GMO 7-Year Asset Class Forecast: January 2021

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by Team
of GMO

Peter Chiappinelli from the GMO Asset Allocation Team comments:

We are, in essence, in a Growth Bubble. Across the globe, the valuation spread between Value and Growth is at historic proportions, and there are all sorts of interesting investment strategies to exploit this phenomenon. This is a “once-in-a-career” type of spread.

The US equity market remains outrageously expensive in absolute and relative terms. With the amazing run-up in US Small Cap stocks in the fourth quarter of 2020 (the Russell 200 Index was up over 31%), and the continuation of that in January (up another 5%), our forecast for US Small Cap stocks is in solid negative territory.

Emerging Value has a forecast that stands head and shoulders above the U.S. We believe Emerging Value is poised to outperform U.S. stocks by over 11% per year for the next 7 years. For those who think this is a crazy concept, be reminded that this exactly what happened in the period from 2000 to 2010. For a decade, emerging equities outperformed U.S. by over 12% per annum. It’s not a crazy notion, it’s just us saying that history can repeat itself (or at least rhyme).

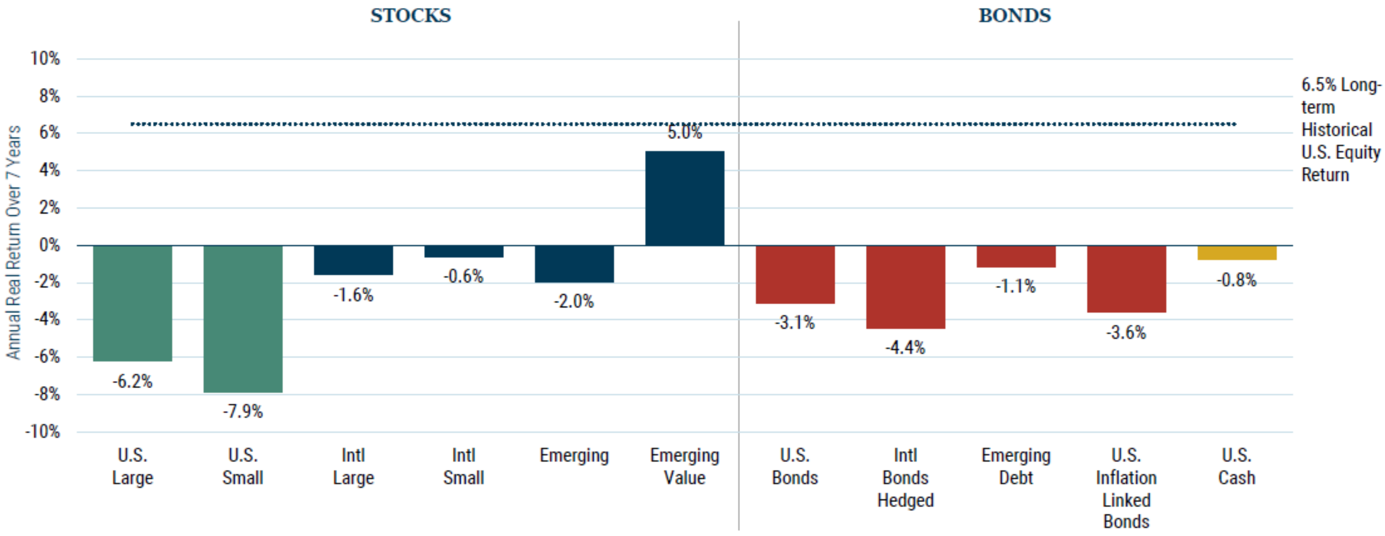
International markets are significantly cheaper than the US as well, in particular Japan Small Cap Value, which has the highest equity forecast of any market we monitor (+7%).

For bonds, the recent increase in longer term bond yields have resulted in slightly better valuations from a month ago. Bonds are still crazily expensive and the return prospects still dismal, just less crazy and less dismal than they were.

In summation, the traditional “60/40” portfolio is still priced, we believe, to deliver painfully disappointing returns over the next 7 years. If being traditional is poised to disappoint, we would argue that investors look as non-traditional as they can stomach. That means:

- Underweight equities.
- Underweight U.S. equities and overweight Emerging Value and Japan Small Value.
- If possible, exploit the historic valuation spread between Value and Growth, using long/short portfolios (that is, go long Value + short Growth).
- Underweight bonds and/or underweight duration.
- Overweight alternatives, especially those employing beta-neutral or duration-neutral positioning.

As of January 31, 2021



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Source: GMO
The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forwardlooking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.