Quarterly Portfolio Commentary

Quarter 2 2022

Morningstar Investment Management South Africa

July 2022

Important Perspective

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 healthcare, 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 have 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.

The strong U.S. dollar has also significantly contributed to outcomes, especially for international unhedged holdings. Currency exposure therefore remains an important risk mitigation tool.

Looking Ahead

There is 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 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

Morningstar Global Cautious Portfolio Update
June 2022

Performance was negative over the quarter as both equity and bond markets continued their price decline as investors priced in the risk of higher interest rates to combat inflation, and the increased risk of recession. This has been a difficult year for multi-asset portfolios as both bonds and equities have performed similarly, not providing the expected diversification benefit. The Portfolio returned –9.5% for the quarter and has generated a return of -14.2% over the past year.

Asset Allocation

Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective, however, due to recent weakness, we have been increasing our US allocation. Overall, we favour markets that offer better value and offer diversification benefits, such as Japan, the UK, or the Global healthcare sector.

The portfolio holds significant exposure to global bonds, with a preference for US bonds. The fixed income allocation is broadly diversified with significant exposure to more defensive assets such as government bonds combined with exposures to both investment grade, high yield, and Emerging Markets Debt.

Fund Selection

Turning to the underlying investments, the contribution from fund selection was negative over the quarter.

From an equity perspective, funds with exposure to defensive stocks delivered decent returns, while funds exposed to growth stocks struggled. The performance of Fidelity Emerging Markets has been disappointing. The Fund's allocation to Technology (Taiwan Semiconductors and Samsung) and Materials (First Quantum Minerals) dominated performance and caused the Fund to underperform the market.

Dodge & Cox Worldwide US Stock had a decent quarter during a very volatile period. The Fund's allocation to Healthcare (Cigna, Bristol-Meyer, and Gilead Sciences) was a positive contributor to performance, over the quarter. Unfortunately, this was not sufficient to offset the losses from their exposure to Financials (Charles Schwab, Wells Fargo, and Capital One). The Fund has been successful in avoiding the expensive technology companies that were sold off.

From a fixed income perspective, US Treasuries held up better than global government bonds and investment grade credit. iShares Global Government Bond Index and Ninety One Investment Grade Corporate Bonds were notable detractors in this regard.

We remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with our expectations.

Recent changes

We have increased our exposure to USA equities, with a tilt towards quality growth stocks that look attractively priced. We took the opportunity to add to global credit where corporate spreads aggressively widened and provided an attractive entry point to lock in an attractive coupon. Finally, we reduced our cash holding and invested in government bonds where yields have risen sharply.

Summary

There is no use sugar-coating how badly the second quarter played out for most investors. For investors with goals in mind, it may feel like two steps forward and one step back. 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.

Looking ahead, we continue to believe stocks and bonds are great assets to help people reach their goals, especially following the healthy rebound in yields. Stocks and bonds offer different mechanics, performing differently in various market environments—making them ideal core assets for the majority of investors. Furthermore, 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.

Morningstar Global Balanced Portfolio Update
June 2022

Performance was negative over the quarter as both equity and bond markets continued their price decline as investors priced in the risk of higher interest rates to combat inflation, and the increased risk of recession. This has been a difficult year for multi-asset portfolios as both bonds and equities have performed similarly, not providing the expected diversification benefit. The Portfolio returned –12.7% for the quarter and has generated a return of -17.3% over the past year.

Asset Allocation
Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective, however, due to recent weakness, we have been increasing our US allocation. Overall, we favour markets that offer better value and offer diversification benefits, such as Japan, the UK, or the Global healthcare sector.

The portfolio holds significant exposure to global bonds, with a preference for US bonds. The fixed income allocation is broadly diversified with significant exposure to more defensive assets such as government bonds combined with exposures to both investment grade, high yield, and Emerging Markets Debt.

Fund Selection
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From an equity perspective, funds with exposure to defensive stocks delivered decent returns, while funds exposed to growth stocks struggled. The performance of Fidelity Emerging Markets has been disappointing. The Fund's allocation to Technology (Taiwan Semiconductors and Samsung) and Materials (First Quantum Minerals) dominated performance and caused the Fund to underperform the market.

Dodge & Cox Worldwide US Stock had a decent quarter during a very volatile period. The Fund's allocation to Healthcare (Cigna, Bristol-Meyer, and Gilead Sciences) was a positive contributor to performance, over the quarter. Unfortunately, this was not sufficient to offset the losses from their exposure to Financials (Charles Schwab, Wells Fargo, and Capital One). The Fund has been successful in avoiding the expensive technology companies that were sold off.

From a fixed income perspective, US Treasuries held up better than global government bonds and investment grade credit. iShares Global Government Bond Index and Ninety One Investment Grade Corporate Bonds were notable detractors in this regard.

We remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with our expectations.

Recent changes
We have increased our exposure to USA equities, with a tilt towards quality growth stocks that look attractively priced. We took the opportunity to add to global credit where corporate spreads aggressively widened and provided an attractive entry point to lock in an attractive coupon. Finally, we reduced our cash holding and invested in government bonds where yields have risen sharply.

Summary
There is no use sugar-coating how badly the second quarter played out for most investors. For investors with goals in mind, it may feel like two steps forward and one step back. 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.

Looking ahead, we continue to believe stocks and bonds are great assets to help people reach their goals, especially following the healthy rebound in yields. Stocks and bonds offer different mechanics, performing differently in various market environments—making them ideal core assets for the majority of investors. Furthermore, 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.

Morningstar Global Growth Portfolio Update
June 2022

Performance was negative over the quarter as both equity and bond markets continued their price decline as investors priced in the risk of higher interest rates to combat inflation, and the increased risk of recession. This has been a difficult year so far for multi-asset portfolios as both bonds and equities have performed similarly, not providing the expected diversification benefit. The Portfolio returned –15.7% for the quarter and has generated a return of -20.1% over the past year.

Asset Allocation

Within equity markets, our allocation is balanced across the different regions. We continue to see the US market as being the least attractive from a relative perspective, however, due to recent weakness, we have been increasing our US allocation. Overall, we favour markets that offer better value and offer diversification benefits, such as Japan, the UK, or the Global healthcare sector.

Our underweight exposure to North American stocks benefited portfolio returns as US stocks detracted from performance. Emerging Markets outperformed Developed markets over the quarter, as Chinese companies rebounded during June. Our overweight position in Emerging Markets reduced the losses over the quarter.

Fund Selection

Turning to the underlying investments, the contribution from fund selection was negative over the quarter.

From an equity perspective, funds with exposure to defensive stocks delivered decent returns, while funds exposed to growth stocks struggled. The performance of Fidelity Emerging Markets has been disappointing. The Fund's allocation to Technology (Taiwan Semiconductors and Samsung) and Materials (First Quantum Minerals) dominated performance and caused the Fund to underperform the market.

Dodge & Cox Worldwide US Stock had a decent quarter during a very volatile period. The Fund's allocation to Healthcare (Cigna, Bristol-Meyer, and Gilead Sciences) was a positive contributor to performance, over the quarter. Unfortunately, this was not sufficient to offset the losses from their exposure to Financials (Charles Schwab, Wells Fargo, and Capital One). The Fund has been successful in avoiding the expensive technology companies that were sold off.

We remain comfortable with the performance profile, especially on a risk-adjusted basis, delivering outcomes that balance against uncertainty and are in line with our expectations.

Recent changes

We have increased our exposure to US equities, with a tilt towards quality growth stocks that look attractively priced. Finally increased the allocation to Emerging Markets.

Summary

There is no use sugar-coating how badly the second quarter played out for most investors. For investors with goals in mind, it may feel like two steps forward and one step back. 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.

Looking ahead, we continue to believe equities are great assets to help people reach their goals. Following the recent losses, the valuations for equities have improved, which is a broad positive that will help investors in the next chapter of their investment journey.

Risk Warnings

Morningstar Investment Management South Africa Disclosure

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.