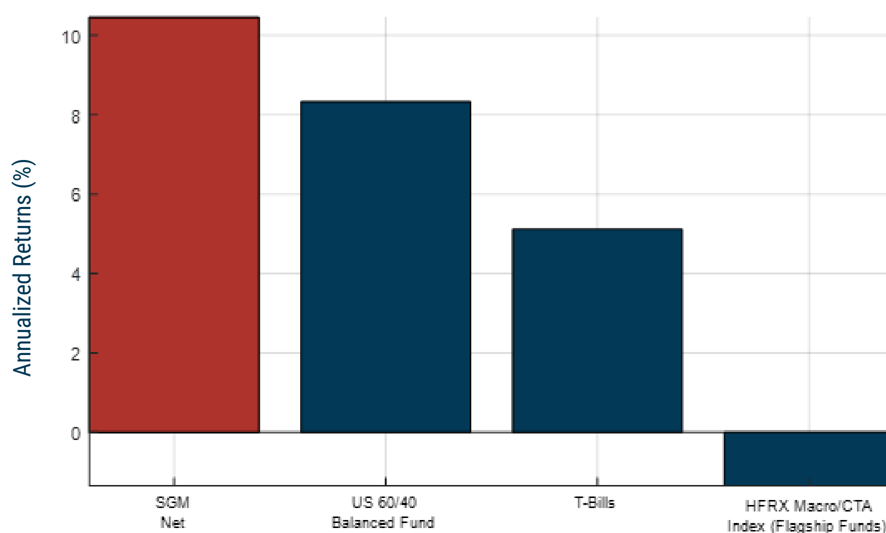
YEAR-END LETTER FOR 2023

Systematic Global Macro Team

Dear Client,

The GMO Systematic Global Macro (SGM) Strategy delivered strong performance in 2023, returning 10.5% net of fees for the 12-month period ending November 30, 2023. That compares to 5.1% for its T-Bill benchmark, 8.3% for a typical 60/40 balanced strategy,[1] and -1.6% for the HFRX Macro/CTA Index (Flagship Funds).

RETURNS | 30 NOVEMBER 2022 - 30 NOVEMBER 2023



Source: GMO

Uncertainty over inflation and the risk of an economic hard landing have resulted in unusually high volatility in the last 12 months, at least compared to the decade before the pandemic. SGM generally aims to have low correlation to stocks and bonds and in 2023 it has remained true to label. For example, in the period from the end of July to the end of October, when the MSCI World Index (USD) fell 9.3%, SGM was up 3.5%. More generally its beta to a 60/40 balanced strategy for the last 12 months was slightly negative, meaning its value added came from pure alpha trades rather than beta exposure. The strategy made some money from a small long position in equities and being short bonds for most of the year, but most of its value added came from relative value trades in currencies and commodities where we think the opportunity set has been reasonably rich.

Notable trades include the Japanese yen, where we've been short most of the year due to a widening interest rate gap; as other countries increased interest rates to fight inflation, Japan's inflation remained low and they saw no reason to follow suit. On the other side of the currency trades, we have profited from long positions in the Brazilian real and Mexican peso, countries where short-term interest rates are over 11% and inflation is only a percent or two more than in the US.

On the commodity side, there were some notable gains in the grain futures where we tended to be short after grain prices doubled in the three years ending June 2022 . We also benefited from technical indicators causing us to pivot to a long position in soybean oil in the middle of 2023 after banking some good profits, then switched back to a short position after a nearly 50% mid-year rally.

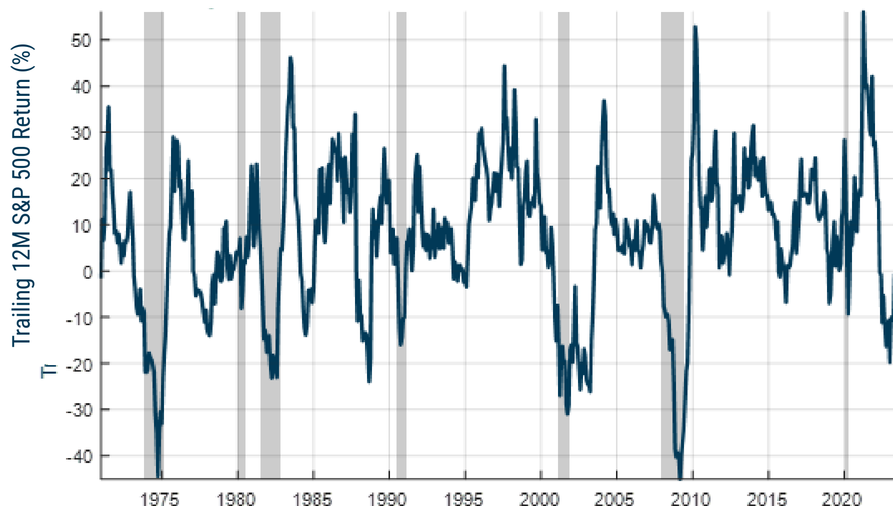
1
60% MSCI World Index, 40% Bloomberg U.S. Aggregate Bond Index

OUTLOOK FOR 2024

1. Caution is warranted

The late 2023 market rally has skewed risks to the downside in 2024. The market seems to be pricing in a Goldilocks soft landing scenario, but high prices leave the market vulnerable to disappointment. Running the economy hot is generally good for profits and this cycle is no exception. The MSCI World ROE is currently around 15%. If the economy cools in the soft landing scenario, the ROE will likely fall towards its long-term median value, which is around 12% measured over any horizon from 10 to 50 years. That would cause the P/E to rise to 25 at current prices, which is 25% above the 30-year median. That's not high enough to have any great confidence that stocks will underperform bonds or cash, but it does mean there is limited upside potential. If things go well, we believe stocks should probably eke out meagre gains. On the other hand, if the economy cools faster than expected and we end up with a hard landing, we believe it's highly likely stocks will disappoint. US stocks have always fallen in a recession, as defined by the National Bureau of Economic Research (NBER).

MARKETS ALWAYS FALL IN A RECESSION



Source: National Bureau of Economic Research

Recent falls in bond yields have also made bonds less attractive. US 10-year bonds have recently fallen below 4% yield, meaning they have around 1.5% negative carry versus short-term Treasuries. To offset that loss, bonds have to produce a capital gain by yields falling even further. Yields would have to fall by around 30 bps in 2024 to offer a normal term premium over cash. It's reasonably likely that will happen, but it's far from certain as the inflation demon hasn't been convincingly defeated yet. Recent dovish comments by the Fed may in fact be counterproductive if improving business and consumer sentiment leads to the economy running hotter for longer and more persistent inflation. In short, neither stocks nor bonds look terribly exciting in 2024.

2. Relative Value Trades Look Much More Interesting

While the major asset classes are not terribly interesting, the cross-sectional opportunities are improving, and they are the bread and butter of active management. In the last 10 years, the cross-sectional spread in equity value has been abnormally low. That is a bad environment for active value strategies. However, spreads are now back to more normal levels, meaning active value strategies should be more effective going forward.

CROSS-SECTIONAL EQUITY VALUE OPPORTUNITIES

Source: GMO

A simple measure of cross-sectional opportunities is the inter-quartile range of log price/book for the countries the SGM Strategy trades relative to their own history. That has now risen to around 25%, the highest level in the last 10 years.

3. Carry is back

Something I'm often asked is how higher interest rates will affect the portfolio. The first obvious thing to point out is that SGM is a derivative-based portfolio with most of the assets invested in short duration fixed income instruments. We'd expect to earn close to the Fed Funds Rate of 5.5%, so that's a tailwind for the portfolio relative to recent years.

Higher rates should also create more active investment opportunities in fixed income and currencies. We've found that rates don't have a floor at zero percent as we previously thought. We saw the Swiss policy rate falling as low as -0.75% from 2015 to 2022. There is still some lower bound even if it is a bit unclear where it is, however, and as rates fall and approach that bound, they tend to compress in cross section. Among the G10 major currencies, the high-low range fell to an all-time low of 1% in March 2020. It becomes very difficult to make money from carry trades when spreads are that low! However, when rates started to rise in late 2021 they rose at different rates in different countries and that opened up opportunities for carry trades. The high-low range is now 5.6% (the US versus Japan), the highest it's been since 2008. As economies slow at different rates it seems likely that the dispersion will rise even further.

4. Economic cycles are diverging

While western markets have struggled with inflation, Asian markets have had a very different experience. Japan still hasn't reached its target level for wage inflation, and China is risking tipping into deflation. China may have reached a reckoning time for its growth model and desperately needs to increase domestic consumption or risk falling into a sustained recession. According to the World Bank, the gross saving rate in China is 45% of GDP, compared to an average of 24% for high-income countries. When China was a low-income country, it was possible to productively deploy a very high saving rate, building out its infrastructure and industrial base while gearing its economy to exports. Now that it's bordering on being a high-income country (which the World Bank defines as GNI per capita of $13,856 or more), the growth

model becomes more difficult. It has become too big to lean on trade as a major growth engine, and China's trade-to-GDP ratio peaked 17 years ago. China compensated for outgrowing its export-oriented growth phase by leaning on housing construction, but that led to a speculative bubble resulting in the average house price to income ratio in China of over 30x, compared to around 5x in the US. That bubble has now burst, leaving a trail of destruction among developers. There is a risk that companies will not be able to find productive ways to invest the high domestic saving rate, in which case the economy will stall unless consumption increases.

The difficulty in productively deploying so much capital can be seen in the falling marginal efficiency of capital, defined as real GDP growth divided by gross capital formation:

CHINESE MARGINAL EFFICIENCY OF CAPITAL

Source: World Bank

Policies that would help include more government fiscal stimulus, lower interest rates, redistributing wealth to the lower income households that have a higher marginal propensity to consume, and building out a stronger social safety net that would reduce precautionary saving. It's likely some or eventually even all these policies will be adopted to some degree, but the adjustment will be a headwind for China for a while. In the meantime, the US economy is doing quite well for now, though European prospects seem a little gloomier.

The SGM Strategy builds these sorts of factors into our value models, but also tries to capture the shorter term fluctuations in the growth cycles with various sentiment indicators. These work better when there's significant divergence between the country and regional growth cycles, so moving into a period of more divergent economic cycles produces opportunities.

CONCLUDING COMMENTS

The outlook for 2024 continues to have a lot of uncertainly. The current optimism could easily turn sour if the economy cools faster than expected or the various geopolitical risks take a turn for the worse. Timing markets is difficult at the best of times but is easiest after large falls when markets are cheap or in extreme bubbles where you want to be short. Today is neither of those things, and in this environment, it is useful to focus on relative value trades that can pay off regardless of the general market direction. Those are the types of trades that the SGM Strategy usually tries to exploit and it's where the strategy's risk budget is currently focused. We recommend investors approach 2024 with caution and remain agile with their investment decisions.

We wish you well, and a successful year of investing.

GMO Systematic Global Macro Team

Annualized Returns as of 9/30/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Systematic Global Macro Strategy	3/31/2002	18.36%	4.82%	3.05%	3.57%	5.71%
FTSE 3-Month T-Bill		4.71%	1.78%	1.74%	1.12%	1.36%

Performance data quoted represents past performance and is not predictive of future performance.
Net returns are presented after the deduction of a model advisory fee and incentive fee if applicable. These returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. Fees paid by accounts within the composite may be higher or lower than the model fees used. A Global Investment Performance Standards (GIPS®) Composite Report is available on GMO.com by clicking the GIPS® Composite Report link in the documents section of the strategy page. GIPS® is a registered trademark owned by CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's Composite Report.

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