MORNINGSTAR Wealth

2024 Outlook

Empowering Investor Success

RISK-AWARE MINDSET

Economic Questions and Portfolio Positioning

The Risks Ahead, Including Geopolitics

GROWTH MINDSET

The Growth Opportunities Available From AI

Taking Advantage of the 5%+ Rate Reset

Our Best Investment Ideas Heading Into 2024

Welcome to Our 2024 Outlook

DAN KEMP
Chief Research and Investment Officer

As we stand at the threshold of 2024, it's essential we remind investors that the presence of uncertainty does not imply a scarcity of opportunities. Our approach to the year will be a blend of caution and optimism.

For those in the U.K., Europe, or the Middle East, the investment arena may appear daunting given recent market volatility. Yet we see investment opportunities emerging. Periods of market volatility and pessimism should not be seen as a barrier to investment but rather are a normal part of the journey to reach financial goals.

We know that 2024 will bring surprises for all investors, so rather than treat the future as if it is encoded in a crystal ball, we've focused this outlook on the wellbeing of the investor. We see positives in this environment, with opportunities to add value in fixed income and selected equity markets, among other ideas. By helping investors overcome whatever challenges the next year holds, it is our commitment to help you make sensible decisions that match the 2024 environment.

The Key Questions on Your Mind

For our 2024 outlook, we've made a conscious effort to spotlight the key issues on the minds of investors. We have created four sections—two looking at risks, two looking at opportunities—then pulling it together into our best investment ideas as we enter 2024. We've brought together our experts from across Morningstar's global Research, Analytics and Investment team to give their insights on each of the following topics:

1. **The Macro Backdrop & Economic Questions:** In a world where economic trends can seem cryptic, our role is to provide clarity and direction. By exploring various economic scenarios, we aim to forge a resilient strategy adaptable to an unpredictable future.
2. **Today's Risks, Including Geopolitical Tensions:** The global political stage is undoubtedly difficult. But we can't let it cloud our long-term view. It becomes crucial to evaluate political uncertainties, while staying anchored to core investment principles.
3. **Understanding AI—Both Opportunities and Risks:** Artificial Intelligence represents a potential revolution. It's thrilling yet overwhelming. It's essential for us to discern hype from reality, understanding how AI can genuinely enhance our portfolios.
4. **Taking Advantage of the 5%+ Rates Reset:** Yes, higher rates can be intimidating. But they also open up new opportunities. It's about turning adversity into advantage, leveraging higher rates to build robust portfolios and capitalise on potential returns.
5. **Sharing Our Best Investment Ideas:** Beyond portfolio construction, our aim is to help shape futures. We're excited to share our best investment ideas, offering insights for informed and confident decision-making.

In the face of these challenges, we at Morningstar remain fundamentally focused, turning to the key pillars of our investment approach. Perhaps the most significant pillar is adopting a long-term perspective on investments, which can be especially difficult to maintain in volatile environment. While market fluctuations may sway investor sentiment in the short run, prudent investors stay the course, focusing on matching their portfolio horizon to their goals.

Most investors have long-term goals (such as retirement) and should therefore focus on long-term value creation. Similarly, it is worth noting that risk management is a critical pillar of successful investing. An effective risk management strategy balances investment opportunities with future uncertainty, equipping investors to navigate through market volatility.

Investors Should be Positive as We Enter 2024

While distilling our entire outlook into a few key takeaways is challenging, there are three areas that I believe are particularly important as we consider the year ahead:

My Top 3 Takeaways from the 2024 Outlook

The Key is a Robust Portfolio: Some of our favoured opportunities—including banks and emerging markets—can be cyclical. We size these exposures carefully and add offsets to create more robust outcomes.

Say Yes to Bonds: We like longer-term bonds more than have in a decade, but we are prepared for surprises, which is why short-duration bonds still factor into our portfolio construction.

Risk Creates Opportunity: Increasing return prospects within fixed income make it a more compelling opportunity but select equity markets still offer more attractive returns.

Putting this together, it becomes clear that the key to successful investing lies in maintaining a long-term view, applying diligent risk management, cultivating solid savings habits, embracing fundamental change and adopting a goal-oriented investment approach. With these guardrails in place, investors are well positioned to navigate the dynamically changing investment landscape and ensure that 2024 becomes a year in which they make meaningful progress towards their goals.

Our Thanks to the Contributors

I am immensely thankful to the 400+ strong team (as of July 2023) of researchers and investment professionals here at Morningstar whose work is represented in this document – it is a great service to the people we serve. The team listed below deserves the true accolades in our mission to empower investor success.


Marta Norton
Chief Investment Officer, Americas


Matt Wacher
Chief Investment Officer, Asia Pacific


Mike Coop
Chief Investment Officer, EMEA


Ryan O. Murphy
Global Head of Behavioral Insights


Kenneth Lamont
Senior Analyst, Manager Research, EMEA


Grady Burkett
Portfolio Manager, Select Equities, Americas


David Sekera
Senior U.S. Market Strategist


Mark Preskett
Senior Portfolio Manager, EMEA


Brian Moriarty
Associate Director, Fixed Income Strategies


Hong Cheng
Portfolio Manager, Outcome-Based Strategies, Americas


Michael Field
Market Strategist Europe, EMEA


Preston Caldwell
Senior U.S. Economist


James Foot
Head of Research, Asia Pacific


Tyler Dann
Head of Research, Americas


Ed Fane
Head of Research, EMEA

Economic Questions and Portfolio Positioning

Why Focus on Economics?

Economics get a lot of headlines — with mass speculation around interest rates, inflation, and economic growth. This impacts markets directly. Asset prices change not just in response to economic change, but also in anticipation of it. Portfolio construction must account for economic change — both expected and unexpected.

Key Takeaways

- We expect further economic change in 2024. Europe and the U.K. remain fragile economically. Against this backdrop, it is plausible for central banks to cut rates from mid-2024 and into 2025.
- Questions around potential recession risks and the inflation outlook will likely persist. The ECB and the Bank of England are walking a tight-rope between reducing inflation and strangling a struggling economy. There are a wide range of potential outcomes around the base case.
- Among equities, valuations present us with opportunities. By looking for undervalued areas of the market that can add robustness, defensive stocks are of interest.
- Certain scenarios pose a challenge to any "base case" assessment. At present, known risks include geopolitics and its impact on the oil price, for example. However, our scenario analysis sheds light on various potential outcomes that are currently unknown too, offering a perspective on non-normal scenarios that can greatly influence investment decision-making. Defensive equities and a mix of bond holdings feature as core assets to manage these risks.

Turning Ideas into Actions for 2024

Inflation Likely Lower, But Not Certain

While everyone talks about "higher for longer" rates, inflation is gradually falling back to central bank targets. This is a potential positive, but is by no means certain.

Recession Risk Alive, But Not Our Base Case

Weak but positive growth is expected in the U.S., although risks remain. If a recession does occur, we want to have defensive assets on hand.

Defensive Equities to Play a Role

We assess certain risk offsets — including healthcare and utilities — to be undervalued and help create robustness.

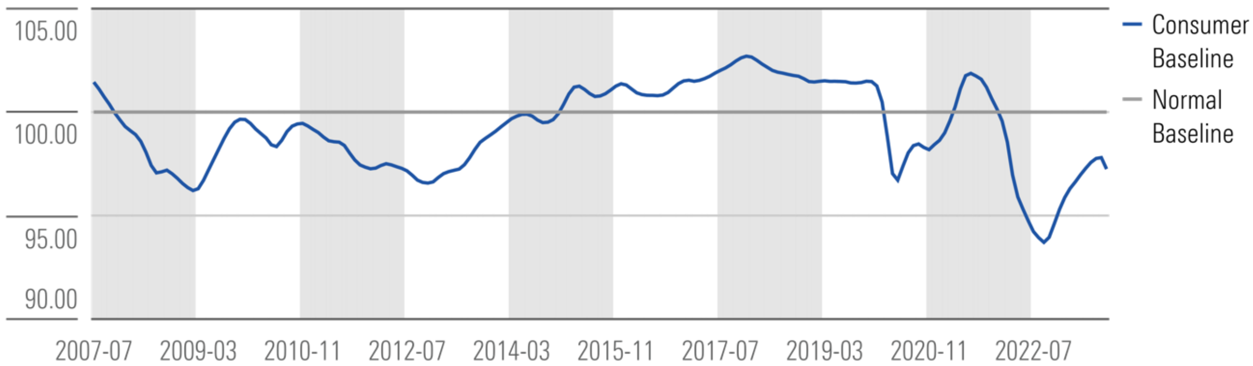
The Economic Reality and Our Base Case

Drawing on the macroeconomic backdrop, market participants are eager to understand the path of interest rates, inflation, and economic growth. This is naturally complex, with divergence between the developed world and emerging markets. For example, the economic trajectory of Europe is vastly different to the U.S. and China heading into 2024. The same can be said for Japan.

Europe and the U.K. remain fragile economically. Economic growth has been essentially flat since Covid, with the Eurozone now likely to be in a technical recession. Sentiment readings have been screening negative for some time now, most notably manufacturing PMIs. Wage inflation has not risen as strongly as in the U.S., meaning that consumers are left particularly cash-strapped, which is pressing heavily on consumer spending.

Inflation has fallen materially from the double-digit levels of late 2022, but remains well above central banks' targeted levels. With the ECB and the Bank of England projecting that inflation will remain high in 2024, central banks still have work to do.

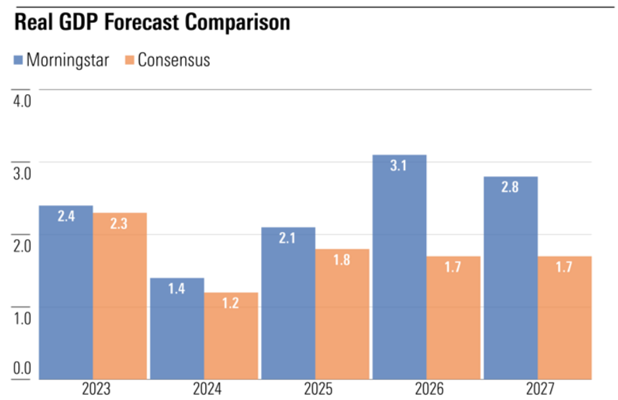
Exhibit Eurozone Consumer Confidence Remains Weak (Under 100 is a Signal of Consumer Vulnerability)

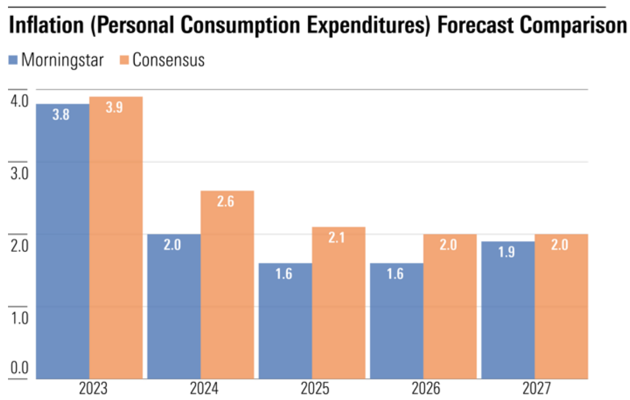


Source: Eurostat. Data as of 30 September 2023. For illustrative purposes only.

In the case of the U.S., our economic outlook is on the optimistic side—relative to expectations—with respect to U.S. GDP growth and inflation for the next several years. Our analysis shows an expectation for GDP growth to slow in 2024, owing to the lagged effects of Federal Reserve rate hikes along with more cautious consumers as household excess savings deplete. But, slowing growth along with normalising inflation could induce the Fed to begin cutting rates aggressively in 2024. We expect monetary loosening to drive a strong GDP growth rebound over 2025 to 2027, which will also be facilitated by supply side expansion in terms of labour supply and productivity. There is an expectation for inflation to return to the Fed's 2% target in 2024 and stay there in following years. The supply constraints which caused a surge in inflation in 2021-2022 are now alleviating. This allowed inflation to fall dramatically in 2023 despite an acceleration in GDP growth. This process still has much room to run.

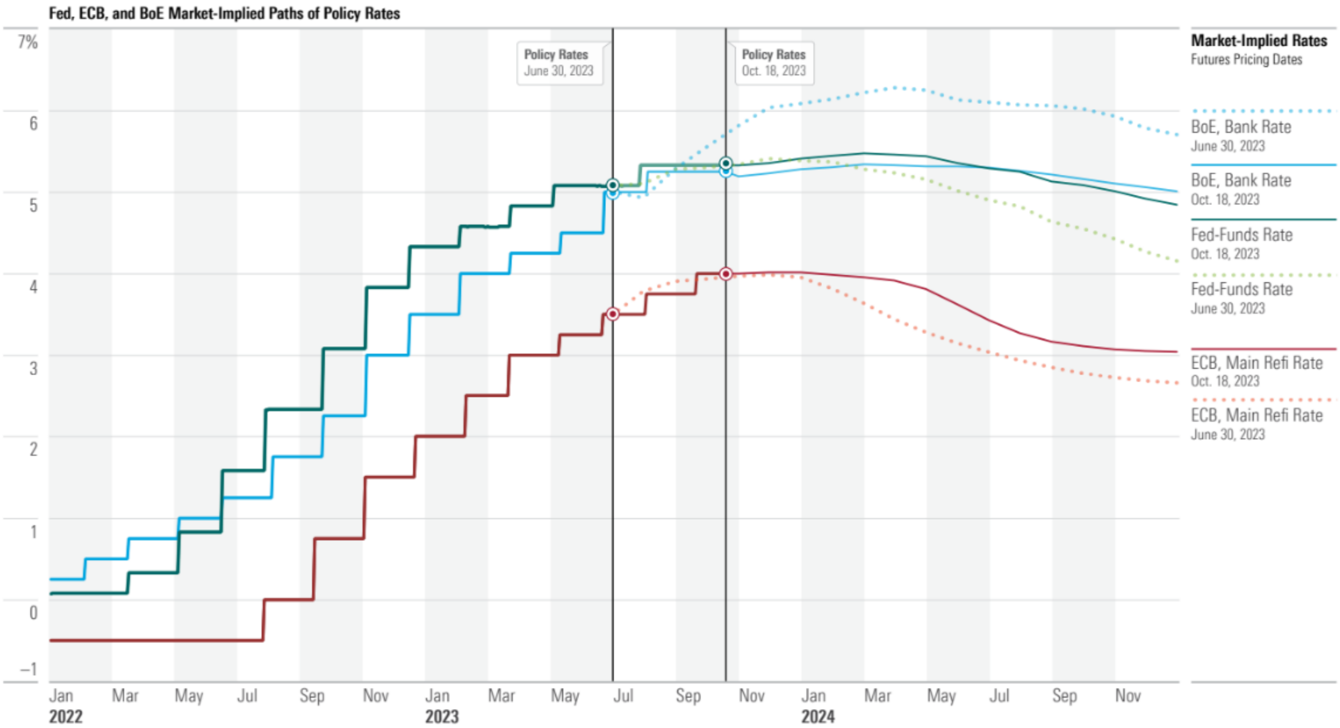
Exhibit U.S. Economic Growth and Inflation Expected to be Lower in 2024





Source: Morningstar Direct, U.S. Economic Outlook, data as of 31 October 2023. The forecasts shown do not guarantee future performance. Data presented is indicative and for illustrative purposes.

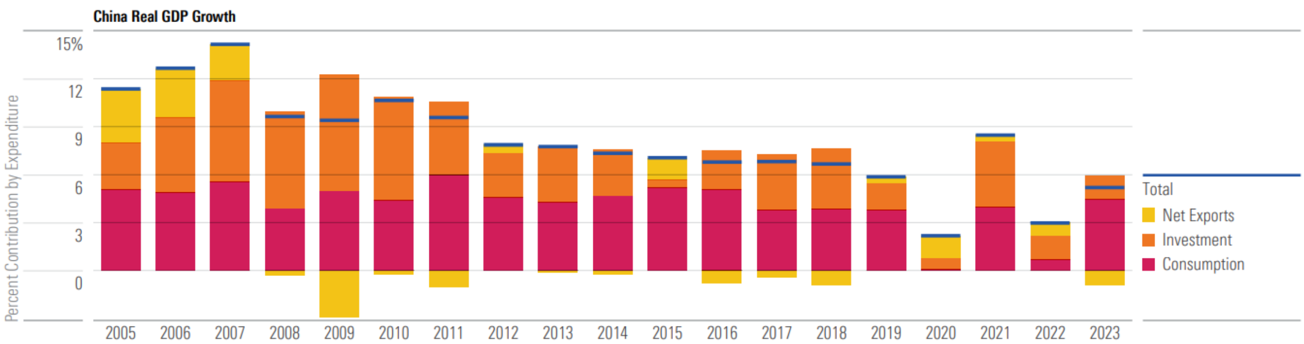
Exhibit Across the U.K. and Europe, the Interest Rate Pathway is Far From Certain, But the Market Expects Rates to Fall



Source: Morningstar Direct, Markets Observer, as of 30 September 2023. For illustrative purposes only.

Turning our attention to the emerging markets, it's crucial to note the diverse economic dynamics at play within this block. Many eyes are directed at China, where inflation is less of an issue. Economic weakness could still present a challenge in 2024 though, as well as geopolitical threats over Taiwan and commercial property risks. Elsewhere, despite the economic slowdown, certain markets in Asia and Africa are demonstrating resilience and offer attractive growth prospects. However, external debt vulnerabilities, commodity price volatility, U.S. dollar strength, and geopolitical risks necessitate a degree of caution.

Exhibit China's Growth Trajectory is a Challenge



Source: OECD Data. Data as of 30 September 2023.

Swing Factors

Our base case scenario is the most likely, but not the only outcome possible. As always, there are swing factors that can push up or down inflation, economic growth and interest rates. Many of these have dramatically changed the course of economies and markets in recent years. Here are three that have the potential to result in a wider range of outcomes than seen in more stable environments.

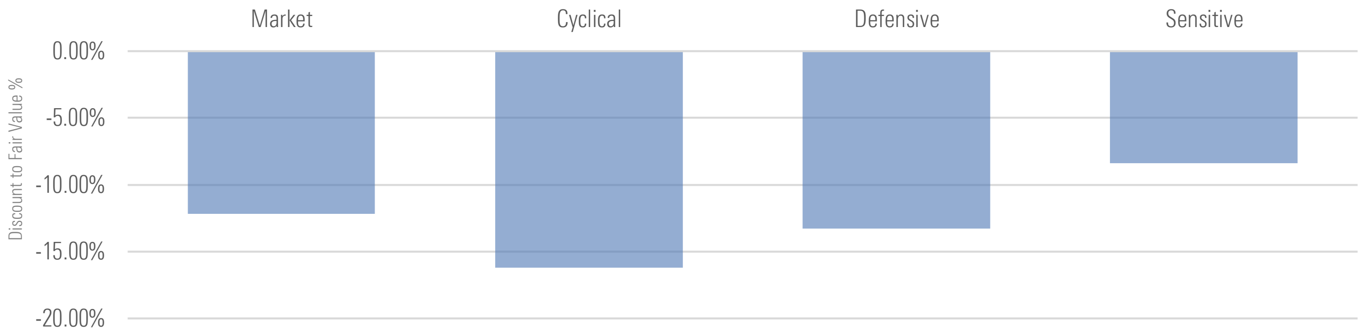
1. Geopolitics has become a greater swing factor in recent years, with the return of military conflict in eastern Europe and the Middle East. We've also seen more abrasive relations between China and the U.S. and scope for elections to result in large policy shifts. As investors anticipate change and adapt to new risks, these conflicts have already impacted prices, with potential knock-on effects on commodity prices including critical energy supplies. We must also weigh the economic effects of an ongoing rise in military spending in Europe, Asia and the U.S.
2. Natural events impacting our physical environment and health have the potential to impact growth and inflation depending on severity and government responses. Extremes in weather impacted energy demand in 2021 with shortfalls in solar and wind in North Asia causing higher demand and prices for gas while pandemics had tragic impacts and ongoing constraints on supply that especially impacted the economy in China from 2020 to 2022.
3. Our third swing factor is the take up of technological innovation. Only when the breakthrough discoveries of the past like the printing press, steam engines, electricity and computing were applied at scale did they enhance productivity, increase growth and ease inflationary pressures. The faster artificial intelligence is applied, the faster the effects will be felt and we are at the point now where application is expected to ramp up.

Taken together, in periods of change like today, investors need to prepare themselves for a wider-than-usual range of potential economic outcomes.

How Much of the Economic Challenge is Priced In?

Looking at equities in terms of defensive versus cyclical sectors, we can see that markets are offering a discount in both areas, in aggregate. This does not typify what we'd expect in a period of economic weakness, where we would usually expect to see cyclicals offer a bigger discount relative to defensives. Given the challenging economic environment, this could be interpreted as favouring defensive over cyclicals, although this view is modest.

Exhibit Globally, Valuations Slightly Favor Cyclical Assets, Although Defensives Aren't Far Behind (Current Discount to Fair Value)



Source: Morningstar Equity Manager Research. Sector roll up includes: Cyclical (materials, consumer cyclicals, financial services, real estate), Defensives (Healthcare, utilities, consumer staples) and Sensitives (Communication services, energy, industrials, technology). Numbers reflect the average discount across the U.S., Europe, and Asia. Data as of 15 November 2023.

At a deeper level, across our Europe Market Outlook, North America Market Outlook, Asia Market Outlook, Australian Market Outlook, and Global Convictions, we can see utilities, communication services, and financial services all look to be pricing in an economic deterioration.

Accounting for a Range of Potential Scenarios

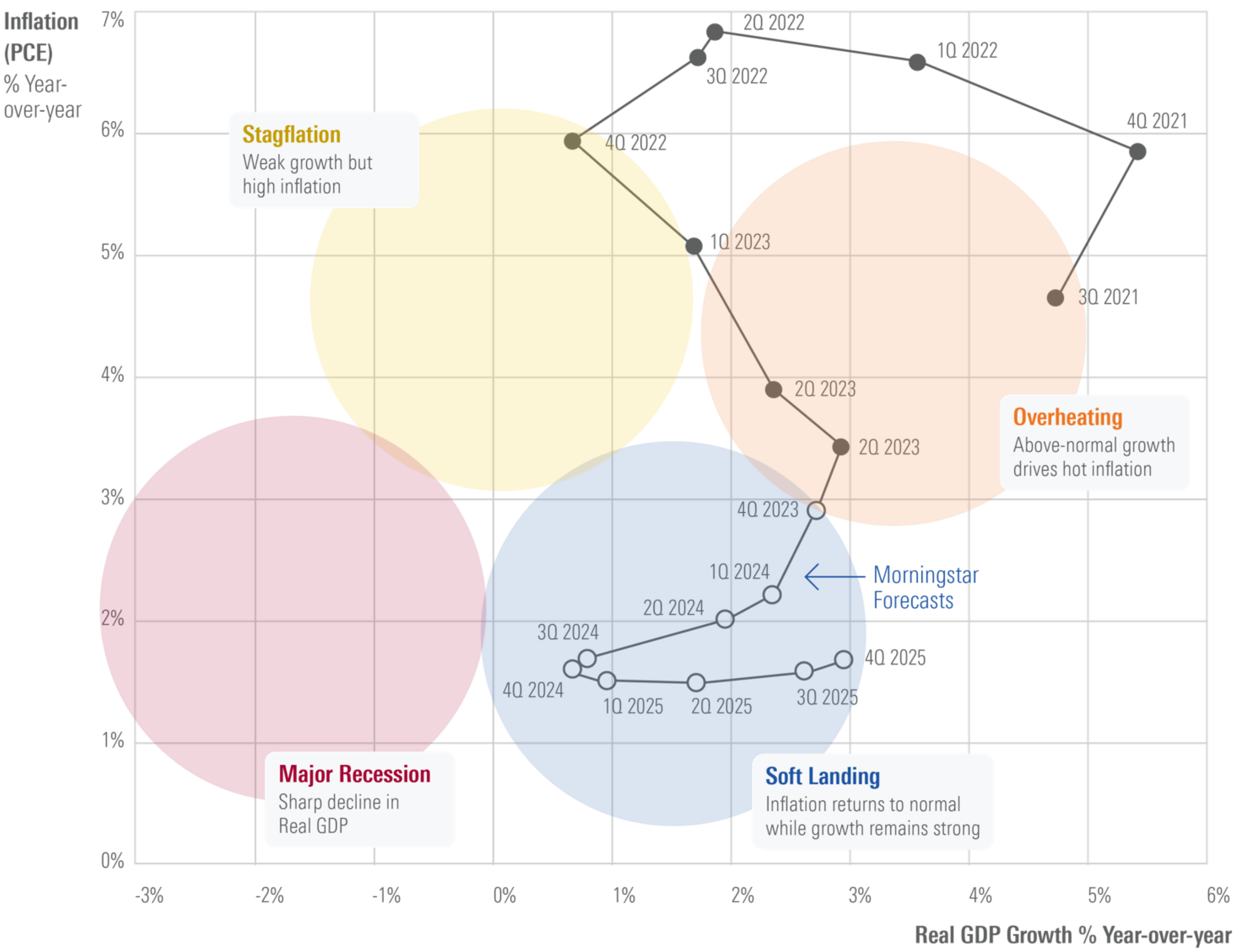
The future is inherently uncertain, so we employ scenario analysis to assess portfolio robustness and readiness in the face of non-normal circumstances. This proactive approach arms us with the necessary tools to navigate through both steady and turbulent times—regardless of the economic direction. Swings in expectations for central bank policy rates have driven a large degree of bond market volatility over the past few years.

In terms of portfolio positioning, our base case macro-outlook of lower growth, inflation and rates, but without a recession, is supportive of classic multi asset portfolios invested in bonds and equities. Bonds in particular have become more attractive as yields have increased.

We are mindful that investors need to stay the course to attain their financial goals, so holding well priced assets that can also support portfolio values in alternative scenarios is valuable, in terms of different economic growth and inflation scenarios.

Treating this as a form of insurance, inflation-linked bonds have become more attractive because their price has fallen, if inflation does turn out to be higher than expected. Defensive equities still offer value and help smooth outcomes in scenarios where economic growth is weaker than expected. Should economic growth turn out to be higher than expected, there are attractively priced cyclicals including financials and smaller companies.

Exhibit Growth and Inflation Scenarios in the U.S. is Tracking Differently to the European Experience



Source: Morningstar Direct, Morningstar Markets Observer. Data as of 31 October 2023. For illustrative purposes only.

Based on our scenario testing, the key portfolio positions that can help facilitate robustness include:

- Defensive equities, including healthcare and utilities,
- Inflation-linked bonds,
- Diversified currency exposure outside the U.S. dollar.

We acknowledge that this outlook comes amid recent volatility and a wide range of possible outcomes. In the coming years, we anticipate a complex macroeconomic playing field, influenced by various global influences and resultant investment implications. From a portfolio management perspective, these fluctuations carry both risk and opportunity, which we are keen to navigate wisely on behalf of our clients.

The Risks Ahead, Including Geopolitics

Why is Risk a Challenge and an Opportunity?

Investors are always walking the tight rope of risk. But aiming for accurate predictions around risk is a fool's game. So rather than predict, we prepare. The perception of risk can greatly impact market sentiment, often creating opportunities, too. We seek to understand both sides of the coin.

Key Takeaways

- Investor sentiment appears skittish as we enter 2024, with the convergence of headline risks.
- A short-list of current risks includes two wars, a potential recession, the upcoming U.K. and U.S. elections, political infighting, increasing signs of defaults (from a very low base) and the continued threat of inflation; to name a few.
- Risks are ever-present and come in different forms, but they are all important. The way we respond differs. We should also acknowledge the risks that aren't yet known.
- The three techniques we can use to fight risks are: a) true diversification, with offsetting positions, b) thoughtful sizing of opportunities arising from external shocks, and c) ongoing analysis on what is priced in.
- Lean into the noise, reframing risk as opportunity. If we see cheaper prices in the market, it can create potential buying opportunities. In today's market, that means taking advantage of higher government bond yields, banks, and sensible emerging market exposure.
- Conversely, some of the worst investing environments come off the back of no perceived risk.
- Remember, markets experience ups and downs - the recent volatility is considered normal in a historical context.

Turning Ideas into Actions for 2024

The Key is a Robust Portfolio

We like longer-term bonds more than we have in a decade, but we are prepared for surprises, which is why short-duration bonds still factor into our portfolio construction.

Focus on Sizing

Increasing return prospects within fixed income make it a more compelling opportunity but select equity market opportunities still offer more attractive returns.

Risk Creates Opportunity

Some of our favourite opportunities—banks, emerging markets—carry high headline risks. We size these exposures carefully and assess offsets—healthcare, utilities—to create robustness.

Today's Risks Feel Elevated, So What Really Matters?

The current market conditions highlight several significant challenges for investors. The key at this juncture is accepting the reality of market risks while not becoming unnerved by them. It's easy to lose one's bearings amidst the continuous stream of market news and speculation, dubbed as "black swan hunting". As investors, it is critical to discern this noise from facts, focusing on long-term investment strategies rather than panic-induced decisions sparked by temporary market fluctuations. If anything, lean into the volatility and reframe nervousness as excitement for opportunities.

As we stand on the precipice of 2024, it is crucial for us as investors to harness the power of behavioural science in maneuvering through the risks that lie in the landscape of economy and geopolitics. As a starting point, let's collectively agree that uncertainty is always present, with at times terrifying headlines dominating our collective consciousness. Nevertheless, equities, which make up the lion's share of most investors' portfolios, have managed to return 7.4% per year after inflation over the trailing 100 years (S&P 500 total real return, annualised), allowing investors to compound returns despite two world wars, the cold war, a global pandemic, and a range of local economic crises. That shift in perspective, from the narrow "what just happened" to the broader "how do market cycles evolve" is key in helping imperfect decision makers choose wisely in the face of irreducible uncertainty.

The Market Hates Uncertainty and Negative Surprises

The resilience of the broader markets may be cold comfort as we look at the litany of *known* risks facing us at the start of 2024, particularly for those with shorter investment time horizons. The sampling below are top of mind for us.

Exhibit Current Headline Risks are Plentiful Entering 2024

Source: Morningstar Investment Management. Risks assessed as of 15 November 2023. For illustrative purposes only.

This collection of concerns is daunting, but it's worth remembering that not every risk requires a whole new portfolio to survive its realisation. A well calibrated portfolio—a collection of global equities, fixed income across a range of maturities, and, at least for our part, carefully selected hedged strategies designed to limit overall interest rate risk—should weather external shocks fairly well.

In other words, we can build robust portfolios that can hold up to a variety of different eventualities; we don't have to have a crystal ball to know what is going to happen next. Rather we can build portfolios that find and protect value over a wide range of "what if's". In fact, to the extent an external shock causes sudden negative sentiment, we likely would consider the price dislocation an opportunity. That was the case during COVID, for example. Recall that in March 2020, global equities crashed in unison, while liquidity concerns froze bond markets, including the U.S. Treasury market, which is known as a global safe haven.

As the pandemic developed and lockdowns ensued, we had no greater foresight than anyone else on the range of potential outcomes. What we did know was that asset prices were getting crushed far beyond our estimates of normalised fair value. As a result, our portfolio managers around the globe added risk—equities (for example, energy stocks), high-yield bonds, emerging-markets bonds, and more—as quickly as we could. The rest is history. After a 22% correction between February 20, 2020 and April 7, 2020, global equity markets rallied tremendously. Despite the massive loss, the Morningstar Global Markets Index managed a 16% return for 2020 in its entirety.

Using Techniques to Manage Portfolio Risks

Of course, not every external shock follows the COVID path. Some really do impair cash flows, meaning that the fair value of the asset permanently deteriorates. A recent, extreme example? Russian equities in the wake of the Ukraine Invasion.

In other instances, a portfolio may not be as well calibrated as the investor thinks. Perhaps that's because a position wasn't sized correctly given all its risks, or the underlying fundamentals of an offsetting position wasn't fully understood.

Of course, none of that matters if it's possible to predict with certainty both the risk and the ensuing market impact. However, we argue that's near to impossible. Think about the most momentous events in recent market history. COVID and lockdowns. Global inflation. Aggressive central bank policy. Few of these developments were_predicted accurately ahead of time, and if a particular investor was able to call one risk, he or she was unable to predict the rest.

With an appreciation for uncertainty firmly in mind, we believe the best approach to managing external shocks—geopolitical or otherwise—is ongoing fundamental asset class analysis and careful portfolio construction. So, with these two tools firmly in hand, we'll walk through the 2024 risks we've identified. Rather than guessing at probabilities certain to be wrong, we will articulate the expected impact of these risks, any opportunities that could emerge, and potential offsets we believe could mitigate possible damage.

Exhibit Our Approach to Handling New Risks as We Enter 2024

Risk	Impact	Nature of Risk	Potential Opportunity	Offsetting Positions
Commercial Real Estate Crash	Regional bank write-downs	Cash Flow Impairment: Banks	Oversold regional banks	
Expanding Middle Eastern Conflict	Energy market disruption	Oil price shocks, which, in turn, could increase recession risk for vulnerable economies		Cheaply priced energy assets like U.S. MLPs and European energy
Prolonged Ukraine/Russia Conflict	Energy/food market disruption, European economic pressure	Food or oil price shocks, which, in turn, could increase recession risk for vulnerable economies		Cheaply priced energy assets like U.S. MLPs and European energy
China's Secular Growth Crash	Stagnating or collapsing Chinese economy	Cash Flow Impairment: Chinese Equities, Heightened recession risk for trade partners	Oversold Chinese Technology Equities	
China/U.S. Conflict	Rapid reshoring, global economic uncertainty	Global equity volatility		Long-term, high-quality government bonds
Resurging Inflation	Higher interest rates, falling corporate earnings, heightened recession risk	Equity and fixed income volatility		Short-term, high-quality government bonds & hedged alternatives
Developed Market Sovereign Deficits	Increased term premium (investors demanding higher long-term yields)	Cash flow impairment: Longer-term yields reset higher, price loss		Cash, hedged alternatives
U.K. and U.S. Contested Election	Political uncertainty	Short-term equity volatility		Long-term, high-quality government bonds

Source: Morningstar Investment Management. Risks assessed as of 15 November 2023. For illustrative purposes only.

A review of this list shows two consistent themes. First, we believe most of these risks result in volatility, but don't necessarily change future return expectations, which means that in many instances, price dislocation that results from these events could be a broad-based buying opportunity.

Second, we tend to look to high-quality government bonds to hedge geopolitical risk. Why? It's a relative safety proposition. Geopolitical events don't consistently cause equity market sell-offs, but when they do, we find more often than not that government bonds—particularly long in duration, but at times short-duration bonds as well—provide an offset.

Elections and Risk Management

As we approach the elections in 2024, the two primary questions for investors revolve around fiscal responsibility and the impact of potential policy changes. The direction the wind blows on these issues could determine the course of the market.

As we've observed from prior similar "event risk", the uncertainty of the moment tends to cause sell-offs in so-called risk assets—equities and corporate bonds as two prime examples. Meanwhile, government bonds tend to act as a store of value because the long-term financial stability of the government aren't necessarily in play.

Exhibit The Impact of Major Global Events, With Short-Term Equity Moves

20 Major Market Events	Date	1-Month	6-Month	1-Year
Russian invades Ukraine	24/02/2022	7.1%	-1.2%	-4.4%
U.S. leaves Afghanistan	30/08/2021	-4.4%	-2.3%	-10.3%
Brexit	24/06/2016	3.1%	8.3%	17.8%
Russia takeover of Crimea	20/02/2014	2.5%	9.7%	0.6%
Lehman collapse	15/09/2008	-27.3%	-38.6%	-13.6%
Bear Stearns collapse	14/03/2008	1.1%	-3.8%	-41.0%
London subway attack	05/07/2005	2.8%	7.6%	8.4%
Iraq war	20/03/2003	2.4%	19.6%	29.2%
9/11	11/09/2001	0.6%	7.7%	-15.5%
Russia currency default	17/08/1998	-4.0%	16.0%	28.2%
Asian Financial Crisis	08/10/1997	-5.5%	13.0%	-0.9%
World Trade Center bombing	26/02/1993	1.4%	5.7%	8.3%
Iraq invasion of Kuwait	02/08/1990	-8.9%	-1.7%	12.8%
1987 Crash	19/10/1987	-21.5%	-18.4%	-10.6%
Nixon resignation	09/08/1974	-8.6%	6.0%	17.3%
Yom Kippur War	06/10/1973	0.2%	-11.7%	-38.9%
Six-Day War	05/06/1967	3.3%	7.5%	13.5%
JFK assassination	22/11/1963	6.8%	6.8%	23.2%
North Korea invades South Korea	25/06/1950	-10.0%	4.1%	11.7%
Pearl Harbor Attack	07/12/1941	-1.0%	-6.5%	4.3%
	Average	**-3.0%**	**1.4%**	**2.0%**
	Median	**0.4%**	**5.9%**	**6.3%**
	% Time Positive	**55.0%**	**60.0%**	**60.0%**

Source: Morningstar Direct, S&P500 Index. Data as of 31 October 2023. Data presented is indicative and for illustrative purposes only.

Dangers in Commercial Real Estate, Although We Still See Merit in Banks

As with most other investors, we see the potential for meaningful write-downs within the office space, in large part due to the changing work preferences in the wake of COVID.

We've attempted to identify the various touchpoints the broader economy has with commercial real estate, and while we see potential pain points for pensions, for example, we think most of the pain for public markets will be localised in regional banks.

Even here, though, we think the risk varies by bank, and, in at least some cases, is overdone. To manage the risk while taking advantage of the opportunity, we've carefully sized exposure to a collection of bank stocks, screening for commercial real estate exposure and avoiding companies that appear particularly exposed.

Here's the overarching takeaway for external risks in 2024: They exist, as they always do, but we believe the vast majority relate to volatility, and present as much opportunity as loss potential. The very essence of external shocks is their uncertainty, both in timing and magnitude.

Without question, many risks potentially have a higher probability than what's on this list, but we just don't know about them yet. It's with this uncertainty in mind that we think having a robustly constructed portfolio that considers the full range of outcomes is a critical component to investing success.

Valuation Risk is Often Ignored, But Really Matters

Overvaluation risk is a real problem that never features on the laundry list of what can go wrong. Everything has a price, with swings in perceived risk creating potential mispricing. No bad news? Likely elevated valuations. A lot of perceived risk? Possibility of attractive prices.

Some great companies have high valuations and need significant growth to deliver on market expectations. Said simply, they have no room for error or disappointment. Other markets are priced for a story of despair—for example, China equities—which only a little need to go right. Fundamentals matter especially with higher rates so investing where there is a valuation buffer or margin of safety is key for the years ahead. This is a story that we see play out again and again in markets.

Chinese Stocks are Perceived as Risky, but Upside Potential Exists

To be clear, we acknowledge the uncertainty that surrounds these markets, and we have no better clarity than others on how it will play out. To manage those concerns, we rely on scenario testing to determine our positioning:

- How much can we own, assuming the worst happens, without jeopardising our overall portfolio outcomes?
- Do we have overlapping exposure here that we don't see at first blush? How can we manage these risks?

Valuations are an underrated tool to shift the risk-to-reward in your favour. And where headline risks are plentiful, we often find tomorrow's golden opportunities.

New Risks, Consistent Approach

Patience and perspective are key in the world of investing. Before making any move, consider what is already priced in and how the markets have already adjusted. While risk might initially sound intimidating, it isn't always a bad thing. Risk can be a catalyst for opportunity if managed with care. After all, in the world of investments, risk not only creates a possibility of loss but also forges avenues for gain.

Risk and reward are different sides of the same coin and investors cannot expect outsized gains without taking on some risk. This does not feel intuitive as our brains are not wired for patience nor for eagerly embracing uncertainty. Histrionic headlines don't help. However, discipline and long-term perspective are never out of style and investing principles can payoff most handsomely during turbulent times.

While the risks we face as we enter 2024 are significant, they are not insurmountable. The keys are to stay calm, focus on the long term, sift through the noise, and apply robust risk management techniques. Remember, even in the face of risk, opportunity lies. Armed with a thorough understanding of the market, sound strategies, and a cool head, investors can not only weather the current market conditions but also find potential opportunities amidst them.

The Growth Opportunities Available from AI

Why Consider Artificial Intelligence?

Artificial intelligence, or AI, has become far more sophisticated in recent years, creating both disruption and opportunity. It brings risk, but there will be winners. We seek to support investors in their understanding of this space.

Key Takeaways

- As a theme, AI has seen significant investor interest and large inflows. The top 10 companies leading the way globally have quickly become household names. We offer new data to help investors understand the leaders in this space.
- As AI is implemented by companies of all shapes and sizes, we could see profit margin expansion, but it carries risk too. Obsolescence is a headline risk, but hidden risks can expose themselves at a portfolio level too.
- Share prices have run up quickly for many AI-focused companies and now carry lofty valuations. On our analysis, second-derivative plays look to provide better opportunity.

Turning Ideas into Actions for 2024

Second-Derivative Plays: Rather than focusing on the big AI players, we see potential opportunity in the next rung of AI adopters. This includes those who can strengthen their products using AI, without the valuation risk.

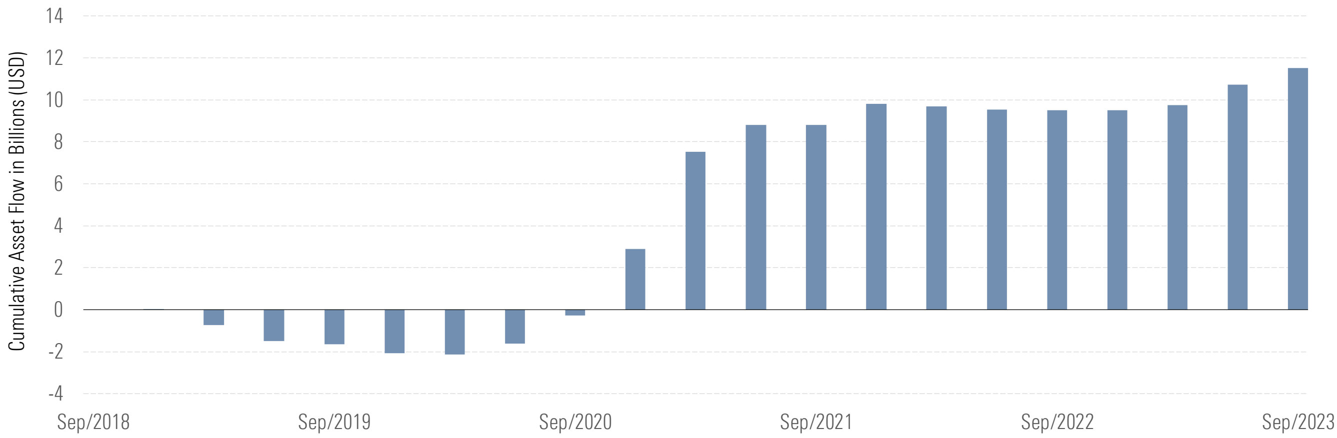
Beware Ultra-High Valuations: As prices have already run up very quickly, there is an embedded expectation of strong growth priced in. As competition rises, we could see disappointments.

Focus on Behaviour: Investors have a bad record of timing their entry into and out of thematic funds. If you find yourself tempted to chase the AI theme, make sure you are aware of your own behaviour.

Taking Stock of the AI Landscape

Artificial intelligence (AI) is largely expected to change the way business is conducted, especially with the progression in generative AI. The pace of change is remarkable, with investors naturally eager to understand the winners and losers. While we'd warn investors not to let hype dominate their investment decisions, we are seeing a tremendous shift in the make-up of equity markets, which are worthy of note for all investor types.

Exhibit Cumulative Flows into AI & Big Data Thematic Funds Globally Over Last Five Years



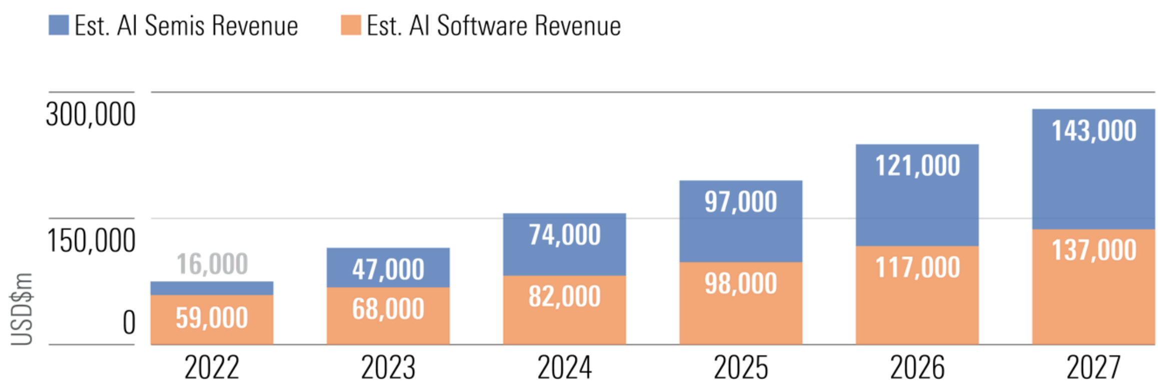
Source: Morningstar Direct, Morningstar Global Thematic Database. Data as of 30 September 2023. For illustrative purposes only.

What, How, Who, and Why?

By now, the majority of people have seen the power of AI first-hand. We expect 2024 to be a year of phenomenal change in this space, with rife competition and practically every company in the world seeking to understand opportunities for automation or growth.

- **What does AI solve?** We see two streams that are additive to company performance. The first is automation, creating efficiencies in the back-office and process improvements. The second is product and service enhancement, potentially creating new revenue growth opportunities.
- **How do we expect it to be used?** Anecdotally, back-office efficiency is the primary motive for most large companies at this stage. However, we expect generative AI and predictive analytics to play a greater role across practically every business function and industry.
- **Who will be using it?** With only a small dose of imagination, we can quickly identify use cases for over 90% of the workforce in developed and many emerging markets.
- **Why is everyone chasing this theme?** This technology offers a significant opportunity to grow profit margins at little cost. There is a race for market share.

Exhibit Between AI Semis and Software, A Long Growth Runway Lies Ahead



Source: Morningstar, Company Documents. Data as of 3 October 2023. Data presented is indicative and for illustrative purposes.

Exhibit The Top 10 Stocks Held in Artificial Intelligence and Big Data ETFs and Mutual Funds Globally

Name	Ticker	Sector	Morningstar Star Rating	Economic Moat
NVIDIA Corp	NVDA	Technology	★★★	Wide
Microsoft Corp	MSFT	Technology	★★★	Wide
Alphabet Inc Class A	GOOGL	Communication Services	★★★★	Wide
Amazon.com Inc	AMZN	Consumer Cyclical	★★★	Wide
Advanced Micro Devices Inc	AMD	Technology	★★★	Narrow
Tesla Inc	TSLA	Consumer Cyclical	★★★	Narrow
ServiceNow Inc	NOW	Technology	★★★	Wide
Meta Platforms Inc Class A	META	Communication Services	★★★	Wide
Taiwan Semiconductor Manufacturing Co Ltd ADR	TSM	Technology	★★★★★	Wide
Snowflake Inc Ordinary Shares - Class A	SNOW	Technology	★★★★	None

Source: Morningstar Direct, Global Thematic Database, Star Rating and Economic Moat Data as of 31 October 2023.

The list of major players in the AI space are already household names, but valuations have increased significantly in anticipation of success. They have a first-mover advantage, although they are still subject to risk.

Risks to be Aware of in AI Stocks

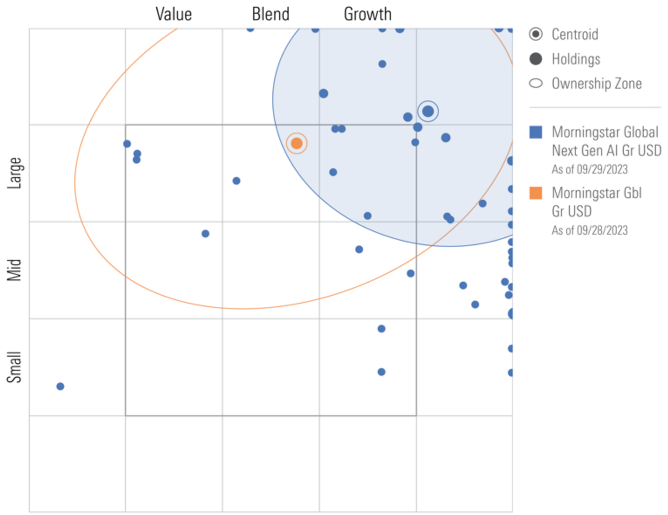
Regarding investment risks, AI does bring some new challenges to the table.

- **Regulation and safety.** Let's start with the risk of artificial intelligence itself. The technological capabilities are under immense scrutiny from governments and regulators. While it is widely acknowledged as a force for good, it also creates significant threats. We do expect regulation, although this will be regional and the big policy changes are likely to come in 2025.
- **Valuation.** Even fast-growing businesses can be poor investments if investors overpay for shares. It's also important to keep in mind that the largest portion of a growth company's value is derived from cash flows generated many years in the future. Companies that develop durable competitive advantages are more likely to sustain long-term free cash flow growth and could warrant richer valuations.

  However, this is a very expensive race with significant uncertainty about who the future winners and losers will be. A lot has to go right for the primary-AI stocks to continue to deliver, which could happen, but the risk-to-reward can deteriorate if investors overpay.

- **Concentration.** As with any emerging technology trend, AI brings new uncertainties to companies and industries. As investors, we should acknowledge this higher level of uncertainty when considering position sizes.
- **Obsolescence.** It's far too early to confidently identify companies that will see their products and services become less relevant because of AI. Still, AI will likely bring change to many industries, and we should remain alert to potential shifts in a firm's industry structure. We're equally skeptical of company managers who downplay AI risks as we are those who overhype AI benefits.
- **Hidden portfolio risks.** Even well-informed investors have limited insight into the distant future. We shouldn't assume that because a company seems insulated from AI risks today that it will remain protected in five years' time. Further, investing heavily in AI-related companies can also bring significant portfolio tilts that could adversely alter the reward-for-risk in a total portfolio context.

Exhibit Know What You're Buying: At a Portfolio Level, Beware of Significant Style Biases



	Value	Blend	Growth
Large	7	16	60
Mid	0	1	15
Small	0	0	2

Weight %
- 50+
- 25–49
- 10–24
- 0–9

Source: Morningstar Direct. Morningstar Global Next Generation Artificial Intelligence Index. Data as of 31 October 2023.

The AI Opportunity Entering 2024: Second-Derivative Plays

While the excitement surrounding the potential for artificial intelligence has boosted those stocks directly tied to AI, we think some of the more attractive undervalued opportunities are those that are second derivative plays on AI.

Here are four examples that we'd describe as second-derivative plays:

- Most companies do not have the expertise or financial wherewithal to build and maintain their own AI platforms. That's where IT consulting companies could come in with technical capabilities in artificial intelligence services.
- Another example is data management providers that host enterprise data on which artificial intelligence models are run.
- AI requires extremely high speeds to train its data models and we expect those with the highest networking speeds to allow it to reap the benefits of spending brought on by investments in generative AI.
- Data centers will likely experience a long tailwind from the explosion of growth in AI. As AI is built, trained, and rolled out, it will require a great deal of computing power and data storage.

A Focus on Economic Moats Could be a Sensible Approach

In periods where product development is in over-drive, it is a dangerous game to chase the winners. A more sensible approach would ordinarily be to focus on durable competitive advantages.

Companies with economic moats could be more likely to benefit and may be less susceptible to disruption from AI than those without moats. Moats based on a combination of customer switching costs, unique data sets and brands could be particularly valuable. Companies with durable advantages could use AI to improve their products and services and strengthen their competitive positions. On the other hand, change brought about by AI could erode companies' economic moats or shift consumer demand away from their products and services. Investors should be on the lookout for permanent changes in industry structures and customer preferences.

In the end, stronger management teams who allocate capital effectively could influence better investment outcomes. Effectively integrating AI into existing products and services will be a complex endeavor for managers. Navigating new competitive threats will require sound strategy and solid execution. Moreover, managers may be tempted to overspend on AI-related product development or pursue ill-advised acquisitions. Consider investing in businesses whose managers have a track record of sensible capital allocation and effective execution.

Actions for Fund Selectors Who Want AI Exposure

Investors may also use funds as a tool to gain exposure to the artificial intelligence theme. These have multiplied in number and now investors can choose from a veritable smorgasbord of options.

A look back at the commercialisation of technologies in the past shows that picking the eventual winners can be anything but straightforward. For example, in 2007, the year the iPhone launched, Nokia sold almost 40% of the world's mobile phone handsets. It is equally as likely that some of the biggest winners in AI will not be those the markets have crowned today. Buying a thematic fund, rather than a single stock means you are less likely to entirely miss the biggest winners.

When running the ruler over thematic funds, the fundamental fund characteristics that boost the chances of achieving long-term investment success, such as low fees, a seasoned management team, and a trusted parent organisation, still apply equally and should form the foundation of any evaluation. That said, the distinctive characteristics of thematic funds mean a more tailored approach to due diligence is required. One manager may build a high-conviction portfolio of stocks selected for their high growth potential, while another may track the same theme by building a broader portfolio of stocks based on their exposure to a theme and integrating other investment metrics such as quality screens into the portfolio-construction process, which will result in a strikingly different exposure.

Looking beyond a name to really understand how a fund targets its theme is even more crucial when it comes to AI. By glancing at a fund name it may not be straight forward to determine if the fund manager uses artificial intelligence to select stocks or if they are selecting stocks exposed to AI (or on the occasion where they do both).

The volatile return profiles of many thematic funds, coupled with low- or no-commission trading and the intra-day trading capabilities of thematic ETFs, can encourage the worst type of investor behaviour, and ultimately result in poor investment outcomes. Findings in our recent study, The Big Shortfall, show that on aggregate, poor investor buying and selling habits connected with thematic funds over the last five years have destroyed most of the returns provided by thematic funds. It goes to show, you can pick the right theme and right fund, but if you use them in the wrong way you can still end up empty handed.

Exhibit Investors Have a Bad Track Record of Timing the Entry and Exit of Thematic Funds

Source: Morningstar Direct, Morningstar Global Thematic Research Database. 5-Year Total Returns, Investor Returns and Return Gap for Thematic and Non-Thematic Funds. Investor return is the asset-weighted return, adjusted for inflows/outflows. It shows the net impact of buying high and selling low. Data as of 30 June 2023. Domiciles included in this chart: Ireland, Luxembourg, United Kingdom, and the United States.

The AI Punchline

Artificial intelligence is an exciting theme and we expect a lot of market interest in 2024. One effective way to access the AI theme without paying huge valuation premiums is via second-derivative plays. These are not the chip makers or those that offer technology interfaces, but rather, those who can effectively embed AI into their workflow and drive new revenue growth opportunities. The principles of good investing still apply.

Taking Advantage of the 5%+ Rate Reset

Why Do 5%+ Interest Rates Matter?

All investors need to consider interest rates. It impacts stocks, bonds, property, and cash. Now that we've seen a major move in interest rates, we seek to help investors understand the new landscape—finding opportunities for tomorrow, not yesterday.

Key Takeaways

- It is possible to use the major reset in interest rates to your advantage, as long as you understand the risks associated with it.
- For the first time in decades, we observe positive expected real yields. The transformation in the income landscape is meaningful, with certain asset classes gaining in attraction.
- It is not just about chasing the yield offered in different asset classes. Investors must realise the importance of considering credit risk and ensuring dividend stability.

Turning Ideas into Actions for 2024

Income Investors to Thrive: For new money, the current income landscape is the most attractive we've seen in at least a decade. Retirees, for example, can produce cashflows from their assets without yield chasing.

Credit Spreads to be Watched: While absolute yields are attractive, a lot of that comes from the reset in government bond yields. The spread is less attractive given the risks, so corporate bonds need to be managed.

Short-Term Bonds Well Placed: We see merit in bonds of all types as we enter 2024, but short-term bonds look particularly attractive, depending on the role it plays in a portfolio.

The Great Reset with 5%+ Interest Rates

It is no secret that the income landscape has changed.

- Interest rates have increased from practically zero across the developed world (even negative in some cases) and have broadly reset at the 4-5.5% level depending on the country.
- Bond yields have anticipated these rises and increased too, with 4-5% yields generally available across the curve.
- Riskier bonds, like high yield, have increased from as low as 4% in 2022 to now offering around 9% today.
- Meanwhile, dividend yields have hardly budged and are now materially lower than yields available in fixed income for most sectors and geographies.

Let's kick off with the large-scale reset in interest rates we've witnessed lately. Drifting up from their historical decade-lows, rates are now near the 5% mark, ushering in a significantly different "base rate" to consider for all asset class views. This shift has upended the investing landscape as we knew it, with opportunities and risks worth delving into.

We have a specific focus on income-producing assets, with their yields undergoing noticeable changes. Yet, the reset in interest rates hasn't come without risks. We've seen significant price falls in asset classes that were historically considered "low-risk" by textbook definitions—including the European 10+ Yr Core Treasury Bond index which is down -43.9% from 31 December 2020 to 15 November 2023. The U.K. 10+ Yr Core Bond index is also down -48.4% over the same period.

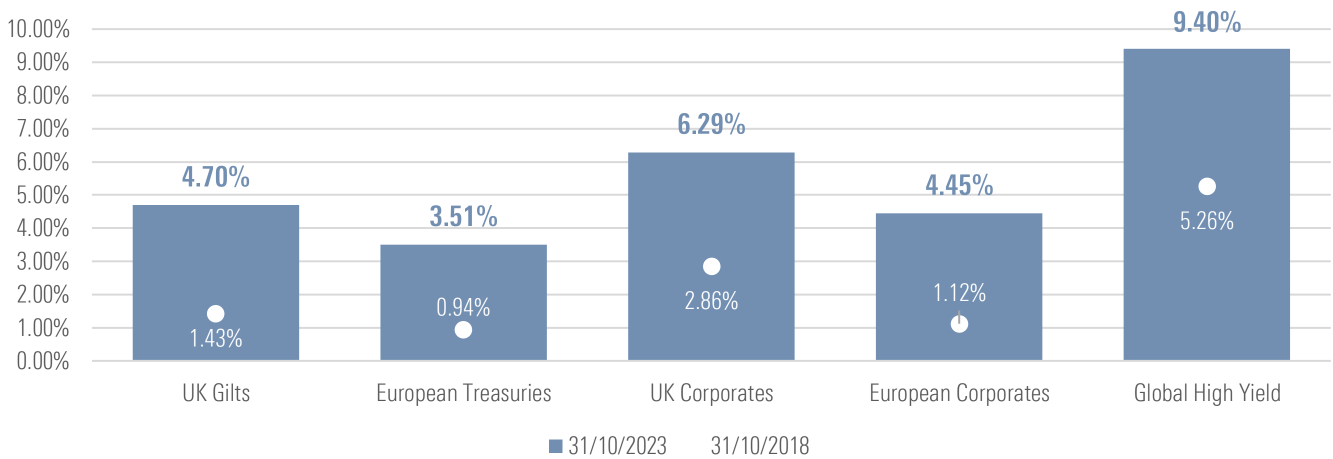
As advocates for independent thinking, we see opportunities being created from these moves. It's worth noting that these transformations continue to carry certain risks.

Yields Available are Better Across the Board, With Areas of Attraction

As we delve into the world of income-producing assets, the noteworthy shift in base rates has greatly impacted the investment case. Navigating this shift can yield fruitful results if we understand how to utilise the fluctuations to our advantage while also being wary of the potential risks involved.

Central to this discussion is the major increase in headline yields available across various income-producing assets. Although, it's important to note that some asset classes shine brighter than others.

Exhibit Bond Yields in the U.K. are Very Attractive Relative to Recent History. European Yields Have Also Improved



Source: Morningstar Direct, Capital Markets Database. Data as of 31 October 2023. Past performance does not guarantee future results.

The beauty of the current investing landscape also lies in the wide array of options, which can be matched to the mandate of a portfolio. For example, if you have a short time horizon, we see opportunities at the shorter end of the yield curve for the first time in decades. For those with a longer time horizon, we can express our views across the shape of the yield curve to get the right balance.

As we navigate these shifts, we've reevaluated the broad equity and fixed income allocations within income portfolios, with a move out of equities and into bonds. This is mostly a shift in allocating capital to areas offering the higher yields. Within bonds, we like short-dated bonds, given the inversion we see across most developed curves, although we do see growing appeal in longer-maturity bonds.

For investors prioritising stability, dividends are another area to consider. However, we've not seen the same uptick in dividend yields as we've seen in fixed-income yields. For example, the yield on the Morningstar US Core Bond index has risen from 1.2% to 5.4% between November 2020 and November 2023. Meanwhile, the dividend yield of the Morningstar US Market index has risen just 0.3% from 1.2% to 1.5% over the same period.

In the realm of dividend-paying stocks, it aids in the careful selection of these stocks while mitigating the risk of dividend cuts. Areas offering attractive dividends are financials, U.K. equities and infrastructure.

Finally, the reset in base rates has brought into question the changing merits of a balanced portfolio (for example, 60% in stocks, 40% in bonds, or equivalent mixes), which we believe are likely overstated. In our view, the merit of a balanced portfolio has improved following the increase in yields.

Positive Views of Income-Producing Asset Classes

How can investors take advantage of the reshaping in the income and interest rate landscape? The shape of the yield curve and regional differences must be tackled in this context, as they are integral to understanding the opportunity set.

- Prominently, short-dated bonds represent a great starting point by yielding above fair value, rendering them a compelling investment choice. This applies across sovereign and corporates, with more companies borrowing for shorter periods.
- As a safety net against potential market uncertainties, longer-dated government bonds are expected to offer an effective hedge in most macroeconomic scenarios.
- Dividend stocks maintain their position as a feasible option for investors, though their appeal is somewhat muted due to the relative attraction of bond yields.
- Emerging market bonds appeal to us as a non-core opportunity. Our enthusiasm towards these bonds remains, although has been modestly tempered by the marked shift in other opportunities. Specifically, the allure of developed-markets bonds has prompted us to moderate our favourable outlook of emerging-markets bonds.
- Cash is now a tool to be considered, although we don't expect it to play much of a role for long-term investors, given the likelihood of bond and equity outperformance.

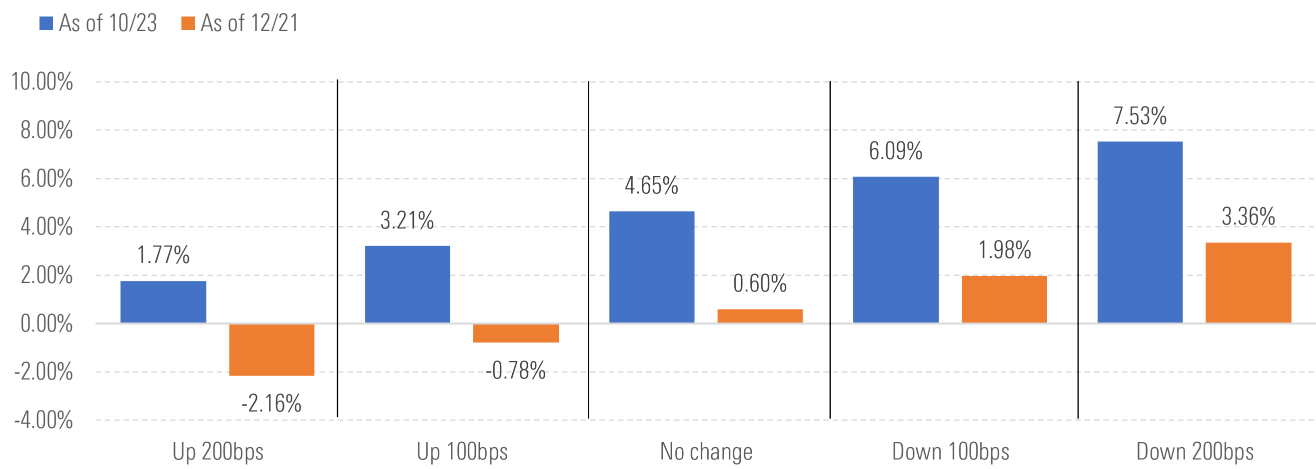
The shape of the yield curve is an important consideration here. Despite the "higher for longer" narrative, we still see an inverted yield curve, where we can capture higher yields for bonds that mature in the short term, while those that mature in 10+ years time continue to be less attractive.

We must reinforce the positive case for bonds—both short and long duration—with their yields now above fair value for the first time since the financial crisis. That said, an inverted yield curve can be a sign of recessionary pre-conditions, with longer-dated bonds expected to provide a necessary hedge.

Bond Math is Favourable

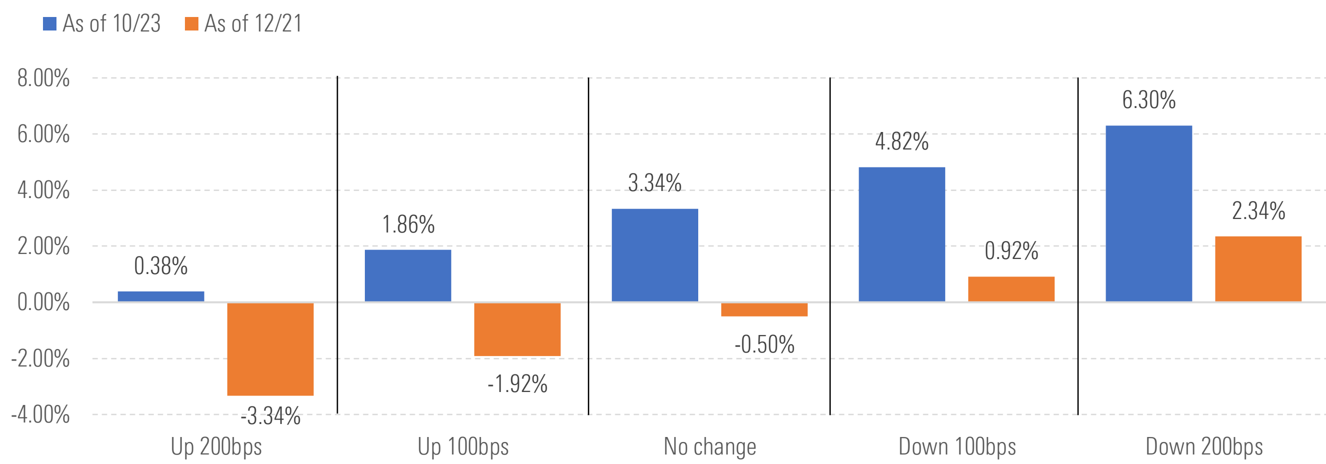
One effective way of thinking about the shape of the yield is to focus on bond math, where we can see the expected gain in different scenarios and how the range of outcomes have shifted:

Exhibit U.K. Gilt 1-Year Simulated Total Return across Interest Rate Scenarios



Source: Morningstar Investment Management calculation. U.K. Gilt Yields. Data as of 31 October 2023. Data presented is indicative and for illustrative purposes only. Simulated performance is not a reliable indicator of future performance.

Exhibit European 1-Year Simulated Total Return across Interest Rate Scenarios



Source: Morningstar Investment Management calculation. European Treasury Yields. Data as of 31 October 2023. Data presented is indicative and for illustrative purposes only. Simulated performance is not a reliable indicator of future performance.

Looking for areas that warrant a dose of caution:

- **Credit spreads:** We perceive corporate bonds as only providing a slight increment in extra yield. Although this might seem lucrative, it is tempered versus government bonds.
- **High yield debt:** Related to the above, it may be tempting to think 9%+ yields are attractive. However, despite offering high absolute yields, we caution the inherent risks tied with these assets. The lure of high returns should always be weighed against a potential default cycle, which is not reflected in spreads.
- **Dividend chasing:** For investors who utilise rule-based vehicles such as active ETFs to access the high dividend names, many dividend indexes can experience big shifts in the sector composition. Investors need to be mindful of sector exposure they are getting. Moreover, while dividends remain a key area to explore and we express this in our portfolios, we do note dividend instability could potentially pose a risk to income investors. Sectors such as energy and financials are more prone to dividend cuts during downturns.

As we look towards the next year, it is important to remain adaptable and open to adjusting our investment views, embracing the evolving landscape and harnessing income-producing assets where sensible.

What Risks are Introduced from 5%+ Rates?

There are plenty of available investment strategies you can employ to navigate these risks and boost the overall return prospects of a portfolio. However, every decision should factor risk into it.

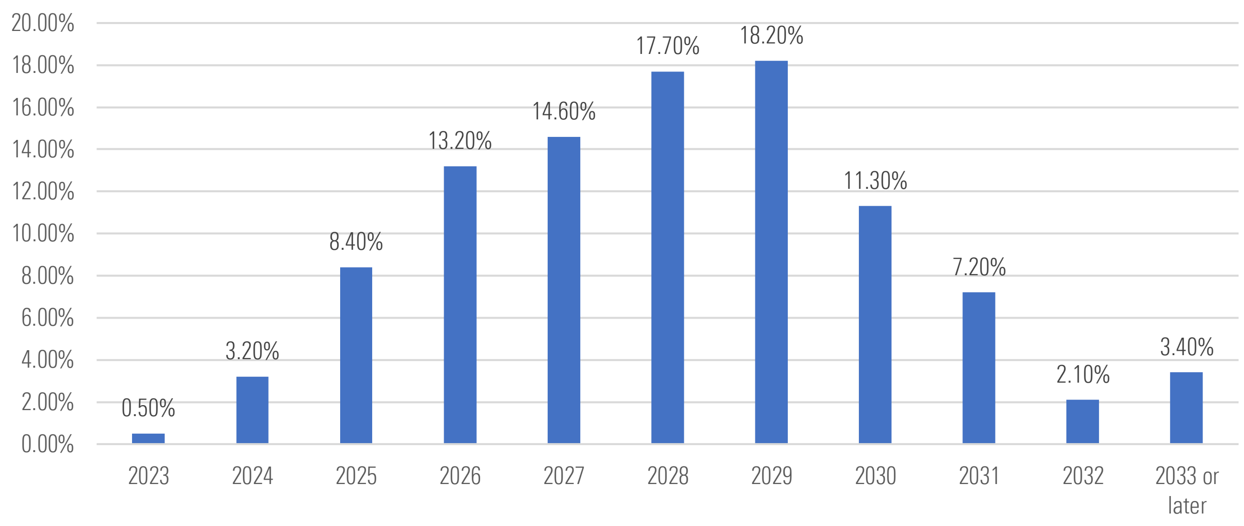
The first is that we must weigh the increase in bond supply—especially a U.S. Treasury maturity wall—which can significantly affect the market by amplifying the volume of bonds. The U.S. Treasury Department has confirmed the need to borrow more than $800bn in the first quarter of 2024, which could test the appetite of investors. All else being equal, this could result in higher yields.

For corporate bonds—whether investment grade or high yield—one obvious risk is a deterioration in company fundamentals. This will often show first among high-yield bonds, where we are seeing early signs of strain—albeit from a historically low base. It is worth noting that high-yield bond issuance is not expected to materially increase in 2024, with most of the debt due to mature in the 2026 to 2029 window. The credit quality has also improved for high yield bonds, so it is arguably better positioned than in prior periods of deteriorating fundamentals. In any case, we identify three areas worthy of your watchlist regarding impairment:

1. Revenue and earnings growth are now declining.
2. Leverage ratios have increased, although remain well within historical norms.
3. Interest coverage has edged lower, from strong levels, meaning companies may find themselves struggling to make repayments.

However, it is worth repeating that we see corporate fundamentals as reasonable and see no immediate risks of a significant rise in defaults.

Exhibit No Signs of a Debt Cliff. High-Yield Bond Maturity Schedule as a Percentage of Outstanding

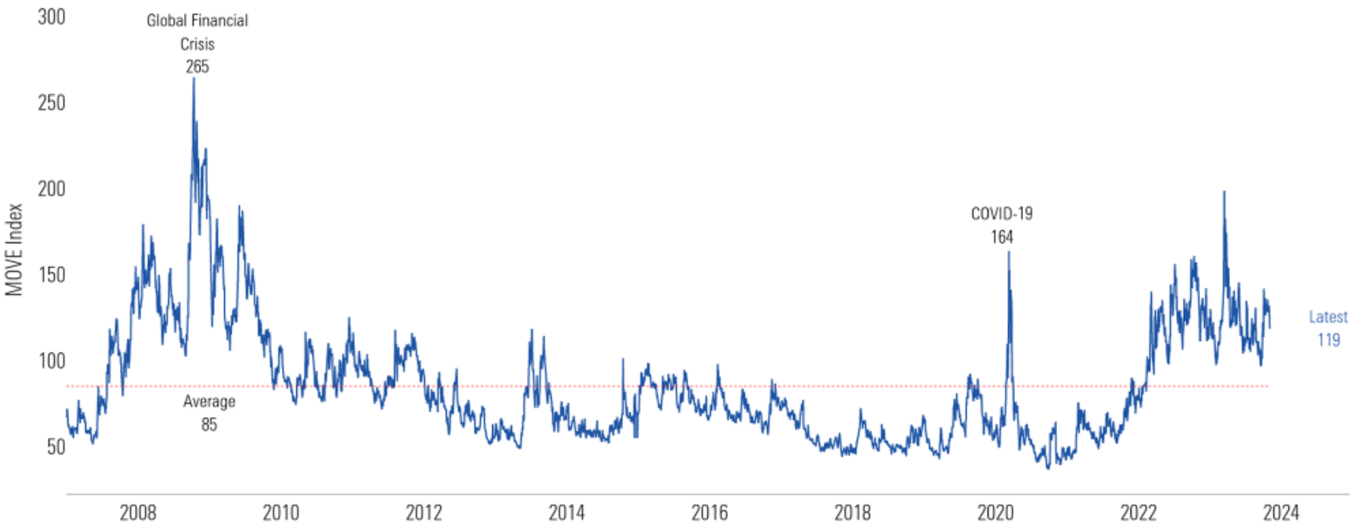


Source: Morningstar Direct, Morningstar U.S. High Yield Bond Index. Data as of 31 October 2023. Forecasts shown are not a reliable indicator of future performance. Data presented is indicative and for illustrative purposes only.

Looking for other risks, inflation could go higher. This is not our base case, but is worth protecting against, with inflation-linked bonds a relatively cheap insurance option at current breakeven levels.

More generally, we've seen a major uptick in bond volatility, especially in long-term bonds, as there is a heightened sense of uncertainty for investors. This does not necessarily pose a risk of impairment, but it could affect the behaviour of investors.

Exhibit Bond Market Volatility Remains Elevated, Which May Make Some Investors Feel Uneasy



Source: Morningstar, Clearnomics. ICE BofAML MOVE Index since 2007. Data as of 3 November 2023. This is for illustration purposes only and not indicative of any investment. An investment cannot be made directly into the index. Past performance is not a guide to future returns.

On the flip side, a continued duration rally is possible if rates fall quickly—perhaps in a deep recession, characterised by a drop in interest rates—which can negatively influence the relative performance of short-dated bonds. In this scenario, they may not experience the same level of increase as their longer-term counterparts. This creates reinvestment risk for short-dated bonds.

An Uplift for Newly Invested Money

It is important to understand that the majority of the positivity in income-producing assets comes from price moves, not rises in dividends or new bond issuance. However, for all future money invested, you'll access the better yields, along with a gradual improvement from new issuance.

The potential for higher yields exists across the entire opportunity set, which is an exciting prospect indeed. However, amid the allure of stability in dividends, we must also consider the risk of dividend cuts in certain sectors and the need to watch for a potential credit default cycle.

The Best Investment Ideas as We Enter 2024

Key Takeaways

- We are cautiously optimistic for both stocks and bonds as we enter 2024, even accounting for heightened risk.
- In equities, we see opportunities in size, style, sector, and country exposures. Targeted exposure is well placed to beat broad market-weight exposure, according to our analysis.
- For bonds, we see broad appeal across different maturity profiles. Government bonds are our preferred exposure. Corporate bonds are priced for a slowdown, but not a recession, so make more sense for shorter maturities.
- The US dollar looks expensive versus other major currencies.

Turning Ideas into Actions for 2024

Say Yes to Bonds: We like government bonds more than we have for at least a decade, but we are prepared for surprises, which is why different duration profiles still factor into portfolio construction.

Identify Pockets of Value: Market-weighted equity benchmarks are not overly attractive compared to targeted areas within. This dispersion creates opportunities to build a diversified mix with better return prospects.

Balance the Pendulum: The market still carries fundamental risk. We therefore carefully assess offsets—such as healthcare—to create robustness. We also see the need to balance the duration of fixed-income assets.

Equity Viewpoint

Four Look-Through Portfolio Ideas:

- Among the basket of undervalued and unloved assets, smaller-capitalisation value stocks stand out.
- Cyclical sectors like financials (namely banks), leap out as attractive. Among economically sensitive sectors, communication services remain appealing. Among defensive sectors, healthcare and utilities could offer a ballast with upside potential.
- Global contrarian plays can be found in emerging markets, specifically Chinese technology and South African equities. The volatility could be worth it, but sizing is important.
- Second-derivative AI plays could offer an earnings tailwind. We see value in select U.S. sectors.

Here is a summary of the broad equity landscape entering 2024:

Equities are fairly well positioned as we start 2024, despite facing a wall of worry. Equities are generally considered reasonably valued overall, with all major countries better placed than a few years ago from a valuation standpoint.

Overall, we see core equities as playing a role for investors. In the U.K. and Europe, we see attractive valuations, with higher-than-usual return prospects based on our analysis. In the U.S., the concentrated rise in the so-called "magnificent seven" has created opportunities to add selected value—which looks especially interesting in smaller, value-oriented companies.

Turning to emerging markets, while undoubtedly risky, we can see strong return prospects in most scenarios, although position sizing remains important. For example, South African equities are attractive in both absolute and relative terms. Fundamentals are robust for S.A. financials, where the banks have capital adequacy levels well above regulated minimums. Both S.A. resources and industrials are supported by relatively stronger balance sheets. We do note near-term risks that may put pressure on interim earnings and constrain capital allocation decisions. Increasing government debt and unreliable energy supply are also fundamental country risks that are deteriorating and could potentially further impair economic growth prospects.

Naturally, reward-for-risk is the key distinction to make, with some developing risks that must be accounted for in equity allocations. One longer-term risk is the lack of earnings growth. Here are some of the other key risks we're watching:

Exhibit The Big Picture for Stocks Must Account for Risk

Moderate Valuations	Softening Economy	Weakening Fundamentals	External Shocks
▪ Valuation expansion has largely been in AI-stocks. Second-derivative AI stocks have not had the same rally. ▪ The U.S. market contains some expensive sectors and concentration risks. ▪ Select opportunities exist in global equities.	▪ High rates can weaken consumer demand, particularly if they persist. ▪ A weaker consumer can impact corporate revenue and ultimately the job market. ▪ Weaker European countries may trough sooner.	▪ Overall corporate leverage is manageable, but debt costs are increasing. ▪ Corporate profitability is high, but vulnerable on the margin. ▪ Capital-intensive sectors remain more exposed to a protracted move higher in debt costs.	▪ Geopolitical risk is high (Ukraine, Israel, China). ▪ An oil market shock could hurt the global economy. ▪ Commercial real estate remains a risk but appears a localised problem. ▪ Suddenly higher long-term yields could have unintended effects.

Source: Morningstar. Views as of November 15, 2023. For informational purposes.

While stocks have certainly not tumbled off a cliff, investors continue to feel nervy, with consumer sentiment scores still well below normal levels. At a deeper level, valuation spreads—the disparity in valuation levels between sectors—is where we see opportunity.

Equity Opportunity 1: Select Sectors—Including Banks, Utilities, & Healthcare

In Europe, we're finding valuation opportunities at the sector level.

Financial services, squarely a cyclical value-leaning sector, leaps out as inexpensive with low expectations. Rising rates led to the banking crisis, concern for which led the sector to underperform. We believe much of the risk here has been discounted and that banks are worth a look.

Looking for undervalued assets that can help with portfolio robustness, we see defensive sectors—including healthcare and utilities—as areas of interest.

Exhibit Price to Fair-Value for Morningstar Global Market Sector Index Averages

Cyclical		Sensitive		Defensive	
Basic Materials	0.90	Communication Services	0.81	Consumer Defensive	0.89
Consumer Cyclical	0.82	Energy	0.95	Healthcare	0.88
Financial Services	0.86	Industrials	0.93	Utilities	0.83
Real Estate	0.78	Technology	0.99		

Undervalued — Fairly Valued — Overvalued

< 0.90 | > 0.90 to 0.95 | > 0.95 to 0.99 | > 0.99 to 1.01 | > 1.01 to 1.05 | > 1.05 to 1.10 | > 1.10

They are not necessarily the cheapest sectors, but can play a strong role in portfolio risk management. Among the more economically sensitive sectors, our preference remains for communication services, despite strong returns year-to-date. It still represents solid value and a reasonable risk-to-reward ratio.

Equity Opportunity 2: Small-Cap Value Stocks

Looking at the style box across Europe, we can see the biggest valuation opportunity exists in the bottom left corner—small value stocks.

This is consistent with our U.S. Equity Outlook, offering a large discount to "fair" which is considerably better than the large-growth counterparts that have dominated 2023 leaderboards.

We note that small-cap stocks are hard to place in a single bucket, in large part because so many disparate industry groups—from biotech to banks—are part of this asset class. Additionally, small companies generally display greater sensitivity to the broad economic environment, given the preponderance of money-losing and highly-levered companies in the small-cap indexes.

Therefore, while small-cap stocks seem substantially cheaper than their large-cap counterparts, careful asset selection is needed, and we think it's important to focus on quality.

Exhibit Price to Fair-Value for U.S. Style Indexes

Size \ Style	All	Value	Core	Growth
All	**0.95**	0.83	0.96	1.01
Large	0.98	0.86	1.00	1.02
Mid	0.87	0.78	0.89	0.96
Small	0.75	0.61	0.78	1.04

Equity Opportunity 3: International Exposures—Including Sensible Sizing in Emerging Markets

The broad opportunity in emerging markets has grown more significant over the course of 2023, as the stocks have lagged developed market peers. Much of the performance drag can be attributed to Chinese stocks as investors weighed looming geopolitical and secular growth concerns. The aggregate sentiment towards emerging markets remains bearish in absolute (compared to its own history) and relative terms (compared to developed markets).

Despite the risks—or maybe because of them!—China itself has become a very interesting opportunity. Chinese equities carry particularly low expectations. However, over the long-term, consumer-facing Chinese technology equities trade at a substantial discount to normalised earnings. and are anticipated to generate excess returns against broad emerging markets.

Equity Opportunity 4: Second-Derivative AI Plays

AI-focused stocks have topped the U.S. leaderboard in 2023, with significantly valuation risks embedded, in our analysis. However, second-derivative plays, including those that can improve margins by using AI capabilities in their products, offer much better valuations with earnings upside.

This could offer a way to access the emerging AI theme, with generative AI allowing companies to generate marketing content, write code, improve processes and efficiency; among other things. No doubt this will create winners who can harness the benefits of AI with the ability to massively scale businesses and losers who cannot.

Top Image Source: Morningstar Equity Research calculations. Average of U.S., Europe, and Asia price to fair-value as of 15 November 2023.
Bottom Image Source: Morningstar Equity Research calculations, as of 15 November 2023.

Fixed Income Viewpoint

Three Look-Through Portfolio Ideas:

- Areas with positive real yields. Broad opportunities exist, especially in developed markets. However, niche opportunities also appeal, including inflation-linked bonds and emerging-markets debt.
- Government bonds over corporate bonds. European bonds looks decent, but our preference is for U.S. Treasuries, with the balance of probable outcomes for yields leaning towards falls.
- Short-duration bonds are attractive for cautious portfolios, adding healthy income with appropriately lower duration risk.

Here is our summary of the broad fixed-income landscape:

The bond market has not provided the defensive features over the past two years that investors grew to love it for in the four decades prior to July 2021. It has been one of the worst periods on record for developed market bonds in 2022 and into 2023.

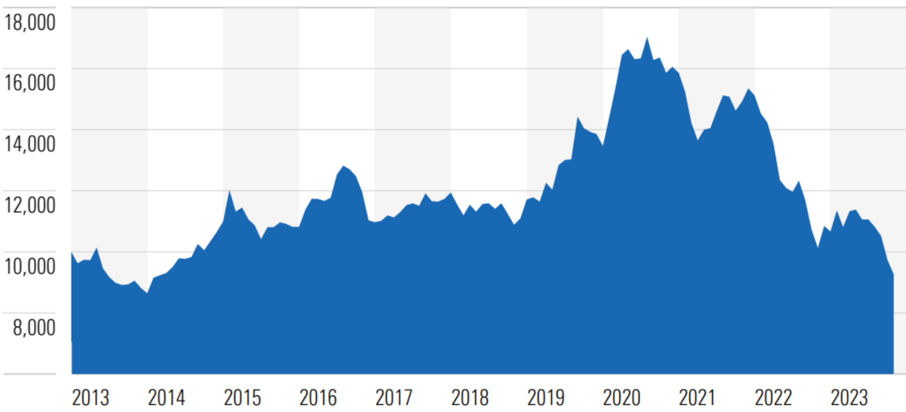
This is especially true for long-dated bonds.

The potential long-term regime for inflation and rates has impacted these bonds, with equity-like drawdowns.

We now see this as a positive in a forward-looking context.

The material increase in bond yields has improved their attractiveness versus other assets, and for portfolio risk management more generally.

Exhibit The 10-Year + U.S. Treasury Index has Fallen Heavily. Bonds are Now Appealing.



Source: Morningstar Direct, Morningstar US 10+ Yr Treasury Bond TR USD, data as of 15 November 2023. Past performance does not guarantee future results.

This applies to the U.K., U.S. and Australia, where yields now cover inflation in many instances, offering positive "real" yields. European yields are also rising strongly but, from a very low base, exhibit less attractive absolute yields to date.

Going slightly deeper, the ability to add income to portfolios while mitigating default risk looks attractive to us currently. Duration risk again looks attractive in many scenarios, but it requires prudent management. We are cognisant of the potentially sizeable drawdown risk from longer-duration assets. Adding materially to duration might make sense at some point, but any changes should be measured and deliberate, given the fast-changing response from central banks and the threat of stickier inflation. One key consideration in a portfolio context is reinvestment risk, with short-dated bonds offering strong yields but could be left behind if rates get cut.

Corporate bonds, whether investment-grade or high yield, offer higher yields than government bonds (given greater credit risk), although the "spread" between the two remains tighter than we might prefer, given the environment. They have a place as a middle ground—providing some extra yield versus government bonds and a duration profile that can help in portfolio construction.

Other bonds, including emerging market debt, retain appeal. However, we've softened our conviction in this space as developed peers now offer more appealing prospects. Our view remains that many emerging-markets sovereigns, though with notable exceptions, have improved their fundamental strength compared to history. This includes improved current account balances, enhanced reserves, movement to orthodox monetary policy, and a build-out of a local investor base allowing for a shift to local currency funding.

In all cases, the key risk for fixed income is that interest rates fail to sufficiently slow economic growth and inflation. For this reason, inflation-linked bonds have appeal as a reasonably cheap form of insurance.

Bonds Opportunity 1: Focus on Positive Real Yields

A slew of opportunities now exist with positive real yields. This is a fantastic pond to fish, with several opportunities apparent:

- **Developed-markets bonds, excluding Japan.** We have seen significant moves across the yield curve. Higher yields make these bonds more attractive, especially shorter-dated bonds where an inverted yield curve exists. The defensive attributes are appealing. On the contrary, Japan is an area to be avoided, in our view, with negative real yields persisting.
- **Emerging-markets debt** still offers attractive yields and prospective currency returns, even accounting for risk. This applies across local and hard currency offerings, although sizing is important. South African government bonds provide attractive implied real yields and could deliver risk-adjusted returns ahead of equity equivalents. Relatively consistent foreign selling over the last 5 years has contributed to nominal yields trading at multi-year highs.
- **Inflation-linked bonds** continue to warrant some attention as they have repriced more attractively. Low inflation expectations make this a cheap form of insurance, with positive real yields now available.

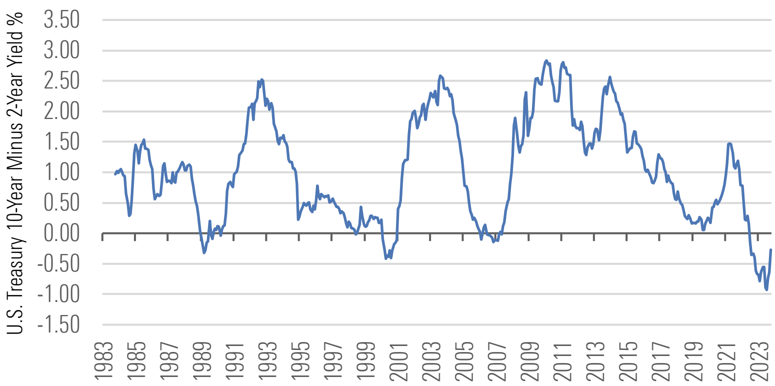
Bonds Opportunity 2: Short-Dated Bonds for Cautious Portfolios

The yield on short-dated bonds still exceeds long-dated bonds. This is coming from an unusual base in a historical context, creating the so-called “inverted yield curve” we still have today.

To take advantage, it can be tempting to favour short-dated bonds. This is certainly sensible in an absolute sense, although timeframe matters.

For investors that are cautious and/or have a short time horizon, short-dated bonds certainly appeal. We do note this brings reinvestment risk, which is notable if interest rates go down as expected. It may not be possible to lock in today’s longer-term rates forever.

Exhibit The Yield Curve (10-Year Minus 2-Year) is Still Negative



In practice, our position is this: short-dated bonds are attractive given the inverted yield curve, so we have a great starting point—with a big gap between the current yield and our fair value yield at the short end of the curve. But for investors with longer horizons, we see merit in exposure across the maturity profile.

Bonds Opportunity 3: Overweight Government Bonds Versus Corporate Bonds

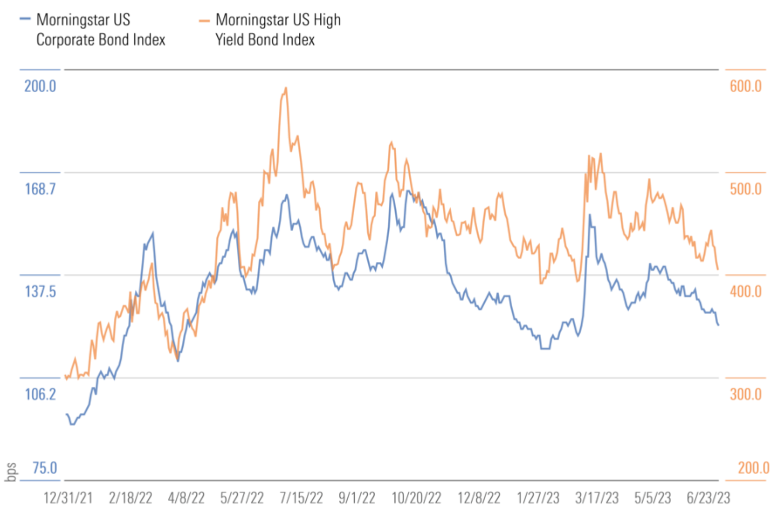
In this environment, we don’t need to stretch for yield. Government bonds in the developed world currently look as attractive to us as we’ve seen in at least a decade. This view holds across all durations.

At the same time, corporate bonds also look attractive, but the “spread” between them is on the tight side.

This is best expressed by watching credit spreads, which would usually increase if economic vulnerabilities rise. Yet, we haven’t seen spreads budge, so corporate bonds (both investment grade and high yield) lose relative appeal given the risk of economic deterioration.

For this reason, our analysis leads us to favour government bonds—particularly U.S. Treasuries—on a risk-adjusted basis. Withstanding another serious inflation run, the skew of upside to downside looks favourable to us. Of note, we do see appeal in short-term corporate bonds, where we can achieve positive real yields.

Exhibit Corporate Spreads Remain Tight Despite Economic Risk



Top Image Source: Source: Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity, as of 31 October 2023.
Bottom Image Source: Morningstar U.S. Corporate Bond Index, Morningstar U.S. High Yield Bond Index, data as of 15 November 2023. For illustration purposes only and not indicative of any investment. An investment cannot be made directly in the index. Past performance does not guarantee future results.

Currency management.

One final opportunity exists by understanding your currency exposure. The U.S. dollar looks expensive although still acts as a flight to safety in turbulence, so prudent international currency positioning (and hedging decisions) is an attractive dimension of portfolio management.

While currencies are notoriously volatile, we tend to think of currency positioning via the lens of portfolio robustness (focusing on those currencies with defensive characteristics where sensible), but also as a potential source of upside at extremes. Looking ahead, we continue to see merit in currencies outside the U.S. dollar. The South African rand continues to trade at depressed levels, having decoupled slightly from comparable emerging market peers due to idiosyncratic SA-specific factors. The yen has the potential to provide diversification qualities and potentially help preserve capital in times of extreme economic and market stress, as well as provide potential upside.

Summary of Portfolio Opportunities

Taken together, the below culminates as a list of our best ideas. By balancing these convictions into a broader diversified portfolio, we foresee a positive outlook for 2024 and beyond.

- Healthcare, banks and utilities
- International equity opportunities
- Small-cap and value stocks
- Positive real yields in fixed income
- Government bonds over corporates
- Diversified currency outside U.S. dollar

For further reading, we encourage you to view our latest equity outlooks—Europe, Asia, North America—along with our U.S. Economic Update, and or our Global Convictions document. If you prefer visuals, you may like our latest Markets Observer, which highlights several of these opportunities in charts.

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