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M&G Investments

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Welcome to the third issue of Ampersand

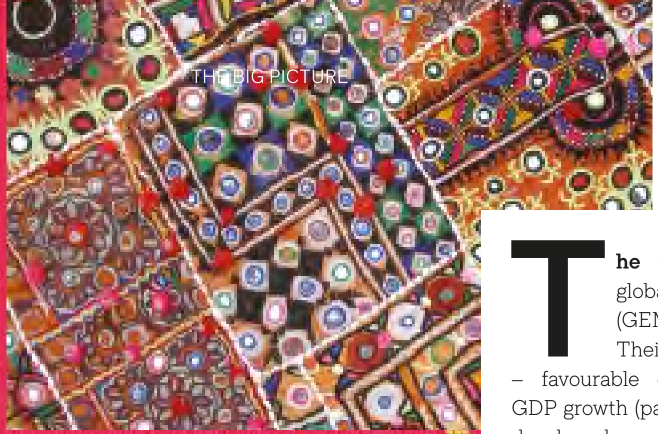
Welcome to the third issue of Ampersand, where we delve into the diverse and dynamic emerging markets in Asia and beyond. Amidst a complex global environment marked by shifting growth trajectories and geopolitical tensions, investors are increasingly recognising the need for targeted, active allocation strategies to capture growth in this vital region. Our focus this edition is on the heterogeneous nature of emerging markets and the case for specialist approaches, particularly in Asia, where growth potential and risks are unevenly distributed.

In 'The Big Picture', we explore the disaggregation of global emerging markets, emphasising the need to avoid broad generalisations. A special feature asks whether China remains the dominant investment story of the coming decade, while Vikas Pershad provides critical insights into India's rapidly evolving equity market. We also examine the strengths of Asian credit markets, and tackle the debate on American exceptionalism and its relevance to emerging markets. As digital infrastructure demands soar, and AI reshapes real estate in Asia, our contributors guide you through these transformative trends.

Continuing our interview series, we speak to Emmanuel Deblanc, who joined M&G as CIO for Private Markets earlier this year. A keen chess player, he talks about his journey to the top, the art of dealmaking and why he thinks private markets are at a turning point.

With Ampersand, our global experts connect the dots in an increasingly complex investment landscape, to bring you insights that identify investment opportunities across asset classes, sectors and regions. We call this Intelligence Connected.

Joseph Pinto
CEO, M&G Asset Management



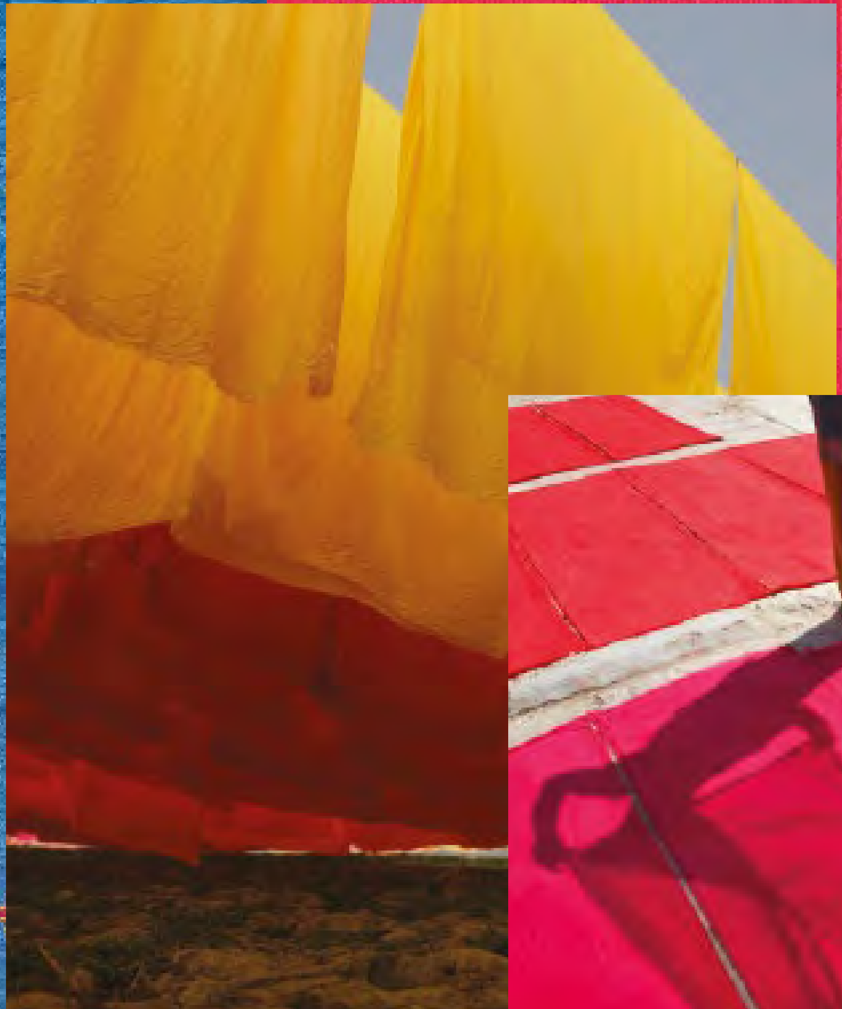
Uncovering the rich tapestry of emerging markets

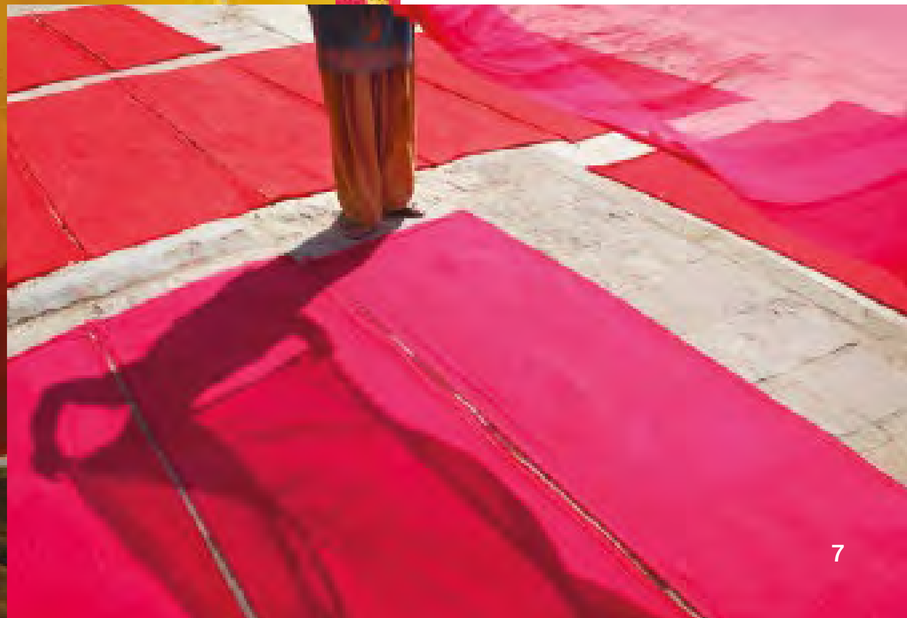
Global emerging markets comprise a large and varied selection of economies and companies. Asia, the dominant region, offers populous and fast-growing nations, as well as globally competitive, innovative companies. However, emerging markets (EMs) are often viewed through a narrow lens and treated as a homogeneous asset class. Simon Sharp and Dominic Howell seek to debunk some of the misconceptions about emerging markets and unveil the diverse range of potential opportunities that investors might be overlooking.

The investment case for global emerging markets (GEMs) is hardly new. Their inherent attractions – favourable demographics, robust GDP growth (particularly compared to developed markets), natural resources, market liberalisation, etc are as valid today as they have always been. The portfolio benefits of allocating to emerging markets with their spread of companies, countries and sectors also remain. However, these positive dynamics have often failed to translate into superior investment performance, especially relative to major developed markets such as the S&P 500 Index.

But why has this been the case, and what have investors been missing? Has the principal culprit perhaps been a tendency to look at GEM equities as a homogeneous investment universe?

This view could be due to the way index providers characterise the asset class. Widely followed benchmarks, such as the MSCI Emerging Markets Index, seek to provide investors with a broad exposure to companies across GEMs. But the index representation of the world does not reflect the full opportunity set available to active investors, argues Michael Bourke, Head of EM Equities. "Currently, China, India, Korea and Taiwan, represent three quarters of the index," he says. "This makes it quite inefficient in terms of it being top heavy in these four markets."





In reality, GEMs are not homogeneous, and never have been. There is plenty more to GEMs than just those four countries, Bourke explains. "You have the Middle East growing, which wasn't even talked about five years ago. There's also Latin America (LatAm) and South Africa, which often divide investors. With high commodities exposure, countries like Brazil tend to be in and out of favour within short time periods."

For Bourke, the divergences in GEMs, combined with share price volatility, can provide plenty of opportunities for active investors. "A go-anywhere, unconstrained approach to GEMs can prove lucrative because of the inefficient nature and the concentrated make-up of the index," he notes.

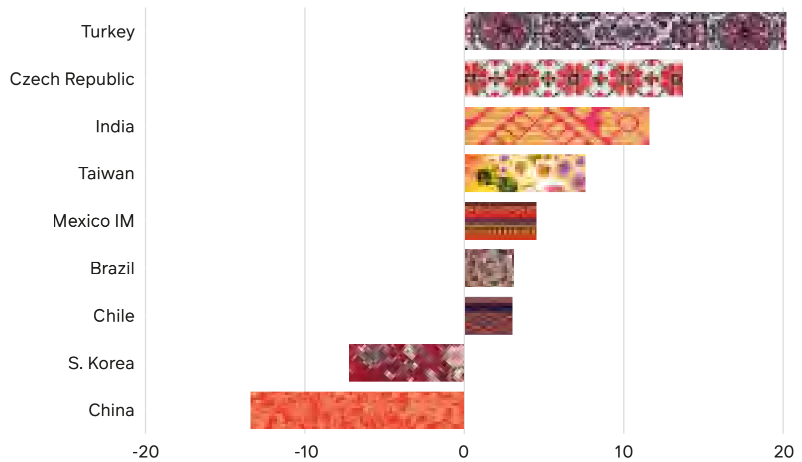
This divergence across the GEMs universe can also be observed in the performance of different markets. Taking the most recent full year, 2023, China posted its third consecutive year of negative equity performance, whereas Taiwan and Mexico both rose over 30%[1].

With 24 countries in the MSCI Emerging Markets Index, dispersion of returns should be expected and often can be readily explained. In addition to country-specific events, such as the China property crisis, structural characteristics impact different countries to different degrees. For instance, some emerging markets are exposed to natural resources and sensitive to global economic growth.

Their domestic political environments will differ, as well as the relevance of geopolitical events such as the war in Ukraine. Some of the strongest drivers for emerging markets are not equally applicable across the board. Despite the perception of overall demographic strength in GEMs, wide discrepancies exist between countries. For instance, the UN predicts the populations of Brazil and India to grow by 47% and 18%, respectively, between 2022 and 2050, but it expects a decline of 7% in China[2].

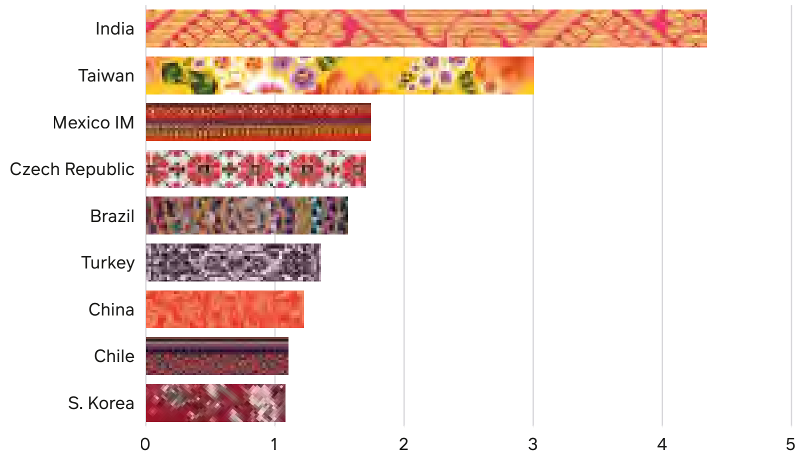
Valuations across GEMs not only reflect this, but take into account other factors such as different sector weights within countries. Asian emerging markets such as Taiwan and South Korea are home to global corporate titans such as Taiwan Semiconductor Manufacturing Company (TSMC)

GEM country performance (%)



Three-year annualised returns, gross in US dollars. Past performance is not a guide to future performance. Source: MSCI, 30 August 2024.

GEM valuations (price/book value)



Source: MSCI, 30 August 2024.

and Samsung Electronics, while major industry leaders such as Tencent and Alibaba are based in China. Other countries may be particularly geared towards growth in transport infrastructure or renewable energy production resulting in a further divergence in valuations.

Differences persist in EM bonds

The scale of opportunities arguably means the EM debt market should also not be ignored by fixed income investors looking to diversify portfolios. Now a $24 trillion market, it has grown from representing just 2% of the global bond market in 2000 to an impressive 25% in 2022[3]. But here, also, important differences persist, as Michael Talbot, Fixed Income Investment Specialist, explains.

"Each country is highly unique, with their respective economies driven by very idiosyncratic factors. Even within regions such as LatAm, Asia and Sub-Saharan Africa, there is often little commonality," he says. "There may be broader trends like higher inflation in LatAm compared to Asia but within LatAm each country will have a slightly different experience of inflation driven by unique factors."

For Talbot, these differences mean a selective bottom-up approach is required when investing in EM bonds.

When looking at GEMs, fixed income investors largely focus on economic development as the key differentiator. In addition, in EM debt markets there is also a choice to be made regarding currency exposure with some debt issued in hard currencies, such as dollars and euros, and some in local currency. Although today, the local currency debt market is many times larger than the hard currency market.

[1] MSCI, 30 August 2024. Index performance gross, annualised, US$.
[2] United Nations, November 2022.
[3] State Street Global Advisors, March 2022.

'GEMs are not homogeneous and never have been.'

These choices are important as performance can vary dramatically across region, bond rating and type. Talbot points out that the GEMs business cycle does not always follow that of developed markets (DMs) and currencies and regions might perform independently from one another, which support the view that EM bonds can be a diversifier from DM assets. They also demonstrate the importance of taking an active approach to contend with potential risks.

Actively benefitting

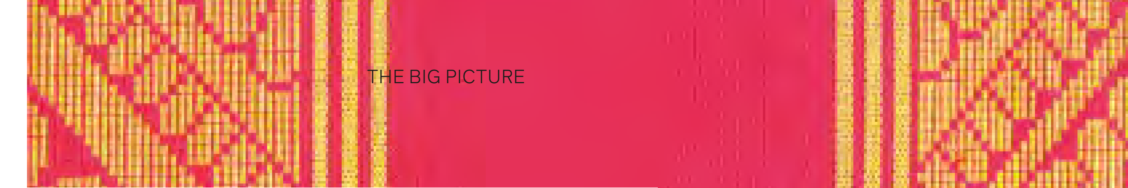
Overall, the dispersion of market returns, certainly across the breadth of emerging market equities, has persisted as deglobalisation has accelerated. The (correct) response by many investors has been to become more discriminating in their allocations to emerging markets. There could be different ways to potentially achieve this:

- Geographic blocks: Allocating to Asia, LatAm and the Middle East which likely share preferred characteristics
- Sector weights
- Factor investing: Value, quality, momentum, yield, volatility
- China: Exclude or include China, which represents 25% of the MSCI EM Index

A decision to exclude China, for example, may provide additional diversification benefits with the residual country exposures allowing a more diverse selection of industries, market structures, political and demographic profiles. Although developed markets offer investors a larger number of individual stocks overall to choose from, within emerging markets sectors such as semiconductors, electronic components, renewable energy and transport infrastructure actually offer more names than in developed markets.

These insights suggest simply investing in an overall GEM equity tracker fund may disappoint. The differences between individual countries are simply too great, with the additional concern that the index is dominated by a handful of countries.

THE BIG PICTURE



With important country-specific differences, diversity in sector exposure and divergence in performance, GEMs investors need the option to discriminate and construct their GEM allocations accordingly. In our view, adopting a highly active, bottom-up approach to emerging markets is key to securing long-term success. Volatility within emerging markets will usually present opportunities – having the flexibility and skill to capitalise on this likely determines performance.

Spotlight on emerging Asia

A need to be selective within countries and sectors raises the question: Where should GEMs investors currently focus? One region at the centre of attention is Asia. Of the 6 billion people in GEMs, roughly 4 billion live in Asia. With its dynamic and evolving economic landscape, there are plenty of reasons why Asia is so prominent.

For a start, it can be seen as the engine of the global economy. China is the region's powerhouse. Over the past 40 years, the country has been transformed through investment and export-focused manufacturing into the world's second largest economy, behind the US. It has reshaped global trade, investment and supply chains and created a vast consumer market.

In addition to China, Asia has some of the fastest-growing economies in the world, led by India with an expected growth rate of 7% in 2024, according to the IMF. Collectively, the IMF forecasts that Asia is set to contribute about 60% of global growth in 2024[4].

From an investment perspective, Asia stands out in GEMs as it represents around 80% of the MSCI EM Index. Asia's dominance can be attributed to the four big markets: China, India, South Korea and Taiwan, which together make up 75% of the index.

According to Bourke, Taiwan and South Korea are similar. They are both relatively mature economies and are actually as rich as, if not richer than, many European countries, he says. In some ways they are not typical EMs but developed market investors struggle to categorise them so they remain dominant constituents of the EM world. They've thrived in recent years because they are technology heavy economies and integral parts of the global technology supply chain. "As major suppliers to both the West and China, in recent years they have benefited from growth in both those regions," he comments.

While China and India are often compared to each other, they are very different. The fact that they both have populations in excess of 1.4 billion people, might be one of the only things that they have in common. China is by far the larger economy, with a gross domestic product (GDP) of $18.53 trillion, more than four times India's $3.94 trillion. Similarly, India has a long way to go in terms of its GDP per capita, which is currently $2,730, compared to $13,140 in China.

However, the different growth trajectories of the two countries have resulted in different perceptions. With significant scope for economic development, India is the current 'growth darling' of EMs, observes Bourke. Indian Prime Minister Narendra Modi certainly has ambitious growth plans for the country, seeking to boost per capita income and make it the third-largest economy in the world[5]. He has even spoken about making India a developed market country by 2047[6].

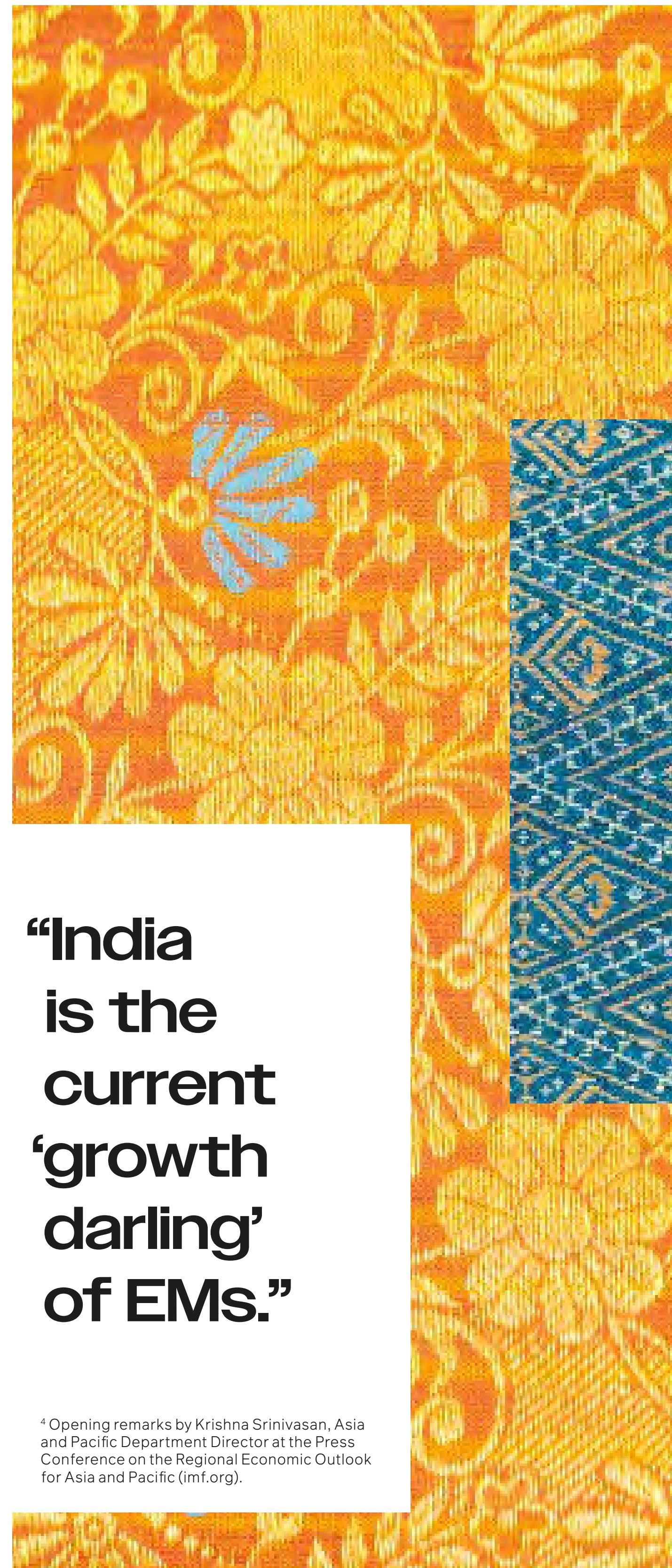
As Vikas Pershad observes in his column elsewhere in this magazine issue, "much of India's untapped potential lies in its demographic dividend". With a large and young population – more than 40% of the population is under 25 years old[7] – many of whom are English speaking, India has a huge and potentially highly productive workforce. Its domestic market also offers a potentially vast and diverse consumer base.

The current optimism around India's future is in stark contrast to the prevailing pessimism about China. After years of rapid growth, investors are worried about the economy's loss of momentum, represented by the struggling property sector and weak consumer demand. Geopolitical tensions with the US over trade and technology have also clouded views on China.

In many cases, these risks may already be reflected in share prices and contrarian investors might wish to explore China's stock market for underappreciated stocks, as David Perrett argues in this magazine issue.

Just as GEMs are more than a homogeneous grouping, there is more to Asia than the big four. "The fact that those four markets are large and dominant doesn't necessarily mean that's all that's going on in Asia," says Bourke. "That's frequently forgotten about."

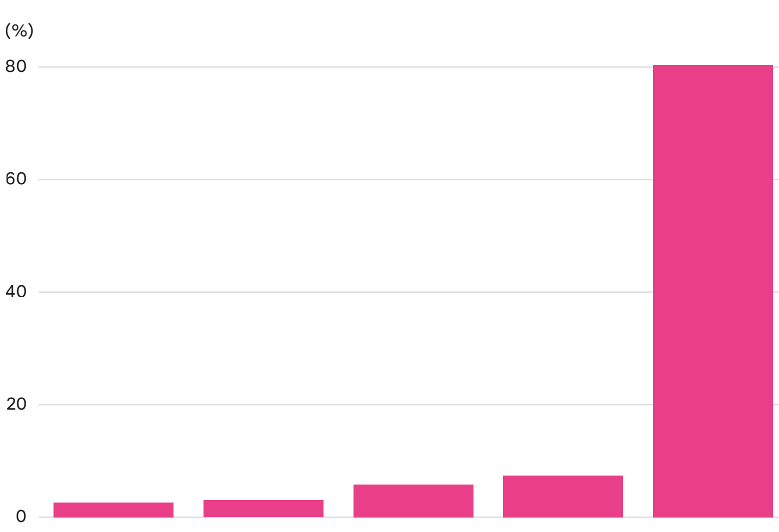
Some of the smaller markets have interesting drivers. Indonesia, for example, has a positive domestic story – as opposed to one closely linked to global growth cycles. "We often compare Indonesia to India. It's fascinating as it has many of the characteristics that investors love about India. It has a relatively large and young population (c.283 million) that is expected to grow in the next few decades[8]," Bourke highlights.



"Indonesia has many of the characteristics that investors love about India."

"India is the current 'growth darling' of EMs."

Asia dominates the MSCI EM Index



Source: M&G, 31 July 2024.

[4] Opening remarks by Krishna Srinivasan, Asia and Pacific Department Director at the Press Conference on the Regional Economic Outlook for Asia and Pacific (imf.org).

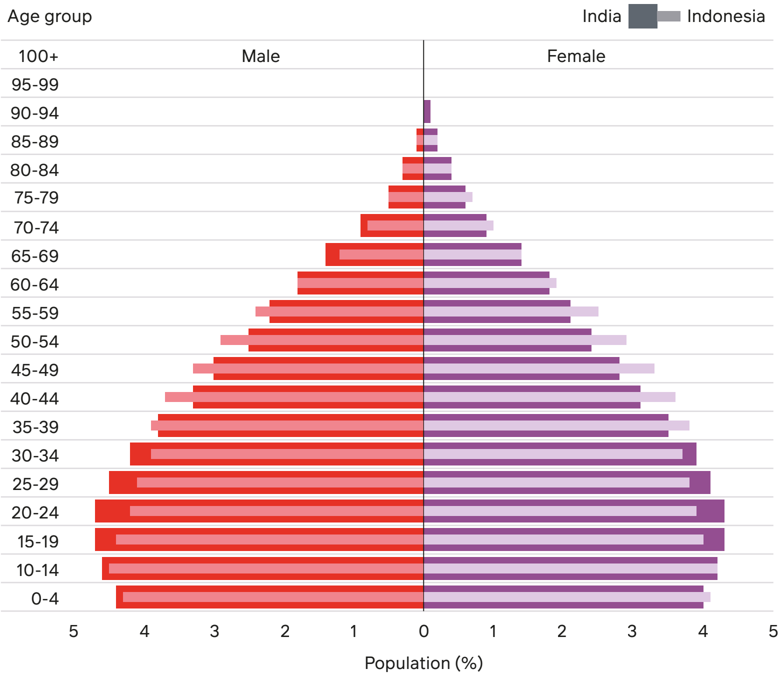
[5] Reuters, 'Exclusive: Modi sets ambitious India economic goals for probable third term', May 2024.
[6] India aims to be developed nation by 2047 – priorities Modi can't ignore (cnbc.com).
[7] Pew Research Center, 'Key facts as India surpasses China as the world's most populous country', February 2023.
[8] UN Department of Economic and Social Affairs, 'World population prospects 2024', (UN.org), 2024.

3 of the 10 largest economies in the world are emerging markets

Rank	Country	GDP (USD trillion)	GDP per capita (USD thousand)
1	US	28.78	85.37
2	China	18.53	13.14
3	Germany	4.59	54.29
4	Japan	4.11	33.14
5	India	3.94	2.73
6	UK	3.50	51.07
7	France	3.13	47.36
8	Brazil	2.33	11.35
9	Canada	2.33	39.58
10	Italy	2.44	54.87

Source: International Monetary Fund, April 2024.

India and Indonesia's population pyramid



Source: World Bank, 2022.

Rising wealth in the coming years could lead to a growing consumer class and opportunities for financial services firms. Indonesia also has some exposure to commodities, including oil and gas, and nickel, which is a widely used component in electric vehicles.

As a relatively stable democracy – the country has recently held presidential elections – Bourke thinks Indonesia is an interesting source of investment ideas, particularly as the valuations are nowhere near as elevated as those in India.

Another market that Bourke considers attractive is Vietnam. Like India and Indonesia, it has all the classic hallmarks that draw investors to Asia, including a fast growing and young population. The economy has also been growing rapidly and is expected to expand close to 6% in 2024, driven by demand for its exports and foreign investment[9]. Vietnam has benefitted from rising geopolitical tensions and firms' efforts to reduce their exposure to China, the so-called 'China Plus One' strategy. Bourke notes: "Vietnam has captured a share of the global supply chain as multinationals such as Samsung Electronics have based some of their production in the country to find a home away from China."

Considering these markets alongside Malaysia, Thailand, the Philippines, Pakistan and even Bangladesh, the range of investment opportunities that exist within Asia is extensive and, importantly, all quite divergent. From the economic powerhouse of China to the advanced technology hubs in Taiwan and South Korea to the fast growing, up and coming markets like Vietnam, Asia is a dynamic region that potentially offers some very exciting and varied opportunities for long-term investors.

Although the investible universe has some attractive structural trends, Bourke cautions that demographics or economic growth rates are not necessarily the core factors for GEMs investors to consider. He believes that understanding the big picture is valuable but what really matters for stock market investors is company earnings and valuations. These factors ultimately determine shareholder returns over the long term. "Picking stocks is all about navigating where we think earnings are going. Our job as investors is to find companies where the future stream of earnings is not being accurately priced by the market," he explains.

There is a danger that GEMs investors fall in love with an investment narrative, be it robust growth prospects or demographics, and invest in stocks at any price. But for Bourke, who adopts a value-oriented investment approach, it is important to remain highly selective, careful and look for value right across the investment universe, even in areas that might be unloved. "GEMs' diversity is your friend as an investor as it offers you the ability to go anywhere to find value and dilute potential risks," he comments.

The cutting edge of innovation

Asia arguably has some of the most innovative and technologically advanced companies in the world. In some respects, it could even be said that the region offers a glimpse of what the future holds, from digital services to autonomous flying taxis set to take off in China next year[10].

[9] IMF, 'IMF Staff Completes 2024 Article IV Mission to Vietnam', June 2024.
[10] ABC News, 'Flying taxis set to take off in China as Beijing pumps up 'low-altitude economy', May 2024.

'Asia's reputation as a manufacturer of low-cost, low-quality goods clearly needs to be rethought.'

Investors may not grasp Asia's position at the forefront of technology. The artificial intelligence (AI) frenzy over the past two years has focused mainly on large US companies such as Nvidia, but it is worth remembering that Asian firms like Taiwan's TSMC and South Korea's SK Hynix are critical players in the global AI supply chain.

With considerable technological skill and know-how, they make the advanced chips used in AI applications and data centres as well as smartphones. TSMC held 62%[11] of the global market share for chip making in the first quarter of 2024; with such cutting-edge capabilities, Asia's reputation as a manufacturer of low-cost, low-quality goods clearly needs to be rethought.

China's Huawei is also competing in the AI race. The company recently announced it has developed advanced chips that it says are comparable to those designed by Nvidia[12]. In the world of technology, it could be argued that Asian firms, most notably in northern Asia, should be considered as global leaders, on a par with, if not ahead of, Western firms.

The same could apply to the electric vehicle (EV) market, where Chinese firms such as BYD and Nio are setting the pace and capturing market share at the expense of established Western car brands. With innovative technology and reasonably priced, high-quality vehicles, BYD is now competing with US firm Tesla.

Besides EVs, Chinese firms hold dominant positions in other industries of the future such as solar and wind power, and batteries. While Chinese manufacturers may face trade restrictions in accessing Western markets, they are arguably well placed to expand into the large markets within Asia.

The future of banking

In the banking sector too, Asia is in the vanguard. Asian companies are at the forefront of redefining the concept of a bank through innovation and seizing opportunities, observes Pershad. He points to digital banks from China's tech giants Alibaba, the owner of Alipay, the world's largest mobile and online payments platform, and Tencent.

In India, the Unified Payments Interface (UPI), developed by the National Payments Corporation of India (NPCI), has revolutionised real-time payments, enabling instant money transfers between any two bank accounts through mobile platforms. UPI has significantly increased the penetration of digital payments in India, providing a safe and accessible digital payment structure for consumers.

In a region where many adults lack access to banking services, digital banks are poised to bridge this gap. "Neobanks such as Vietnam's Timo and the Philippines' Tonik are leading the charge, providing digital-only services tailored to the needs of the unbanked and underbanked populations," he says.

With just a smartphone, individuals in remote areas can open accounts, conduct money transfers, and apply for credit.

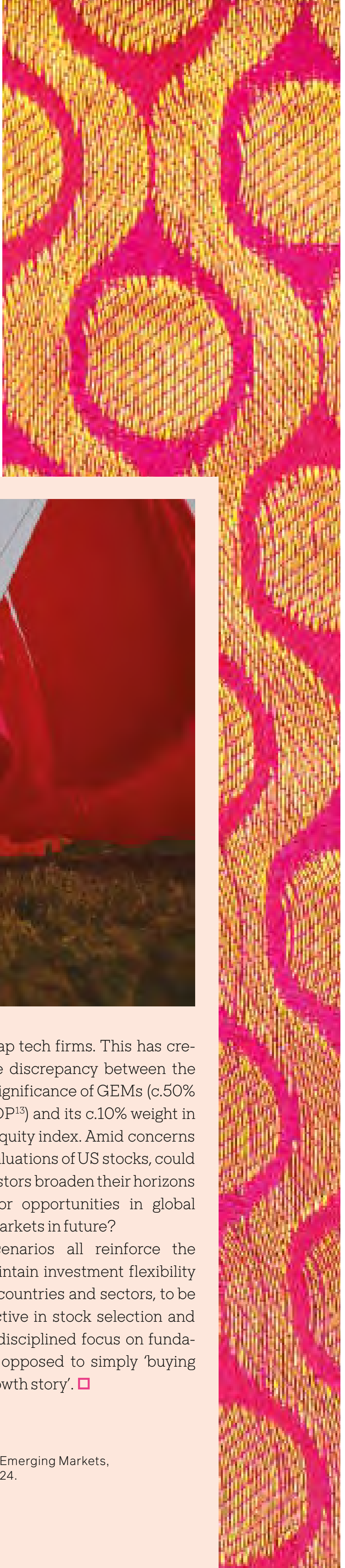
Pershad believes Asia's banking sector is on an exciting trajectory, driven by transformative developments as it prioritises innovation, inclusion and profitability. "By embracing this wave of change, investors can potentially not only contribute to the growth of the region, but also capitalise on the vast potential offered by Asia's evolving financial landscape," he says.

[11] CNBC, 'TSMC second quarter profit beats expectations as AI chip boom continues', July 2024.
[12] Reuters, 'Huawei readies new AI chip to challenge Nvidia in China, WSJ reports', August 2024.

Flexibility and selectivity

This dynamic economic landscape justifies Asia's prominence in the GEMs investment universe. However, active GEMs investors have the freedom and flexibility to look even further afield in search of attractive opportunities. The performance of GEMs can be as divergent as their economies are idiosyncratic. Economic conditions and cycles vary across GEMs and a truly global approach to investing in this asset class can help equity and bond investors navigate risks and volatility.

> 'The performance of GEMs can be as divergent as their economies are idiosyncratic.'



There are potentially plenty of reasons why investors might be excited about opportunities in GEMs, but it's important to remember that when it comes to equity investing, fundamentals, company earnings, profits and valuation are what really matters. The challenge therefore is to find companies that can harness structural growth trends or innovation profitably, at attractive valuations, rather than simply buying the EM growth story. For Bourke and Talbot, the search for value requires a careful, bottom-up approach to investing.

Despite favourable prospects, GEMs have struggled to attract the attention of global investors in recent years as an asset class. Instead, capital has flowed principally to the US, and in particular the mega-cap tech firms. This has created a wide discrepancy between the economic significance of GEMs (c.50% of global GDP[13]) and its c.10% weight in the global equity index. Amid concerns about the valuations of US stocks, could we see investors broaden their horizons and look for opportunities in global emerging markets in future?

These scenarios all reinforce the need to maintain investment flexibility across EM countries and sectors, to be highly selective in stock selection and maintain a disciplined focus on fundamentals as opposed to simply 'buying the EMs growth story'.

[13] World Bank, Emerging Markets, September 2024.

THE MIDDLE KINGDOM

Is China the investment story of the next decade?

A more thoughtful and far-reaching set of stimulus measures by the Chinese authorities has nullified some of the negative perception among global investors when it comes to China. David Perrett, Co-Head of Asia Pacific Equities, suggests that continued caution could be creating some compelling long-term opportunities for stockpickers. He explains why he thinks Chinese equities have the potential to become one of the investment stories of the next decade.

THE MIDDLE KINGDOM

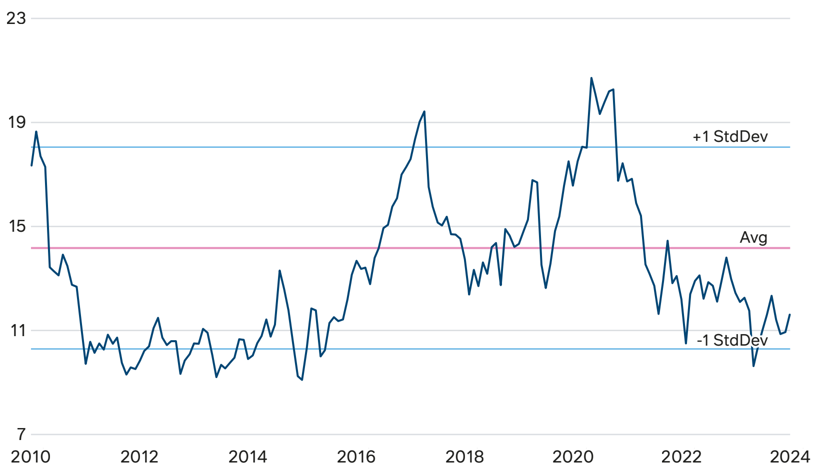
When it comes to investing in China today, weak sentiment and depressed valuations abound and the prevailing narrative encompasses pessimism and uncertainty. News headlines and commentary tend to focus on the country's challenging economic situation, including its troubled property sector and weak consumer demand, and geopolitical tensions with the US. These concerns are arguably reflected in the low valuation of the country's stock market, which has retreated materially from a peak in 2021.

However, to paraphrase a well-known saying, the time of maximum pessimism could also be the best time to look for opportunities. Although there are genuine concerns about the economic picture in China, we believe it is possible to construct a different, positive view. Bursting a property bubble or going through a major economic transition is a messy, painful experience. It takes time but, as seasoned investors, in our experience, these periods can lay the seeds of structural change and improvements that potentially deliver outsized returns over the coming years.

The problems in China today are better understood and policymakers have delivered new and far-reaching fiscal and monetary programs which go beyond simply repeating the established playbook of increasing spending on infrastructure. Measures seem more targeted at boosting consumption and shoring up the balance sheets of local authorities and banks; moves that have underpinned the negative slide in the stock market. The policies have served to mitigate high levels of uncertainty and low expectations and we believe that discerning investors can potentially identify some very promising long-term opportunities in an environment that is improving for investors.

China's stock market valuation has fallen from its recent peak

($) MSCI China – one-year forward price to earnings ratio



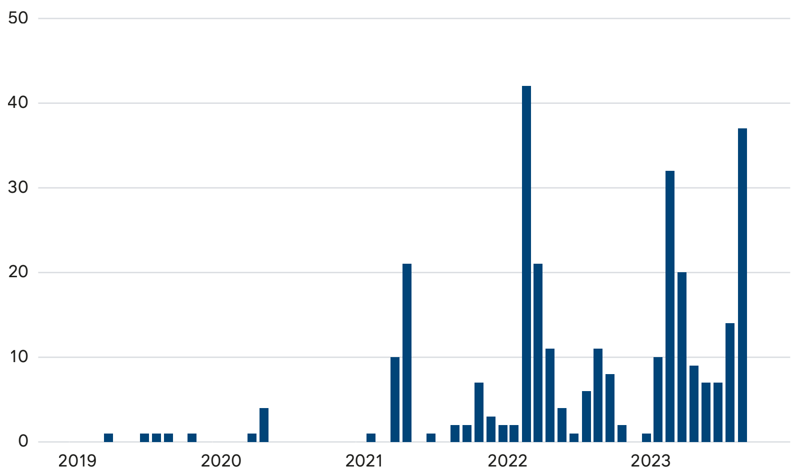
Source: LSEG Datastream, October 2024. Past performance is not a guide to future performance.

We are not suggesting that investors allocate a large portion of their global assets to China. However, given our view that, in many cases, the risks are already reflected in share prices, we believe there are several reasons why contrarian investors might wish to take a closer look at their China equity allocation.

We would point out that China represents around 18% of the global economy but Chinese equities (even with the recent run of good performance) only account for around 3% of the MSCI ACWI global index. In our view this is a disproportionately low level for such an important economic power. Even though we believe that stock markets are driven by corporate profits rather than economic growth, we feel that China is being widely overlooked by global investors.

Share buy backs have been rising in China

No. of firms in China's HSCI Index announcing buy backs



Source: Goldman Sachs, Bloomberg, M&G, June 2024.

Change in corporate focus

Turning to focus on how corporate China is being run from a bottom-up basis, we see an encouraging picture. Quality Chinese firms have adapted to the tough operating environment of recent times. They are increasingly focusing on their core businesses and importantly, in a region that has historically prioritised growth at all costs, profitability. This shift in focus from top-line growth to bottom-line growth is a big structural change that is great news for long-term shareholders.

We are also observing weak and uncompetitive companies going bust, which means greater market share and increased revenue for companies who prove to be best in class.

Improving shareholder returns

Another welcome development to highlight is Chinese firms increasing their returns to shareholders. Across the board, companies are buying back more shares and paying out an increased portion of their profits in dividends. Many state-owned enterprises (SOEs) are leading this trend, with the government, who is the main shareholder, keen to receive cash to fund stimulus measures and to care for an ageing population. In the past this money might have been invested in low return projects. As a minority investor, we are happy to invest in those SOEs (and private enterprises) that are boosting their dividend payments and returning a greater portion of their profits to shareholders.

It's not just through dividends that Chinese companies are engaged in efforts to return cash to shareholders. With equity valuations at depressed levels, in some cases, the value of companies is less than the cash on their balance sheet, we are seeing a sharp increase in share buybacks. These buybacks should boost future returns on equity, while at the same time sending a powerful message that many Chinese companies see their shares as undervalued.

China represents around 18% of the global economy but Chinese equities only account for around 3% of the MSCI ACWI global index.

Industries of the future

A factor that many global investors might not be aware of is that China is leading the way in many of the industries of the future. At the recent policy meeting, the Third Plenum, the government outlined its prioritisation of technology and innovation in the economy, with a focus on advanced manufacturing.

One area where China is at the forefront is in electric vehicles (EVs), with firms like BYD gaining wider recognition – efforts to raise brand awareness beyond China were arguably helped by BYD's role as an official partner of the UEFA Euro 2024 tournament.

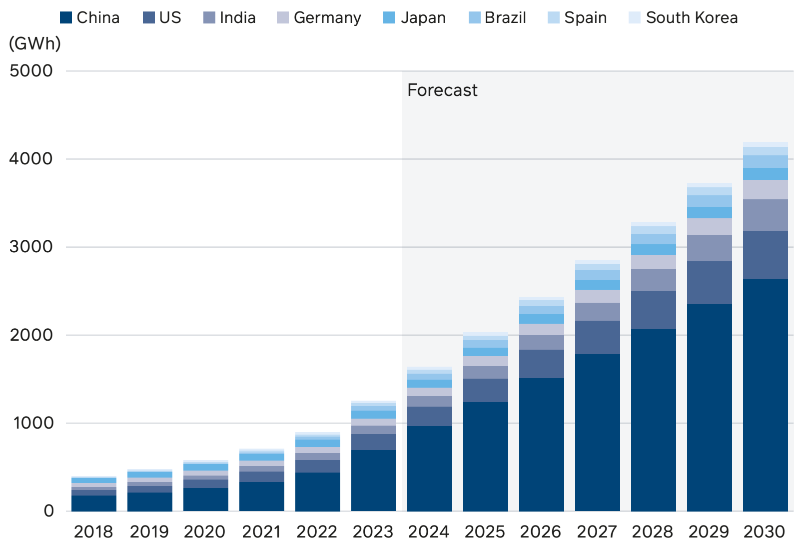
There is a lot of talk about subsidies and unfair competition and the European Union (EU) has provisionally proposed tariffs on imports of Chinese EVs to protect domestic production. However, China is not alone in providing subsidies. The real issue is that the China EV industry has built huge economies of scale. This is because China never had a traditional auto industry; instead it had joint ventures with Western firms. Therefore, it had nothing to lose by becoming the first mover in mass EV production. In July, half of all vehicles sold in China were either EVs or plug-in hybrids, illustrating the country's significant progress in EV adoption.

China is also a dominant player in solar and wind power, batteries and many other industries. In addition, it's the leading economy in supply chain management. We believe these are all going to be very important for the future.

Although geopolitics might mean Chinese firms struggle to operate in the US, we believe that there are plenty of other markets for them to expand into. Over time we are likely to see innovative, future-focused Chinese companies become dominant in Latin America, the

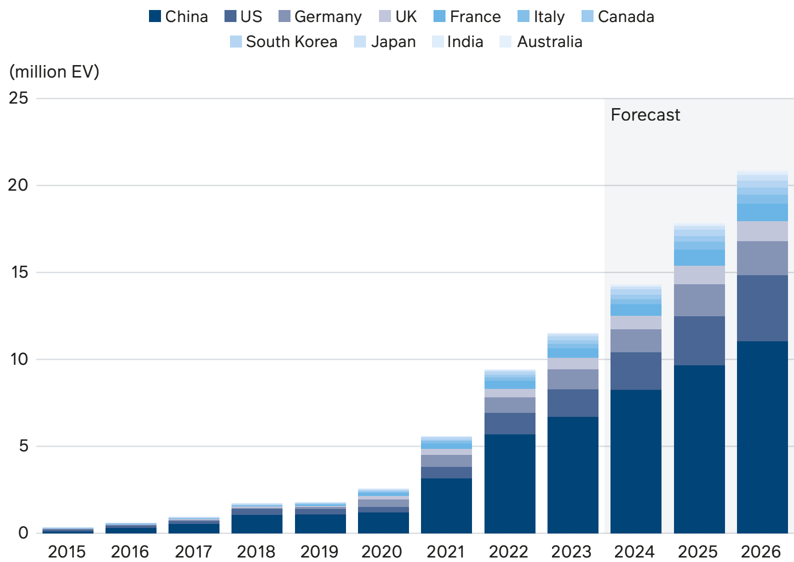
China has a leading role in the industries of the future

Solar capacity forecast



Source: M&G, Bloomberg, June 2024.

Electric vehicle fleet forecast



Source: M&G, Bloomberg, June 2024.

Middle East, Africa and Southeast Asia. We believe their current valuations do not reflect this exciting potential.

Investment story of the next decade?

Investor sentiment towards China remains cautious despite the renewed policy focus, which is reflected in equity valuations. Indeed, the majority of market participants remain heavily focused on policy announcements and very near-term economic and consumption data points.

Our focus is on positive emerging structural trends that are happening at the company and industry level. Corporates are increasingly focused on their core business and generating strong bottom line, rather than top line, growth. We are also seeing industry consolidation as the weak are pushed out by the strong.

Meanwhile, globally, Chinese companies are starting to dominate structurally growing industries tied to renewable energy or supply chain management. Finally, we are seeing Chinese companies boost shareholder returns, whether via share buy backs on a scale never seen before or through higher dividends. All this at a time that valuation is at, or near, all-time lows. It certainly implies a very interesting set-up as we look out to the next decade. □

China is leading the way in many of the industries of the future.

People say India's expensive – but we think it's one of the cheapest markets in the world

Vikas Pershad
Portfolio Manager, Equities APAC

The combined economies of India and China accounted for two-thirds of global production 250 years ago. By 1950, however, India's share of world income stood at just 3%. Today, India is the world's most populous democracy, third-largest economy by purchasing power parity and fourth-largest equity market, re-establishing its status as a global economic force. Its diverse and rapidly growing economy, bolstered by a strong domestic market and strategic geopolitical position, is reshaping the global economic landscape.

On a day-to-day view what could all of this mean for investors? India is the busiest initial public offering (IPO) market in the world with 6,000 listed companies and approximately 2,000 with a market capitalisation in excess of $100 million. This translates to a broad and deep investment opportunity set, which, we believe allows for active managers to outperform due to the dispersion within these companies. There's also various gradations of quality of investment when it comes to management teams and business models, which make it fertile ground for the long-term investor.

India's mantle as the best-performing market in the world for the last two decades will inevitably attract scepticism around whether that can continue – but we've been hearing the same argument for almost 20 years and in rupee terms or in dollar terms, it's better than any market in the world, in our view. Only the US comes close, but it has experienced a concentrated rally driven by large tech and trillions of dollars of market cap created by a small handful of companies. Meanwhile in India, the rally has been broader based – and we expect that to widen and lengthen.

The feeling on the ground is that the historical place that India once had as one of the two largest economies in the world is its rightful status, and the prime minister and subsequent administrations will pull and push on the levers as necessary until it gets there. Today, India is the world's fastest-growing major economy, averaging 8.3% growth over a three-year period[1].

I've been investing in India for over twenty years. In that time, stability has come to the government, the economy has continued to grow at a high rate (even on a much higher base than where it once was), and most companies have gone through a revolution in how they treat minority shareholders.

From a top-down perspective, the direct result is clear to me: the country's listed market cap has increased by tenfold. I've also seen evident changes on a bottom-up basis and this comes through in every interaction in India: the collective intelligence of management teams is higher, signalled by more thoughtful capital allocation; the focus on investing in and growing in India, rather than on creating global empires, is readily apparent; and the excitement to participate in India's growth story is palpable among executives and investors alike. In a capital market context, this is no longer an emerging market. India has emerged.

How is modern India transforming?

On an international level, both the US and European Union (EU) view India as a strategic partner in the Indo-Pacific region, with shared democratic values and mutual interests in security and economic growth.

Washington D.C. could seek to enhance trade relations with India by negotiating bilateral trade agreements that address issues such as tariffs, market access, and intellectual property rights. The growing Indian middle class presents significant opportunities for American exporters in sectors like technology, defence, and consumer goods.

The long-term reactions from Brussels are likely to focus on negotiating a comprehensive trade and investment agreement with India to facilitate greater economic integration. Such an agreement would address trade barriers, regulatory cooperation, and sustainable development.

India's the world's fastest-growing major economy, averaging 8.3% growth over a three-year period

Domestically, India's economic structure is characterised by a mix of agriculture, industry and services. The services sector, including information technology, telecommunications, and financial services, is a major driver of growth, contributing over 50% of GDP. Agriculture remains crucial, employing a significant portion of the workforce and ensuring food security.

Much of India's untapped potential lies in its demographic dividend, yet just 36%[2] of India's population lives in urban areas despite having the largest young population in the world. Both economic growth and urbanisation will be driven by India's ability to incorporate this cohort – as well as more women – into the workforce.

The rise of the consumer and the manufacturing sector simultaneously could create substantial economic growth. That, in turn should give rise to a rich vein of investment prospects. Notwithstanding the opportunities, one must also be mindful of the hurdles that need to be overcome, from addressing infrastructure gaps and managing urbanisation to investing in education and skills in order to reap the demographic dividend by ensuring the workforce is equipped for the demands of a changing economy.

A key driver of India's economic resilience and global competitiveness can be attributed to its domestic market, boasting a population in excess of 1.4 billion people. This offers both a vast and diverse consumer base. The growing middle class and increasing disposable incomes are driving demand for a wide range of goods and services – from education to healthcare, premium foods and appliances. This isn't a one-year or five-year phenomenon, but one which we believe will play out over a number of decades.

The rapid adoption of digital technologies, including mobile internet and digital payments, is transforming India by giving more people a chance to participate in its economic growth story and creating new opportunities for businesses. The government's 'Digital India' initiative aims to harness technology for inclusive growth. India's start-up ecosystem is thriving, with entrepreneurs driving innovation in sectors like e-commerce, fintech, and health tech.

The government's support for startups through initiatives like 'Startup India' is looking to foster a culture of entrepreneurship. For public market investors, this translates into an opportunity set that is broader and deeper by the year.

We believe that US companies are likely to increase investment in India's technology, healthcare, and renewable energy sectors. Collaboration in research and development, particu-

[1] Deloitte, 'India economic outlook, August 2024', Deloitte.com, August 2024.
[2] World Bank, 'Urban population (% of total population) – India', data.worldbank.org

India is the busiest IPO market in the world with 6,000 listed companies and approximately 2,000 with a market capitalisation in excess of $100 million.

COLUMN

larly in areas like artificial intelligence (AI) and clean energy, will surely be pivotal. With India's emphasis on digital transformation and innovation, the EU is also expected to deepen cooperation in technology, cybersecurity, and data governance, leveraging India's strengths in IT and software services.

Long tails to growth

To reap the dividends of a large and young population (40% of India's population are under 25 years old[3]), many of whom are English-speaking and can be absorbed into companies rapidly, employment is an essential component to boost economic growth.

Manufacturing, supported by the 'Make in India' initiative, is gaining momentum, with a focus on increasing the sector's GDP share, creating jobs and diversifying global supply chains.

We believe that this focus on increasing production in India combined with global geopolitical dynamics supporting supply chain diversification towards the country underpin the trend of key sectors seeing long tails to growth.

A great example of this is the scale of iPhones being manufactured in India – almost 14% or $14 billion in the last fiscal year[4], double the previous year and counting. It's also feeding into a domestic market where more people want these handsets. Meanwhile, the government is telling companies that if they want to sell in India to Indians, then things have to be made by Indians in India – and we're also a great export hub.

Shrinking the import bill

After oil, India's second-largest import bill is on electronic components. Today, research finds that for every $2 spent on oil, $1 is spent on the electronic components – a large number that's growing quickly.

While oil is harder to circumvent, the government has its sights set on shrinking that large import bill on electronic components as quickly as possible.

As a result, we've seen Indian electronic manufacturing services companies (EMS) go vertical over the last three years, particularly over the last 18 months, and our view is that's a long tail of opportunity to continue tapping into. We've seen this phenomenon of diversification play out repeatedly as people moved away from the US 40 years ago to Japan, followed by South Korea, Taiwan and China – and we believe it's only a matter of time before they make their way to India. That's why we're putting capital there.

Electronic components feed into higher-end appliances from consumer devices to automotives, and the latter is a sector that we have exposure to. In the financial year 2023-24, passenger vehicle sales topped four million in India[5]. While the penetration rate compared to China is still low (27 million units per year[6]), if the acceleration continues as is, it won't be long before these rates catch up in what is now the most populous country on the planet.

When this is taken into account along with the rising middle class and our approach of daily portfolio buying, we see opportunities in the automotive sector. In the last three years, we've moved our exposure around, starting off much more heavily positioned in four wheelers, then two wheelers, and now commercial vehicles. But we also have a lot more exposure to the components industry in India than we had just a year ago – and that's a very long tail to growth. Again, that's one cluster: components, appliances, automotives and parts.

India: Expensive or cheap?

We've been hearing that India is the most expensive market in the world over the last 20, 15, 10 and five years. We actually think it's been the cheapest market in the world.

Why? Because it's been trading at the highest discount to intrinsic value, which is why it continues to do well. If the market were close to close today, globally, India would be the only one to be up nine consecutive years and last year was the only one to have been up eight consecutive years.

A lot of the companies and sectors that we invest in are GDP multiplier growth sectors that are seeing margin expansion, so earnings should grow even faster and that could continue for a long time – and companies have become much smarter about investing for the long-term. This might be the biggest change I've seen over the last 20 years.

While India's stock market value exceeds $5 trillion[7], for the long-term investor I believe that it's one of the most exciting markets in the world, if not one of the cheapest still. □

[3] Pew Research Center, 'Key facts as India surpasses China as the world's most populous country', pewresearch.org, February 2023.
[4] CNBC, 'Apple doubles India iPhone production to $14 billion as it shifts from China: Report', cnbc.com, April 2024.
[5] Fortune India, 'Car sales zoom past 4 million mark in FY24', fortuneindia.com, April 2024.
[6] Forbes, 'Chinese auto brands to surge to 33% of global market, report says', forbes.com, June 2024.
[7] Bloomberg, 'India's stock value tops $5 trillion as Modi's win powers rally,' Bloomberg.com, June 2024.

FOUR REASONS TO CONSIDER ASIAN CREDIT

The Asian Credit market has grown significantly over the last 20 years. Harriet Habergham explores four features of the asset class which, in our view, provide investors with a wealth of opportunities, including the maturation of the market, the unique feature of strong government support, a supportive environment and hidden gems.

A still relatively nascent but burgeoning asset class, Asian credit can offer fixed income investors the opportunity to tap into Asia's booming economic story, while also benefiting from an expanding universe of bonds and positive technical support for the market.

Here are four of the key reasons why we believe that Asian bonds offer an attractive proposition, highlighting some of the structural factors supporting the market and identifying key pockets of opportunity.

1. A maturing market

The size of the Asian bond market has grown significantly over the last 20 years. Between 2006 and 2021 issuance volume of international bonds from Asian issuers grew at an annual rate of about 11% on average, before peaking at about USD 626 billion in 2021[1]. This provides investors a rich hunting ground for identifying opportunities.

Not only has the Asian credit world grown over the years, it has also evolved into an asset class characterised by high credit quality and strong fundamentals.

In recent years, the narrative around Asian credit has been marred by China's real estate crisis, marked by the collapse of major developers such as Evergrande and Country Garden. However, the meltdown of the China property sector mainly pertains to the high yield segment of the bond market. The impact on the market as a whole is minimal. Furthermore, after stringent funding restrictions led to a major shakeout, causing over 50% of high yield Chinese developers to default, the sector now comprises less than 2% of the Asian USD credit market[2].

Meanwhile, the share of investment grade issuers in Greater China was 87.3% in 2023. This compares to the share of investment grade issuers in the US which stood at 44.9% in 2023[3]. For the broader region, as proxied by the J.P. Morgan Asia Credit index, the proportion of investment grade rated bonds by market weight has grown over the past ten years, standing at 86% in 2023.

The high proportion of investment grade issuers reflects a deleveraging trend which has occurred in Asia, supported by the macroeconomic growth story.

2006-2021: Issuance volume of international bonds from Asian issuers grew at an annual rate of about 11% on average, before peaking at about USD 626 billion in 2021.

ASIAN CREDIT

2. Government support

One unique feature of Asian corporate bonds is that many issuers enjoy the strong links with government entities. Around 60% of the J.P. Morgan Asia Credit Index have some linkage with governments. As a result, these companies benefit from government support, in contrast to the Western world where corporates are privately owned. Additionally, these bonds then indirectly benefit from stable sovereign credit ratings. For example, China has an A+ long-term rating from S&P Global, on its belief that its economy will return to self-sustaining growth of above 4% over the next few years[4].

However, it is important as bond investors to understand the extent to which government support can be applied to companies. Factors such as strategic importance to the government and how closely linked to the government it is will play a part in deciding how much support investors can expect from the government. We believe it takes an active manager with in-depth knowledge of the market to identify those companies which can benefit from strong support.

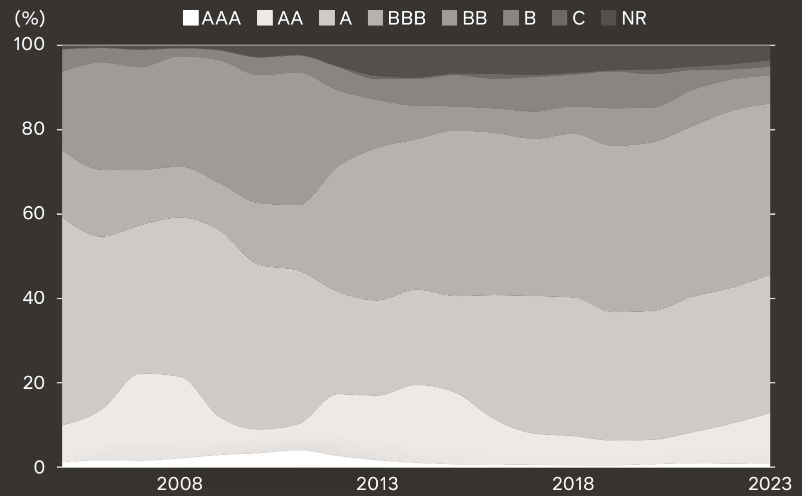
3. A supportive environment

The appeal of Asian IG corporates is enhanced by positive supply-demand dynamics. The volume of Asian USD IG corporate bonds being issued has notably declined as issuers shift towards more cost-effective domestic funding sources. This is coupled with bond maturities and recurring coupon payments which has led to an overall shrinking market with increased liquidity. This has been the trend for the past two to three years where we see a net redemption environment where principal maturities and coupon payments exceed new bond supply into the market. Ample liquidity can also be observed by the well subscribed new issuances that have come to the market.

Another trend to point out is that Chinese institutions have emerged as key buyers of China USD bonds, driven by widening yield differentials between dollar bonds and onshore renminbi bonds. As a whole, this supply and demand imbalance forms a positive technical support for the market.

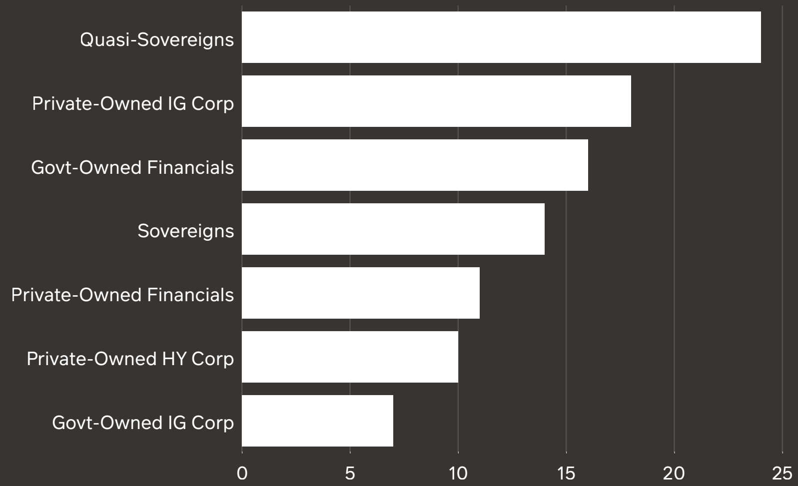
'As bond investors it's important to understand the extent to which government support can be applied to companies.'

J.P. Morgan Asia Credit – index weight across rating categories



Source: Bloomberg, J.P. Morgan, 31 December 2023.

Government-related entities make up around 60% of Asian Credit market (%)



Source: J.P. Morgan, January 2024.

[1] ICMA, 'The Asian International Bond Markets: Development and Trends', March 2024.
[2] M&G Investments, '2024 The year of the wood dragon: Breathing fire into the Asian Credit Market', February 2024.
[3] 'S&P Global, 'Default, Transition, and Recovery: 2023 Annual Greater China Corporate Default and Rating Transition Study', June 2024.

[4] S&P Global, 'China Ratings Affirmed at A+/A-1', June 2024.

Apart from the demand and supply dynamics acting as a tailwind for Asian credits, Asian corporates have exhibited resilience and steadfast performance supported by stable economic fundamentals.

The growth outlook for Asia is stronger relative to the rest of the world. Most Asian nations have reported steady real GDP growth for Q1 2024, both quarterly and annually. Meanwhile, regional growth is forecasted to be 4.5% for 2024, driven by robust private consumption[5].

The asset class will likely also benefit as central banks embark on their monetary loosening cycles globally. This, in turn, could prompt lower interest rates across most Asian bond markets.

4. Hidden gems

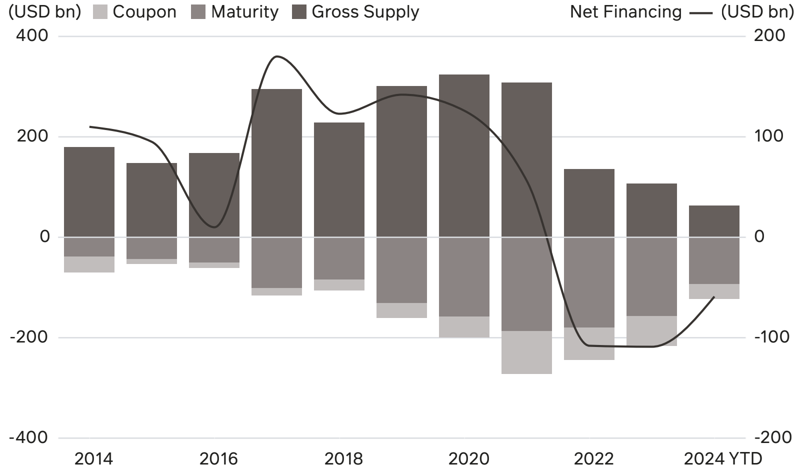
Within Asian credit, we believe there are hidden gems that offer potential value enhancement. By conducting in-depth analysis of individual credits and sectors, investors can identify opportunities that may have been overlooked.

This is particularly the case in China where we focus on the bottom-up play. We look for mispricings in the market or a value opportunity. For example, we have been overweight in asset management companies because they are strategically important to the government and they are undergoing reform. As a result, these remain under-appreciated as investors have not recognised the companies' significance and importance to financial stability within China.

We also look at certain IG companies in the China technology sector, which not only trade at higher yields compared to their US peers, but also boast robust balance sheets and net cash positions, making them attractive prospects for investors seeking value within the sector. For example, we consider China technology names which provide IT services and have a strong domestic market franchise, as well as those that produce electronic components. Some of these companies continued to benefit or have already benefitted from the prospect of being upgraded by international rating agencies.

[5] IMF, 'Asia's Growth and Inflation Outlook Improves but Risks Remain', April 2024.

Net supply in Asian USD bond market is expected to contract for the third consecutive year in 2024



Source: J.P. Morgan, Bond Radar, Bloomberg Finance L.P., as at 17 June 2024.

While many investors cite concerns over the impact of geopolitical tensions on Asian companies, as well as the prospect of increased US tariffs, the policies discussed so far are tilted towards targeting selected sectors such as the exports of advanced chips or AI technology. As a result, we think that the impact would be manageable. This is also because the bulk of these affected bond holdings have been transferred from US accounts into the hands of domestic players since the previous round of proposed sanctions and tariffs. Moreover, the impacted companies within our investable universe is relatively small. However, rising trade protectionism necessitates a more granular, bottom-up approach in credit investments to account for the varying impact on individual Asian firms.

Asian companies are also at the forefront of various areas of technology, such as the production of technology components and digital finance, providing investors with the opportunities to diversify into bonds that not only offer financial returns but also align with future growth industries.

There are countries within the asset class where there is more of a macro theme, such as India, where the growth has been very strong, providing an uplift to the operating environment for the companies we invest in. ☐

'Asian corporates have exhibited resilience and steadfast performance supported by stable economic fundamentals.'

M&G Investments
The Bond Vigilantes
BLOG TEAM
ARGENTINA IN FOCUS
EMERGING MARKETS ARE NOT ALL THE SAME!
ONCE A WEALTH POWERHOUSE, ARGENTINA HAS ENDURED EVERY FINANCIAL CRISIS IMAGINABLE, SOMETIMES IN THE SAME WEEK.
WITH A NEW CHAINSAW-WIELDING PRESIDENT IN PLACE, WE EXPLORE ONE OF LATIN AMERICA'S MOST COLOURFUL DEBT ISSUERS.
EVA FUND MANAGER
CLAUDIA EM FUND MANAGER
CHARLES EM FUND MANAGER
EDITION 3

THE ARGENTINE PARADOX
Fe
U
Ag
Zn
Pb
Mn
Cu
W
THE PARADOX IS AS PLAIN AS IT IS BAFFLING. ONE OF THE 10 WEALTHIEST COUNTIES IN THE WORLD (ADMITTEDLY IN 1910),
ARGENTINA IS BLESSED WITH RESOURCES, GEOGRAPHY AND AN EDUCATED POPULATION. YET FOR 100 YEARS IT HAS STRUGGLED TO BREAK FREE FROM FINANCIAL CRISIS.
INFLATION
PAST DUE
DEBT
PERON, CRISIS & A DRAMA
A MILITARY COUP IN 1943 SAW ARMY OFFICER JUAN PERON TAKE HIS PLACE IN ARGENTINIAN HISTORY. WINNING POWER IN '46, RE-ELECTED IN '52 AND BACK AGAIN IN '73, HIS LEFT-LEANING POLITICS VEERED RIGHT AND THE COUNTRY WAS NEVER FROM CATASTROPHE. BUT HIS LEGACY ENDURES, INTERTWINED WITH THE WOMAN WHO STOOD BESIDE HIM... EVITA.
EVA, LET'S NOT MAKE A DRAMA OUT OF THIS CRISIS...
LONDON, 1970
TIM RICE
EVITA
EVITA
INTERESTING...
PERONISM
PERON'S POLITICS MAY HAVE SHIFTED TOWARDS POPULISM AND REPRESSION -- BUT THE ORIGINAL SOCIALIST IDEALS HAVE DOMINATED THE COUNTRY. DEFINED BY ITS SO-CALLED THREE FLAGS, SOCIOECONOMIC EQUALITY AND INCLUSIVE NATIONALISM LAY AT ITS HEART. WORKERS' RIGHTS AND EVA PERON'S FIGHT FOR WOMEN'S SUFFRAGE STAND OUT AS EARLY MOMENTS OF PERONISM.
Economic Independence
Social Justice
Political Sovereignty
IS IT ME OR ARE THEY STARTING TO LEAN TO THE RIGHT?
THE WORLD RECORD NO ONE WANTS
THE DEATH OF PERON IN '74 LED TO CHAOS AND MILITARY RULE BUT HAD THE PIVOTAL MOMENT ALREADY HAPPENED IN '52 WITH THE DEATH OF EVITA AND AN IDEA OF WHAT ARGENTINA COULD BE?
2020
2014
2001
1989
1982
1951
1956
1890
1827
REGARDLESS, IT'S BEEN A ROLLER COASTER SINCE THE 1920'S, WITH REVOLVING DOOR POLITICS AND SPIRALLING DEBT CULMINATING IN A RECORD 9 DEFAULTS.

THE DEFAULT DEFAULTER – ARGENTINA'S LOW POINTS IN FOCUS
AUGUST 1982
THE 70S SAW MASSIVE BORROWING, PARTICULARLY FROM US BANKS, TAKING THE WIND OUT OF PERON'S 'THREE FLAGS'. BETWEEN '79 AND '82, LATIN AMERICAN DEBT LEAPT FROM $59 BILLION TO $327 BILLION. WHEN ANOTHER OIL CRISIS HIT, US INFLATION AND INTEREST RATES ROSE AND ARGENTINA'S DEBT BECAME UNSERVICEABLE.
INFLATION
DEBT
SEPTEMBER 2001
BETWEEN 1994 AND 2001, SPENDING AND BORROWING INCREASED WHILE ECONOMIC GROWTH WAS ANAEMIC. THE POLITICAL SITUATION WAS ARGUABLY WORSE, WITH FIVE PRESIDENTS IN JUST 14 DAYS IN THE RUN-UP TO THE LARGEST DEFAULT ON RECORD, AT $95 BILLION.
VOTE
DEBT
MAY 2020
AFTER 2001 CAME A TURBULENT PERIOD OF RESTRUCTURING, INJUNCTIONS AND DEFAULTS. THE INFAMOUS 'RUFO' CLAUSE SCUPPERED REPAYMENTS AND BY 2019 DEBT HAD REACHED $323 BILLION. EVEN BEFORE COVID APPEARED, ANOTHER DEFAULT LOOKED UNAVOIDABLE.
DEBT
RUFO
AT LEAST THERE'S NOTHING ELSE THEY CAN THROW AT ME!
ARGENTINA'S TRAVAILS HAD MUCH TO TEACH GLOBAL FINANCIAL INSTITUTIONS, BUT WHEN GREECE DEFAULTED ON A PAYMENT OF €1.6 BILLION IN 2015, FOLLOWING MULTIPLE BAILOUTS, THERE WERE UNAVOIDABLE PARALLELS.
-1.6
-1.6
-1.6
-1.6
IT SEEMS SOME ARGENTINIAN LESSONS ARE HARD TO LEARN?
unemployment
tax collection
ONE FOR STUDENTS OF DEBT, THE HIGHLY UNUSUAL CENTURY BOND ISSUED IN 2017 WAS ONE UNEXPECTED ANSWER TO ARGENTINA'S DEBT CRISIS. DESPITE BEING ISSUED IN A ZERO-INTEREST ENVIRONMENT, IT ULTIMATELY FAILED (AS ANALYSTS PREDICTED AND HISTORY SUGGESTED) AND WAS ONE OF THE BONDS DEFAULTED ON IN 2020.
HURRAH LOOK AT THIS
DO NOT LOOK HERE
INFLATION
DEBT
CENTURY BOND
PIN OF REALITY
ENTER PRESIDENT MILEI
AGAINST THE BACKDROP OF ANOTHER DEFAULT AND WITH INFLATION PASSING 200%, THE 2023 ELECTION WAS WON BY ECONOMIST JAVIER MILEI ON AN ANTI-SOCIALIST TICKET.
ERM... EXCUSE ME MR MILEI, BUT WASN'T THE CHAINSAW MEANT TO BE A METAPHOR??
SLASH CUT CLOSE!
Socialism
A COLOURFUL CHARACTER WITH FIVE CLONED DOGS, MILEI CAMPAIGNED WIELDING A CHAINSAW, THREATENING TO "BLOW UP" THE CENTRAL BANK AND CUT TIES WITH ANY COUNTRY HE DEEMED SOCIALIST. SINCE TAKING OFFICE, THOUGH, HE HAS DIALLED DOWN THE VITRIOL – AND PUT THE CHAINSAW AWAY.
SHOCK THERAPY?
PRESIDENT MILEI MAKES NO SECRET OF HIS DISLIKE OF PERONISM, BLAMING IT FOR ARGENTINA'S WOES. HIS SELF-DESCRIBED 'SHOCK MEASURE' POLICIES TO REDUCE DEBT AND FIGHT INFLATION INCLUDE CUTS TO PUBLIC SPENDING AND THE POSSIBLE PRIVATISATION OF SOVEREIGN ASSETS.
STATE MEDIA
WELFARE
GOVT SPENDING
ARGENTINA TODAY
STILL ONE OF THE LARGEST ECONOMIES IN LATIN AMERICA, ARGENTINA HAS A LOT GOING FOR IT, SOME ONGOING CHALLENGES AND A FEW IDIOSYNCRASIES.
THE GOOD
BLESSED WITH NATURAL RESOURCES, FROM FERTILE FARMLAND TO GAS, OIL AND LITHIUM, ARGENTINA HAS A GDP OF AROUND $600 BILLION. TRADE AND INVESTMENT WITH THE US, EUROPE AND CHINA ARE STRONG, THE LATTER BEHIND MAJOR INFRASTRUCTURE PROJECTS, INCLUDING ANOTHER NUCLEAR POWER PLANT.
MILEI
INFLATION
DEBT
THE BAD
INFLATION AND BOND VALUES MAY HAVE SETTLED BUT ARGENTINA'S DEBT CHALLENGES AFFECT EVERY ECONOMIC DECISION. RECENT AUSTERITY POLICIES DESIGNED TO COMBAT SPENDING WILL SURELY AFFECT LIVING STANDARDS FOR MANY.
THE UNUSUAL
A QUIRK OF THIS ECONOMY (ANYONE STILL THINK EMS ARE ALL THE SAME??) IS THAT PROVINCES CAN ISSUE DEBT. BUENOS AIRES AND CORDOBA HAVE BOTH RAISED FUNDS THIS WAY AND WHILE THEY ARE CLOSELY TIED TO THE FORTUNES OF THE SOVEREIGN IT SHOWS A CERTAIN INNOVATION, ONE WE MAY SEE MORE OF GIVEN THE CURRENT POLITICAL CULTURE.
GOOD OMENS? ARGENTINA'S FINANCIAL PAST MAY BE LITTERED WITH CHALLENGES, BUT THIS PROUD NATION'S FOOTBALLERS REGULARLY HIT THE HEIGHTS. HISTORICALLY, ARGENTINA HAS NEVER BEFORE DEFAULTED DURING A TROPHY-WINNING YEAR...
DOES THIS MEAN INVESTORS SHOULD BE PAYING AS MUCH ATTENTION TO MESSI'S AGEING LEGS AS BOND PRICES?
FIFA World Cup 2026
ARGENTINA ECONOMY

UNMASKING AMERICAN EXCEPTIONALISM:

THE CONVERGENCE OF DEVELOPED AND EMERGING MARKETS

Growth in the US has surpassed that of major economies, with its equity markets reaching all-time highs in 2023, largely driven by the performance of the Magnificent Seven (Mag 7). Its performance has reignited the discussion on American exceptionalism and its underlying factors. Noura Tan delves into the unique characteristics and strengths of the US economy that have contributed to its resilience and outperformance; while also examining potential challenges and factors that could impact the duration of this exceptionalism. By gaining a deeper understanding of the evolving dynamics between developed markets (DMs) and emerging markets (EMs), we can better assess the global economic landscape and how this shift will shape investors' approach to EMs.

'Altogether, while the US continues to demonstrate its resilience and adaptability through global economic downturns, it is clear that its exceptionalism is being tested.'

How 'great' is America? In recent years, the spotlight has returned to the notion of American exceptionalism, given the performance of the US economy and its equity markets. While major economies faced stagnation and even contraction in 2023, the US has maintained a post-pandemic upswing spanning 16 quarters, with only minor disruptions in 2022. Contrary to global trends and despite the Federal Reserve's aggressive monetary policy, it has showcased steady economic growth, fuelled by a strong labour market and robust domestic consumer demand.

This economic fortitude has allowed the US to sustain a bullish trajectory in its equity markets where the Mag 7, a group of mega-cap tech companies, have emerged as key players. By the end of 2023, the Mag 7, consisting of Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla, collectively returned 75.7%[1] and captured 28% of the US market[2]. These milestones have etched an image of an exceptional America, unyielding amidst global economic turbulence.

Yet, history reveals a cyclical pattern of relative equity performance between US and non-US equities. For instance, the early 2000s saw a transition in economic leadership, marked by the unravelling of US corporate scandals, the bursting of the dot-com bubble, and China's entry into the World Trade Organization, which led to a surge in its markets. Today, the changing terrain of trade, technology, and geopolitical relations are reshaping the roles and potential of these markets.

Current trends indicate that the discourse surrounding American exceptionalism is intertwined with a bigger conversation about the shifting dynamics between DMs and EMs. Looking ahead, we question the endurance of American exceptionalism – what are the fundamental drivers underpinning its performance, and how long can it be sustained? Crucially, what role will EMs play in this evolving narrative?

[1]Rocco Pendola, Paul Curcio, and David Tony, 'What are the Magnificent 7 stocks?', (edition.cnn.com), June 2024.
[2]Sweta Killa, 'Magnify Gains in 2024 With 'Magnificent Seven', (nasdaq.com), December 2023.

Stars, stripes, and silicon

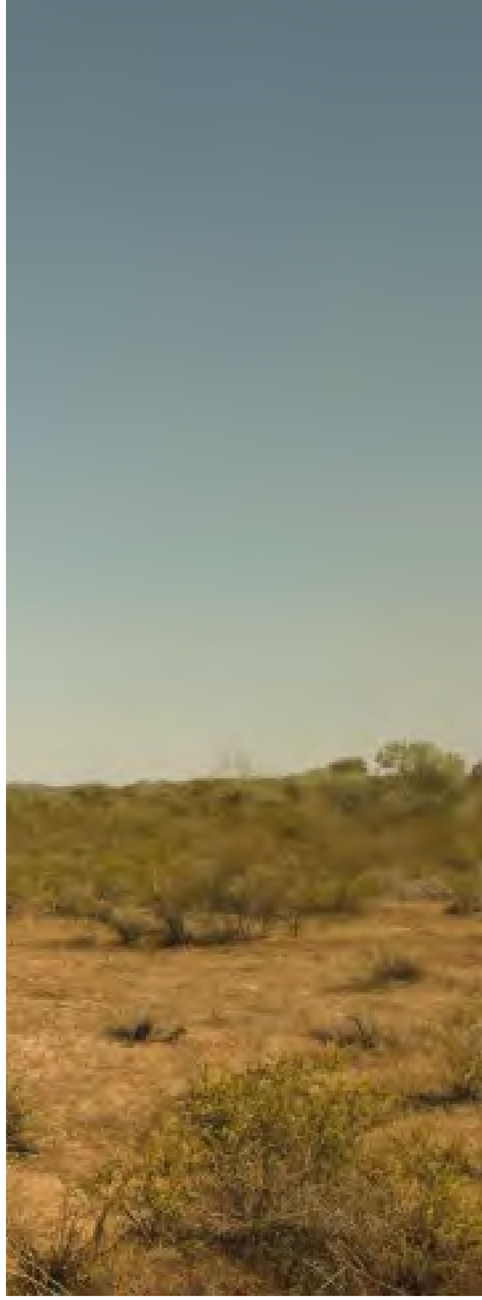
The adage 'Never bet against America' appears to ring true as the US demonstrates a unique ability to navigate economic trials, while its tech giants have cemented the country's market dominance. Much like the transformative railway boom of yesteryear, advancements in generative artificial intelligence (AI) have fortified the US's standing in the global tech arena alongside China. The term 'The Magnificent Seven', borrowed from the 1960 American cowboy film, now refers to the seven tech companies that have effectively capitalised on the AI gold rush. These firms exert significant influence on the market through their size and influence, setting trends and the pace for the broader market.

The ascendence of the Mag 7 has raised fears of a new tech bubble, reminiscent of past episodes like the Nifty Fifty and the dot-com bubble. However, a comparison of today's fundamentals and valuation multiples with those of the dot-com era suggests we are not in a bubble scenario. The Mag 7 are flush with cash, carry little debt, and unlike the dot-com bubble's peak, today's market sees firms like NVIDIA trading at 37x forward earnings[3], with stock performance largely supported by earnings growth. Nonetheless, the question remains about whether the influence of the Mag 7 is overstated and how the fragmentation of the cohort impacts the broader US equity market.

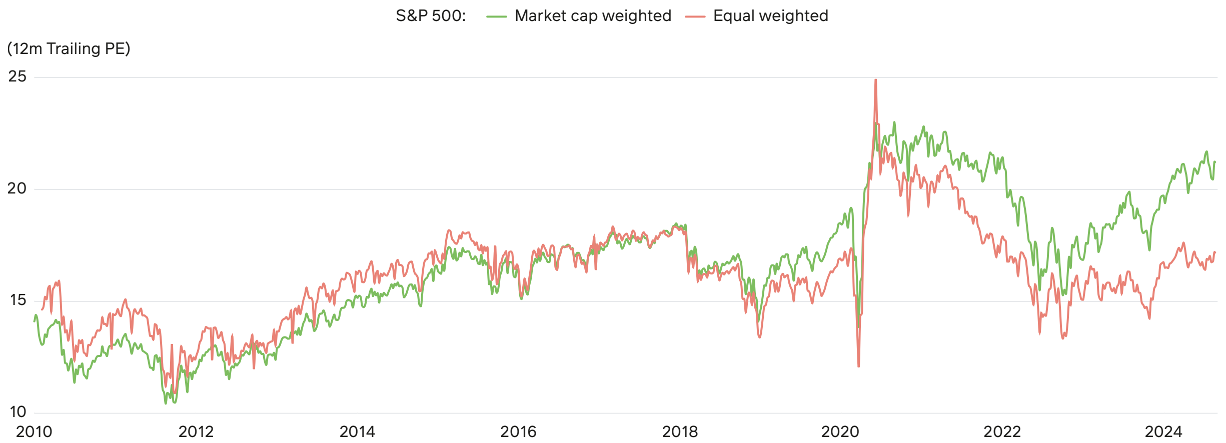
In 2023, NVIDIA, Meta, and Tesla were among the top-performing stocks globally, while Microsoft, Alphabet, Apple, and Amazon didn't secure a spot in the top 100[4]. By Q2 2024, only NVIDIA retained a position in the top 100[5]. This suggests a gradual expansion of investors' horizons, extending beyond the Mag 7. John Weavers, Fund Manager, M&G North American Dividend Fund, notes: "The allure of the US as an investment market stems from a significant number of companies exhibiting high returns on capital and robust growth. Nonetheless, the relative growth rates are converging rapidly, and by year-end, they are projected to be broadly comparable. Paying a 30% premium for some of these companies may not seem justified, a sentiment beginning to reflect in market performance trends."

So, can the US equity market sustain its attractiveness without the outsized influence of the Mag 7? The performance of the S&P 500 Equal Weight Index, which assigns equal weight to each company regardless of size, suggests it can.

[3]As of 29 August 2024.
[4,5]M&G Equities & Multi Asset Team, 'Quarterly Equities and Multi Asset Outlook – Q3 2024', (mandg.com), July 2024.



Broad valuation strength across US equities even without the Mag 7



Source: Bloomberg, August 2024.

"Over extended periods, the S&P 500 performs almost identically to the S&P 500 Equal Weight Index," Weavers elaborates. "This alignment serves as a powerful illustration of the broader theme: the attractiveness of the US investment market lies in the robust performance by most of its firms, characterised by high returns on capital and substantial growth. The Mag 7 have become distinctive primarily due to their size in the marketplace, but they are not uniquely positioned to scale and grow. This dominance is reflected by a substantial surge in capital reinvestment since 2016, resulting in an accelerated growth rate over the past decade and a superior equity market performance."

Just as in the original film, *The Magnificent Seven*, where only three of the seven renowned cowboys survived the final showdown, the belief that the Mag 7 will collectively sustain market performance seems increasingly untenable. Investors must now seek out companies that will survive and prosper across all scenarios. What remains to be seen is how shifting economic fundamentals – driven by factors such as unsustainable debt levels, de-dollarisation, and the convergence between EM and DM economies – might challenge the narrative of American exceptionalism.

High noon for US economic hegemony

The preeminence of US equity markets has been upheld by an exceptional return on capital, fostered by open capital markets, a favourable regulatory environment, ready liquidity, substantial market size, and a culture that fosters innovation and entrepreneurship. However, American exceptionalism has been rooted in certain economic fundamentals that are now being undermined. The Congressional Budget Office's June update paints a sobering fiscal picture: a $1.9 trillion deficit this year and a debt-to-GDP ratio soaring past 120% by 2034[6]. To put it in context, the US's deficit, as a share of GDP, is set to grow from 5.6% this year to 6.1% in a decade[7], dwarfing the European Union's mandated 3% limit.

Tony Balestrieri, CIO of the Americas, affirms: "The issue lies in the magnitude of deficit spending across many Western economies. I am particularly concerned about the lack of fiscal discipline in the US. No matter who is elected in November, there is not a strong desire to bring the deficit back in line. Spending at current levels, which is typically associated with recessions, shows no signs of abating. If we fall into a recession, further increases in spending to stimulate the economy would only exacerbate the situation, leading to larger funding needs, higher interest expense outlays, and a potential crowding out effect resulting in higher-for-longer long-term rates."

The dollar's supremacy as the world's reserve currency has allowed the US to maintain substantial trade and government spending deficits. However, the impending announcement of a blockchain-based payment system by the BRIC nations, coupled with the International Monetary Fund (IMF)'s report of a gradual decline in the dollar's share of foreign reserves held by central banks[8], suggests a growing momentum in the de-dollarisation trend.

This development could necessitate significant domestic fiscal adjustments, potentially restricting access to capital, increasing borrowing costs, and lowering stock market values. Broadly, it could precipitate a general depreciation of US financial assets, causing them to lag behind global peers.

Balestrieri tempers this view by asking: "Where can one turn to find another reserve currency? There is no viable alternative to the US dollar, which remains the dominant currency despite some diversification efforts. This trend is unlikely to change in the near term. While the US has its challenges, it is arguably better positioned than other options which face significant growth and demographic challenges. While the de-dollarisation trend may continue, it is not an immediate concern for the US."

Altogether, while the US continues to demonstrate its resilience and adaptability through global economic downturns, it is clear that its exceptionalism is being tested. The fiscal backdrop is evolving where the conditions in the US economy and broader DMs open up a new dialogue about opportunities in EMs.

[6,7] Congressional Budget Office (COB), 'An Update to the Budget and Economic Outlook: 2024 to 2034', (cbo.gov), June 2024.
[8] International Monetary Fund (IMF), 'Currency Composition of Official Foreign Exchange Reserves (COFER)', (data.imf.org).

GLOBAL EQUITIES

"AMERICAN EXCEPTIONALISM DOES NOT IMPLY THAT ALL EXCEPTIONAL COMPANIES ARE AMERICAN."

Are EMs still the 'Wild West'?

EM equities have undeniably underperformed those of DMs' since the 2008 Global Financial Crisis. This disparity has become even more pronounced in recent years, largely due to persistent concerns around heightened risk and volatility associated with EM investments. In reality, EM economies have consistently outpaced DMs in growth, and EM equity market volatility is now on par with that of DMs.

This shift is underpinned by two key developments: EM economies have made notable progress in enhancing their governance and economic frameworks, aligning more closely with those of DMs[9]. Concurrently, DMs have experienced heightened unpredictability and volatility, making their economic profiles more akin to those traditionally associated with EMs. This convergence is one signal of a profound transition in global economic dynamics, urging investors to reconsider traditional risk assessments.

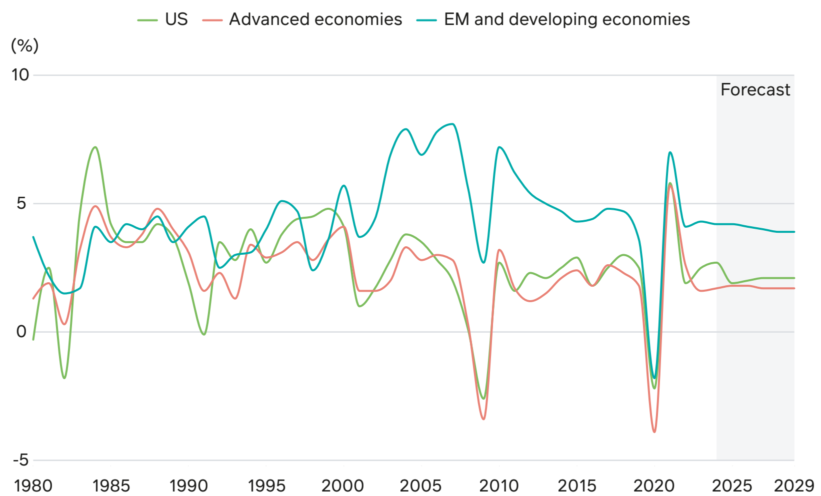
The prolonged high-rate environment and the sluggish pace of rate cuts in DMs are proving unsustainable owing to substantial debt burdens. As the rate cycle reaches a turning point, we anticipate a renewed investor focus on EMs. Defined by healthier debt-to-GDP ratios and more robust fiscal balances, EM sovereigns have been in a more favourable position compared to their DM counterparts.

Historically reliant on China, EM growth is also now increasingly diversified, supported by a broader array of countries. Countries like India, Taiwan, and Mexico are emerging as new growth engines, bolstered by structural reforms, technological advancements, and post-COVID supply chain reconfigurations.

Michael Bourke, Fund Manager, M&G Global Emerging Markets Fund, maintains: "The heterogeneity within EMs isn't new, but it's often overlooked. When dispersion is low and correlations are high, investors miss out on diversification. Recently, increased dispersion in EMs has highlighted their variety, offering more substantial choices.

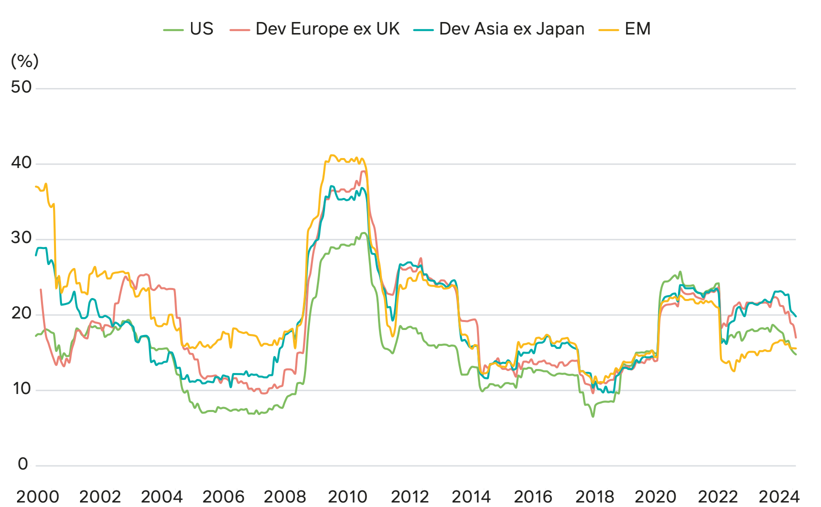
[9] See M&G Investments, 'Does corruption perception matter to investors?', (mandg.com), April 2024.

EMs outpace DMs in two decades of growth



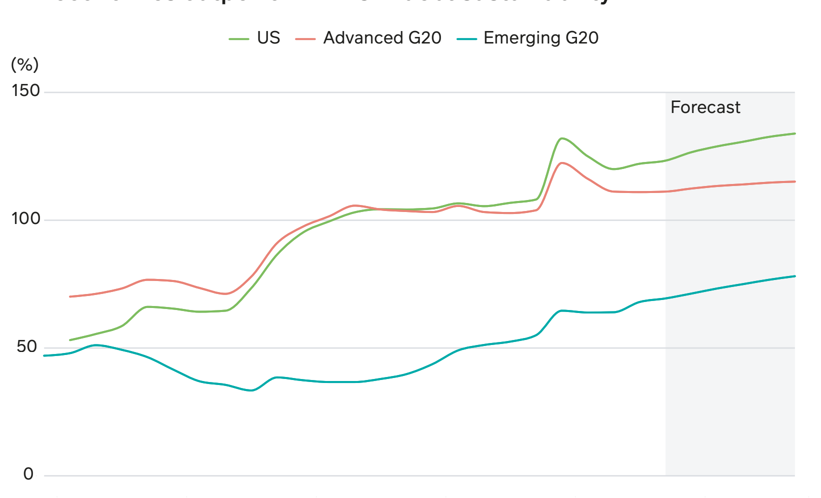
Source: IMF, August 2024.

Equity volatility in EMs is in sync with DMs



Source: LSEG Datastream, August 2024.

EM economies outperform DMs in debt sustainability



Source: LSEG Datastream, August 2024.

GLOBAL EQUITIES

This makes the asset class seem more diverse, though it always has been. The recent price discovery has simply made this heterogeneity more apparent."

Furthermore, secular trends such as AI, the global energy transition, and nearshoring are serving as pivotal growth catalysts for select EM countries. AI manufacturing is propelling the demand for advanced technologies, particularly in Asia, where countries like Taiwan and South Korea are deeply integrated with global tech giants. Previously dominated by materials, utilities, and banking, firms like TSMC and Samsung represent a development in EMs. From being virtually non-existent, the tech sector has more than doubled over the last two decades and now constitutes 24.34% of the MSCI EM Index[10].

"American exceptionalism does not imply that all exceptional companies are American," Bourke reminds us. "Many of these companies, like Tesla and NVIDIA, are exceptional due to their international operations. For example, TSMC has outperformed its US peer, Intel, over the past five years and has become a favourite among American tech investors, despite not being an American company.

TSMC is also being subsidised by the US government as part of efforts to build technology capacity within the US. This aligns with the idea that EMs also possess companies with remarkable qualities, despite the challenges they face."

At the same time, the energy transition necessitates substantial investments in natural resources and renewable infrastructure, while nearshoring is rerouting supply chains and boosting domestic manufacturing capabilities. These trends are supported by accelerating urbanisation, dramatic demographic growth, and robust consumption patterns in Asian EMs[11].

The outdated perception of EMs as the 'Wild West' is gradually being replaced by a recognition of their growing stability and investment potential. Despite recent struggles, the changing economic environment and improving fundamentals of many EMs suggest a brighter future ahead. As these markets continue to advance and diversify, we believe they offer investors not only growth opportunities but also a vital means of achieving a more balanced and resilient portfolio.

Saddling up for change

The narrative of American exceptionalism has been reinforced by the strength of the US economy and the achievements of its equity markets, notably led by the Mag 7. Even with the fragmentation of the Mag 7, the US equity market retains its overall strength and remains attractive to investors due to potential high returns on capital and significant growth.

The debate about American exceptionalism is more so part of a greater dialogue about the evolving dynamics between DMs and EMs. This broader discussion highlights the interconnectedness of global markets and the growth potential that EMs present. In this scenario, it's not so much a showdown between the US and EMs, but rather a consideration of the new sheriffs in town, as EMs increasingly assert (and in some cases re-assert) their influence on the global stage. As the US and other DMs contend with mounting fiscal pressures, unsustainable debt levels, and currency diversification, EMs – with their rapidly expanding economies and growing global influence – offer a promising avenue for diversification for investors.

The US has indeed performed exceptionally given the greater economic environment, in our opinion; however, its claim to exceptionalism will face growing scrutiny. As these trends unfold, it would be worthwhile for investors to consider the broader picture, recognising the potential for growth and diversification that EMs offer. The shifting paradigm underscores the importance of a diversified investment strategy, one that leverages the strengths of both DMs and EMs to navigate the complexities of a modern global economic landscape. □

[10] Shuo Xu, 'Sector and Factor Evolution in Emerging Markets', (msci.com).
[11] Jeongmin Seong, Chris Bradley, Nick Leung, Lola Woetzel, Kweilin Ellingrud, Gautam Kumra, and Peixi Wang, 'Asia on the cusp of a new era', (mckinsey.com), September 2023.

GLOBAL ELECTIONS

Do elections really matter to investors?

A record year for national elections – of no less than 50 globally – naturally brings around-the-clock coverage of campaigns, soundbites and even attempted assassinations on a presidential candidate across newsrooms and just about every social media app, podcast and TV show. Amid a sea of information, Tony Finding sits down with Romil Patel to explain what matters from an investor's perspective in order to avoid getting caught in the noise while identifying and capitalising on market dislocation opportunities as they arise.

A single election rarely modifies the trajectory of the global economy in a drastic way. Therefore, the importance of election outcomes to investors is inherently linked to changes around the fundamental way that societies and economies are structured. In other words, investors seek to track the evolution of the economic fundamentals that serve to anchor asset returns over a long-term time horizon.

Tony Finding, Fund Manager on the Episode Allocation and Episode Growth strategies, identifies three specific key variables here: the impact on and behaviour of inflation, profits and real interest rates. "If it doesn't impact those three on a sustained basis then it ought to just be short-run volatility," he says. "Any measures that go after profits aggressively and anything that takes a risk with inflation is much more likely to then be durable, which means the election is likely to matter to investors. But those longer-term trends really haven't been altered by election outcomes in recent years, in our view."

"We try and keep a sense of focus on what ultimately matters – those three factors, but we also stress that how markets are priced to begin with matters."

Free and fair elections are akin to oxygen for a healthy and functioning democracy, but it can take a number of election cycles before voter appetite for change culminates in a new governing party. Prior to the current UK government under Sir Keir Starmer, the Conservative Party held power for 14 years after succeeding the previous Labour administrations of Tony Blair and Gordon Brown (13 years collectively).

Beware of the disciplinary forces

The mega-consequences of the 2022 Liz Truss 'mini-budget' which triggered gilt market mayhem and cemented an ultimately short tenure as prime minister demonstrates how a slightly more radical policy can cause market dislocations that actually provide real-time feedback which serves almost as a disciplinary force to the politicians of today.

"I think a lot of the lessons learned from the volatility in the gilt market will be acting as a constraint on the Labour Party in terms of how much leeway they have to do anything particularly radical," says Finding.

"In the case of the UK, investors quite rightly have taken it with a high degree of comfort that nothing material is going to change. Yes, there will be some areas of taxation that are almost certainly going to change, but really in terms of how society is set up and structured and those broad incentive structures, very little is actually going to change."

For Finding, looking at those incentive structures – the operational independence of the Bank of England around issues such as inflation, and the ability of non-elected people to operate some of those tools in pursuit of their own mandate – remains largely the same.

'Any measures that go after profits aggressively and anything that takes a risk with inflation is much more likely to then be durable, which means the election is likely to matter to investors.'

‘For our investment process, we try and be as dispassionate as possible and the challenge with elections are that they’re generally highly emotive affairs, and it’s important that we remain detached.’

Trump vs central bank independence

The most closely-watched democratic election of 2024 is unsurprisingly the race for the White House – as well as Congress, comprising the House of Representatives (with all 435 seats up for election) and Senate (33 seats up for election).

While the news headlines have been dominated by the Democratic Party presidential nominee, an attempted assassination of the Republican Party nominee and the economy among other issues, investors will be closely monitoring the three key variables – behaviour of inflation, impact on profits and real interest rates – particularly in the case of a Trump 2.0 presidency. The context? Central bank independence free from political influence.

“Trump has been particularly vocal around the operation of the US Federal Reserve (Fed),” Finding reflects. “How much scope he would have to materially change that is up for debate but if you start attacking some of those fundamental institutions that are an intrinsic part of society, that would be very important for investors in US assets, especially for fixed income if that affects the medium-term inflation outcomes.”

“Whether Trump 2.0 would cause significant volatility will depend on how much of his rhetoric actually changes policy direction. While Trump has been very vocal about wanting a weaker dollar, the general consensus amongst economists is that the introduction of a load of tariffs would actually lead to a strong dollar. Therefore, how all of this would actually manifest itself is extremely interesting.”

Capitalising on market dislocations

Investment opportunities can arise if the market overreacts to unexpected outcomes. Mexico held elections in June 2024 and while a Claudia Sheinbaum victory to become the country’s first female president was anticipated, the scale of her landslide victory took markets by surprise.

“The financial markets decided they really didn’t like the sheer gains of the ruling Morena Party so they dropped sharply on fears that Claudia Sheinbaum could have the legislative support to pass less market-friendly measures, such as judicial reform for example,” says Finding. “This is quite interesting because the party has got a popular mandate, it’s been perceived as pro-markets and produced some good economic outcomes. Mexican assets, particularly the peso have performed very well over the last few years and then it takes a knock by the size of the majority after the election.

“For our investment process, we try and be as dispassionate as possible and the challenge with elections are that they’re generally highly emotive affairs, and it’s important that we remain detached.”

Interestingly, the feedback loop of financial markets in Mexico was similar to the Liz Truss episode in the UK. The message from the market was: “Hang on, we need to be careful about how we go about this because we don’t want to be changing the broader incentive structures that have caused good economic outcomes in Mexico.”

Disciplinary market forces are generally a good thing – and we could see these powers at play once more if the fiscal situation in the US spirals out of control.

Whilst it is the case that many forces beyond the electoral cycle influence the outcomes for investors and beyond the short run volatility associated with election noise, the extent to which elections really matter for longer-term outcomes of financial markets is still up for debate. □

GLOBAL ELECTIONS

‘If you start attacking some of those fundamental institutions that are an intrinsic part of society, that would be very important for investors in US assets, especially for fixed income.’

IN CONVERSATION WITH...

EMMANUEL DEBLANC

A (former) chess player, Emmanuel Deblanc joined M&G Investments as the CIO for Private Markets in 2024. He sits down with Romil Patel to discuss the early days of his career and the journey to the top, why he thinks private markets are at a turning point – and the art of dealmaking in a more competitive world than ever before.

Before getting into the investment industry, how did you make your first pennies?

Chess is a passion of mine, and I used to play it competitively. My first pay cheque was actually from winning a chess tournament – I was 17 and it was in France!

Tell us about the early days of your career – how you came to work in the investment industry, where your first post was and what motivated you to go down the private markets route?

I was relatively young when I realised that I wanted to work in finance as it played to my strengths. I thought: 'I'm ok with numbers and that's a differentiating factor.' This was a key attraction and motivation behind my desire to join the industry. When I saw a job advertised in the Financial Times, I applied as back then, that was the reference point to get a job, and a good source for discovering opportunities. My career began as a financial modeller – a quant in a joint venture, which included S.G. Warburg and Bechtel. It was basically a job mixing coding and finance, which I thought was quite interesting. At the time, the word 'coding' when combined with finance considerably narrowed the field of candidates.

What did the journey up to CIO entail – what was your hardest challenge and what did it teach you?

Learning to adapt to a world where you're not doing deal after deal, and adapting your mind to slower processes or longer-term horizons are certainly important aspects behind the role. But the other is: how do you get there? Dealmaking is quite addictive and over time I learnt to convert jobs and tasks into deals, but it was a major change of environment.

The direct – and sometimes blunt – language of dealmakers is occasionally required in a transaction to get things moving. That can be in stark contrast to the culture in a corporate setting, where you need buy-in from a wide range of stakeholders over what feels like longer time periods.

In your view, how does the art of dealmaking fit in with this competitive era that we live in now? And for those early in their career looking to work their way up the ladder – be it in private markets, equities or bonds – what would you say to them when it comes to dealmaking?

I would suggest that you need to think in a non-binary way, it's not a simple yes or no. There can be more caveats in negotiations – 'yes, but' or 'no, but'. This could be either meeting someone halfway, finding an alternative to a status quo, and overcoming disagreements or opposing views.

Similarly, this can help the other side. They can actually hear what your need is, and start their sentences with: 'No, but', or preferably: 'Yes, but', and work through those conditions.

To me, that's what the art of the deal is. It's about respecting and listening to the other side and being seen as a viable counterparty. There are obviously other types of negotiating and everyone has to do what's right by their own person-

ality and style. In terms of value for us at M&G Investments, demonstrating consistency, respect and the ability to truly listen to others goes a long way.

As far as going up the ladder though, I would highly recommend ignoring the ladder and instead focus on getting the job done, exploring new ideas – it pays off more than talking about doing things.

Private markets are at a key point in their journey given their broadening appeal with investors. As they are no longer the preserve of institutions only, what's your view on their appeal to a wider range of investors – and what are the key barriers and opportunities?

I think that we are somewhat at a turning point. We're growing and it's really been quite fast in the credit space in recent years, and for some of the segments – be it core real estate or infrastructure – the real interest rate rise has created some tension in the system, and even slowed down the deal flow in some cases. So, we're in a maturing stage, a normalisation where we're not riding the wave of quantitative easing, and therefore we're probably on our way to a more sustainable level of demand that's based on the healthy benefits of private markets as opposed to those which may be linked to a point in time, or macroeconomic policy by some of the main central banks – what one could describe as the 'private markets tourists'.

At the same time, we're getting new demands and that's a maturing position on the traditional investors in the space, or the institutional side. On the other hand, we've also got new demand coming from the high-net-worth individuals, from the wholesale retail market. We are at a turning point because we're seeing a greater ask for private market asset classes in the main, and that should provide the second phase of growth in this space.

It's a normal part of growing up. We're gradually expanding the universe of investors with limitations in terms of the needs of those investors – the need for them to be educated, their liquidity needs or constraints, and in terms of risk profile, having a proposition out there for the market for these new investors that is offering diversification from day one. That's what we try to position: access to a well-diversified book early in the investment process as opposed to the institutional side, which can afford to wait to build up an exposure over a number of years.

"If you see a theme, if you spot a pattern, don't hold back, express yourself and push for it."

If we look at markets as a whole, what's your top concern and your biggest source of hope and of those, which do you think will come to dominate?

My biggest source of hope from a private markets perspective is that we're just at the beginning. Looking at the new areas of the economy that need to be funded, I believe there's a fundamental need for private markets to get things going in terms of transition, climate-related strategies. Where you have an emerging segment of the economy, new technologies, a nascent regulatory framework, that's where private markets can add value, in my opinion.

What we also see is that as private markets mature, more options, products and segments are being developed and that's the natural course of business. Therefore, our role is to see how we can best match investors' appetite or needs with those segments and it really is quite exciting to see this happening over the years, where we are initially helping to create a market, a niche, that may become mainstream a few years later.

What are your favourite sources of information for investments but also global affairs, geopolitics, culture and sports?

The Foreign Press in the main (American and European), which I find extremely useful as part of gathering a wide range of perspectives. I also read Foreign Affairs, I think it's helpful in getting a longer-term view on the geopolitical dimension.

What's your favourite town, city or country and why?

For me it's Stockholm, I love the city and the architecture. You could say it's the Paris of the north! There are amazing restaurants, good cultural venues and it's a great place to do business. It feels straightforward, it's a rather welcoming society, socially and business-wise and they've got a lovely, pragmatic approach there. There's also no fear of innovation in that country.

What do you like to do when you're out of the office?

My favourite pastimes are kitesurfing, squash – and playing chess, of course! I go to Cabarete in the Dominican Republic and Akyaka in Turkey. The Dominican Republic has amazing waves and Turkey's got very reliable wind.

What advice would you give to somebody early in their career in the investment industry?

Don't be afraid of having new ideas – and express them, don't be afraid to be bold. If you see a theme, if you spot a pattern, don't hold back, express yourself and push for it – don't have the remorse of not having pursued a new idea. It might be a good idea. That would be my piece of high conviction career advice. □

FUTURE CITIES

HOW THE AI REVOLUTION COULD RESHAPE THE URBAN LANDSCAPE

Beyond the hype, artificial intelligence is set to have wide-reaching implications across industries, transforming the way we live, work and play. Here, Alex Rolandi explores the impact the technology could have on the urban landscape, what this might mean for real estate investors, and why there will be winners and losers amongst the cities of tomorrow's world.

REAL ESTATE

"Can machines think?" This was the question posed by mathematician and computer scientist Alan Turing in a seminal paper exploring the possibilities of artificial intelligence (AI) published over seven decades ago[1]. In 1951, just one year later, what is widely considered the first successful AI program was written by fellow computing pioneer Christopher Strachey[2]. The technology has come a long way since those early days.

With the launch of ChatGPT in 2022, AI arguably went mainstream as the doors were opened to a wider user base, spurring a surge in global investment that reached $22.4 billion throughout 2023, up from $2.6 billion the previous year[3]. Beyond the hype, some believe we are only at the start of this journey and just beginning to understand what the wider implications of AI could be for humanity[4] and how it could reshape the global economy.

Although its true potential and long-term impact is still not fully known, there is little doubt that AI has the capacity to revolutionise industries, enhance healthcare, and help solve global challenges such as climate change, food security and water scarcity. This transformative technology could change the way we live, work and play.

A better future is possible. AI implementation could lead to unprecedented levels of efficiency and innovation, realising a utopian vision of society where humans are liberated from mundane tasks and are able to focus on creative and intellectual pursuits.

Conversely, in a dystopian scenario, unchecked AI development could exacerbate inequalities, lead to mass unemployment due to automation, and pose significant ethical and security risks. The concentration of AI power in the hands of a few could result in surveillance states and loss of privacy, while autonomous systems might act unpredictably, causing harm. The future of AI hinges on responsible development, ethical considerations, and robust regulatory frameworks to ensure it benefits humanity as a whole.

From a real estate perspective, we believe there will be winners and losers amongst the cities of tomorrow's world as AI continues to evolve. The scene is set for a dramatic geographic dispersion in the not-so-distant future as this disruptive technology becomes increasingly embedded in the long-term super trends currently unfolding and defining our times.

[1] Alan Turing, Mind, 'Computing machinery and intelligence', October 1950.
[2] Encylopedia Britannica, 'History of Artificial Intelligence', June 2024.
[3] Our World in Data, 'Quid via AI Index; US Bureau of Labor Statistics', 2024.
[4] Forbes, 'Generative AI Adds New Dimension to Productivity That We're Just Beginning To Understand', July 2023.

A transformed world

Automation in itself is nothing new, but unlike previous iterations – such as the first industrial revolution over 200 years ago which largely modernised agrarian and rural societies – artificial intelligence could even replace jobs that require nuanced judgement, sophisticated reasoning, creative problem-solving and data interpretation.

"Most of these are white collar jobs in more developed countries," notes Singapore-based Regina Lim, Head of Property Research, Asia.

According to a recent study by the International Monetary Fund, 60% of jobs in advanced economies are highly exposed to AI[5] adoption. Of these, half are expected to be negatively impacted, while half stand to benefit from higher productivity from AI integration or augmentation. On a global scale, nearly 40% of all jobs are likely to be affected as the technology is increasingly assimilated into business processes.

Job disruption could disproportionately impact highly skilled or creative roles and drive the flow of talent, enterprises and capital towards cities that harness, invest, and regulate AI well.

"We already find ourselves in a situation where the rich are getting richer, and the poor are getting poorer in many regions. Even though technology, industrialisation and globalisation benefited most countries, the benefits did not reach everyone equally within each country," says Lim. "Not everyone is winning, and I think it will be the same with AI. As the technology continues to develop, it will likely magnify already existing disparities in income and wealth."

"Higher income jobs have higher AI complementarity and can expect disproportionately higher income growth," adds Lim. "College educated and younger workers can adapt to AI faster. Fiscal and redistributive policies will impact income and wealth inequality."

There is a possibility that AI could exacerbate cross-country inequalities as advanced economies might be better positioned to harness the power of AI relative to less developed regions. As it stands, while nearly 40% of AI companies are based in the US, a number of Asia Pacific countries also have first mover advantage due to a high concentration of such firms[6]. Furthermore, five out of the top 10 innovative cities are found in the APAC region.

"Countries that invest in AI to create and protect that ecosystem through regulation, and the best redistribution policies, are less likely to be left behind as AI advances," Lim explains.

Riding the wave of change

Given AI's likely significant impact on job security and income propensity, we expect highly mobile skilled professionals to migrate towards AI-enabled cities to maximise their earnings potential. These cities would invest into AI infrastructure, carefully adopt the latest available tools and proactively regulate intellectual property rights, data integrity and privacy issues well. It would be natural for companies and capital to follow the flow of talent to these cities in order to compete.

"In real estate terms, it's important to be aware that today hub cities brimming with global talent like New York, London, Shanghai, and Singapore are thriving because of their respective governments. Legal constructs have facilitated a flow of capital and people that has accumulated to an extent where scale generates scale. Real estate becomes more valuable when there are more people using it," Lim states.

"Once a city becomes like a London or a Tokyo, it is usually very, very hard to unseat as the incumbency is there. So capital begets capital, and talent begets talent. When you win the talent, the businesses and capital will follow."

As a result, a widening of income and wealth inequality between countries could potentially lead to higher geopolitical tensions, but more importantly, income gaps within cities may also increase, which could affect social cohesion. As such, proactive fiscal and redistributive policies should be an important consideration for governments.

The need to prepare for such potentially dramatic social and economic changes has not been overlooked. Alongside the impact on jobs, AI's ramifications in privacy and security have been a core talking point for policy-

[5] International Monetary Fund (IMF), 'GenAI: Artificial intelligence and the future of work', January 2024.
[6] JLL, Innovation Geographies 2024, M&G Real Estate based on data from Oxford Economics, national statistics, as at Nov 2023.

'60% OF JOBS IN ADVANCED ECONOMIES ARE HIGHLY EXPOSED TO AI ADOPTION.'

REAL ESTATE

makers and technology firms seeking to develop means to manage its rollout accordingly. The European Union has taken the lead in this area with its Artificial Intelligence Act, which came into effect in August. The law places obligations on the technology firms relating to transparency, copyright and bias, and other regions are expected to introduce policy frameworks[7].

Lim highlights that it will be fundamental for real estate investors to be aware of how countries are proactively engaging with AI to ride this wave of change, and which cities are "future-ready".

"The aim is to continue investing in the winners, tracking which cities are implementing the right policies and fostering the right ecosystem for AI," she adds.

In the medium-term, with disruption set to transform office-based jobs in sectors such as finance, prime employee-focused, ESG compliant offices in cities like Tokyo, Seoul, and Singapore may be most resilient as demand shifts.

Strategically, we think offices in secondary cities could be less relevant over time as mundane or manual tasks are replaced by AI. Innovative cities with progressive economic, technologically informed policies could draw more demand from occupiers. ESG regulation and support as well as quality of life factors will continue to be crucial for cities as well, in our view.

Longer lifespans, increasing demands

The world's population is expected to peak at 10.3 billion in 2083, up from 8.2 billion in 2024 – slightly earlier than previous predictions, data from the UN shows[8]. Currently, just over half the global population live in cities, but by 2050, this will likely increase to nearly 70%[9].

Meanwhile, global life expectancy is on the rise once again, returning to pre-COVID levels in nearly all countries and regions. Among other factors, AI could play a significant role in this ongoing demographic shift by facilitating an acceleration in disease identification, drug discovery, and targeted therapies. This, in turn, would impact demand for rental properties and the need to build more housing.

[7] CNBC, 'EU AI Act goes into effect: Here's what it means for U.S. tech firms (cnbc.com), August 2024.
[8] UN, 'World Population Prospects', July 2024.
[9] World Bank Group, 'Urban Development', 2024.

'THE MASS ADOPTION OF AI AND CLOUD COMPUTING WILL NEED TO BE SUPPORTED WITH VAST COMPUTING POWER AND EXTENSIVE RESOURCES.'

"If everyone's going to live longer and healthier lives than today, then the current shortage of housing in cities like London is going to be even more severe," Lim points out. "Likewise, with people living longer, there will also be a greater need for more independent retirement living."

Powering the AI revolution

The mass adoption of AI and cloud computing will need to be supported with vast computing power and extensive resources such as computing hardware, high-speed connectivity networks, power supply, cloud infrastructure, and data storage.

For Dickson Koh, Manager, Property Research, Asia, this means there will be a transformative shift in data centre design and site selection.

"For instance, to keep up with the growing demand for computational power, data centres' power densities would need to increase exponentially, which would translate to heavier racks and affects floorplate loads and footprint," he explains.

Data centres dedicated to AI applications could hit as much as 80-100kW per rack, a tremendous ramp up from the current average deployment of 10kW per rack[10]. The increased heat generation will result in a shift away from traditional air cooling towards various types of liquid cooling. Moreover, increasingly tough sustainability performance regulations and reporting requirements are making power and water efficiency paramount. There is a need for AI infrastructure to be carbon neutral.

"While demand for data centres will increase substantially, power densities, grid access and cooling technology will evolve further, heightening location risks and obsolescence," Koh adds.

In terms of locational criteria, markets with availability of power (particularly renewable energy), competitive energy pricing, cheaper land, and accommodative government policies are poised to benefit.

"There have been several recent data centre developments taking place in Japan's regional cities such as Hokkaido and Kitakyushu in the Fukuoka Prefecture, for example," Koh explains. "Different data centres models have varying locational considerations. While edge data centres will continue to grow near major cities to be close to the end-users, it is likely that the expansion of hyperscale data centres will be more widely distributed."

At the same time, demand for advanced chips is likely to lift exports and growth for large fabricators in countries such as Taiwan and South Korea. Indeed, South Korean companies have been absolute leaders in supplying HBM chips, which are critical for AI servers.

To keep up with this rapidly changing environment, we believe real estate investors need to keep their finger on the pulse of this ever-evolving digital innovation.

Since the advent of artificial intelligence all those years ago, it has conjured visions of a transformed world – some for the better, others for the worse. But although there are many unknowns on the horizon, one thing seems certain: AI is here to stay, and it has the potential to drastically transform urban environments across the globe. □

[10] IDC, 'Asia/Pacific (Excluding Japan) DC Deployment model and spend forecast, 2H22: 2022-2027', July 2024.

The timeless nature of income

Capital gains took a precedence during the post-Global Financial Crisis era of ultra-low interest rates and quantitative easing measures implemented by central banks. Now we find ourselves in a very different environment, we believe income investing could be making a comeback. Alex Rolandi speaks with the investment teams to find out why this is important, and how investors can address the income challenge without sacrificing growth.

The investment landscape has changed significantly since the Global Financial Crisis (GFC). At the time, the crash instigated the most severe economic meltdown since the Great Depression of the 1930s[1], ushering in a period of financial regulatory reform, quantitative easing measures, and ultra-low interest rates. In the aftermath, investors were forced to seek yield beyond the traditional areas of bonds and cash savings accounts.

This gave rise to the saying 'There is No Alternative' – or TINA – the notion that with rates at rock bottom, investors who wanted to achieve a decent return felt obliged to invest in stocks. Capital gains took a precedence.

The once popular and well-established strategy of equity income, in particular, was somewhat overshadowed by the outperformance of growth stocks largely led by US technology equities – companies that, until recently, generally didn't pay dividends. Investors became accustomed to the significant and relatively rapid returns from these tech stocks and forgot about the slow and steady nature of income.

Then along came COVID in 2020[2], and most of the world was brought to a standstill by government-enforced lockdowns to stem the spread of the virus. Despite the significant slowdown in economic activity across the globe, growth in certain areas of the technology sector, at least, seemed to be galvanised.

"During COVID, we had this last surge of growth. This was not from the big mega-cap tech names, but actually from what we would describe as the much more speculative areas of technology, which didn't have any cash flows, and were very much dependent on longer-term growth," notes Stuart Rhodes, Global Dividend Fund Manager.

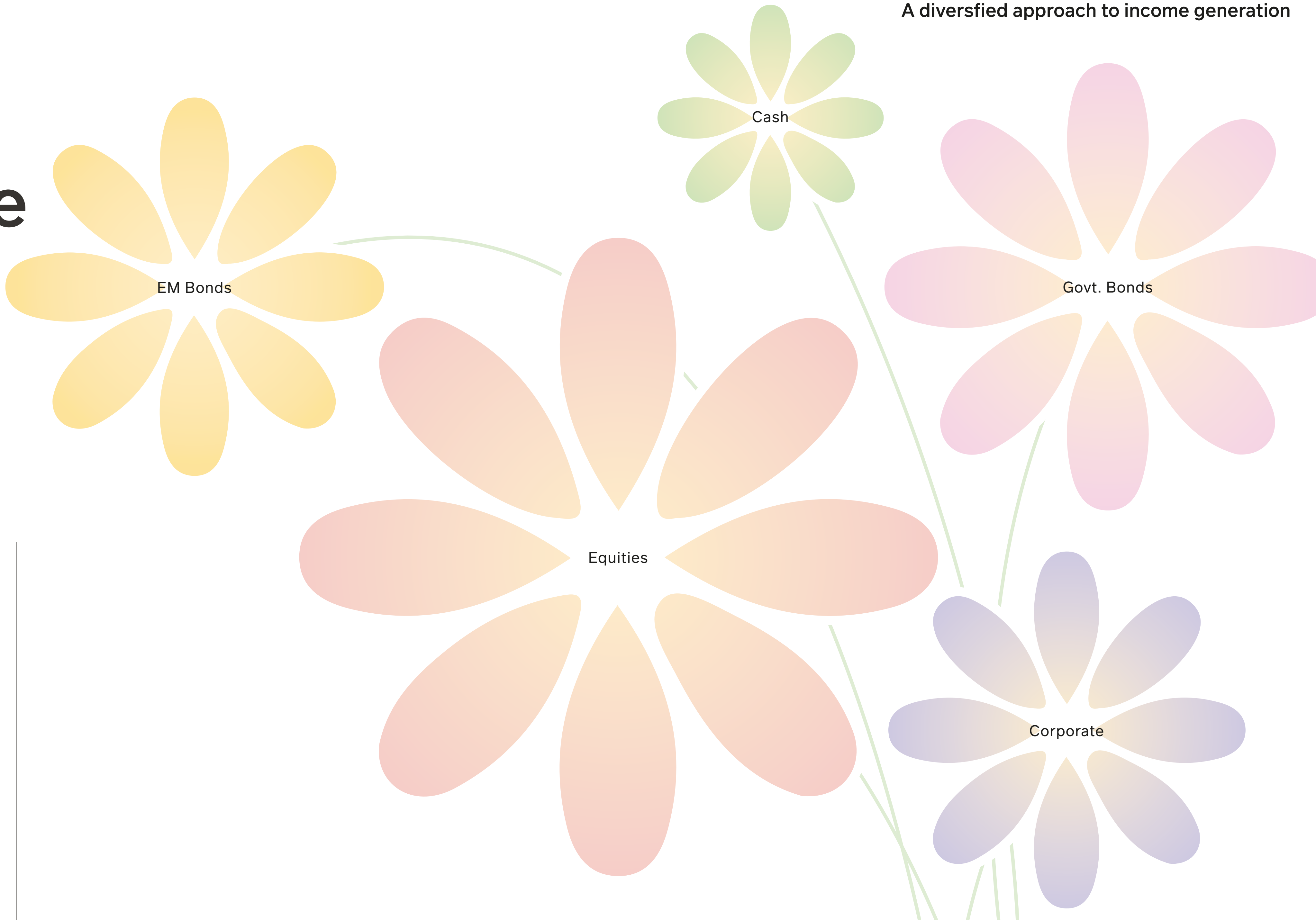
From a dividends perspective, 2020 and 2021 were challenging years. Equity income found itself in the wilderness once more as investors sought performance elsewhere. But this changed abruptly in January 2022. Now the prospect of compounding dividends could once again be an attractive artform.

"Rates and yields started to move aggressively upwards, putting a dent in pretty much the majority of the equity market's growth spectrum," explains Rhodes.

"It especially dented the speculative

[1] Encyclopedia Britannica, '5 of the World's Most Devastating Financial Crises', (britannica.com), September 2023.
[2] BBC, 'Coronavirus: How the pandemic has changed the world economy', (bbc.com), January 2021.

A diversfied approach to income generation



'With further volatility possible on the horizon, we believe complex market conditions require alternative investment routes.'

side, and that bubble really burst. That made a lot of people think again about being a bit more diversified than they potentially were at that stage of the cycle."

With dividends accounting for the majority of total equity returns over the last three decades[3], investors may harness the power of compounding to potentially accelerate their wealth accumulation. Indeed, Albert Einstein himself is said to have called compounding the 'eighth wonder of the world'.

A transformed landscape

These days, we find ourselves in a whole new paradigm. In developed countries, interest rates have risen to levels not seen in around 20 years. In this brave new world, the landscape for income is completely transformed. The polarised nature of the market presents attractive opportunities, in our view.

"Inflation now appears to be moderating, but that only means prices are appreciating at a slower rate than before," notes Stefano Amato, Multi Asset Fund Manager. "Prices are still generally higher than they were two or three years ago."

Most end clients with investable assets are either at, or approaching, retirement age. But wealth is generally distributed unevenly between individuals. In Great Britain, data from the 2021 census shows that the wealthiest 10% held around half of all wealth, primarily in private pensions and property[4]. The report highlighted age as the best predictor of individual wealth: the 60-64 age group had nine times the level of investable assets than those born thirty or so years later.

"People who have had time to accumulate wealth, and therefore have capital to invest are usually in the decumulation phase of life, either still working or looking at retirement, when the need for income is more present," says Amato.

> 'Albert Einstein himself is said to have called compounding the 'eighth wonder of the world'.'

The UK's population is expected to surpass 70 million by mid-2031, while life expectancy is also projected to increase for both men and women, rising to 92.5 and 94.6 years respectively by 2070[5]. Over the next half-century, the pension age population will likely continue to grow, putting further pressure on the old-age dependency ratio.

"For people not in a phase of their careers where they are earning well or commanding more salary bargaining power, they really feel the impact of rising prices. Having a portion of their investments that specifically targets not just income today, but also growing that income over time, is quite important for them," explains Amato.

Investors looking to generate a regular, long-term income by taking cash from their savings are often faced with the decision of how to choose between guaranteed but potentially low-returning annuities and potentially higher-returning but riskier assets. Individuals have to make sure that the investment decisions they take generate sufficient income to keep pace with inflation without depleting their pot too soon.

Building robust portfolios

From a multi asset perspective, it is best to diversify sources of returns and income generation across a broad range of asset classes.

"This can allow us to build robust portfolios that may benefit from medium-term asset appreciation but are also able to withstand unforeseen economic shocks," says Amato.

We believe dividend growth can be a winning strategy due to the benefits of

[3] Bloomberg, July 2024.
[4] ONS, 'Distribution of individual total wealth by characteristic in Great Britain: April 2018 to March 2020', (ons.gov.uk), January 2022.
[5] Department for Work and Pensions, 'State Pension age Review 2023', (gov.uk), March 2023.

> 'We find ourselves in a whole new paradigm – the landscape for income investing is completely transformed.'

compounding, while the current environment is also conducive to finding optimal value in fixed income.

Valuation and behavioural analysis play a key role in identifying possible opportunities across markets and geographies. Looking at the fundamentals helps situate where we are in the playing field. "You need to be dynamic to respond to changes in markets," Amato points out.

By implementing a robust cross-asset valuation framework, diligent asset managers may identify 'fair value' for a wide range of assets across the world, in light of historical expected returns, economic theories, and investor preferences for each asset class.

"We look for long opportunities in markets that we believe are cheap and exhibiting signs of emotional selling such as investor capitulation, forced selling, or deleveraging," explains Amato. "We also limit or avoid exposure to assets that we think are expensive and where sentiment is extended or complacent to growing risks."

The polarised nature of the market means attractive prospects may be found across a wide range of sectors such as utilities, healthcare, and consumer staples in both developed and emerging economies. Taking a flexible approach, whereby the exposure to different asset classes is adjusted according to their relative attractiveness, can be a determining factor in a saturated market.

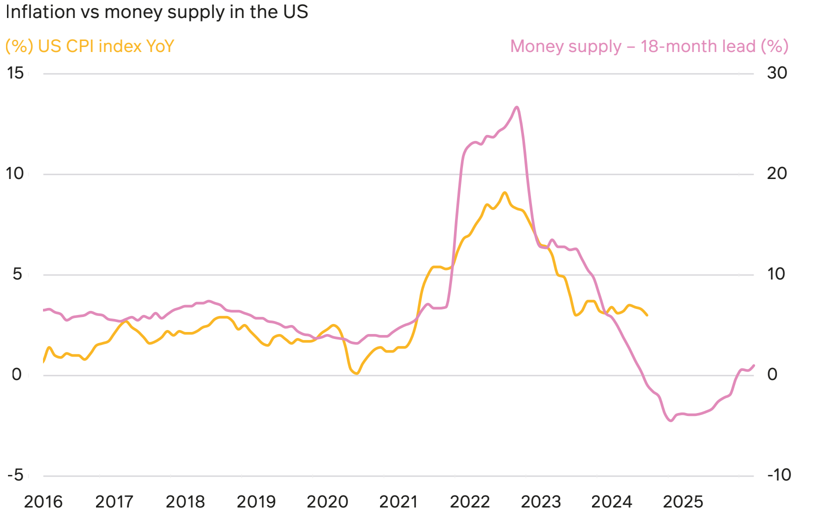
By investing in a well-diversified blend of assets expected to deliver a sufficient level of income, such as dividend-paying shares, interest-bearing fixed income instruments and property, it may be possible to grow both income and capital without sacrificing one's capital.

According to Amato, long-dated government bonds are attractive at present, with the potential for interesting yields along with portfolio insurance properties.

Even so, there is a need to be wary of the risk of complacency. "The equities rally was very narrow. A lot of the appreciation came from a small number of companies – Big Tech and AI – which have a very large weight in indices," reflects Amato. "But now the narrative

Too little money chasing too many goods?

Inflation vs money supply in the US



Source: M&G, Bloomberg, 31 May 2024.

is changing. Now there are credible objections: this is the tech, but where is the killer app? How are we going to make money?"

There is also the possibility that inflation may prove more stubborn than markets expect, in which case there would be a need for repricing. Broadening the search for income, focusing on the most attractive total return opportunities and then optimising exposures across different sources of income provides the stability needed to stand the test of time.

Diminishing inflationary pressures

Throughout the 20 years prior to the pandemic, the US Federal Reserve and other central banks had generally succeeded in maintaining a stable level of money supply growth. The outbreak of COVID led to a notable slowdown in economic activity across the world as vast swathes of the population were confined to their homes – meaning people built up substantial savings.

In the UK, for example, households saved 11% of their income throughout the first quarter of 2024, an increase from 5.8% in the final quarter of 2019, according to the Office of National Statistics. At the start of the pandemic, however, the savings ratio spiked at 27.4% as usual consumption levels dropped off[6].

The aggressive quantitative easing measures implemented since COVID led to a further boost in money supply, which contributed to subsequent inflationary pressures.

This situation then reversed as central banks raised interest rates and reduced liquidity through quantitative tightening operations. Lower liquidity means inflationary pressures are diminishing and, in our opinion, will likely continue to do so, particularly as monetary policy remains tight on a historical basis.

The current unique rates-inflation dynamic has allowed for the re-emergence of the opportunity to deploy cash and increase duration in investment portfolios.

"Bonds today offer an attractive risk-reward. Not long ago, rates were close to zero, leaving investors with very limited upside compared to a large downside risk. Today, it is the other way around, particularly as we now know central banks are at the end of their hiking cycle and will likely cut rates going forward," highlights Carlo Putti, Investment Director, Fixed Income.

When investing in the fixed income market, there are essentially two main risks an investor can take: one is the duration risk, which is the sensitivity to changes in interest rates, and the other one is the credit risk.

"What we aim to do is look for what the optimal exposure to those two risks is," Putti explains. This can sometimes mean going against the status quo of what the market may be saying at any given time, but this can be a positive differentiator.

"After the GFC we were able to capture the risk premium in credit. But now we are in a different position," he says. "When you look at spreads, investors are generally suggesting that everything is fine and we are still in a strong economy, but when you look at the macroenvironment, when you look at the data – such as the housing and labour markets – things are deteriorating."

Weighing up risk

It could be a good time to take on more duration risk, while being more selective on credit, according to Putti, especially in light of the volatility in August 2024 when financial markets experienced a sharp correction triggered by a weaker than expected labour report.

"A cautious allocation to risky assets, along with a high exposure to duration, can help investors remain buoyant through the current environment," he remarks.

With further volatility possible on the horizon, we believe complex market conditions require alternative investment routes. Remaining agile could prove critical in capturing any potential dislocations that may arise.

As we find ourselves in a stage of global transition, megatrends are forging a path to a potentially better future, albeit amidst a complicated macroeconomic and geopolitical backdrop. Nevertheless, a combination of 'patient opportunism' and diversification could be the necessary ingredients to help investors achieve their goals in a changing world. ☐

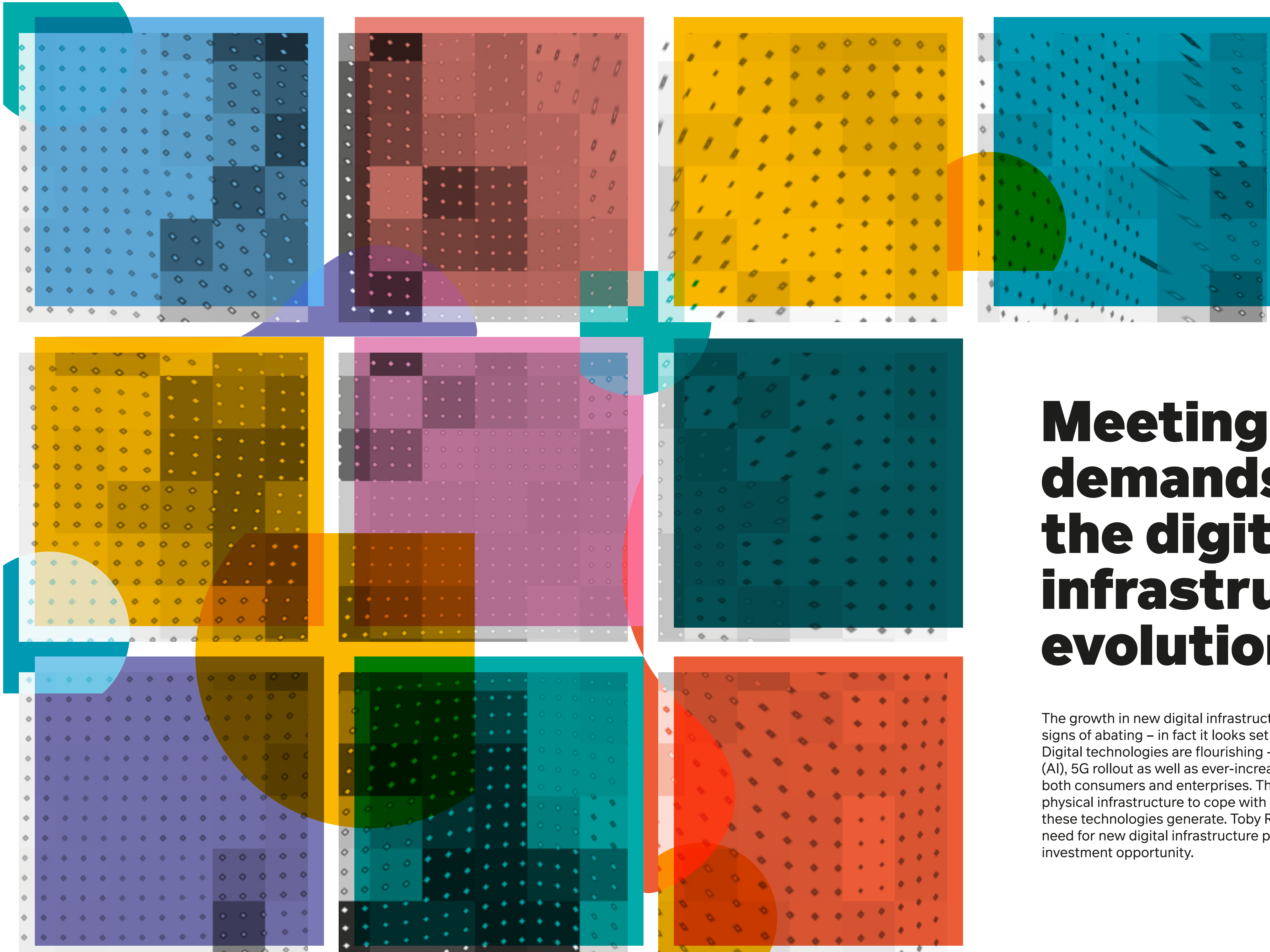
'Valuation and behavioural analysis play a key role in identifying possible opportunities across markets and geographies.'

[6] ONS, 'Households' finances and saving, UK: 2020 to 2024', (ons.gov.uk), July 2024.

INCOME

"We look for long opportunities in markets that we believe are cheap and exhibiting signs of emotional selling such as investor capitulation, forced selling, or deleveraging."

PRIVATE MARKETS



Meeting the demands of the digital infrastructure evolution

The growth in new digital infrastructure build shows no signs of abating – in fact it looks set to accelerate sharply. Digital technologies are flourishing – artificial intelligence (AI), 5G rollout as well as ever-increasing digital adoption by both consumers and enterprises. This expansion demands physical infrastructure to cope with the increased data traffic these technologies generate. Toby Rutterford asks if this need for new digital infrastructure provides a compelling investment opportunity.

The growth in data traffic has been exponential over the last few years. As the chart below shows, over the last 13 years data creation has increased 74x. Globally, according to Statista, we generate 403 billion GB of data each day, including 347 billion daily emails.

The drivers for this expansion have been led by technological advances with digital adoption becoming even more embedded across most industries. It is also likely that COVID acted as an accelerant, highlighting the essential nature of many digital technologies. Further, it acted as a catalyst for the way interactions are now moving to a hybrid of physical and virtual mediums.

Evolving opportunity set

What does all this mean for investors? The market for digital infrastructure has progressively evolved.

Several years ago, growth was focused on the sale and leaseback of mobile towers supporting cellular comms and continues today with the roll-out of 5G. These investments have defensive characteristics offering investors stable contractual cashflows. Opportunities then expanded into fibre internet connectivity for both commercial and retail customers. This continues to be a major growth driver.

However, whilst diverse segments within the digital infrastructure market remain, the constant throughout has been the ever-increasing need for data centres. All these digital services (comms, data processing, internet trafficking etc) require banks of servers housed in specialised facilities to deliver these services, and the explosion of cloud computing has only fuelled growth. Providing a critical service, these data centres are hard to replace and provide highly dependable cashflows to investors.

The value of telecoms-related infrastructure investment (data centres, fibre, towers etc) has increased significantly over the last few years and in our opinion, this growth is set to continue.

Growth drivers

Digital infrastructure will continue to be driven by three core areas: data use, cloud adoption and artificial intelligence (AI).

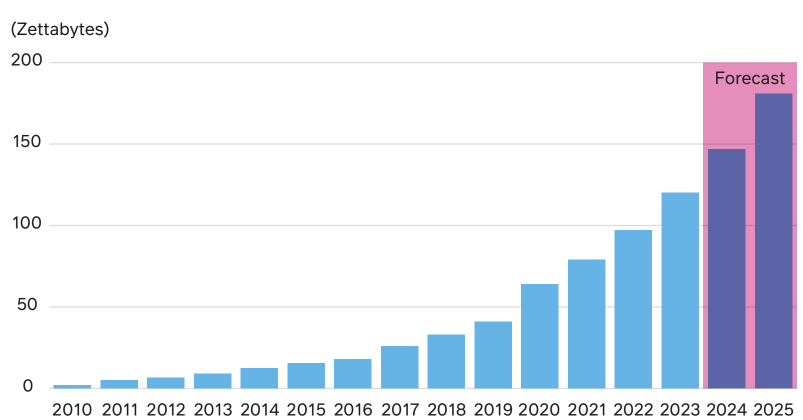
Data usage: Growth in data consumption continues unabated with major industry participants predicting growth in data use and digital adoption increasing at a rate of 3.5x between 2022 and 2029[1]. 5G-led improved device capabilities together with users consuming more data as they spend more time on devices being prime drivers.

Cloud adoption: A major source of growth by example, Microsoft's cloud unit, Azure, increased revenue from $2 billion in 2016 to $57 billion in 2023[2]. Once a relatively minor contributor to Microsoft revenue, it now represents 27% of total income.

AI: The full impact of AI is unclear, but its potential is undeniable, and adoption has been significant. Launched in 2022, Chat GPT secured c.100 million users within two months. Commercially, Goldman Sachs believe generative AI could deliver an increase of $7 trillion to global GDP over 10-years[3]. But this explosive growth has second-order consequences – the power consumption per Chat GPT query is estimated to be 10x more power intensive versus a simple Google search.

> 'The explosion of cloud computing has only fuelled growth.'

Global data generated annually



Source: Statista, Bernard Marr & Co, 2024.

[1] Ericsson Mobile Data Outlook, 2024.
[2] Microsoft Inc, April 2024.
[3] 'Generative AI could raise global GDP by 7%' report, Goldman Sachs, April 2023.

Sustainability matters

With the increase in data usage and subsequent expansion of new data centre builds, an obvious question is whether data centre operators can take higher power loads from the grid in a responsible and sustainable manner. Power efficiency is the key metric operators focus on, primarily the power usage effectiveness (PUE) ratio. This measures the relative power used to run core IT equipment within a data centre versus ancillary equipment, such as cooling and power distribution equipment. A PUE above 1.0 means more power is being expended on ancillary functions rather than IT equipment. The lower the figure, the more efficient the data centre is in terms of power usage.

Considerable progress has been made in terms of efficiency gains over recent years, particularly by the largest cloud providers ie, 'hyperscalers' such as Alphabet, Microsoft and Amazon. Indeed, Alphabet's current trailing 12-month 2024 PUE is 1.1 – sharply better than the industry average of 1.58[4].

Overall, whilst data centre power usage is clearly increasing, efficiency gains from improved hardware and cooling, as well as the intrinsic efficiency of hyperscale centres, have helped limit growth in energy demand. As evidence, according to the International Energy Agency (IEA), from 2015-2022 whilst data centre workloads increased by 340%, the respective increase in energy use rose by only 20-70% over the same period[5].

Water use, a key element in cooling systems is also a key sustainability factor, and here there has been solid progress particularly with increased use of air-based systems and advances in immersion cooling. Regulation also plays a part in promoting greater efficiency as shown in Germany with the new Energy Efficiency Act in 2023.

'Growth of data leads to growth in power consumption.'

Selective opportunities

For an investor, the obvious questions are what will be required to support this growth, and which particular areas of infrastructure stand to benefit most? In our view, the clearest beneficiary will be data centres with new builds required to support the increased storage and processing capacity needed. Already however, data centre demand is outstripping available capacity creating an interesting opportunity to deploy capital. However, there are key factors potential investors need to be aware of.

When it comes to grid constraints, practical considerations persist which may temper the rate of growth. Prime among these is power consumption. As already highlighted, growth of digital data leads to growth in power consumption. And this is a very real pinch point. Supply-side grid constraints led by data centre growth has already led to moratoriums in cities such as Dublin, Singapore and parts of the US. The IEA estimate data centre power consumption will likely double from 2022 to 2026 – an increase greater than total energy demand in Germany.

The data-driven demand for more power is compounded by an existing lag in new grid investment. In Europe, an estimated €580 billion of grid investment is needed by 2030 to meet EU green goals, in the US this figure is closer to $2 trillion[6]. Highlighting the gap between demand and supply, in the US the average time between a commercial enterprise requesting interconnection to the grid and this being achieved is almost five years (up from less than three years in 2010).

Clearly the demand is there, but the ability for investors to deploy their capital is constrained. This implies market selection and an ability to be an energy solutions provider will be key to successful execution.

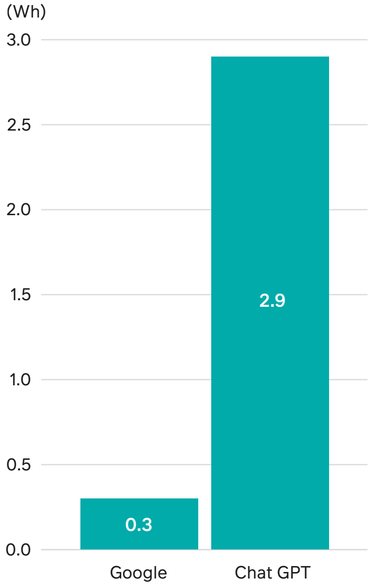
Whilst demand overall for data centres is high, it is less clear that all data centre locations will retain their attractiveness over time. At some stage demand will stabilise with a clear risk that certain assets become 'stranded' as tenant contracts expire. Securing a location able to optimise demand both today but also into the future is crucial. Equally important is not overpaying when speculatively acquiring sites.

The value of a data centre investment depends on the contract which underpins the asset. Understanding where the balance of power lies is important in contract negotiations. On the one hand, data centre operators have pricing power given the development and construction constraints involved in building the asset. However, the most attractive customers are the 'hyperscalers', who clearly have bargaining power due to their scale.

Does skilled labour exist locally to allow the execution of new data centre business plans? In certain markets this is a real issue and can threaten the deliverability of projects.

The supply chain hangover post-COVID persists. The supply chain for essential equipment continues to be disrupted with extended lead times for delivery of critical kit. Whilst normalisation of supply chains and lead times remains a distant prospect, it seems likely that those data centre operators who can order equipment at scale will be preferred by suppliers.

Power consumption per search



Source: IEA, 'Electricity 2024, Analysis and forecast to 2026', (iea.blob.core.windows.net).

[4] Google Data Centres, August 2024.
[5] IEA, 'Electricity 2024, Analysis and forecast to 2026', January 2024.
[6] IEA, 'World Energy Outlook 2022', October 2022.

Overall, it appears we are now in an environment where the spread of investment outcomes across different asset classes is wider than historically has been the case. Selectivity therefore is important – partnering with operators with a demonstrable track record of value-creation, or 'alpha' generation, is imperative. This expertise can be leveraged to fully exploit the two clear investment themes we believe have emerged:

1. Provision of digital capacity, primarily through investment in data centres and adjacent infrastructure.
2. Provision of energy solutions, unlocking capacity constraints and, in the process, decarbonising the energy mix.

In our view, success factors will likely include:

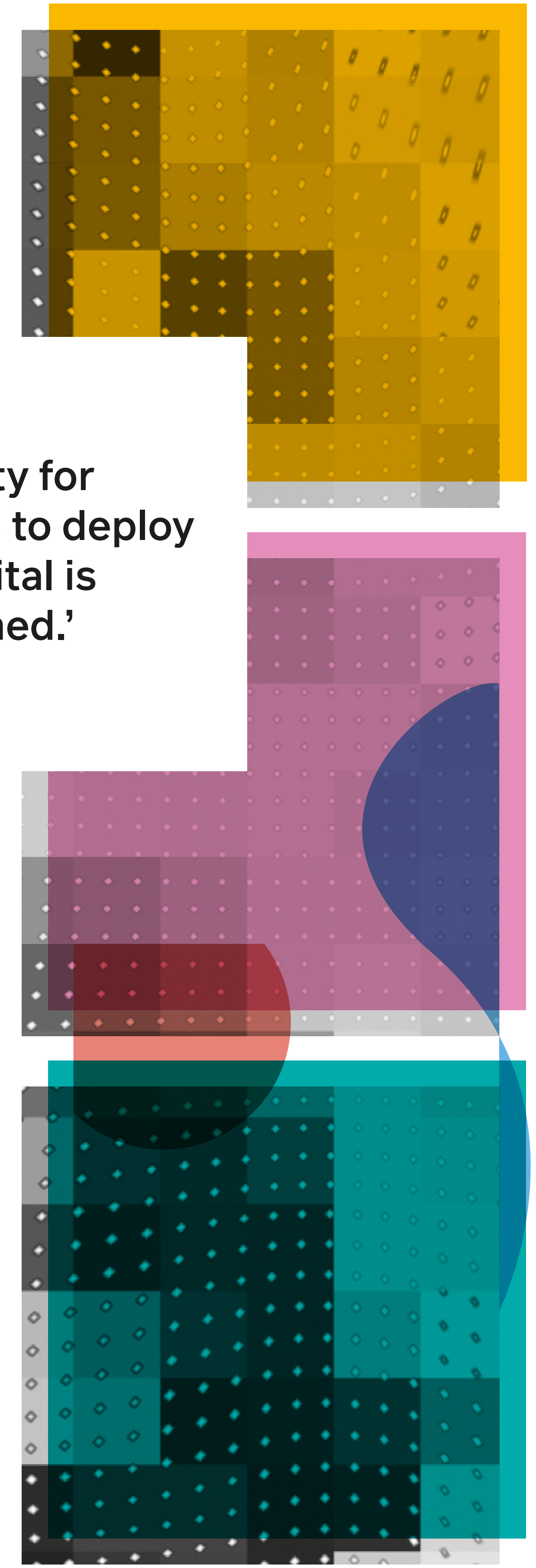
- Partnering with experienced operators, particularly those with relationships with high-quality customers.
- A holistic approach encompassing energy solutions and environmental considerations.
- Focus on newer more efficient data centres likely to retain long-term value.
- Capital protection secured through high-quality contracts.

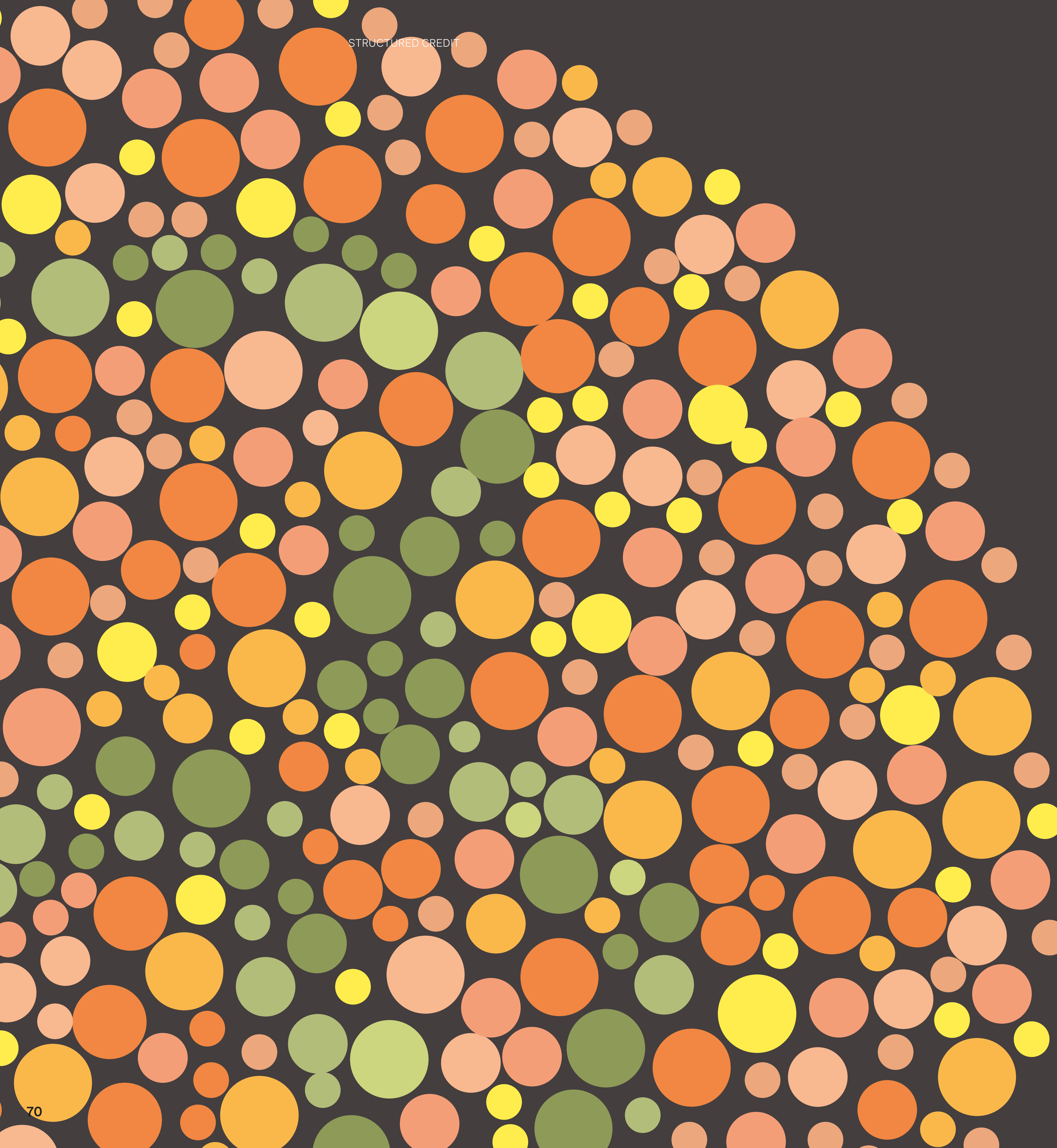
Why private markets?

We believe using private markets to access these growth opportunities should be the preferred route for investors. Public markets usually tend to have a bias against capex strategies and a focus on delivering quarterly earnings and yield. In contrast the 'patient capital' nature of private markets lends itself to this once in a generation opportunity.

There has also been a 'take-private' trend within the data centre market – this is not a coincidence with many of these larger operators destined to become the preferred partners with hyperscalers looking to quickly add more capacity. Many of these larger players are backed by large infrastructure funds with substantial amounts of fresh capital available to fund construction of these new sites. In our view, this presents a compelling long-term opportunity for private market investors. □

'The ability for investors to deploy their capital is constrained.'





STRUCTURED CREDIT

Demystifying the world of structured credit

As an asset class, Structured Credit has been around for decades. However, despite not being new, many investors remain slightly mystified by it and the role(s) it could play in their portfolios, being labelled as overly complex or an investment area reserved largely for highly experienced investors. Despite the perception, structured credit in fact is very straightforward with a focus on loan and credit products that help provide an integral source of funding for the real economy.

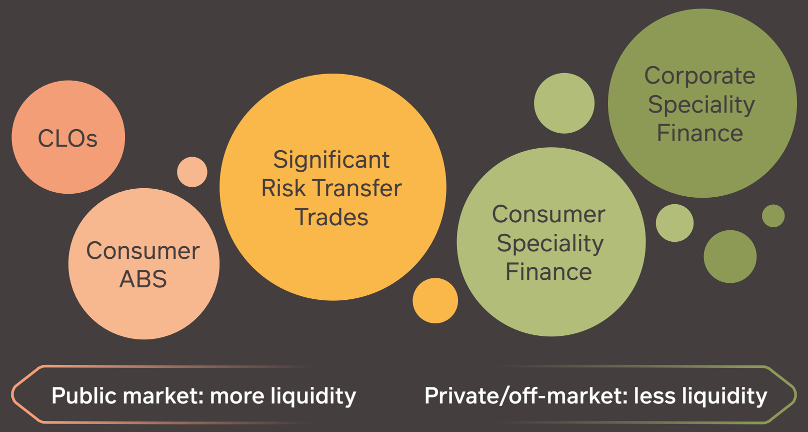
Following the Global Financial Crisis (GFC), the asset class has evolved to offer exposure to a broader array of investment opportunities as issuers have increasingly moved to use structured credit not only as a funding tool but as a capital management tool amid the stronger regulatory requirements that have been brought into place, particularly in Europe. Today greater opportunities are available to match the risk/return profile of a broad range of investors. Here, Jo Tomkins explores what's driving the growth in this investment area and why Structured Credit can play an important role within a diversified Fixed Income portfolio.

Less complex than you think

Structured credit opportunities can be accessed through public and private markets and, as such, the asset class does not fit neatly into a 'defined' box. Regardless of the route of access, at heart it is simply taking cashflows from a range of real economy lending and credit assets – think interest and principal payments on mortgages, car loans and leases, credit cards, commercial loans etc – and packaging these cashflows into marketable securities that investors can buy, potentially providing them with steady income streams which are often contractual in nature. These asset-backed securities (ABS), together with collateralised loan obligations (CLOs), significant risk transfer (SRT) and Specialty Finance transactions, form the wider structured credit universe.

The attractions of the asset class remain as compelling as ever.

The structured credit investment universe



Source: M&G Investments, May 2024.

An expanding asset class

Outstanding volumes of ABS and CLO issuance have grown in recent years, while tighter capital and regulatory constraints placed on retail banks in the wake of the GFC have given rise to new opportunities for external investors to gain access to the core parts of banks' lending books as banks have reassessed the lending segments they were prepared to commit their capital to. They either withdrew from or reduced exposure to several credit areas creating a gap which private, non-bank lenders eagerly stepped in to fill. Hence the steady rise of private structured credit markets post-GFC.

For investors this means there is now a broader spectrum and a greater capacity, of addressable opportunities within structured credit for them to invest in. We see growth only set to continue from here given the acceleration of the megatrends underlying the growth and expansion of this asset class. And, in our view, the attractions of structured credit remain as compelling as ever. It can potentially provide investors with higher risk-adjusted returns relative to other similar rated fixed income alternatives. For those looking for diversification, the ability to access differentiated asset exposures not normally found within traditional fixed income portfolios and potential returns that are largely uncorrelated with other established asset classes can prove useful during periods of broader market volatility. In fact, the asset class can offer a comprehensive set of attractions which investors may wish to consider.

A range of compelling attributes?

The benefits to investors considering an allocation to structured credit fall mainly into the categories of returns, diversification, losses and structural protections:

Returns: Potentially greater return potential – both absolute, and relative to other fixed income and credit asset classes together with a more muted volatility profile. This return or yield premium is typically due to the (perceived) complexity of investments and reduced liquidity, although the European ABS market has proved to be consistently more liquid than many had presumed.

Diversification: Structured credit products are inherently diversified as they usually comprise hundreds or even thousands of individual consumer or commercial loans. As a result, there is a wide spread of individual borrowers, across loan types and geographies, leading to cashflow sources being highly diversified and granular.

Harnessing a range of compelling attributes

Resilient collateral performance
Historically low delinquency and default rates even through the GFC and pandemic. Benefits from even stricter loan underwriting standards post-GFC.

Typically high absolute returns
Short dated, income-driven returns with low duration. Junior/mezz tranches are high cashflowing and generate low / mid-teen IRRs.

Highly scalable asset classes
A substantial and diverse market globally with multi-year structural drivers at the core of the diverse and varied asset opportunity.

Typically attractive relative returns
Higher risk-adjusted returns vs. other credit asset classes, often with a more muted volatility profile. Return premiums due to (perceived or actual) complexity and limited competition for assets.

Asset diversification benefits
Exposure to harder-to-access core bank lending assets. Focus on granular and diversified risk eg, by loan type, geography and number of borrowers.

Diversifying asset allocations
Loans to consumers and non-corporate collateral types, providing diversification for most investors' fixed income and private credit portfolios.

Source: M&G. IRR examples are for illustrative purposes only and not a guarantee of future returns.

Losses: European structured credit markets today are more transparent thanks to the efforts by regulators and the ECB to ensure a high degree of loan-level information in each transaction. This allows investors to analyse the transaction before buying to ensure adequate compensation for the risk, and to ensure sufficient downside protection. Historically low loss rates for structured credit asset classes in Europe including ABS and CLOs, particularly relative to the experience of US equivalents, are also a factor of robust loan underwriting standards post-GFC.

Structural protections: Key structural features are typically built into transactions helping to cushion investors against potential losses while investments can provide recourse to the borrower as well as the asset. Structured credit securities or notes are normally sold as 'tranches' – securities sold in different categories according to the position in the capital structure: senior, mezzanine, junior and residual with the bonds backed by the cashflows from the asset pool and bankruptcy remote from the bank or lender. Each tranche category has a different risk/return profile together with a different credit rating assigned, with investors able to choose which one best serves their investment needs and matches their risk appetite. Further buffer exists as more often the underlying pool of loans has more assets than liabilities ie they are over-collateralised. In addition, often the interest received on the pool of loans is greater than the liabilities.

There's always risk...

Of course, structured credit will not be the correct route for everyone, and risks exist as with any asset class. There's no escaping the fact that some structured credit products ie, those with exposure to the more illiquid assets comprising the investment universe, can offer limited or no liquidity to investors. For some investors this may be a major hurdle. Thankfully products exist today offering both daily and monthly liquidity.

Structured credit is also not immune to changes in interest rates. Floating-rate in nature, they are attractive when interest rates are rising, increasing interest income. But of course, income receipts can equally decline when rates start to fall.

As with all credit investments, there remains the risk of defaults turning into actual losses for the investor should borrowers default on their debt payments en masse and the assets underpinning the loans become impaired.

While there is a degree of complexity relating to the construction of a structured credit security, most often the nature of the underlying income-producing assets are not. We believe the potential to capture higher risk-adjusted returns, irrespective of market conditions, together with its clear portfolio diversification benefits merits structured credit being a prime consideration for fixed income investors looking to add another dimension to their portfolios. □

Written, curated and designed in-house by M&G Investments.

We dedicate this issue in loving memory of our dear colleague, Jessie Sahota.

For Investment Professionals only.

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