



**The Colony Group**

# MARKET PERSPECTIVES

## ► QUARTER ONE 2022

**T**he unusual nature of the global pandemic helped lead to the extraordinary economic cycle we are currently experiencing. Over the past two years, we have had the shortest economic contraction, quickest economic recovery, briefest bear market, and speediest recovery from a bear market in history. The word “unprecedented” has become tired and overused during this period but, as we discuss throughout this letter, still seems fitting.

To be sure, the first quarter of 2022 was a volatile one. Investors faced the first Federal Reserve (Fed)-orchestrated interest-rate increase since 2018, Russia's invasion of Ukraine, a spike in oil and commodity prices, accelerating inflation, new variants of the coronavirus, and rising long-term interest rates. These issues sent equities on a roller coaster ride that pushed the S&P 500 Price Index to a decline of 12.5% through early March, only to then rally 8.6% into the quarter-end. By the end of March, the pain from the market having experienced its first correction since the pandemic selloff was subsiding.

Despite the outsized moves of the equity markets, commodities stole the spotlight. As measured by the S&P/GSCI Index, commodities returned 33.1%, their best quarter since the third quarter of 1990. Oil prices jumped to over \$100 per barrel after Russia invaded Ukraine, as Russia is the third-largest producer and largest exporter of oil. Notably, the commodity rally expanded well beyond energy with both agricultural and industrial commodities surging too. The sharp move higher in commodities is once again stoking inflation concerns. The Bureau of Labor Statistics reported that the Consumer Price Index (CPI) rose 8.5% in March compared to last year, the fastest year-over-year increase since December 1981.

The surge in inflation prompted one of the largest drawdowns for bonds ever, according to Bloomberg News. Rising rates caused the Bloomberg Aggregate Bond Index to return -5.9%, its worst quarterly performance in over 40 years.

Higher inflation and rising bond yields are causing many strategists to reduce their growth forecasts. While we agree

## Colony Investment Leadership Team



**BRIAN KATZ, CFA**

*President of Colony  
Investment Management &  
Chief Investment Officer*



**RICHARD D. STEINBERG,  
CFA**

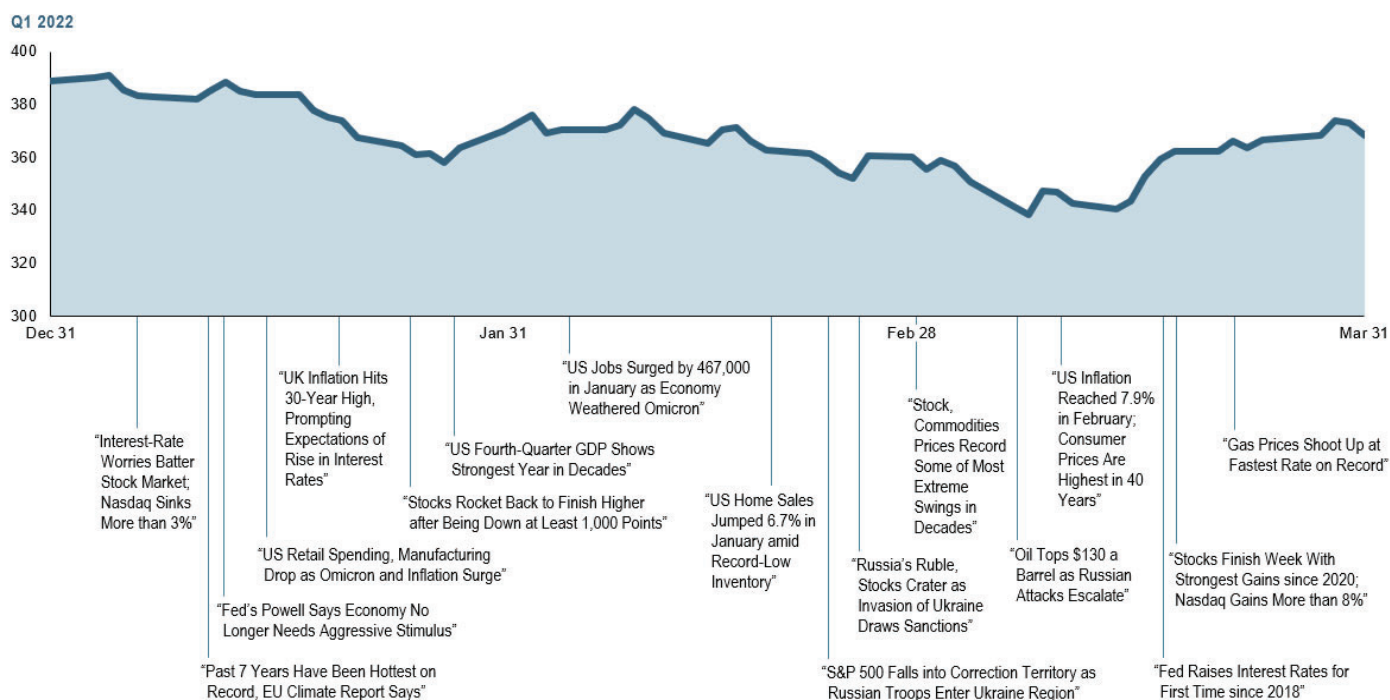
*Chief Market Strategist &  
Co-Chair, Colony Investment  
Management*



**JASON BLACKWELL,  
CFA, CAIA®**

*Chief Investment Strategist*

## MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q1 2022



*These headlines are not offered to explain market 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 dividends]. MSCI data © MSCI 2022, 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.

that the odds of a recession have increased, we believe it would take a more significant deterioration in economic activity for the U.S. to fall into recession. A strong labor market and robust corporate earnings, along with relatively narrow credit spreads, suggest the economy still has adequate momentum. We'll be watching these data points for potential shifts in our outlook.

## ABC's of the Yield Curve

This quarter, the Fed started the process of reversing its easy monetary policies put into place during the pandemic. Its first step was to raise the federal funds target rate by 0.25%. This caused a sharp move higher in bond yields and has many pundits intensely focusing on the yield curve.

Bonds issued by the U.S. Treasury come with varying maturities and yields. Typically, the longer the maturity, the higher the yield. These differences in yields across scaling maturities, often referred to as the term structure, reflect investors' expectations for future interest rates. Of course, the path of future interest rates is inherently unknowable, which is why the price of bonds is constantly changing.

The yield curve plots the yields for Treasuries across a set of maturities. It is normal for the curve to be upward sloping as investors demand more yield for accepting the uncertainty of future

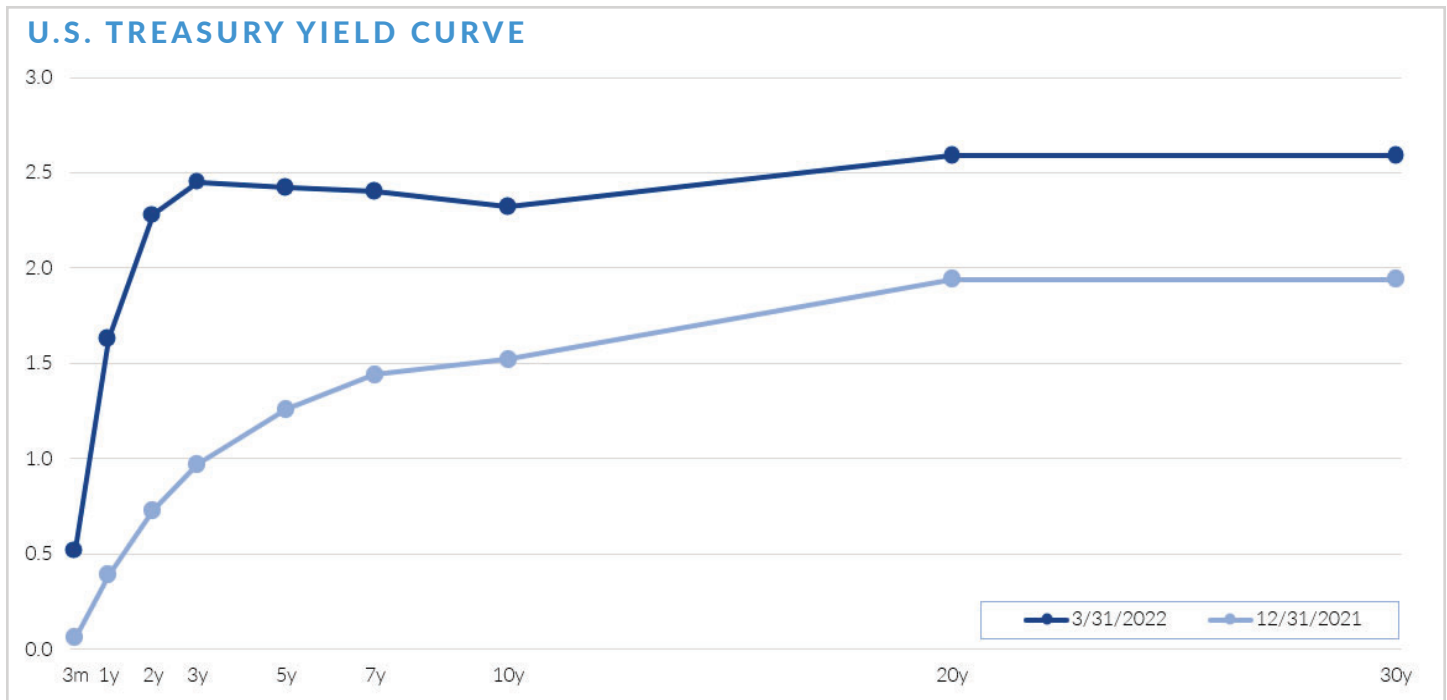
interest rates. When the yield curve inverts, it means the yields on longer-term bonds are lower than those on shorter-term bonds. Historically, an inverted yield curve has been a harbinger of a recession.

While yields have risen across the curve, the sharpest increases have occurred in the shorter end of the curve, specifically for 1-, 2-, and 3-year Treasuries. Indeed, recently, the 2-year Treasury yield briefly moved above the 10-year. While this piece has inverted, it has not been confirmed by other segments of the curve. The Fed prefers the 10-year and 3-month yields, which remain sharply positive.

It generally takes up to two years from the initial yield-curve inversion before a recession takes hold. Given that potential runway, we feel comfortable waiting for more data for confirmation. As we write, only two (5y/10y and 20y/30y) of the 56 segments on the standard yield curve have inverted. We usually see more than half of the points invert before a recession.

### WHAT THIS MEANS

The yield curve is telling us something, but as of now its message remains hazy. We concur with those who argue that the economy is more fragile now than at the outset of the year. Persistently higher than expected inflation, partly exacerbated by the Russia-Ukraine war, and hawkish central banks are imposing a growth tax on the



Source: Federal Reserve Bank of St. Louis.

economy. Nevertheless, we are not convinced that a recession is either imminent or unavoidable.

We are not as confident that the yield curve can still accurately discern when an economic contraction is forthcoming due to quantitative easing (QE). Since the Great Financial Crisis, the Fed’s QE programs make it the largest purchaser of Treasury bonds, which is depressing yields and distorting the messaging inherent in the yield curve.

Instead, we suspect that the bond market is telling us that the Fed is unlikely to completely follow through on its commitment to raising rates rather than that an economic slowdown is imminent.

## Don’t Give Up on Bonds

For decades, academics and financial practitioners have argued that bonds were effective at increasing diversification and reducing risk in a portfolio. After the worst quarterly decline for the asset class in over 40 years, some investors may be questioning this axiom.

We believe that some historical context warrants consideration. Correlations between equities and bonds have oscillated between positive and negative over the last several decades. Over the long-term, however, bonds have proven to be a useful diversifier.

In the post-World War II era, there have been two major interest-rate cycles. The first cycle saw the 10-year U.S. Treasury bond rise to 15.8% in 1981, its highest level ever. Fed Chairman Paul Volker raised interest rates to record high levels to break the rampant and persistent inflation of the 1970s. Long-term interest rates then started a long decline that culminated with the 10-year yield

touching 0.32% in March 2020.

It is understandable why many investors feel that a new cycle of rising interest rates has begun. Since the lows, the 10-year has climbed approximately 200 basis points through quarter end. Inflation remains sticky, causing many to believe rates will remain elevated. The Fed is forecasting seven rate hikes in 2022, with the federal funds target jumping to 2.8% through the end of 2024.

Nevertheless, many of the factors that pushed global interest rates lower remain in place. First, savings are outgrowing private investment. Excess savings are generally invested into safe government bonds, pushing yields lower. Next, most of the recent rise in inflation is from supply disruptions rather than excess demand. When these supply disruptions dissipate, inflation should settle down, allowing yields to ease. Lastly, a combination of weak productivity growth and demographics, or slowing population growth, has prevented global GDP growth from accelerating over the past decade. These conditions are unlikely to shift meaningfully anytime soon.

### WHAT THIS MEANS

There are good reasons to believe that rates are heading higher over the near term. Inflation remains elevated, and the Fed seems intent on increasing rates until inflation slows.

The markets are saying that these issues will abate, however. Inflation expectations, as exhibited by the futures markets, show that institutional investors expect inflation to remain high over the near term but then come off the boil a few years from now. Some forward markets are even predicting a rate cut as early as 2023.

It is likely too soon to start doubting the diversification benefits of fixed income. Negative returns from the equity markets in the first quarter were not offset by positive returns from fixed income, as has been the case in the past. Nevertheless, one quarter does not constitute a trend. The interconnectedness of bonds, the economy, and equities supports the idea that at some point the negative correlation between stocks and bonds will return. This may occur if the Fed raises interest rates too much, causing economic growth to slow and bond yields to fall.

## Conclusion

Investors struggle with uncertainty, and the path forward from today has many unknowns for us to ponder. The current economic recovery is highly atypical, and no investor alive today has experienced anything like it. In addition, the Russia-Ukraine war has had its share of surprises, ranging from the intensity of Ukraine's resistance to the coordinated sanctions imposed by the West. Finally, the supply-chain disruptions from the pandemic and the war have no clear end in sight.

We came into the year expecting that growth would slow from the high rates experienced in 2021. That may happen more quickly than we originally expected if the war continues to disrupt supply chains

and commodity markets, keeping central bankers more inclined to raise interest rates. Thus, the path forward remains highly uncertain. A combination of strong economic momentum, excess savings on consumer balance sheets, and a tight labor market with rising wages have us still leaning cautiously optimistic.

Both stocks and bonds declined during the first quarter, causing investors to question the diversification benefits of fixed income. The current interest-rate cycle may squeeze future returns, but the correlation between equities and fixed income should not remain high indefinitely. At some point, the Fed will succeed in containing inflation, and expected returns from bonds should expand.

Given the myriad and changing variables involved in forecasting short-term returns, we endeavor to build all-weather portfolios with both offensive and defensive characteristics. We sometimes reweight our allocations between the two based on our perception of risk and opportunity. We believe this is the most prudent approach to helping our clients achieve their goals.

---

Sources: Strategas Research Partners, Bespoke Investment Group, BCA Research, International Energy Agency (IEA), Ned Davis Research, Bloomberg, Morningstar Direct, FactSet, and Dimensional Fund Advisors.



Colony Market Perspectives is prepared by The Colony Group, LLC. Sources include Strategas, JP Morgan, and FactSet. 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.