QUARTERLY MARKET REVIEW

MARKET REVIEW

Equities roared back in the second quarter as optimism regarding a possible end to the Iran conflict and renewed enthusiasm for the prospects of AI turned investor sentiment unabashedly positive. There are still plenty of challenges and plenty of volatility, as demonstrated by markets actually being down a little in June. Investors continue to wrestle with elevated inflation and concerns that the new Fed Chair, Kevin Warsh, may prove much more hawkish than expected. The market is starting to differentiate between tech firms, and Microsoft dropped almost 20% in June as it fell out of favor. A surge in the share price after the SpaceX IPO briefly saw it become the world's fifth most valuable company, before it tumbled 25% from its peak (and then recovered slightly towards the end of the quarter). The Iran war has entered a strange on/off phase, and market sentiment has reacted sharply to each announcement of a ceasefire and the subsequent breaking of the ceasefire.

World equities, as measured by MSCI ACWI, returned an impressive 14.9% for the quarter. Emerging markets were again the winner as the MSCI Emerging Markets Index was up 24.1%. U.S. dollar currency moves had little impact on the quarter as emerging markets were also up 24.1% in local currency terms. In developed equities, the USA beat the rest of the world, and the S&P 500 posted 15.2%. MSCI EAFE was the laggard and returned 10.8% for the quarter, which equated to a modestly better 11.5% in local currency terms. Value lost badly to growth globally, and MSCI ACWI Value returned 10.6% for the quarter while MSCI ACWI Growth posted 19.8%.

Bonds had a more sedate time, with the 10-year nominal yield rising 14 bps to finish the quarter at 4.44%. Meanwhile, the 10-year real yield rose a slightly bigger 20 bps to 2.20%, leaving the break-even inflation figure down 6 bps at a still pretty benign 2.24%. Against this backdrop, traditional bond investors were largely flat, while credit investors fared much better. The Bloomberg U.S. Aggregate Index returned 0.7%, while the ICE BofAML U.S. High Yield Index posted 2.5%, and the JP Morgan EMBIG Diversified Index was up 4.6%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth enjoyed a big rebound as sentiment turned positive again. Optimism and speculative fervor surrounding AI returned, as well as a general risk-on atmosphere, as the Iran conflict was at least temporarily resolved. 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 Resource and Climate Change strategies. They had a tough quarter as energy prices fell as the situation in the Middle East improved. We believe they remain at favorable valuations and can provide a source of diversification if an energy crisis develops.

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. They do offer the potential for meaningful diversification, particularly if, for example, stagflation causes stocks and bonds to perform 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 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 like 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 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.

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