GMO

MARKET REVIEW | *30 September 2023*

QUARTERLY MARKET REVIEW

Market Review

Once again, the quarter started well for equities. Despite continued moderately hawkish rhetoric from the Fed and another 25 basis point increase in rates July, the market believed that the tightening cycle was possibly coming to an end as price pressures appear to be easing. Equities gained further traction on news that the Fed Bank of St. Louis's President James Bullard (who called for aggressive hikes) had resigned.

On the other hand, strong jobs data and higher than expected GDP growth led some to question what motivation the Fed has to aggressively lower rates once they consider the battle against inflation to be won. Of course, those same people may or may not be less obsessed with the direction of interest rates and cheer good economic news for its own sake.

Through August and September, the market started paying attention as yields continued to charge upwards. Despite a pause in rate rises in September, the Fed may not believe that the battle against inflation has been won, and a massive rebound in Energy prices did not help. Coupled with the economy remaining surprisingly resilient, the belief that rates will be "higher for longer" began to firm. If this becomes an established consensus view, there is certainly scope for a significant repricing of U.S. risk assets.

It was a more mixed quarter for mega-caps in the U.S., though perhaps some profit taking was inevitable after the stellar rise. Microsoft and Apple fell back, the latter also facing challenges from being (allegedly) banned from use by Chinese Government employees, while Alphabet and Nvidia continued to climb as the fervor around AI still carries great expectations despite having receded somewhat.

The geopolitical environment remains extremely worrying as there is ongoing saber-rattling between the U.S. and China over Taiwan. In Europe, there have yet to be positive developments in the war in Ukraine. And in the Middle East, the UN, in a report toward the end of September, expressed disquiet about an increase in the expansion of Israeli settlements in occupied Palestinian territory and “continued inflammatory rhetoric” from government representatives.

World equities, as measured by MSCI ACWI, returned a disappointing -3.4% to dampen their strong start to 2023. The U.S. led the way in developed markets as the S&P 500 posted -3.3%, with MSCI EAFE delivering -4.1%, hurt by a strengthening U.S. dollar. Equities were significantly better in local terms, with MSCI EAFE (local) down just -1.3%. MSCI Emerging Markets led the way with a -2.9% return, which was also a better -1.4% in local currency terms. Value enjoyed a decent quarter against growth, with MSCI ACWI Growth down -4.9% which was some 3.1% behind the MSCI ACWI Value return of -1.8%.

Meanwhile, the U.S. yield curve continued last quarter's charge upward. The 2-year yield rose 16 bps to finish at 5.03%, while the inversion started to unwind as the 10-year yield rose an incredible 78 bps to finish at 4.59%. As with last quarter, 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 should acknowledge that the optimists believe this time is different as it is just a short-term inflation technicality (or distortion, or whatever). TIPS fared a little better and the 10-year real yield rose by 65 bps to 2.24%, leaving the 10-year break-even inflation measure up 13 bps at 2.35%.

Against this backdrop, traditional bond investors had a horrible quarter from duration, partially offset by a positive quarter in credit. The Bloomberg U.S. Aggregate Index returned -3.2%, in contrast to the ICE BofAML U.S. High Yield Index posting 0.5%, and the JP Morgan EMBIG Diversified returning -2.2% (this negative performance was all interest rate driven, as the spread actually tightened to 431 bps).

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. The selloffs in 2022 made some assets look increasingly interesting, and we have continued cautiously adding to risk. 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 extreme divergence in valuation between the USD and many overseas currencies makes the case to invest outside the U.S. even more compelling.

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 by investing in liquid alternatives.

3) Skirt around the growth bubble by pivoting your equity exposure to EM and developed ex-U.S., focusing on value, and deep value in particular.

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, offers an intriguing opportunity.

ABOUT GMO

Founded in 1977, GMO is a global asset manager committed to delivering superior performance and advice to our clients. We are privately owned, which allows us to singularly focus on our sole business – achieving outstanding long-term client investment outcomes. Offering multi-asset, equity, fixed income, and alternative strategies, we invest with a long-term, valuation-based philosophical approach.

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