A letter from our Chief Investment Officer
Change creates opportunities

Morningstar Wealth
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For Financial Professionals Only

Key points

- Kick start to 2025
- Further rate cuts likely
- Knee-jerk reactions to trade negotiations are creating opportunities

The year has started with Central banks sitting on the sidelines in the UK and US, while markets react to US trade negotiations and the release of DeepSeek, a Chinese competitor to Chat GPT.

The shock trade announcements and the challenge of lower cost AI competitors are reminders that change can create opportunities for investors, especially when markets under or overreact. The best "vintages" of opportunities are the years when you can buy at bargain basement prices, usually because investors overestimate the negative impacts of change and so become excessively pessimistic. Such investments increase in value a lot over time, like great wines, but you can't be sure when the payoff will come.

Not only do you need deep research to assess the impact of change, you also need the courage to invest when the news flow is dreadful and what you're buying is very out of favour. Finally, you need the patience to wait until the value is realised.

As challenging as this sounds, profiting from change is possible. In fact, it's been the source of great opportunities in recent years, that have found their way into Morningstar Multi Asset Portfolios.

The energy industry is one such example, with 2020/2021 turning out to be a vintage year for investment in Oil and Gas companies. Share prices had plummeted because of fears that decarbonisation policies would quickly decimate demand, at a time when COVID era lockdowns were hitting a key oil and gas buyer: the global transport industry. With oil prices trading at extreme lows and share prices not far behind, the reaction had gone too far. Ultimately the energy transition needed to be more gradual than feared. Energy turned out to be one of the best performing investments in 2022.

China was an example of a regional opportunity, where the perception of permanent negative change created a rare opportunity in 2022/2023. Here adverse government regulation, deflating property values and corruption crackdowns were seen by investors as permanent changes. Share prices of dominant franchises plummeted in the ensuing 3-year bear market, as many foreign investors fled. What followed was a swing back to less regulation and more support for companies. Share prices surged in September last year and continue to rally, led recently by Technology focused giants. We still view China as an attractive opportunity.

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This year we are seeing more opportunities emerging in Latin America and Korea. The catalysts are concerns about US trade negotiations and a domestic political crisis. In our view, there has been an overreaction to potentially negative impacts that are not permanent. Share and currency prices have dropped to levels that offer an attractive reward for risk. We have recently added exposure.

The same concerns about US import tariffs are affecting bond prices, as investors consider the impact on inflation and interest rates. At first glance it seems reasonable to expect higher tariffs to lead to higher inflation, but there is not a strong direct link with the Consumer Price Index (CPI). To start with, services and non-traded goods are not subject to tariffs and these form a much bigger part of the spending basket. It is also rare for 100% of tariff increases to be fully passed onto buyers. The bottom line is that interest rates have further to fall, and this is supportive of high-quality government bonds.

Morningstar Portfolios have recently been updated to add exposure to emerging opportunities and more cost-effective diversifiers.

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