

Morningstar Balanced Portfolio

Portfolio Commentary

- Global stock and bond markets posted broad gains in the second quarter, as economies re-opened, and central banks offered their stance on inflation developments.
- Volatility across equity markets fell to pre-pandemic levels. Renewed demand for oil pushed prices higher and energy stocks topped the sector list.
- Bonds partially recovered from a rough first quarter. High-yield bonds continued to outpace government and corporate bonds.

Stock and bond markets posted broad gains in the second quarter, and volatility ebbed, as investors navigated the cross-currents of a global economy emerging from the coronavirus pandemic.

Stocks were driven by the dynamics of a recovering economy: the reality of higher inflation, a mixed picture on employment and continued support from central banks. This shift came as the Federal Reserve indicated in June that it may raise rates somewhat sooner than expected, albeit not likely until 2023. Meanwhile, the Bank of Canada maintained its target for the overnight rate at the effective lower bound of $\frac{1}{4}$ percent and signaled its expectation to remain at that level until sometime in the second half of 2022.

Divergence in North American sector performance narrowed in the second quarter, with all but the U.S. utilities sector and Canadian Health Care sector posting gains. By the end of the period, one of the most dominant trends from late 2020 and the first quarter began to fade: the outperformance of cash-flow producing value stocks over popular growth stocks. Still, with central banks (and especially the Federal Reserve) still injecting enormous stimulus, markets were not spooked. Some factors stayed constant from earlier developments: resurgent economic activity boosting the price of oil, and in turn, energy stocks. In fact, oil prices rose 20% in the quarter and 94% over the past year. In this context, emerging markets showed resilience to a regulatory clampdown in China towards mega-tech companies,

with the broad emerging-markets basket matching developed markets for the quarter.

In the bond market, following a rough first three months of 2021, where prices were hit by fears of rising inflation, investors returned in the second quarter. Updates from central banks influenced bond market participants, with a return of investor interest resulting in a reversal of some of their lost ground—with the U.S. faring better than European equivalents. In riskier fixed-income markets, high-yield bonds continued to outpace core and corporate counterparts.

The currency market also saw increased volatility, with the U.S. dollar perking up in June after sharply declining for most of the quarter. To the contrary, the Japanese yen, British pound, Euro and Australian dollar all saw relative strength but weakened as the quarter ended. The Fed's hinting at higher rates and a more aggressive stance on inflation was a telling development here.

Broad domestic fixed income indices reversed course in the second quarter, delivering positive returns, with the FTSE Canada Universe Bond Index up 1.66%. Shorter term bonds were relatively flat, with the FTSE Canada Short Term Bond Index up about 0.06%. Returns in global fixed income were modestly positive, with the FTSE World Government Bond Index up 0.75% in local terms, but down 0.51% in Canadian dollars in the period. Canadian Real Return Bonds rebounded with a 3.53% return in the quarter.

Domestic stocks, as represented by the S&P/TSX Composite, continued to deliver strong returns, with an 8.54% showing in the second quarter. The Information Technology sector had the highest returns, up 23.0% in the period, and the Energy sector was up 13.9%. Small Cap stocks continued to run ahead of the broader market, with the S&P/TSX Small Cap index up 9.15%.

The S&P 500 gained 6.95% in the second quarter in Canadian dollar terms. The MSCI EAFE Index of foreign developed markets gained a more muted 3.62%, and the MSCI Emerging Markets Index had a similar return of 3.57%.

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Morningstar Balanced Portfolio

The Morningstar Balanced Portfolio underperformed its blended benchmark¹ during the first quarter.

Return Bonds for diversification and as a form of insurance against unexpected future inflation.

Positive Contributors

- Energy exposure via Global X MLP & Energy Infrastructure ETF.
- Active managers Canoe Defensive International Equity Fund and Capital Group Global Equity Fund.

Performance Detractors

- Active managers Galibier Canadian Equity Pool and Invesco Select Emerging Markets Pool.
- Japanese Stocks.

Activity and Valuation-Driven Asset Allocation Positioning:

Over the past 12 months, stocks are meaningfully higher, with some key markets hitting a new record high on the last day of the quarter. To really hammer home the post-pandemic rally, take U.S. stocks for example, which are up 97% from the 2020 low set on March 20, 2020. This is obviously good news for those with a higher risk tolerance that have enjoyed the high returns, but it has also seen the risk appetite and return expectations of many investors rise to worrying levels. Some investor surveys even suggest participants now expect 15%+ returns every year for the next five years, which is extraordinary by historical norms. Like gravity, investors should be reminded that long-term asset prices are inevitably a reflection of the fundamentals beneath it.

We (Morningstar) made no changes to the Portfolio in the quarter. Overall, the Portfolio continues to be slightly below a neutral weight in equities versus our benchmarks. Intra-equity, we continue to remain overweight non-U.S. equities, specifically value-leaning securities, and sectors such as energy and financials, and countries such as Japan, the U.K., Germany and Mexico as they remain among the more attractive areas in the equity market by our analysis.

In fixed income, we remain slightly underweight duration and overweight emerging-markets debt. We remain overweight Real

¹The 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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