MORNINGSTAR Wealth

Investment Insight
Vigilance

Morningstar Wealth
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For Financial Advisers to use with their clients

Key points

- Normal levels of risk taking still justified
- Vigilance needed to track rapidly changing environment
- Bonds becoming more attractive

After a stellar 2024, investors are facing an environment that calls for vigilance.
I noted in the last CIO letter that equity returns were much larger than usual in 2024 and a lot of optimism was priced in to the world's dominant market: the US. Our approach has been to look beyond hot AI theme companies, for opportunities that are priced for bad outcomes, such as Chinese and more recently Korean shares. There is also better value in markets with different drivers of profits vs the AI market darlings, such as US smaller companies and UK equities.

But there is a limit to how much you can diversify within equity markets, when the leading market gets expensive, very popular and driven by a small number of global behemoths.
Are we at a point where investors should consider taking less risk than usual?
This is not a decision to be taken lightly. It's notoriously difficult to get it right and investors can end up less likely to meet their goals, either missing out on returns by being too defensive, or suffering intolerable losses by being too bold.
So, the bar is high for moving away from your normal level of risk taking. A comprehensive analysis is needed to assess whether conditions are extreme enough to be confident of adding value by taking more, or less risk than usual. Our research shows three factors are important to consider: valuation, capital supply and investor risk tolerance.
The first factor is a like a slow moving form of gravity that eventually pulls share prices up or down a lot, when they move far below or far above fair value. Right now, this signal is flashing a warning signal because the US market is overvalued, though there are enough undervalued and fairly valued equity opportunities elsewhere to populate a portfolio.
The second factor is like an amplifier – it can supercharge booms when capital gushes freely, enabling companies to raise capital far too easily and on terms excessively in their favour. It can also prompt a bust, when capital cannot be raised at all, typically during a banking crisis, even for the most stable and profitable company. Today capital supply is at normal levels, having swung from being too easy in 2021 to being harder to access after the Silicon Valley Bank collapse in 2023.
Finally, investor behaviour towards risk which can change very quickly from indiscriminate buying driven by fear of missing out (greed) to panic induced selling (fear). Currently our systematic analysis shows mild overall greed, led by the US.
Greed and fear coupled together, signals support normal risk taking, especially as returns come down for the main "opt out" asset: cash. Even so vigilance is needed because of the extra uncertainty about

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how the economy will adjust to the seismic rise in interest rates, the application of AI and policy surprises in this second Trump presidential term.

Equities also face stiffer competition from government bonds after the recent rise in yields. In effect investors are pricing in larger deficits, higher inflation and hence higher interest rates in response to fears about the Trump tax, spending and tariff policies. The USD has surged vs all currencies while government bond yields have risen in most developed bond markets. In the UK disillusionment with the new government has contributed to an extra rise in bond yields, as investors focus on disappointing economic growth, GB Pound weakness vs the US Dollar and the increased use of debt announced in the budget.

The end result is that investors can earn close to 5% on government bonds with little credit risk when inflation is 2-3% and interest rates have scope to come down because they are still well above inflation rates. UK's fiscal safeguards, political stability, lack of demand led inflationary pressures and government spending and tax discipline all suggest gilts offer good value. M

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