

QUARTERLY MARKET REVIEW

MARKET REVIEW

It was another excellent quarter for equities. Tariff uncertainty persists, but the reactions are more muted as the on/off nature over the course of the year appears to have led to a certain amount of apathy, which will presumably change once there is more clarity. Inflation remains on the problematic side, but weaker jobs data underscored the dueling forces dividing policymakers over the path of rates. Indeed, the Fed did slash rates by 0.25% in September, leaving the market hopeful that there may be more to come before year end. Tech was buoyant as a federal judge ruled against the U.S. government's request to force Google to sell off Chrome and Android, and Nvidia further spurred excitement as it pledged to invest up to \$100bn in OpenAI.

Partisan disagreements over federal spending levels, and undoubtedly some unrelated issues, meant that Congress failed to pass appropriations legislation for the 2026 fiscal year, and the fourth quarter is going to begin with the U.S. in a shutdown. Earlier in the quarter, President Trump was hopeful that he had brokered the beginnings of a truce between Russia and Ukraine, but an increase in hostilities towards the end of August seemed to belie this, and by the end of the quarter, peace still looks very far away. There was much more success for the U.S. administration in the Middle East, with an agreement reached for a ceasefire and hostage release deal. This was a truly remarkable feat, as it included a very public apology from Israel to Qatar for violating their sovereignty in the September Doha air strike.

World equities, as measured by MSCI ACWI, returned 7.6% for the quarter. Emerging market equities were the winner, with the MSCI Emerging Markets Index up 10.6%, followed by the USA as the S&P 500 posted 8.1%, while developed markets outside the USA lagged with MSCI EAFE delivering 4.8%. After a difficult start to the year, the USD clawed back some ground against a basket of both emerging and developed currencies, and in local currency terms, MSCI Emerging Markets was up 12.2% and the MSCI EAFE was up 5.4%. At a global level, growth was the winner again, as MSCI ACWI Value returned 6.1% for the quarter while MSCI ACWI Growth posted 9.0%. However, this was powered by growth outperformance of 5.7% in the USA, while value actually beat growth by a similar 5.2% within EAFE.

Bonds had a reasonable quarter, with the 10-year nominal yield falling 8 bps to finish the quarter at 4.16%. Meanwhile, the 10-year real yield fell a slightly bigger 15 bps to 1.80%, leaving the break-even inflation figure up 7 bps at a still pretty benign 2.36%. Against this backdrop, traditional bond investors did fine, while credit investors fared better as spreads generally narrowed to reflect the "risk-on" mood. The Bloomberg U.S. Aggregate Index returned 2.0%, while the ICE BofAML U.S. High Yield Index posted 2.4%, and the JP Morgan EMBIG Diversified Index was up 4.8%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth enjoyed another incredible quarter in the USA, fueled by optimism and speculative fervor, with positive sentiment surrounding AI and optimism about impending rate cuts driving markets. We are content to maintain our emphasis on value, as we know that positive sentiment cannot support overly excited valuations based on unrealistic growth expectations indefinitely. Last quarter, we noted that Palantir, which may well be a fine company, was trading in excess of 100 x sales with a market cap similar to that of Coca-Cola or Bank of America. It has now left those two stalwarts in its rearview mirror, breaching the largest 20 companies in the USA, and approaching the size of Johnson & Johnson or Exxon. Again, at that spectacularly inflated valuation, it is hard to see how it will prove to be a good investment, even if it turns out to be a truly exceptional company.

Despite the ongoing volatility, we maintain a modest but meaningful exposure to our Resource and Climate Change strategies. It is heartening that clean energy stocks have continued to show the excellent signs of recovery that started last quarter, although we believe that they remain at favorable valuations. The pursuit of a global trade war by the U.S. has led to extreme uncertainty, with roller-coaster-like moves 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.

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 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.
- 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.

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