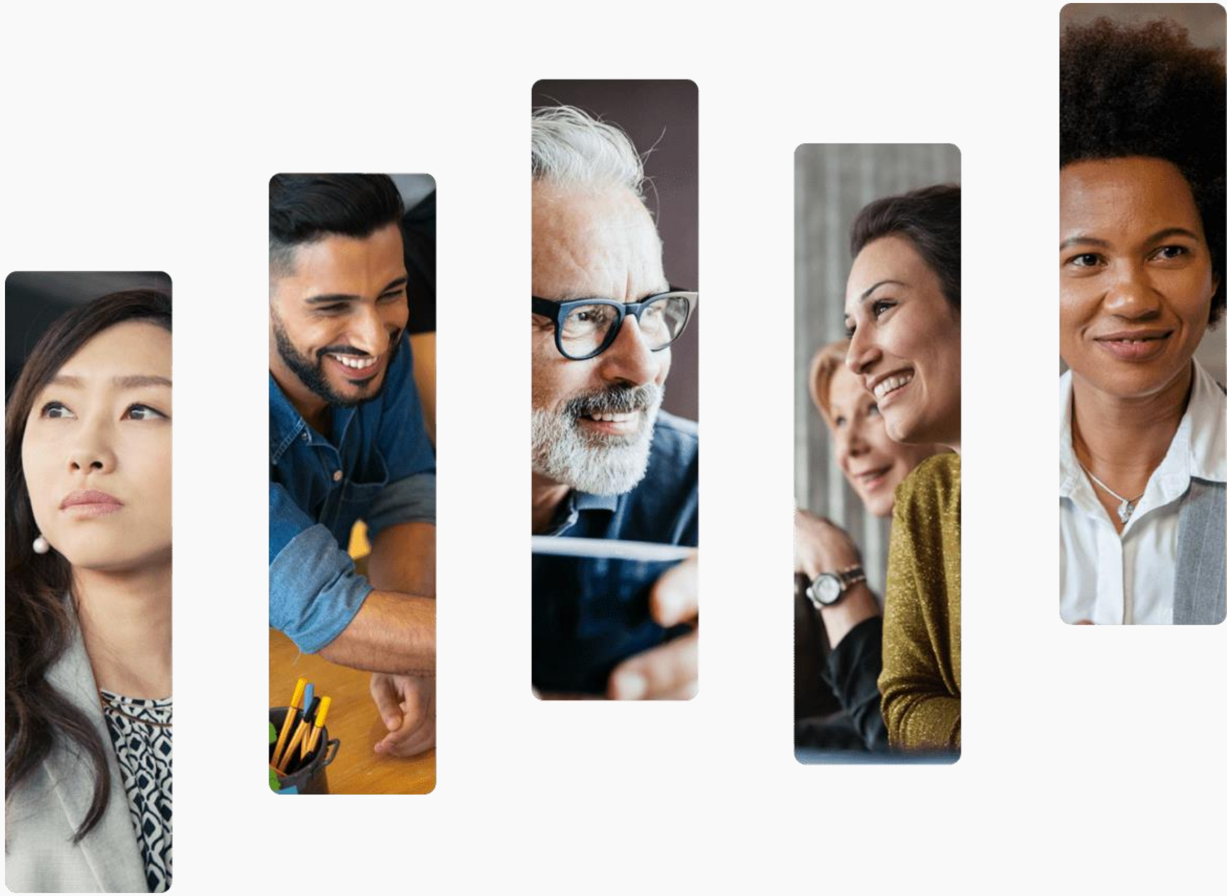
MORNINGSTAR Wealth

Market Update

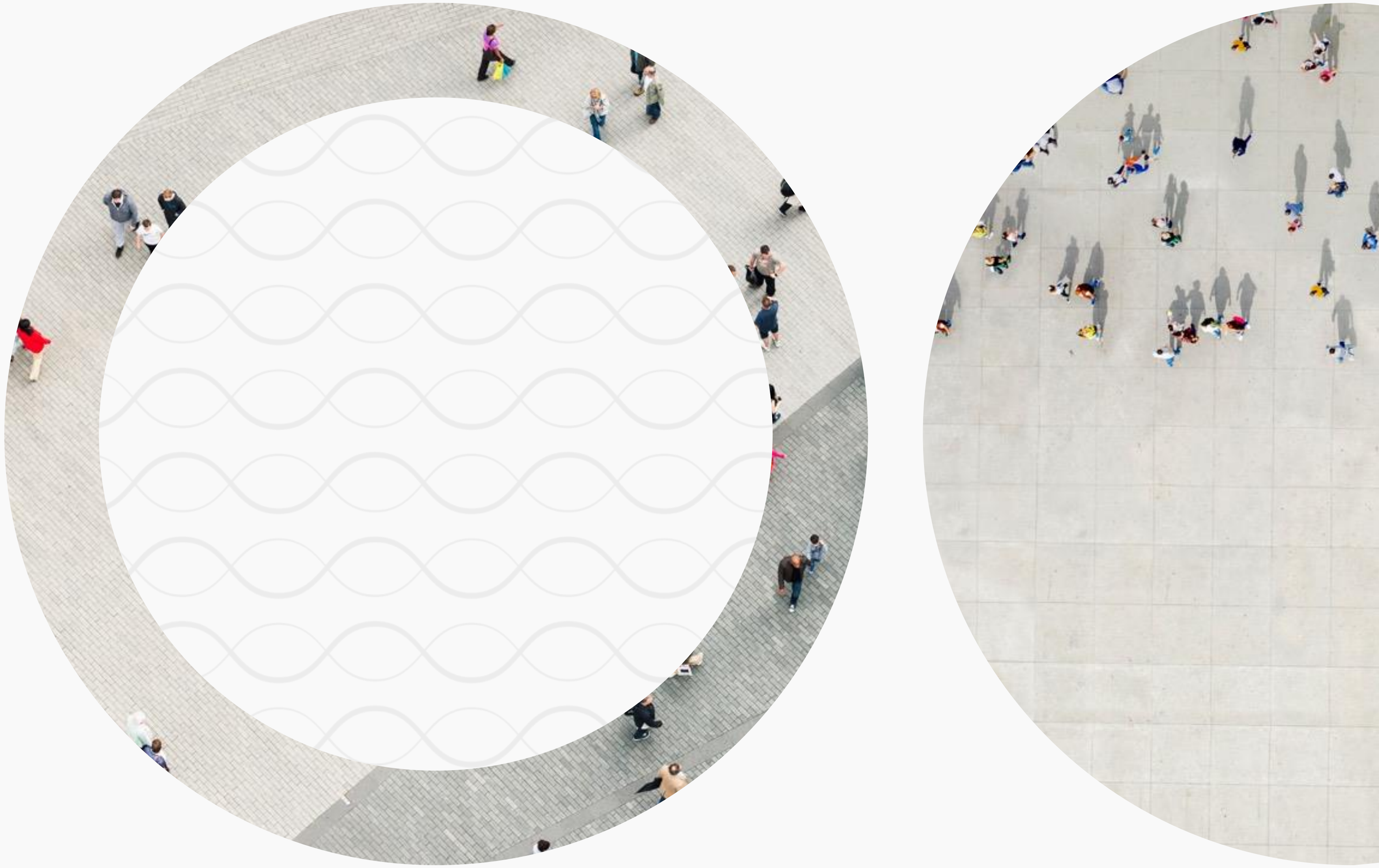


Natalie Tysoe, Portfolio Specialist
Thursday 19th October 2023

Learning Objectives

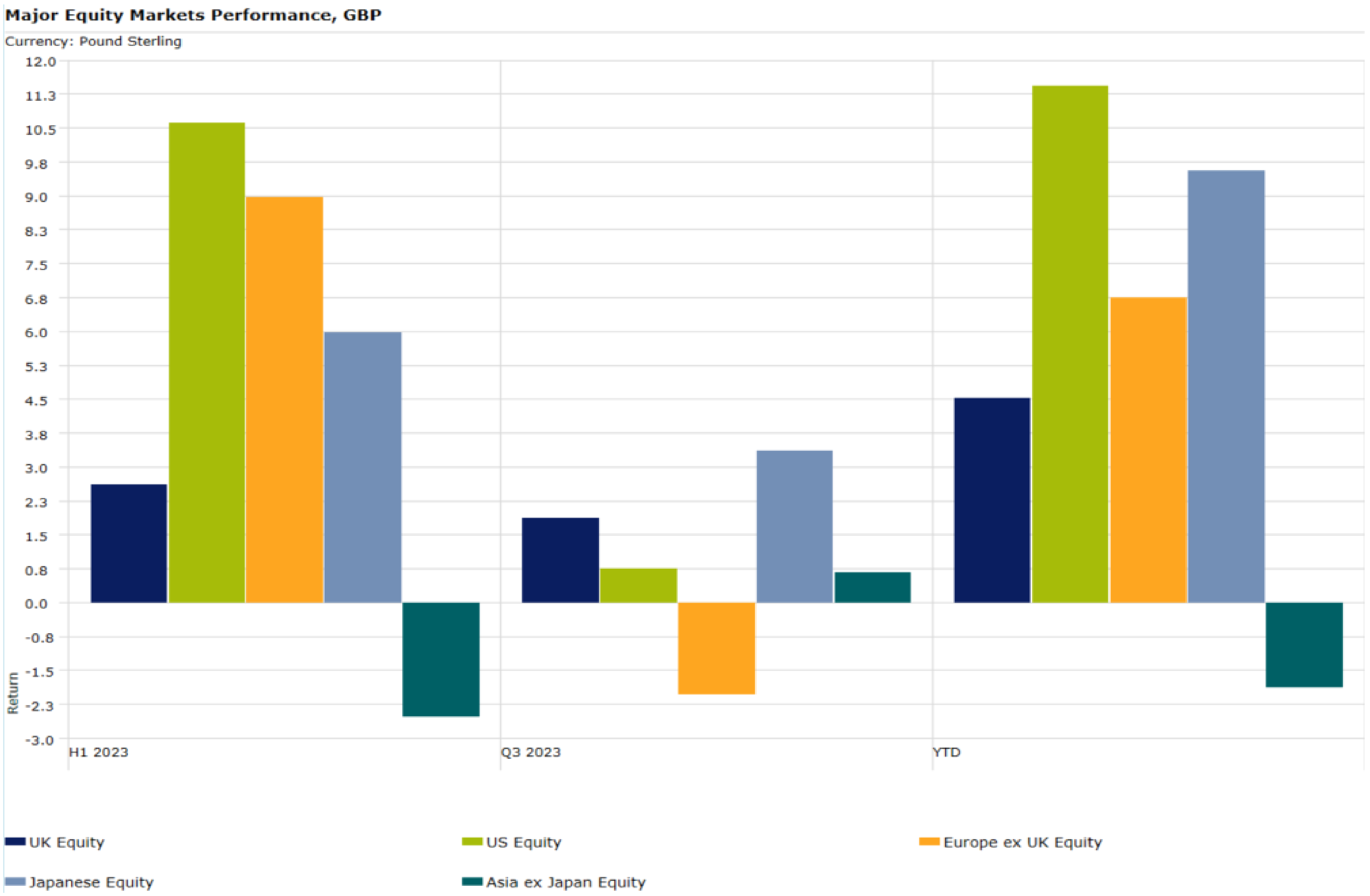
- A recap of the market movements so far this year.
- Understand & explore the key themes driving markets.
- Decipher the current investment risks and how to manage them.
- Uncovering investment opportunities in an uncertain environment.

The year so far…



The year so far … a broadly positive year for sterling investors

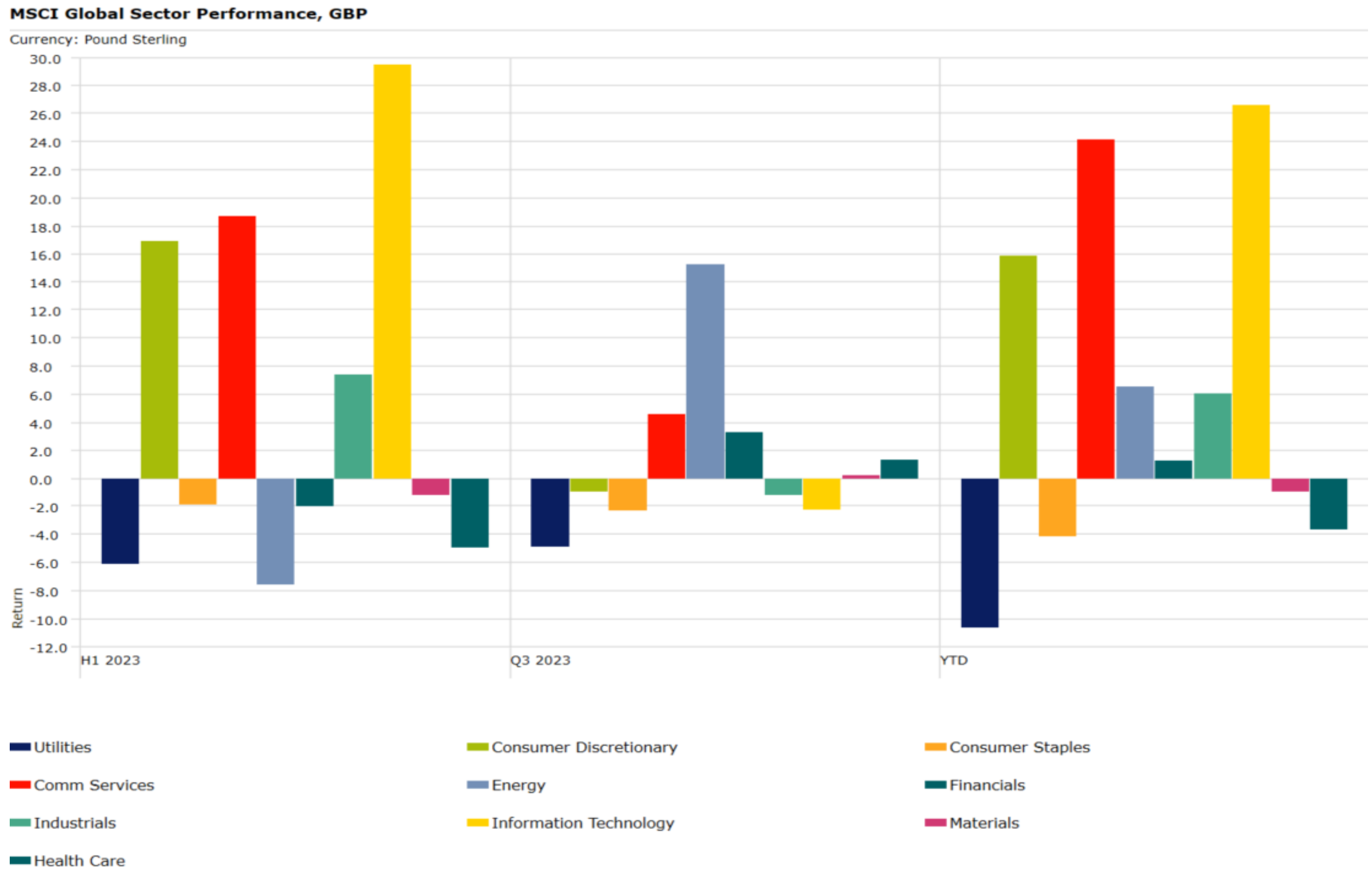
Key takeaway: a stellar year so far for US and Japanese equity, while Asia ex Japan struggles



Source: Morningstar Direct, data to 30/09/2023. Past performance is no guarantee of future performance.

The year so far … three stand-out sectors year-to-date

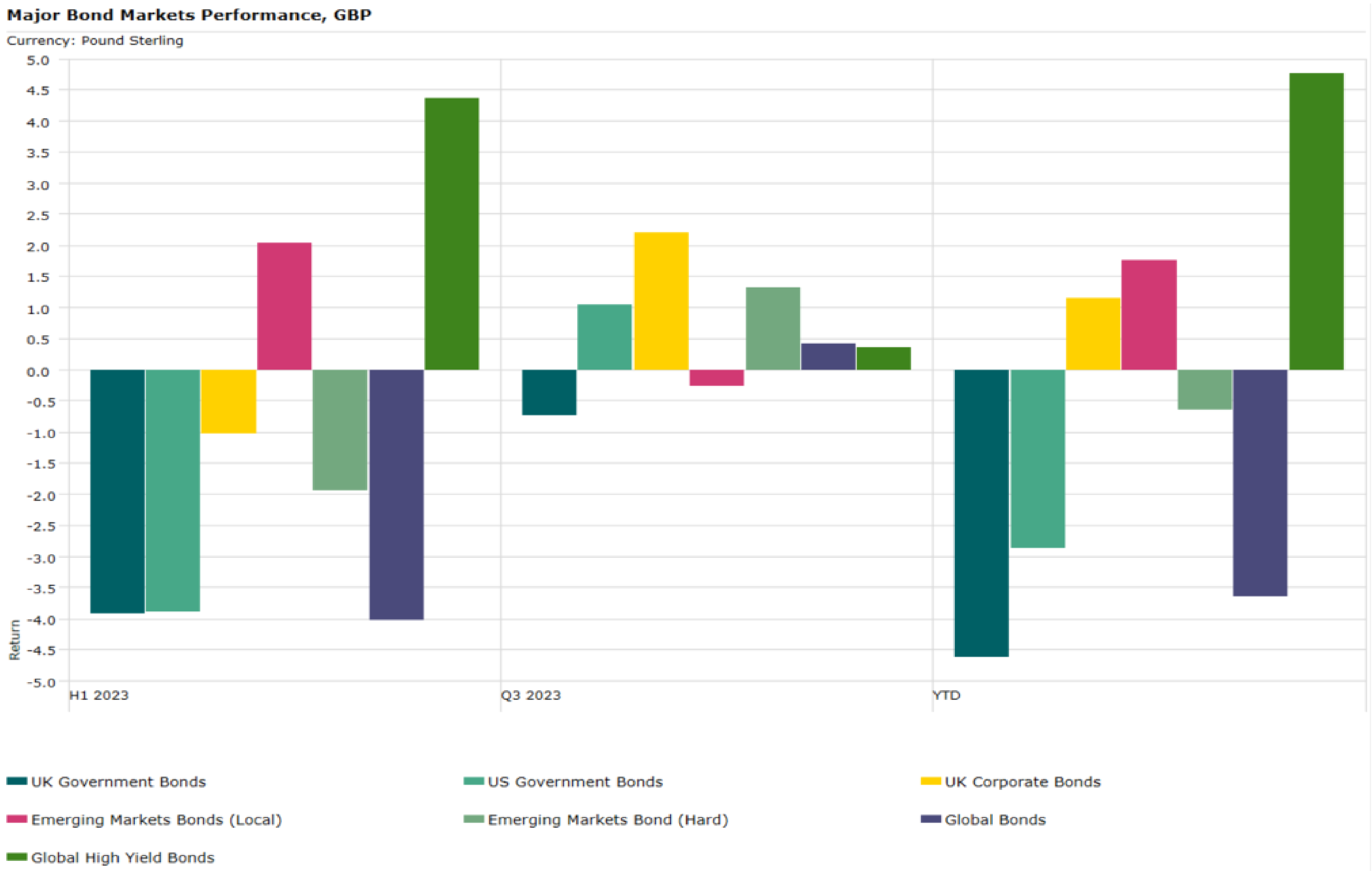
Key takeaway: the three key sectors remain well ahead YTD, driven by the "magnificent 7", although it was Energy that stood out in Q3



Source: Morningstar Direct, data to 30/09/2023. Past performance is no guarantee of future performance.

The year so far … government bonds struggle while High Yield and Emerging Market Debt rally

Key takeaway: UK government bonds struggle the most year-to-date as the Bank of England took an aggressive stance on inflation



Source: Morningstar Direct, data to 30/09/2023. Past performance is no guarantee of future performance.

Key themes driving markets

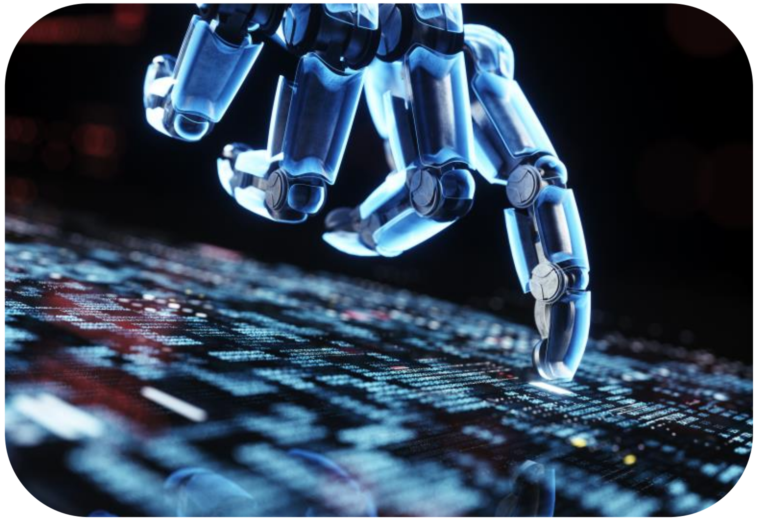
Key themes driving markets

Higher for longer?

The uncertain path of inflation and interest rates continues to impact markets.

Finding an attractive yield

While cash rates may seem tempting, other assets are also delivering attractive returns.

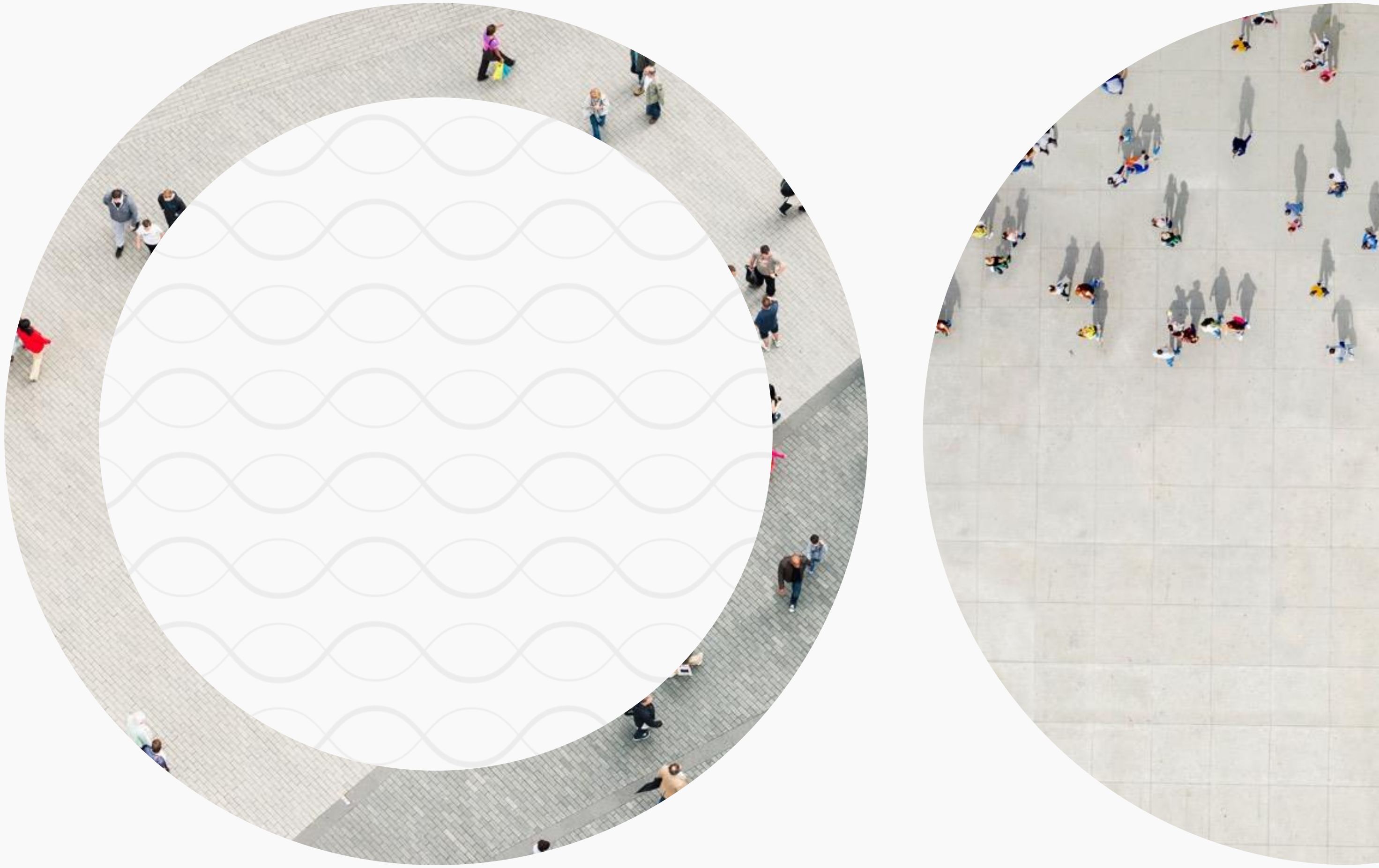


Artificial Intelligence (AI) Frenzy

Extreme performance in a narrow selection of stocks.

Morningstar Wealth as at 30/09/2023.

Higher for longer

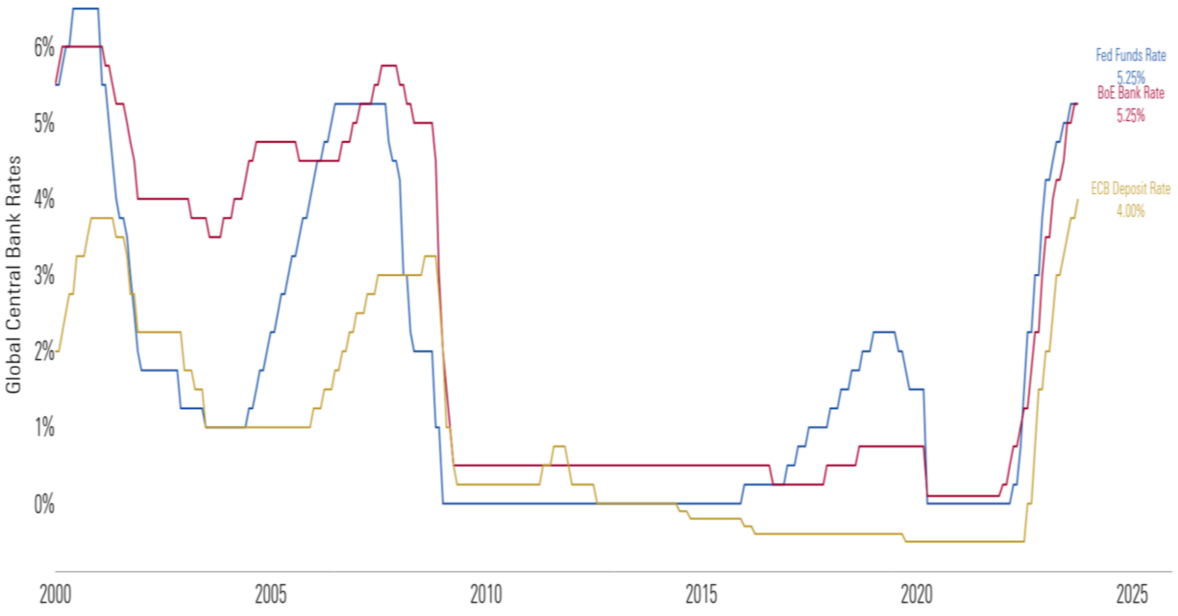


Softening inflation but higher for longer interest rates?

Key takeaway: central banks remain focused on the continued effort to bring inflation back down to the 2% target, thereby not pinning themselves to when interest rates might begin to fall

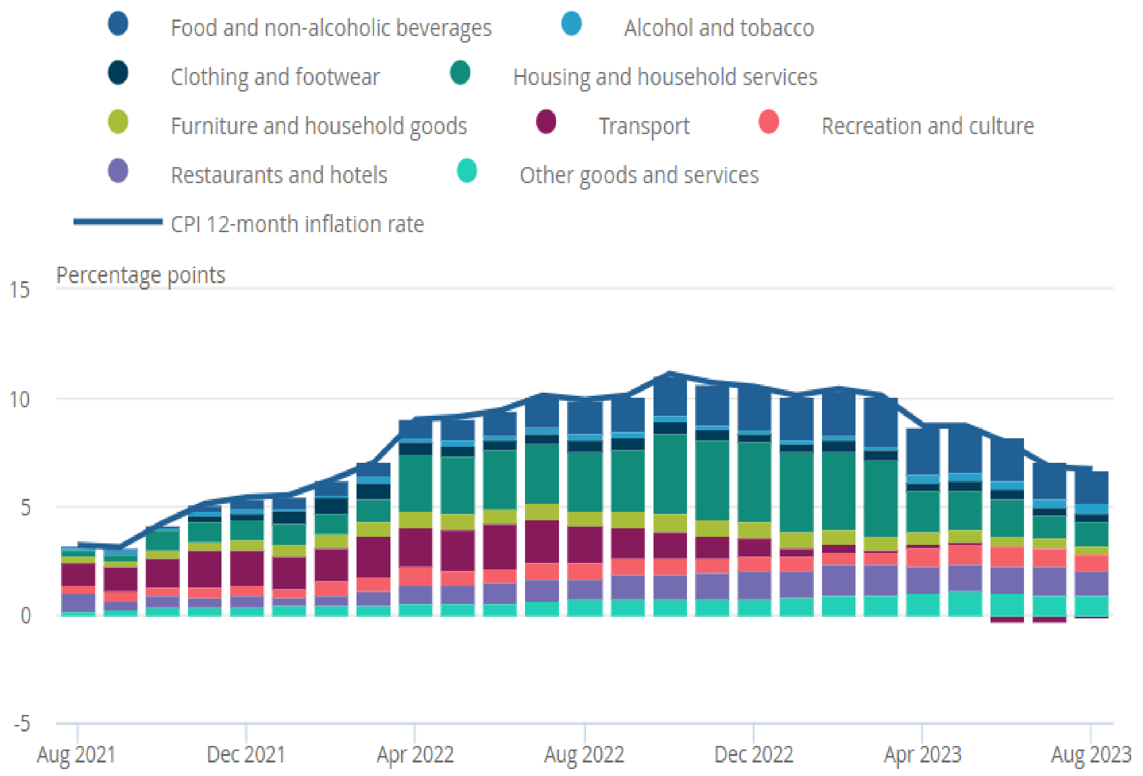
Global central bank interest rates

Federal Reserve (US), Bank of England and European Central Bank interest rates

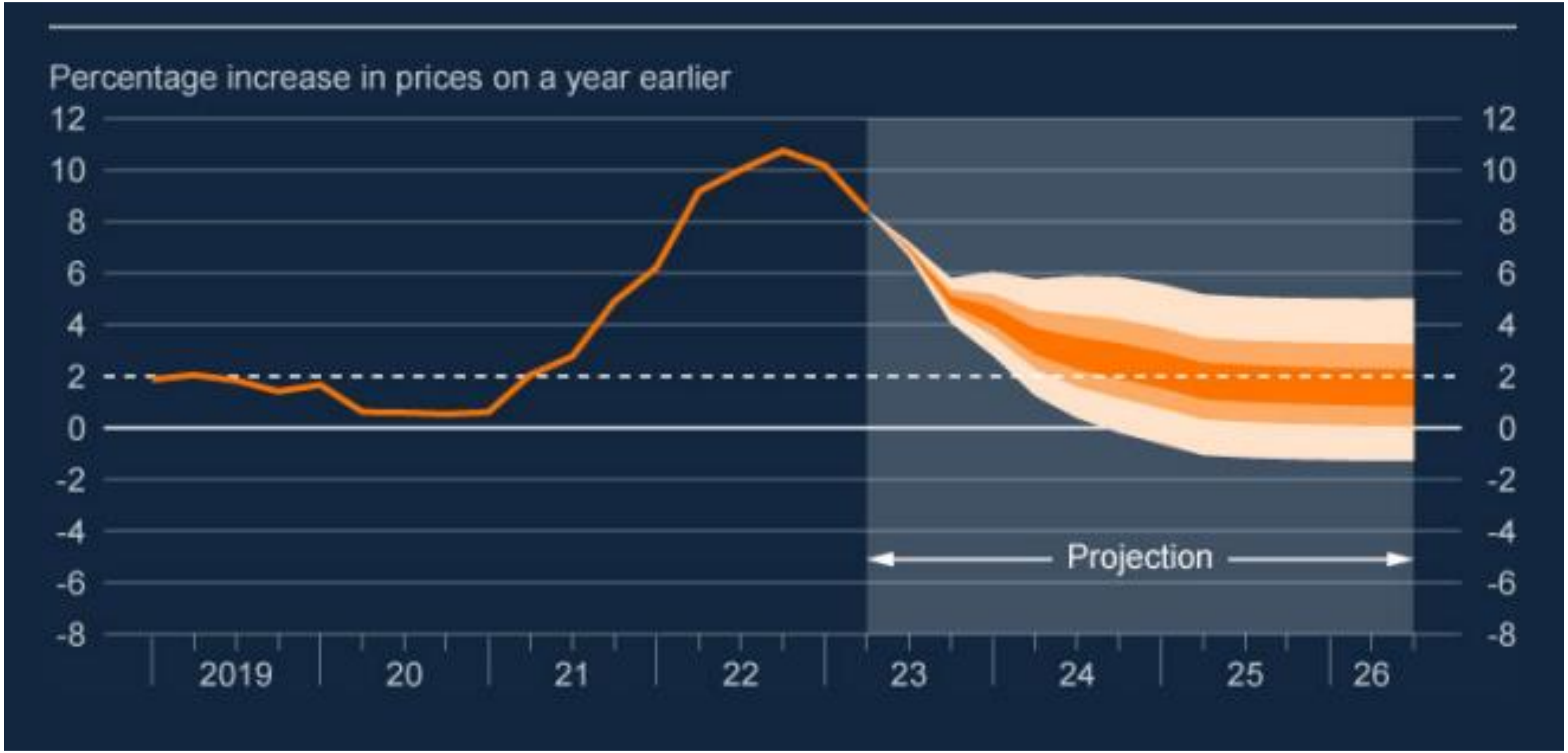


Continued evidence of softening inflation

Inflation has softened in the UK, but remains too high



Bank of England CPI inflation projections



Key Takeaway: inflation in the UK remains high, but the Bank of England expect the 2% target to be reached by early 2025

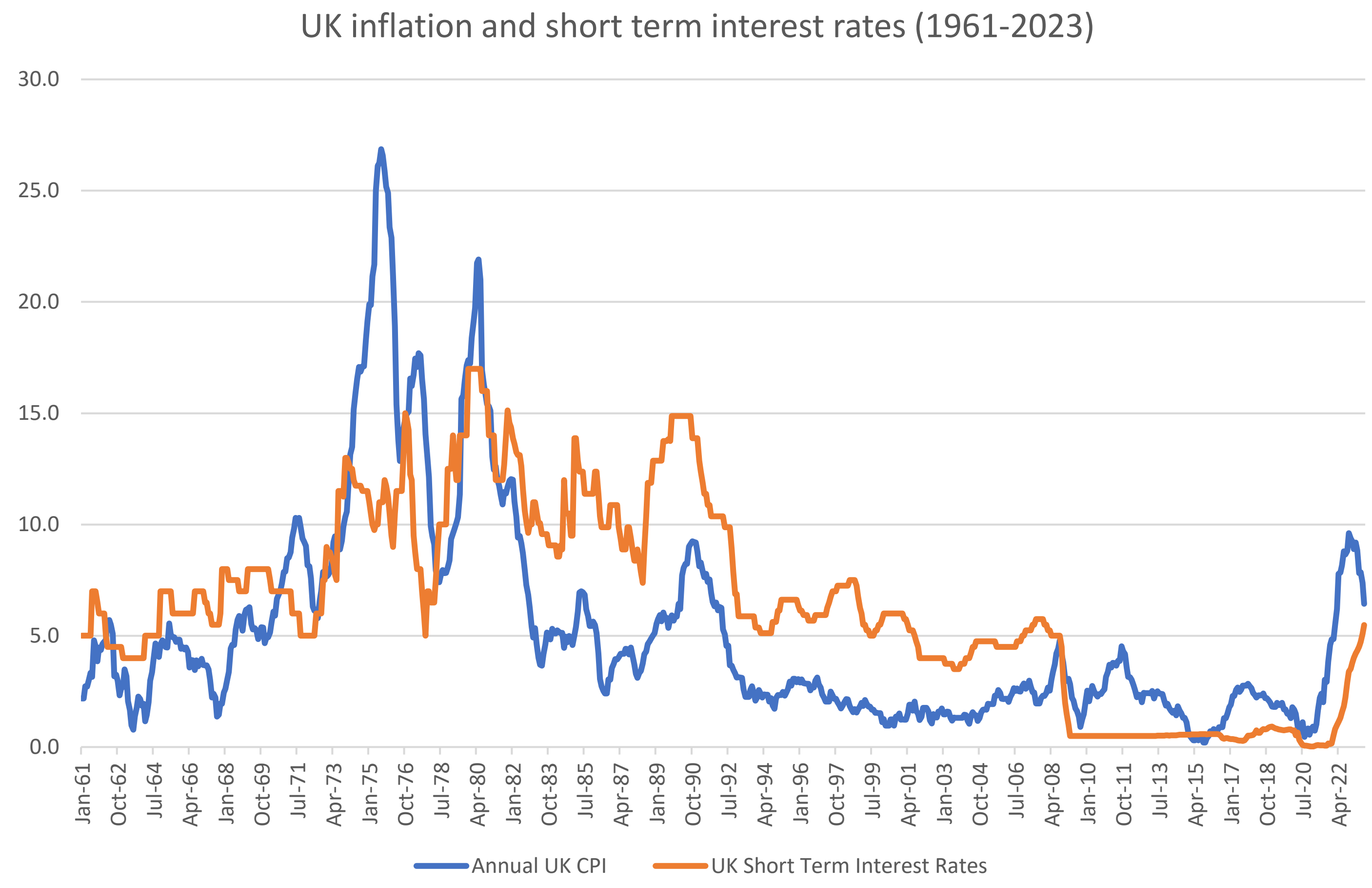
The market-implied path of interest rates has moved materially higher since May

Key Takeaway: market expectations of interest rates have risen over the past 6 months, thereby causing shifts in the bond market

Finding an attractive yield

Cash is ideally suited to funding short term needs

Key takeaway: rise in interest rates means cash is no longer falling in value vs inflation

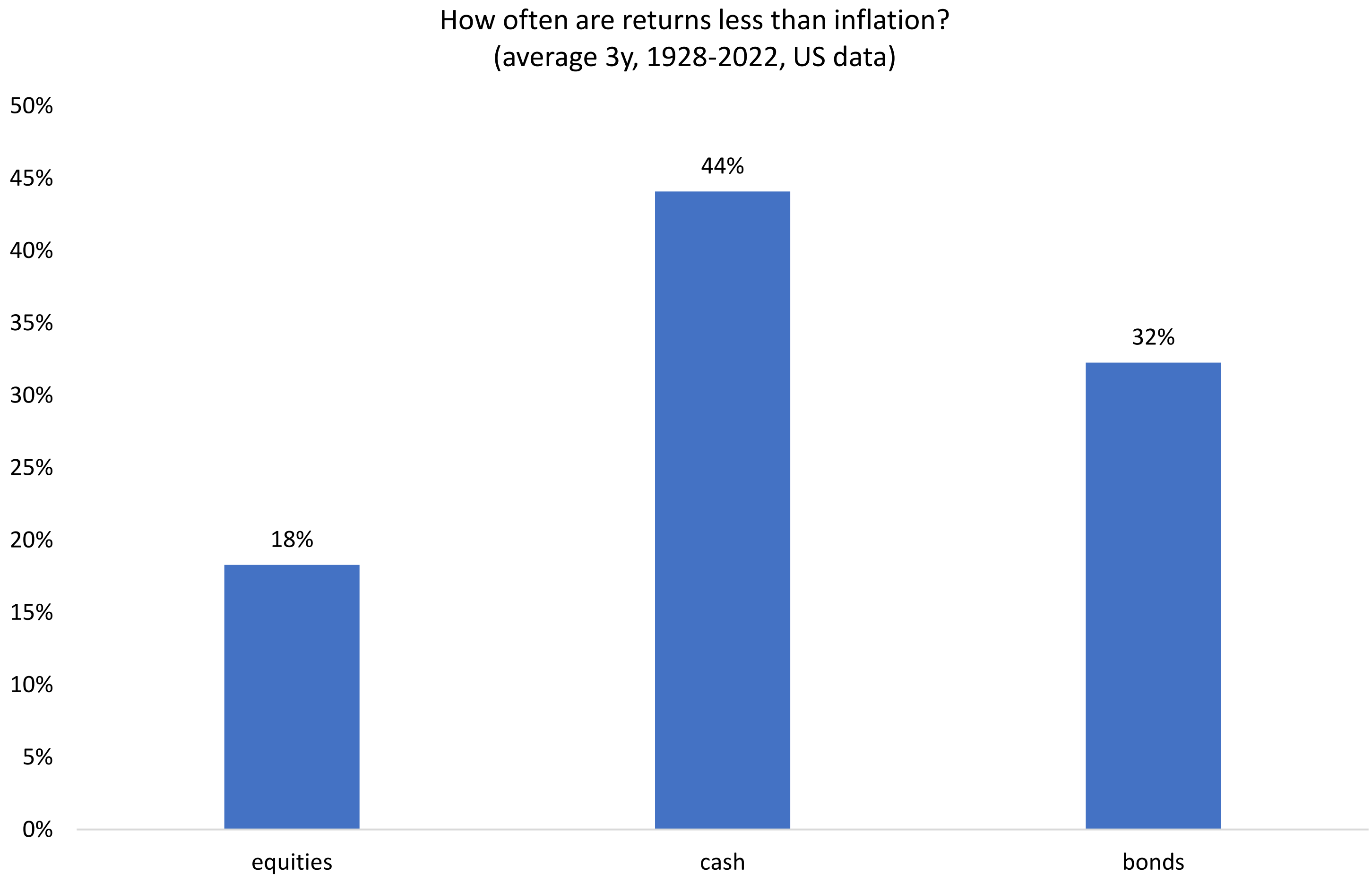


- Liquidity and short-term stability makes cash ideal for funding short term needs.
- Long period of ultra-low rates and rising inflation caused short term funds to switch to riskier longer-term investments.
- Interest rates now high enough for cash to fulfil its traditional role as secure short-term asset.

Source: FRED, data from 01/01/1961 to 01/07/2023

Cash is not suited to meeting medium to longer term goals

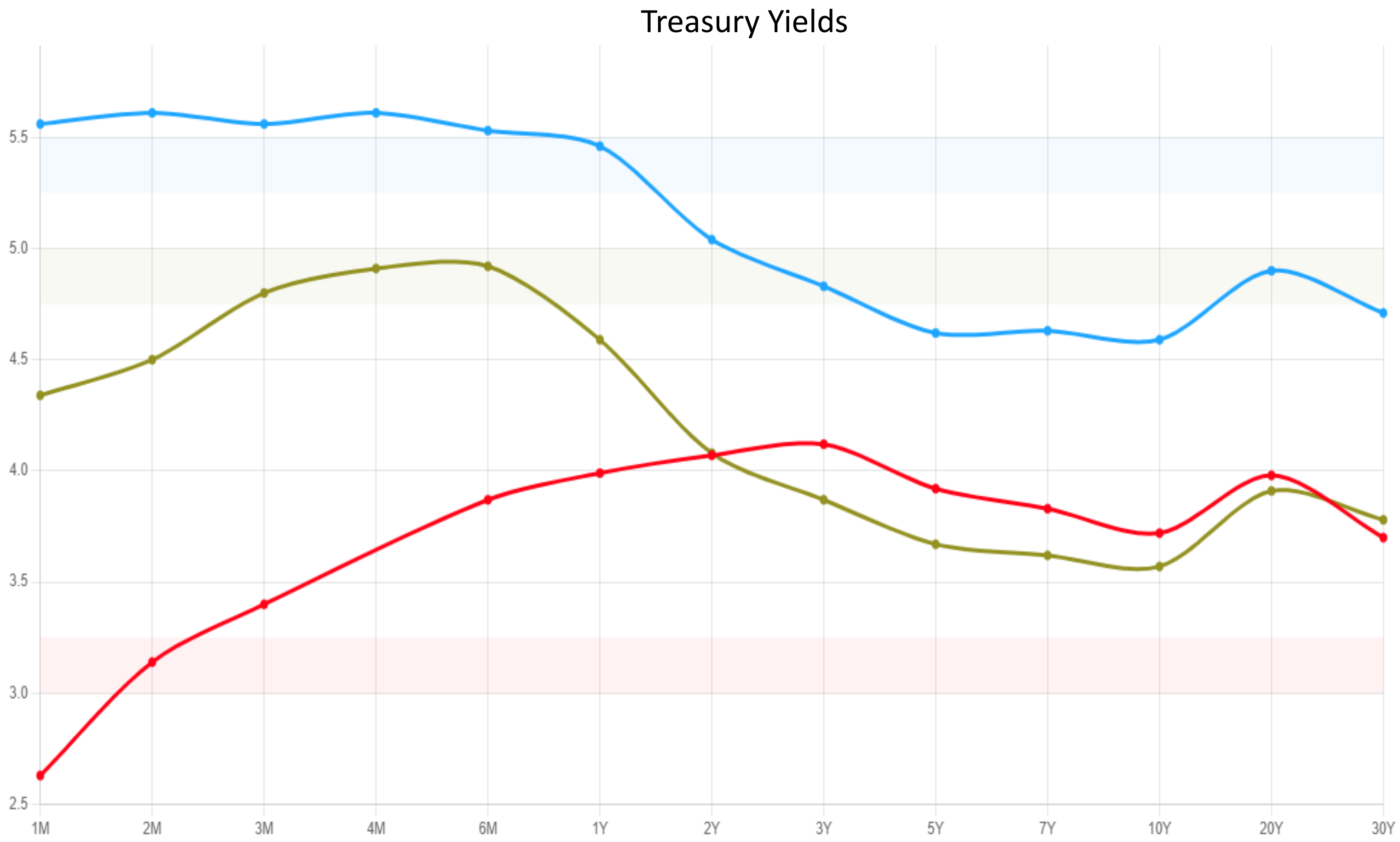
Key takeaway: Cash returns are less likely to keep pace with inflation



- Cash returns less likely to keep pace with inflation than bonds and equities.
- When inflation falls so do interest rates.

Source: Morningstar Direct & FRED – Federal Reserve of St. Louis. Data to 31/12/2022.

The path of inflation and interest rates continues to impact markets



30 Sept 2023 6 months ago 12 months ago

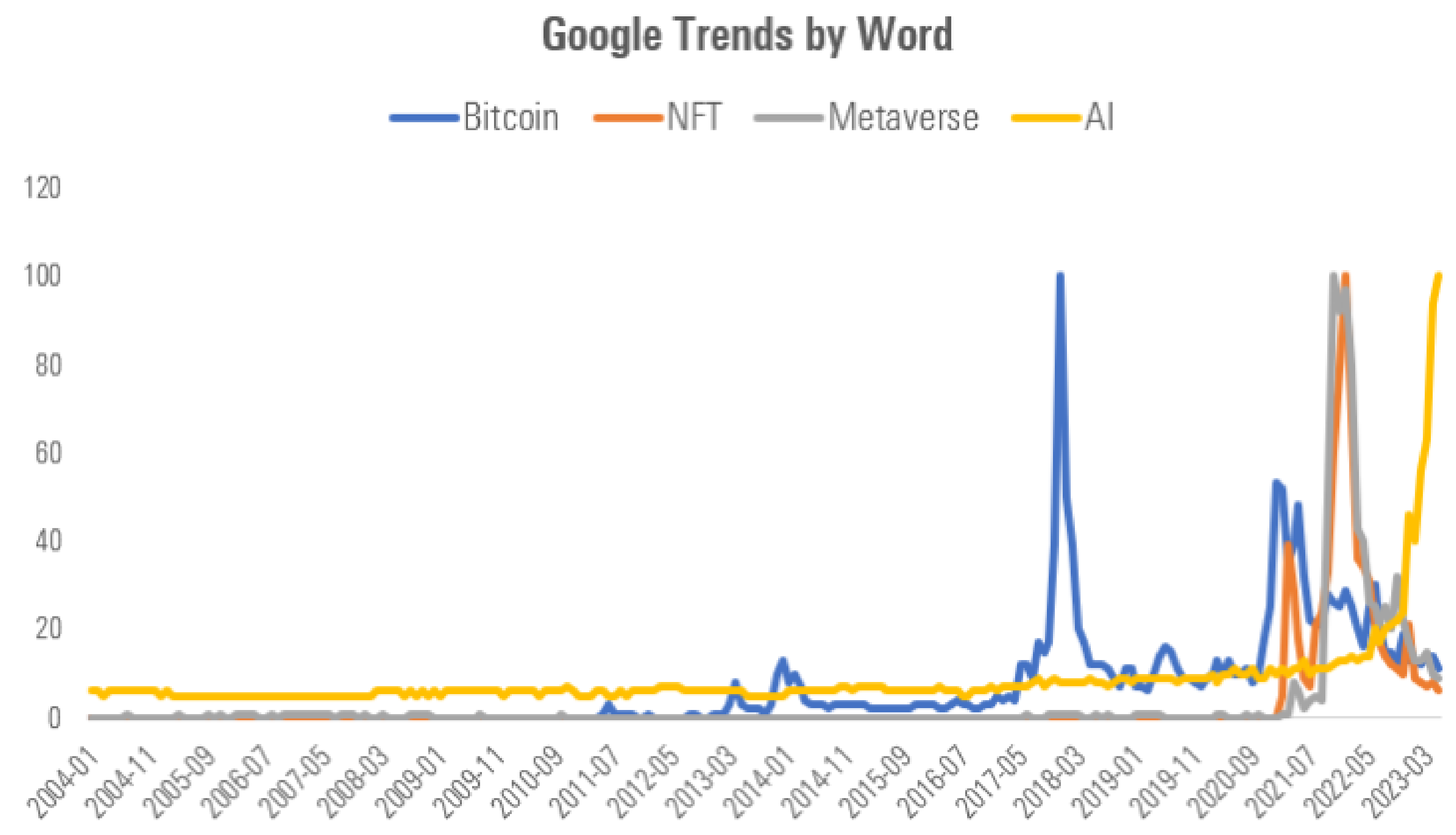
- Income yields on bonds have moved up with interest rate increases.
- Portfolios can now generate more in the way of income for clients.

Key Takeaway: markets are continually attempting to price in future interest rates, thereby causing significant pricing shifts

AI Frenzy

Everybody is talking AI

Key takeaway: there's a lot of optimism in AI, but optimism can sometimes lead to overvaluation



AI Excitement

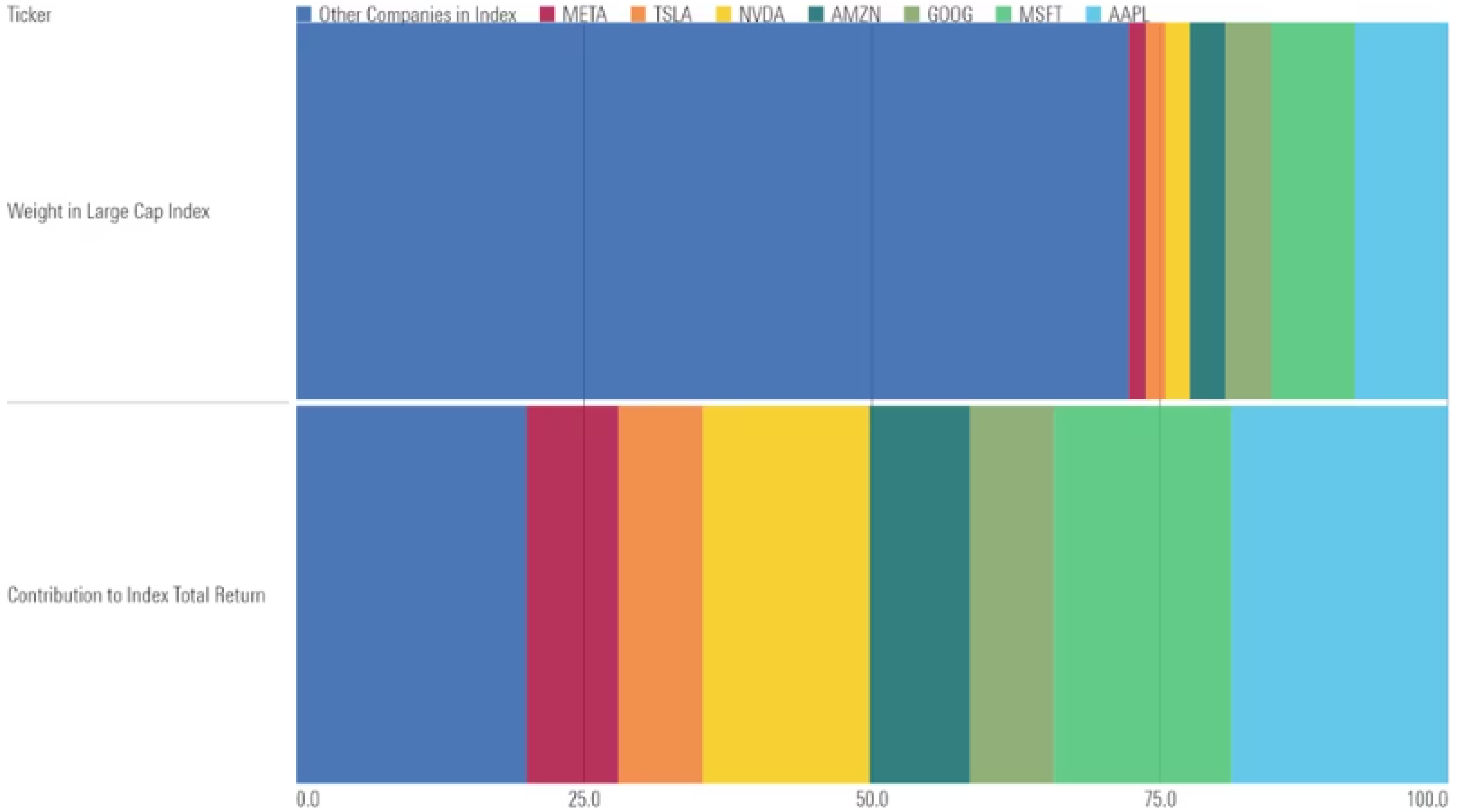
- The future of AI is up for debate
- With any new disruptor, it's hard to decipher which companies will benefit.
- Understanding the fundamentals and thereby what drives performance remains key to our investment process.

Source: Google Trends as at 30/06/2023. Past performance is no guarantee of future performance

…which has set the stage for a narrow rally

Key takeaway: approximately seven stocks—commonly referred to as *the magnificent seven*—make up roughly 80% of the total return in U.S. large caps so far this year.

U.S. Large Cap: Return Contribution by Stock Year-to-Date

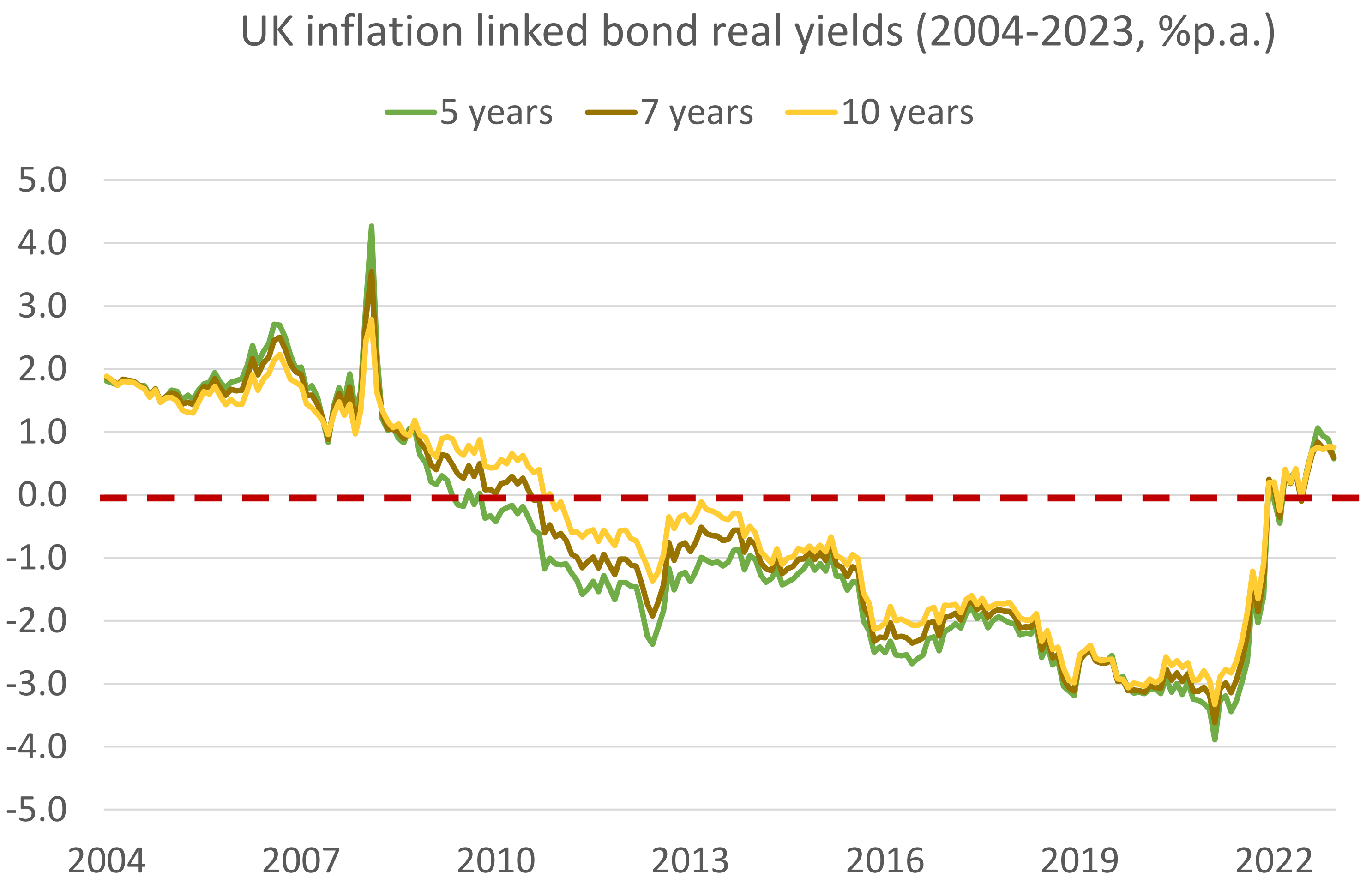


Source: Morningstar Markets Observer, Morningstar Direct. Data as of June 30, 2023. Past performance is no guarantee of future performance.

Managing the current investment risks

Managing against inflation risk?

Key takeaway: UK inflation-linked bonds offer a positive return above the rate of inflation

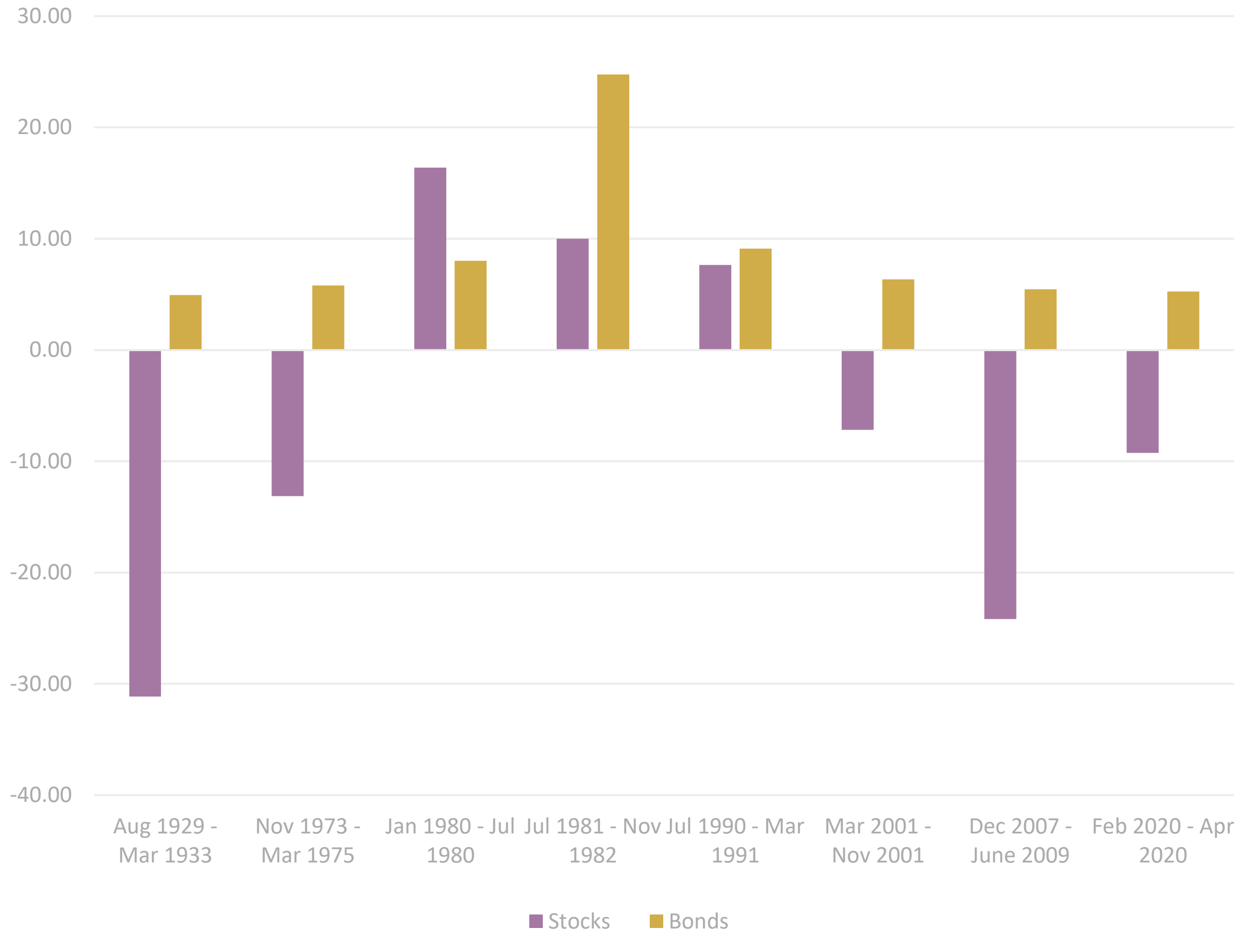


UK Inflation Linked Bonds are more attractive due to

- rise in yields
- easing of demand and supply inflationary pressures
- large rise in interest rates.

Managing against the risk of recession?

Key takeaway: While bonds disappointed as diversifiers in 2022, they've historically performed well during economic downturns.

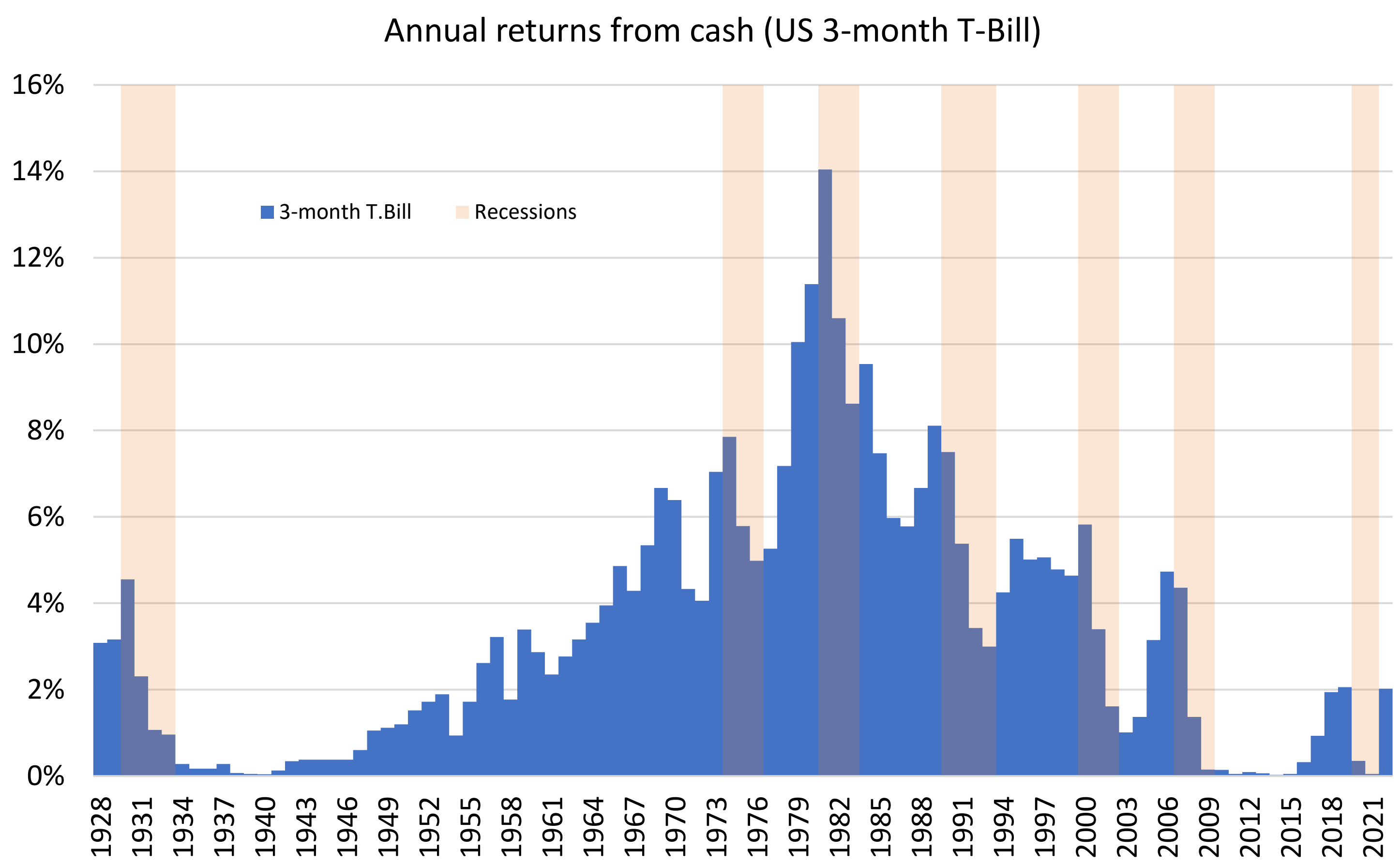


- Recessions driven by policy mistakes and shocks so are rare and hard to predict.
- Govt bonds offer greatest chance of positive returns.
- Within equities companies with more secure income streams hold up better.
- We have added some exposure to core infrastructure assets following large sell offs, these complement holdings in consumer staples, healthcare, and quality companies.

Source: Data as at 31 Dec 2022. Stock performance based on the IA SBBI Large Stock Index. Bond performance is based on the IA SBBI IT Govt Index. Returns for periods greater than 1 year are annualized. Past performance is no guarantee of future performance.

Cash is not suited to diversifying portfolios in a recession

Key takeaway: Return from cash declines during recessions

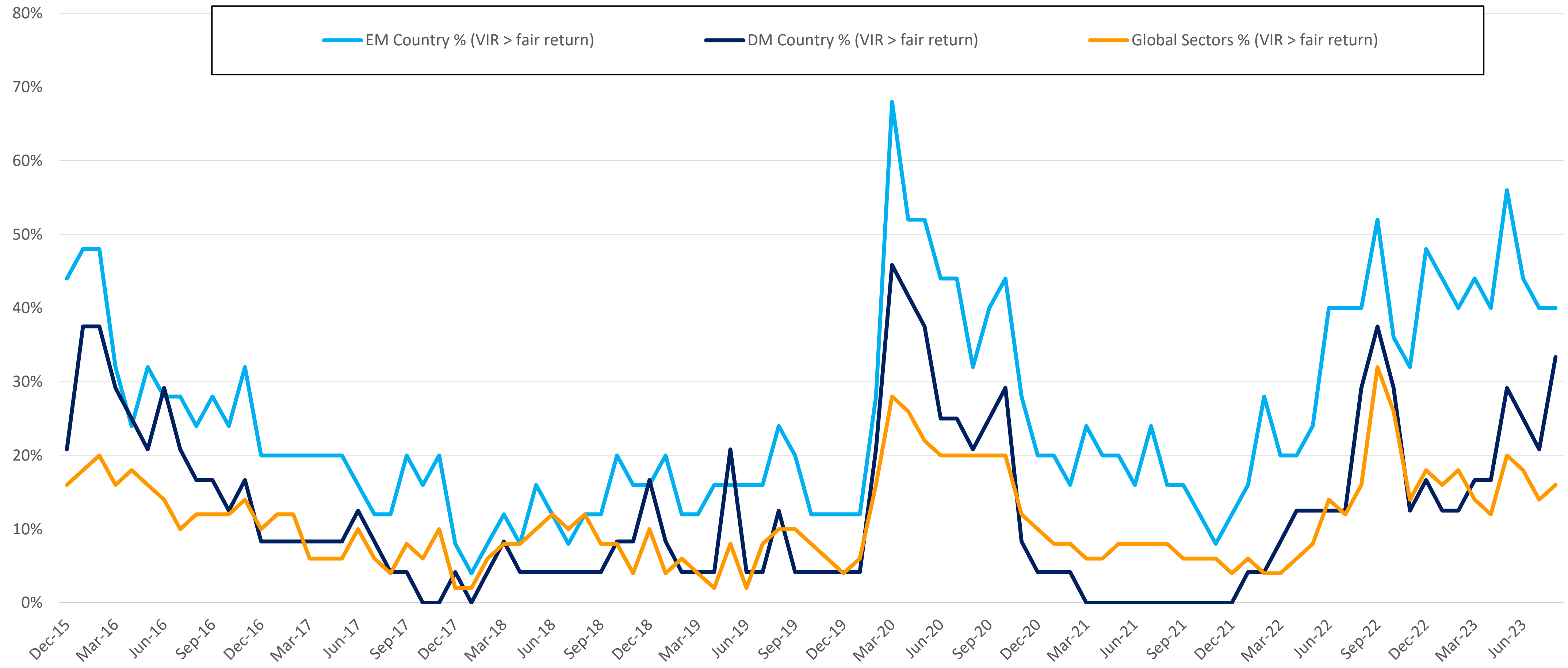


- Worst returns from equities occur in a recession when corporate earnings fall.
- Govts respond to recessions by making money cheap and easy to access.
- Returns from cash come down during recessions.
- Returns from high quality bonds go up in recession.

Where are the opportunities?

Where are the opportunities?

Key takeaway: **Emerging Market Equities** and bonds still better than developed markets.



Source: Morningstar Wealth, EMEA

Where are the opportunities?

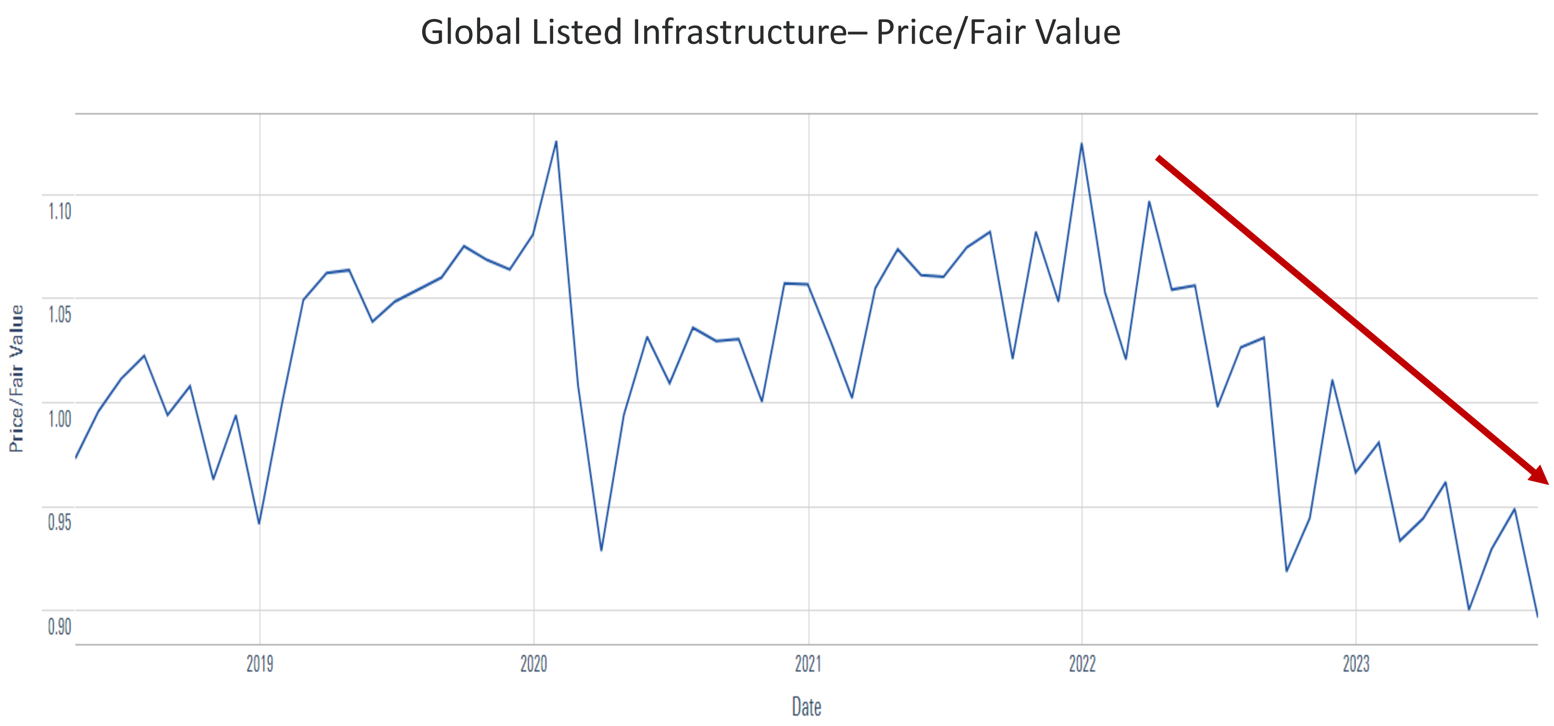
Key takeaway: **Japanese Yen** is significantly undervalued against Sterling

Source: Morningstar Direct, from 30/09/2020 to 30/09/2023

Where are the opportunities?

Key takeaway: not only do **Utilities** offer additional diversification benefits, but they are also defensive in nature and valuations have improved

Opportunity to add to global listed infrastructure at lower prices



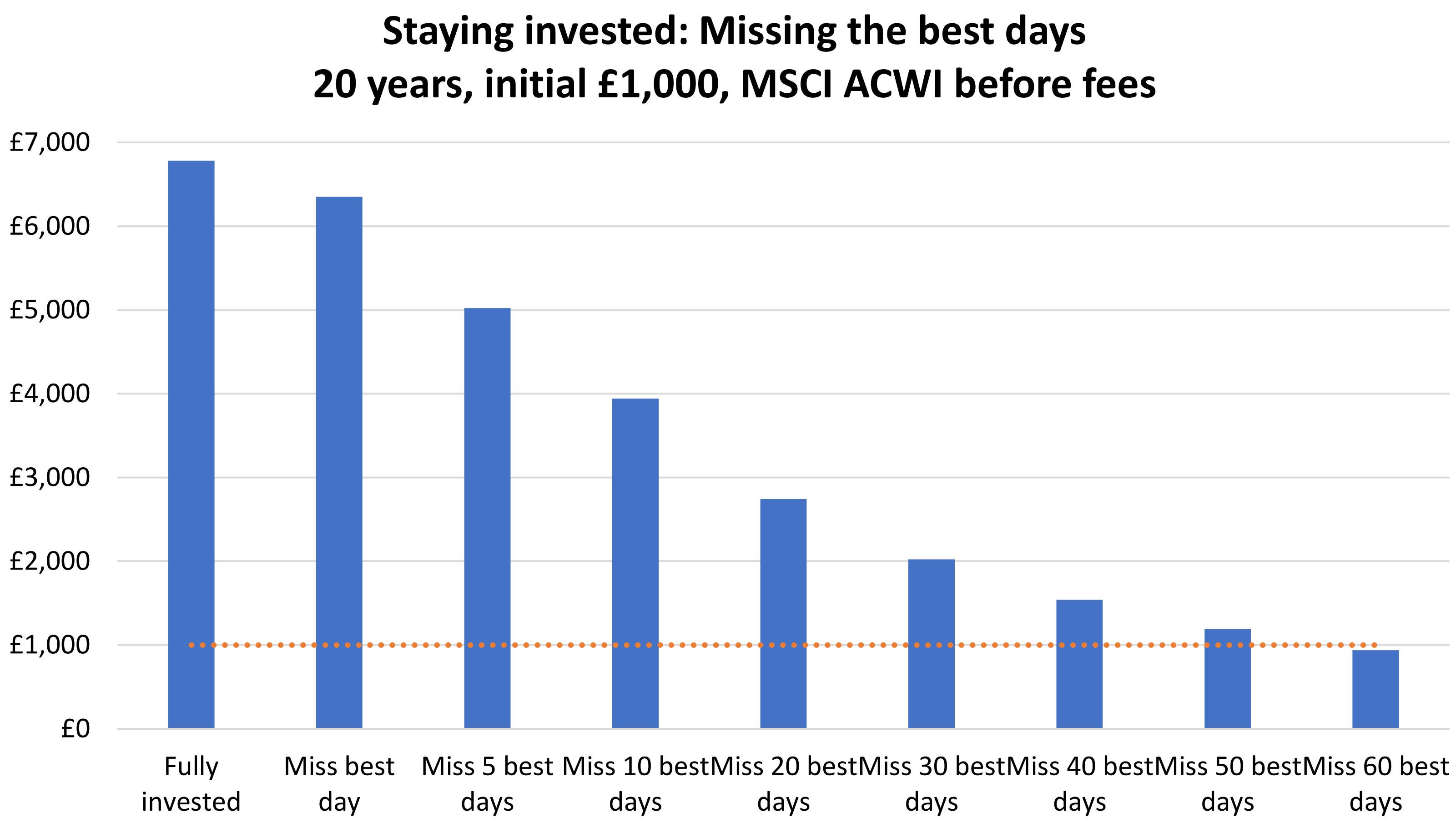
Why Core Infrastructure / Utilities?

- **Improved valuations** over the past 12 months.
- Increase **defensive exposure** with less sensitivity to the economy low correlation to other sectors.

Source: Morningstar Investment Management, as at 30 September 2023. The chart is based on Morningstar estimates of fair values and the L&G Global Infrastructure Index Fund stock weights

Does not pay to “time” the markets

Key takeaway: Most likely outcome is missing out on returns and failing to meet objectives



- Notoriously hard to time switching between cash and investment market.
- Reduces likelihood of meeting objectives.
- Worst time to switch away from bonds is when they have already sold off.

Q & A

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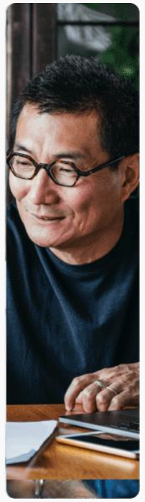


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