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The Colony Group

MARKET PERSPECTIVES

► QUARTER THREE 2024

Investment markets produced another strong quarter of returns despite a deteriorating geopolitical landscape. The Federal Reserve (Fed) cut interest rates, kicking off the highly anticipated process of normalizing monetary policy, and China announced a substantial stimulus program, which roused investor bullishness.

Previously lagging sections of the equity markets outperformed during the third quarter. For instance, international equities outperformed domestic equities (8.1% versus 5.9% for the MSCI ACWI ex-USA and S&P 500), smaller-cap U.S. stocks outperformed their larger-cap peers (9.3% versus 5.9% for the Russell 2000 and S&P 500), and value stocks beat growth stocks (9.5% versus 3.4% for the Russell 3000 Value and Growth). We will see in time whether recent trading portends a leadership change or if the market falls back into the trends that persisted during the first half of the year.

Bonds were boosted by the Fed's decision to cut interest rates by 50 basis points (or 0.50%) in September, the first

rate cut since the early days of the pandemic. The Barclays US Aggregate Bond Index returned +5.2%, its strongest gain since the fourth quarter of 2023. The Fed's decision likely signals policymakers are growing comfortable with the level of inflation. Loosening monetary policy alongside solid economic growth is historically a profitable backdrop for investors while it lasts.

The U.S. economy is proving to be more resilient than expected following a tightening cycle that included eleven interest rate hikes implemented by the Fed between March 2022 and July 2023. Their pivot from rate hikes to cuts is partly responsible for the previously discussed, recent leadership changes experienced throughout the investment markets.

Change is sometimes desirable and sometimes not. When winter thaws and gives way to the green shoots of spring, most people are excited to enjoy time outdoors. The transition from summer to fall, depending on your tastes or the weather, elicits a wider range of emotions. Some of us look forward to

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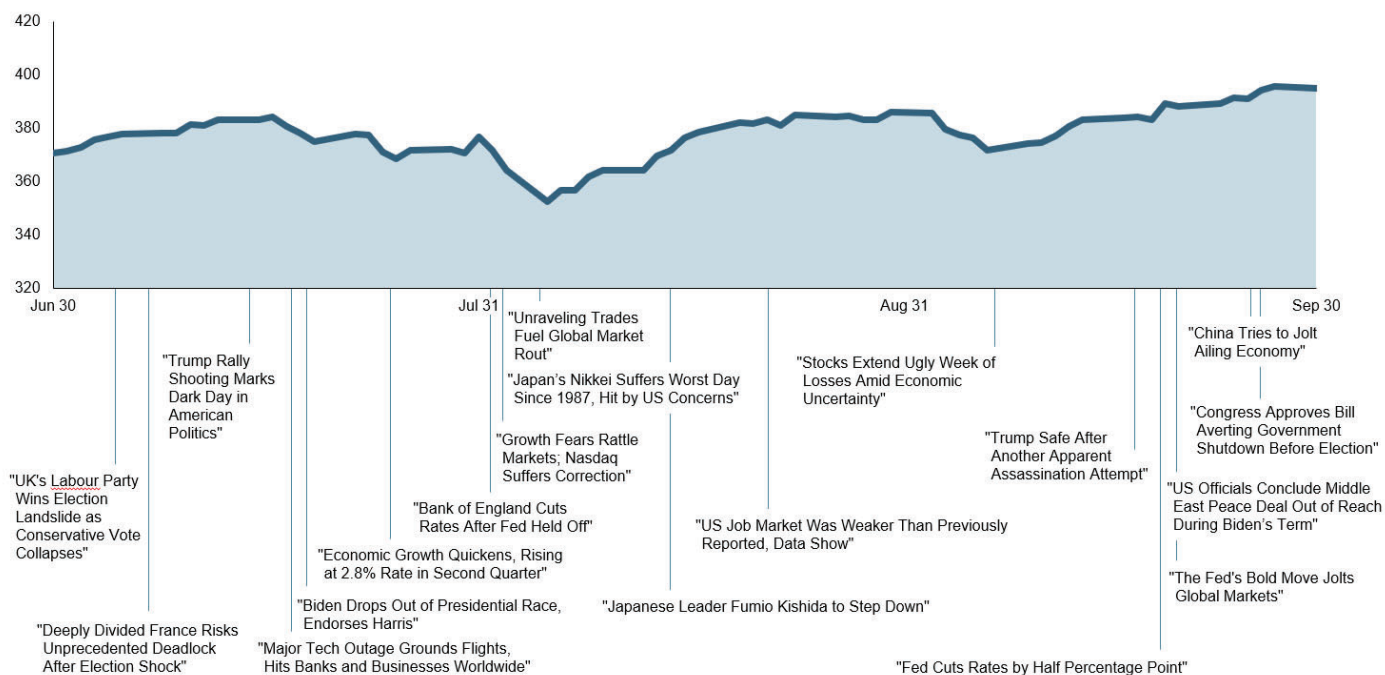
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MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q3 2024



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.

the colors, cooling temperatures, and fun holidays. This is similar to how many investors have been looking forward to a stock market with broader participation.

One thing investors may not be looking forward to are the U.S. elections. We will have turnover in the White House regardless of who wins and there are likely to be changes in Congress. This type of uncertainty understandably makes investors apprehensive. While this may create near-term volatility, we believe the impact on long-term returns is not as strong.

Changing Seasons in the Investment Markets Too?

The Autumnal equinox marks the changeover from summer to fall. While seasonal changes happen around the same date each year, investment market reversals occur more randomly, making them difficult to identify without the benefit of hindsight.

Once again, we are seeing emerging signs that a shift may be underway, coincidental with the change of seasons. First, some of the first half's laggards in the equity markets perked up during the third quarter. We previously highlighted that small-cap stocks outperformed large-cap stocks, international equities outperformed

their domestic counterparts, and value stocks outperformed growth stocks. Cyclical sectors, such as industrials, materials, and utilities were among the best performing sectors despite underperforming during the first half of the year. Even the maligned real estate sector saw buying interest during the quarter.

The bond market also seemed to undergo a trend change during the quarter as the Fed followed through on its promised interest rate cut. The Fed decided to reduce interest rates by 50 basis points (0.5%) rather than moving at a more measured pace, such as 25 basis points. The 10-year Treasury yield declined from 4.48% at the start of the quarter to 3.81% at quarter's end.

China's equity market, which had trailed the performance of most other countries, caught fire during the last week of the quarter after policymakers announced a massive stimulus package. The People's Bank of China cut interest rate by 20 basis points (0.20%), twice the size of their typical adjustment, and announced several regulatory and spending initiatives targeting the housing and stock markets. They recently hinted that more measures may be forthcoming.

WHAT THIS MEANS

An old investment saw asserts that market inflection points are processes not events. This is another way of saying that it generally

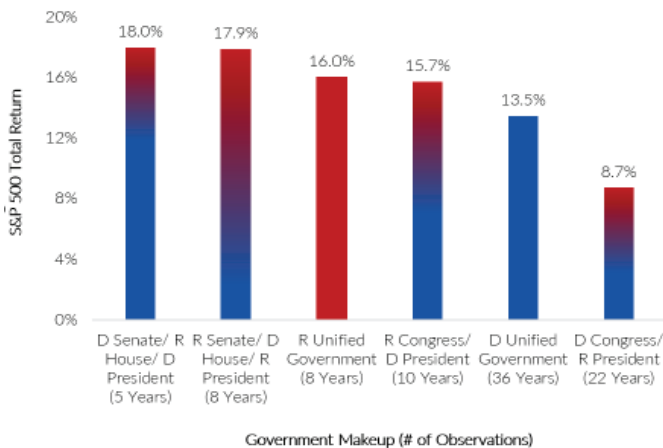
takes time for markets to experience major trend changes. They do not occur all at once or in a uniform fashion. Instead, certain market segments may move before others. Only when we look backwards is it obvious what has transpired.

Is this what is occurring now? We can't be sure, but it is starting to feel like we may be in the early innings of some sort of leadership change. For many years now, pundits have predicted that the equity markets would broaden. We've spoken a lot about the level of concentration in the U.S. equity markets over the past several quarters. Indeed, most of the stock market's strong performance over the past several years has been driven by a small subset of large stocks, affectionately referred to as the Magnificent 7. As the market's strength and leadership continues broadens out, it is usually associated with a healthy market. This quarter's performance, where the S&P 500 posted strong returns despite the underperformance from the Magnificent 7, shows that this is possible.

Election

In case you've been asleep for the past several months, we wanted to remind you that there is a Presidential election this November. Once again, we find ourselves fielding calls from clients concerned that the sky may fall if their candidate doesn't win. Spoiler alert – it won't.

Our founding fathers were shrewd to build checks and balances into our political system. Each branch of the government is empowered to prevent actions by other branches and are required to share power. Historically, these checks and balances have prevented any one party or individual from having too much power.



Since 1933, the U.S. has operated under a divided government most of the time: i.e., Republicans control one branch while Democrats control another. Importantly, there is no discernible difference in the performance of the stock market based on which party controls what branch of government (see chart). Also of note, nearly every possible combination of government makeup has produced robust returns.

When it comes to long-term performance, corporate performance as measured by earnings, free-cash-flow, and other metrics generally matters more than most laws or regulations. We note that the government has inherent economic stabilizers built into it that sit outside policymakers' authority and kick in before the political process can unfold. During recessions, taxes decline due to declining wages and spending programs such as unemployment and Medicaid insurance kicks in. These stabilizers, because they are systematized, are generally more responsive and less exposed to partisan bickering. According to the Congressional Budget Office (CBO), automatic stabilizers have added approximately 0.4% for each 1% difference between actual and potential GDP (Russek 2015), often referred to as the output gap.

WHAT THIS MEANS

Markets have a way of quickly finding equilibrium. Certainly, events such as elections, war, and natural disasters, have a near-term impact on markets. The longer-term impact of these events, if any, is difficult to establish. It is only if they leave a lasting impact on the market's fundamentals (e.g., earnings growth, valuations, profitability, cost of capital, margins, etc...) that matter to long-term returns.

Our economy and financial system were designed to be resilient. This has been proven out across time. While individual investor's sentiment may gravitate towards extremes, markets, or the collective wisdom of their participants, tend to operate more towards the center.

We don't mean to imply that there won't be volatility in the investment markets associated with the election. We just believe that the country will eventually move forward with a new President, and market participants will switch their focus back to what matters most: corporate performance.

Conclusion

We should gain a clearer understanding of the future direction of the investment markets over the next several months. That is not to imply that we will have resolutions to many of today's uncertainties, such as how the election will unfold or what will happen next with Israel and Iran or Russia and Ukraine. If anything, we are making the argument that those things are relatively insignificant with regards to their long-term impact on investment returns.

We would be remiss if we did not talk about the evolution The Colony Group (Colony) is undertaking. It's certainly an exciting time here, and the energy across our offices is palpable. As we write this, Colony has the deepest, most experienced investment team in its over 35-year history. We are confident that this should lead to even better outcomes and experiences for our clients. While we are proud of our past successes, we are excited for the future.

Sources: Alpine Macro, The Brookings Institution, Standard and Poor's, Federal Reserve Bank of St. Louis, and Congressional Budget Office



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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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