

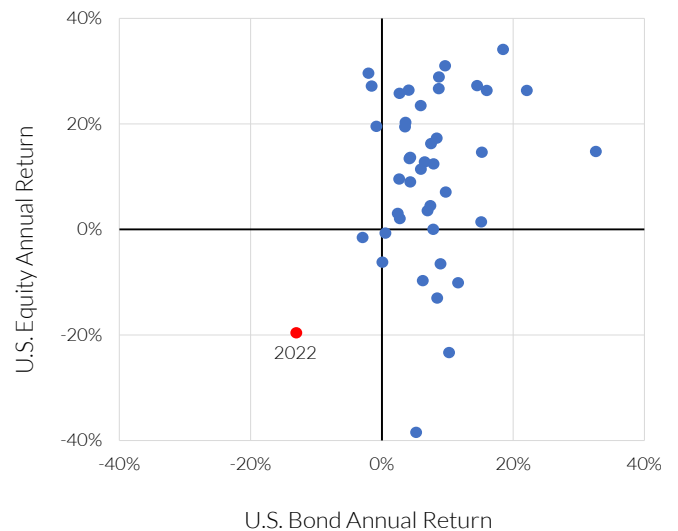


OUR VIEW

JANUARY 2023

For the last four decades a portfolio consisting of stocks and bonds provided diversification and correlation benefits. In years when stock returns were negative bonds typically generated positive returns, and vice versa, smoothing the overall returns of a portfolio (Chart 1). This diversification benefit ended with a thud in 2022 as both stocks and bonds suffered meaningful negative returns (Table 1). In fact, bond returns were the lowest in modern financial history, providing no diversification or inverse correlation benefit. We do not expect 2023 to be a repeat of last year. Much has changed in the prior 12 months, and in our view we are well into the market’s correction. It is worth noting that market bottoms occur before economic troughs and the current cycle is likely to be a similar corrective phase which will inevitably set up the next bull market.

Chart 1: Nothing Worked in 2022



Source: Bloomberg, Data 1980 to 2022.

2022 Half-Empty

Investor sentiment entering 2022 was ebullient after nearly two years of rewarded risk taking. However, inflation which had been benign, if not dead, for 40 years was too significant a factor for global central banks to ignore. Not only did inflation rise rapidly, and prove intransigent, but rising inflation was exacerbated by the Russian invasion of Ukraine, an event that brought a myriad of additional and related risks – a hot war in Europe, an energy crisis,

2022 Market Returns

	Q4	2022
U.S. Equity	7.2%	-19.2%
Non-U.S. Equity	14.3%	-15.6%
U.S. Bonds	1.9%	-13.0%
Non-U.S. Bonds	4.6%	-16.3%

Source: Bloomberg, Total Return.

Table 1



supply chain disruptions and commodity inflation. Financial markets registered the importance of the transition to a new interest rate environment by selling off sharply, long before the impact of higher rates could be felt in the economy.

Investor sentiment was reset. Many, if not most, speculative investments (e.g., crypto, SPACs, new and profitless companies, etc.) were quickly and violently sold. Even the most dominant and profitable companies, often viewed as safe havens, witnessed a meaningful downward re-rating in valuation multiples, albeit over a longer trajectory. Ultimately, 2022 will be remembered as a year to own energy and the U.S. Dollar, everything else was highly correlated and negative.

The difference between “growth” and “value” investing styles was significant in 2022. Value outperformed by 23 percentage points suggesting that value investing is back. However, as we noted in our whitepaper, [Redefining Growth and Value Investing](#), we caution against simplistic definitions based on historic norms. Value investing’s core tenet of a margin of safety is established by a technologically and competitively privileged business position and the resulting durability of its value creation rather than metrics such as statistical cheapness, tangible asset values, or financial engineering. In 2022 Energy was the best performing sector. Out of favor and statistically cheap, but also the fastest growing and most profitable sector during the year, energy blurred the lines of old wall street labels while simultaneously reminding us that the intersection of low expectations, good growth, and an attractive valuation can result in positive performance.

2023 Half-Full

If last year was the “year of inflation,” then 2023 could be the “year of recession.” It is a consensus view that Europe and China are, or will, experience economic recessions and the U.S. is likely to experience one as well. Importantly, we enter 2023 with an entirely different investor sentiment, one where concern for earnings and profitability have cast a bearish cloud on equities. Earnings forecasts for

U.S. equities have come down roughly 12% in the last year via a combination of slower growth and lower margin expectations. We believe it is ultimately constructive for the market to have lower expectations, even if it remains uncertain if, or when, there will be a recession. In the last three recessions over the past 20 years, earnings in the U.S. declined 20-30% (yr./yr.). Applying a longer lens of the last 60 years U.S. corporate earnings declined 13 times, with an average decline of 12.8%. Importantly however, the equity market only declined in 4 of those 13 years, evidence that the market often digests negative news well in advance of actual results.

Inflation in the U.S. has peaked and is beginning to decelerate, from 9% in June to 6.5% currently. A target rate of 2% seems aspirational at this point, but we do not believe the Fed needs to reach that level to pause or stop raising rates. When this occurs the equity market will likely react positively, irrespective of the state of the real economy and business prospects. We have recently seen evidence of financial markets anticipating this. We believe equity investors should take comfort that a recession in the U.S. means the Fed will shift its focus from inflation (i.e., rate hikes) and toward supporting economic growth (i.e., rate cuts). Additionally, a resolution to the Ukraine War and/or the continued relaxation of strict anti-covid policies in China would be supportive of lower inflation via improved supply chains and a lower risk premium on oil, natural gas, food and other important commodities.

After a protracted period of low and declining bond yields, last year saw a major reset. Currently, short duration U.S. Treasuries yield roughly 4.6%, a level last seen before the great financial crisis, and the 10-year Treasury bond yields 3.6%. The inverted yield curve is a signal that the bond market is anticipating a further decline in inflation, a recession, and eventually rate cuts.

Portfolio Positioning

Equity – We have a neutral position in equities with a bias to add exposure when it becomes apparent that the Fed is comfortable with the trajectory of inflation. The U.S. and



Asia, particularly India ([The Base Case for India](#)), remain our favored geographic areas.

Cash – We are comfortable holding above average cash levels currently as yields in short duration fixed income have returned to attractive levels and we intend to redeploy cash when the market offers a compelling opportunity.

Bonds – We have recently added duration to our fixed income holdings, having had modest duration for years.

Diversifiers – Investments that are uncorrelated to equities and fixed income are valuable. Lowering portfolio risk with distinct drivers of potential return and low or no correlation to other asset classes remains a focus area. We wrote of these investments in a 2020 whitepaper, [Pivoting Away from Traditional Fixed Income](#), and the timeliness of our recommendation remains applicable to owning diversifiers today.

Innovation - We continue to seek opportunities positioned to benefit from the intersection of large addressable markets and disruptive change, whether in technology,

energy transition, materials science or healthcare. Change is not only constant but critical to drive future productivity, so despite a likely bear market for the financing of innovation we see the environment as an opportunity.

Looking Forward

Half-empty or Half-full may depend on one's timeframe or disposition. The biggest risk for investors is that inflation does not continue to recede towards historical norms. In that case central banks will stay vigilant and maintain or raise rates further. With higher rates, equity valuation multiples would contract further, bonds would sell off, and market sentiment would decline as would consumer and corporate spending. This could in turn lead to a recession which would drive down inflation, ultimately resolving the problem. While timing is always difficult to predict we believe we are well into the corrective process with equity valuation multiples down 25% in the last year, and suggest that investors remain patient, the next positive market opportunity is closer than it may seem.

DISCLOSURES

The Colony Group, LLC ("Colony") is an SEC Registered Investment Advisor with offices in Massachusetts, New York, New Jersey, Maryland, Virginia, Florida, Colorado, Connecticut, California, and New Hampshire. Registration does not imply that the SEC has endorsed or approved the qualifications of Colony or its respective representatives to provide the advisory services described herein. In Florida, Colony is registered to do business as The Colony Group of Florida, LLC. Colony provides individuals and institutions with personalized financial advisory services.

This white paper represents the opinions of The Colony Group, LLC ("Colony"), the white paper contains forward-looking statements, and presents information that may change due to market conditions. Information provided herein is general and educational in nature. It is not intended to be, nor should be construed as, specific planning, tax, or investment advice. Market conditions can vary widely over time and can result in a loss of portfolio value.

Colony's investment advisory services are provided only pursuant to an advisory agreement with the client. Colony's Form ADV Part 2A, 2B, Form CRS, and Privacy Statement will be provided on request and as required by law. For a description of fees payable for investment advisory services, please see Colony's Form ADV Part 2A.