

QUARTERLY MARKET REVIEW

MARKET REVIEW

It was another solid quarter for equities. There was some relief in the U.S. following the end of the government shutdown in November, coupled with the Fed cutting rates at both its October and December meetings. The latter cut was a far from unanimous decision, though, and even several who voted in favor of a cut did so reluctantly. Inflation refuses to go away, and the outlook for future cuts is extremely uncertain. While it appears that an increasing number of commentators are prepared to at least consider that tech valuations may be starting to get a bit bubbly, there was a lot for the bulls to get excited about as well, with Amazon announcing a \$38bn multi-year strategic partnership with OpenAI during the quarter. The biggest risks next year may be geopolitical. Peace talks on the Russia-Ukraine conflict have stalled yet again, and although the ceasefire in Gaza is holding, conditions are likely to worsen as Israel has banned around 40 international aid agencies for failing to agree to new draconian registration requirements. The U.S. has been increasing pressure on Venezuela, including seizing oil tankers, while also reiterating that it 'needs' to control Greenland.

World equities, as measured by MSCI ACWI, returned 3.3% for the quarter. The USA was the laggard as the S&P 500 posted 2.7%, while the MSCI Emerging Markets Index was up 4.7%, and developed markets outside the USA performed slightly better again, with MSCI EAFE delivering 4.9%. After a difficult start to the year, the USD continued to claw back some ground against a basket of both emerging and developed currencies, most notably improving significantly against the yen, and in local currency terms, MSCI Emerging Markets was up 5.6% and the MSCI EAFE was up 6.1%. At a global level, value was the winner, as MSCI ACWI Value returned 3.7% for the quarter while MSCI ACWI Growth posted 2.8%. However, the regional split was again very pronounced, with growth outperformance of 1.5% in the USA, while value actually beat growth by an impressive 6% within EAFE.

Bonds had a reasonable quarter, with the 10-year nominal yield rising 2 bps to finish the quarter at 4.18%. Meanwhile, the 10-year real yield rose a considerably bigger 13 bps to 1.93%, leaving the break-even inflation figure down 11 bps at a pretty benign 2.25%. Against this backdrop, traditional bond investors did fine, while credit investors fared a little better. The Bloomberg U.S. Aggregate Index returned 1.1%, while the ICE BofAML U.S. High Yield Index posted 1.6%, and the JP Morgan EMBIG Diversified Index was up 3.3%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth enjoyed another winning quarter in the USA, fueled by optimism and speculative fervor, with positive sentiment surrounding AI and, perhaps misplaced, optimism about impending rate cuts driving markets. We are content to maintain our emphasis on value, as we know that positive sentiment cannot support overly excited valuations based on unrealistic growth expectations indefinitely.

Despite the ongoing volatility, we maintain a modest but meaningful exposure to our Resource and Climate Change strategies. It is heartening that clean energy stocks have continued to show the excellent signs of recovery that started in the summer, although we believe that they remain at favorable valuations.

The ongoing pursuit of a global trade war by the U.S. has led to extreme uncertainty, with roller-coaster-like moves as markets react to short-term headlines. Once things settle down, it could well be the case that investors pay attention to valuations again as the veil of U.S. exceptionalism may be lifted once and for all. Indeed, if the rhetoric surrounding the annexation of Greenland comes to fruition, the U.S. will likely face some form of sanctions and boycotts from the majority of its allies.

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

- Exploit this global growth bubble with a long, cheap value/short, expensive growth equity strategy.
- 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. They do offer the potential for meaningful diversification, particularly if, for example, stagflation caused stocks and bonds to do poorly at the same time.
- 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.
- Although U.S. equities in general still 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.
- 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 couple of years may not be over, and it could be a bumpy ride.

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