DIAMOND HILL

INVESTED IN THE LONG RUN

Markets' Ongoing Malaise

Feb 2024

Markets notched modest gains in February, rising amid headlines that seem to have changed minimally in recent memory. In USD terms, the MSCI ACWI Index rose +4.3%, even as investors continue debating the global monetary policy outlook, parsing the macroeconomic data tea leaves and weighing the potential impact of ongoing geopolitical tensions.

On the monetary policy front, the major developed world central bankers largely remain on the same page: the heads of the Bank of England, European Central Bank and Federal Reserve all stressed in February the likelihood there will be some rate cuts in 2024 — but not as many and not as soon as investors seem to think. Federal Reserve head Jerome Powell explicitly said early in the month a March rate hike was off the table — which seemingly finally convinced investors and contributed to falling bond prices. Powell's comments were predicated on a notably strong January US jobs report, which nearly doubled economists' expectations for jobs growth. Meanwhile, US inflation data have moderated, contributing to expectations that while rate cuts may not be imminent, they are still in sight this year.

The monetary policy picture isn't all that different in the UK and Europe, though the underlying data vary some. Still, inflation remains relatively elevated, while economies show few signs of precipitous declines, even if growth is slowing. Indeed, the UK entered a technical recession (defined as two consecutive quarters of negative GDP growth) in Q4 2023, and the EU cut its 2024 growth and inflation forecasts.

While global central bankers seemingly remain united on the right path forward, the macroeconomic data still paint a relatively confusing picture. For example, in Europe, private sector lending fell, and overall euro zone wage growth is finally slowing, as is inflation in Germany and France — but services inflation in those countries remains sticky as services industry wages are rising quickly. Against this backdrop, markets in Europe rose a moderate +1.6% in February, with returns diverging across countries. Poland and Italy led, rising a robust +6.3% and 5.8%, respectively, and larger economies like Germany (+4.1%) and France (+2.6%) added to positive returns. Meanwhile, the UK's market was flat for the month.

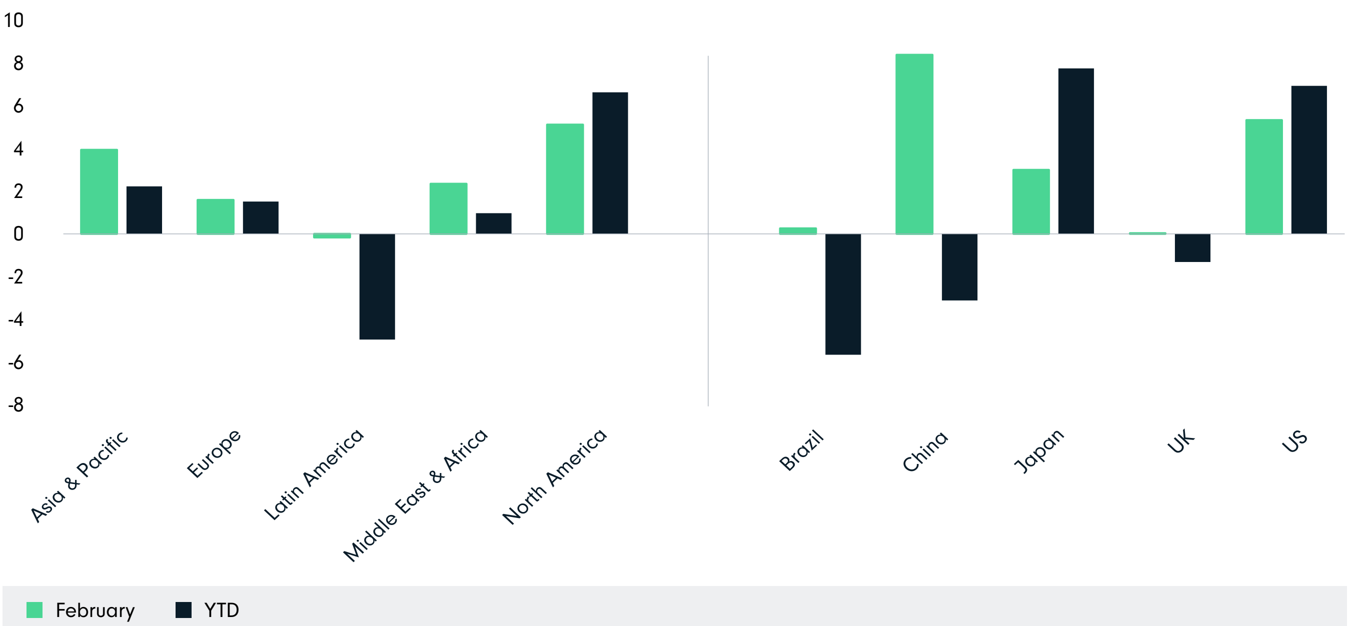
Regionally, stocks in the Asia and Pacific region led global stocks, up +3.9% in February. China's market gained a robust 8.3% in February, paring year-to-date losses. Nevertheless, the country seemingly remains in the economic doldrums, with ongoing deflation likely the byproduct of weak private-sector demand and weighing on corporate earnings. Factory activity has contracted for the last five months, and the country's recent real estate crisis seems to be weighing on small businesses, contributing to sluggish growth. This combination has decreased both domestic and international investors' confidence in the economic and market outlook — as reflected by the lowest annual foreign direct investment rate in 2023 since the 1990s. Whether China's leadership can maintain February's market momentum and get the economy back on track will undoubtedly be top of mind for many investors in the coming months.

Japan (+3.0% in February) is likewise in an interesting economic position: As momentum for wage increases has picked up and service sector prices have risen, the central bank has become increasingly convinced it may finally end its ultra-loose negative interest rate policy, which has been in place since 2016. The current overnight interest rate is -0.1% — though in its recent economic outlook report, the Bank of Japan noted the likelihood the country hits its 2% inflation target continues gradually rising. Simultaneously, though, Japan's economy entered a technical recession in Q4, with GDP growth declining -0.4% annualized (-0.1% quarter over quarter) — likely complicating the monetary policy path moving forward. Elsewhere in Asia, Korea (+7.4%), the Philippines (+5.5%) and Taiwan (+5.5%) also delivered positive February performances.

The Middle East and Africa rose +2.3% in February, led by Israel (+8.7%), whose market rose despite ongoing war in Gaza. Saudi Arabia (+6.6%) and Qatar (+5.0%) were also positive. Conversely, Egypt's market fell -12.5% as the country nears a loan deal with the International Monetary Fund which is expected to help ease its foreign currency crisis. Further complicating Egypt's economic woes are ongoing attacks by Houthi rebels on Red Sea shipping — which are not only contributing to snarled supply chains globally but are also hurting Egypt's Suez Canal-related revenues. South Africa's market also declined -5.6% in February as the country faces rolling blackouts and port and rail blockages — the result of structural problems, including state-run power and freight monopolies.

Latin America was the only region in the red, with markets there declining -0.2%. There was wide dispersion among individual countries, though: Peru was up +11.3%, while Mexico declined -2.8%.

Exhibit 1 — February Returns for Major Markets (USD) (%)



Source: FactSet, as of 29 February 2024.

At the sector level, discretionary stocks led, rising +6.9%, followed by technology (+5.7%), industrials (+4.5%) and financials (+2.6%). Utilities (-2.7%), staples (-1.9%) and materials (-0.9%) were the only negative sectors, though real estate (+0.1%) and energy (+0.4%) were relatively flat in the month.

Though the underlying details have changed, many of the global economic and political headlines remain the same. Supply chains are still snarled — no longer due primarily to pandemic-related shutdowns, but tied to ongoing violence, particularly in the Middle East. Prices around much of the world remain inflated — though the biggest gainers now seem to have shifted, at least in developed markets, from consumer goods to service-sector wages. Developed-world central bankers remain conflicted about the best monetary policy path moving forward — though they seem to have shifted from mainly rate-hiking to (potentially) rate-cutting mode. Against this backdrop, stocks seem, for now, to be climbing the proverbial wall of worry. In such an environment, we maintain our confidence in our diligent approach to seeking high-quality companies trading at compelling valuations and will remain committed to deploying it to the best of our ability, however markets continue evolving from here.

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

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