GMO

YEAR-END LETTER FOR 2024

Systematic Global Macro Team

Dear Client,

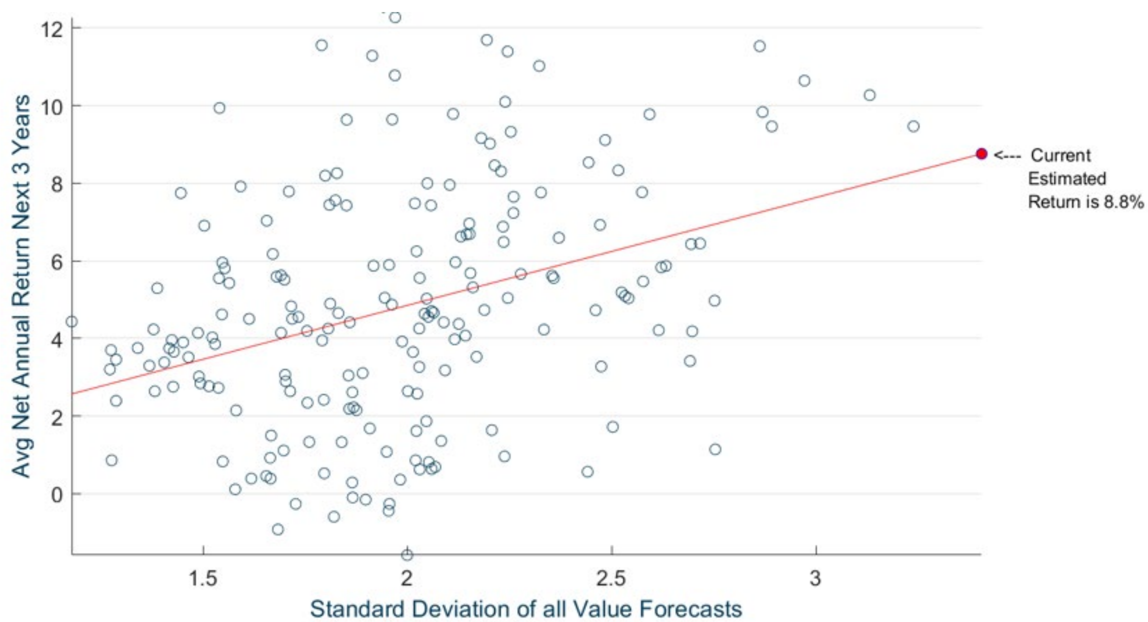
2024 was a difficult year for the GMO Systematic Global Macro (SGM) Strategy, which was down -13.4% net of fees for the year. In aggregate, commodities are the major source of losses, contributing -19.5%.

The biggest challenge for the year has been widening value spreads in commodities. A value process will generally lose money in that environment. However, the flip side is that wider value spreads mean better prospective returns over the next few years.

At the same time, the strong outperformance of the U.S. equity market has further widened the value spread in equities. The U.S. economy has done well in the last few years, with continuing stimulus resulting from a lack of fiscal discipline being a likely source of that outperformance. However, with so much good news built in the market is vulnerable to any kind of disappointment.

Historically wide valuation spreads have been associated with good returns for SGM over the following three years, and that historical relationship suggests a rich opportunity set today.

EXHIBIT 1: FUTURE 3-YEAR RETURNS VS. SPREAD IN FORECASTS



As of Dec 2024 | Source: GMO

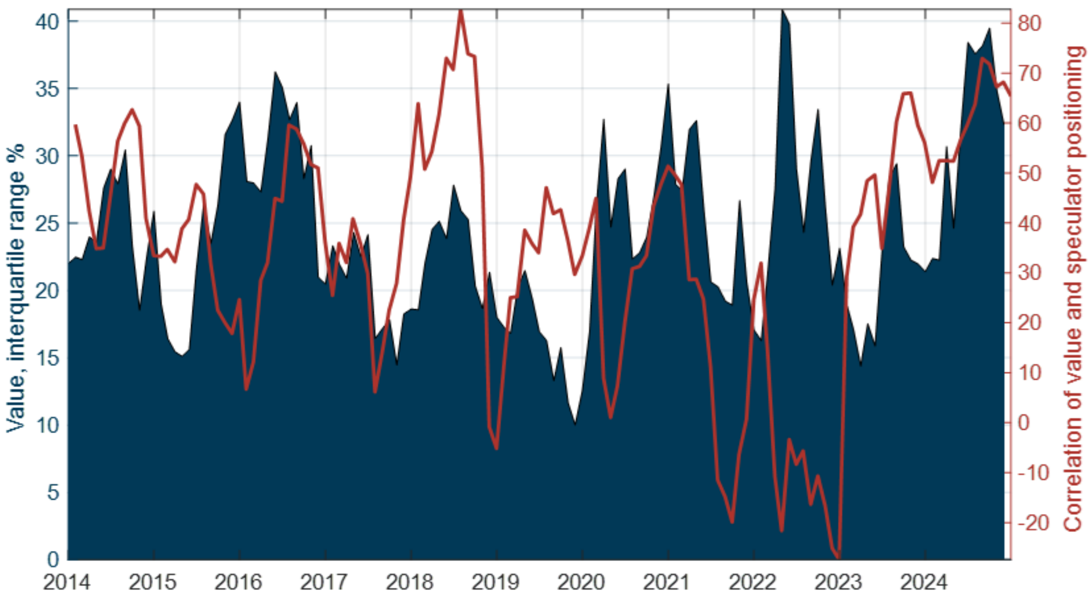
The expectations provided above are based upon the reasonable beliefs of the Systematical Global Macro Team and are not a guarantee. Expectations speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update such expectations. Expectations are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in the expectations above.

Commodity Outlook

The last two years have seen a lot of commodities deviating away from their fair values, as shown in Exhibit 2. The blue area is the inter-quartile range of our value signals, expressed as a percent under or overvalued.

The notable feature of the current rally is its unusual correlation with speculative positioning in the futures markets, shown with the red line. Speculator positioning usually cycles over a fairly short period of time, but this cycle is unusual in its length. The correlation of speculator positioning with value bottomed out in December 2022 and has only just rolled over in the last few months.

EXHIBIT 2: VALUE SIGNALS VS. SPECULATOR POSITIONING



As of Dec 2024 | Source: GMO

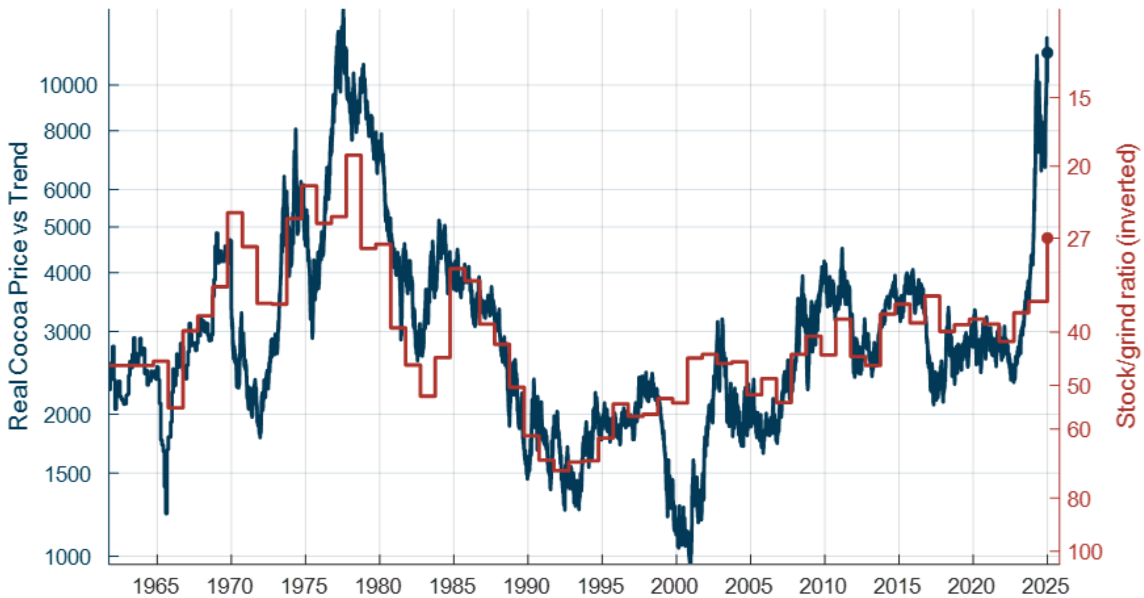
Generally, when speculators rapidly build up a position in a market it signals there is a risk of flighty money departing rapidly and SGM, being good contrarian investors, will take the opposite trade. However, occasionally speculator-driven trends will extend further and for longer than normal, and in that circumstance contrarian investors will do poorly until the trends reverse.

Cocoa

Cocoa has been the most challenging trade for 2024, at -9.8% it accounts for half of our losses in commodities. Cocoa bean futures started the year priced at around $4,200/MT before peaking at $11,500/MT in April following bad weather and predictions of falling crop yields. Prices fell from there and 2025 was looking to be a bumper production year until heavy rainfalls in October reduced the predicted yield, sending prices soaring again in December.

Every value opportunity has a story, and this is no exception. Low production should lead to inflated prices but often investors overreact to the news and that's what creates the investment opportunity. In order to estimate if a market has overreacted to news, we need to measure what a reasonable reaction to changes in the balance of supply and demand should be. In the case of cocoa beans, one way of measuring that is to look at the ratio of cocoa bean stocks to the rate at which they are being ground into cocoa paste. Exhibit 3 compares the real cocoa price versus its trend in blue to the stock to grind ratio (expressed as a percentage). The International Cocoa Organization (ICCO) has just downgraded its estimate of that rate to 27%, or just over three months of stocks. Based on a historical fit that would justify a price of under $5,000/MT, less than half of its current price.

EXHIBIT 3: COCOA PRICE VS. SUPPLY AND DEMAND



As of Dec 2024 | Source: GMO

Exhibit 4 shows the likely culprit for the extreme price moves: speculators remain long, extending the trends in the market. Patience is likely to deliver a good return on a short value position in cocoa, though there is always uncertainty, and our position remains modest at around 7% short.

EXHIBIT 4: COCOA FUTURES LONG LESS SHORT TRADES

As of Dec 2024 | Source: GMO

Gold and Silver

Gold and silver are both up over 20% in 2024. We've had modest shorts in both, resulting in around 5% loss to the portfolio. Gold set a record high $2,800/ounce in October 2024. In real terms it wasn't quite the peak (that was 1980) but it was close. We prefer a more generous measure for the fair gold price, comparing the total value of gold in circulation to global GDP. Real GDP has risen around 1.5% per annum faster than gold supply since the mid-1970s, so if a constant portion of GDP was spent on gold the real price would have to rise. Based on that more generous measure gold is still about 50% above its 50-year median.

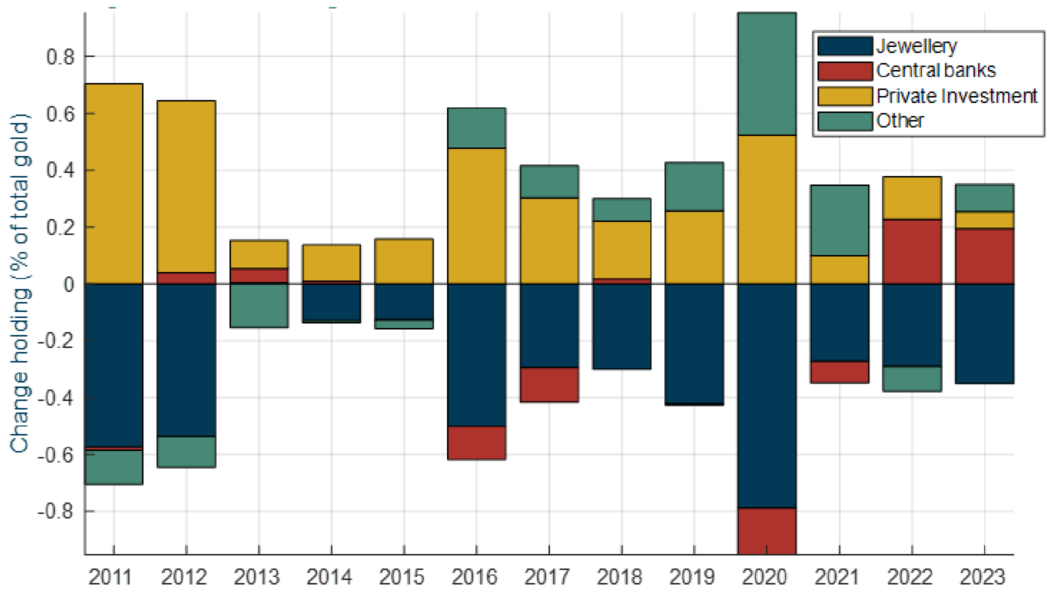
Gold generally has a high correlation with real bond yields. If the real bond yield rises, bonds become more attractive compared to gold which has no cash flow yield. In recent history that relationship has held quite closely, but it broke down spectacularly in February 2022 when Russia invaded Ukraine. That event led to freezing and talk of confiscating Russian foreign exchange reserves. That may have led to more interest in central banks holding gold as part of their reserves.

EXHIBIT 5: GOLD VS. REAL BOND YIELDS

As of Dec 2024 | Source: GMO

However, while central bank buying is the narrative being widely discussed it's not clear how much that really explains. The World Gold Council provides data on the breakdown of gold holdings since 2010. Exhibit 6 shows how that has changed each year. In each of 2022 and 2023 central banks have increased their share of total gold holdings by 0.2%. That's a fairly small number. In the 10 years to 2020 there was a much bigger rotation occurring, away from jewelry and towards private investment. That much bigger rotation didn't seem to change the gold price much with the total value of gold in circulation divided by GDP being at its 50-year median as recently as 2022. Private investment, which includes ETFs, is now falling, being replaced with a smaller amount of central bank buying. It is not clear why central bank buying in such small amounts would lead to a 50% appreciation in the price of gold.

EXHIBIT 6: CHANGE IN GOLD HOLDINGS



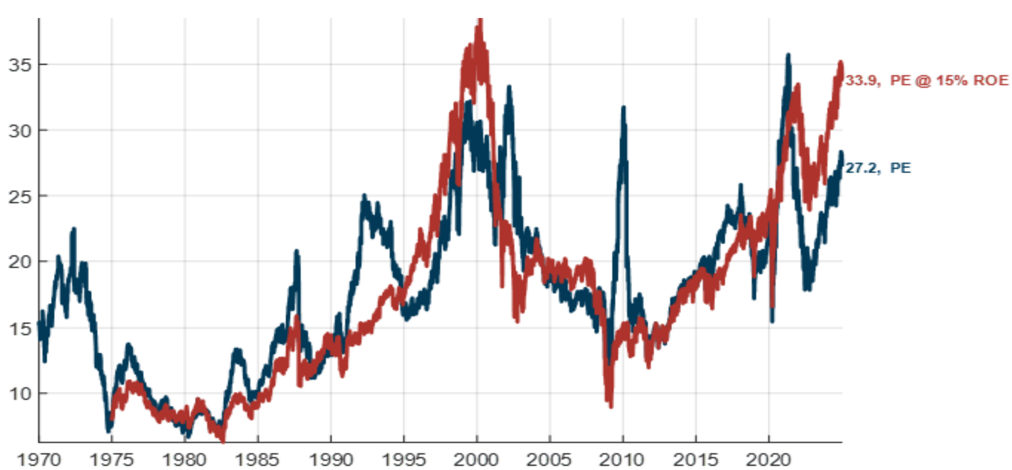
As of Dec 2023 | Source: Gold Hub

The more likely explanation for the expansion of the gold price is speculative trend following, again extending for longer than is usual. If that is accurate then price falls are likely. The price of both metals peaked in October, with gold now 6% off its high for the year and silver down 17%.

Equity Outlook

The big story for 2024 was U.S. outperformance, particularly the Magnificent Seven stocks which now constitute over 30% of the S&P 500 market capitalization. Those seven stocks have admittedly shown very strong earnings growth, but most of the returns from the S&P 500 index still came from rising price ratios. The PE for the S&P 500 is now 27 based on a very high ROE at 19%. If the ROE returned to a more normal 15% the PE ratio would be over 34, levels only seen in the Tech bubble.

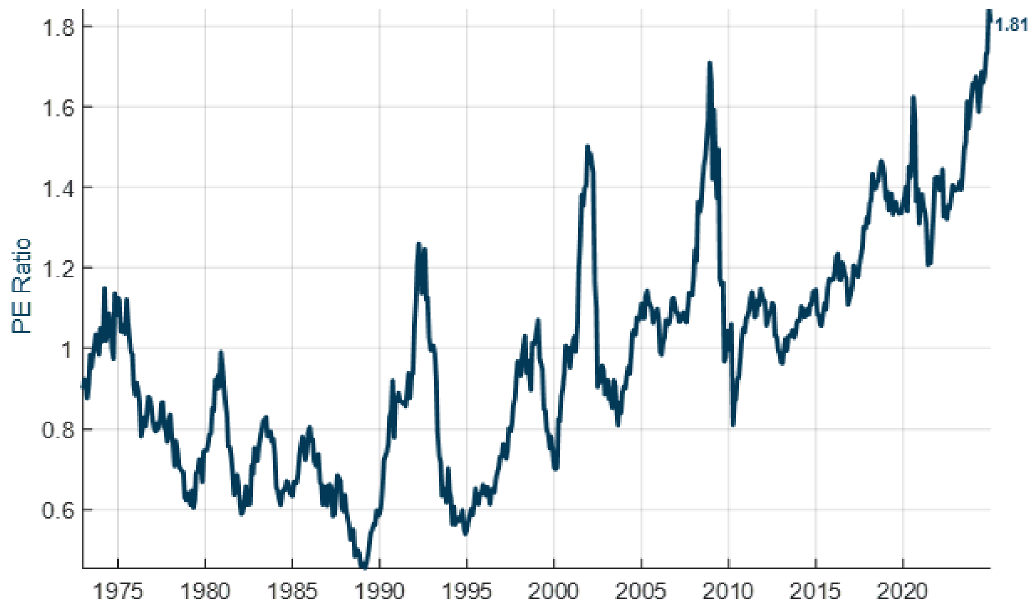
EXHIBIT 7: S&P 500 PE



As of Dec 2024 | Source: GMO

That outperformance has not been reflected in stocks outside the U.S. The PE ratio for the S&P 500 index is now 1.8x the MSCI EAFE index. That's the highest level ever achieved.

EXHIBIT 8: S&P 500/MSCI EAFE PE RATIO

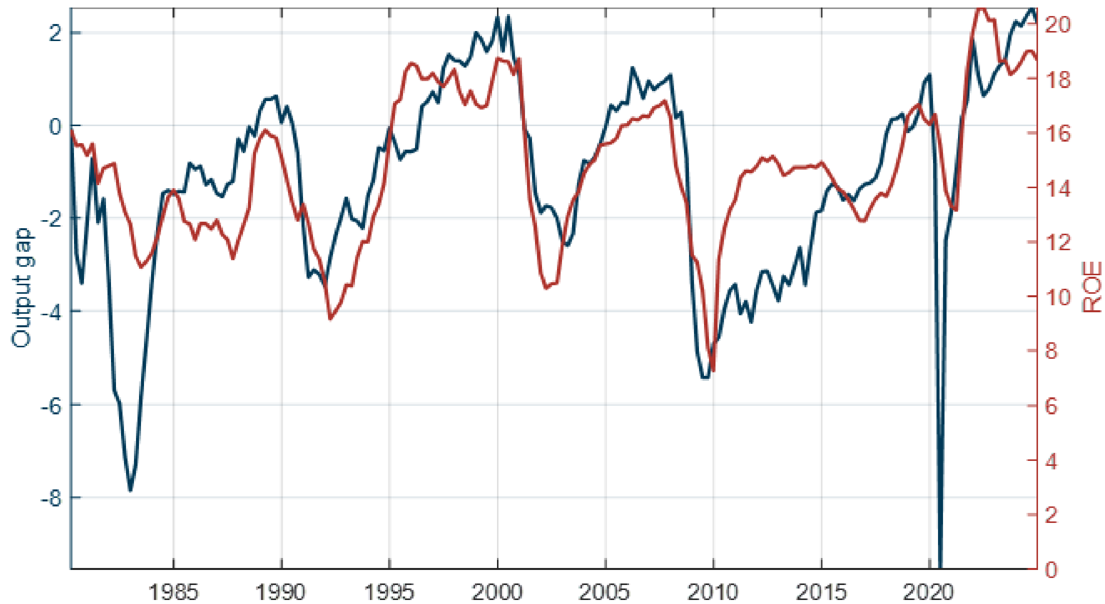


As of Dec 2024 | Source: GMO

There are a lot of arguments about U.S. exceptionalism explaining this outperformance. However, we'd posit a much more banal explanation: U.S. stocks are benefitting from reckless fiscal stimulus at the wrong time of the economic cycle.

One way of measuring where a country is in its economic cycle is to look at the "output gap", defined as the amount by which the actual output of an economy falls short of its potential output. According to Oxford Economics, the U.S. is operating at the highest level of economic activity ever compared to its potential. When the output gap is very narrow firms have very little idle capacity and it's easy to make high profits. That tight historical relationship is shown in Exhibit 9.

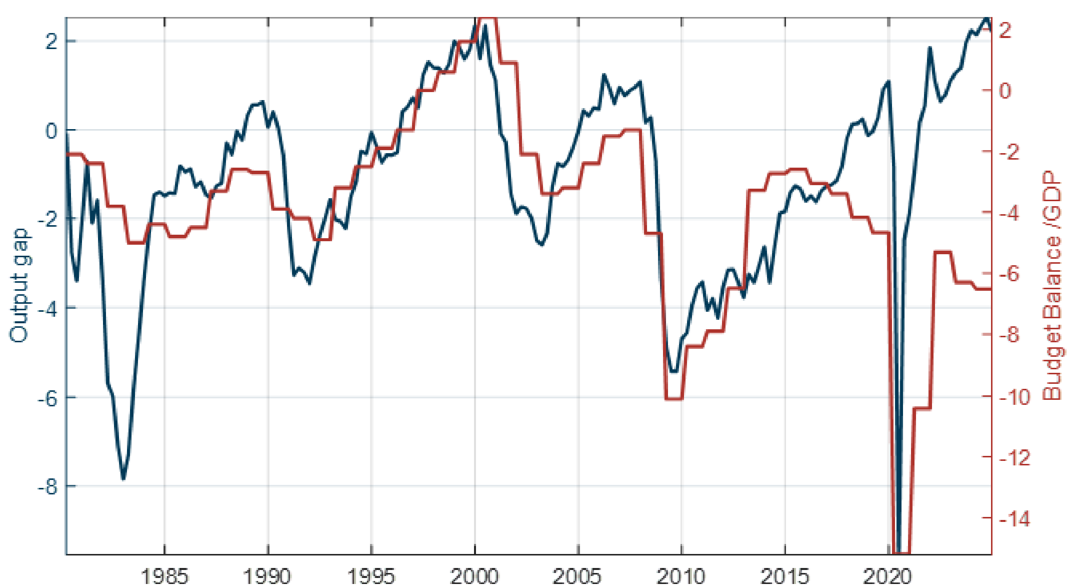
EXHIBIT 9: S&P 500 ROE VS. OUTPUT GAP



As of Dec 2024 | Source: GMO

The danger of running too tight an output gap is that it can create inflation, hence the necessity of the Fed having to continue applying the monetary break. Neoclassical economic theory suggests that this is a period where the U.S. should be running fiscal surpluses not deficits. Automatic stabilizers usually help in doing that as a strong economy means high tax receipts and falls in social welfare payments. That has been the usual pattern in most economies, including the U.S. up to 2016. However, after 2016 both political parties in the U.S. seem to have decided fiscal discipline no longer matters. The perversity is that when everyone decides something no longer matters it's probably the time when it matters the most.

EXHIBIT 10: BUDGET BALANCE VS. OUTPUT GAP



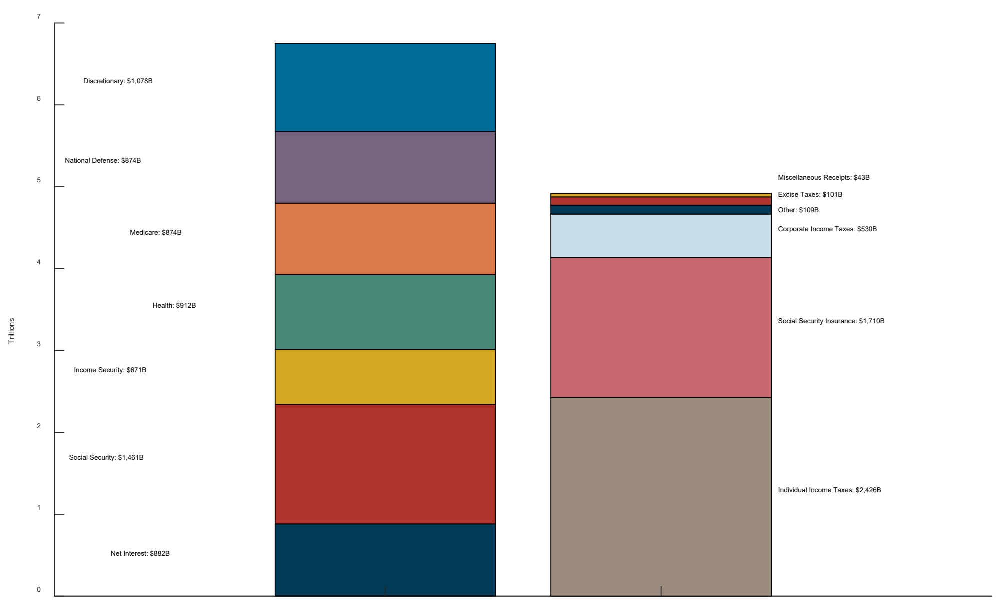
As of Dec 2024 | Source: GMO

2025 will see the U.S. federal government debt owed to the public pass 100% of GDP. That's likely a trigger point where the risk of fiscal profligacy sparking a debt crisis increases. The Congressional Budget Office forecasts that debt/GDP will reach 122% by 2034, but that is based on very optimistic assumptions like Trump not renewing his 2017 tax cuts when they expire in 2025. The Committee for a Responsible Federal Budget made a central estimate that Trump's campaign plans will add $7.75 trillion to the federal debt by 2034, which would imply debt at over 140% of GDP, and that still assumes that there are no major recessions in that period.

When we say both parties have decided fiscal discipline no longer matters, we are probably being a little harsh. Perhaps it is more accurate to say that there is a deep disagreement about how to balance the budget and that is leading to political paralysis. For a long time, the Republican party has championed the idea of small government and balancing the budget through spending cuts. With the parlous state of U.S. budget perhaps now is the time. Trump has been elected as an agent of change and the Republican party will soon control the House and the Senate. Elon Musk has been put in charge of the Department of Government Expenditure (DOGE) and promised to slash $2 trillion from spending which would be enough to balance the budget. Is that a credible goal? It seems hard to understand how it could realistically be achieved.

In fiscal 2024, the federal government spent $6.8 trillion, leaving a deficit of $1.9 trillion. If interest payments are ignored, as they can't be reduced, spending was $5.9 trillion. Stripping $2 trillion out of spending would require reducing spending in all categories outside interest by over 1/3. Discretionary spending other than defense is a common target for cuts, but at just over $1 trillion that can't be cut enough to make much difference.

EXHIBIT 11: OUTLAYS OF THE U.S. GOVERNMENT



As of Sept 2024 | Source: U.S. Treasury

Balancing the budget through spending cuts alone would require deep cuts to entitlements like health and social security, and any cuts there would be extremely unpopular. It seems hard to see how social security payment can be cut as it's funded by social security insurance receipts. Asking people to pay for social security but then redirecting those funds seems like a hard sell.

Health care seems to be a more credible area that could in theory be cut. According to the World Bank, the U.S. spends 17% of GDP on health care while the European Union and most other developed countries spend around 11%. Americans die on average four years earlier than Europeans, so they don't seem to be getting value for money. It seems credible that U.S.

healthcare expenditure could be cut by 1/3. However, the federal government only pays for around 1/3 of U.S. healthcare. One of the primary ways other countries save money is having a strong state-run healthcare system that controls drug and treatment prices. The U.S. could replicate that system, and it could save the U.S. citizens a lot of money, but adopting the system used elsewhere would be unlikely to reduce the amount spent by the federal government.

Increasing tariffs could help with revenues, but it's unlikely to really move the needle. Existing import duties raised around $80 billion in 2023[1] , a fairly inconsequential number. A 20% across the board tariff on all U.S. imports could, in theory, raise around $800 billion in revenue. However, that would include taxing things like crude oil that's imported from Canada, refined, then exported to Mexico. Trying to clip 25% for passing though the U.S. would quickly lead to the U.S. being cut out of that value chain. If you exclude goods that are imported and re-exported and adjust for the drop in trade and cost of retaliation, the U.S. would be lucky to collect a quarter of that $800 billion. Tariffs won't solve the budget problem.

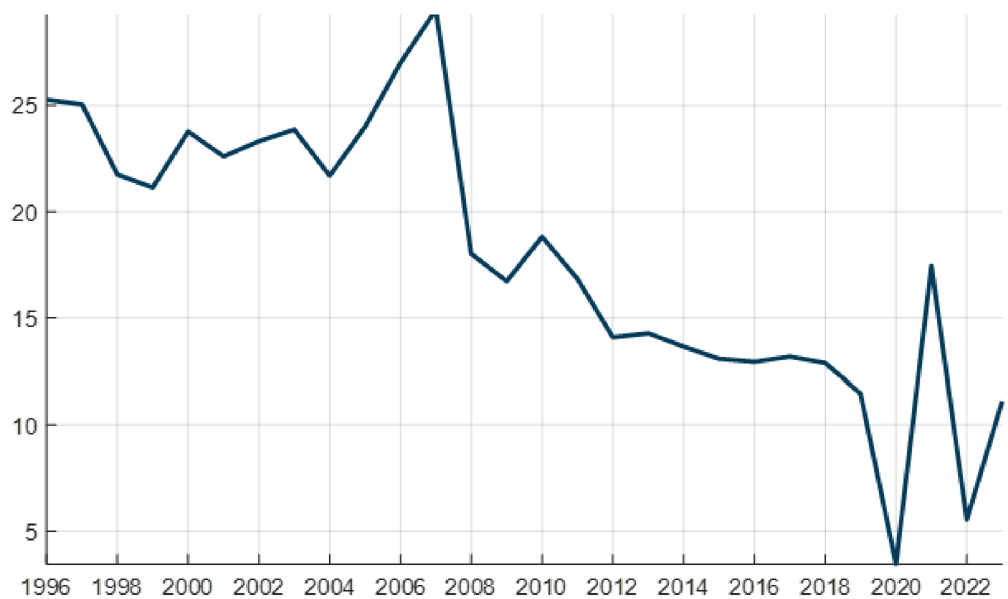
It is hard to escape the conclusion that the U.S. equity market is living on borrowed time. If the budget problems aren't solved, then there will eventually be a fiscal crisis that will hurt both bonds and equities. If the fiscal problems are solved then the U.S. output gap will widen, the market's ROE will likely fall, the PE ratio will rise to Tech bubble like levels, and the equity market will again likely fall.

The SGM team believes that the U.S. market enjoys advantages over many other markets and deserves a PE premium, but nothing like the current level that's priced in. We were long the U.S. early in 2024 due to good sentiment signals, but the recent rally has made the market less attractive from a value perspective and we're entering 2025 short the U.S.

China

While the U.S. is overstimulating its market, China is doing the opposite. China's problems are structural rather than cyclical. According to the World Bank, China's gross saving rate in 2022 was 46% of GDP compared to 24% in high income countries and 34% in middle income countries, a category that includes China. China's per capita GNI in 2023 was $13,400 which puts it very close to the World Bank's definition of a high-income country, which is $14,005. As a borderline high-income country, it seems increasingly unlikely that China can profitably invest 46% of its GDP each year, and given the size of the economy it isn't practical to export capital in sufficient quantities to meaningfully address the imbalance.

EXHIBIT 12: MARGINAL EFFICIENCY OF CAPITAL WITH LABOR ADJUSTMENT



As of Dec 2023

[1] https://www.whitehouse.gov/cea/written-materials/2024/07/12/tariffs-as-a-major-revenue-source-implications-for-distribution-and-growth/

Exhibit 12 shows the falling marginal efficiency of capital in China. The marginal efficiency of capital is defined as the change in real GDP divided by the gross saving rate. We've added a labor adjustment, subtracting 0.7x labor growth from GDP growth. This comes from the Cobb-Douglas production function, using a common estimate that a 1% growth in labor leads to a 0.7% growth in GDP. Once that is subtracted, we can estimate the portion of GDP growth that comes from capital deepening.

If the return on capital falls enough then it will be hard to get businesses to invest, and without investment or consumption the economy will stall. For a while, a lot of the excess savings was absorbed by the property sector but when the expectation of ever rising property prices was dashed that investment evaporated. Youth unemployment is now at 17% so China desperately needs a new growth driver. The government has introduced some stimulus but not enough. The goal needs to be a large reduction in the gross savings rate for China's economic model to be sustainable.

Given all the bad news the market has fallen a lot. The real price index for the Hang Seng, which has increasingly become a mainly Chinese stock index, is down 62% from its peak in 2007 and hasn't fared well in recent years. The 12-month forward PE is now around 9, and it would normally look very attractive on a value basis. However, it is at risk of being a value trap, and we have given a low fair PE to the market. We are still willing to buy at the right price so we will follow sentiment and treat the market with caution.

Europe

We are long European stocks based largely on relative value, but we are concerned about Germany and remain short that market.

While priced attractively, Germany is at risk of becoming the sick man of Europe. In some ways China's imbalances are becoming Germany's problem. China has historically been a customer for German industrial goods, but as China moves up the value chain it is increasingly becoming a competitor in those same markets. Nothing shows that more starkly than then impressive rise of China's auto industry, focusing on electric vehicles (EVs). In 2024, 47% of car sales in China were new energy vehicles and they were dominated by Chinese brands. Historically, German automotive companies have made a large portion of their profits in China, but they are increasingly becoming irrelevant in the world's largest car market. The Europeans have become so worried about Chinese dominance that they have enacted tariffs to protect the local industries. Despite that, VW is likely to close underutilized plants in Germany for the first time and there is talk of de-industrialization in Germany. The auto industry is a large part of the economy, but the challenges are not just autos.

Currencies and Bonds

For a while we have talked about the savings surplus and weak labor growth leading to structurally lower interest rates. All of that remains true, but fiscal profligacy can still override that by creating credit risk. As both U.S. and global government debt levels exceed 100% of GDP that becomes an increasing concern, and we have few high conviction bond trades on at the moment.

Currencies on the other hand have been a highlight for the year, including generally being short the yen but closing that short temporarily during its Q3 rally. We'd expect USD strength to be a theme next year if tariffs and fiscal stimulus push U.S. rates higher.

Concluding Comments

While 2024 has been a very difficult year for the SGM Strategy, our return lies within a two standard deviation confidence interval and drawdowns of this nature will occur from time to time. It is the worst annual calendar year return, but it isn't the worst high to low drawdown. That honor lies with the quant meltdown in August 2007. It wasn't even a year of extreme volatility, with the ex-post standard deviation of daily returns being only 11%. We simply saw some unusual market behavior with trends extending further than we'd normally expect and mean reversion trades not paying off.

On a positive note, as markets deviate further from their fair values the prospective opportunity set improves. The cross-sectional spread of value forecasts is now a 3.2 standard deviation event, the widest spread we've ever seen in over 20 years of running the Systematic Global Macro Strategy. Wide value spreads tend to predict good future returns, so we see this as an unusually good environment for investing in macro opportunities.

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

GMO Systematic Global Macro Team

Annualized Returns as of 12/31/2024 (Net, USD)	Inception	1-Year	3-Year	5-Year	10-Year	ITD
GMO Systematic Global Macro Strategy	3/31/2002	-13.45%	0.56%	0.80%	1.65%	4.77%
FTSE 3-Mo. T-Bill		5.45%	4.05%	2.54%	1.79%	1.59%

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. **GMO LLC claims compliance with the Global Investment Performance Standards (GIPS®). 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.**

Disclaimer

The views expressed are the views of Jason Halliwell and the GMO Systematic Global Macro team through the period ending January 2025, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.