

MORNINGSTAR Wealth

# Market Update

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Thursday 19<sup>th</sup> 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.

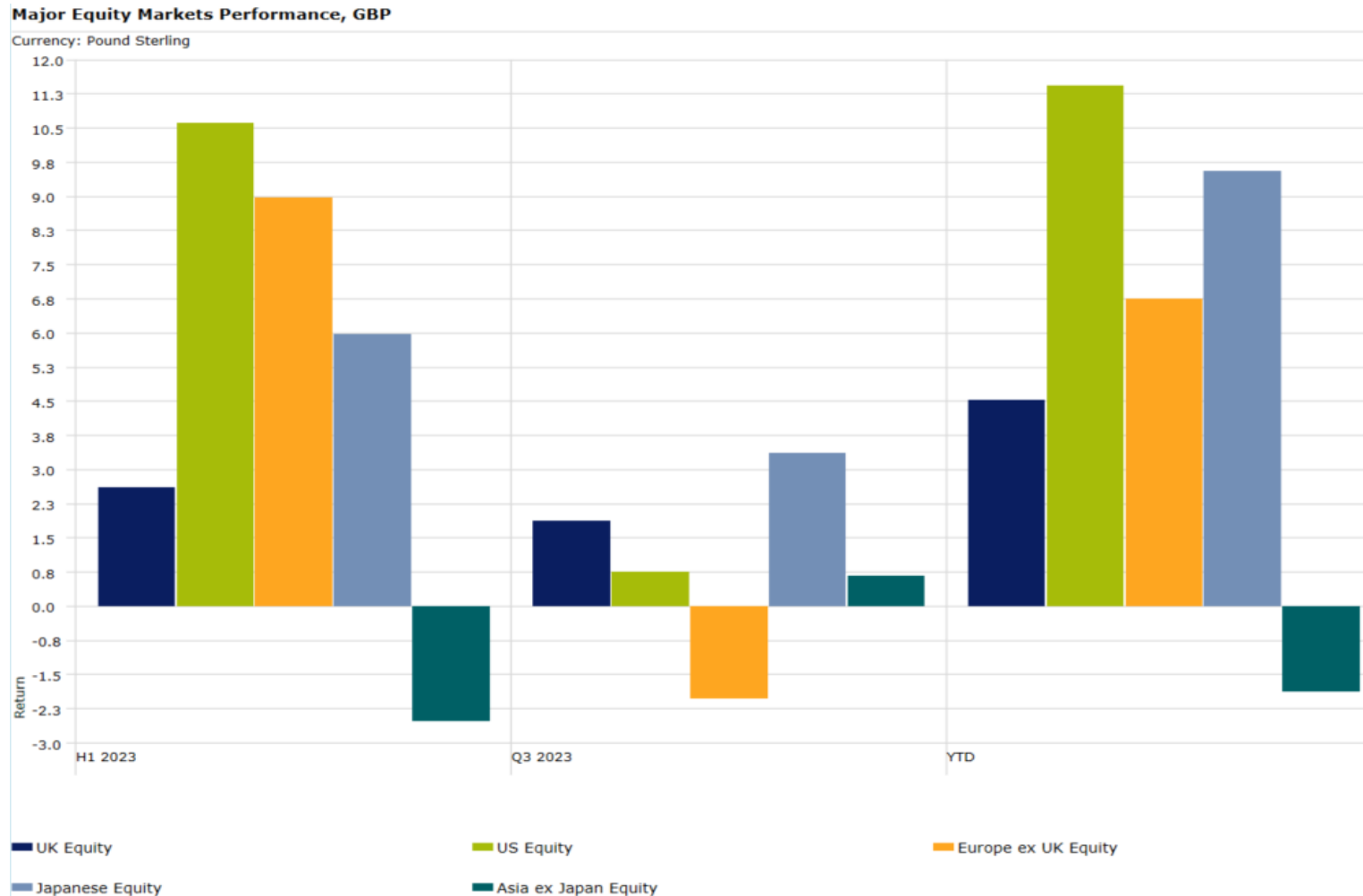


# The year so far...



# The year so far ... a broadly positive year for sterling investors

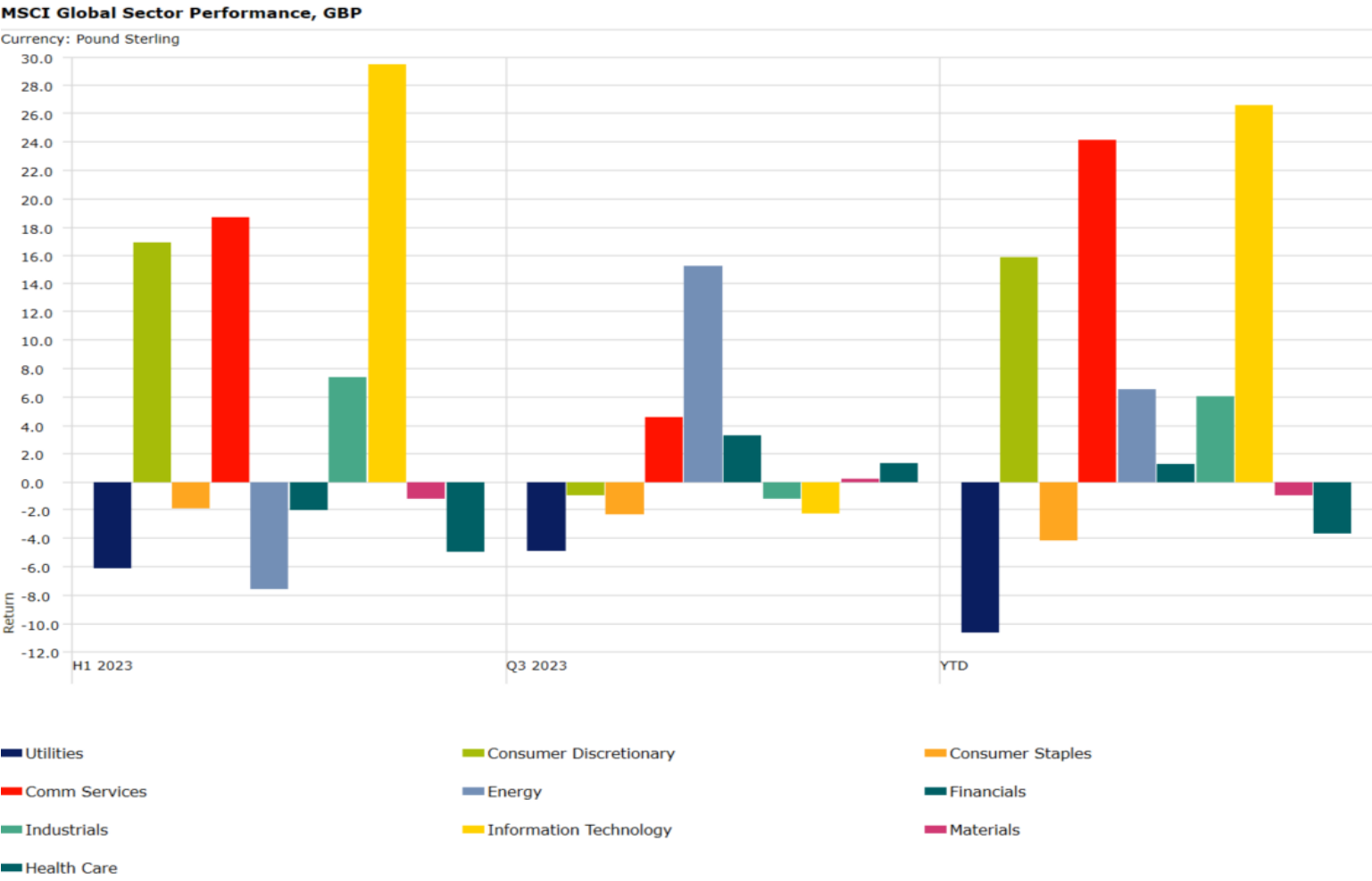
Key takeaway: a stellar year so far for US and Japanese equity, while Asia ex Japan struggles



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

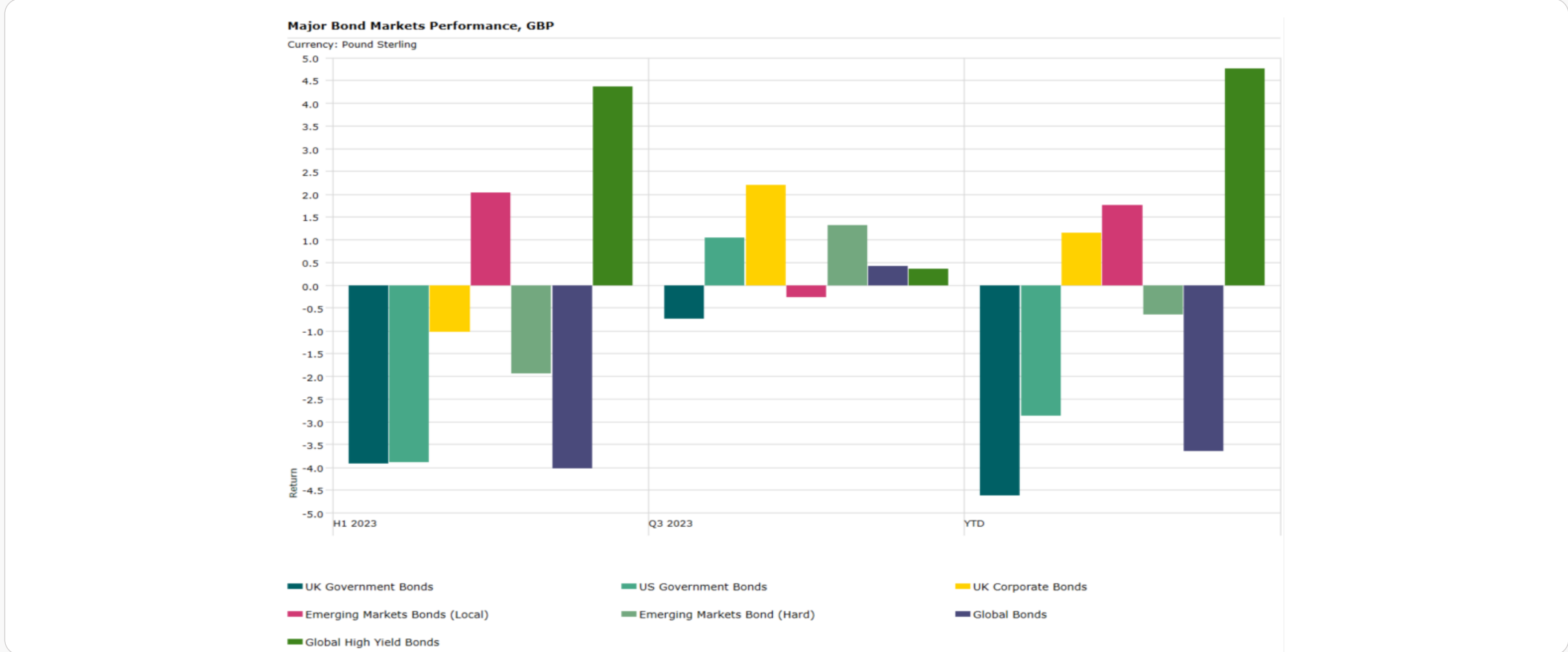
Key takeaway: the three key sectors remain well ahead YTD, driven by the “magnificent 7”, although it was Energy that stood out in Q3



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



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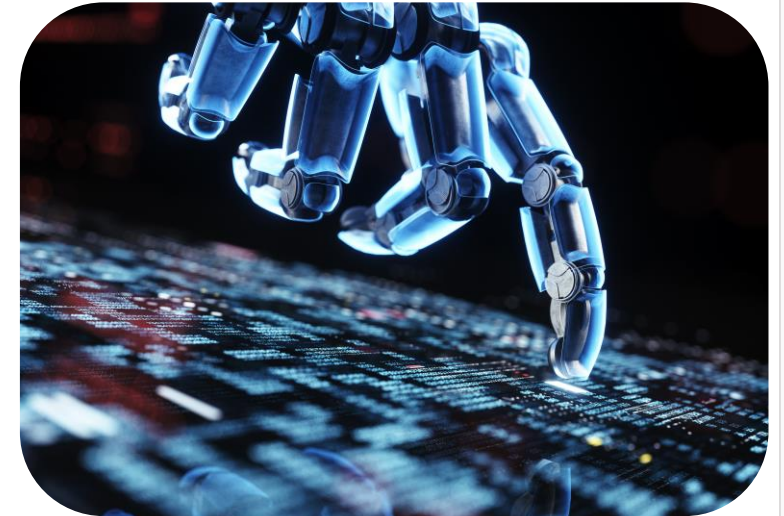
## Higher for longer?

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.



# Higher for longer

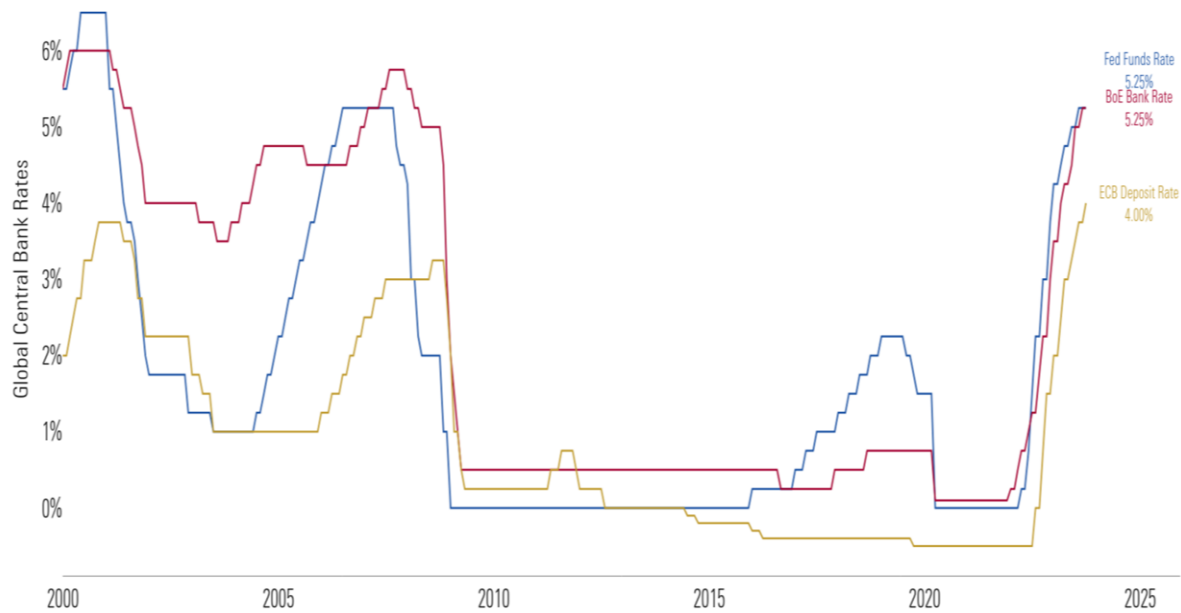


## Softening inflation but higher for longer interest rates?

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

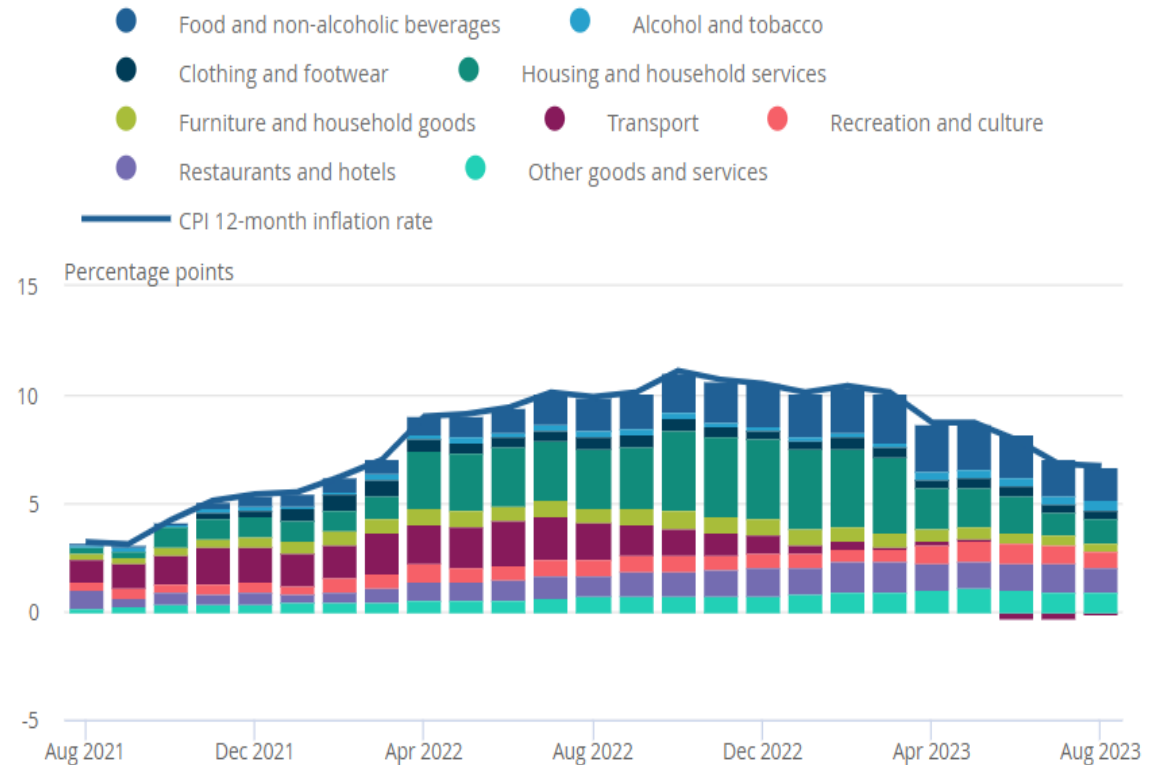
### Global central bank interest rates

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

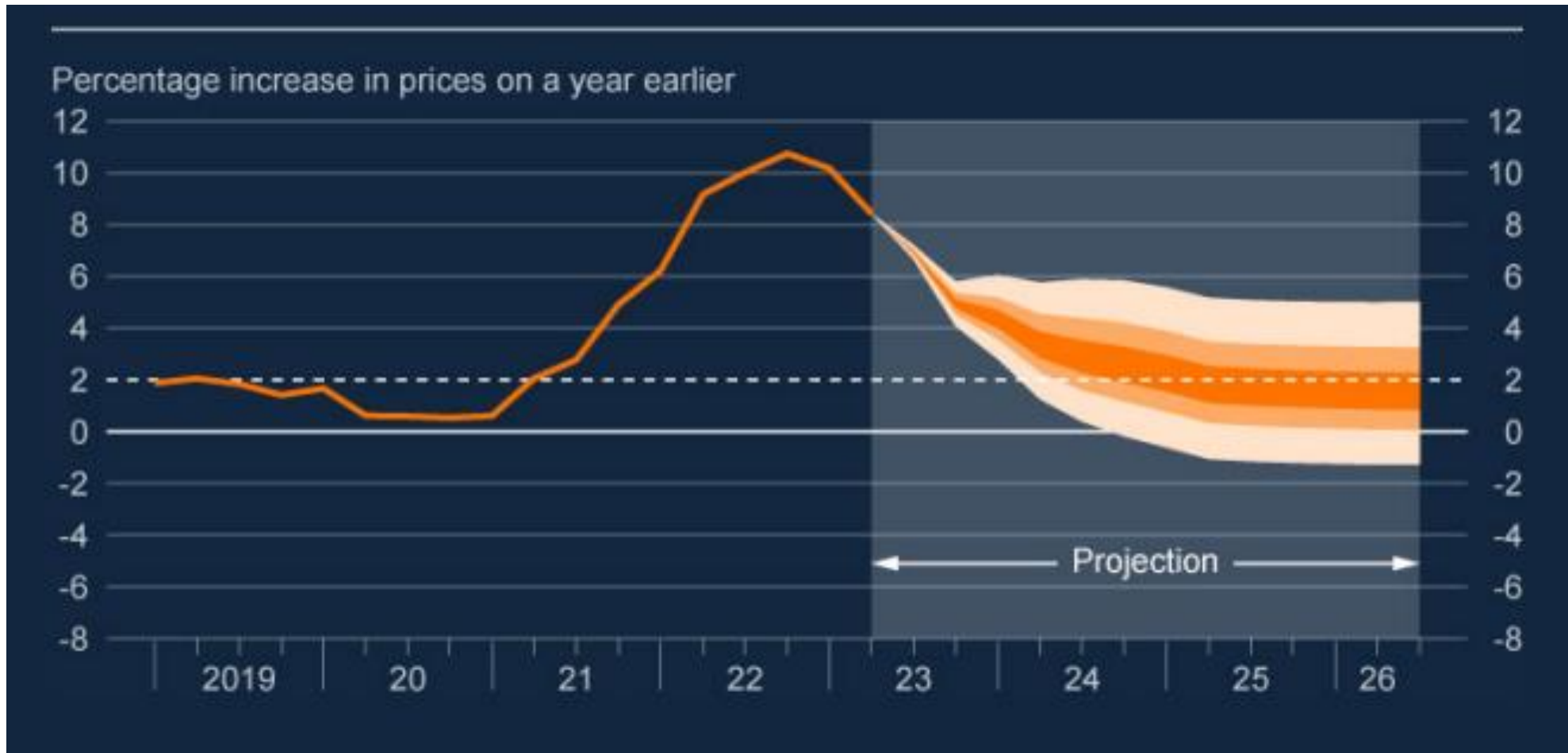


### Continued evidence of softening inflation

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

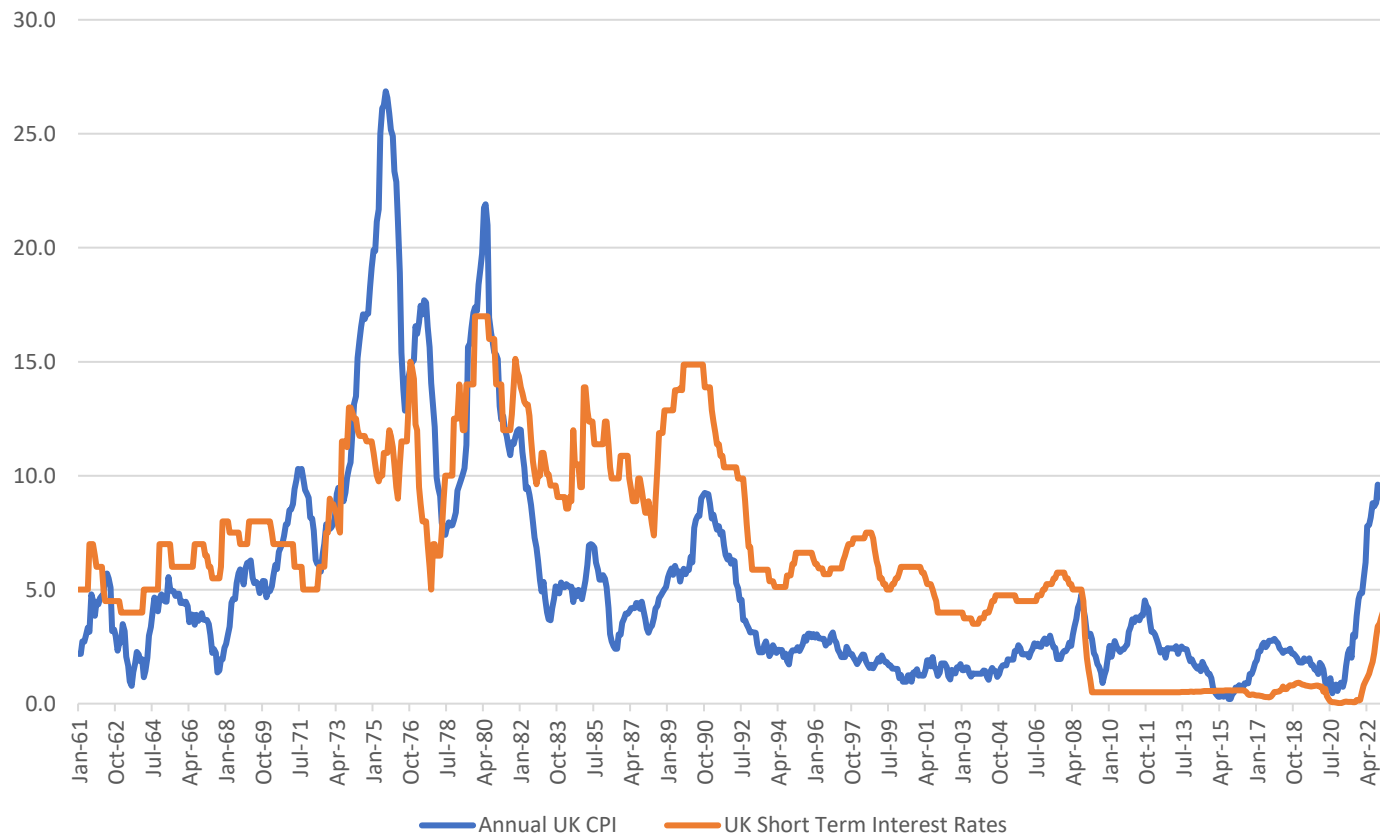




## Cash is ideally suited to funding short term needs

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

UK inflation and short term interest rates (1961-2023)

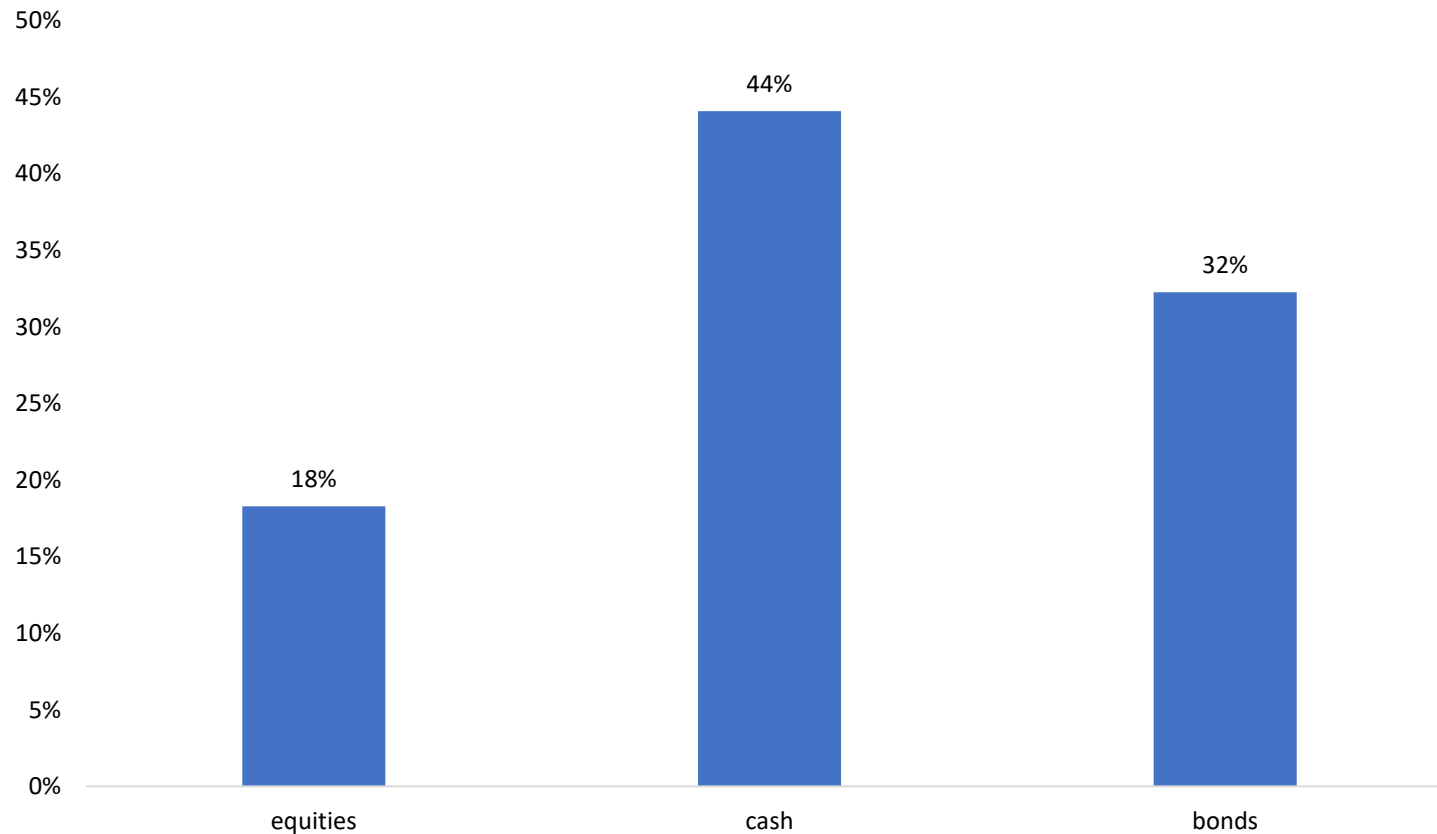


- Liquidity and short-term stability makes cash ideal for funding short term needs.
- Long period of ultra-low rates and rising inflation caused short term funds to switch to riskier longer-term investments.
- Interest rates now high enough for cash to fulfil its traditional role as secure short-term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

# Cash is not suited to meeting medium to longer term goals

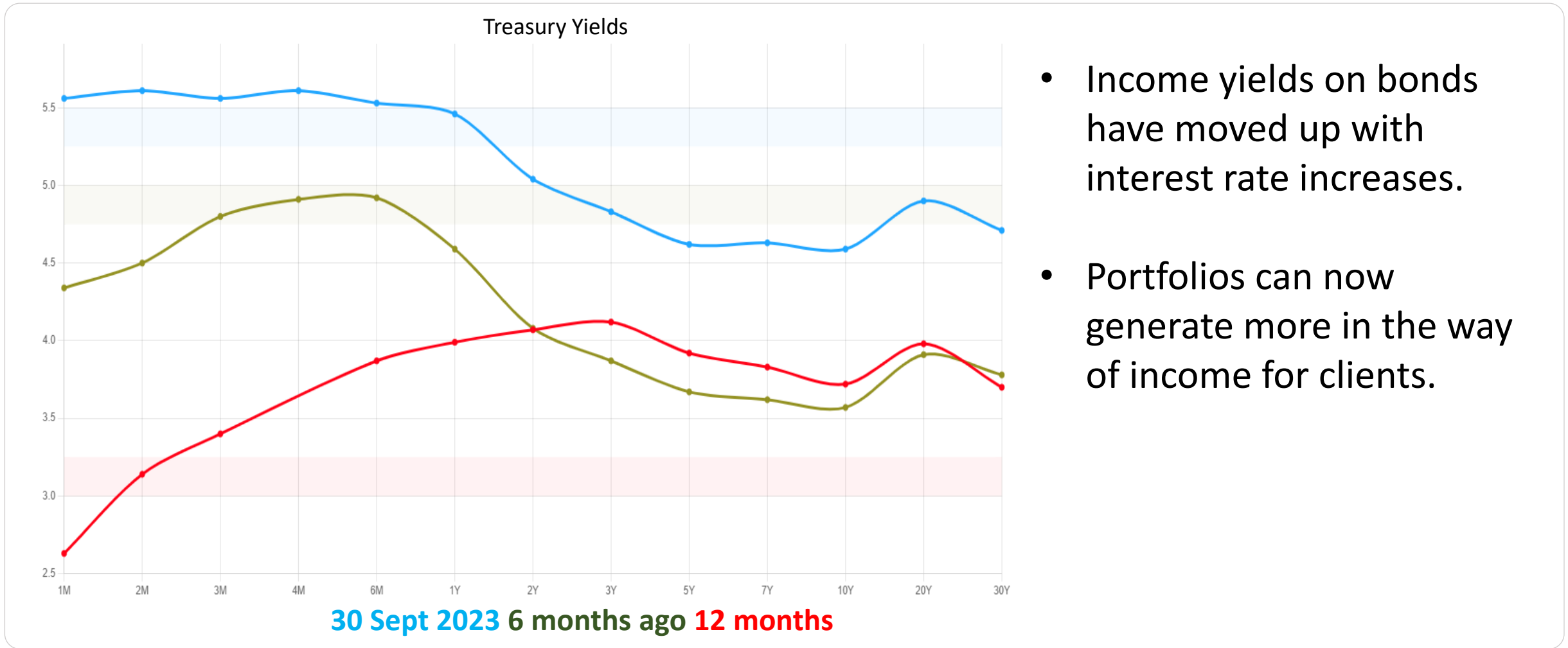
Key takeaway: Cash returns are less likely to keep pace with inflation

How often are returns less than inflation?  
(average 3y, 1928-2022, US data)



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

## The path of inflation and interest rates continues to impact markets



- 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

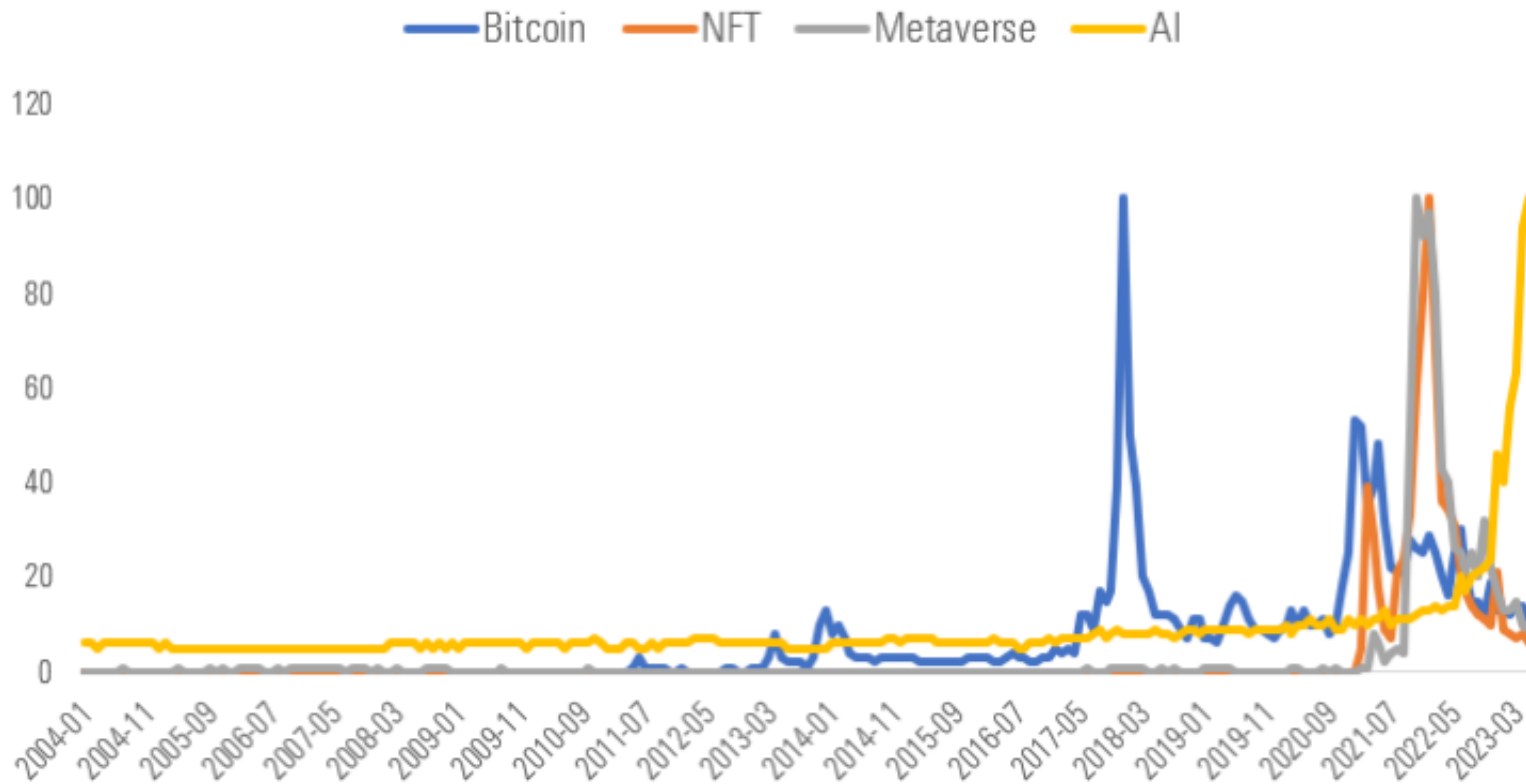
# AI Frenzy



# Everybody is talking AI

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

## Google Trends by Word



## 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.

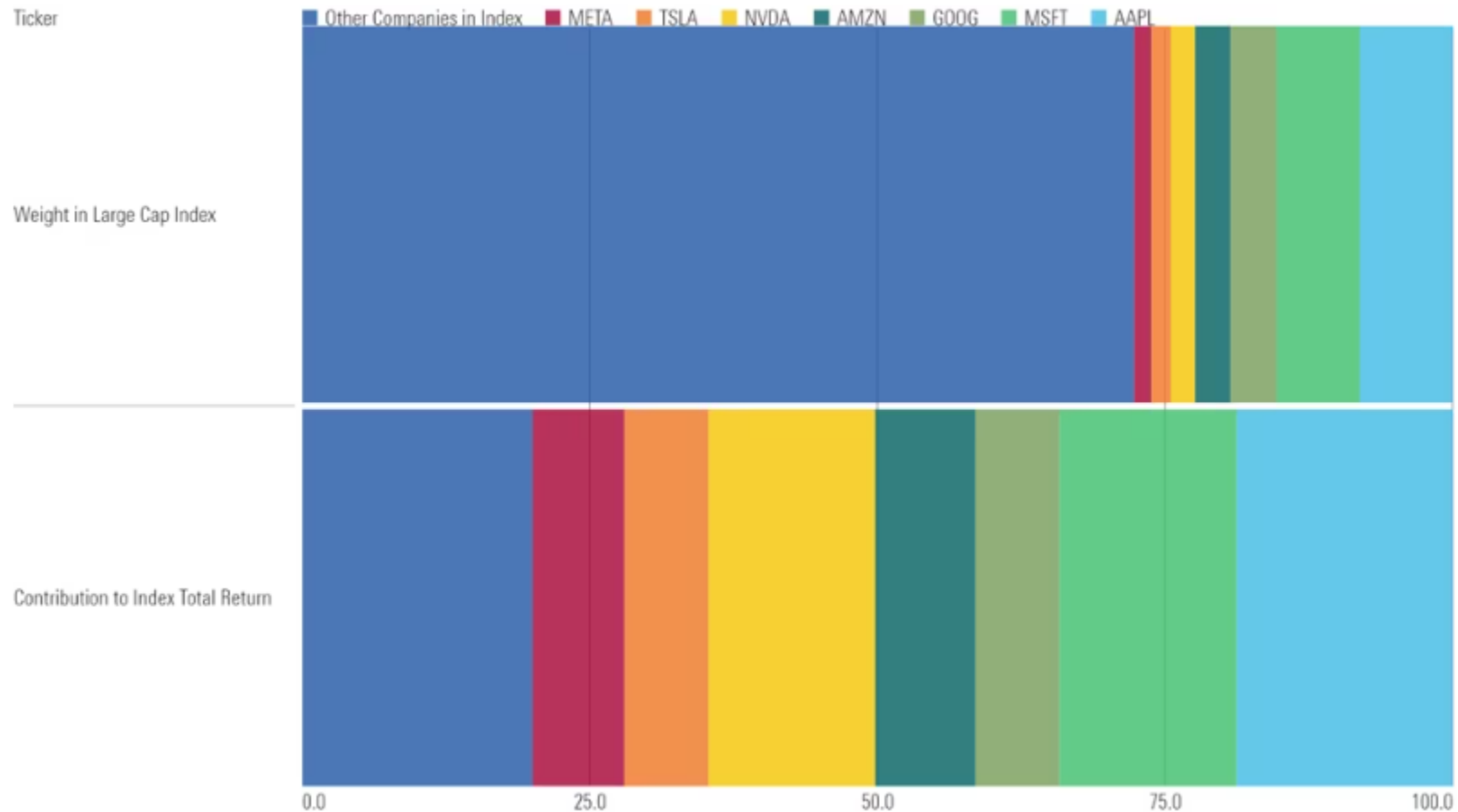
Source: Google Trends as at 30/06/2023. Past performance is no guarantee of future performance



## ...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 bond real yields (2004-2023, %p.a.)

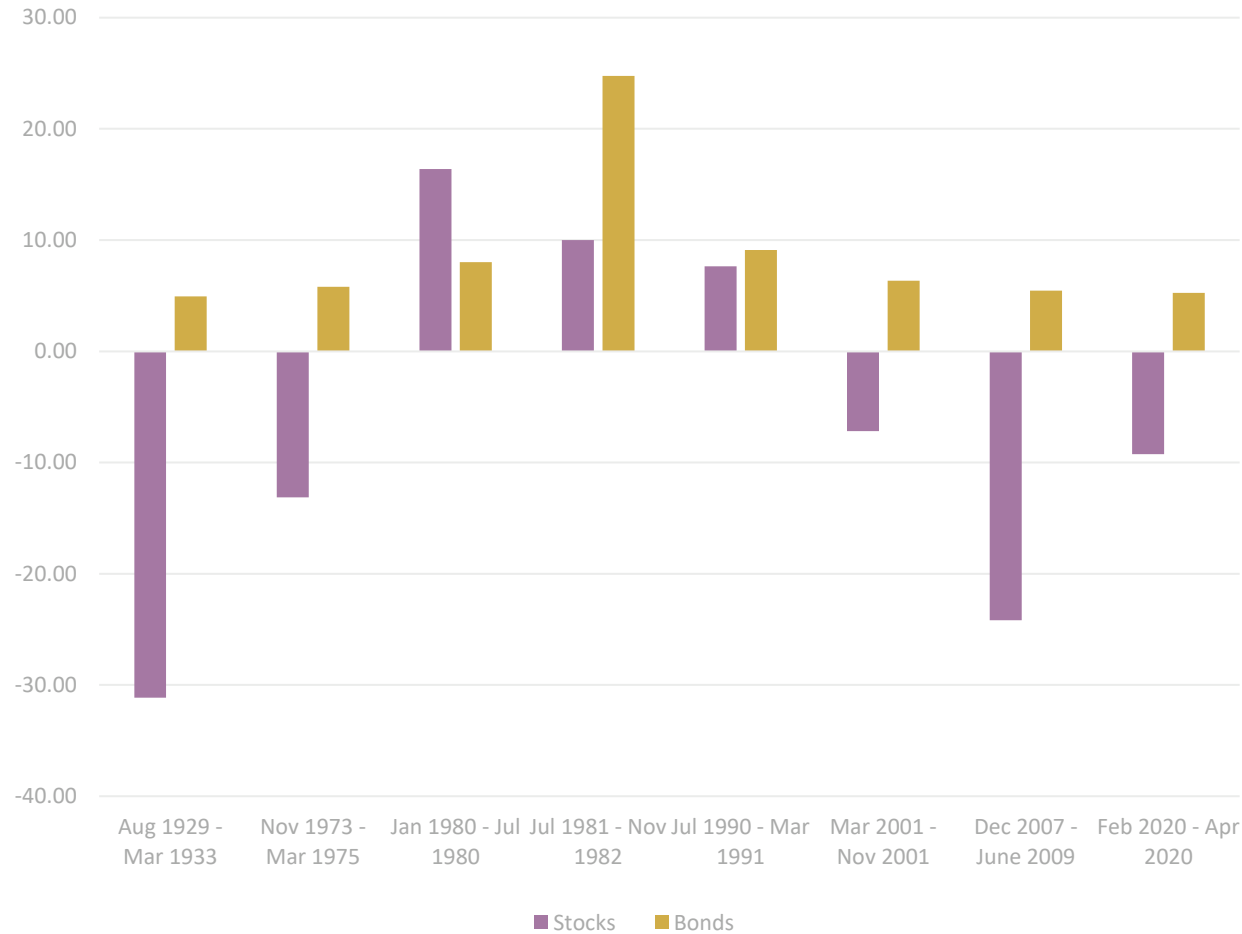


UK Inflation Linked Bonds are more attractive due to

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

## Managing against the risk of recession?

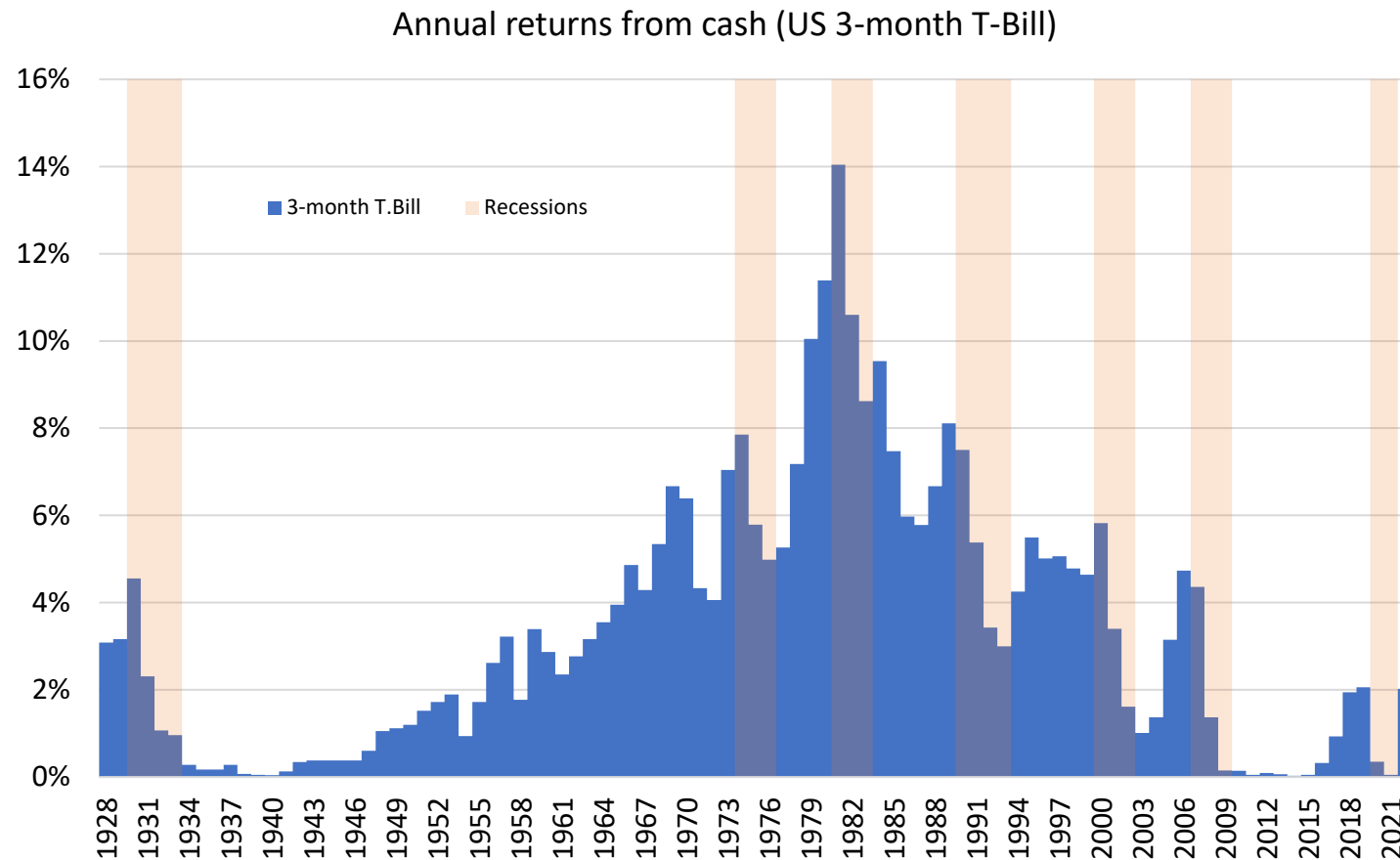
Key takeaway: While bonds disappointed as diversifiers in 2022, they've historically performed well during economic downturns.



- 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.

# 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.

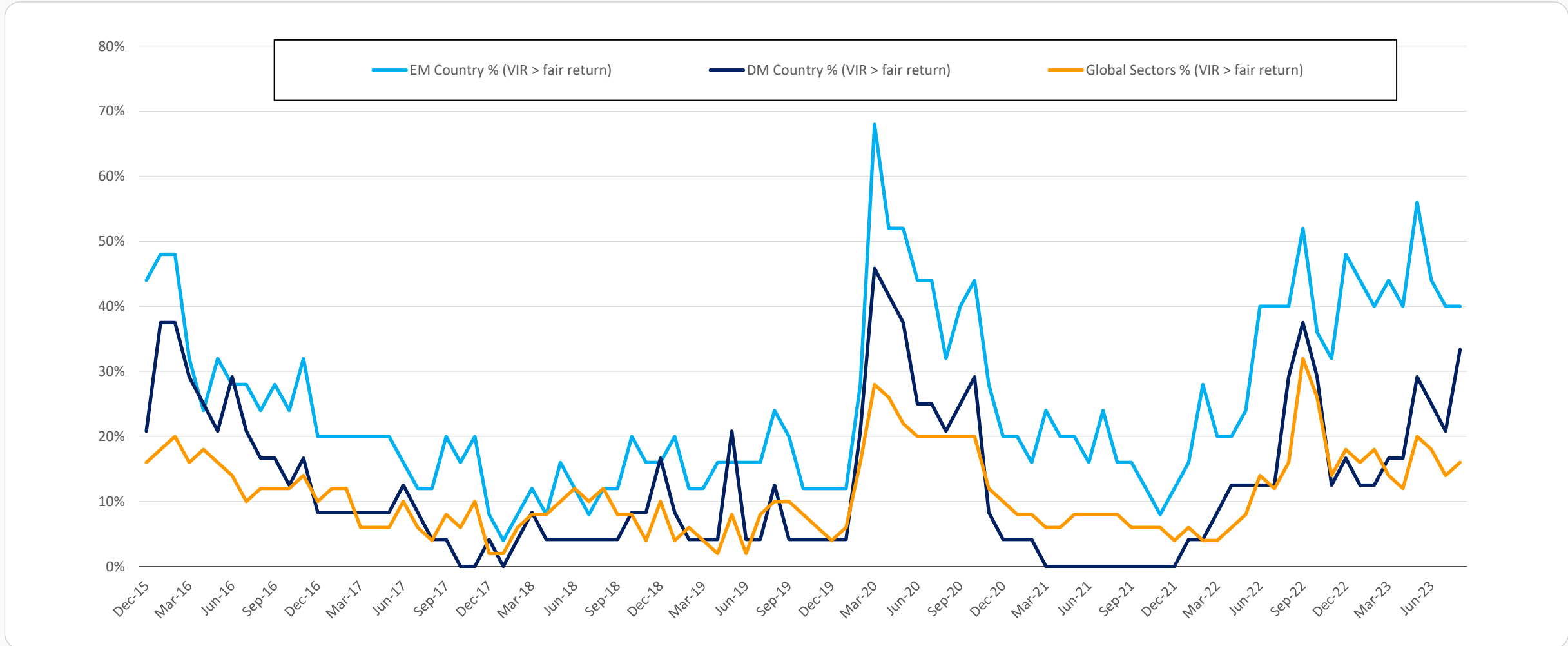


# Where are the opportunities?



# 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



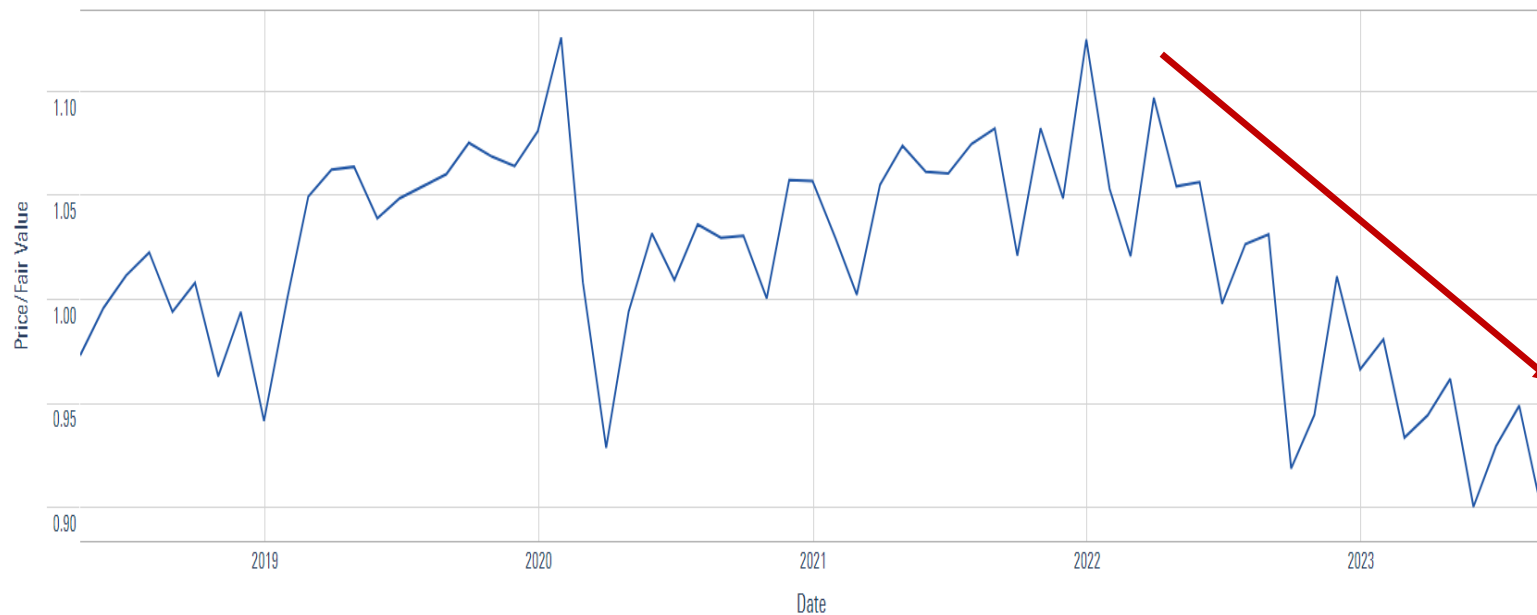
Source: Morningstar Direct, from 30/09/2020 to 30/09/2023

# 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

Global Listed Infrastructure– Price/Fair Value



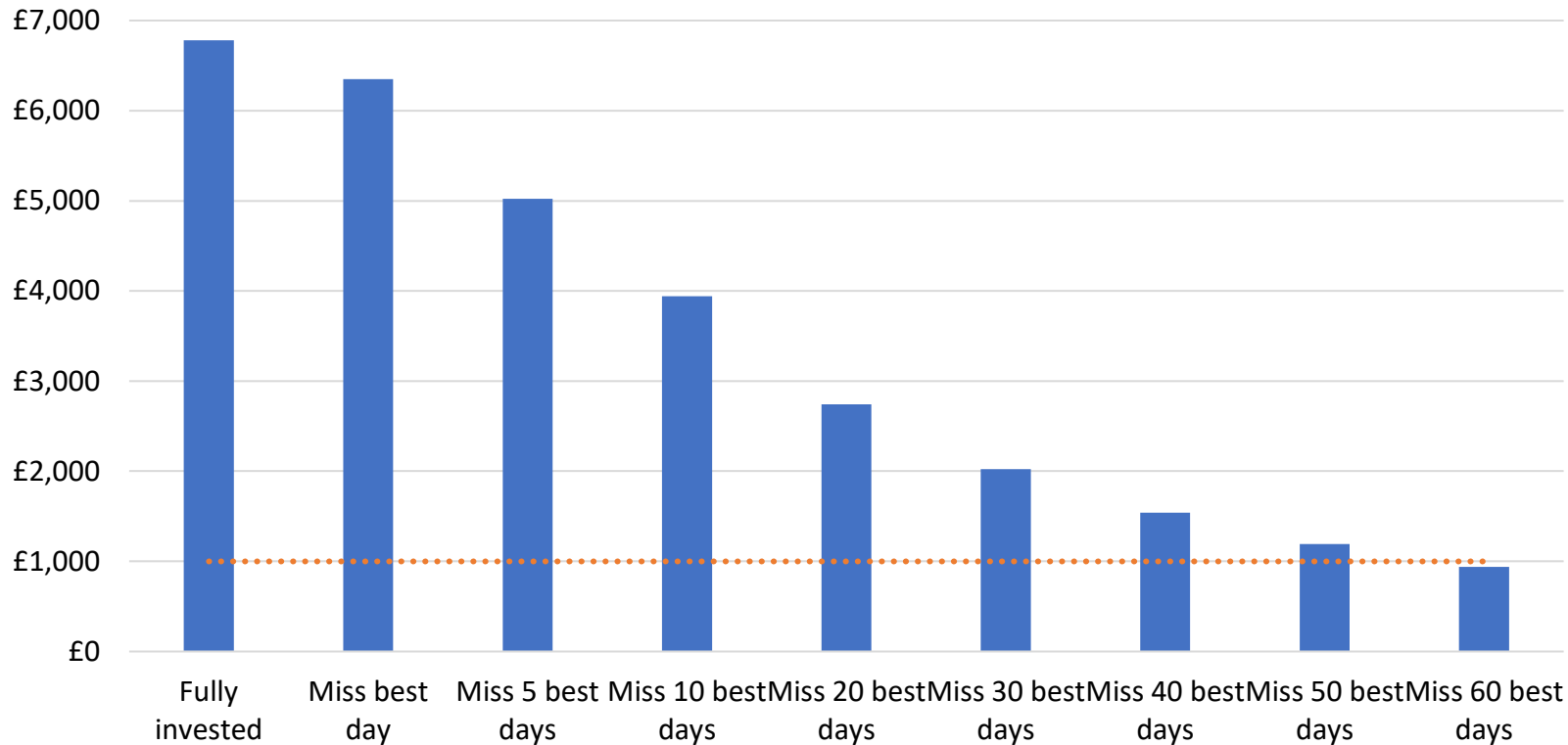
## Why Core Infrastructure / Utilities?

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

## Does not pay to “time” the markets

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

**Staying invested: Missing the best days**  
20 years, initial £1,000, MSCI ACWI before fees



- 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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