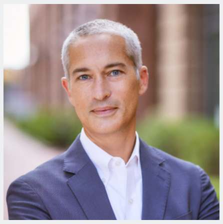
DIAMOND HILL

INVESTED IN THE LONG RUN

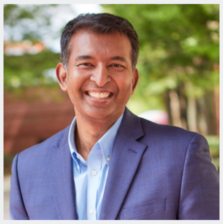
Mid-Year Check-in — US and Non-US Equities

Jul 2023

Portfolio managers Austin Hawley, CFA, and Krishna Mohanraj, CFA, share their thoughts on the US and non-US market environments thus far in 2023.



Austin Hawley, CFA
Portfolio Manager – Large Cap, Large Cap Concentrated, Select



Krishna Mohanraj, CFA
Portfolio Manager – International

What has struck you about the past half-year in US equity markets?

Austin Hawley, CFA: What has stood out to me has been the resiliency of the global economy, as well as corporate earnings, in the face of a number of notable headwinds. We are in the middle of a major monetary policy transition with a historic pace of Fed tightening as the monetary authority attempts to combat a notable increase in inflation. We have grappled with questions about the soundness of certain banks and the potential for broader fallout. We have witnessed rising geopolitical tensions — tensions well remarked on in the news — yet the economy has continued plugging along as corporate earnings have come in broadly in line or slightly better than expectations.

There's that saying that the stock market climbs a wall of worry. When I reflect on the last six months, it does appear we have taken more steps up that proverbial wall, which has been broadly beneficial to the stock market. Stocks have rallied, most notably growth stocks which have seen significant increases. To me, this appears like we've discounted a coming recession two or three times over the last three years, and each time investors get a bit more comfortable with resilience in the economy and corporate earnings.

That said, I don't think we should be overly complacent about the current market backdrop. The banking crisis in early March included the third and fourth largest bank failures in history, followed by the second largest in May. These are the type of unexpected events that could rattle markets periodically given all these macro headwinds.

When I look at the landscape we are working in today, I continue to believe that our philosophy and process position our equity portfolios well to benefit from an environment that is likely to have higher interest rates, higher inflation and possibly significantly more volatility than we've had over the past decade or so. In such an environment, I think more traditional value stocks and those that are possibly slightly more cyclical — meaning companies that can produce abundant cash flows in the near and intermediate term — are going to become more attractive to investors.

How are you thinking about the current environment and how it relates to non-US stocks?

Krishna Mohanraj, CFA: To me, now is as good a time as any to be an active investor in the international space. Not because there is no macro uncertainty — in fact, it's because of the uncertainty and the headlines that create opportunities.

Let's look back at what's happened just year to date. In China, there was the euphoria then the disappointment around the country finally reopening following covid-related shutdowns. In Japan, you have rising expectations that the country might have turned the corner to become more investable. There have been political turmoil and protests in Peru and Brazil, among other countries. In Mexico and India, there are elections next year, and the pseudo campaigning cycle has already started. And we saw the end of Credit Suisse, a Swiss banking icon with over 170 years of history.

We have Russia's ongoing war in Ukraine, made more complicated by internal strife embodied by the Wagner group's ultimately abandoned coup attempt in June. Then — the big elephant in the room — the tension between China and the US which has resulted in conversations around nearshoring and diversifying manufacturing investments away from China (known as the China-plus-one strategy) and what all that could mean for so many economies globally.

The year thus far, with its abundance of headlines, has definitely not been boring. There are few guarantees in investing, but it's probably safe to assume it's not going to be any less exciting for the rest of 2023. Yet, this is par for the course in international investing. In fact, this is the kind of environment disciplined, long-term oriented investors should actively take advantage of. Bad headlines are often where we find terrific investment ideas. Since the inception of the Diamond Hill International Strategy in 2016, we've seen our share of big, bad headlines — from Brexit, to trade wars, then covid followed by the vaccine and recovery, then multiple markets going back into shutdown then recovery. We've seen historic increases in inflation and central bank tightening, the outbreak of war in Europe and an entire country — Russia — effectively disappearing from capital markets.

What's important to keep in mind is, for long-term oriented stock pickers, with every bad headline there's often opportunity in international stocks. We know macro uncertainty is a constant, and it's something we look forward to. It is the reason you want to own a carefully curated portfolio and not a benchmark. If you're truly worried about the macro environment, why own an international index product which gives you a piece of so many mediocre businesses when you can be selective and seek the best opportunities? That is what our team is focused on.