From the Desk of the CIO
Marta Norton Shares What’s Top of Mind: November 2023

My Takeaways
▸ Beware the rising specter of geopolitical risk; it is rife with behavioral traps.
▸ Our focus in these troubling times? Portfolio construction and the fundamentals that drive long-term asset prices.
▸ Here in the U.S., we’ve spent 2023 at the short end of the curve but rising longer-term yields have caught our attention.
▸ Relatedly, we’re more enthused about fixed income returns than we’ve been in more than a decade.

Interested in knowing my thoughts on a particular topic? Email us at wealth.us@morningstar.com with your ideas and feedback!

Chart of the Month
Given the events of the past month, it’s no surprise to see geopolitical risk indexes jump higher.

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Exhibit 1: 30 Day Moving Average of Daily Geopolitical Risk Index

It is impossible to find the words to describe the terrorism in Israel on Oct. 7, 2023, or the ensuing humanitarian crisis that has since developed in Gaza. Like the rest of the world, I find the daily headlines a sobering reminder of the value we should all place on human life; my thoughts and prayers are with those who are suffering.

As CIO for the Americas within Morningstar’s Wealth business, it’s also my team’s responsibility to assess the economic and investment implications of the conflict. Herein lies the behavioral trap. Faced with developments of this magnitude, it’s tempting to jump to conclusions on how the conflict will take
shape, buying and selling asset classes on overconfident speculative views around oil, for example, or the global economy.

Two key words: overconfident and speculative. The future is always unknowable, but especially in times like these, where the range of outcomes doesn’t follow a normal distribution.

So, what to do? Buy-and-hold, and assume it will all work out? After all, the U.S. stock market has survived and thrived despite a cacophony of wars, pandemics, recessions, and more.

Exhibit 2: U.S. Stock Market Since the Great Depression

![Graph showing growth of S&P 500 index from January 1926 to January 2020.](image)


Well, in many cases, yes. A portfolio that’s well calibrated for a person’s time horizon and risk profile doesn’t need constant adjustments for every geopolitical crisis that develops.

But what if a geopolitical crisis threatens the cash flows that drive long-term returns? In that instance, ignorance isn’t necessarily the best approach. For example, when Russia invaded Ukraine nearly two years ago, questions emerged around Russian exposure within European banks and the earnings power of German companies. We owned positions in both markets, and while prices appeared attractive, we spent several months conducting scenario analysis around adverse outcomes to ensure we understood any structural or permanent impairments. That work helped us size the positions for the risk, while maintaining exposure to markets that ultimately proved resilient in the ensuing years.

For most investors, direct investment exposure to today’s developing crisis in the Middle East is minimal. So rather than concerns surrounding impaired cash flows, risks relate more to oil markets and the broader economic impact at a time of a potential global slowdown.

This type of risk is nothing new; a multi-asset portfolio that invests in asset classes designed to offset one another — global stocks, bonds of both short and long maturities, and (at least for us) hedged alternatives designed to have limited interest rate risk — shouldn’t be undone by economic shocks. However, I’d argue the best protection for unforeseen events is when investors truly understand the offsets they’ve embedded in their portfolios according to two overarching principles:
1. “Safe haven” and “diversification” characteristics aren’t permanent; they vary based on the prevailing environment.
2. Not only does the environment matter to the fundamental drivers of return, but so does the price an investor pays for the underlying asset class.

We’ll look at these considerations from the perspective of bonds below.

**Yields at 5%? Now That’s Getting Interesting**

In a market concerned about geopolitical risk, U.S. Treasuries jump to mind as a safe haven. And indeed, in the days immediately following Oct. 7, 2023, we saw the 10-year yield fall, even in the midst of heightened deficit concerns and the Fed’s commitment to higher-for-longer.

But U.S. Treasuries, particularly at the longer end, haven’t felt like a safe haven for the past two-plus years. Since January 2021 through October 2023, the Bloomberg U.S. Aggregate Bond Index is down 6.25%, disappointing 60/40 investors who thought of core bonds as the only necessary safety valve for drawdown protection. This proved costly for retirees or those with short-term investment horizons.

The past few months have been particularly surprising given the long-held “New Normal” assumption of near-zero rates, not to mention January 2023 market expectations for rate cuts by mid-year. With larger Treasury auction announcements and the Fed’s higher-for-longer resolve, the 10-year Treasury yield moved 83 basis points, from 4.05% at the beginning of August 2023 to 4.88% by the end of October 2023.

As difficult as this adjustment has been—and acknowledging the unpredictable outcomes that could come from suddenly higher rates for parts of the economy that assumed low rates in perpetuity—we’re enthused by the future return potential embedded in bonds today. A 4.88% 10-year yield is within the historical model range of 3% to 5% and is, for the first time in our model’s history, above fair value.

**Exhibit 3: Treasury Yield Curve with Fair Value**

But while we celebrate the improved return outlook, we also acknowledge that the role of long duration debt today isn’t what’s been for the past decade or so. Our research has shown us that long-duration debt
Treasuries have less utility when the federal funds rate is above 4% and can be especially disappointing when inflation volatility is high, or rate uncertainty abounds.

**Exhibit 4: Optimal Portfolio Construction at Different Fed Fund Rates**

This should be obvious. We were all taught in investments 101 that duration is a risk, even when it pertains to U.S. Treasuries. However, over the trailing decade, the realization of that risk remained dormant. With the resurgence of inflation following the pandemic, and the Fed’s response, U.S. Treasuries across the curve have revealed their vulnerabilities as aggressive policy rate-setting drove the yield curve higher from an ultra-low interest rate environment.

This is what I mean above when I suggest investors should understand the fundamental drivers of the asset classes they’ve put in their portfolios, and the prices paid for them.

There is a role and a scenario for different types of securities. Misunderstanding that role can prove incredibly costly. Case and point: The 60/40 investor who relies predominately on intermediate- and long-term debt for its volatility-dampening characteristics must understand that the duration inherent in that portfolio means it won’t be protective in an environment when interest rate risk looms large. That’s especially true when yields are at rock-bottom levels.

For more holistic construction, we’ve emphasized short-term bonds in our multi-asset portfolios and have also included hedged alternatives like merger arbitrage and convertible arbitrage, which have limited rate exposure. (In fact, these alternatives have proved more protective than short duration for much of the current period.)

As yields have improved further out on the curve, we think the rate risk is better priced and we are more comfortable extending out the yield curve. Even so, the 10-year yield, while above our assessment of its long-term fair value, isn’t quite as attractive as the two-year yield, which looks even better relative to fair value.
So, it’s a matter of slowly edging in, with an eye on price, rather than a single, big market-timing move. Here’s the larger takeaway: Portfolio construction should be simple, but not simpler than it needs to be considering the full breadth of outcomes in the market.

**Remembering Gratitude this Thanksgiving**

As broadly anticipated, the Fed stayed the course in November but left the door open for a hike in December 2023. We expect the higher yield curve to stay the Fed’s hand next month as well, but we’ll continue to monitor incoming earnings and economic data to assess trends, given the Fed’s data dependence. More broadly, like the rest of the world, I’ll be paying close attention to developments in Israel and Gaza. As we gather to celebrate Thanksgiving later this month in the relative safety of our homes far from war, I’m hopeful we collectively embrace gratitude and empathy.
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03 We invest for the long-term. Taking a patient, long-term view helps people ride out the market’s ups and downs and take advantage of opportunities when they arise.

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