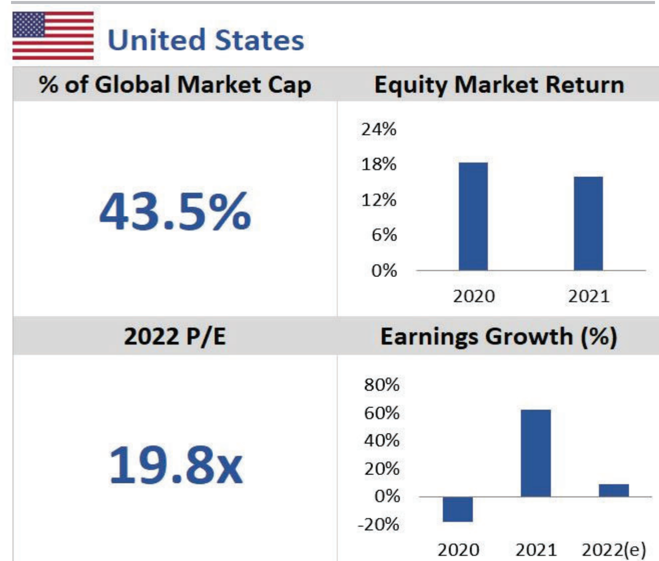
Low interest rates and improving business conditions usually make for a good equity market, and we have had that for much of the last 18 months. More recently, negative inflation data has raised the question among investors; is this the end of low rates and the equity bull market? One challenge to a clear answer has been the pandemic. For example, many global supply chains are currently broken, resulting in an increase in prices due to supply shortages which are likely neither permanent nor immaterial. This type of inflation cannot be cured simply by central banks raising interest rates in our opinion. More likely, the Fed will get its signal to increase rates from an improving labor market, higher wages, and more certainty around imbedded inflation. Importantly, higher rates do not automatically result in a bear market and there are numerous examples to support this, the best recent example being the 17 rate increases (25 basis points each) from 2003-2007[1] before the equity market capitulated.

Nonetheless, it is likely equity market volatility will increase as this process begins, especially since investors in the last decade have experienced very little Fed tightening since the great financial crisis with one exception in 2018 when there were four rate increases, the last two of which made equity investors nervous about the trajectory of future increases.

While the market may take some time to digest the prospect of higher rates, we think there is a positive five-year scenario of global growth built on increasing vaccine penetration and an eventual end to the pandemic. A backlog of pent-up demand for capital goods and services will provide a tail wind for companies and industries at a time when consumer and corporate balance sheets are strong. Inflation will likely be higher than recent history, but not so high as to cause the Fed to implement extraordinary measures. In our opinion, the result of this confluence of relative strength will be increasing earnings growth for corporations in an environment that should still allow for valuations to remain above historic averages (chart 1).

[1]The Federal Funds target rate went from 1.0% to 5.25% over this four-year period.

Chart 1



Source: The World Bank and Bloomberg. S&P 500 index. 2021 is YTD through 9/30.

India

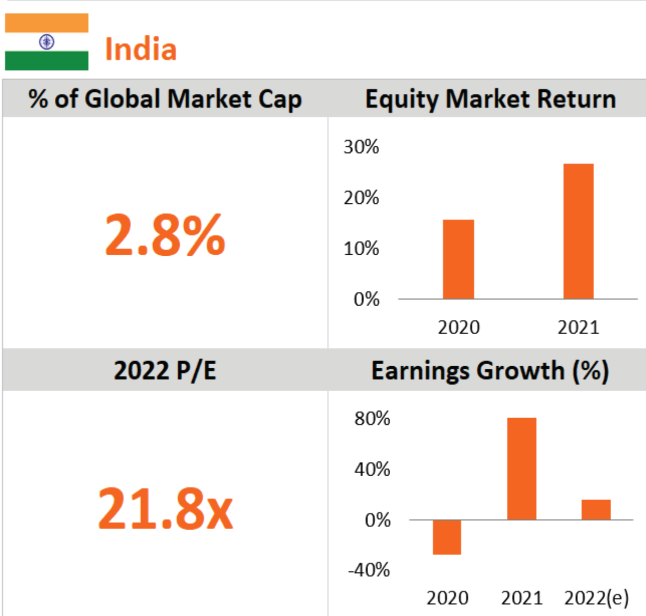
Notwithstanding a population of 1.4 billion people, India makes up less than 3% of the global equity market capitalization, making it “too small” to be worthwhile for some investors. We disagree. India has one of the world’s youngest and most attractive demographic profiles making it an area of intense focus for us long-term. When the global pandemic struck, the kneejerk reaction for many investors was to sell equities, especially in developing markets like India which were presumed to be at greater risk due to population density and a relatively poor health care system. In fairness, this year the pandemic in India created a severe health crisis resulting in significant business disruptions. However, what has not been reported is how well India is performing despite the health crisis.

Investment Outlook

Since April 2020, the Indian equity market has appreciated 112.6%[2], buoyed by some advantageous structural developments which suggest ongoing durability. Large economic sectors of the economy such as technology and real estate are driving job growth and benefitting from pandemic driven realities that companies will utilize more technology and people want more residential space. Government divestment and privatization is also creating opportunities and expanding enthusiasm for the private sector. Additionally, the trade wars of the last several years have injected a sense of pragmatism in global buyers to expand their supply chains, a benefit to India's exporters which have been taking incremental market share from China and others. India's "start-up" ecosystem is thriving with new companies achieving critical mass faster than anticipated, and job creation expanding rapidly (e.g., e-commerce delivery).

Indian listed companies have benefitted from faster and more successful adjustments to global supply chain issues than the larger, unorganized private segment of the Indian economy, leading to market share gains and strong earnings growth (chart 2). The combination of strong growth and rising global equity multiples is affording India a premium equity valuation, one that can be supported by India's growth rate potential, which should exceed developed economies.

Chart 2



Source: The World Bank and Bloomberg. MSCI India index. 2021 is YTD through 9/30.

[2]Source Bloomberg. MSCI India index, 4/1/20 through 9/30/21 including dividends.

China

China stands in stark contrast to India with its slowing economic growth, autocratic government, aggressive geopolitical activities (e.g., Taiwan), and increasing regulatory oversight. The avalanche of negative headlines coming from China has led its equity market to decline -16.6% this year. The market now trades at a modest 12.5x CY 2022 earnings (chart 3), a substantial discount to developed and developing markets. Skepticism regarding China is so high that market pundits are asking, is the country even investible?

Chart 3

Source: The World Bank and Bloomberg. MSCI China index. 2021 is YTD through 9/30.

In our view China should trade at a discount to India, the U.S., and many other developed markets, but we are not of the view that the world's second largest economy is wholly un-investible. Regulatory action that appears to be targeting foreign investors (e.g., the U.S. IPO of Didi), technology companies, and entrepreneurs (e.g., Alibaba and Tencent) is not about the narratives being peddled by the press, but rather about needed regulatory oversight in an economy where business, technology, and society are changing rapidly. Lest we forget, the U.S. has plenty of regulatory oversight for the same purpose of protecting consumers and competition.

The Chinese government's primary goal is to prevent social unrest in an effort to stay in power. Increasing oversight on rapidly growing technology monopolies,

after school for-profit education companies, usurious lenders, all have the politically popular benefit of protecting the interests of the common person as well as being necessary for the government to keep up with the evolution of Chinese enterprises.

A second goal of China is to expand its sphere of influence, access to foreign capital, and standing in the global community. One ultimate means to this end is to have the Renminbi become a global reserve currency, competing with the U.S. Dollar, Euro, and Japanese Yen. This will take time and can only happen by having large and stable investment markets (currency, equity and debt). In our opinion, It is counterproductive for China to punish foreign investors and lose access to their capital. In fact, if one looks at China over the past 20 years, it has been putting an infrastructure of markets and policies in place to open China and compete on a global basis for foreign capital. Increasing regulation is one measure that could be deemed beneficial, not only for protecting the domestic consumer but also foreign investor interests.

This summer it was revealed that China's largest property developer, Evergrande, was existentially indebted. Investors are applying the cockroach theory and extrapolating that other property developers face similar leverage and solvency issues, which has ramifications for several sectors of the economy with close ties to property development, such as banks, materials and manufacturing. Tightening credit standards in China seems likely, as does a related slowing of the pace of economic activity. The risk of a major financial default in China is unknowable and unanalyzable, which means the overhang in the Chinese equity markets is likely to continue until there is some resolution. However, if a major default were to occur, the subsequent volatility could make for a very interesting opportunity to invest in some world class assets and businesses at more attractive valuations.

Circling back to incentives and priorities, the Chinese government is unlikely to accept social unrest, which means a workout or bailout is a likely outcome if necessary. As a result, we feel China, the world's second largest economy, is investible over the long-term; but it requires the discerning eye of experienced active managers to identify only the highest quality investments.

Closing Thoughts

Investors almost never get the proverbial free lunch of low valuations, boundless growth, and a positive narrative environment, which means that, as investors, we need to accept risk to generate a return that is greater than the risk-free rate. Today's market is a good example of this, as valuations are above historic averages and there are plenty of negative headlines. These can be mitigated by maintaining a long time horizon and selecting prudent risks, which we see as evident in all three geographies.

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