QUARTERLY MARKET REVIEW

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Perhaps the biggest headline for the quarter was that Joe Biden dropped out of the presidential race, although it did not translate to any shockwaves in the economy or the markets as Kamala Harris picked up the baton in a relatively seamless way. Around the world, the political situation worsened significantly as Israel broadened its offensive with strikes and targeted ground operations in Lebanon, along with more strikes in Yemen. This raises the very real concern of significant involvement from Iran, and all out conflict in the region.

Markets were very volatile, as big moves greeted every bit of news, or perceived news. Tech initially soared before falling back on the potential for regulatory curbs on chip sales to China, although it largely recovered as the period rolled on. A big sell-off at the start of August followed worries that the recession was finally arriving as labor market data showed significant cooling, but this was soon forgotten as talk turned to impending rate cuts. Indeed, the Fed did finally oblige in September with a 50-bps reduction, though it was accompanied by a warning that they would continue to be cautious in their approach.

World equities, as measured by MSCI ACWI, returned an excellent 6.6% for the quarter. The U.S. lagged modestly in developed markets as the S&P 500 posted 5.9%, with MSCI EAFE doing better with a return of 7.3%, helped by a significant sell-off in the U.S. dollar. They were considerably more lackluster in local terms, with MSCI EAFE (local) up a pretty paltry 0.8%. MSCI Emerging Markets was again the star performer in the third quarter, continuing to make up the ground lost earlier in the year, with a return of some 8.7%, helped by a spectacular bounce in China. Emerging markets also benefited, albeit moderately, from relative dollar weakening, and the MSCI Emerging Markets Index (local) return was just a little worse at 6.6%. Value had a strong quarter against Growth, as MSCI ACWI Value returned 9.4% for the quarter with MSCI ACWI Growth posting 4.1%.

Bonds had a good quarter on the back of the first rate cut, with the 10-year nominal yield plunging 55 bps to finish September at 3.81%. Perhaps more importantly, the yield curve is no longer inverted with the 2-year nominal yield sitting at 3.66%. It is somewhat of a relief that this traditional harbinger of doom has unwound without any unpleasantness, so perhaps the optimists who insisted that it was just an inflation-driven, short-term technicality were right. Meanwhile, the 10-year real yield fell a slightly smaller 45 bps to 1.63%, leaving the breakeven inflation figure down 10 bps at a pretty benign 2.18%. Against this backdrop, traditional bond investors were handsomely rewarded and the Bloomberg U.S. Aggregate Index returned 5.2%. Credit did modestly better, as the ICE BofAML U.S. High Yield Index posted 5.3% and the JP Morgan EMBIG Diversified Index posted 6.2%.

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 had been adding selectively to risk. Value enjoyed a good quarter relative to Growth, and it would be nice if this proved the first step back towards parity of valuation – although the last couple of years have demonstrated that strong investor sentiment towards Growth and excitement in AI innovations cannot be underestimated. 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. Despite the big cut in September, it is still surprising that markets have not reacted with more disappointment to the Fed's cautious approach, and it remains to be seen what will happen if they are ultimately underwhelmed by central banks' actions. Even with the pullback in the dollar, 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:
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 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 18 months may not be over and it could be a bumpy ride.