Morningstar Moderate Portfolio

Portfolio Commentary

- For the third quarter in a row, stocks and bonds have fallen. The selloff has been broad-based and indiscriminate.
- Central banks remain serious about bringing down inflation, contributing to deteriorating investor sentiment.
- Fears of a global recession continue, with the U.S. dollar reaching new highs.
- On a positive note, valuations of stocks and bonds continue to improve, sowing the seeds for future returns.

Investors continue to be nervous, with asset prices falling across the board. Stocks have now fallen for three quarters in a row, while bonds have equally headed south. Nine of the 10 major equity sectors also fell in the third quarter of 2022, highlighting the indiscriminate nature of the selloff we're currently experiencing.

There are two broad schools of thought emerging. One is that the setback has created a healthy reset—improving valuations and sowing the seeds to future returns. The other is that we're in the middle of a new post-stimulus world with harder realities ahead.

Either way, as we get closer to the end of 2022, it's clearly become a year that's tested even the most hardened of investors. Exuberance has given way to pessimism, driven by weakening corporate profits, concerns about slowing consumer demand, liquidity tightening, and the potential for recession as the central banks redoubled their commitment to bring inflation down.

At a deeper level, inflation has remained stubbornly high, with core inflation becoming a contributing driver (earlier, it was energy prices that drove inflation, along with loose monetary policy). The ongoing war in Ukraine has also continued to wreak havoc on global supply chains and energy supplies. China, which represents close to 19% of global gross domestic product, is struggling with a sharp economic slowdown. Earnings warnings from high-profile global companies, such as FedEx, among others, have spooked investors.

Indeed, we are swimming in a sea of red, offsetting some of the prior gains that investors had enjoyed. The experience of the past three months also shows that sometimes market rules of thumb—such as bonds moving in the opposite direction of stocks—are a sign that a broader definition of diversification may be needed, with portfolio robustness a key focal point.

Among equities, there have been few places to hide. Whether we're talking about value versus growth, or large versus small companies, there are very few winners. Even the defensive sectors have sold off, including healthcare and consumer staples. One key issue is that the market is anticipating a decline in corporate earnings on the horizon—the magnitude and duration of which are hard to know in advance.

Turning to fixed income, both government and corporate bonds have felt the pain, with broad-based losses across the risk spectrum. The most aggressive moves continue to come from long-duration bonds, which carry a higher sensitivity to interest rate changes. The silver lining is that the yields on most fixed-income assets are much higher.

Yet, for all the talk about stocks and bonds, it was currency that took the headlines in the third quarter. The U.S. dollar has had a remarkable run, reaching new highs against almost every other major currency, while some notable deterioration occurred in Europe—especially the British pound. This flight to safety toward the U.S. dollar is commonplace in a fearful market, but it can exacerbate issues for global companies as well as emerging markets that borrow in U.S. dollars.

With so few places to hide, it's understandable that investors are feeling very nervous. However, for those still investing, the outlook is improving as lower prices imply higher returns. Valuations, on almost every measure, continue to improve. In such environments, it's helpful to think about investing as a little like farming—there are times when we (Morningstar) are harvesting previous gains and times when we are sowing the seeds for future returns. As prices fall, we're moving into sowing season.

As it stands, equity prices are in a similar place to where they were in the last quarter of 2020, so investors are likely to be further along in their journey toward their financial goals than they expected to be when they started.

However, for valuation-driven investors (who aim to buy assets at discounts to what they're worth), periods like this can result in

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tremendous opportunities. The uncertainty that dominates the headlines today can lead investors to cut and run, leaving upside to those willing to invest and stay the course for the long run.

Broad domestic fixed income indices stabilized somewhat in the quarter, with the FTSE Canada Universe Bond Index up 0.5%. Shorter term bonds remained negative, with the FTSE Canada Short Term Bond Index down 0.3%. Canadian Real Return Bonds recovered slightly, with a 0.7% return in the quarter. Returns in global fixed income continued to be negative, with the FTSE World Government Bond Index down 4.2% in local terms, and down 1.6% in Canadian dollars in the period.

Domestic stocks, as represented by the S&P/TSX Composite, continue their negative trajectory, albeit at a more moderate pace from Q2, and slumped 1.4%. Sector performance was mixed, with Industrials, Consumer Discretionary, Consumer Staples and Materials each delivering low positive returns in the quarter, with other sectors dropping low to mid single-digit percentages.

The S&P 500 was up 1.2% in the quarter in Canadian dollar terms, masking a 5.0% loss in $USD. The MSCI EAFE Index of foreign developed markets fell 3.4%, and the MSCI Emerging Markets Index dropped 5.8%.

The Morningstar Moderate Portfolio underperformed its blended benchmark[1] during the third quarter.

Positive Contributors

- Global Energy exposure
- Active manager Mackenzie Ivy Canadian Fund
- Active manager Templeton Global Bond Fund

Performance Detractors

- Currency Hedged U.S. Equity exposure
- Active manager Galibier Canadian Equity Pool
- Active manager CI International Equity Fund

Activity and Valuation-Driven Asset Allocation Positioning:

We made no changes to the portfolio composition in the quarter, and our targets remain approximately 1% below neutral weight in equities.

Abstracting from the short-term headlines, recent price declines have set the stage for a much-improved long-term investing environment, in our view. The selloff has also led to an improvement in broad equity markets valuations.

With real yields reaching their highest level since 2009, we assign a medium conviction to core fixed income markets, indicating a more balanced reward for risk picture within bonds today.

In face of a challenging market environment, the Morningstar global sentiment index has made a U-turn, moving from levels associated with extreme exuberance to moderately pessimistic within less than a year. Along with the shift in sentiment, we have witnessed considerable repricing *within* asset classes as high-flying technology companies and other speculative assets such as cryptocurrencies have sold off strongly.

Periods of market volatility can be unnerving for clients. These are the times when special attention should be given to managing our behavioural biases as investors. At Morningstar, we follow a disciplined valuation-driven investment process guided by a set of investment principles that keep us focused on the long-term and what we believe really matters fundamentally. Periods of uncertainty often lead to the biggest opportunities in the market, as market participants overreact to news.

Our history, which spans over five decades, has taught us five key lessons: 1) to be long-term minded, 2) to use a consistent framework for assessing value, 3) to deeply assess fundamentals, 4) to think contrarian, and 5) to understand where you are in the capital cycle. As we navigate markets today, we remind ourselves of these lessons and remain convinced that better days lie ahead.

[1]The Morningstar Moderate Portfolio's benchmark comprises 43% FTSE TMX Canada Universe Bond Index, 12% FTSE World Government Bond Index in Canadian dollars, 12% S&P/TSX Composite Index, 28% MSCI All Country World Index ex Canada IMI Index in Canadian dollars and 5% FTSE TMX 91 Day T-Bill Index.

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