DIAMOND HILL

INVESTED IN THE LONG RUN

Geopolitical Tension Boils Over

Oct 2023

As war broke out in the Middle East, global stocks declined in October, falling -3% in USD terms as measured by the MSCI ACWI Index and bringing YTD gains to around 7%. Increased uncertainty on several fronts — including the potential impact of war on oil prices, inflation and therefore monetary policy — likely also weighed on markets. A sharp increase in bond-market volatility also contributed to opacity on the likely direction of global monetary policy from here.

Though headlines were understandably focused on the war between Israel and Hamas, markets largely moved sideways as violence broke out — perhaps a testament to the ongoing mixed bag of economic data that seem to point to relatively resilient, if somewhat stagnated, global economies. Notably, the US economy turned in a surprisingly strong third quarter, notching 4.9% annualized GDP growth. Though some were quick to point out, the rate may not be sustainable given sizable contributions from consumer spending and inventories, the latter of which especially could moderate significantly next quarter.

Monetary Policy Decisions

Against this backdrop, the US Federal Reserve, Bank of England (both just after the month concluded) and the European Central Bank (ECB) decided to pause rate hikes in the month as data showed signs inflation is moderating — though central bank heads also indicated they believe benchmark interest rates are likely to remain higher for longer. The ECB is expected to keep rates higher even as it possibly seeks to begin shrinking its balance sheet.

Meanwhile, the Bank of Japan (BoJ) made its second change to its yield-curve control policy in the last couple of months, allowing interest rates on Japanese government bonds to rise above 1% — though the BoJ remains the lone major global central bank to maintain a negative benchmark rate (-0.1%). Though the country has seemingly finally emerged from a couple of decades of economic malaise, it still faces a challenging macroeconomic backdrop as the yen has weakened significantly relative to the US dollar, which raises the cost of imports and threatens to push inflation higher than officials would like to see.

Europe

Across Europe, markets generally declined. Notably, the region's largest economies — France, Germany and the UK — were in the red, all declining roughly -4%. Poland was the positive outlier, rising +16% following its parliamentary election, which will return former prime minister Donald Tusk to office and potentially put the country on a more pro-European path. Conversely, Turkey declined steeply in October, -13%, even as it raised interest rates for the fifth time in five months and showed signs of normalizing its monetary policy.

China

Trade tensions with China resumed, as the US tightened its rules on artificial intelligence (AI) chips to China, and China responded with restrictions on graphite (a key component in electric vehicles) exports to the US. While the Chinese economy delivered a stronger-than-anticipated third quarter of economic growth (+4.9% year over year), factory activity contracted, contributing to a cloudy outlook as political leaders continue efforts to stabilize the country's property and banking sectors.

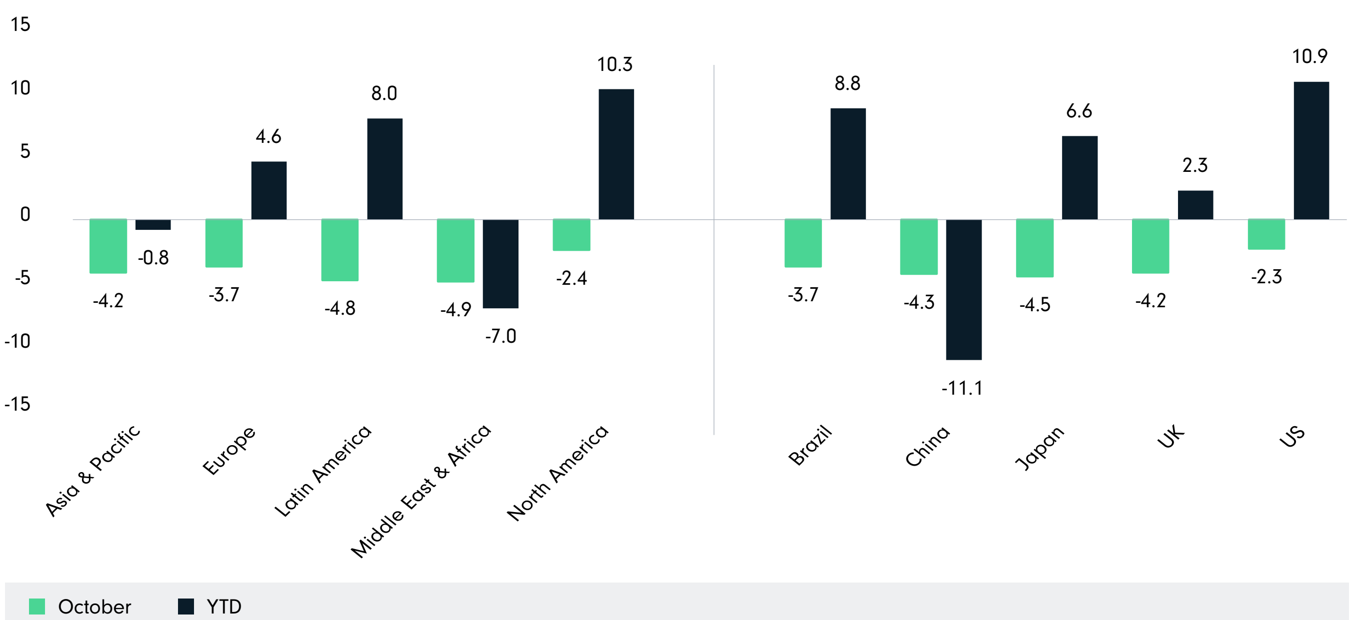
Emerging Markets

Emerging markets declined nearly -4% in October, dragging the region into negative year-to-date territory (-2%). Not surprisingly, given the outbreak of violence, the Middle East and Africa declined -5% in October, led by Israel (-13%). Egypt was the sole country to remain in positive territory during the month, rising nearly +5%. South Africa declined a more moderate -2%. Within Latin America, Chile (-9%) and Mexico (-6%) declined the most, though all countries were in the red (Peru slid -3% and Brazil -4%).

Asia Pacific

Stocks across the Asia Pacific region were also negative in October, led down by Indonesia (-8%) and Korea (-7%), as countries continue wrestling with a combination of pandemic-induced supply chain disruptions, the fallout of increasing tensions between China and much of the developed world, and stubbornly high domestic inflation.

Exhibit 1 — October and YTD Returns for Major Markets (USD) (%)



Source: FactSet, as of 31 Oct 2023.

Sector Performance

From a sector perspective, everything was in the red, with utilities (-1%) and energy (-2%) declining the least. Conversely, industrials (-6%) was the weakest group, with real estate, health care and consumer discretionary (all down -5%) closely following, given a macroeconomic and interest rate backdrop that likely pressured sentiment around each sector. Year to date, technology (12%) and energy (10%) stocks continued leading the way, while real estate (-10%), materials (-3%) and communication services (-3%) stocks were the bottom performers.

Summary

Though geopolitics dominated most headlines in October, markets seemed primarily focused on the issues that have dominated much of the conversation for the last many quarters: inflation, monetary policy and the economic growth outlook. As has been the case, the data remain a markedly mixed bag, with each country facing a slightly different combination of specific challenges.

Though we recognize heightened volatility can challenge investors' nerves, as value-oriented investors, we also recognize such market environments offer an opportunity to identify high-quality companies whose valuations fail to reflect the strength of their underlying fundamentals and businesses. As ever, we will remain vigilant in the face of growing global uncertainty on many fronts.

MSCI ACWI Index measures the performance of large- and mid-cap stocks in developed and emerging markets. The index is unmanaged, market capitalization weighted, include net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.