Lessons for Investors From 2024's Market Drama

Morningstar Indexes' take on the perils of forecasting, the benefits of asset-class diversification, and the dynamism of markets.

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The cycle of greed and fear has been turning. Enthusiasm for artificial intelligence, which has powered the Morningstar US Market Index[1], a broad gauge of equities, ever since the launch of ChatGPT in late 2022, continued into 2024. Stocks have logged hefty gains this year, but not without serious bumps along the way. In the third quarter, jitters over the economy and equity prices roiled markets. Jobs reports, inflation prints, and earnings announcements caused selloffs. Both an unexpected interest rate hike by the Bank of Japan and expected rate cuts by the US Federal Reserve contributed to volatility.

A "Trump bump" followed the US election. In a repeat of 2016, stocks rallied, especially segments seen as beneficiaries of lower taxes, regulatory rollbacks, and protectionism. The Morningstar US Small Value Index[2] was the best performer within the Style Box on the day after the election, up more than 5%. Meanwhile, the Morningstar US Core Bond Index[3], sank, as debt fears sent yields rising.

Ultimately, investors overestimate the impact of politics on their portfolios. Markets' initial reaction to Trump's election in 2016 faded, as investment fundamentals reasserted themselves. The bigger question concerns valuations in the US equity market. Only time will tell who's right: bears predicting the bursting of the AI bubble or bulls who say the market is just "climbing a wall of worry." Pessimism tends to sound smarter. But it's the optimists who've been repeatedly vindicated in recent years.

Whatever the future holds, market drama holds lasting lessons for investors:
1) Macroeconomic forecasting is difficult.
2) The market is going to fluctuate.
3) Diversification isn't dead.
4) The relationship between interest rates and assets isn't fixed.
5) There is nothing permanent except change.

1 Construction Rules for Morningstar US Market Indexes. Morningstar Indexes.
2 Construction Rules for Morningstar US Style Indexes. Morningstar Indexes.
3 Construction Rules for Morningstar Bond Indexes. Morningstar Indexes.

1) Macroeconomic Forecasting Is Difficult

An economic outlook is the starting point for many investment plans. That's concerning because of how often they are wrong. Consider just how far off the mark the consensus has been recently. A smattering of headlines from 2023 is displayed in Exhibit 1. None has aged particularly well.

Exhibit 1 The Consensus Has Been Wrong: Media Headlines Coming into 2024


The US Economy Is Headed for a Hard Landing

Futures Markets Expect 6 Rate Cuts in 2024

China's grand-reopening – Setting the scene for a strong 2023

Sources: Bloomberg, Barron's, and HSBC.

In 2022 and 2023, it was accepted as an article of faith that the US was headed for recession. The only question was whether it would experience a "hard" or "soft landing." Generationally high inflation had provoked a commensurate monetary policy response. The Treasury yield curve was inverted—a popular recessionary indicator. And yet, deep into 2024, we are still airborne.

At one point the market was expecting seven rate cuts in 2024. The consensus moved to six, then three. The Fed cut 50 basis points in September and another 25 in November. That might be it for the year.

Meanwhile, the Chinese economy—the second-largest contributor to global growth—was perceived to be a coiled spring, ready to bounce back from its "zero-covid" lockdowns. These days, China is seen as structurally challenged. Its property market is deeply troubled. Its demographics are bad. Massive government stimulus in 2024 received a mixed response from investors.

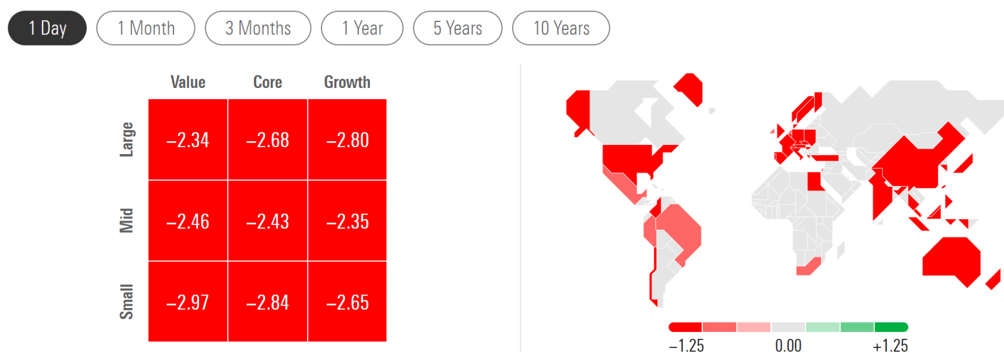
Investors who followed consensus into bets on US bonds, against US equities, or on China would have underperformed. The Morningstar US Market Index gained nearly 25% for the year through mid-November 2024. The Morningstar US Core Bond Index was slightly negative during that time. Though fixed income did benefit from rate cuts, yields have spiked in the wake of the election. Debt fears have resurrected talk of "bond vigilantes." The Morningstar China Index has enjoyed a decent year overall, despite the country's macroeconomic struggles. Investors would have been far better off, however, in US equities. Global diversification has fallen deeply out of favor with many American investors. Perhaps 2025 will see a leadership rotation. As forecasts for next year begin to proliferate, investors would be wise to view them skeptically.

2) The Market Is Going to Fluctuate

Bull markets foster complacency. The Morningstar US Market Index climbed 26% in 2023 and then gained another 14% in the first half of 2024. Ever since the launch of ChatGPT in late 2022, market enthusiasm around artificial intelligence has driven heady gains in stocks like Nvidia, Microsoft, and Meta Platforms. When markets are setting fresh highs, expectations grow unrealistic. Investors forget that stocks can go down. The 20%-plus drawdowns of 2022 and 2020 fade from memory.

Investor sentiment can turn on a dime. In the third quarter of 2024, the narrative shifted, as fears over a narrow and pricey market set against the backdrop of macroeconomic and political risk took hold. Then the Bank of Japan surprised markets by hiking rates. It's said that "in a crisis, correlations go to 1." That was certainly the case on Aug. 5. Across investment style, size, and geography, there was no place for equity investors to hide, as displayed in Exhibit 2. All nine Morningstar Style Box indexes fell. The Morningstar US Market Index lost 3%, while the Morningstar Japan Index fell 12%.

Exhibit 2 Equity Market Segments: No Place to Hide Across Style, Size, and Geography on Aug. 5, 2024



Source: Morningstar.com. Data as of Aug. 5, 2024.

Does it even matter if the market fluctuates? In the course of a year that saw strong equity market gains, especially after the election, third-quarter volatility looks like a blip. The issue with volatility is that it amplifies the fear and greed cycle. Investors are prone to buy volatile investments high and sell them low.

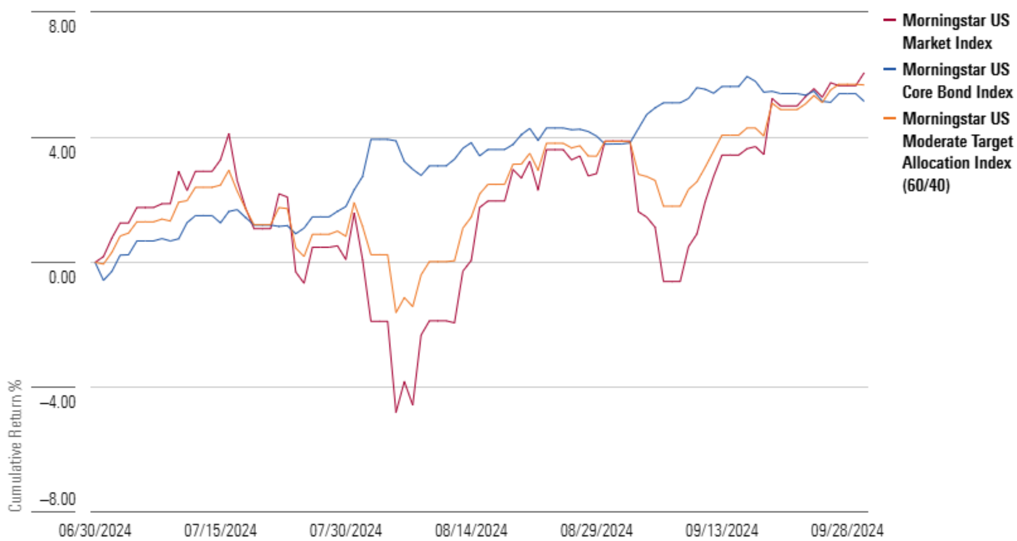
Morningstar quantifies this effect by calculating Investor Returns, adjusting funds' performance for collective purchases and sales. The Mind the Gap study measures the difference between posted returns and the actual investor experience. According to the 2024 edition, "The more volatile a fund's returns versus peers, the larger the gaps tended to be."[4]

4 Ptak, J. Mind the Gap 2024. Morningstar. Aug. 15, 2024.

3) Diversification Isn't Dead

"Bonds are so back," wrote Morningstar's Jason Kephart in August.[5] While equities were hitting the skids in the third quarter of 2024, the Morningstar US Core Bond Index climbed. The 10-year US Treasury yield fell, and bond prices rose, benefiting from a flight to safety and from expectations of interest-rate cuts. Multi-asset investors have seen diversification pay off, as displayed in Exhibit 3. The Morningstar US Moderate Target Allocation Index, which represents the traditional mix of 60% stocks and 40% bonds, preserved capital better than an all-equity portfolio in the third quarter.

Exhibit 3 Third-Quarter Performance: Bonds Have Diversified Equity Market Losses



Source: Morningstar Direct. Gross returns are in US dollars for the Morningstar Global Factor Indexes. Data as of June 30, 2024.

Why is this noteworthy? After all, bonds are often referred to as "portfolio ballast." Yet, it was not long ago that fixed income failed to play its traditional role of steadying the ship during equity market selloffs. In 2022, investors suffered through what Morningstar's John Rekenthaler termed the "worst bond market ever," thanks to generationally high inflation and the most rapid and severe monetary policy response in 40 years.[6] Stocks and bonds fell in lockstep. Headlines proclaimed the "death of diversification" and the "end of the 60/40 portfolio."

Investors who had come to expect bonds to rise during equity bear markets were deeply disappointed. Unlike the "pandemic panic" in the first quarter of 2020, the global financial crisis of 2007-09, and the aftermath of the dot-com bubble in 2000-02, the Morningstar US Core Bond Index failed to rise as stocks fell in 2022. As a result, the Morningstar US Moderate Target Allocation Index declined nearly as much as an all-equities portfolio in 2022.

5 Kephart, J. "The 60/40 Portfolio: Bonds Are So Back." Morningstar. Aug 12, 2024.
6 Rekenthaler, J. "The Worst Bond Market Ever." Morningstar. Nov. 21, 2022.

According to Morningstar research, inflation and rising interest rates cause correlations between stocks and bonds to rise.[7] The two asset classes moved together during inflationary episodes soon after World War II, in 1966-70, and 1977-80. But inflation stayed so benign for so long thereafter that few investors were prepared for its reappearance in 2022. Interest-rate hikes intended to combat inflation wreaked havoc on both major asset classes that year. Meanwhile, commodities-related assets, linked to a key inflation driver, rose in 2022. The Morningstar Global Upstream Natural Resources Index gained more than 15%. This is consistent with the history of other inflationary periods.

While the stock/bond relationship got back on in the third quarter of 2024, it's important to note that fixed income isn't a monolithic asset class. The high-quality, interest-rate-sensitive Morningstar US Core Bond Index benefited from a flight to safety and expectations of monetary loosening, but fixed-income segments with lower-credit-quality profiles and greater sensitivity to the economy did not. The Morningstar US High Yield Bond Index and the Morningstar LSTA US Leveraged Loan Index have behaved more like equities. That is not unusual from a historical perspective. As displayed in Exhibit 4, over the past 10 years, US high-yield and bank loans have been more closely correlated with stocks than with high-quality core bonds in the US.

Exhibit 4 Correlation Matrix: High Yield and Leveraged Loans Move More With Stocks Than High-Quality Bonds

	1	2	3	4
1 Morningstar US Market TR USD	1.000			
2 Morningstar US Core Bd TR USD	0.368	1.000		
3 Morningstar US HY Bd TR USD	0.814	0.484	1.000	
4 Morningstar LSTA US LL TR USD	0.625	0.143	0.803	1.000

0.76 to 1.00
0.51 to 0.75
0.26 to 0.50
0.01 to 0.25
0.00 to –0.24
–0.25 to –0.49
–0.50 to –0.74
–0.75 to –1.00

Source: Morningstar Direct. The correlation matrix is for 10 years through Oct. 31, 2024.

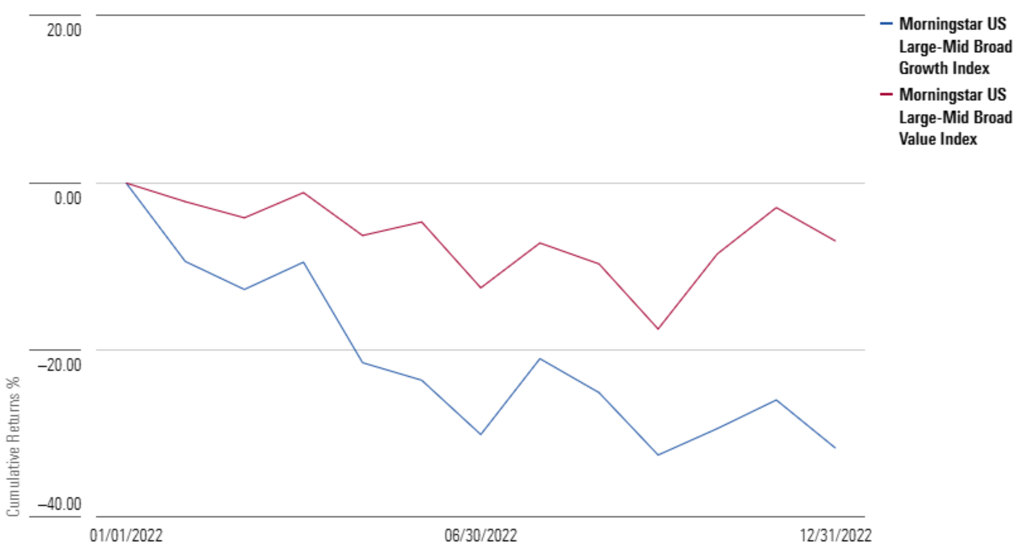
Investors have learned that correlations are dynamic. The relationship between stocks, bonds, and other assets is constantly in flux. In down markets for stocks, high-quality, interest-rate-sensitive bonds have often acted as shock absorbers. In inflationary periods, this relationship breaks down, and the more economically sensitive fixed-income areas behave more like equities.

7 Arnott, A. "How Rising Interest Rates Change the Relationship Between Stocks and Bonds." Morningstar. April 23, 2024

4) The Relationship Between Interest Rates and Assets Isn't Fixed

Remember back in 2022, when everyone said growth stocks were falling because of rate hikes? In that year of inflation and sharp rate hikes, the Morningstar US Large-Mid Cap Broad Growth Index[8] fell more than 31%, while the value benchmark shed just 7%, as displayed in Exhibit 5. The narrative went that higher rates devalue the long-dated earnings of fast-growing companies discounted back to the present.

Exhibit 5 Growth Stocks' 2022 Woes Were Blamed on Interest Rates



Source: Morningstar Direct.

Yet, somehow growth stocks have massively outperformed in 2023 and 2024 despite rates remaining at levels described as "restrictive." AI enthusiasm seems to have overwhelmed the interest-rate effect. Just as in 2022, the energy sector, which benefited from a soaring oil price after the Russian invasion of Ukraine, helped the value side of the market.

The conventional wisdom regarding the relationship between interest rates and asset price performance has been challenged in other ways recently:

- Rates declined in 2024, but bonds have lost money.
- Banks underperformed in 2023 despite rising rates.
- Dividend payers outperformed in 2022 despite rising rates.
- Emerging markets have not suffered badly from US rate hikes.

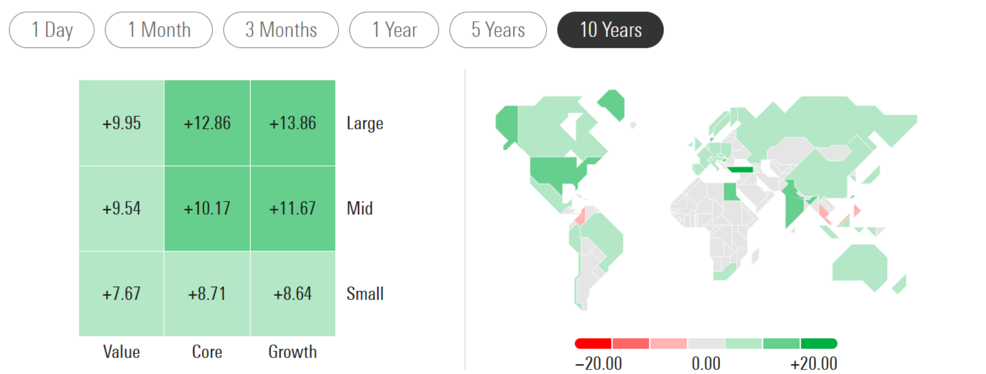
Interest rates are just one variable among many that influence investment performance. Sector effects, earnings, and valuations all matter, too. The forces that move markets, how assets interact, and which investments best suit the macro environment are less predictable than we like to think. Rules of thumb about investing are hardly the immutable laws of physics.

8 Construction Rules for Morningstar Broad Style Indexes. Morningstar Indexes.

5) There Is Nothing Permanent Except Change

As discussed above, correlations can go to 1 in crises. But over the long term, market segments can diverge dramatically. For more than 10 years, growth stocks have outperformed value; large caps have beaten small; and the US has been the place to be for equity investors. As displayed in Exhibit 6, the Morningstar US Market Barometer shows a massive differential between the top-performing large-growth market segment and the laggard small-cap value. Despite academic research supporting a long-term performance advantage for small-cap value, tech themes like mobile computing, the cloud, and artificial intelligence have continued to power large-growth stocks. From a geographic perspective, the Morningstar US Market Index's 10-year performance lands it in dark green territory. It has massively outperformed most major global markets, especially from the perspective of dollar-based investors.

Exhibit 6 Equity Market Segments: Dramatic Divergence Over the Past 10 Years



Source: Morningstar.com. Data as of Nov. 15, 2024.

Ever since late 2022, highly profitable "quality" stocks, mostly larger caps and with a growth bent, have reigned supreme. The "Magnificent Seven" of Apple, Microsoft, Nvidia, Alphabet, Amazon.com, Meta Platforms, and Tesla has beaten the value side of the market and smaller caps. Morningstar factor indexes focused on value, yield, size, and low volatility lagged quality and momentum.

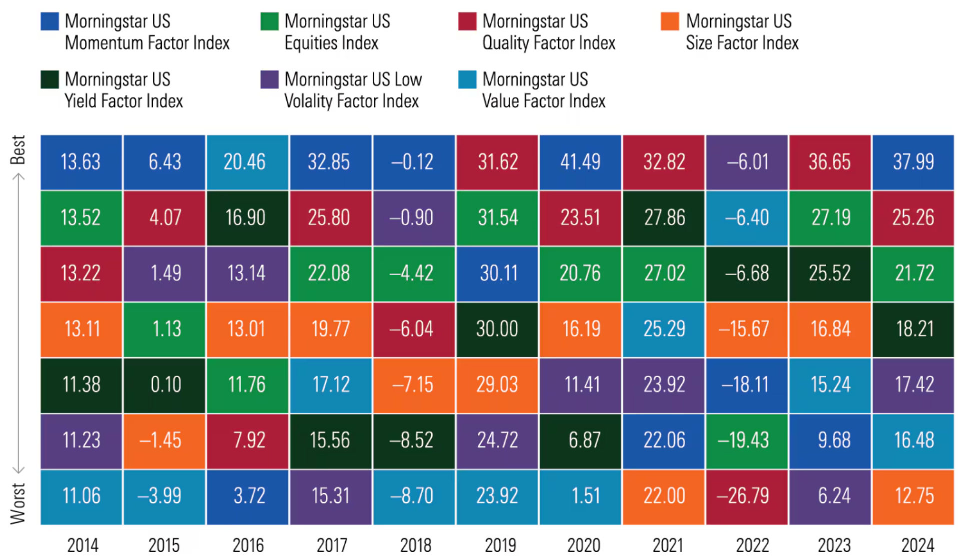
“Rotation" is a term that has trended throughout 2024. Whether viewed through the lens of the Morningstar Style Box, sectors, or investment factors, equity market leadership has shown signs of change. The Morningstar Global Markets ex-US Index outgained its US counterpart in the third quarter, with the Morningstar Emerging Markets Index up even more. Value beat growth. Small caps outperformed. The presidential election set off a furious rally in US small caps, perceived to benefit disproportionately from the new administration's agenda.

Change is nothing new in markets. As displayed in Exhibit 7, in any given year, a different group of stocks could be on top. Morningstar Factor Indexes[9] display the dynamism of equity market leadership.

9 Construction Rules for Morningstar Global Factor Indexes. Morningstar Indexes.

Exhibit 7 Market Leadership Is Constantly in Flux

Morningstar Factor Indexes: Periodic Table of Returns



Source: Morningstar Direct. 2024 returns are through Sept. 30.

Will 2024's rotations last? Investors will be reminded that signs of change manifested in 2016, 2018, and 2022. These ultimately turned out to be head fakes.

To paraphrase an axiom, the degree of change is often overestimated in the short term but underestimated in the long term. After the dot-com bubble burst in 2000, value and smaller caps trounced growth for years. Skepticism toward the technology sector was ubiquitous. A commodities "super cycle" fueled by China's expanding economy drove financial markets globally in the early 2000s. US equities experienced a 'lost decade," while emerging markets and European shares outperformed.

Consider that in 2009, US stocks represented 40% of the Morningstar Global Markets Index's weight (it's now well over 60%). The energy sector represented more than 10% of global equity market value 15 years ago (it's now closer to 4%). Few predicted US equities and the US dollar would so thoroughly dominate the era following a crisis that originated in the American housing market and financial system. How many expected the technology sector to reach such heights back when the FANG acronym—for Facebook, Amazon.com, Netflix, and Google—was first conceived back in 2013?

Don't Predict. Prepare.

So, what's an investor to do? Divining market direction over the short term is extremely difficult. It can also be vexing over longer time periods. The era of dominance for US large-cap growth stocks has lasted far longer than many have expected. It has given life to many thematic strategies.

On the flip side, several cohorts have been frustrated. Emerging-markets enthusiasts, believers in the value effect, and small-cap investors have all underperformed—badly. Dividend-focused investors have failed to participate fully in equity market gains because of the outperformance of the fast-growing, dividend-light section of the market.

Diversification is always a sensible approach in the face of uncertainty. Portfolios should be ready for a range of scenarios. Equities outside the US could outperform; value stocks may beat growth, and small caps could go on a winning streak. Today's healthy bond yields are a better starting point for future fixed-income returns than they were during the years of ultralow interest rates following the financial crisis. Natural-resources-related investments, for their part, have shown they can enjoy days in the sun. Because the future rarely resembles the past, the case for holding a broad set of assets is strong.

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles, and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

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