Morningstar Balanced Portfolio

Portfolio Commentary

- Equities and bonds continue to come under pressure from rising interest rates and persistent inflation.
- Fears of a recession continue to fester, although corporate profits have remained robust so far.
- Within equities, large performance differentials exist. Energy companies remain the standout in 2022 and growth-oriented stocks the laggards. Within bonds, short-dated bonds are holding up, while those sensitive to interest rates and credit risks have struggled.
- Looking ahead, improving yields and valuations are a positive development for investors in pursuit of their long-term goals.

For just the second time in 40 years, bonds and stocks both posted losses for two consecutive quarters. This is an obvious concern for investors as they weigh four key developments: 1) An inflationary squeeze, 2) Rising interest rates, 3) Recessionary preconditions, and 4) Tightening corporate profit margins.

Of the four developments, the primary driver of the 2022 downturn continues to be inflation and the consequential reset in investor expectations. In this regard, uncomfortably high and persistent inflation has spurred central banks to raise interest rates, while the war in Ukraine pushes up energy prices, tangling supply chains, and casting a cloud over the global economy.

Prominently, the U.S. Federal Reserve raised rates in May and June by a combined 125 basis points (1.25%) and promised more hikes until inflation shrinks toward the 2% goal.

Of relevance for investors, corporate earnings have remained robust so far, but profit margins are under pressure from rising costs and revenue growth is in doubt as consumers rethink their spending plans. High commodity prices are also proving problematic for inflation, as oil prices extend their climb and sit above $100 a barrel. That said, other key commodities including gold, wheat and copper have declined, perhaps as a sign of demand-led concerns surrounding the global economy.

Taken together, equities are flirting around "official" bear market levels; however, it remains a fragmented story. At the sector level, energy stocks are the standout performer, while defensive value-oriented areas of the market have lived up to their reputation and held up relatively well during the downdraft. Sectors include health care, utilities and consumer staples, all of which provide services that are required in both good and bad times. Generally, stocks in these categories are considered less volatile and less affected by the ups and downs of long-term market cycles. Among the laggards, the dominant trend continues to be the fall of growth stocks.

Looking to emerging markets, we've (Morningstar) seen continued weakness, although many emerging countries have held up better than their developed peers. China was one of the few bright spots, following a period of meaningful weakness, as the government provided some regulatory relief for various industries and the country began to re-open after COVID spikes hit major metropolitan areas. The Morningstar China Index ended the quarter up 8.5%.

Turning to fixed income, bonds of all kinds ended the quarter in the red, as the rise in yields and decline in prices seen during the first quarter rolled on. While central banks were raising short-term rates, the bond market pushed long-term rates higher. Long-term bonds continue to take a heavy punch thanks to their vulnerability to rising interest rates. Bond investors are also worried that higher rates might tip the economy into recession, which caused a selloff in credit-sensitive bonds. This has become more pronounced as consumer confidence deteriorates, with higher-quality bonds seeing a recent revival. On a look-through basis, bonds with less sensitivity to changes in interest rates are holding up relatively well.

There's no use sugar-coating how badly the second quarter played out for most investors. For investors with goals in mind (which is the majority) it may feel like two steps forward and one step back. And as the second half of the year begins, attention is likely to continue surrounding the inflation threat and a potential economic recession. Behaviourally, this is an important time to remain grounded principally.

Looking ahead, we continue to believe stocks and bonds are fabulous assets to help people reach their goals, especially following the healthy rebound in yields. Stocks and bonds offer

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different mechanics, performing differently in various market environments—making them ideal core assets for the majority of investors. Further, following recent losses, the valuations for both stocks and bonds have improved, which is a broad positive that will help investors in the next chapter of their investment journey.

Broad domestic fixed income indices continued to decline heavily in the quarter, with the FTSE Canada Universe Bond Index down 5.66%. Shorter term bonds were comparatively better, but still negative, with the FTSE Canada Short Term Bond Index down 1.46%. Returns in global fixed income followed suit, with the FTSE World Government Bond Index down 4.74% in local terms, and down 4.56% in Canadian dollars in the period. Canadian Real Return Bonds suffered, with a whopping 8.90% drop in the quarter.

Domestic stocks, as represented by the S&P/TSX Composite could not hold onto first quarter gains, and slumped 13.2%. All sectors ended in the red, with Energy, Utilities, Consumer Staples and Communication Services down single digit percentages, and other sectors even worse.

The S&P 500 dropped 13.35% in the second quarter in Canadian dollar terms. The MSCI EAFE Index of foreign developed markets fell 11.71%, and the MSCI Emerging Markets Index dropped 8.43%.

The Morningstar Balanced Portfolio outperformed its blended benchmark[1] during the second quarter.

Positive Contributors

- Active managers Mackenzie Ivy Canadian Fund and Beutel Goodman American Equity Fund relative to equities
- Global energy exposure

Performance Detractors

- Currency-hedged U.S. equity exposure
- Active managers Templeton Global Bond Fund and TD U.S. Blue Chip Equity Fund

Activity and Valuation-Driven Asset Allocation Positioning:

We modestly reduced our exposure to credit and foreign bonds mostly in favour of domestic bonds and reduced some exposure to energy, and broad-based active equity foreign managers. We eliminated our Mexican equity ETF exposure. We reintroduced some dedicated exposure to U.S. Health Care and added exposure to a China equity ETF. We also increased our exposure to German equities and more value-oriented Emerging Markets via ETFs and added to the Franklin Bissett Canadian Equity Fund. The net effect was a slight increase in equity exposure, leaving the portfolio approximately 1% below neutral weight in equities.

Stocks and bonds are falling at the same time, creating an uncomfortable period with few places to hide. In this environment, it is tempting to throw the baby out with the bathwater and flock towards the scarce winners, but we still see the best portfolio mix maintaining a healthy level of stocks and bonds.

Moreover, the merits of stocks and bonds have improved, with higher yields and a better foundation for future return potential. It has also demonstrated the benefits of taking a valuation-driven approach, allowing us to protect capital at an important time. That's not to boldly declare we've reached a bottom, as that will only be clear in hindsight, but it does build the case to stick with a portfolio that includes an appropriate core exposure to stocks and bonds.

Turning to the current situation, we need to balance return potential and risk. With questions around a regime change of higher inflation and rates, one way to help us monitor the situation is to reassess our return and risk expectations over time. We like to use "valuation-implied returns," which wrap up several methods of valuation analysis into a consistent output, allowing us to monitor a collective pulse on market conditions. Using this analysis, we can see the return prospects for both stocks and bonds are improving significantly.

[1]The Morningstar Balanced Portfolio's benchmark comprises 30% FTSE TMX Canada Universe Bond Index, 8% FTSE World Government Bond Index in Canadian dollars, 18% S&P/TSX Composite Index, 42% MSCI All Country World Index ex Canada IMI Index in Canadian dollars and 2% FTSE TMX 91 Day T-Bill Index.

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