

QUARTERLY MARKET REVIEW

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The headline for the quarter is that anxiety as to whether tariffs and government staff firings would torpedo growth in the U.S. weighed heavily on markets. Volatility spiked as U.S. government policy seemed to change on an almost daily basis, with every delay or roll back of tariffs greeted with, typically short-lived, optimism. Ultimately, data showed a plunge in U.S. consumer sentiment coupled with a surge in long-term inflation expectations.

Tech investors were also rattled by DeepSeek, a Chinese AI model that purported to be built at a fraction of the cost of its Western competitors, although there were questions raised as to how much piggybacking it had done on others' technology. Unfortunately, progress that had been made regarding ceasefires in both Gaza and Russia / Ukraine appears to have reversed, and there remains no end in sight to either conflict.

World equities, as measured by MSCI ACWI, returned -1.3% for the quarter. U.S. equities gave back the relative outperformance from the fourth quarter of 2024, trailing badly as the S&P 500 posted -4.3%. This was more than 10% behind developed ex-U.S., as the MSCI EAFE index rose 6.9%. Some of this was down to a partial unwinding of the dollar strengthening that we saw at the end of last year, and EAFE was up a smaller 2.9% in local currency terms. Emerging market equities were up a very similar 2.7% in local currency terms, but did not benefit from FX gains to the same extent and so were just a touch better than this at 2.9% in USD terms. At a global level, value was a big winner, as MSCI ACWI Value returned 4.8% for the quarter while MSCI ACWI Growth posted -6.8%. Again, the biggest divergence was in the U.S., where Value beat Growth by 13.7% as the Magnificent Seven really faltered (the worst were a broadly 35% fall in Tesla and a 20% fall in Nvidia).

Bonds had a good quarter, with the 10-year nominal yield falling 35 bps to finish the quarter at 4.23%. Meanwhile, the 10-year real yield fell a slightly bigger 39 bps to 1.85%, leaving the break-even inflation figure up 4 bps at, a still pretty benign, 2.38%. Against this backdrop, traditional bond investors did well, while credit investors fared worse as spreads generally widened to reflect the heightened risk and uncertainty. The Bloomberg U.S. Aggregate index returned 2.8%, while the ICE BofAML U.S. High Yield Index posted 0.9%, and the JP Morgan EMBIG Diversified index was up 2.2%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Value enjoyed an excellent quarter in developed markets, while it was a modest winner in emerging markets. We are content to maintain our emphasis on value as we know that positive sentiment towards things like AI cannot bolster overly optimistic valuations based on unrealistic growth expectations indefinitely. Despite the ongoing uncertainty and volatility, we maintain a modest, but meaningful, exposure to our resource and climate change strategies as clean energy stocks have fallen to very favourable valuations. The pursuit of a global trade war by the U.S. has led to extreme uncertainty, with spikes in volatility as markets react to short-term headlines. 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, while the investment strategy of expecting share prices to always go up has been exposed as the illusion it always was.

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.
- 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.
- 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 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 eighteen months may not be over and it could be a bumpy ride.

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