



MARKET PERSPECTIVES

▶ QUARTER TWO 2022

U.S. equities experienced their worst first-half performance since 1970. Typically, when equities suffer from large declines, investors can rely on their fixed-income investments to help soften the blow. That was not the case, however, as nearly every asset class declined in value.

The S&P 500 declined -16.1% during the second quarter as markets absorbed an evolving list of risks. In January, the Federal Reserve (Fed) started preparing investors for the removal of the monetary stimulus put in place during the pandemic. May's consumer price index (CPI) increased 8.6% year-over-year, the largest rise since 1981, causing fear that inflation was growing out of control. As a result, the Fed raised the Federal Funds target rate by 75 basis points (0.75%), fueling concerns that higher rates might lead to a recession.

These issues were not unique to the U.S. as international equity markets also experienced declines, with the MSCI ACWI ex-U.S. Index down -13.7% during the quarter. Global economies are slowly desynchronizing as exogenous events,

such as the Russia-Ukraine war and China lockdowns, have differing effects on regions around the world. Certainly, Europe's reliance on Russian natural gas is exacerbating the impact the war is having there more so than in the U.S., which imports very little Russian oil and gas. Nevertheless, European equities modestly outperformed their U.S. counterparts, most likely because of materially lower valuations.

Bonds once again failed to be the counterbalance that investors expected, with the Bloomberg U.S. Aggregate Bond Index returning -4.7% this quarter. While bond returns improved modestly from the first quarter (and outperformed equities), the -10.4% return for the first half of the year represents one of the worst drawdowns in the asset class's history. Near the end of June and into early July, bonds became uncorrelated with equities, providing hope that their diversification benefits are re-emerging.

As we consider how the rest of the year may unfold, we encourage clients to keep their wits about them. All too often

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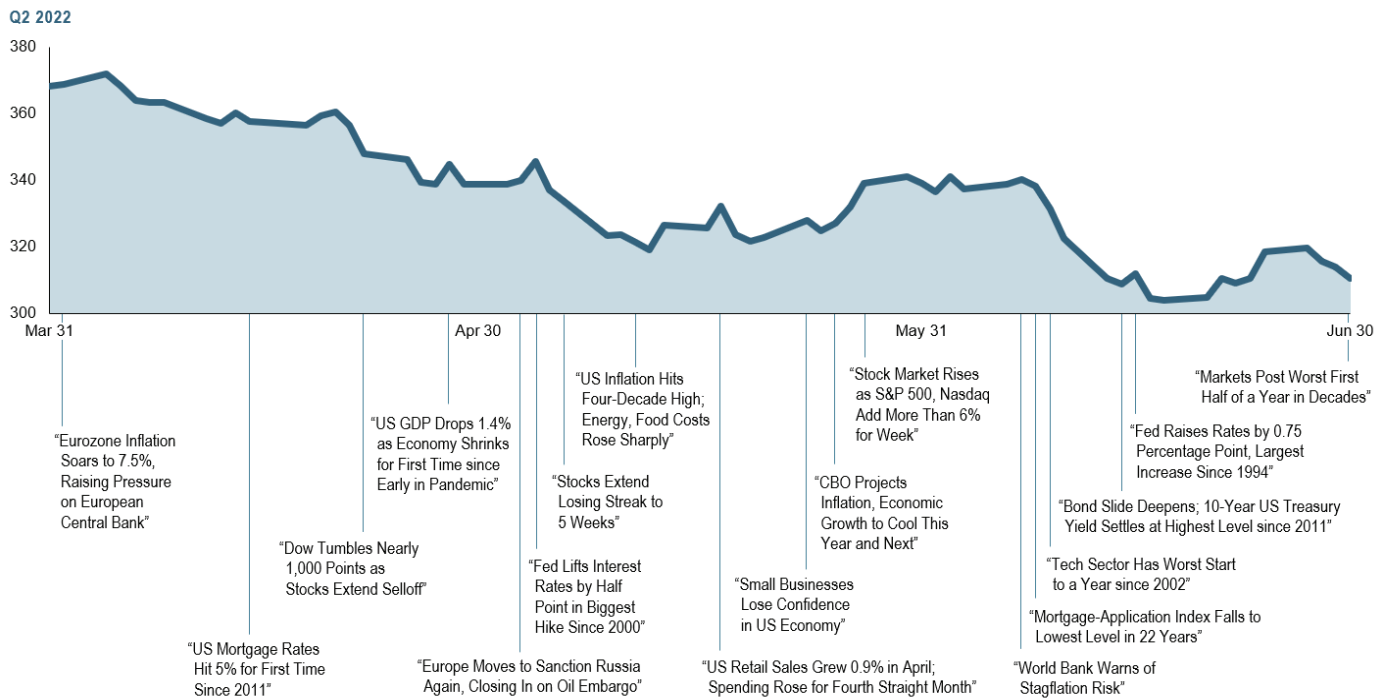
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MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q2 2022



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.**

investors let their emotions get the best of them when making decisions. While the world economy has challenges ahead, we remind you that despite the multitude of crises we have endured over the past 100 years, the economy and investment markets have remained resilient.

“I Go to Extremes” – Billy Joel

Capital markets tend to swing between the emotional extremes of fear and greed; after all, humans are still the marginal decision-makers. Today, fear is dominant. Markets have had much to worry about, including war, an unrelenting pandemic, high and seemingly unbridled inflation, continued supply-chain challenges, rising commodity prices, and an increasing probability of recession. That’s a lot to assimilate in a half year.

When volatility becomes apparent, as it is now, and uncertainty is running high, investors tend to push markets sharply lower, often to levels below their intrinsic value. Contrarily, when greed is the dominant emotion and fear of missing out (FOMO) is rampant, markets sometimes soar to levels beyond what a rational person would consider reasonable.

Market pundits sometimes focus on averages to provide context for the current environment. For example, an often-repeated fact that uses averages is that U.S. equities have returned 10.5% annualized

from 1926 through the end of last year. Another is that the trailing 12-month price-to-earnings (P/E) multiple paid for stocks in the S&P 500 has averaged 17.7x over the past 20 years. While this information can be useful, it belies the fact that actual returns or P/E multiples spend very little time at or near the average. Indeed, since World War II, the number of calendar years U.S. equities returned the average, which for this exercise we define as +/- 1.5% from the average, was five out of 76, or less than 7% of the time. More often, particularly over shorter periods of time, returns and valuations are materially higher or lower than what is implied by looking at averages.

Arguably, this speaks to the degree to which emotion influences market prices. Based on the evidence, it holds significant sway over short periods of time. We are reminded of a famous quote from Benjamin Graham, whom some consider to be the father of value investing: “...in the short term the stock market behaves like a voting machine, but in the long term it acts like a weighing machine.”¹ The rise and fall of the meme stocks is a recent example of Graham’s premise, whereby greed pushed these stocks well beyond what the fundamentals support. Ultimately, these stocks reversed course and gave up unwarranted gains. The above quote effectively summarizes our argument that sentiment and public opinion dominate over the near term, but, over the long run, fundamentals like growth and valuation should prevail.

¹Benjamin Graham, *The Intelligent Investor*, 4th ed., 2003, Chapter 1.

WHAT THIS MEANS

Investors have turned cautious after nearly two years of optimism. In hindsight, there was likely too much complacency at the start of this year. If this complacency was the kerosene, then rising interest rates, a war in Europe, and China's draconian Covid response were the matches that ignited investors' angst. As inflation reached historically high levels and the Fed conveyed its resolve for continuing to raise rates until inflation is defeated, investors responded by taking prices down across most asset classes.

We believe that at some point, if we are not there already, the markets will become oversold and present a buying opportunity for longer-term investors. Market bottoms are a process, usually occurring only after the market has undergone several selloffs and partial recoveries and when the news flow and sentiment reflect peak pessimism.

Cycles

As we outlined in the previous section, there currently are a multitude of issues weighing on the markets and economy. We share investors' concerns regarding these issues but take solace in knowing the U.S. economy has coped with worse. Since the turn of the century, our economy has survived the dot.com bubble, the Great Financial Crisis, the debt-ceiling crisis and resulting U.S. credit-rating downgrade, and a global pandemic. Many considered these events insurmountable while they were occurring. Yet the country endured, and the economy prospered.

How is it that the U.S. economy has regularly recovered to new highs following a crisis? According to a recent Barron's article, the U.S. economy has increased 30-fold since 1920, more than 10 times as fast as the population grew.² We believe a host of factors contributed to this achievement, not the least of which is the inherent resiliency innate to a market-based economic system.

In a market-based economy, prices are usually determined by buyers and sellers. Prices generally adjust until supply and demand come into balance. Inflation is typically the result of either too much demand relative to supply or too little supply relative to demand. Today, a combination of strong demand and reduced supply has conspired to push inflation to elevated levels.

This process of price discovery on a macro level is what helps create economic cycles. Buyers and sellers often move past equilibrium, sometimes causing expansions, contractions, inflation, or deflation. Both the Fed and politicians have tried to manage these cycles through policy decisions. The Fed's management of monetary policy has been a focal point this year. By raising or lowering interest rates, the Fed hopes to affect the cost of capital, which has consequences for the economy.

The economy has gone through many cycles of expansions and

contractions. Often, one sows the seeds of the other. During a contraction, the Fed will reduce the cost of capital by lowering the Federal Funds target rate, inducing companies and consumers to spend more. A company considering a capital investment that may have been unprofitable under a higher interest-rate regime may find that same investment profitable if the cost to borrow is lower. Likewise, consumers can better afford big-ticket purchases, such as houses and automobiles, if the cost to finance those purchases is lower.

Monetary policy is often described as a blunt instrument. It takes time for these types of policy changes to work their way into the system. Given the long lead times, it is not uncommon for the Fed to overdo it. Indeed, our current situation is at least in part due to the stimulus put in place during the economic recovery. While their current objective is to slow rather than stall the economy, it is possible that they tighten more than necessary and we find ourselves in a mild recession. Given the magnitude of the current market decline, we believe investors are already discounting this outcome.

WHAT THIS MEANS

While the U.S. economy is not an entirely free market, as policy makers increasingly meddle, it remains arguably one of the best examples of a market-based economy. The current bout of rising inflation is partly a function of policymakers' attempt to mitigate the economic hardship caused by the pandemic, as higher demand was pulled forward by extraordinary levels of stimulus. Now that the Fed has started its tightening campaign in earnest and as the fiscal thrust wanes, it is interesting how quickly inflation fears are starting to give way to fears of a recession. While we would never openly root for a recession, it would likely have the beneficial effect of taking the wind out of the inflation sail. The Fed seems to believe that this is a worthwhile price to pay to prevent inflation from becoming entrenched.

Conclusion

We believe the global economy is at an important crossroad. On the one hand, the significant amounts of stimulus still in the system, along with the previously mentioned exogenous shocks, are causing prices to rise at a rate not seen since the early 1980s. This inflation is causing angst among investors, which is affecting most asset classes.

As this stimulus is slowly removed, now that nearly every central bank across the world is engaging in some form of monetary tightening, a new fear is emerging. Investors are slowly shifting from concerns about inflation to concerns about a recession. Ironically, often one is the cure for the other. In this case, a growth slowdown may be just what the doctor ordered to help quell inflation.

We are compelled to remind clients that what is transpiring in the economy in the Covid era is unique. Never has the global economy been essentially turned off for several months and then almost as abruptly restarted. This explains the extraordinary economic growth of 2021 and at least some of the resultant high inflation. Economists expected that both growth and inflation would decelerate. We are seeing that in the economic growth numbers and likely would have

seen inflation come down if not for the war pushing up commodity prices and China's continued lockdowns in 2022 extending supply-chain shortages. We recommend not overreacting based on these observations while the world continues to readjust.

Sources: U.S. Energy Information Administration (EIA), FactSet, Morningstar Direct, Investopedia, and Barron's.



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