

QUARTERLY MARKET REVIEW

MARKET REVIEW

It was a volatile quarter. By the end of it, Wall Street's bulls had driven stocks to all-time highs, up roughly 25% from the troughs we had seen in April. Much of the volatility was driven by news feeding through about various tariffs, and then by subsequent pauses to tariffs. There were court rulings both for and against the legality of Trump's tariffs, and threats of punitive tariffs on parties across the spectrum, for example, the EU and Apple. Although the Trump administration is indicating that they are having positive conversations, including notably with China, the trade deals remain to be done, and it is a little surprising that the market has just brushed off this massive source of uncertainty. Indeed, the Fed warned that a trade war could lead to higher inflation and lower growth; while also reiterating it was not in their remit to bolster stock markets.

The President's "Big Beautiful Bill" narrowly made it through the House, prompting a sell-off in Treasuries amid worries of the potential for a ballooning deficit, although Treasuries did recover subsequently. Elon Musk called the bill a "disgusting abomination", leading to the very public ending of his friendship with President Trump. The geopolitical situation remains precarious as there is still no end in sight to the conflicts in Gaza and between Russia/Ukraine, although India and Pakistan moved quickly to de-escalate what could have been a very worrying situation involving two nuclear powers. The U.S. and Iran also traded strikes. The U.S. employed the first combat use of the MOP bomb on Iranian nuclear facilities, while Iran seemed to respond somewhat halfheartedly and the situation appeared to be resolved, at least for now.

World equities, as measured by MSCI ACWI, returned 11.5% for the quarter. In contrast to recent quarters, there were only modest performance differentials between regions. The S&P 500 posted 10.9%, MSCI EAFE was up 11.8%, and the MSCI Emerging Markets Index returned 12.0%. It was another quarter where non-USA equities were boosted by a weakening dollar, and in local currency terms MSCI EAFE posted a much less impressive 4.8%, while MSCI Emerging Markets was up 7.9% in local currency terms. At a global level, growth was a big winner, as MSCI ACWI Value returned 5.8% for the quarter while MSCI ACWI Growth posted 17.3%. Again, the biggest divergence was in the U.S., where growth beat value by 16% in what looked like a speculative rally.

Bonds had a reasonable quarter, with the 10-year nominal yield rising just one basis point to finish the quarter at 4.24%. Meanwhile, the 10-year real yield rose a slightly bigger 10 bps to 1.95%, leaving the break-even inflation figure down 9 bps at a pretty benign 2.29%. 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 1.2%, while the ICE BofAML U.S. High Yield Index posted 3.6%, and the JP Morgan EMBIG Diversified Index was up 3.3%.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. Growth enjoyed an incredible quarter in the USA, fueled by optimism and speculative fervor. 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. Palantir, for example, may be a good company but it is now trading in excess of 100x sales with a market cap similar to Coca Cola or Bank of America. 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 great 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 shown some good signs of recovery, 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:

- Exploit this global growth bubble with a long cheap value/short expensive growth equity strategy.
- 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.
- 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.
- 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, is an intriguing opportunity.
- 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 18 months may not be over and it could be a bumpy ride.

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