



The Colony Group

MARKET PERSPECTIVES

► QUARTER THREE 2022

Investment markets got off to a promising start in the third quarter before ending with a thud. After a challenging first half of the year, risk assets began a recovery in mid-June with the S&P 500 rising 17.4% between June 16 and August 16. Bonds also staged a rally with the Bloomberg US Aggregate Bond Index rising 4.3% over a similar period. The recovery proved fleeting, however, as it became clear that the Federal Reserve (Fed) was not close to pivoting away from hiking rates, causing the S&P 500 to end the quarter at new lows for the year.

The key events influencing the quarter were a worse than expected September CPI report, two rapid three-quarter percent interest-rate increases, and Fed Chairman Powell's hawkish speech at the Jackson Hole Economic Symposium acknowledging that raising policy rates to combat inflation may cause economic pain. These events pushed most risk assets back toward their prior lows. Domestic equities and fixed income both experienced similar declines: -4.9% for the S&P 500 and -4.8% for the Bloomberg US Aggregate Bond Index.

International equities performed worse, with the MSCI All Country World ex-USA Index declining -9.9%, although most of this differential was driven by the strong U.S. dollar, which we expand upon below.

This has unquestionably been a painful year for investors. While many of us have experienced equity drawdowns worse than this, we have not in recent times had to navigate an environment where both stocks and bonds experience simultaneous, meaningful declines. Indeed, the traditional 60/40 portfolio (60% S&P 500 / 40% Bloomberg US Aggregate Bond Index) had its worst first three quarters of performance in over 50 years.

Yet, every dark cloud has its silver lining. The move down in bond prices means that yields have risen to the most attractive levels in several years, particularly shorter-maturity bonds. Moreover, the selloff in equities has pushed stocks to more reasonable valuations and removed some froth from speculative areas of the markets.

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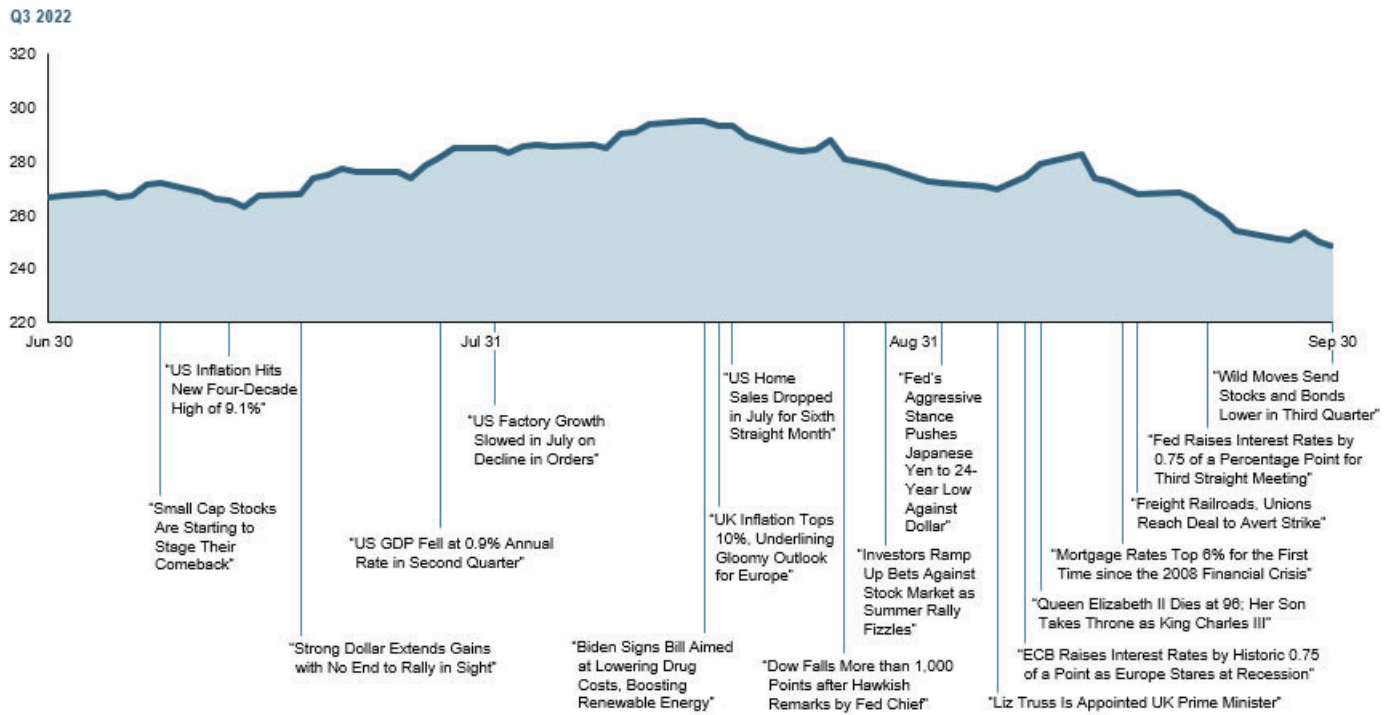
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MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q3 2022



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 remain largely focused on the Fed and its interest-rate projections. This explains why we are seeing extreme reactions to each new economic data point. In this environment, bad news for economic growth can be good news for the financial markets since slowing growth may provide the Fed the cover to moderate its hawkish stance. We are also beginning to see investors' fears shift from inflation toward the growing probability of a recession.

Weighing the Risk of Recession

We have talked repeatedly in past letters about how remarkable the pandemic and post-pandemic economy has been. The global economy was effectively shut down and then restarted. Policymakers across the globe supported their economies at a scale that surpassed anything seen in history, including both the Great Depression (1929 – 1939) and Global Financial Crisis (2007 – 2009). The pandemic and the resulting economic response caused the U.S. economy to experience its sharpest contraction on record followed by the strongest GDP growth since 1984. As we again find ourselves in uncharted territory, strategists are struggling to determine what might come next, as demonstrated by the wide dispersion of their forecasts.

As the Fed continues its unprecedented monetary tightening campaign, investors' angst is slowly transitioning away from inflation and towards the risk of a recession. The Fed has hiked rates by more than three percentage points since March and has guided for an additional 1.25 percentage points before the end of the year. Nevertheless, despite the Fed's determination, many economists still believe that interest rates remain accommodative because target rates remain below the inflation rate.

It is more than just monetary policy that is providing a headwind to growth. Financial conditions have tightened across a multitude of factors. Strength in the dollar is challenging companies selling goods and services outside the U.S. (more on this in the next section). Credit spreads, which measure the incremental yield above Treasuries that companies must pay to borrow, have widened out, increasing the cost of capital. The Federal Reserve Bank of Chicago maintains an index called the National Financial Conditions Index that does a nice job of illustrating this broader point. It shows that financial conditions have tightened considerably over the past several quarters, bouncing around the line that separates accommodative and restrictive.

CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX



Monetary policy generally works with a lag of nine months to two years; thus we expect to see more signs of slowing growth before the end of the year. Also, because of this lag, many investors are skeptical that the Fed can orchestrate a so-called soft landing, where economic growth moderates but avoids a recession.

Importantly, should we fall into a recession, it does not necessarily mean that investment markets are poised for another significant leg lower. We believe that recessions generally fall into two broad categories, which we refer to as either a boom-bust recession or a balance-sheet recession.

The boom-bust recession is the more common of the two. These are usually the result of an overheating economy that causes inflation to rise. The Fed responds by increasing rates in an attempt to rebalance demand and supply. This often leads to a slowdown in demand beyond what the Fed intended, pushing the economy into a contraction. Ironically, the Fed's attempt to regulate the economy is what usually causes these types of recessions. Notably, these retrenchments tend to be shallower and shorter in duration.

Conversely, a balance-sheet recession is usually much more severe. They are characterized by high levels of private-sector debt frequently arising from overinvestment. The best example of a balance-sheet recession occurred during the Global Financial Crisis, when cheap money caused excessive investment in the residential real estate sector. This led to systemic failures within the financial system due in part to the abundance of mortgage debt cycling through the finance industry. Balance sheet-recessions typically take longer to work themselves out, and the damage is generally more severe.

WHAT THIS MEANS

It seems inevitable that the U.S. will enter into a recession sometime over the next couple of years. That assumes we are not in one already. While that may scare investors, history shows that it is customary for the economy to experience cycles despite policymakers' best efforts to avoid them.

We remain in the camp that, if we have a recession, it will likely be of the milder, boom-bust variety. We are not seeing signs of widespread overinvestment, and private-sector debt as a percentage of GDP is below recent highs.

King Dollar

The dollar continues to operate as the world's dominant reserve currency. According to the International Monetary Fund (IMF), approximately 60% of global central banks' foreign exchange reserves are in the U.S. dollars. Moreover, about half of all international trade, loans, and debt securities are denominated in dollars. Lastly, most global commodity markets, such as oil and copper, transact in dollars. Its prevalence has made the dollar mission critical to the global financial system.

This year, the dollar has been unusually strong. The U.S. Dollar Index, a measure of the dollar against a basket of foreign currencies, increased 16.8% through the end of the third quarter. A move of this size is uncommon in currency markets, where major currencies typically see swings of no more than 5% in a calendar year. Compounding matters, we are seeing the supply of dollars diminish as the Fed ramps up its quantitative tightening program. The relative

scarcity of dollars across the world has likely added to its volatility.

There are several reasons for the strong dollar. First, as the world's reserve currency, the dollar typically benefits when investors seek out safety. This is because investors prefer relatively safe and liquid investments, such as U.S. Treasury bonds, during turbulent times. Additionally, the U.S. was more aggressive than other G7 countries in stimulating its economy during the pandemic and has been at the forefront of unwinding those policies. This helps explain why the U.S. has had relatively stronger growth and higher interest rates, which makes direct investment in dollar-denominated assets more appealing.

WHAT THIS MEANS

Dollar strength has a broad range of investment implications. Importantly, a stronger dollar helps suppress inflation in the U.S. by increasing the purchasing power of the currency, thus reducing the price of imported goods in dollars. While this helps the domestic economy, it has the opposite effect outside the U.S., essentially exporting inflation abroad.

Dollar strength is partly responsible for the lower returns generated by international investments. Translating returns from a weaker currency to a stronger one diminishes those returns by an amount equal to the relative change between the two currencies. This impact should not be underestimated. Indeed, over the past 10 years ending September 30, 2022, the MSCI Europe Australasia and Far East (EAFE) Index (a commonly used index to measure returns from developed international markets) return in local currencies was twice as large as the return in dollars: 7.4% versus 3.7%. In this context, the relative performance advantage for the U.S. compared to international equities is not as striking.

This so-called translation effect is also borne by multinational corporations when translating overseas profits and cash flows back to the home country's currency. For U.S. companies, a strong dollar reduces earnings from abroad. This is significant because approximately 40% of the S&P 500 constituents' revenues are sourced outside the U.S. and exposed to currency risk. Therefore, we expect that this year's dollar strength will continue to put pressure on earnings.

By most measures, the dollar is overvalued. As a result, we expect it may decline as we move into the later stages of monetary tightening. If so, it may provide some relief to earnings and help returns from international investments become more competitive.

Conclusion

While the normalization process from the pandemic has been slower than expected, it is progressing. Volatility may settle down once the normalization process makes more progress. The Fed is seemingly more than halfway through its tightening campaign. In our opinion, if higher rates lead to a recession, it will signify a return to the normal ebbs and flows of the economic cycle.

Empirical evidence strongly suggests that market timing is extremely difficult and that missing out on just a few large up days materially curtails returns. The bear market in equities suggests that some amount of recession fears is already discounted by the market. Selling after the damage is done inevitably leads to poor performance.

Sources: FactSet, Congressional Research Service, Federal Reserve Bank of Chicago, International Monetary Fund, Gavekal, Morningstar, and Ned Davis Research.



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