Global Convictions & Outlook

Asset Class Research with a Long-Term Perspective

Morningstar Investment Management
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For Professional Clients

Asset Class Convictions

The goal of assigning a conviction level to an asset class is to distill the attractiveness of an investment opportunity into a single rank. The term "conviction" derives from the Latin verb "convincere," which means to argue.

In assigning an asset class conviction, an analyst trades off the aspects of an investment opportunity that argue for and against it, culminating in the expression of a conviction level. The conviction level is expressed on a five-point scale (Low, Low to Medium, Medium, Medium to High, and High), and serves as a key input into our asset-allocation process.

Our conviction scoring system is based on four criteria: absolute valuation; relative valuation; contrarian indicators; and fundamental risk.

2023 continues to see gains across the board, although we're seeing significant divergence within asset classes. Once again, inflation and interest rates are playing a prominent role, with inflation retreating at different speeds across the world as interest rates near their expected peaks. Economic resilience has been another major theme for the year to date, with stronger than expected growth.

So far, removing the punchbowl hasn't stopped the party, with the market balancing optimism about peak interest rates versus the prospects of a weaker economy. The unwinding of stimulus after a decade of near-zero rates is a complex undertaking, but inflation is coming down and jobs are holding up. Despite clear pressure building in parts of society—especially households and businesses with debt funding needs—the economy is showing resilience. This contrasts with the original consensus that higher interest rates would tip the economy into recession, knocking indebted companies with no profits out and taking the markets down with it.

Exhibit 1. Our Convictions Continue to Evolve, with Selected Opportunities Evident[1]

	Conviction Level				
	Low Poor Reward for Risk	Low to Medium	Medium Fair Reward for Risk	Medium to High	High Attractive Reward for Risk
Equities					
Broad Markets					
U.S.			■		
Japan			■		
U.K.			■		
Europe ex-U.K.			■		
Emerging Markets				■	
Select Countries & Sectors					
Communication Services			■		
Germany				■	
China				■	
Global Energy		■			
U.S. Energy Infrastructure			■		
Bonds					
U.S.					
Treasuries			■		
TIPS			■		
Credit			■		
High Yield			■		
Agency MBS			■		
Municipal High Yield		■			
Emerging Markets					
Hard Currency (USD)			■		
Local Currency				■	

Source: Morningstar Investment Management. Views as of 15th July 2023 and subject to change. For illustrative purposes only. References to specific asset classes should not be viewed as a recommendation to buy or sell any specific security in those asset classes. Conviction is subject to change at any time without notice.

Market Context & Forward-Looking Ideas

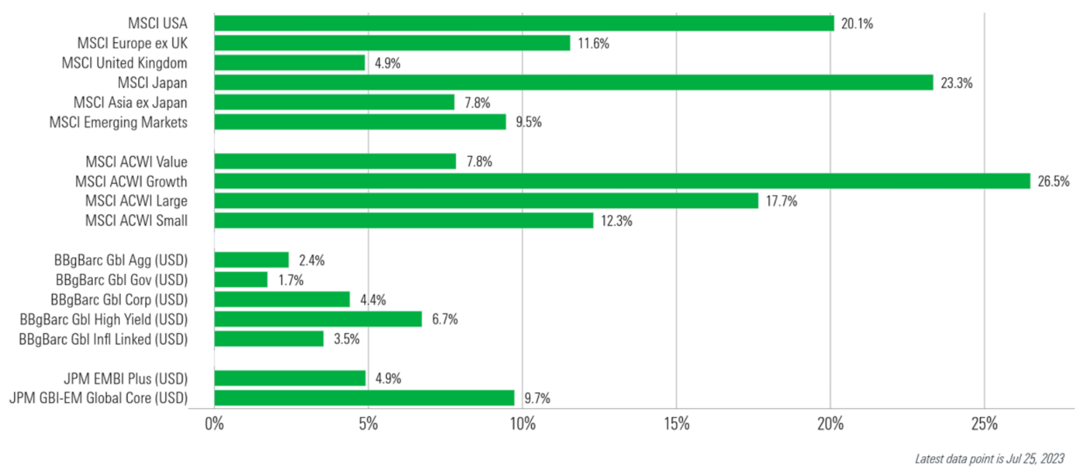
If anything, the prospect of peak interest rates has supported markets, coupled with a new wave of excitement regarding artificial intelligence.

The hype surrounding artificial intelligence has been extraordinary, specifically regarding natural language processing tools such as ChatGPT. This is driving stocks that may stand to benefit from the unlocking of growth and disruption, as investors wrestle to understand the winners and losers. In part due to this, we witnessed unusually high concentration in a number of companies dominating the index returns. The "magnificent seven" was a term coined to celebrate the dominance of a selected few winners.

From an asset-class standpoint, we're also witnessing a few noteworthy developments:

- Stocks are beating bonds by a healthy margin in 2023, although this is not synchronised.
- Unlike a typical bull market, developed world stocks are outperforming emerging markets. Large companies are also outperforming small companies.
- Defensive assets continue to be shaped by higher-than-usual rates, especially for short-dated bonds.

Exhibit 2. 2023 Year-to-Date Outcomes of Major Market Indexes



Source: Clearnomics, Morningstar, MSCI, Bloomberg, JPMorgan, as of July 26, 2023. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Reference to specific asset classes should not be viewed as a recommendation to buy or sell any specific security in those asset classes.

Given the recent gains, it is healthy to question the likelihood of continued strength. We live in a world of continued uncertainty. In our view, the question for investors isn't whether to raise the sails and ride the tailwind of a new bull market, or to batten down the hatches in preparation for a near-term squall, but rather how to best position their portfolios based on today's valuations.

As investors rather than economists, and opting for true diversification, we see opportunities for those willing to expand their horizons, with a few selected areas particularly interesting. These are expressed in the portfolios we manage, with sizing and access dependent on the mandate served. A shortlist of our convictions include:

- Short-duration bonds and inflation-protected securities
- Defensive equities like healthcare and consumer staples
- Emerging-markets debt
- German equities
- Chinese tech stocks
- Brazilian equities
- Broadly neutral on stocks to bonds.

Valuation-Driven Asset-Allocation Views (as of July 2023)

EQUITY MARKETS

Asset Class	Conviction
U.S. Equities	**Medium**
• Consumer Staples	Low to Medium
• Healthcare	Medium
• Energy Infrastructure	Medium
• Financials	Medium

Rationale

Backdrop

Optimism was in short supply entering 2023. With 2022 having been one of the most significant draw-down periods experienced , sentiment surveys were at historical lows, most Wall Street equity strategists were predicting negative returns, while the possibility of a recession was a standard talking point.

Thus far in 2023, equity markets have looked beyond all of it. The Nasdaq put together a historic first half, finishing up 32% for its best start to the year since 1983,[2] while other major U.S. equity benchmarks were meaningfully positive as well. The markets most recent trough was in October, and many major U.S. equity benchmarks are up more than 20%, signalling a new bull market[3], if only by the technical definition.

It remains to be seen whether the first half's positive returns can be sustained. Worries remain, including the Fed's path, inflation's trajectory, and lofty valuations. There are also potential concerns that the markets returns were dominated by a select few companies (mostly technology) in the first half, and it may infer we're living through a "bear market rally."

But whether you call something a bull market, or a bear market is semantics. It may affect how things are recorded in the history books, but naming conventions don't change the quantifiable facts: Markets have charted a consistent upward course since October.

Outlook

It's important to note that our conviction for the U.S. equity market remains a Medium overall conviction—which implies a balanced approach is warranted. The scores across two key "pillars"—absolute valuation and relative valuation—have improved moderately, while scores for contrarian indicators and fundamental risk remained unchanged. This is not to say that we consider U.S. equities to be an outright bargain—we don't. But our process tells us that the situation has moderately improved, which is reflected in our conviction.

At a deeper level, valuation spreads—the disparity in valuation levels between sectors—has narrowed. More pointedly, in this environment, we see fewer opportunities to be granular. In 2020–21, we identified opportunities clustered in more cyclical (or economically sensitive) areas of the market. Specifically, regarding energy stocks: Our valuation approach incorporates a mean-reversion framework for energy prices longer term, which leads us to conclude that energy producers in particular have become fairly valued, but we acknowledge that a prolonged period of structurally higher commodity prices has not been fully priced into these shares and also that companies have shown fairly strong capital discipline even as pricing has firmed, which is a significant, positive departure from previous cycles. Energy infrastructure shares remain relatively appealing within the energy sector. On financials, our research leads us to believe that large U.S. banks are still relatively attractive. The last area on our radar is defensive sectors, most notably healthcare, which have improved in our relative rankings and could help offset equity risk as it is not highly correlated with economic cycles. Regarding technology stocks, we don't assess these stocks with a broad brush, though we are wary of the potential for a crowding situation in the sector, which in aggregate has been "over-earning" relative to its own history (meaning, profit margins of late have been elevated versus long-term averages). So, care is required in this space, especially with interest-rate rises and valuation multiple implications from those increases.

All this to say—a long-term perspective remains a critical ingredient for investor success. This is perhaps even more relevant during periods of market volatility.

[2] Source: Morningstar Direct, as of 30/06/2023.

[3] Source: Clearnomics, as of 30/06/2023.

Asset Class	Conviction	Rationale
Europe ex-U.K. Equities	**Medium**	**Backdrop**
• European Communications	Medium	
• European Energy	Low to Medium	
• European Financials	Medium to High	
• European Healthcare	Low to Medium	
• Germany	Medium to High	

Backdrop

European stocks advanced the first half, up more than double digits. There were two key trends observed that seem to drive returns: better-than-expected economic activity and signs that inflation is trending lower.

Europe's inflation rate has been stickier and higher than the U.S. and it's been a major overhang on European equities. But there has been good news on the inflation front. The most recent report showed that euro zone inflation dropped to the lowest level since January 2022, buoying stocks across Europe amid hopes it will temper the European Central Bank's aggressive stance on taming inflation with higher interest rates.

Using survey data, a U.S. recession was a 50/50 proposition to start the year, but in Europe there seemed to be much more confidence a recession would materialise. If Europe is in a recession, it hasn't been pronounced. LVMH—one of the largest companies in Europe and a barometer for consumer health—can be used as one metric to judge the health of the European economy. Their most recent earnings press release simply stated: "Excellent start to the year for LVMH," while elaborating further on record high sales, strong consumer spending, and the return of international travel and tourism. Like the U.S., significant amounts of negativity were priced into European markets entering the year, and a persistent rally has sustained itself since the trough last October.

Going forward, attractive valuations and interesting opportunities are available to European investors. While valuation comparisons between countries aren't a perfect science, certain industry groups in Europe have some of the most reasonable valuations in the developed world.

Outlook

While we generally like European stocks, we find attractive opportunities when we dig into country and sector differentials. For example, we've reaffirmed our attraction to German stocks, which remain an appealing area despite the impact of the Russian conflict. In aggregate, we find German stocks offer solid balance sheets and potential upside to earnings—without eye-popping valuations. At a sector level, our positive view on European-integrated energy companies has moderated following recent strength, as it no longer offers the same valuation appeal. European banks, on the other hand, look more attractive on our analysis.

Asset Class	Conviction	Rationale
U.K. Equities	**Medium**	**Backdrop**

Backdrop

U.K. equities have seen positive returns since the October bottom, but returns have trailed broader Europe and U.S. markets.

Malaise is likely the best description of the current U.K. economy. GDP has barely grown and is still lower than before the pandemic. Inflation continues to be a problem, at the highest rate in the developed world. The unemployment rate has edged up slightly but is still at levels last seen in the 1970s according to ONS data.

Wage pressure has been a focus of the inflation debate as the U.K. is seeing wages rise faster than broader Europe. The persistence of U.K. inflation has led to a higher likelihood of rate hikes looming from the Bank of England (BOE), which is a key difference from other major developed economies. The Federal Reserve is nearly finished with rate hikes and the European Central Bank may soon be finished if, as many expect, core inflation continues trending lower. The BOE, however, has the most challenging task with sticky inflation.

Outlook

Our overall conviction score for the U.K. remains at Medium. While relative valuations remain at Medium to High, absolute valuations is Medium. This means our long-standing belief that investors were being well compensated for the risk of investing in U.K. stocks has softened, coming more in line with international peers.

That said, they remain a solid dividend play, where we have seen many companies reinstate their dividends at more sensible and sustainable levels. Revenue is cyclical given the underlying key sectors of financials, energy, and materials, and we don't expect any material changes to this going forward. Both operating and financial leverage are also stable. From a fundamental standpoint, we note that most U.K. corporates are high-quality businesses, although certain scenarios pose a risk to corporate profitability.

Asset Class	Conviction	Rationale
Australian Equities	**Medium**	**Backdrop** The Australian economy continues to slow as the Reserve Bank of Australia (RBA) put the economy through its most aggressive tightening cycle in modern history to fight inflation since May of last year. As rising interest rates increase debt servicing commitments; the disposable income of indebted households is under pressure. The savings buffer from massive fiscal stimulus programs in 2020 and 2021 has depleted and household consumption is being curtailed. The RBA initially paused rate hikes in April and then resumed its hikes both in May and June, a hawkish tilt that led many economists to see a higher chance of a recession this year given anaemic economic growth. Australian equities are positive for the year though have settled into a tighter trading range after staging a recovery from weakness during March. **Outlook** Headwinds exist but performance this year relative to the major global indices has been subdued. Australian shares retain a Medium conviction, in line with many major global peers according to our analysis. While opportunities do exist at a more granular level—especially for those willing to invest differently to the index—we continue to see greater merit in global exposure, including Germany, China, and other select emerging markets. It would take a further decline in prices before we see outright attraction in this asset class.

Asset Class	Conviction	Rationale
Japan Equities • Japan Financials	**Medium** Medium	**Backdrop** Japanese equities were one of the better-performing global equity markets last year, and that trend has continued. While surging inflation is considered an economic threat in the U.S. and Europe, Japan has a recent history of disinflation and low wage gains, which has made inflation a welcomed guest of sorts. Japan remains an economic outlier as the monetary policy is still ultra-accommodative and GDP growth will likely remain above trend. Domestic spending in Japan is starting to pick up, with the reopening gathering some steam and more tourism returning. Wage growth continues to edge higher, and the stickier parts of inflation (i.e., services inflation) is approaching the Bank of Japan's 2% inflation target. The trade balance with the rest of the world is also improving, in part due to the decline in the oil price (Japan being a net oil importer), which could eventually reduce the pressure on the Japanese yen. Some big investors are taking notice of the positives happening in Japan: Warren Buffett recently increased his exposure to Japanese equities through large positions in five Japanese trading conglomerates, which could potentially send a signal to other market participants that Japanese equities are becoming more attractive. Buffett described his venture into Japanese equities to his fellow Berkshire Hathaway shareholders in May: "They're doing intelligent things, and they're sizable, so we just started buying them," and have been "more than pleasantly surprised" at their progress. **Outlook** We continue to see merit in Japanese equities. For the most part, our conviction in Japanese stocks is built on some major structural change taking place at a corporate level. While much of this structural tailwind is now behind us, we still see scope for a continuation of improving shareholder interests, rising dividend payouts, and board independence. Japanese stocks also carry attractive diversifying properties that can help in broad market setbacks. Sentiment toward Japanese financials has improved significantly over recent months as the Bank of Japan has adjusted its prolonged quantitative-easing program, a step toward interest-rate normalisation.

Asset Class	Conviction	Rationale
Emerging-Markets Equities • China Equities • Brazil Equities	**Medium to High** Medium to High Medium to High	**Backdrop** Emerging market stocks are positive this year, but they continue to lag U.S. equities which has been the same story for roughly a decade. This has been despite the weaker U.S. dollar, which usually is a trigger for emerging markets to outperform. Concerns about China's economy have been a headwind, and these worries seem unlikely to lift over the near-term. China—the largest emerging-market—has observed a bumpy economic recovery since the government abandoned strict Covid measures late last year. Initially, optimism soared but that optimism has cooled off. The Chinese economy is decelerating after a strong first quarter. Consumption remains the key focus this year, and the data continues to indicate the Chinese consumer is cautious. The excess savings in China are lower than in the developed world and are less likely to be spent, given these savings were accumulated without the support of fiscal stimulus. Broadening out, the structural story around emerging markets remains intact. A burgeoning middle class continues to develop in emerging markets and should present interesting opportunities for investors, albeit with higher volatility. **Outlook** We retain our conviction at Medium to High. We consider emerging-markets equities to be among our preferred equity regions (alongside selected European equities). We also need to remember that emerging markets are heterogeneous. Investors tend to bucket emerging markets as one, but often the real opportunities present themselves at a country, sector, or regional level. For example, despite the many challenges confronting Chinese equities, both the absolute and relative valuation remains attractive.

Asset Class	Conviction	Rationale
Global Sectors • Energy • Financials • Communication Services	 Low to Medium Medium Medium	**Backdrop** Inflation and interest rates have been the biggest forces hanging over financial markets this past year. From a sector perspective, there's an uneven distribution when it comes to winners and losers from those forces. The winners? Technology. Just 10 stocks, which account for 30% of the U.S. large-cap market, make up nearly all the year-to-date returns through the end of the second quarter. Nine of those ten companies are in the technology sector. There has also been meaningful outperformance in industrials and consumer discretionary companies, particularly those tied into areas like travel and tourism. The losers? Financials and real estate. Financials struggled through a period of extreme volatility that saw a few regional banks dissolve or get taken over by the government. However, this has also created many interesting opportunities to own financials as the market soured on the entire category and it seems that only a few companies were holding most of the risk. Real estate—particularly commercial real estate—has also struggled as higher rates have created a headwind and specific segments like office space are dealing with low occupancy rates and uncertain futures, in effect, making them less valuable in the eyes of investors. **Outlook** The opportunity to add value via sector positioning has narrowed. That said, we continue to see opportunities, especially at the defensive end. Let's start with energy stocks, given their extraordinary run. This sector was among our highest-ranking opportunities last year and has enjoyed a period of elevated commodity prices. However, this opportunity has narrowed. Communication services too has seen a reduction in appeal and has been downgraded to a Medium score. Weakness over the course of 2022 was caused by a combination of rising discount rates, slowing revenue growth, as well as some stock specific concerns. The negative sentiment reached fever pitch levels in October and November 2022. Over the first half of 2023, the narrative around some of the largest players changed with sentiment becoming decisively less bearish. Defensive value-oriented areas of the market continue to live up to their reputation and have held up relatively well during the downdraft. Sectors include healthcare, utilities, and consumer staples, all of which provide services that are required in both good and bad times. Generally, stocks in these categories are less volatile and less affected by the ups and downs of long-term market cycles. This could be important if we see a broad-based decline in corporate earnings.

FIXED INCOME

Asset Class	Conviction
Developed-Markets Sovereign	
• U.S. Treasuries	Medium
• Euro Government	Low-to-Medium
• U.K. Gilts	Low to Medium
• Japan	Medium
• Australia	Medium

Rationale

Backdrop

The bond market has not provided the defensive features over the past two years that investors grew to love it for in the four decades prior to July 2021.

After one of the worst years on record for developed market bonds, the first half of 2023 has been roughly flat across the globe. This isn't an outcome that will rally investor support but we're getting closer to a point where high-grade bonds should provide the strong diversification benefits that aid portfolios. For one, yields are higher now offering more income potential. Second, most central banks around the globe are indicating we're inching closer to the end of rate hiking cycles, which is welcome news for bonds.

Given where yields sit today, it's not unreasonable to believe the worst could be behind us. A key aspect of the bond market is that interest rates adjusting higher from zero hurts most at the beginning. An increase in rates from 3% to 4% will be much less dramatic than the move from 1% to 2%, for the simple fact that if you're getting paid a coupon of 3%–4%, and you reinvest, it has a tremendous compounding effect that isn't replicated with 1%–2% yields. Higher yields will ultimately translate to higher future returns.

Outlook

The material increase in bond yields has improved the forward-looking prospects, which applies positively to the U.S., U.K., and Australia. Europe is also rising from a very low base, although the absolute yields remain broadly unattractive. In all cases, yields fail to cover current inflation, but that ought to be expected given the environment. However, yields are now in excess of our long-term inflation expectations. Going slightly deeper, the ability to add income to portfolios while mitigating duration/default risk looks attractive to us currently. Rising government bonds are a positive for future return generation, and we expect this asset class to continue playing a role for investors.

That said, overall, we feel that managing duration risk makes sense in most scenarios. We are cognisant of the rather sizeable drawdown in government bonds in 2022, and adding materially to duration might make sense at some point. But any changes should be measured and deliberate, given the fast-changing response from central banks and the threat of stickier inflation. In this sense, government bonds are in an odd spot. On the one hand, the global macro environment is widely uncertain with a range of outcomes. The domestic economy is challenged with slowing growth and surging inflation that has the potential to reduce aggregate demand. To complicate matters, central banks have been late to make decisions to address inflation that could ultimately lead them to a tough bridge—fight inflation aggressively or do what you can to maintain the economic recovery. Unfortunately, at this stage, these decisions seem to be mutually exclusive. Further, given the delicate nature of both the domestic and global economy, long-term sovereign bonds seem appropriate to hedge against risks, whether that is aggressive central bank action, a weakening of demand, or both.

Asset Class	Conviction
Investment-Grade Credit	
• U.S.	Medium
• European Corporates	Low to Medium
• U.K. Corporates	Low to Medium
• Australian Corporates	Medium

Rationale

Backdrop

Investment-grade bonds offer higher yields than government bonds (given greater credit risk) and it's becoming clear there are interesting opportunities for investors. Like government bonds, the payback from last year—a year that saw a historic pace of rate hikes—comes in the form of higher interest rates, which means higher bond yields for investors. When yields were low—or even negative—investment-grade bonds faced constraints from effective lower bounds during risk-off episodes. But after a painful adjustment to higher yields, investment-grade credit now offers some of the most attractive levels of income in more than a decade.

Outlook

Both locally and globally, the higher yields have improved the attractiveness of this asset class over the long run, albeit from a low base. A key element is credit spreads—the difference between corporate-bond yields and government-bond yields—which have moved closer to fair value in our analysis, although not enough to be deemed attractive. In this regard, one should be careful of lower-rated companies with high debt levels, as a heightened default cycle can't be ruled out. From a fundamental standpoint, the Federal Reserve's increased involvement in this asset class had provided a backstop, although withdrawal of that support, increasing leverage ratios, and the possibility of higher yields are a cause for concern over the medium to long term.

In summary, this space has improved, but the inherent appeal remains muted. We see some attraction as a middle ground—providing some extra yield versus government bonds and a duration profile that can help in portfolio construction.

Asset Class	Conviction
High-Yield Credit	
• U.S. High Yield	Medium
• European High Yield	Medium

Rationale

Backdrop

High-yield bonds have staged a nice rally this year, up mid-single digits. High-yield bonds suffered last year because of rising interest rates, but there are now parts of the high-yield bond market in the U.S. and Europe yielding high single digits, and in some cases, low double digits. Risk will be significantly higher in these types of bonds, but to some investors, these yields could draw in money that previously would've been invested in stocks. It's been a long time since bonds have competed with stocks for investor dollars.

Outlook

Improved valuation, both on an absolute and relative basis, leads to our overall conviction of Medium. In our view, this bears watching — but it's not a "fat pitch" opportunity yet. While headline default risks are still deemed to be low, this could change with central banks tightening conditions and recessionary preconditions festering. A shorter duration profile relative to other bonds is also a potential positive in a rising-rate environment.

Asset Class	Conviction
Emerging-Markets Bonds	
• Local Currency	Medium to High
• Hard Currency	Medium

Rationale

Backdrop

Emerging-markets bonds participated in the "risk on" rally this year, offering returns in the low-single digits so far.

Like high-yield bonds, headline yields in emerging-markets bonds are rising to enticing levels, in the high single-digit range. This reflects the reality that many emerging-markets central banks have raised interest rates far in excess of their developed market counterparts to combat inflation pressures. As the inflation outlook in most emerging-markets countries continues to improve, so has the performance in the asset class.

Outlook

Emerging-markets debt in local currency, which we still prefer over hard currency, continues to offer healthy absolute yields, accounting for the added risk. Our view remains that many emerging-markets sovereigns, though with notable exceptions, have improved their fundamental strength compared to history. This includes improved current account balances, enhanced reserves, movement to orthodox monetary policy, and a build-out of a local investor base allowing for a shift to local currency funding. In addition, the aggregation of emerging-markets currencies also look undervalued overall and could offer a tailwind over time.

The area can be volatile, yet even allowing for some pessimistic assumptions, our research suggests that investors could see upside if they're willing to risk short-term volatility. In other words, we think investors can expect to be compensated for this risk over time, especially for local-currency bonds.

Asset Class	Conviction
U.S. Agency MBS	**Medium**

Rationale

Backdrop

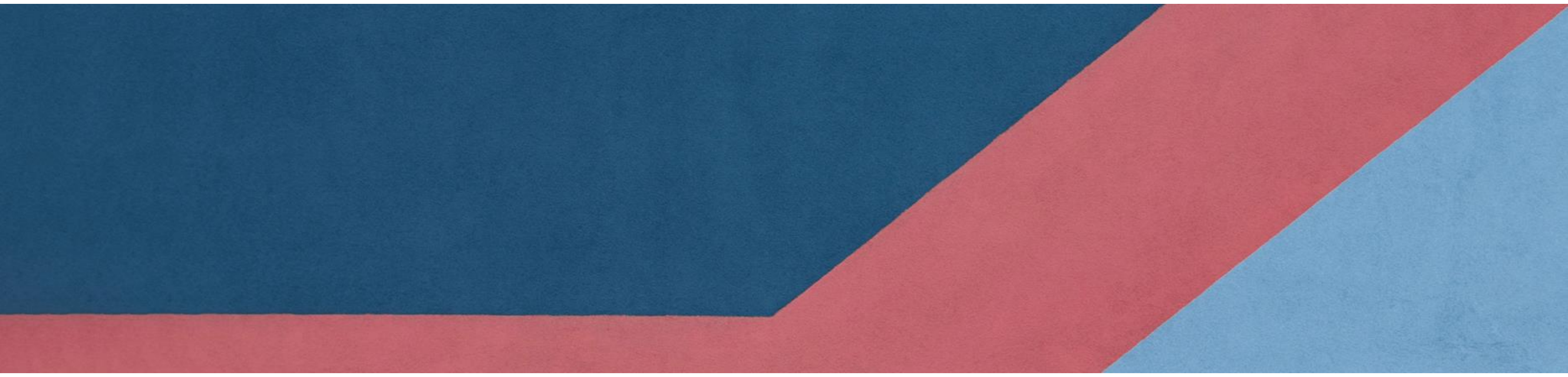
U.S. mortgage-backed securities (MBS) have been positive this year, albeit modestly, though they did underperform government bonds and investment-grade bonds.

There is reason to believe they could present an attractive opportunity going forward. Many of the regional banks that failed in recent months held large pools of MBS that they were forced to sell down to meet depositor redemptions. In effect, good merchandise went on sale, and it wasn't an issue of quality. The housing market also appears to be bouncing off the lows observed last year, which could foreshadow more MBS supply coming to the market as the year progresses.

Outlook

Overall, considerable weakness has been experienced while fundamentals remain solid. Given the sharp rally in mortgage rates and significant duration extension, the attractiveness of this asset class has improved. Investors will continue to watch inflation and the result it has on overall consumer demand. The idea of slowing economic activity should support higher-rated assets, such as agency MBS, as there is no inherent default risk. That said, further spread widening may take place before it turns in investors' favour should the economic environment turn sour.

Asset Class	Conviction	Rationale
Global Inflation-Linked Bonds • U.S. TIPS	 Medium	**Backdrop** Treasury Inflation-Protected Securities (TIPS) are roughly flat this year. TIPS didn't serve as an inflation hedge last year, which was confusing to many investors, and there are a couple reasons for this: TIPS help protect from unexpected inflation, which we had more of in 2021 than we did in 2022, despite the record prints on actual inflation last year. The second reason for negative performance was rising rates. Given inflation is cooling, it seems likely TIPS will revert back to the role investors expect going forward. TIPS can be viewed as an alternative or an addition to holding Treasuries. Yields are roughly 1.5% or more in real terms right now, which means that an investor who holds to maturity can expect to receive the real rate plus the rate of inflation based on CPI. **Outlook** The increase in yields dwarfed the increase in inflation last year, a situation that is unlikely to repeat this year. TIPS should benefit from higher interest rates. In addition, recent trends in inflation indicate it may be falling from peak levels, yet it wouldn't take much for markets to reprice inflation should something give. One important consideration is duration risk, where inflation-linked bonds are often longer-dated securities with meaningful interest-rate sensitivity.



OTHER ASSETS

Asset Class	Conviction	Rationale
U.S. Municipal Bonds	**Medium**	**Backdrop** Municipal bonds have advanced with the broader bond market this year, and credit fundamentals continue to hold up. Higher employment and increasing wages have bolstered tax receipts. Home values, a factor in property tax revenues, are facing headwinds in the form of rising mortgage rates but demand for homes has held up remarkably well given low levels of inventory. Lastly, many cities and municipalities are still in an attractive cash position following the influx of stimulus during the Covid pandemic. **Outlook** Yields on high-quality municipal bonds have trended higher and look attractive on a tax-adjusted basis. Considering the uncertain economic environment, we expect volatility to persist, however, given the higher-quality nature of municipal securities, downside risks look manageable compared to similar quality corporate bonds. Fundamentals of state and local governments have held up better than expected in the wake of the pandemic. That said, uncertainty around further interest-rate increases and high inflation could lead to further outflows, which can hinder the performance of the overall asset class.

Asset Class	Conviction	Rationale
Global Infrastructure • U.S. Energy Infra & MLPs	**Low to Medium** Medium	**Backdrop** Global infrastructure represents a wide collection of income-producing assets, which includes airports, rail, and energy-related holdings. Transportation infrastructure, namely airports and toll roads, has fared well this year. Several European airports announced a return to paying out dividends this year, after a 2-3-year hiatus, with current passenger volumes finally getting back to pre-Covid levels as of June 2023. Major toll road assets have benefitted from the higher inflation environment, as tolls charged are typically linked to inflation-linked price index levels. **Outlook** We expect a return to higher, normalised income levels for airports as passenger travel volumes continue to revert to pre-COVID-impacted levels. That said, infrastructure at an overall asset class level does not present as attractively priced as broader equities at the present time. Within infrastructure there are pockets of relative value, with railroads currently looking more attractively priced than toll roads, as recession and inflation concerns have weighed on railroads more heavily. Oil prices are significantly higher, and energy infrastructure equity prices have rebounded strongly—which has served, at the margin, to mute our historically positive view of this asset class. That said, we continue to see some appeal given the relatively high dividend yields and continued demand recovery. We also cite further governance and capital-allocation discipline. Specifically, our expectation is for a meaningful reduction in capital expenditures by energy infrastructure companies, with overall spend being reduced toward maintenance or steady-state levels. Headwinds remain amid the push to address climate change, but the transition to renewable energy is likely to be a long path, potentially allowing for an extended period of robust free cash flow generation for the industry—which we anticipate will be used to strengthen balance sheets and return cash to shareholders.

Asset Class	Conviction	Rationale
Listed Property • U.S. REITs • Global REITs • Australian REITs	 Low to Medium Low to Medium Low to Medium	**Backdrop** After rallying strongly at the start of the year, global real estate investment trusts (GREITs) experienced significant volatility associated with troubles in some areas of commercial real estate. Rising interest rates, higher debt service, and inflation leading to higher construction costs have been key themes hanging over the asset class. Recent concerns over potential tenant bankruptcy risk and the ongoing availability of bank debt funding have particularly weighed on the outlook for office REITs and REITs seen to be carrying high levels of debt. Office REITs face a more depressed rental-growth outlook over the short term on recession concerns and an uncertain outlook over the medium to long term due to uneven work patterns between employees working from home versus working physically in an office building. **Outlook** REITs continue to remain dually exposed to economic conditions, both from a top-line rental growth perspective and also from a funding conditions perspective. As trusts that pay out high levels of earnings as dividends, REITs rely heavily on debt (and equity) markets to fund their highly capital-intensive operations. With debt funding costs and construction costs on the rise, investors need to be wary of trusts exhibiting highly leveraged balance sheets and/or large property development exposure. Listed property is starting to present better value in select areas, while as a broad group, it remains relatively unattractively priced to the major equities markets.

Alternatives

Alternatives offered a strong ballast last year, though the impact is less profound this year as strong equity returns drown out their impact. Of course, this depends on the strategy being adopted. Our view remains that alternative offerings should exhibit genuinely diversifying assets with reasonable costs and liquidity. More specifically, with rising bond yields implicating both stocks and bonds in similar ways, alternative assets can appeal given that returns from this asset class tend to have a lower direct relationship with the performance of traditional asset classes such as equities and bonds.

Currency

While currencies are notoriously volatile, we tend to think of currency positioning via the lens of portfolio robustness (focusing on those currencies with defensive characteristics where sensible) but also as a potential source of upside at extremes. Looking ahead, we continue to see merit in currencies outside the U.S. dollar, although more recent falls in the U.S. dollar moderate this view. The yen has the potential to provide diversification qualities and potentially help preserve capital in times of extreme economic and market stress, as well as provide potential upside.

Cash

Cash rates have improved, but remain well below the inflation rate, so losing money in real terms. However, we balance this view, as the market vulnerabilities are worth protecting against. More pointedly, we see cash serving three purposes. First, cash helps reduce the sensitivity to interest-rate rises, especially relative to long-dated bonds, which is still an important risk to manage. Second, cash should help buffer from any future volatility resulting from a fall in equity markets. And third, cash provides ample liquidity to take advantage of investment opportunities as they arise.

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