Unlearn What You Have Learned About Investing: Lessons From 2023

Morningstar Indexes' insights into market leadership, the impact of macroeconomic factors on assets, and diversification.

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In *Star Wars: The Empire Strikes Back*, Yoda told Luke Skywalker, "You must unlearn what you have learned." Investors would do well to heed the Jedi master's invocation to abandon preconceived notions. As 2023 draws to a close, we reflect on a year filled with unforeseen events and common assumptions overturned. To be fair, that describes most years.

When 2023 began, economists were debating whether the United States would experience a hard or soft landing with inflation raging and the yield curve inverted. Yet, by the third quarter of the year, gross domestic product was expanding by 5%. On the flip side, China's much anticipated postpandemic economic recovery didn't materialize, giving way to concerns over "Xi's failing model."[1] The Israel-Hamas War was as unexpected as Russia's invasion of Ukraine in 2022.

Investment markets were also full of surprises in 2023. Equities rebounded impressively from a miserable 2022, and Japan came to life. Tech-related growth stocks resumed market leadership. Meanwhile, investors lured into fixed income by high yields and the promise of falling rates were met with borrowing costs that promised to stay "higher for longer."

Morningstar Indexes proposes five (un)learnings from 2023.

1) Higher interest rates aren't necessarily bad for growth stocks.
2) Higher interest rates aren't necessarily good for banks.
3) Economic growth and recovery don't always boost small caps.
4) Low valuations alone can't lift equities outside the U.S.
5) Bonds sometimes diversify equity risk and sometimes don't—and fixed income isn't a monolith.

1 *The Economist*. "Xi's broken model: Why China's economy won't be fixed." Aug. 26, 2023.

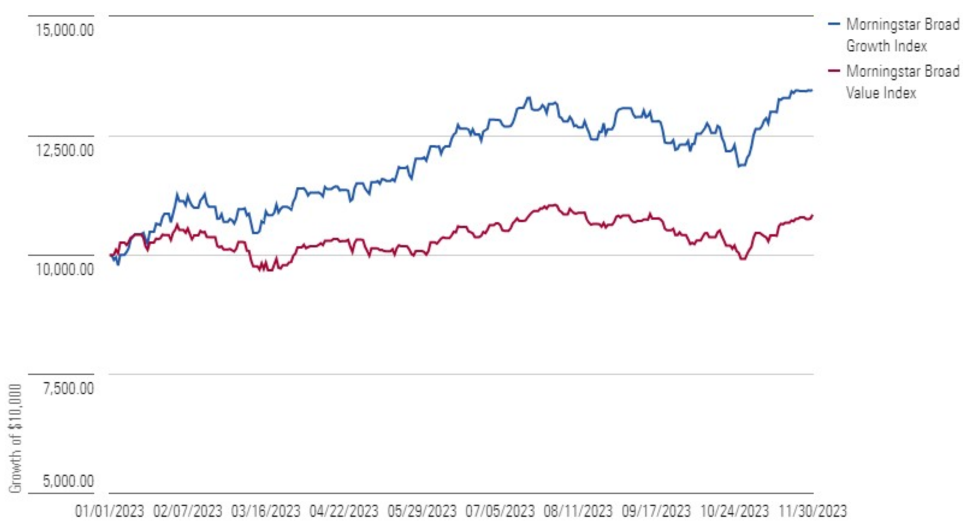
Higher Interest Rates Aren't Necessarily Bad for Growth Stocks

Growth stocks are more sensitive to interest rates than value stocks. Higher rates devalue the long-dated earnings of fast-growing companies discounted back to the present.

This narrative trended heavily in 2022, a year in which Morningstar's growth stock indexes—tracking both U.S. and global equities—fell roughly 30%, while the Federal Reserve and other central banks jacked up rates to combat persistent inflation. Meanwhile, value stock indexes lost just 7% last year.

We've heard considerably less about growth stocks' sensitivity to rates in 2023 because the growth section of the market bounced back despite several rate hikes. In the U.S., the federal-funds effective rate moved to 5.3%, and a "higher for longer" rate reality set in. Yet, the "Magnificent Seven," a clique of mega-cap growth stocks including Nvidia, Microsoft, Apple, Tesla, Amazon.com, Meta, and Alphabet, captured the lion's share of equity gains. Outside the U.S., Taiwan Semiconductor and ASML were big winners. Many of 2023's stars are perceived beneficiaries of the theme that's been consuming investors ever since the introduction of ChatGPT in November 2022: artificial intelligence.

Exhibit 1 Growth Stocks Shook Off High Interest Rates to Outperform in 2023



Source: Morningstar Direct. Data as of Nov. 30, 2023, for the Morningstar US Large Mid Broad Growth Index Total Return USD and Morningstar US Large-Mid Broad Value Index Total Return USD.

Growth stocks' outperformance amid 2023's rising rates is hardly anomalous. Growth also beat value between 2015 and 2018, amid the Fed's efforts to normalize rates after post-financial-crisis monetary stimulus. In 1999, growth stocks outperformed despite three Fed rate hikes.

While the future of AI is uncertain, today's growth stock dominance is built on firmer foundations than in the 1990s, when "eyeballs" were cooler than earnings. The "Magnificent Seven" all generate strong cash flows. They have "moats," or durable competitive advantages that protect their profits from competition.

Valuation matters, though. Coming into 2022, growth stocks carried lofty prices. They soared in 2020 and 2021 as investors extrapolated the rate of pandemic-era technological change onto the future. Then, when inflation went from "transitory" to "stubborn" and the monetary policy response finally arrived, sentiment changed. The market's highest flyers fell the furthest. Plus, Russia's invasion of Ukraine sent oil prices through the roof, lifting value-leaning energy stocks.

The swing from euphoria to despondence opened opportunity. The Morningstar Wide Moat Focus Index, which selects U.S. wide-moat stocks with the lowest share prices relative to Morningstar analyst estimates of fair value, added Meta, Amazon, Alphabet, Microsoft, Salesforce, and others at its December 2022 reconstitution. Nvidia was already an index constituent.

Valuation calls can take time to play out, but AI has been a powerful catalyst. Fallen growth stocks helped propel the Wide Moat Focus Index to strong 2023 returns. Clearly, rates are just one variable in the complex interplay of factors driving asset prices and determining market leadership.

Higher Interest Rates Aren't Necessarily Good for Banks

Bank failures were on few prediction lists for 2023. Yet, the first quarter saw the collapse of Silicon Valley Bank and other lenders linked to venture capital and cryptocurrency, as well as the demise of 167-year-old Credit Suisse. In May, First Republic Bank became the second-largest bank failure in U.S. history. The Morningstar US Banks-Regional Index tells the story of a troubled industry.

Exhibit 2 U.S. Regional Banks Plunged in 2023 Amid Several Failures, Rising Interest Rates Were Blamed

Source: Morningstar Direct. Data as of Nov. 30, 2023, for the Morningstar US Market Index Total Return USD and Morningstar US Banks-Regional Index Total Return USD.

Curiously, rising interest rates were blamed for the turmoil. Aren't higher rates supposed to be good for banks? "Higher rates are a positive driver of earnings across much of the financials sector, from banks that charge more for loans to insurers that earn more on their investable float," wrote Michael Wong, Morningstar's director of equity research for financial services, in early 2022.[2] Indeed, the Fed's steep rate hikes in 2022 widened the spread between deposit rates and lending rates.

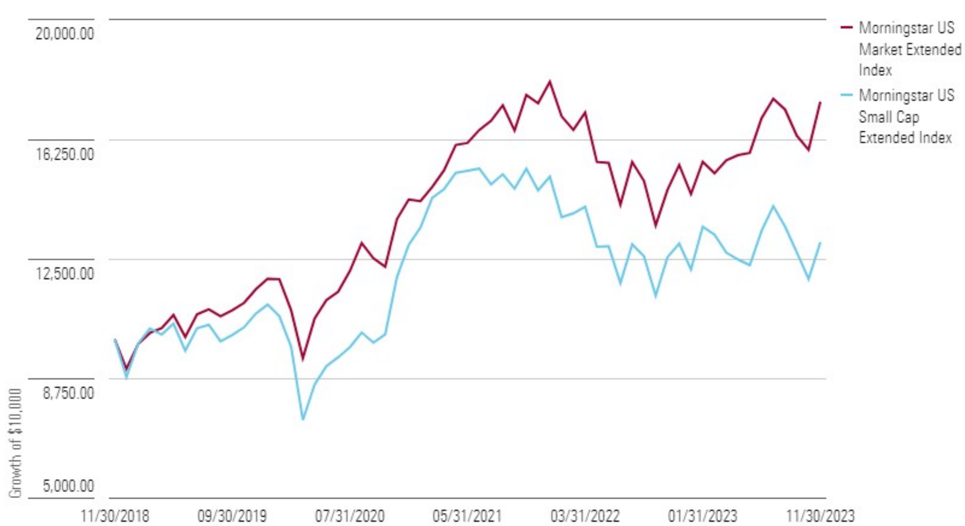
At the same time though, financial institutions suffered painful markdowns on their books of long-term U.S. Treasuries and agency mortgage-backed securities. Duration risk on bank balance sheets has blown up before. The steep interest-rate hikes of 1978–82 helped cause the U.S. savings and loan crisis.[3] So, it turns out that the relationship between interest rates and the health of banks and other financial institutions is far more complicated than indicated by the old rule of thumb.

The same is true for dividend-paying stocks. The Morningstar Dividend Yield Focus Index was in positive territory in 2022 even as the overall equity market was down, but it lagged badly in 2023. The conventional wisdom holds that when rates go up, dividend income becomes less attractive, and higher borrowing costs hurt dividend payers that borrow to fund operations. The reversal of fortune has more to do with sector dynamics than rates. Energy and defensive areas buoyed the equity-income section of the market in 2022, while a bias toward value stocks hurt in 2023. Many of 2023's big winners don't pay dividends.

Economic Growth and Recovery Don't Always Boost Small Caps

Consider the plight of U.S. small-cap stocks over the past five years.

Exhibit 3 U.S. Small Caps Have Lagged Badly, Including During Periods of Economic Growth and Recovery



Source: Morningstar Direct. Five-year trailing return data as of Nov. 30, 2023. Total returns in U.S. dollars.

What's especially surprising is that small caps have underperformed during periods of economic growth and recovery. This defies a common investment assumption. Small caps are widely perceived to be

2 Wong, M. "Higher Interest Rates Could Lift Financials Stocks." Morningstar Quarter-End Insights. April 6, 2022. https://www.morningstar.com/articles/1087452/higher-interest-rates-could-lift-financials-stocks

3 Ligon, K. 2005. "A Changing Rate Environment Challenges Bank Interest Rate Risk Management." FDIC. https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/sisummer05-article1.pdf

economically sensitive, rallying in recoveries and lagging heading into recessions. They are more domestically focused and less diversified in their business lines than large caps, and they are thought to have more exposure to interest rates, consumer demand, and commodities prices. "When recessions end, small caps have led the way" is a commonly heard investment insight.

Yet, small caps underperformed during the bounceback from the pandemic recession and equity market plunge that took U.S. economic growth to 6.1% in 2021. They also lagged badly in 2023, when the economy defied forecasts of both a hard and soft landing and grew nearly 5% in the third quarter.

Sector biases help explain small caps' woes. The small-cap universe is relatively light on technology, the best-performing sector. Heavy exposure to financials, real estate, and materials has dragged.

Small caps are thought to possess a long-term performance advantage. Decades ago, academic research postulated that small caps compensate investors for their extra risk. They are less proven, less liquid, and more volatile. Small caps have led during many periods, including the early 2000s. Diversification and valuation are better reasons for small-cap exposure than economic forecasts.

Low Valuations Alone Can't Lift Equities Outside the U.S.

It was by no means obvious in 2010 that U.S. equities would so thoroughly dominate in the years after a financial crisis that originated in the U.S. housing market and financial system.

Exhibit 4 U.S. Equities Have Dramatically Outperformed Their Global Counterparts

Source: Morningstar. Ten-year trailing return data as of Nov. 30, 2023. Total returns in U.S. dollars.

How has this happened? Valuations for U.S. equities have soared, but earnings growth, high returns on capital, innovation, and moats are there, too. Dollar strength explains some but not all of the gap.

Markets outside the U.S. have simply not kept up. Chinese internet giants like Tencent and Alibaba had a spectacular rise but then were undermined by a government crackdown starting in late 2020. Corporate Europe has been labeled as "the land that ambition forgot"[4] for its lack of dynamism.

Enter Japan. The Morningstar Japan Index's near 30% gain for 2023 in yen terms illustrates that valuation alone is not enough to power equity market returns. Several catalysts are at work. Corporate Japan has undertaken real structural reform, with governance having improved markedly. Price rises have broken a long cycle of deflation; wages are growing; and capital expenditure is afoot.

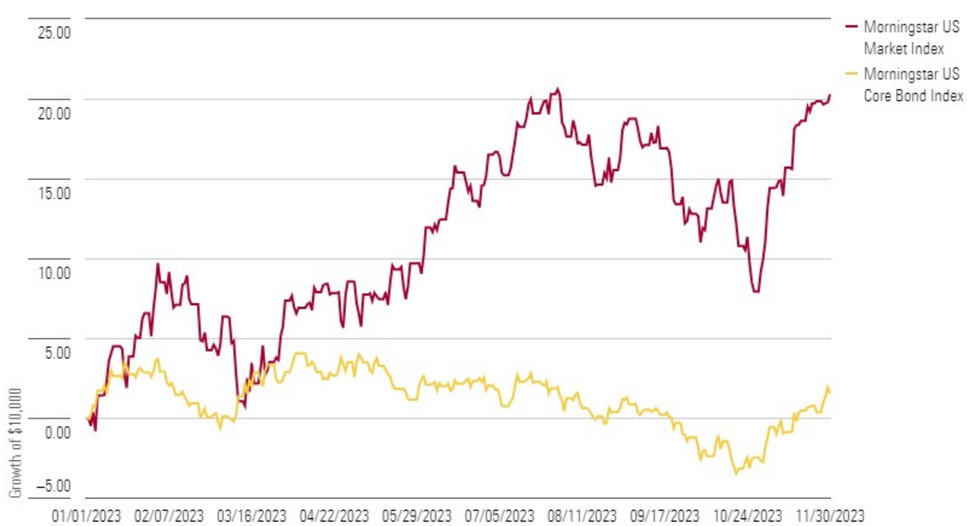
What other catalysts might emerge to turn the tide toward equities outside the U.S.? China's economic recovery from the pandemic was a false dawn. The long-term structural story around emerging markets remains compelling, but equity returns don't always follow growth.

Regardless of what happens in the near term, there's a good strategic case to be made for maintaining global exposure. Investing across borders confers diversification benefits even though correlations have climbed. Leading franchises can be found everywhere, including companies that derive significant revenues from the U.S. Lower valuations alone aren't enough to prompt a leadership rotation, but widening the opportunity set is a sensible move for investors.

Bonds Sometimes Diversify Equity Risk and Sometimes Don't—and Fixed Income Isn't a Monolith

After a 2022 called "The Worst Bond Market Ever,"[5] fixed income was far less dramatic in 2023.

Exhibit 5 The Broad Bond Market Bounced Back in 2023 From 2022's 'Death of Diversification'



Source: Morningstar. Data as of Nov. 30, 2023. Total returns in U.S. dollars.

4 *The Economist*. "The land that ambition forgot." June 5, 2021.

5 Rekenthaler, J. "The Worst Bond Market Ever." Morningstar.com. Nov. 21, 2022. https://www.morningstar.com/economy/worst-bond-market-ever

Early gains for the Morningstar US Core Bond Index were erased in the third quarter as the yield curve became less inverted. Then in November, the U.S. bond market enjoyed its best month since 1985. Optimism around interest-rate cuts in 2024 lifted the core bond index into positive territory for 2023 and gave a jolt to the Morningstar US Moderate Target Allocation Index, which represents the traditional mix of 60% stocks and 40% bonds.

It's been quite a turnaround from 2022 when the "death of diversification" was widely declared. Fixed income failed in its role as portfolio ballast last year. Previous bear markets for equities, including the "pandemic panic" in the first quarter of 2020 and the global financial crisis of 2007-09, saw the Morningstar US Core Bond Index rise, benefiting from a flight to safety and quantitative easing. In 2022, Morningstar's 60/40 benchmark declined nearly as much as a pure equities portfolio.

No one complains about positive correlations between stocks and bonds when both asset classes rise, as they have in 2023. The fact is that relationships between assets are dynamic. Diversification across stocks and fixed-income instruments of different types is a sensible long-term strategy but won’t always benefit investors in the short term.

Meanwhile, credit-sensitive sections of the bond market thrived in 2023. The Morningstar US High Yield Bond Index, which comprises lower-rated corporate debt, posted a healthy gain. A strong economy has kept default rates low. Many companies refinanced debt before borrowing costs rose.

Leveraged loans, for their part, are one of the best-performing asset classes of 2023. With the Morningstar LSTA US Leveraged Loan Index's yield over 10%, coupled with low default rates, demand for bank loans has soared. Reduced primary issuance in 2023 has strengthened the secondary market.

From a diversification perspective, it's important to remember that credit-sensitive instruments have tended to be more equitylike in their behavior. The fact that high-yield corporates and leveraged loans have thrived in 2023, a positive year for equities, reinforces this link. Historical volatility for both asset classes, while below the level of stocks, far exceeds that of Treasuries. Fixed income is anything but a monolithic asset class.

How Should Investors Apply These Unlearnings?

Investors should be skeptical of conventional wisdom. Uncertainty surrounds the forces that move markets, how assets interact, and which investments best suit the macro environment. Rules of thumb about investing are hardly the immutable laws of physics.

Tuning out the noise, sticking with a strategic asset allocation, and rebalancing periodically is a sensible approach. Tactical bets are extremely difficult to get right. Investors persistently miss out on returns by mistiming purchases and sales.[6]

Valuation-driven investing also holds merit, as the Morningstar Wide Moat Focus Index's track record demonstrates. Patience is critical, however, because prices and intrinsic value can take years to converge. The growth stock rebound of 2023 was a valuation call that played out quickly because AI was a catalyst. The failure of equities outside the U.S. to take the leadership mantle shows that low prices alone don't catalyze markets.

6 Mind the Gap 2023. Morningstar. https://www.morningstar.com/lp/mind-the-gap.

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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