Global Convictions

Our Valuation-Driven Asset Allocation Views Looking Ahead From Q4 2018

Morningstar Investment Management LLC
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For Retail Investor Use

Asset Class Convictions

The goal of assigning a conviction level to an asset class is to distill the attractiveness of an investment opportunity into a single rank. The term "conviction" derives from the Latin verb "convincere," which means *to argue*.

In assigning an asset class conviction, an analyst trades off the aspects of an investment opportunity that argue for and against it, culminating in the expression of a conviction level. The conviction level is expressed on a five-point scale (Low, Low to Medium, Medium, Medium to High, and High), and serves as a key input into our asset allocation process.

Our conviction scoring system is based on four criteria: absolute valuation; relative valuation; contrarian indicators; and fundamental risk.

We Remain Defensive Despite Market Declines

The last quarter of 2018 saw significant declines in risk assets, with major equity markets posting double-digit losses and credit spreads widening to multiyear highs. Meanwhile, many defensive assets

Exhibit 1 Risk Assets Were So Overvalued, Even Major Declines Haven't Changed Our Views on Most Investments

	Conviction Level				
Equity	Low	Low to Medium	Medium	Medium to High	High
U.S.	■				
Consumer Staples			■		
Healthcare		■			
Energy Infrastructure			■		
Quality		■			
EAFE					
Japan			■		
U.K.			■		
Europe ex-U.K.		■			
European Telecoms				■	
Emerging Markets			■		
Europe				■	
Russia				■	
Asia			■		
Latin America		■			
Bonds					
U.S.					
Treasuries		○	■		
TIPS		○	■		
Credit		■			
High Yield	■				
Municipals		■			
Emerging Markets					
Hard Currency (USD)			■		
Local Currency			■		

■ Current Weighting ○ Previous Quarter's Conviction

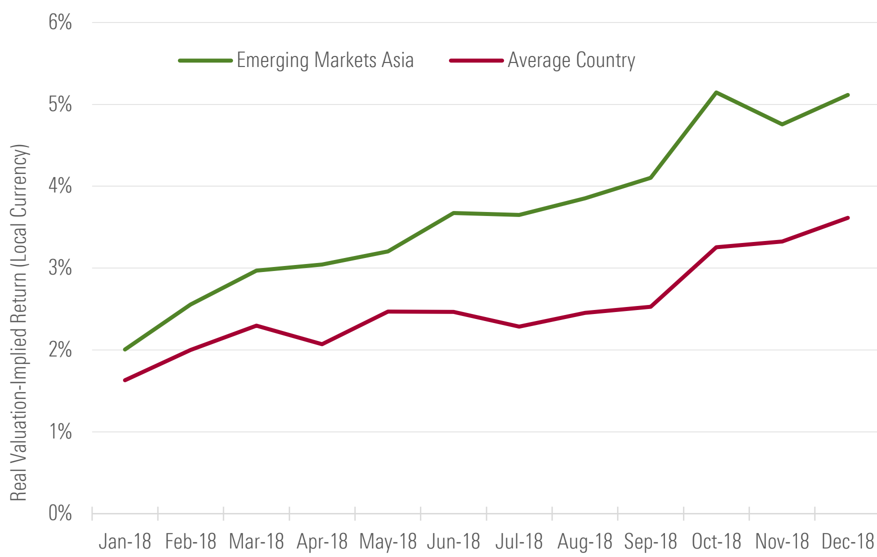
Source: Morningstar Investment Management LLC. Views as of 12/31/2018.

outperformed. The recent repricing has created some opportunities, we believe, however we continue to view many risk assets, like U.S. stocks, as being overpriced.

U.S. equity was battered in the fourth quarter, with energy stocks taking the hardest hits. The once-high-flying tech sector also came back to ground. For the year, only healthcare and consumer discretionary stocks posted gains. The overall market enjoyed a nine-plus-year bull market before the fourth quarter, when it narrowly escaped a bear-market loss of 20%. So, in the scope of nearly a decade of gains, the latest losses weren't significant enough to change our outlook for U.S. stocks.

Instead, we're looking to potentially redeploy capital to areas of the market that saw valuations improve most. For example, stocks in Europe and emerging markets (EM)—particularly EM Asia—lost further ground in the quarter despite being underpriced in our view before the fourth quarter began. These stock markets are fundamentally strong yet we believe investors have overlooked their appeal (see Exhibit 2).

Exhibit 2 While Our Overall Outlook on Stocks Has Improved Modestly, EM Asia Has Grown Particularly Attractive



Source: Morningstar Investment Management. Valuation-implied returns estimate annual inflation-adjusted performance over the next full market cycle (about five to 10 years). Data as of 12/31/2018. "Average Country" is the average valuation-implied return for the constituents of the MSCI All Country World Index.

We're also starting to see opportunities in credit, with investment-grade and high-yield spreads over Treasuries widen to 47 basis points and 217 basis points, respectively. That's the highest level for each since 2016 and a considerable turnaround from three months ago.

Markets can become the most interesting to us after a major fall because that's typically when we would expect to be able to find underpriced assets. Our defensive positioning leading up to the market correction should make it easier for us to move quickly into new opportunities. But for clarity's sake, "moving quickly" may be a relative term. We won't buy any asset that we can't confidently appraise the fundamental value of. Thus, our investment process isn't automatic—we won't buy once this ratio or that measure reaches a certain level.

Instead, we constantly reassess an asset class' fundamentals to arrive at a fair value (or intrinsic value) estimate. We then compare that value to the price the market is offering for the asset. When the price of an asset is comfortably below our estimate of fair value, we consider buying. But other factors add to this decision—primarily, the risk of loss and how popular (or unpopular) the asset has become with the market. Our global team works together to research and evaluate each asset class before portfolio managers use this information to make potential trades in their portfolios.

This might not sound exciting—in fact, it can be rather plodding at times. But that's by design. We don't want our emotions to drive us to make bad decisions. So we'll take our time and seek to understand the fundamentals before making any new investment. We know this isn't the only way to invest, but we believe this way of investing can help investors reach their financial goals.

Our Valuation-Driven Asset Allocation Views (as of Dec. 31, 2018)

EQUITY MARKETS		
Asset Class	**Conviction**	**Rationale**
U.S. Equities ► Consumer Staples ► Healthcare ► Quality	Low Medium Low to Medium Low to Medium	After hitting repeated all-time highs over the course of 2018, U.S. equities were hit by uncertainty in the final quarter of the year. Sentiment seemed to reverse on the outlook for U.S. growth, the booming technology sector, and the perception that the U.S. stands to benefit the most (or lose the least) from trade disputes. Concerns regarding the escalating trade wars also impacted sentiment, as did doubt that Trump will be able to implement his agenda after Republicans lost the House. Elsewhere, monetary policy brought its own uncertainty, with strongly rising bond yields at the start of the quarter (anticipating further tightening from the Fed) replaced with fears of an impending recession (citing a flattening yield curve). While the outcomes of these issues are unknowable, in our view valuations in U.S. equities are not adequately compensating investors for the risk of the permanent loss of capital. Granted, valuations in U.S. equities have improved in an absolute sense (courtesy of the approximately 12% fall in the S&P 500, quarter to mid-December), but the asset class is expected to only slightly outperform inflation, on a 10-year view, on our analysis. Furthermore, little has changed in terms of the asset class' appeal relative to global peers. Indeed, these changes are insufficient to alter our view that U.S. equities are the least attractive of the major equity regions and continue to pose the elevated risk of loss. The consumer staples sector stands apart. Consumer staples companies face many competitive headwinds that have weighed on returns in recent years. However, the sector continues to trade above its fair value, making it unattractive on an absolute basis. Nevertheless, considering how unattractive the rest of the U.S. equity market is, we believe it is a reasonable investment at both a sector level and for active managers looking for idiosyncratic opportunities. Another exception to our dim overall outlook for U.S. stocks is quality stocks, defined as those with strong fundamentals that suggest greater certainty to future cash flows. These stocks trade at multiples that may be more attractive than the broad market but, more importantly, have historically offered defensive properties. Quality stocks may provide price-conscious investors a way to stay invested in U.S. stocks while reducing the downside risk.
Europe ex-U.K. Equities ► European Telecoms ► European Energy ► European Financials ► European Healthcare ► European Utilities	Low to Medium Medium to High Medium Medium Medium Low to Medium	European equities have followed key global peers lower in recent times, with the combined specter of Brexit negotiations, less stimulatory monetary policy from the European Central Bank, and an uncertain political environment. Therefore, our forward-looking expectations have improved, although caution is still warranted from a valuation perspective, with aggregate expected returns still lower than what we would consider fair. However, we see opportunities for better returns at a sector level. We retain our positive view on European energy companies, which continue to appeal, indeed even more so, following the rout in the oil price, which has impacted sentiment toward the energy sector. Notwithstanding concerns about Italian banks, we think European financials also look attractively priced, as do telecoms, which have endured weakness relating to concerns around revenue trends, changing business models, and greater regulation. Nonetheless, we believe current valuations provide attractive reward for risk, with investors overly pessimistic on the outlook for the sector, in our view.

U.K. Equities	Medium	As we move inside the final 100 days before the U.K.'s scheduled divorce from the European Union, poor sentiment continues to plague U.K. equities. This is an understandable response—humans do not like to feel uncomfortable when investing—but it is likely to prompt irrational decision-making (which is usually damaging to portfolio outcomes). With this, U.K. equities appear among our most-attractive valuation opportunities, particularly relative to other equity regions, with the risk of Brexit and tightening monetary policy being largely reflected in current share prices, in our view. Said another way, while we cannot forecast what Brexit will ultimately look like (or indeed if that decision may be reversed), we believe that investors are being well-compensated for the range of possible Brexit outcomes, notwithstanding that certain scenarios pose significant risk to corporate profitability.
Japan Equities ► Japan Financials	Medium Medium to High	Valuations in Japanese equities appear reasonably attractive, having improved over the course of 2018 as poor trade-related sentiment has created uncertainty in this export-led market. In addition to the strengthening valuation opportunity, we are further attracted to the compelling fundamentals of the asset class. In particular, we note the focus of Japanese corporates on improving corporate governance, which typically leads to more efficient use of capital. We expect this trend to continue, benefiting shareholders through higher dividends and buybacks, improved profit margins, earnings growth, and ultimately potential return on equity. With this in mind, we maintain a preference for domestic-facing companies, most notably financials. In this regard, fundamentals have improved, following a long period of deleveraging. Sentiment toward Japanese financials has also been hindered by the central bank's prolonged quantitative easing program that has driven down longer-term yields, making it difficult for banks to make money (and lowering investment income for insurers). Thus, market expectations for the asset class remain below what we might reasonably expect, with the sector leveraged to any improvement in economic conditions, increasing inflation, and ongoing monetary tightening, however minimal. At these levels, we believe valuations provide attractive compensation to invest.
Emerging-Markets Equities ► EM-Asia ► EM-Europe ► EM-Latin America ► Russia Equities	Medium Medium Medium to High Low to Medium Medium to High	Emerging-markets equities have encountered a challenging period, with trade threats boding poorly for sentiment toward key exporting nations like China, South Korea, and Taiwan (whose companies combined make up almost 60% of the MSCI Emerging Market Index). This has reinforced the valuation opportunity, in our view, with expected returns improving as investors become overly pessimistic on the outlook for emerging-markets companies. With returns across emerging markets quite divergent, we continue to see company- and country-specific opportunities in the asset class, particularly in parts of Europe and to some extent Asia. Our return projections for Chinese stocks have risen over the course of 2018, even as we remain cautious given risk to fundamentals posed by the increasing debt levels across the Chinese economy, particularly in the corporate sector. Our relatively positive view of Russian equities underpins our conviction toward emerging Europe, with attractive valuations providing acceptable compensation for the risk.

FIXED INCOME

Asset Class	Conviction	Rationale
Developed-Markets Sovereign ► U.S. Treasuries ► Europe ex-U.K. ► U.K. Gilts ► Japan ► Australia	 Medium Low Low Low Medium	Yields in several key government bond markets, led by the U.S., have risen over the course of the last year, pushed higher by rising U.S. inflation expectations and the unwinding of the Federal Reserve's stimulus program that has been in place since the global financial crisis. This peaked in early November, with the yield on the U.S. 10-year bond soaring to almost 3.25%, sharply refocusing investor attention on interest rate-sensitive assets. Closing the year however, slumping equity markets and concerns around global growth have dampened investor confidence. With it, interest rate expectations have fallen sharply. Indeed, the yield on U.S. 10-year bonds now stands at about 2.7%, well below the peaks seen less than a month before, and back to levels last observed at the end of January 2018. Of particular concern to investors, yields on five-year bonds have fallen below those with shorter maturities: First versus three-year maturities, but as these too fell, now both sit lower then than one-year issues, which historically has indicated the increasing risk of recession. While the reliability of this indicator, and certainly the timing, is difficult to predict, we note that central banks in the U.S., Europe, U.K., and even Japan look to be on the path to more normal monetary policy (to varying degrees, with the U.S. most advanced in this regard, and Japan the least). With this, a significant tailwind for bond markets in recent years appears to be moving toward a headwind, further raising the risk of a policy misstep should we encounter more challenging economic conditions. More importantly, through a valuation lens, government bonds in the U.K., Europe, and Japan remain significantly overvalued. U.S. government bonds, while offering better relative value, still look expensive in a historical context, especially after these final moves. This view comes from considering investors are being forced to accept lower yields on bonds that have a longer time to maturity than what they may have had in the past. This is a poor trade-off, as it reduces future income while increasing the risk of capital loss should bond yields rise toward their longer-term fair value. Therefore, with forecast benchmark returns looking unattractive, investors in this this asset class will need to adopt a flexible and disciplined approach, identifying those bonds that offer value while managing fixed-income levers like credit spreads and bond duration (sensitivity to interest rate movements) to reduce the risk of a permanent loss of capital.
Investment-Grade Credit ► U.S. ► European Corporates ► U.K. Corporates	 Low to Medium Low Low	Investment-grade credit markets in the U.S., U.K., and Europe are expensive in absolute terms, with their coupons not adequate compensation for the risk of material capital losses that may come about from changes to interest rates, inflation expectations, the default cycle, and, ultimately, rising credit spreads. While credit spreads in the U.S. (the largest corporate bond market) appear acceptable compared to government bonds, this ignores that the quality of this asset class has deteriorated, with a significant proportion of this index now classified "BBB," which is the lowest credit rating a bond can have while remaining investment grade. Thus adverse circumstances have the potential to be disruptive, as a credit downgrade cycle could see many issuers jettisoned to high-yield status which may lead to disorderly selling by investors who are mandated only to hold investment-grade bonds. With this, and the asset class being particularly sensitive to rising interest rates courtesy of its long maturity profile, we continue to pursue superior reward-for-risk opportunities in other parts of the bond universe.

High-Yield Credit	Low	Notwithstanding the improvement in yields and credit spreads in recent months, the asset class remains generally unattractive. The falling oil price is influencing outcomes in this space, yet the risk of capital loss remains if we were to experience a crisis in which credit effectively dries up (i.e., it becomes harder and more expensive to find investors willing to lend to these lower-quality businesses), thereby increasing the risk of default as these companies can no longer fund their ongoing operations.
Emerging-Markets Bonds ► Local Currency ► Hard Currency	 Medium Medium	Rising U.S. interest rates, a stronger U.S. dollar, and the increasing threat of a trade war have seen yields on emerging-markets bonds increase recently, accompanied by emerging-markets currency weakness. With this, we believe the asset class is now more attractive in both an absolute and relative sense, offering a better reward for risk compared to most developed markets. Valuations have especially improved for emerging-markets bonds issued in hard currency (U.S. dollars). We recently upgraded our conviction toward hard-currency EMD, joining local-currency EMD (where the bonds are denominated in the currency of the issuing nation) on a Medium conviction rating.
Global Inflation-Linked Bonds ► U.S. TIPS	Low to Medium Medium	With inflation-linked bonds, the value of the principal rises (or falls) with changes in inflation expectations. Over the course of 2018, inflation expectations, especially in the U.S, increased as the Fed moved further down path to a more normal monetary policy environment. Nonetheless, inflation expectations remain below long-term normal levels, and, with the change in sentiment in the final quarter, they have fallen back to levels only touched at the recent low in mid-2017, and only surpassed in November 2016. We believe the still-benign inflation expectations currently witnessed around the world means inflation-linked bond valuations offer a reasonable longer-term opportunity to add historically cheap inflation protection to portfolios, which can be useful for portfolio construction purposes.

OTHER ASSETS

Asset Class	Conviction	Rationale
U.S. Municipal Bonds	Low to Medium	We expect municipal bonds' absolute after-tax returns to be subdued but higher than after-tax returns from other U.S. fixed-income investment-grade bonds. Thanks to the recovery of the U.S. economy, most municipalities' balance sheets have been strengthening, but significant, long-term fundamental headwinds remain.
Global Infrastructure	Low	As with other interest-rate sensitive asset classes, global infrastructure has seen some weakness over the past 12 months. The regulated utilities have not fared as well as the more economically-sensitive areas of the infrastructure market (such as airports and railroads), which benefit from improving economic sentiment and broader equities market strength. While the backdrop has improved, we continue to cite valuation risks and thus don't see sufficient reward on a risk-adjusted basis.
► U.S. Energy Infra & MLPs	Medium	This is a contrarian play in the U.S. Negative sentiment on the industry may be overblown, and the valuations of industry benchmarks may offer relative value compared with the overall U.S. equity market, which we find overpriced. These infrastructure companies are attractively priced and tend to be less sensitive to commodity pricing, except on the extreme downside. And industry restructurings may improve governance. The bottom line is that fracking and the boom in natural gas production presents what may be a rare opportunity to participate in rapid growth of an industry.

Alternatives	In a world where bond yields are still relatively low and a challenging landscape for equities, alternative assets can appeal given that returns from this asset class have a lower direct relationship with the performance of traditional asset classes like equities and bonds. Investment selection remains critical, however, with our preference for genuinely diversifying assets with a focus on reasonable cost and liquidity.
Cash	In an environment characterized by unstable investor sentiment and overvaluation concerns, cash continues to appeal as the one asset class that can help protect capital with a high level of certainty. We see our cash reserves serving three purposes. First, cash helps reduce the sensitivity to interest rate rises, especially relative to long-dated bonds, which we believe is an important risk to manage. Second, cash should help buffer the portfolio from any future volatility resulting from a fall in equity markets. And third, cash provides us with ample liquidity to take advantage of investment opportunities as they arise. This means we will avoid having to sell down existing investments to fund purchases (at what may otherwise be an inopportune time to sell, with price weakness often induced by investor fear and panic).

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