QUARTERLY MARKET REVIEW

MARKET REVIEW

Global equities posted modest gains in the third quarter. Stocks linked to AI were volatile as massive corporate investment in AI seems to be both a cause for excitement and a cause of worry. They also had a big stumble at the end of July as Situational Awareness LP was forced into a fire sale of all its public equities following margin calls during a market downturn – though this is perhaps more of a cautionary tale on leverage rather than on AI stock investing. Tariffs raised their ugly heads again as the USA and Canada engaged in an escalating trade war, with levies of up to 50% being imposed on a wide range of goods. The Middle East conflict has kept oil prices elevated, exacerbating already problematic inflation. Indeed, the hot inflation numbers drove the Fed to raise interest rates in September, while longer-term yields suffered a big spike upwards. Somewhat amazingly, the optimism of investors and their ability to largely ignore risks and potential problems show no real sign of abating.

World equities, as measured by MSCI ACWI, returned 1.6% for the quarter. Emerging markets were the laggards, albeit after a very strong second quarter, as the MSCI Emerging Markets Index was down -0.4%, which was slightly better than the -2.9% return in local currency terms. In developed equities, the USA beat the rest of the world, and the S&P 500 posted 2.3%. MSCI EAFE returned 0.8% for the quarter, which equated to a broadly similar 0.6% in local currency terms. Value beat growth across the globe, and MSCI ACWI Value returned 3.7% for the quarter while MSCI ACWI Growth posted -0.5%.

Bonds had a more challenging time, with the 10-year nominal yield spiking an amazing 85 bps to finish the quarter at 5.29%. Meanwhile, the 10-year real yield rose a slightly smaller 73 bps to 2.93%, leaving the break-even inflation figure up 12 bps at a still pretty benign 2.36%. Against this backdrop, bond investors were hit hard. The Bloomberg U.S. Aggregate Index returned -3.5%, while the ICE BofAML U.S. High Yield Index posted -1.8%, and the JP Morgan EMBIG Diversified Index was down -3.9%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth underperformed after its big bounce back in the second quarter, and sentiment seems more mixed. Optimism and speculative fervor surrounding AI remain, despite growing concerns over the massive amount of capex and the mounting debt piles needed to finance it. The Iran conflict ceasefire did not hold, although the situation also did not escalate meaningfully, and negotiations are ongoing. 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. Resources was modestly up as energy prices climbed, but Climate Change had another tough quarter as a (potentially highly) interest-rate sensitive investment. We believe that they remain at favorable valuations and also provide a source of diversification.

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. They offer the potential for meaningful diversification, particularly if, for example, stagflation causes 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 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 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 couple of years may not be over, and it could be a bumpy ride.

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