Investment Insight
Beyond Technology?

Morningstar Investment Management EMEA

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For Financial Advisers to use with their clients

After another tech stock driven rally, where can investors still find opportunities that are not fully priced? It is getting more challenging to identify undervalued equity markets, after the surge in prices.

Japan is one sharemarket that has become more fashionable, for the first time in decades. Our research back in 2013 flagged slow-burn structural changes: the so called third arrow of Shinzo Abe's economic plan. These micro-economic reforms targeted higher economic growth by incentivising the private sector to become more productive. Changes in corporate governance have led to a rising tide of higher profit margins, increasing payouts to shareholders and a unique structural dynamic. Another attraction is the Japanese Yen which is at dirt cheap levels, that leave upside for currency gains and the potential for these to be large in the event of adverse scenarios. We retain higher than usual exposures in portfolios, while taking profits following the extensive rally and pricing in of improving fundamentals.

At the other end of the popularity spectrum we have UK equities, seemingly abandoned by local investors, while global private investors flock to a melange of distressed sectors like real estate and in-vogue investments like AI themed plays. For two decades, defined benefit UK pension funds have been heavy sellers, as they transitioned from equity-heavy and UK biased portfolios to more bond-heavy and internationally biased portfolios. UK retail investors also traded UK for international assets, reducing their UK equity exposure a lot. Of course, the UK has not been the only market seeing money flow to the US.

The structural unwind of British bias to UK shares has been a major headwind, depressing valuation levels. From here there is less scope for all UK shares to be impacted by the exodus of capital. Indeed, there is little connection between dominant British listed firms and the UK or each other, because they are multinationals active across global financial services, healthcare, consumer staples, materials and energy. At current prices they rank well vs global comparables, hence we continue to invest more than usual in the UK.

Just as IT companies carried over their outperformance from 2023 to 2024, so did riskier bonds. Growth, inflation and oil prices turned out higher than expected, triggering an unwind of optimistic expectations for large and rapid falls in interest rates this year. This impacted longer dated bonds which are typically dominated by govt borrowings. High Yield and Emerging Market debt outperformed and we have been trimming exposures as the extra yield for their risks comes down. By comparison the yields available on safer debt mean they are well placed to perform their role of a portfolio stabiliser in crisis periods and to generate returns superior to cash and inflation.

The story of 2024 is one of gyrating markets and rapid swings in sentiment. Your portfolios continue to hold a diverse mix of assets that can provide support in a variety of market and economic conditions.