

QUARTERLY MARKET REVIEW

MARKET REVIEW

The U.S. economy remains in decent shape, and inflation, despite being annoyingly sticky with the odd unpleasant surprise, appears to be broadly heading in the right direction. Corporate earnings for the year have mostly beaten expectations and optimism surrounding AI is still strong. Against that, the Fed is remaining steadfast and refusing to lower rates until they believe the time is right, although there is increasing optimism that the first move is imminent. Nvidia briefly became the most valuable company in the world before falling back behind Microsoft and Apple (though all of them retain a market cap in excess of \$3 trillion).

Geopolitical worries worsened significantly as Israel and Iran traded direct, but somewhat contained, blows with each other in April, and China held military drills around Taiwan on May 23rd in response to what it worryingly referred to as "separatist acts." In Europe, the Russia-Ukraine war appears to be escalating rather than approaching a conclusion.

World equities, as measured by MSCI ACWI, returned an impressive 2.9% for the quarter. The U.S. led the way in developed markets as the S&P 500 posted 4.3%, with MSCI EAFE trailing far behind with a return of -0.4%, hindered again by a seemingly ever stronger U.S. dollar. They were significantly better in local terms, with MSCI EAFE (local) up 1.0%. MSCI Emerging Markets was the star performer in the second quarter, making up some of the ground lost earlier in the year, with a return of some 5.0%, helped by a rebounding China. Emerging markets also suffered from a currency drag, and the MSCI Emerging Markets Index (local) return was an excellent 6.2%. Value had another brutal quarter against Growth, as MSCI ACWI Value returned -0.6% for the quarter with MSCI ACWI Growth posting 6.2%. Amazingly, all of this Growth outperformance came from the U.S. and MSCI ACWI ex-USA Value actually pipped MSCI ACWI ex-USA Growth by 60 bps.

Bonds continued to exhibit the volatility we have seen over the last few quarters, as investor's crystal balls could not make up their minds on the "when" and "how much" was going to be delivered by the Fed. After touching 4.7% in April, the 10-year U.S. nominal yield fell in the second half of the period to finish at 4.36%, still up 16 bps from the end of March. The 10-year real yield rose a slightly bigger 20 bps to 2.08%, leaving the break-even inflation figure down 4 bps at a pretty benign 2.28%. The yield curve inversion remains solidly intact. Again, as previous quarters, we would note that, as indicators go, an inverted yield curve has historically been a very reliable forerunner of unpleasantness in the markets and the economy, although we do acknowledge that the optimists believe this time is different as it is just a short-term inflation technicality (or distortion, or whatever).

Against this backdrop, traditional bond investors had a mostly flat quarter and the Bloomberg U.S. Aggregate Index returned 0.1%. Credit did modestly better, as the ICE BofAML U.S. High Yield Index posted 1.1% and the JP Morgan EMBIG Diversified Index posted 0.3%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Despite the strong recovery in 2023, continuing into 2024, we are adding selectively to risk. Even as Growth enjoyed another extremely strong quarter relative to Value, we are content to maintain our emphasis on Value as we know that positive sentiment cannot bolster overly optimistic valuations based on unrealistic growth expectations indefinitely. Indeed, certain parts of the market have been hit extremely hard even as some parts have surged, and we have built a modest, but meaningful, exposure to our Resource and Climate Change strategies as clean energy stocks have fallen to very favorable valuations, while acknowledging that this could prove to be a relatively volatile position. It is perhaps surprising that markets have not reacted with disappointment to the Fed's "wait and see" approach, and it remains to be seen what will happen if they are ultimately underwhelmed by central banks' actions, or perhaps that should be lack of actions. Higher rates typically cause people to reassess the fundamental value of investments, and this should be particularly bad for anything more speculative in nature while being relatively good for Value and relatively good for non-U.S. equities. The divergence in valuation between the USD and many overseas currencies makes the case to invest outside the U.S. even more compelling. It is perhaps noteworthy that Value has been winning outside the U.S. while the AI revolution has assured Growth's continued, but perhaps temporary, dominance in the U.S.

Our views, and positioning, have not markedly changed and we reiterate many of the suggestions we offered last quarter:

- 1) Exploit this global Growth bubble with a long cheap Value/short expensive Growth equity strategy.
- 2) Avoid the Growth bubble completely by investing in liquid alternatives, although pure alpha strategies may struggle to compete for capital given the attractiveness of some traditional assets.
- 3) Skirt around the Growth bubble by pivoting your equity exposure to equities outside the U.S., focusing on Value, and "Deep Value", in particular. One very intriguing area is Japan Small Cap Value, which further benefits from the cheapness of the yen along with improving governance.
- 4) Although U.S. equities in general look to be the most expensive, the relative pricing of the cheapest fifth of the market, or "Deep Value", looks to be an intriguing opportunity.
- 5) Clean energy looks to be trading at very cheap valuations given its future potential, though a note of caution here as the challenges of the last 18 months may not be over and it could be a bumpy ride.

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