QUARTERLY MARKET REVIEW

Market Review

The quarter started badly for markets as inflation remained stubborn, and this worry was exacerbated on the potential outlook for energy prices following the shocking events in the Middle East and whether this might ultimately lead to wider conflict in the region. Although there have been related incidents involving Lebanon, Syria, and Iran, along with Yemen-based Houthi attacks disrupting sea freight in the Red Sea, to date an all-encompassing regional war has been avoided.

As November rolled on, U.S. consumer spending, inflation, and the labor market all cooled, with evidence pointing to a gradual slowing in growth, even though optimism remained that this would lead to a soft landing rather than a painful recession. This led to a surge in traditional assets that lasted to the end of the year, fueled by speculation that the Fed is going to drive rates down aggressively in 2024, despite guidance being much more tempered.

After briefly touching 5% in mid-October, the 10-year U.S. nominal yield plummeted downward as year end approached and finished 2023 at 3.88%, round tripping back to the levels we saw at the end of June. The market is pricing in five or six rate cuts in 2024, though policy makers are being a lot more circumspect. The 2-year yield finished at 4.23%, so the inverted yield curve is still very much a worry. Interestingly, the 10-year real yield sits at 1.72%, leaving the break-even inflation figure at a surprisingly benign 2.16%.

World equities, as measured by MSCI ACWI, returned an impressive 11.0%, leaving them up an excellent 22.2% for the full year. The U.S. led the way in developed markets as the S&P 500 posted 11.7% for the quarter, with MSCI EAFE a little behind with 10.4%, albeit helped by a faltering U.S. dollar. They were significantly worse in local terms, with MSCI EAFE (local) up just 5.0%. MSCI Emerging Markets was the laggard in U.S. dollar terms, with a return of 7.9%, though if you exclude the struggling China they were considerably better, with MSCI Emerging Markets ex-China notching some 13.0%. Emerging markets enjoyed less of a currency boost than non-U.S. developed markets and the discrepancy to the MSCI Emerging Markets index (local) return of 5.6% was much smaller. Value had a tough quarter against Growth, driven by underperformance in developed markets. MSCI ACWI Value returned 9.2% for the quarter, while MSCI ACWI Growth posted 12.7%.

It was also a much-needed strong quarter for duration. As noted above, the 2-year yield fell an incredible 80 bps to finish at 4.23%, but the inversion remained intact as the 10-year yield fell a similar 71 bps to finish at 3.88%. Again, as 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 worse and the 10-year real yield fell by 52 bps.

Against this backdrop, traditional bond investors enjoyed an excellent quarter. The Bloomberg U.S. Aggregate index returned 6.8%, dragging it to a positive 5.5% return for the full year. The ICE BofAML U.S. High Yield Index posting 7.1% and the JP Morgan EMBIG Diversified index posted an impressive 9.2%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Despite the strong recovery in 2023, we have continued cautiously adding to risk. In truth, we were happier doing this at end of quarter three valuations than at the end of year valuations, although we see plenty of assets that offer fair or better compensation for the associated risks. It will be very interesting to see how 2024 pans out from an interest rate perspective and what will happen if the market is disappointed 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. Despite the modest correction in the fourth quarter, 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.
– 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 emerging markets and developed ex-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 like an intriguing opportunity.

ABOUT GMO

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