

Morningstar Balanced Portfolio

Portfolio Commentary

- After a dramatic 2020, we (Morningstar) have seen the green shoots of “reflation”, with several significant developments co-existing.
- We’ve witnessed strong returns for equities but weak returns for bonds in the first quarter of 2021.
- Among equities, the corners of the markets that had been hot—in some cases for years—turned cold.
- In the bond market, dormant expectations for inflation began to emerge, leading to losses across interest-rate-sensitive parts of the market.

What a difference a quarter of a year makes. After a dramatic 2020, we have seen the green shoots of “reflation”, with several significant developments co-existing. The major market influences are a) inflation expectations are higher with central banks, for now, willing to let prices rise, b) economic growth forecasts increasing following solid vaccine progress, c) company reporting broadly exceeding expectations, d) geopolitical tensions and systemic risks softening, and e) investors conditioned by strong returns through good news and bad.

This culminated in strong returns for equities but weak returns for bonds in the first quarter. Among equities, the corners of the markets that had been hot—in some cases for years—turned cold. In fact, we saw a remarkable change with value stocks at the top of the leaderboard, buoyed by energy and financial companies, and technology stocks landed in the unusual position of worst performers. Smaller companies more likely to have their fortunes tied to the strength of the economy were among the best performers. Dividend-payers, which struggled in 2020, also saw a first-quarter recovery.

In the bond market, dormant expectations for inflation began to emerge, leading to losses across interest-rate-sensitive sectors of the market even as central banks committed to easy-money policies. The first-quarter bond sell-off hit government bonds the hardest, followed by safer core and corporate bonds. Only high-yield bonds managed to end the quarter just in positive territory.

In the background, the yield curve (which looks at the effective interest rate for governments over different time periods) steepened severely from three months ago on expectations for stronger economic growth. For example, the 10-year government bond yield in Canada rose from 0.67% to 1.55% in the quarter, reaching pre-pandemic levels.

On a year-over-year basis, a more compelling story emerges as the scope of the bounce back from the depth of last year’s brutal bear market becomes clear. From where it ended in the first quarter of 2020, stocks are up significantly.

Meanwhile, under the hood of the stock market, we continue to see significant changes in leadership. Perhaps most notable is the recent strength in value stocks, which have been lagging significantly in recent years. Still, the longer-term performance gaps in preference of growth stocks remain wide. While losing the least in the bear market, wide-moat stocks have lagged in the recovery.

Domestic fixed income indices were shaken in the first quarter, with the FTSE Canada Universe Bond Index declining 5.04% and the FTSE Canada Short Term Bond Index down 0.59%. Returns in global fixed income also lagged, with the FTSE World Government Bond Index down 3.09% in local terms, and down 6.95% in Canadian dollars in the period. Canadian Real Return Bonds suffered with a -7.3% return in the quarter.

Domestic stocks, as represented by the S&P/TSX Composite, had another strong return of 8.05% in the first quarter. Health Care had the highest returns, up 38.3% in the period, and the Energy sector continued its rebound with a 29.1% return. Small Cap stocks continued to run ahead of the broader market, with the S&P/TSX Small Cap index up 9.74%.

The S&P 500 gained 4.63% in the first quarter in Canadian dollar terms. The MSCI EAFE Index of foreign developed markets rose a comparatively modest 2.09%, and the MSCI Emerging Markets Index rose 0.91%.

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Morningstar Balanced Portfolio

The Morningstar Balanced Portfolio outperformed its blended benchmark¹ during the first quarter.

Positive Contributors

- Relative performance in foreign fixed income from PIMCO Monthly Income Fund.
- Energy exposure via Global X MLP & Energy Infrastructure ETF and iShares Global Energy ETF.
- Value stocks in Beutel Goodman American Equity Fund.
- U.S. Financial Stocks.

Performance Detractors

- Absolute returns from active domestic fixed income managers.
- Active managers Canoe Defensive International Equity Fund and Capital Group Global Equity Fund.

Activity and Valuation-Driven Asset Allocation Positioning:

After an active 2020, the first quarter of 2021 saw no changes in our target exposures.

Overall, the portfolio remains slightly below a neutral weight in equities versus our benchmarks. Intra-equity, we continue to remain overweight non-U.S. equities, specifically value-leaning securities, and sectors such as energy and financials, and countries such as Japan, the U.K., Germany, South Korea and Mexico as they remain among the more attractive areas in the equity market by our analysis.

In fixed income, we remain slightly underweight duration and overweight emerging-markets debt. Despite the low probability of inflation rising in the short term, we remain overweight Real Return Bonds for diversification and as a form of insurance against unexpected future inflation.

¹The Morningstar Balanced Portfolio's benchmark comprises 30% FTSE TMX Canada Universe Bond Index, 8% FTSE World Government Bond Index in Canadian dollars, 18% S&P/TSX Composite Index, 42% MSCI

All Country World Index ex Canada IMI Index in Canadian dollars and 2% FTSE TMX 91 Day T-Bill Index.

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