MORNINGSTAR Wealth

Global Convictions & Outlook

Asset Class Research with a Long-Term Perspective

Morningstar Wealth
April 2024

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For Professional Clients

It has been a positive start of 2024 for risk-tolerant investors. This is especially true for those with high equity exposure, with stocks advancing in most parts of the world. At a global level, the Morningstar Global Markets index increased by high-single digits for the first quarter and over 20% for the last year in local currency terms. The gain also marked the fastest first quarter rise in five years for the S&P500, with every sector increasing except real estate. Among defensive assets, bonds have been broadly treading water, with yields inching higher after a period of volatility.

Looking ahead, market participants are trying to reconcile a few key developments. On one hand, the market backdrop appears favourable, with sentiment improving and corporate earnings rising. On the other hand, central banks may not pursue rate cuts at the speed many hoped, with valuations edging on expensive across many measures. Taken together, we believe a cautiously optimistic stance is warranted, balancing risk and return drivers while selectively identifying pockets of opportunity.

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).

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

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. Banks				■	
Bonds					
U.S.					
Treasuries			■		
TIPS			■		
Credit			■		
High Yield			■		
Agency MBS				■	
Municipal Bonds			■		
Emerging Markets					
Hard Currency (USD)			■		
Local Currency				■	

Source: Morningstar Investment Management. Views as of 15th April 2024 and subject to change. For illustrative purposes only.
[1] 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.

Broad Investment Backdrop

Investors appear to be shrugging off news that the central banks may postpone rate cuts as board members await additional cooling signs amid resilient global economic activity, a strong job market, and elevated inflation readings. Strong corporate earnings results are helping equity markets, especially for AI-related companies.

Let's remember that investors went into the start of the year optimistic that a soft landing was in store for the economy, inflation would continue to normalise, and central banks would start cutting interest rates by mid-year. Fast forward a few months, rate cut expectations have been pushed out as economic data proves resilient in many parts of the globe.

That said, equity returns have been far from uniform across countries. Japanese stocks are rising strongly, while U.K. equities have eked out small gains despite a recession announcement. Performance has been similarly divergent across emerging markets; Chinese and Brazilian stocks enduring losses while India has gained.

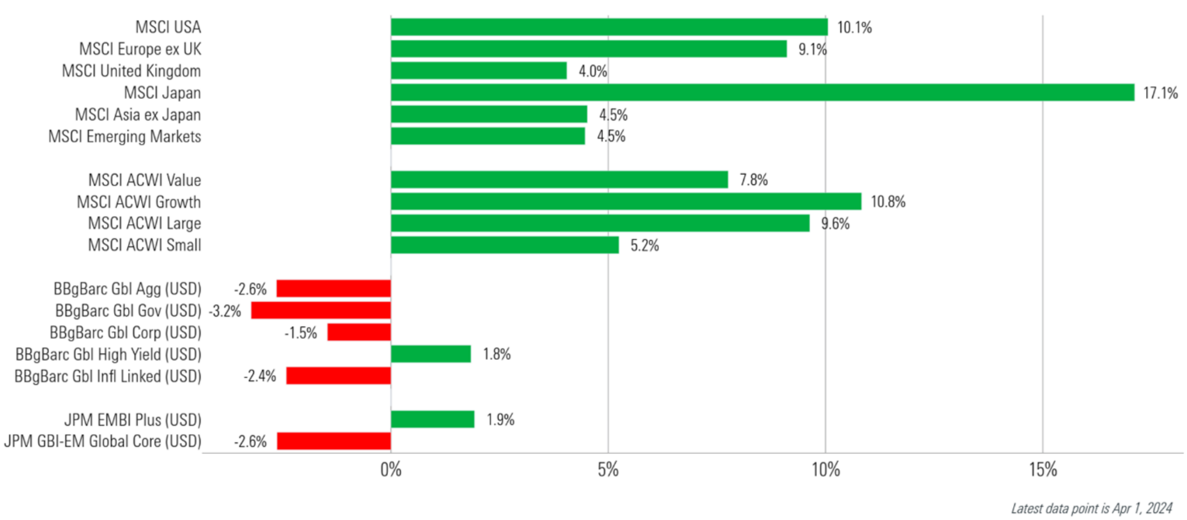
While this creates a complex landscape, we still see positives in this environment and opportunities to add value. A short list of our convictions include:

- Defensive equities, like healthcare and consumer staples
- U.S. banks
- Chinese tech stocks
- Emerging-markets debt
- Government bonds and inflation-protected securities

The market's proclivity for mega-cap stocks is a major talking point, with the "Magnificent Seven" dominating performance in recent memory, although this has been heavily swayed by Nvidia, which rose more than 80% in the first quarter of 2024. Outside of Nvidia, Tesla was down -27% in the quarter—the worst stock in the entire S&P 500. Apple was also down 11%, while Google was up 8% but trailed the broad market. Withstanding these changes, market concentration in the very largest stocks has reached a level not seen since the "nifty-fifty" era of the early 1970's.

Turning to bonds, improving news on the global economy is causing yields to inch higher, providing a headwind for fixed income asset classes. High-yield bonds have been a standout among fixed income.

Exhibit 2. Q1 2024 Returns Were Positive for Equities, With Bonds Struggling



Source: Clearnomics, Morningstar, MSCI, Bloomberg, JPMorgan, as of April 1, 2024. 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.

Asset-Allocation Research (as of April 2024)

EQUITY MARKETS

Asset Class	Conviction
U.S. Equities	**Medium**
• Consumer Staples	Medium to High
• Healthcare	Medium
• Energy Infrastructure	Medium
• Banks	Medium to High
• Communication Services	Medium

Rationale

Backdrop

U.S. stocks continued last year's trajectory, finishing up more than 10% in the first three months in local currency terms, making it the best first quarter since 2019.

While last year was defined by mega-cap technology companies—notably the Magnificent Seven (Mag 7)—the market showed its strength might lie in more than a single industry. Two members of the Mag 7—Tesla and Apple—fell back to earth in the quarter. However, these details are hidden behind the S&P 500's headline return. So, where did the returns come from? Well, certain members of the Mag 7—notably Nvidia and Meta—remained as top performing stocks in the market, but we also observed strong returns in the energy, financial, and industrial sectors, which are industry groups that have lagged in recent years.

Entering the year, we questioned the narrative that high-flying growth stocks were unimpeachable. The verdict is still being deliberated on, but there appears to be some early indications that market leadership could be evolving. As valuation driven investors, we would welcome this outcome, as we continue to believe some of the most compelling U.S. equity opportunities exist outside of the technology sector and other *hot* areas of the market.

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—is where we see opportunity. 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 more fully valued. However, 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, though not without risk. 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. We have recently updated our work on the Communication Services sector in the US. Despite excellent share returns – most notably. Meta – our updated work suggests that while not as compelling as was the case at year end 2022, valuations in the sector are still reasonable on an absolute basis and, when compared to other equity asset classes (particularly those in more growth-oriented sectors), are relatively appealing.

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.

Asset Class	Conviction	Rationale
Europe ex-U.K. Equities • European Energy • European Financials • Germany	**Medium** Medium Medium Medium	**Backdrop** Eurozone equities delivered a strong first quarter, up high-single digits. But results are often compared to U.S. stocks, rendering the returns less exciting—a stubborn trend that continues to persist. But there are additional details worth discussing. For example, the sector and industry composition in Europe is much different than the U.S. The weight in technology stocks is approximately 20% higher in the U.S., which has been a significant factor in U.S. stocks outpacing European stocks. As highlighted in the U.S. backdrop, if recent performance trends in manufacturing and banking industry groups strengthen, this could potentially tilt the performance scale back in favour of Europe. However, a single quarter's performance is not sufficient to conclude that this trend will persist. From an economic standpoint, Europe's largest economy—Germany—has been dealing with an economic slowdown, and this problem has filtered through equity markets. But the *problem* also creates attractive valuations and potentially interesting investment opportunities. Thinking through investment opportunities, we believe the price you pay is often the single biggest determinant in the outcome. When U.S. equities (specifically large cap) are discussed, it's not uncommon to hear they're *"priced for perfection."* That's not the case in Europe and one of the reasons we continue to pay close attention to the asset class. **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 continued macroeconomic concerns. In aggregate, we find German stocks offer solid balance sheets and potential upside to earnings—without eye-popping valuations. At a sector level, we hold positive views on European-integrated energy companies. European banks valuations, on the other hand, have started to moderate.

Asset Class	Conviction	Rationale
U.K. Equities	**Medium**	**Backdrop** U.K. equities were positive in the quarter, up low-single digits, but they underperformed broader Europe by a meaningful amount. Our discourse on the sector and industry differences between the U.S. and Europe holds true for the U.K. as well. However, negative sentiment related to slower economic growth and more stubborn inflation is resulting in investors less willing to pay up for shares of U.K equities. As an example, the U.K. equity market has one of the highest dividend yields in the developed world, which is mostly a function of weaker share prices. With that in mind, investors should prioritise future prospects over past performance. Looking ahead, attractive relative valuations exist, and the U.K. offers a diverse industry composition relative to the U.S., making it compelling for diversification purposes. **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, U.K. equities 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

Australian equities delivered positive but relatively modest returns for the quarter relative to global peers. Given where many other equity markets finished, this was a disappointing result.

Relative to other markets, Australia has not benefitted from the "tech tailwind", as its largest industries are the financials and materials sectors. Australian equities trade on lower PE multiples compared to US equities but earnings growth has also been less impressive in comparison. Notably, given their large exposure to materials, China has historically been a large buyer of Australia's natural resources (iron ore, coal, metals, etc.). As China's economy has slowed, Australia's equity market fortunes have slowed in unison.

Outlook

Headwinds exist, but performance in the last year relative to the major global indexes was 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 Chinese Equities on valuation grounds, and other select emerging markets.

Asset Class	**Conviction**	
Japan Equities	**Low to Medium**	

Backdrop

Japan's equity markets hit their highest levels in more than 30 years last year, and that momentum continued into the new year.

Japanese equities were one of the best performing global equity markets for the quarter. However, returns have been diluted by the sharp fall in the Japanese yen, providing a stark reminder that when investing overseas, we must take account of currency changes, as they can materially impact returns.

A couple items underpin the success in Japan. There's a structural element: Japan's government has been getting serious about reform. One example was the Tokyo Stock Exchange (TSE) ordering all listed companies trading at below book value to get serious about correcting that, otherwise risk being delisted. Put simply, if a company is trading below book value, the market is indicating the company is worth less than the physical assets they hold.

From an investment perspective, Japan hopes these reforms will bring more foreign investment. To date, they've already captured one big investor: Warren Buffett, who mentioned last year, "*we'll keep looking for more opportunities in Japan"* while referencing Berkshire's significant investments in five Japanese trading companies.

The history of Japanese equities has mostly been defined by booms and busts—there haven't been many *relaxing* periods of moderate growth. But investors might be well served to know that material changes are occurring to reshape their markets, and investors would be wise to continue paying attention.

Outlook

The strong returns from Japan resulted in a downgrade to Low-Medium. While much of the 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
Emerging-Markets Equities	**Medium to High**
• China Equities	Medium to High

Rationale

Backdrop
Emerging-markets were positive in the quarter in local-currency terms, but the continued underperformance relative to other global equity markets is what many investors are focused on.

China makes up around a quarter of the index and plays a heavy hand in determining the fate of broader emerging-market equities. China's disappointing economic indicators, including weaker growth, debt concerns and property downturn has corresponded with negative sentiment. Despite this, China may be more attractive than conventional wisdom would indicate. Valuations are very cheap and the challenges confronting China well understood by the markets, with pessimistic economic scenarios already priced.

Stepping back, the structural story around emerging markets remains intact. Collectively, these countries represent approximately 80% of the world's population and nearly 70% of the world's GDP growth, but less than 10% of the total global equity market cap. A burgeoning middle class continues to develop and should present interesting opportunities for investors, albeit with higher volatility.

As a nod to Charlie Munger's old investing quote, *"fish where the fish are"* we should keep in mind *plenty of fish* exist in emerging markets.

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). Emerging markets as a whole continue to offer attractive valuations, with a forward price/earnings ratio of 12.1x, well below developed world peers.

Asset Class	Conviction
Global Sectors	
• Energy	Low to Medium
• Financials	Medium
• Communication Services	Medium

Rationale

Backdrop
The sector story in global equities has been: Technology is getting larger, and everything else is getting smaller by comparison. Admittedly, that's a bit of a generalisation, but it holds much truth. The counter would be other sectors have become much more reasonably priced from a valuation perspective as technology ascended.

As valuation-driven investors, we are always peeling back the layers, attempting to identify sectors that hold some combination of factors (depressed valuations, upward earnings revisions, catalyst, etc.) that might indicate opportunity lies ahead. Of course, bells never ring to inform us when a market inflection point has been reached, which means we approach each situation cautiously.

But the market action observed in recent years has and should continue to create interesting long-term investing opportunities at the sector level. For example, the energy market was one of the worst performing sectors last year but has become one of the best performing sectors this year.

Outlook
We continue to see opportunities at the defensive end, as well as financials. Defensive value-oriented areas of the market have struggled, despite generally robust earnings. 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 should be less volatile and less affected by the ups and downs of long-term market cycles. Yet, following weakness, they now present decent valuation opportunities.

FIXED INCOME

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

Rationale

Backdrop

The bond market has not provided the defensive features over the past few years that investors had come accustomed too. In aggregate, bonds have been in a drawdown for more than 44 months, the longest drought in recorded history.

On top of that, many government bond markets turned in another negative quarter, making investors a bit restless with this part of their portfolio.

The good news? 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, like we saw in the past few years. Any increase in rates from where we sit today will likely be much less dramatic than what already happened (i.e., going from 0% to 5%) for the simple fact that you're getting paid a coupon now that isn't replicated with 1%–2% yields. In short, higher yields will ultimately translate to higher future expected returns.

Outlook

The material increase in bond yields has improved forward-looking prospects, which applies positively to the U.S., U.K., and Australia. Europe is also rising from a very low base, although absolute yields remain broadly unattractive. Yields now cover inflation in many instances, offering positive "real" yields.

Going slightly deeper, the ability to add income to portfolios while mitigating duration/default risk looks attractive to us currently. Healthy government bond yields 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 potentially sizeable drawdown risk from longer duration assets and adjusting our bond allocations higher at a moderate pace. 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. The key risk for fixed income is that interest rates fail to sufficiently slow economic growth and inflation.

For corporates, many firms are using free cash flow to fund capex, not debt, and service-oriented firms are less reliant on debt financing than industrials. At the consumer level, most mortgages have locked in lower rates and while we are seeing signs of slowing housing activity, the risk of a collapse is relatively contained. 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 persistent 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—balancing between a hard and soft landing. 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	Medium
• U.K. Corporates	Medium
• Australian Corporates	Medium

Rationale

Backdrop

Much of the discussion around developed-markets sovereign bonds are applicable to investment-grade bonds as well. Investment-grade bond returns travelled a similar path in the first quarter.

Obviously, one quarter does not change our views on what this asset class represents, still believing investment-grade bonds continue to be an extremely valuable part of investor portfolios. The combination of 1) declining interest rates, and/or 2) higher yields that exist today should serve as a benefit going forward.

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 remain below where they should be, in our analysis, and 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.

In summary, this space has improved, but the inherent appeal remains muted relative to government bonds. 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	Rationale
High-Yield Credit • U.S. High Yield • European High Yield	 Medium Medium	**Backdrop** High-yield bonds had a decent quarter and topped the leaderboard among fixed-income assets. Generally, the high-yield bond market in the U.S. and Europe offers yields in the high single digits, and in some cases, low double digits. While these bonds carry higher risks, their advantages become more apparent when managed with a diversified portfolio that includes high-quality bonds. **Outlook** Our overall conviction is Medium. In our view, this bears watching. 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	Rationale
Emerging-Markets Bonds • Local Currency • Hard Currency	 Medium to High Medium	**Backdrop** While the broader bond market was slightly negative, emerging-market bonds were able to buck the trend, though currency played a role. While the risks of emerging-market bonds are discussed frequently, they also provide meaningful diversification benefits, which was on display during the quarter. Like high-yield bonds, headline yields in emerging-markets bonds remain at enticing levels, in the high single-digit range. While emerging-market bonds carry more risk than other parts of the bond market, there is a substantial yield cushion in place. This reflects the reality that many emerging-markets central banks have raised interest rates far more than their developed market counterparts to combat inflation pressures. As the inflation outlook in most emerging-markets countries continues to improve, so has the resilience of 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 looks 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	Rationale
Global Inflation-Linked Bonds • U.S. TIPS	 Medium	**Backdrop** Inflation-protected securities were approximately flat in the quarter. Compared to other areas of the bond market, this was a fine result on relative basis. Inflation remains a very real concern, especially in the U.S. economy. A key point to remember is that U.S. Treasury Inflation-Protected Securities (TIPS) generally protect against *unexpected* inflation. If the trends observed in the March inflation report continue, TIPS will likely draw more investor interest. **Outlook** TIPS should eventually benefit from higher interest rates, and it wouldn't take much for markets to reprice inflation, which could offer upside. 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
Global Infrastructure • U.S. Energy Infra & MLPs	**Medium** Medium	**Backdrop** Global infrastructure represents a wide collection of income-producing assets, which includes utilities, airports, rail, and energy-related holdings. Global infrastructure indices delivered small positive returns over the quarter, lagging the broader equities market's strong start to the year. Within infrastructure, European airports and North American railroads performed well, while communications infrastructure continued to struggle due to concerns over their more leveraged balance sheets. An area that has been showing strength of late but remains relatively appealing in our view: oil and gas master limited partnerships (MLPs). MLPs are publicly traded partnerships focusing on energy infrastructure, serving as "the pipes and plumbing" that move oil and gas. They trade like stocks, on exchanges, derive 90% of their revenue from energy activities, and pass along the bulk of their earnings through distributions. Those distributions mean a hefty yield bolsters the total return for these companies, but they also carry reasonable valuations compared to the broader U.S. energy market, greater capital discipline in recent times, stronger balance sheets of late, and potential upside—though arguably not as great as that of the producers—should energy prices stay higher for longer. **Outlook** As an income-focused asset class, we continue to see the outlook for infrastructure as being strongly influenced by the outlook for interest rates. Utilities comprise a significant weight within infrastructure. We see utilities as presenting better relative value today, particularly when compared to more cyclical and higher growth areas of the market which have done well over the past year. That said, we still see an uncertain road ahead for utilities as companies balance up their renewable energy infrastructure spending plans against ensuring they receive attractive returns on these new investments in the face of higher interest rates, construction costs, and electricity bills for customers.

Asset Class	Conviction	Rationale
Listed Property • U.S. REITs • Global REITs	 Medium Medium	**Backdrop** Real estate was one of the worst-performing sectors in the quarter, finishing modestly negative, after rallying strongly in late 2023. During 2024 the market's expectations regarding central banks' interest rate cuts have moderated both in terms of timing (now expected to be later) and magnitude (less cuts). The real estate asset class continues to make plenty of headlines, mostly tied to office assets in urban city-centers that have been underperforming due to work-from-home (WFH), tenant bankruptcies, and/or debt funding concerns. But it's important to remember, real estate is a large category and office assets represent only a small slice of a much larger pie. Global REITs had been an underweight across our portfolios for several years, but recent negative sentiment has created better relative value. **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. While we see better relative value in listed property, investors need to tread carefully. 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 increasing the chances of dilutive and discounted equity raisings taking place.

Alternatives

Alternatives continue to provide a nice ballast, though the impact is less pronounced when strong equity returns are present. Of course, this depends on the strategy being adopted. Our view remains that alternative offerings should exhibit genuinely diversifying characteristics (i.e., low correlations to stocks and bonds) 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. 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, offering positive real yields in many developed markets. In the current environment, 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. That said, as equity and bond markets have repriced lower, we see opportunities to keep money at work.

Since its original publication, this piece may have been edited to reflect the regulatory requirements of regions outside of the country it was originally published in.

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