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MARKET PERSPECTIVES

▶ QUARTER TWO 2024

Investment markets largely performed well during the second quarter despite getting off to an inauspicious start, with the S&P 500 recording its first monthly decline of the year in April. A higher-than-expected inflation report for March gave rise to renewed concerns that the Federal Reserve (Fed) will keep rates higher for longer. Investors have been keenly focused on inflation in hopes that it will finally slow enough to allow the Fed to follow through with interest rate cuts. After March's hot inflation numbers, consumer prices decelerated in April and May pushing interest rates down, equity returns up, and bond returns modestly higher.

Sadly, not all sectors shared in the equity market's prosperity as S&P 500 market concentration reached never-before-seen levels (Chart 1). The weight of the top ten names in the S&P 500 reached more than 32%, far surpassing the highs from the late 1990s and early 2000s. In what is becoming a familiar occurrence, value, small-, and mid-cap stocks all lagged, declining during the quarter, while large-cap and growth stocks led the way higher.

CHART 1: S&P TOP 10 CONCENTRATION



Geopolitical risks continue to linger. France has become the newest hot spot. In June, France's President, Emmanuel Macron, surprised investors by calling for snap legislative elections. This was widely perceived as a risky gamble as it

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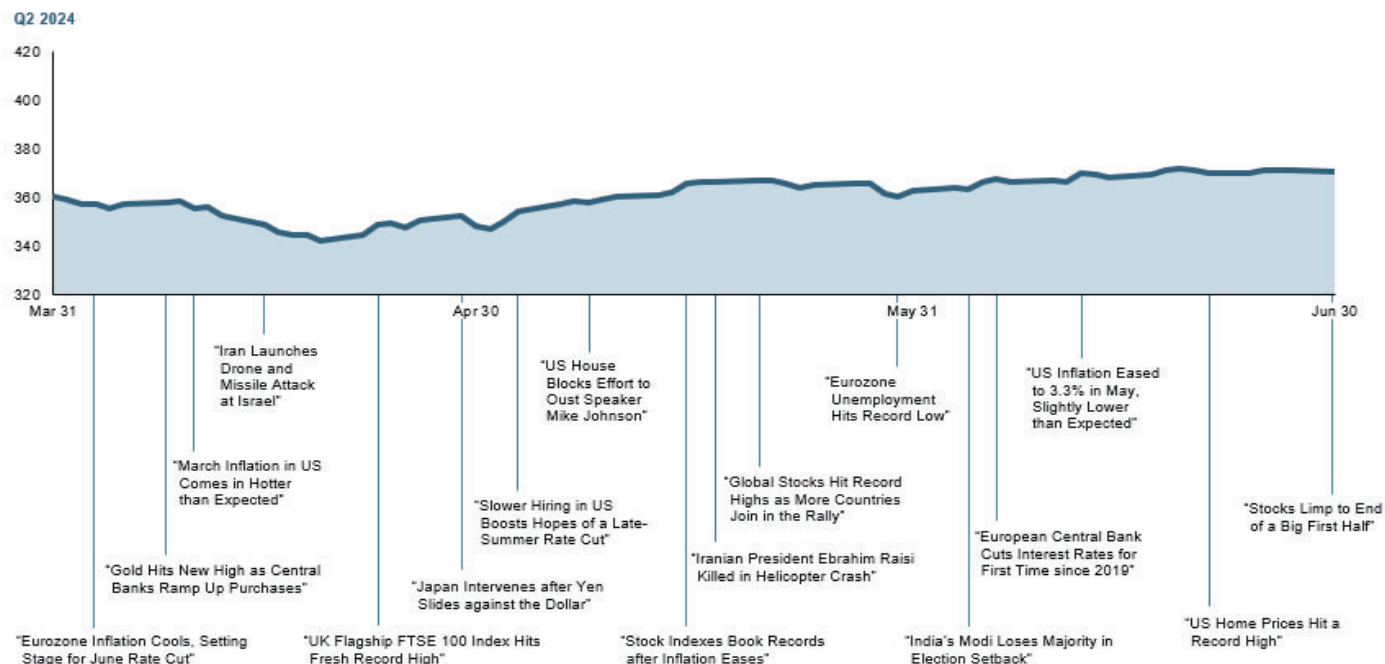
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MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q2 2024



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.

Source: MSCI ACWI Index (net dividends), MSCI data © MSCI 2024, all rights reserved. Index level based at 100 starting January 2000.

opened the door for the far-right Rassemblement National (RN) party to gain a majority. European markets underperformed other regions due to this surprise. The risk may have paid off, however, as neither of the three front-running parties were able to grab a majority, helping the European markets to recover some of their earlier losses after the quarter ended.

Alas, geopolitics will likely remain a dark cloud that surges to the forefront from time to time over the foreseeable future. The wars in the Ukraine and Gaza are showing no signs of letting up. Several important elections will occur shortly, not the least of which is the U.S. Presidential election. Finally, we expect tensions between the U.S. and China to heat up again as we approach the election. To the extent that the friction between the two superpowers remains economic rather than military, it may create some opportunities for investors.

The equity market's performance since bottoming on October 12, 2022 has been spectacular. Between October 2022 and the end of the second quarter 2024, the S&P 500 has returned 52.7% (28.0% annualized) and the NASDAQ Composite is up 70.2% (36.5%). The euphoria around artificial intelligence and its impact on the markets is reminiscent of the dot.com era. In fact, the analogies between the late 1990s and today are striking. In the section below, we highlight some of these commonalities.

Innovation Cold War

Wikipedia defines The Cold War as "a period of geopolitical tension between the United States and the Soviet Union and their respective allies, the Western Bloc and Eastern Bloc, that started in 1947, two years after World War II and lasted to 1991, the fall of the Soviet Union." We believe that a new, albeit very different, Cold War is emerging between the U.S. and China.

The original Cold War between the U.S. and the Soviet Union involved an arms race that triggered the stockpiling of nuclear weapons, with each superpower acquiring enough firepower to destroy the world several times over. Today, the fault lines between the U.S. and China have thus far been economic in nature, with the U.S. utilizing tariffs, sanctions, and export bans rather than bombs and missiles.

For the past several decades, China has thrived as the manufacturing hub of the world. According to the Organization for Economic Co-operation and Development (OECD), China accounts for 29% of the world's manufacturing compared to just 16% for the U.S., the second largest contributor. China originally exploited its abundance of cheap labor to foster economic growth. More recently, however, China has evolved to produce more complex, higher value-added goods, which places them in closer competition with the U.S.

The next frontier of this conflict is seemingly targeting technology and innovation. The U.S. and its allies are seeking to limit China's access to mission-critical technologies, such as high-end semiconductors. Beijing has retaliated by restricting access to its rare earth metals, graphite, and solar panels. China has an early lead in solar and electric vehicles, while the U.S. has an edge in artificial intelligence and advanced semiconductors.

WHAT THIS MEANS

Cold Wars are not necessarily counterproductive. The previous Cold War produced a wave of innovation, in addition to increases in the world's nuclear stockpiles, such as magnetic resonance imaging (MRI), solar panels, home insulation, and digital photography, to name a few. A return to the high productivity levels of the 1950s or 1990s could provide a meaningful boost to wealth and human well-being. Artificial intelligence, which, according to most experts is likely to be a generational innovation, may be the next example of an innovation formed via a Cold War.

Innovation and the usual resultant boost in productivity helps increase per-capita GDP growth. Per-capita GDP growth, calculated by dividing total economic output by the population count, is used by economists to measure the overall prosperity of a country. In theory, the more countries that prosper through innovation the better it is for worldwide growth.

Another outcome from rising China and U.S. hostilities has been a rethinking of global supply chains. As a result of growing tensions between the East and West, companies are shifting their manufacturing away from geopolitical hotspots and unfriendly countries and bringing it back home or to friendlier countries, often referred to as onshoring, nearshoring, or friendshoring. As a result, we are starting to see early signs of a resurgence in capital investment in the U.S., which may lead to more jobs and greater demand for raw materials and industrial goods. Many investors overlook how poorly the returns from these sectors and other equity-market segments have been. More on that in the next section.

This is not the first time the world has experienced a transition of superpowers. Prior periods of an emerging superpower challenging the old world order have caused geopolitical tensions to escalate across the globe.

Back to the 1990s

Investment bubbles do not form naturally. They are generally encouraged by loose monetary or fiscal policy. So, as we exit an elongated period of loose fiscal policy, it should come as no surprise

that a new bubble may be forming.

After dragging the markets lower in 2022, the so-called Magnificent Seven stocks – Alphabet (GOOGL; GOOG), Amazon (AMZN), Apple (AAPL), Meta Platforms (META), Microsoft (MSFT), NVIDIA (NVDA), and Tesla (TSLA) – have once again dominated the S&P 500's performance since it bottomed out in October 2022. Few would question that these are great companies. Nevertheless, not all of them will prove to have the enduring competitive advantages that their valuations seem to embed today.

Many pundits have been highlighting the similarities between the market environment today and the late 1990s. The mid-1990s witnessed the rise of the internet, which ignited a surge in capital spending as companies raced to build out the internet's infrastructure. Jobs were plentiful. The dollar was strong as the U.S. economy desynchronized from the global economy. Equities boomed, especially the technology sector, but the market became bifurcated with striking performance differentials between the winners and losers.

Many market observers have noted that today's Magnificent Seven resemble the Four Horsemen from the late 1990s – Dell (DELL), Microsoft (MSFT), Cisco Systems (CSCO), and Intel (INTC). These four stocks led the S&P 500 and NASDAQ Composite to record highs before peaking in March of 2000, marking the beginning of dot.com bubble bursting. Like today, the S&P 500 became extraordinarily concentrated and the domestic equity market split, with technology and growth companies thriving while small-cap and value stocks floundered. Strategas's Jason De Sena Trennert noted in a recent report (Trennert, 2024), "1) the gap between the performance of the market cap and equal weighted index has only been this wide in two other cycles – the late 90s and the late teens; 2) reversals from such wide gaps are often severe and rapid; and 3) the valuation difference between these two indices is also historically wide."

WHAT THIS MEANS

Since the top of the dot.com bubble, nearly 25 years later, only Microsoft has traded above its prior peak, and it took Microsoft nearly 17 years to get back to new highs. Dell, Cisco Systems, and Intel all remain below 2000 levels. It's a sober reminder that the recoveries by the previous leaders that we experienced during the last two bear markets are the exception.

History may not repeat but it often rhymes. Certainly, artificial intelligence will be as groundbreaking an innovation as the internet was. We also believe that some of today's Magnificent Seven stocks are trading at what will prove to be near all-time highs. So, piling into these names indiscriminately after their recent runup may not be

the best strategy. Valuations matter, and the richer the stock price, the harder a stock may crash from disappointing news. A careful consideration of a company's fundamentals, including its growth prospects, stock valuation, and the quality of management remain critical to effective investment decision making.

Conclusion

The remainder of this year will be an important litmus test for the economy and investment markets. The economy continues to normalize from the extraordinary circumstances surrounding the

pandemic. How far along we are in that process is a critical question moving forward. In addition, we should gain more certainty over who the next group of world leaders will be as more than 40% of the world's population will hold national elections this year.

Growth and inflation have both been slowing. It is unclear currently whether this is the much talked about soft landing or something more deleterious. Here, we believe that the absolute numbers matter more than the trend. With inflation nearing the Fed's target and the unemployment rate still relatively low, we may have another year of strong returns.

Sources: BCA Research, OECD, Alpine Macro, and Strategas Research Partners



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Chart 1: The S&P is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. Past performance is not indicative of future results.

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