

QUARTERLY MARKET REVIEW

Market Review

Although one might have expected the market to be somewhat disappointed with the Fed's cautious "wait and see" approach, with no rate cuts yet forthcoming in 2024, positive sentiment remains steadfastly undaunted. Indeed, there now appears to be excitement that they might be able to cut "as early as June". The prospect of a soft landing is providing more than enough fuel for the optimists' fire while they wait for the expected reversal in monetary policy. The Magnificent Seven proved not to be bullet proof. Although Nvidia and Meta enjoyed excellent quarters, both Tesla and Apple faltered to post significantly negative returns for the quarter.

Globally, it is also a little surprising that markets do not seem to be worried about the situation in the Middle East, as the conflict seems increasingly likely to spread to the wider region. Meanwhile, China's travails continued as shadow banking giant Zhongzhi Enterprise Group filed for bankruptcy - marking one of the country's biggest ever corporate collapses and putting more stress on already fragile consumer and investor sentiment.

World equities, as measured by MSCI ACWI, returned an impressive 8.1% for the quarter. The U.S. led the way in developed markets as the S&P 500 posted 10.6%, with MSCI EAFE well behind with 5.7%, albeit hindered by a surging U.S. dollar. They were significantly better in local terms, with MSCI EAFE (local) up 9.8%. MSCI Emerging Markets was the laggard in U.S. dollar terms, with a return of just 2.1%, though if you exclude the struggling China, they were a bit better, with MSCI Emerging Markets ex-China posting 3.7%. Emerging markets did not suffer as much of a currency drag as non-U.S. developed markets and the discrepancy to the MSCI Emerging Markets Index (local) return of 4.2% was much smaller. Value had a tough quarter against Growth, driven by underperformance in both developed and emerging markets. MSCI ACWI Value returned 6.8% for the quarter, while MSCI ACWI Growth posted 9.5%.

After a very strong fourth quarter of 2023, duration took a step back to start 2024. The 10-year U.S. nominal yield rose 32 bps over the quarter to finish at 4.20%, while the 10-year real yield rose 16 bps to 1.88%, leaving the break-even inflation figure up 16 bps to, a still benign, 2.32%. The yield curve inversion remains solidly intact. Again, as in previous quarters, 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).

Against this backdrop, traditional bond investors enjoyed a tougher quarter and the Bloomberg U.S. Aggregate Index returned -0.8%. Credit did a lot better as it benefitted from the general market optimism and the ICE BofAML U.S. High Yield Index posted 1.5%, and the JP Morgan EMBIG Diversified Index posted 2.0%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Despite the strong recovery in 2023, continuing into 2024, we are adding selectively to risk. Even as Growth enjoyed another strong quarter relative to Value, we are content to maintain our emphasis on Value as we know that positive sentiment cannot bolster overly optimistic valuations based on unrealistic growth expectations indefinitely. Indeed, certain parts of the market have been hit extremely hard even as some parts have surged, and we have built a modest, but meaningful, exposure to our Resources and Climate Change strategies as clean energy stocks have fallen to very favorable valuations, while acknowledging that this could prove to be a relatively volatile position. It is perhaps surprising that markets have not reacted with disappointment to the Fed's "wait and see" approach, and it remains to be seen what will happen if they are ultimately underwhelmed by central banks actions, or perhaps that should be lack of actions. 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 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:

- Exploit this global Growth bubble with a long cheap Value/short expensive Growth equity strategy.
- Avoid the Growth bubble by investing in liquid alternatives.
- Skirt around the Growth bubble by pivoting your equity exposure to equities outside the U.S., focusing on Value, and Deep Value in particular.
- 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, looks to be an intriguing opportunity.

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