PUBLIC EQUITIES

A combination of better-than-expected economic data, corporate cost-cutting measures, and enthusiasm around AI helped drive markets higher this year. However, since the end of July we have seen a distinct turn in sentiment as the Fed poured cold water on optimistic hopes for early interest rate cuts and more signs of a slowing economy emerged. Indices have since retreated to their lowest levels since early June with the S&P 500 and Nasdaq shaving 3.3% and 3.9%, respectively.

The main story during the first half of the year was how mega-cap technology stocks were driving an overwhelming proportion of the market's gains. But by July, those mega-caps were no longer a bargain. The S&P 500 was trading at an estimated 18.7x on a 12-month forward-looking basis, well above its 10-year average of 17.7x and the 16.8x multiple it traded at coming into the year. Market strength appeared to be broadening out into other areas like small-caps, value, and cyclical sectors which had been left behind. This was always a risk-on trade though and somewhat precarious during this late part of the cycle. As the market sold off in August and September, these stocks bore a disproportionate amount of pain. As shown in Figure 5 below, small-cap stocks are near trough trailing P/E multiples. Assuming we see further economic moderation in the coming quarters, companies with more stable revenue, earnings, and margins, regardless of industry or size, are likely to be rewarded. This bodes well for active management, which has been seeing a mini renaissance over the last year and half.

European markets continued to sputter, as the region dealt with higher inflation and lower GDP growth than the US but were helped by their relatively meager valuations coming into the third quarter. The Stoxx 600 retreated 2.0% in Q3 but managed to stay in positive territory for 2023

Figure 5. Russell 2000 Index nearing trough trailing P/E multiples

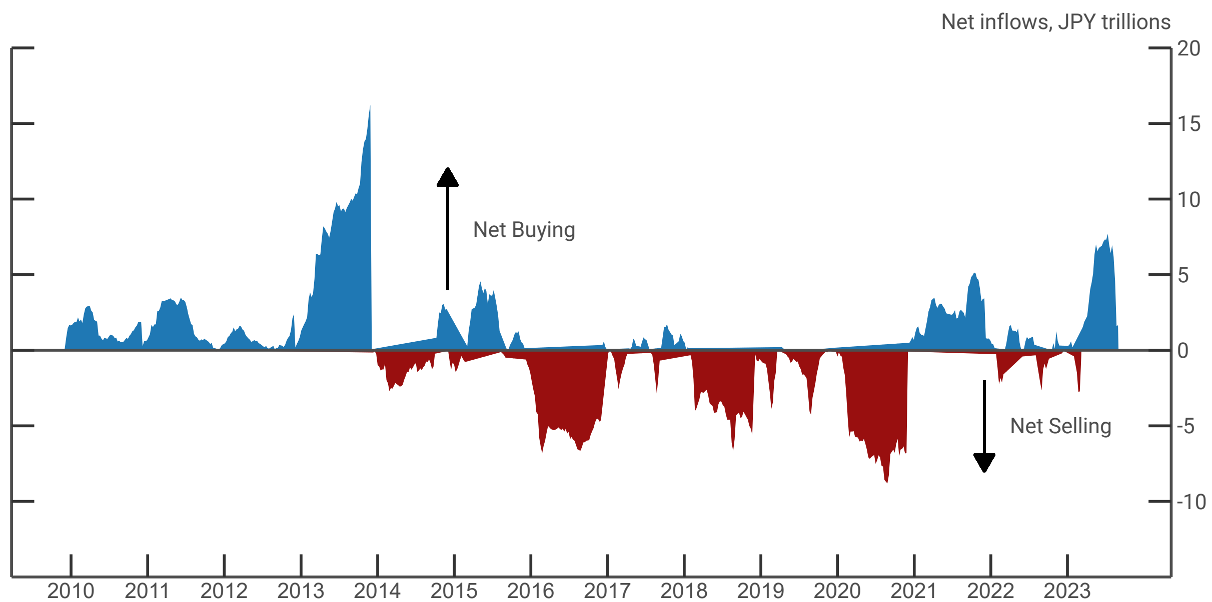
so far with 4.96% in gains YTD. Also worth noting is the euro's significant depreciation, falling 6.6% since mid-July. Europe has a relatively high concentration of consumer goods companies, especially at the luxury end, and industrial sector companies. These are heavy exporters that have been impacted by China's weakness but nonetheless stand to benefit from the weaker euro.

As we've noted in previous letters, Japan has had arguably the most going for it among the developed markets given its relatively attractive valuation multiples, Yield Curve Control (YCC) monetary policy, return to positive inflation, and improving corporate governance culture. The Nikkei 225 has appeared to plateau but remains up 23.9% YTD. Some investors are asking whether it is too late to invest in Japan after such a strong run and the answer depends on whether we're seeing a structural evolution gaining momentum. We believe economic rationality points in a positive direction. The compounding effect of decades of deflation had a tremendous effect on Japanese companies, forcing them to focus on efficiency and preventing them from investing in R&D, people, and capital-intensive projects. This was necessary to keep the lights on. Progressing into an inflationary regime dramatically changes the calculus, encouraging more investment and providing cover for price increases. There now appears to be real potential for higher earnings

growth as corporate attitudes shift and companies are more willingly pass on rising costs and seek to increase productivity through investments in automation, robotics, and software.

Foreign flows into Japan this year pale in comparison to the level of inflows seen following the introduction of Abenomics in late 2012 and the many years of outflows witnessed since then (Figure 6). Most institutional portfolios remain underweight Japan as much of the early flows have been fast money into passive funds.

Figure 6. Cumulative foreign inflows in Japanese equities (JPY Trillion)



Source: RockCreek, Bloomberg.