QUARTERLY MARKET REVIEW

MARKET REVIEW

After an excellent start to the year, equities faltered in March as the U.S. and Israel waged war on Iran. Four weeks on, the Strait of Hormuz is all but impassable, leading to fears of an energy crisis. Inflation was already proving stubbornly sticky, and the war significantly exacerbates the problem. This, in turn, renders the future direction of interest rates incredibly uncertain, though there is likely scope for cuts if a prolonged war tips the world into recession. As well as the wider war in the Middle East, with Israel taking action in both Gaza and Lebanon along with Iran, there is no sign of a breakthrough in the Russia-Ukraine conflict.

Beyond these geopolitical events, markets have also been volatile due to AI concerns. While there remains plenty of optimism for the upside, it has also become clear that there are likely to be casualties. In early February, SaaS (Software as a Service) companies were hit extremely hard as the market became worried that AI would make much of their competitive edge redundant. The sheer scale of capex being thrown at AI, data centers, and the associated energy infrastructure has also prompted the market to ask questions.

World equities, as measured by MSCI ACWI, returned -3.2% for the quarter. The U.S. was again the laggard as the S&P 500 posted a return of -4.3%. It should be noted that the USA was lagging the rest of the world by considerably more but has held up better since the commencement of the Iran war, likely due to geographical distance and better energy resilience. The MSCI Emerging Market index was only down -0.2% for the quarter, and some of this was due to dollar strength, perhaps as a flight to higher quality currencies at a time of elevated risk, and the index was up 2.1% in local currency terms. Similarly, MSCI EAFE returned -1.2% for the quarter, but was up 0.2% in local currency terms. Value beat growth across the globe, and MSCI ACWI Value returned 1.2% for the quarter while MSCI ACWI Growth posted -7.7%.

Bonds had a modestly challenging time, with the 10-year nominal yield rising 12 bps to finish the quarter at 4.30%. Meanwhile, the 10-year real yield rose a slightly smaller 9 bps to 2.02%, leaving the break-even inflation figure up 3 bps at a still pretty benign 2.28%. Against this backdrop, traditional bond investors were largely flat, while credit investors fared moderately worse. The Bloomberg U.S. Aggregate index returned -0.1%, while the ICE BofAML U.S. High Yield Index posted -0.6%, and the JP Morgan EMBIG Diversified index was down -1.3%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth suffered a tough quarter, particularly in the U.S., as sentiment turned. Optimism and speculative fervour surrounding AI became far more cautious, with pessimism about the scope for rate cuts and the potential fallout from a prolonged war further derailing markets. We are content to maintain our emphasis on value, as we believe that valuations based on unrealistic growth expectations will come under more pressure.

Despite the ongoing volatility, we maintain a modest, but meaningful, exposure to our Resources and Climate Change strategies. We believe that they remain at favorable valuations and also provide a source of diversification if an energy crisis develops. Tariffs and Greenland have firmly taken a back seat in investors' minds, where they are likely to stay until the war in Iran is resolved. However, the ongoing pursuit of a global trade war by the U.S. undoubtedly still contributes to further uncertainty. 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.

Our views and positioning have not markedly changed. 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. They do offer the potential for meaningful diversification, particularly if, for example, stagflation caused stocks and bonds to do poorly at the same time.

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 corporate governance. It should be noted that Japan, and indeed many non-U.S. markets, would likely prove more vulnerable than the U.S. in the event of a prolonged energy crisis.

4) 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 an interesting 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 couple of years may not be over and it could be a bumpy ride. Indeed, Energy and Resources had a strong quarter and would likely continue to perform while the Strait of Hormuz impasse threatens supplies.

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.

AMSTERDAM | BOSTON | LONDON | SAN FRANCISCO* | SINGAPORE | SYDNEY | TOKYO**

*GMO's West Coast Hub is comprised of members of Investment, Global Client Relations, and other teams located in and around the Greater San Francisco area
**Representative Office