Morningstar Conservative Portfolio

Portfolio Commentary

- Global stock and bond markets have faltered in recent times, with inflation worries and the China crackdown influencing returns.
- A few bright spots exist, including energy companies and Japanese stocks.
- Emerging markets are among the biggest laggards, with Chinese technology companies falling heavily.
- Looking ahead, the supportive environment is evolving quickly and requires a watchful eye. We (Morningstar) are broadly positioned for a continuation of the economic recovery, although we retain a defensive ballast.

The global rally in asset prices has faltered in recent times. While some equity markets continue to post modest gains, the total return backdrop has paled in comparison to recent memory, with emerging markets a particular sore point. Thus far, it is more akin to a stumble than a fall, with year-to-date returns still strong and the post-pandemic recovery intact. Several factors are at play, but the two prominent influences are 1) inflation fears, and 2) the China regulatory crackdown.

Inflation fears have been with us for most of 2021 yet continue to be regarded as the biggest tail risk—potentially derailing both equities and bonds. More recently, this has included central bank dialogue around a gradual tapering of its loose monetary conditions. While some see the inflation increase as being driven by a rebound from depressed prices in 2020 (the so-called "base rate" effect) and/or temporary supply-chain issues, others point to massive fiscal and monetary stimulus contributing to a structural increase in inflation. The reopening of businesses is another contributor, although this has lost some steam as the delta variant continues to create economic challenges.

The combination of rising inflation worries and central bank tapering translates into rising bond yields. This was perhaps the most noteworthy financial market move late in the third quarter of 2021, influencing the returns of both stocks and bonds.

For equities, a rise in bond yields typically equates to downward pressure on stock prices—all else being equal—and that's exactly what we saw in the third quarter. The obvious exception were energy companies, which saw another meaningful boost to returns, supported by higher commodity prices. Japan was another rare bright spot. To the downside, we saw a remarkable shift in Chinese technology companies and the potential bankruptcy of a large real estate developer, Evergrande. This Chinese weakness carried contagion fears, bringing down the entire emerging market basket and practically wiping the gains year-to-date. Small-cap stocks also fell late in the quarter, giving back some of their lead over large-cap stocks in the past year.

For bonds, inflation fears are driving yields higher and have helped inflation-protected bonds. On the other hand, nominal government bonds have failed to offset equity risk recently, generally posting modest negative returns. Longer-dated government bonds are now down meaningfully year-to-date, while emerging market bonds in local currency are also down. Higher-quality corporate bonds are generally doing better and broadly flat, despite a rise in volatility. Currency moves are the final piece of the puzzle, where we have seen recent strength in safe-haven currencies like the U.S. dollar.

The supportive environment is evolving quickly, and all eyes appear to be on inflation at the moment. Regarding the recovery, most of the cyclical upswing may now be behind us, although we continue to see positives. The key now is to stay a step ahead of the pack, positioning portfolios in a way that reflects longer-term forward-looking realities.

Many investors remain encouraged by the economic recovery, with strong corporate earnings and cheap interest rates, and so continue investing full throttle. Others are beginning to question the durability of the recovery. This type of bifurcation among market participants is normal at this stage of a recovery, as the economic cycle matures, and the positive dataflow softens somewhat.

Broad domestic fixed income indices delivered mixed returns in the quarter, with the FTSE Canada Universe Bond Index down 0.51%. Shorter term bonds were a relative haven, with the FTSE Canada Short Term Bond Index up about 0.08%. Returns in global fixed income were modestly positive, with the FTSE World

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Government Bond Index virtually unchanged in local terms, but up 1.04% in Canadian dollars in the period. Canadian Real Return Bonds dropped 0.27% return in the quarter.

Domestic stocks, as represented by the S&P/TSX Composite took a breather, with a 0.17% showing in the third quarter. Consumer Staples had the highest returns, up 4.61% in the period, and the Industrials sector was up 3.94%. Small Cap stocks lagged broader market, with the S&P/TSX Small Cap index down 2.54%.

The S&P 500 gained 2.90% in the third quarter in Canadian dollar terms. The MSCI EAFE Index of foreign developed markets gained a more modest 1.85%, and the MSCI Emerging Markets Index had a steep drop of -5.97%.

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

Positive Contributors

- Short term bonds.
- Japanese stocks.

Performance Detractors

- Foreign bonds from active manager Templeton Global Bond Fund.
- Active manager Invesco Select Emerging Markets Pool.

Valuation-Driven Asset Allocation Positioning:

The market rally has been strong and sustained, with robust asset returns over the past year and a half. We have continued to see the general tide shift toward some of our higher-conviction asset classes and we remain constructive on these areas as they rebound. We believe the portfolios are set up well to benefit from further normalization of the global economy as businesses hurt by the pandemic continue to recover, and we are encouraged by the gains enjoyed thus far by some of our cyclical value positions.

The portfolios' overall targeted equity levels remain a couple of percentage points below their benchmark weights, which mainly reflects what we consider to be rich valuations in the United States as well as the fact that some of our opportunistic positions contribute some extra beta. Within equity we remain overweight non-U.S. equities, including both developed and emerging markets. And the overall equity portfolio is leaning towards traditional value sectors, with an underweight in growth stocks. This is a result of relative valuations, with a number of growth stocks sporting pricey multiples, in our view. We have targeted extra exposure in energy. As a partial offset to the economic sensitivity energy and the portfolios' overall value leaning, we also have some extra Japan exposure for defensiveness. We continue to see return potential in emerging-market stocks and maintain a modest overweight in this area.

Within bonds, we remain modestly short of benchmark duration. With yields still low, we see little benefit to further extending overall duration. We continue to be overweight emerging-market debt—one of the few fixed income asset classes that looks attractive to us. We are growing more cautious on high-yield bond exposure given current narrow credit spreads. We remain overweight in real return bonds as a hedge against future inflation, although given that breakeven rates have risen, our conviction has been reduced.

[1] The Morningstar Conservative Portfolio's benchmark comprises 54% FTSE TMX Canada Universe Bond Index, 16% FTSE World Government Bond Index in Canadian dollars, 6% S&P/TSX Composite Index, 14% MSCI All Country World Index ex Canada IMI Index in Canadian dollars and 10% FTSE TMX 91 Day T-Bill Index.

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