GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Emerging Markets
First Quarter 2024
COMMENTARY

Higher Rates for Longer; Why Value Investing May be Poised for a Comeback

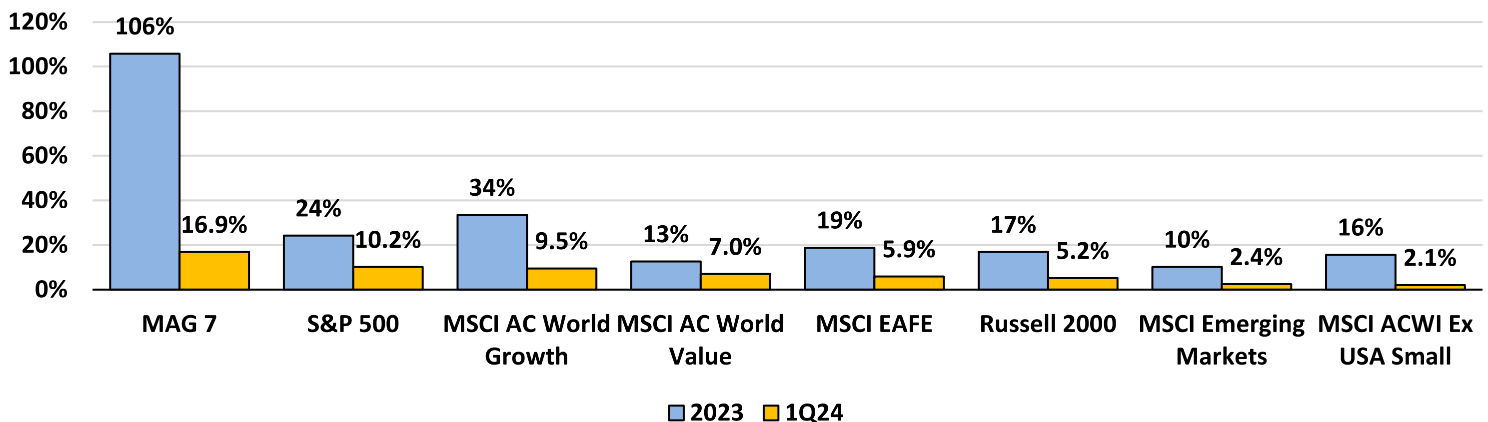
Total Returns (Net of Fees) +	Q1
GVA Emerging Markets	**-4.4%**
MSCI Emerging Markets Index*	2.4%
MSCI Emerging Markets Value Index	1.3%
MSCI Emerging Markets Growth Index	3.4%

Regional Indices	Q1
MSCI China	-2.2%
MSCI Korea	1.6%
MSCI Taiwan	12.4%
MSCI India	6.1%
MSCI Emerging Markets Small Cap	1.1%

	GVA Emerging Markets Net Return	MSCI Emerging Markets Net Return*
1 Year	-2.1%	8.2%
3 Years**	-5.8%	-5.1%
Since Inception**	-1.1%	2.7%

*Benchmark | **Annualized | +Net of fee performance was calculated by retroactively applying the highest model fee for the composite which is the fee new clients would expect to pay based on the early adopter fee schedule (0.60%).

The first quarter of this year was a prolongment of the year 2023, characterized by the stellar performance of US growth stocks (principally the Magnificent 7), and the general underperformance of Non-US, Small, and Value stocks. GVA believes that all three of these trends are overextended and will reverse in the medium term (see Q4 2023 commentary), eventually creating significant tailwinds to our performance.



Source: Factset. M7 = "Magnificent Seven" stocks – Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon (AMZN), Nvidia (NVDA), Tesla (TSLA) and Meta Platforms (META)

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Higher for Longer

The "higher for longer" script has been our base case for 2 years and we believe our approach is well suited to benefit going forward.

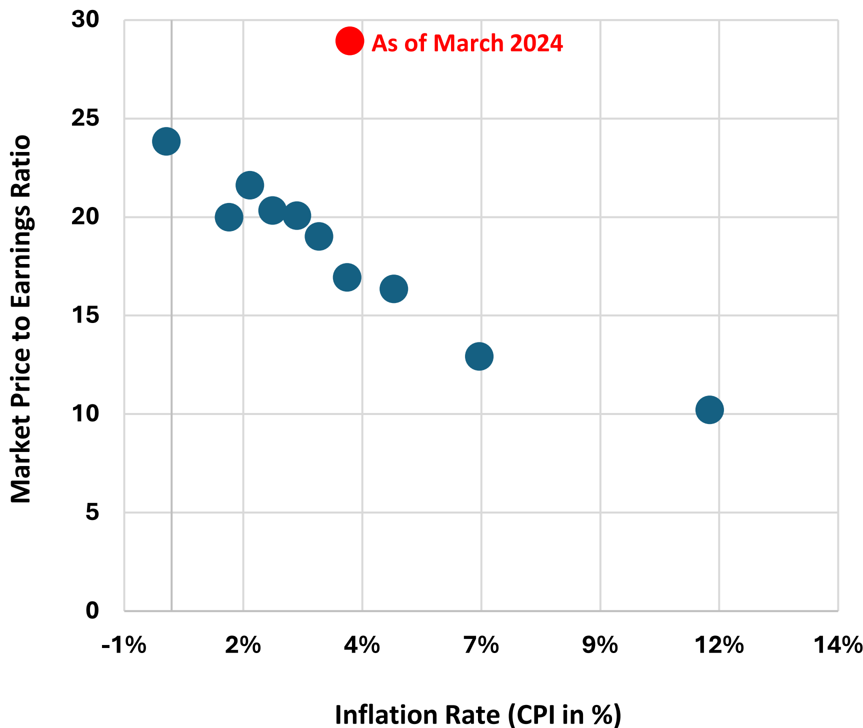
As interest rates rise, borrowing costs go up. This negatively impacts companies that rely on external financing to maintain and grow their business. Similarly, consumers find it more expensive to buy homes, cars, and goods that require financing. This tends to weigh on corporate profitability as well as economic growth.

Warren Buffett, in a 1977 Fortune article How Inflation Swindles the Equity Investor described the challenges created by inflation and how it impacts corporates and investors:

"Whatever the level of reported profits (even if nil), more dollars for receivables, inventory and fixed assets are continuously required by the business in order to merely match the unit volume of the previous year. The less prosperous the enterprise, the greater the proportion of available sustenance claimed by the tapeworm. A business earning 8% or 10% on equity often has no leftovers for expansion, debt reduction or "real" dividends. The tapeworm of inflation simply cleans the plate".

This is why periods of higher inflation and interest rates typically lead to valuation multiple compression. When this happens, Growth stocks are often hit the hardest as expectations for future growth are highest. What is unusual about this cycle is that higher inflation rates have yet to lead to PE compression in the markets. GVA believes that it is only a matter of time before we see a mean reversion:

S&P 500 P/E and CPI (1945-2022)
Deciles formed on inflation (monthly observations)



Source: Factset

During periods of high interest rates and high inflation, investors focus their attention on companies with current earnings visibility and high sustainable dividends (i.e. Value) and less so on companies that rely on substantial cash flow and profits to occur in the future (i.e. Growth): the higher the discount rate of the future cash flows, the lower the resulting present value. As a result, Value typically outperforms in higher rate and inflationary environments. A study of 6 inflationary events in the US over the past 80 years confirms that:

Inflationary Event	Segment of the Market	CPI	Dividend	Real Capital Gain	Total Nominal Return	Total Real Return
1941-1943	Cheap 30%	9.1%	8.0%	2.6%	19.6%	9.6%
	Expensive 30%	9.1%	5.6%	-13.0%	1.7%	-6.7%
1946-1948	Cheap 30%	11.9%	5.1%	-9.6%	7.4%	-4.1%
	Expensive 30%	11.9%	3.9%	-15.4%	0.4%	-10.3%
1950-1951	Cheap 30%	8.5%	9.1%	12.3%	29.9%	19.7%
	Expensive 30%	8.5%	7.5%	-2.1%	13.9%	4.9%
1973-1982	Cheap 30%	8.9%	6.6%	-0.5%	14.9%	5.6%
	Expensive 30%	8.9%	3.2%	-9.3%	2.8%	-5.6%
1989-1991	Cheap 30%	5.2%	5.5%	-2.9%	7.8%	2.5%
	Expensive 30%	5.2%	2.5%	8.8%	16.5%	10.8%
2021-2023	Cheap 30%	7.3%	2.9%	24.0%	34.2%	25.1%
	Expensive 30%	7.3%	1.0%	-0.5%	7.8%	0.5%
Average	Cheap 30%	8.5%	6.2%	4.3%	18.9%	9.7%
Average	Expensive 30%	8.5%	3.9%	-5.2%	7.2%	-1.1%
Average	Market	8.5%	4.6%	-3.5%	9.6%	1.1%

Source: Factset

This study shows that in periods of higher inflation US equity markets have typically struggled and delivered subpar annual real returns of 1.1% (versus 7.1% real over the past 100 years). This is due to lower real capital gains, as valuation multiples compress and real EPS growth disappoints. The value segment has delivered positive real returns in all but one of these inflationary episodes thanks to its higher dividend distribution and a positive average real capital gain. Overall, in these 6 inflationary events, value stocks have delivered an average +9.7% annual real return versus +1.1% for the index and –1.1% for the expensive names.

GVA has no edge in predicting where inflation and interest rates will be a year from now, but GVA believes that the era of ultralow interest rates is behind us as many structural changes (greater use of fiscal policies, higher capex trend, emergence of a new age of scarcity) will make the past 4 decades of steady declines in interest rates reverse going forward. GVA is convinced that this shift will lead to a new market leadership where value stocks will regain their appeal. GVA's strategies are ideally positioned for this scenario owning exclusively cash generating businesses that return the majority of their unused cash to their shareholders.

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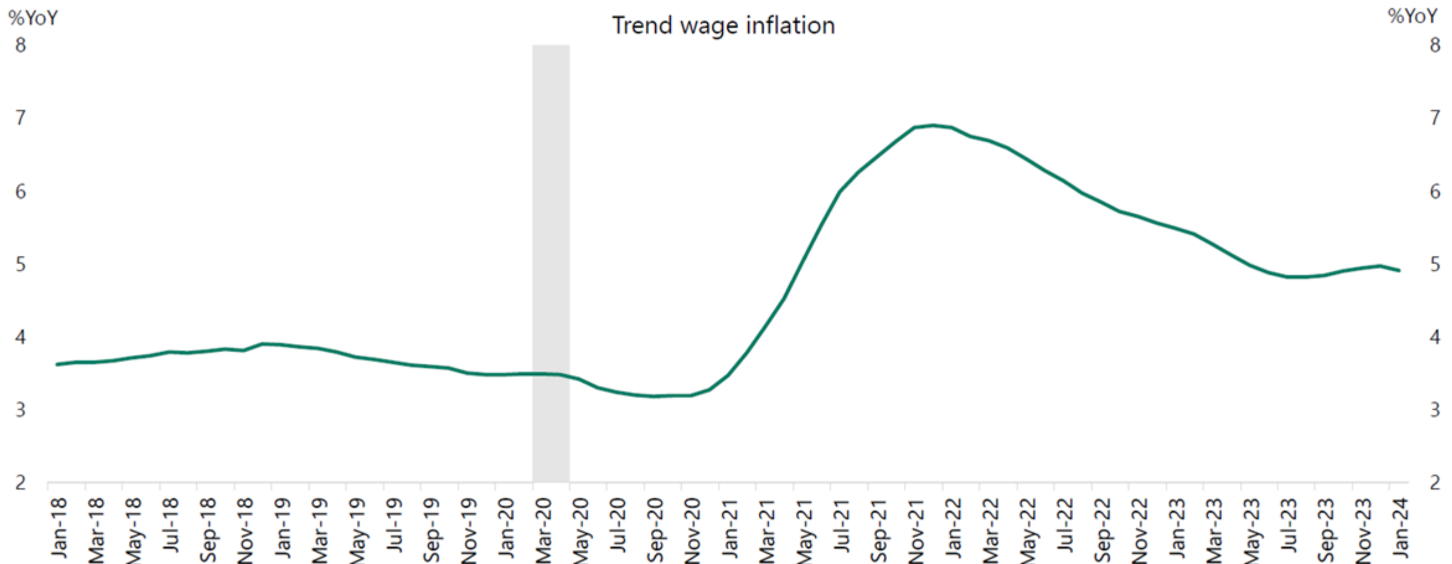
Most importantly they typically trade at around a 50% discount to the market while delivering above average profitability and maintaining unlevered balance sheets.

Notable Market Observations

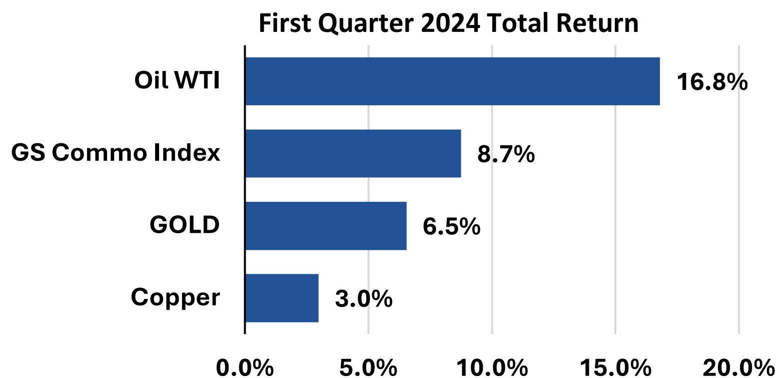
Last December's Fed pivot was the main trigger for this sustained equity rally. The dovish signal was a boost to corporate confidence, which in turn had positive effects on the labor market and consumer spending. Ironically, these favorable economic dynamics put upward pressure on CPI and PPI that might strengthen in the coming quarters. This will complexify the Fed's mission to bring down inflation to its 2% target. Although inflation rates have dropped considerably off the peak, levels remain elevated due to a combination of high wages, rising commodity prices, and stretched shelter costs.

1) A tight labor market has resulted in wage inflation trending at +5% with no signs of cooling down.



Source: Federal Reserve Bank of New York, Apollo Chief Economist

2) Commodity prices are rebounding as global growth shows signs of bottoming out and supply concerns are exacerbated by geopolitical tensions. Energy alone accounts for roughly 8% of CPI.



Source: Factset

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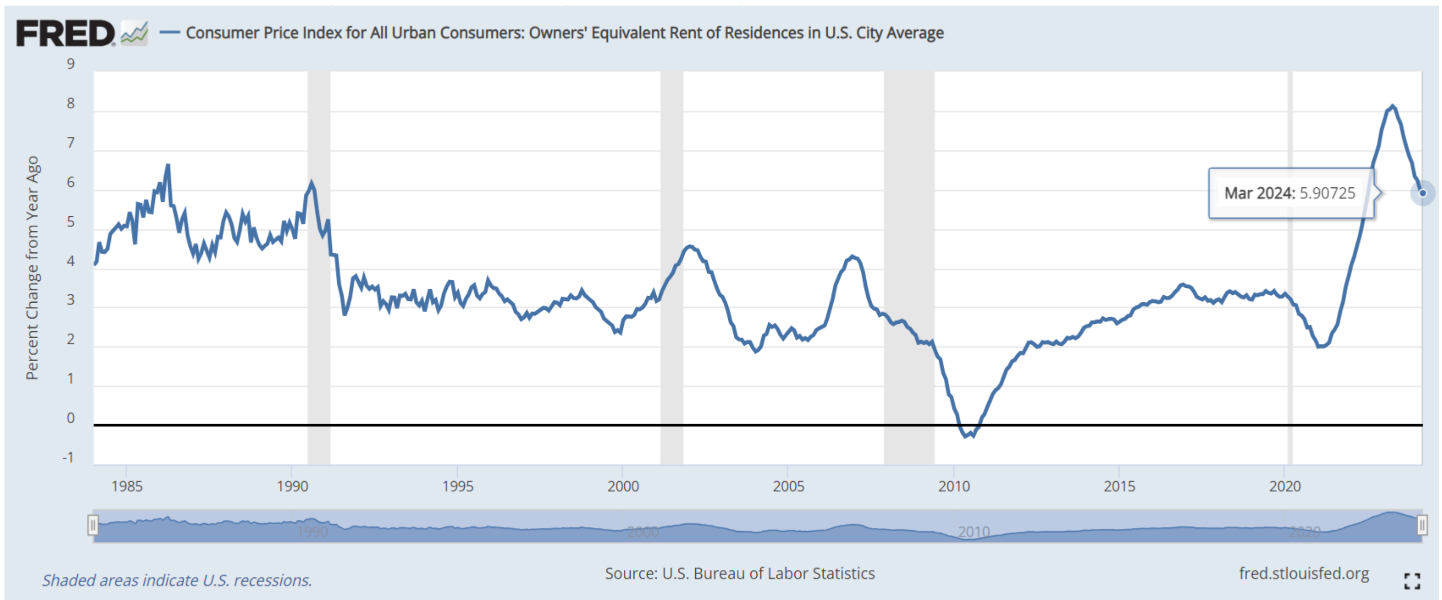
3) One of the biggest drivers of inflation currently is Owner's Equivalent Rent (OER), which growing at ~6% YoY and makes up almost 30% of the CPI basket. Although OER growth is down from the 8% peak a year ago, growth is still running well above the 3-4% historical norm.



The year started with US investors pricing in 6-7 rate cuts occurring in 2024, but a few stubbornly high inflation prints dropped consensus expectations to 1-2 cuts. Fiscal excesses have also had an impact on inflation, with the national debt now sitting at close to $35 trillion and the annual deficit expected to be $1.6 trillion this year. The CBO is projecting that the interest costs alone on the national debt will be ~$1 trillion in 2025. Instead of cutting rates, it is still possible the Fed might end up having to hike again for fear of revisiting a 70s' like scenario.

Even though bond investors are starting to reflect this potentiality through higher yields, equity investors remain euphoric, and valuation multiples keep expanding. Mega cap techs are central to the euphoria, although the equity story around the Magnificent 7 has evolved over the past 12 months, creating an even more concentrated AI-driven group. The Magnificent 7 has slowly morphed into the Fabulous 4 (Nvidia, Meta, Amazon, and Microsoft). As valuation multiples reached new highs, the narrowness of the market broke past the previous high mark of 2020 and remains well above the heights of the TMT bubble peak:

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The narrowness of market performance has created headwinds for our strategies. GVA focuses exclusively on the cheapest 20% of companies in the world, and only buys companies with strong balance sheets that generate high free cash flow and have strong shareholder returns. This subsegment of the market has been largely ignored by investors for several years. Not surprisingly, GVA's strategies underperformed over the quarter.

Please feel free to contact us with any questions or comments. Thank you for your interest in Global Value Advisors. We look forward to updating you again next quarter.

Sincerely,

Phillippe Rolland
CIO, Portfolio Manager

Todd Bassion, CFA
Portfolio Manager

Matthew Marotta, CFA
Investment Research Portfolio Implementation

OFFICE CONTACT

18 Sewall Street
Marblehead, MA 01945

Phone
(781) 639-2750

Fax
(781) 639-2751

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** This information is presented as supplemental to the GIPS Report, which are available here

*Sector weights include exposure to iShares MSCI China A ETF and iShares MSCI India A ETF. ETF exposures are broken out by sector on a look-through basis.

Past performance is not indicative of future results. The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated by retroactively applying the highest model fee for the composite which is the fee new clients would expect to pay based on the early adopter fee schedule (0.60%). The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year.

The standard investment management fee schedule for new business is as follows: 0.60% in perpetuity on all investments made prior to strategy assets reaching $150 million, thereafter, 1.00% on the first $25 million and 0.90% on all additional funds. Management fees are paid quarterly in arrears. Actual investment advisory fees incurred by clients may vary.