For Investment Professional only

The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested. Past performance is not a guide to future performance.

Quarterly Outlook – Q4 2022

Are we there yet?

- We are getting closer, but we are not quite there yet.
- As growth slows, we could increasingly see competing fiscal and monetary policies.
- We anticipate continued central bank hawkishness into year end as markets look for hints of a change in tack.
- For long-term investors, who don't mind seeing their portfolios fluctuate in the medium term, this is as good a time as any other to add to liquid risk assets.
- For the near term, we expect rangebound markets, with the breadth of this range being driven by newsflow.
- Consensus corporate earnings forecasts have come down, but likely not enough.
- As volatility stays elevated, we see some compelling investment opportunities, but selectivity and diversification remain key.

Markets are being influenced by a multitude of factors and companies remain affected in very disparate ways. In the near term, we see markets remaining volatile and range bound, with the breadth of this range being driven by newsflow. They will also likely remain very sensitive to any news that hints at a change in tack by central banks. In the corporate sector, consensus earnings revisions have come down, but likely not enough. However, corporates in general are in better shape than they were going into the Global Financial Crisis (GFC), and the indiscriminate market sell off is providing attractive opportunities on a selective basis.

Quarterly Outlook – Q4
October 2022

M&G Equities & Multi Asset

I often remind my team that one of the strongest traits of an investor is resiliency. You never know what the market will throw at you, and weathering volatility without panicking and keeping the rudder steady is key. The last few days of the third quarter was one of those times that required a steady hand, as we experienced extreme and historical price moves in the UK government bond market, which had a short-term ripple effect on other assets. The expansionary fiscal policy introduced by the newly appointed leadership in the UK government prompted forced selling of gilts by UK pension funds with liability-driven strategies. The move resulted in an increase of gilt yields (by more than 150 basis points across the curve) in only a few days, and sent sterling into a tail spin.

What happened in the UK has made markets aware that a persisting war in Ukraine, rising inflation and hawkish central banks are not the only cards being dealt at the table of uncertainty. There is a higher likelihood of governments around the world starting to implement fiscally expansionary policies to counteract the decline in growth and the discontent across their constituencies. As is likely to happen in the UK, we could end up with the paradox of central banks raising rates and implementing quantitative tightening to offset fiscal policy initiatives implemented by their own governments to foster growth. This is not a good recipe for fiscal health and currency stability, as the UK has reminded us.

The uncertainty ahead is likely to bring continued volatility in both equities and fixed income markets into year end. Certainly, valuations across both asset classes appear compelling. In equities, the main equity indices are almost back to their lows for the year, and in many areas, corporate bond valuations look equally compelling, according to my fixed income colleagues.

It has been well flagged that the profits expectations that feed into equity and credit valuations are at odds with increasing expectations for the growth slowdown ahead. Consensus earnings forecasts have come down, but likely not enough. A number of companies have been guiding profits lower during the latter part of the third quarter on both sides of the Atlantic, including FedEx, Nike, Next and semiconductor companies exposed to the consumer market. Other corporates, while not warning, have started tightening belts, starting with jobs freezes.

So, we have poor macroeconomic and microeconomic data confirming investors fears and extremely bearish sentiment across public markets. The question to ask is: ‘’Are we there yet’’? Are valuations discounting all the expected ills?

The answer depends on investment horizons and the willingness to deal with increased volatility in the near term. For long-term investors, who don’t mind seeing their portfolios fluctuate in the medium term, this is a good time as any other to add to liquid risk assets.

Over the shorter term (going into year end), we see markets remaining volatile and range bound, with the breadth of this range being driven by newsflow. We have learned that, at times like these, when sentiment is extensively negative and the market converges toward the same cautious positioning, any positive news can generate a rebound. We find it difficult, however, to see any positive trigger ahead that could carry the market for a protracted rally (say beyond the summer highs). Such triggers would include, for example, a resolution to the war in Ukraine and a lifting of sanctions, a significant drop in inflation, and/or a U-turn from central banks. None of these appear a near-term likelihood.

We expect central banks to continue to raise rates. They have a window of opportunity while employment data remains relatively resilient and fighting inflation is a priority. That said, Central Banks remain data driven. Hence, markets will be very sensitive to any news that hints to a change of tack.

It is also difficult to see a protracted fall from this point. Note, the key word here is ‘protracted’. In markets that are this jittery, any negative news can trigger a leg down but, for a protracted fall, we would need a credit crisis like the one we saw in 2008. However, as my team reminds me, corporate balance sheets now are generally a lot stronger than they were in the Global Financial Crisis (GFC), and the capital adequacy of the banking sector is in much better shape. While this is true particularly across developed markets, there have been clear improvements also in many of the larger and most stable emerging markets. In Asia, for example, our investment team points out that most regional corporates do not appear to be running significant currency mismatches between their revenue and debt and are, thus, not vulnerable to US dollar strength in the same way as they were in 1997 and 1998.

As we have said in the past, a market where the next news and the next data point remain uncertain, is not an environment for 'broad strokes investing' – that is, generalised macro-driven sector, style or country calls. Markets are being influenced by a multitude of factors and companies remain affected in very disparate ways. Even within the same sector, companies are faring very differently based on tilts in exposure, balance sheet solidity, and pricing power. This remains a market in which to seek selective opportunities as the baby gets thrown out with the bathwater and look for companies with solid fundamentals as they are sold off in the market frenzy.

Looking at positioning in our portfolios, across our multi asset strategies we remain underweight duration, but have moved closer to neutral by taking advantage of the recent yield rises. The underweight is centered at the short end of the yield curve, while we are more constructive at the long end. We remain neutral in equities overall, and we continue to hold higher cash balances to take advantage of opportunities arising from market volatility across asset classes. We have traded tactically around what we see as behavioural episodes in markets, such as the volatility of UK gilts at the end of the third quarter.

Within equities, recent market volatility and subsequent share price dislocations continue to provide us with significant stock-specific opportunities, where the level of price action is unwarranted given the underlying fundamentals. One area that we continue to like is technology. We prefer companies exposed to enterprise IT, cloud and data. We are less constructive on consumer-related technology where we are seeing increasing signs of weakness. More deeply cyclical sectors are also starting to show some selective opportunities, for example chemicals.

At a country level, we find selective opportunities across all markets but some compelling ones are to be found in Japan, where corporate reform and restructuring has continued to gather pace during the last quarter. In the UK, while we are cautious on the macro backdrop, some of the large-cap equities are offering particularly good value with the silver lining of large revenue exposures to international markets, where a weaker sterling boosts translated revenues.

One interesting change during the last quarter has happened in the convertibles space, as our Portfolio Manager Leonard Vinville explains. Convertibles traditionally outperform their underlying equity stocks in a bear market phase. However, in the third quarter, the convertible 'convexity' (ie, participating more when the underlying equity price rises than when it falls) has improved, creating some value opportunities in the higher-yielding areas of the universe that trade near or below their bond floor value (the bond floor is the value of a convertible as a fixed interest instrument – in other words, the present value of the coupon payments and redemption at maturity).

Last but not least, we continue to like longer-term themes such as renewables (along with suppliers as well as users of low-carbon technology) and infrastructure (inflation-linked, higher and growing dividends, which counteract inflation), as these are areas where capital expenditure will continue to rise independent of the prevailing market conditions. Many areas in climate-related investments have underperformed their carbon-intensive peers this year. However, the need to diversify energy sources from a strategic viewpoint, besides climate considerations, remains a priority and is shown by recent government policies such as the Inflation Reduction Act in the US, which became law in August and offers incentives for the adoption and expansion of renewable energy.

As we continue to remind ourselves and our clients, there are a number of good return opportunities in markets, but selectivity and diversification remain key.

In the following pages, you will find views from our M&G Multi Asset and Equities investment desks, offering more colour at a regional or thematic level. We wish you an enjoyable and – hopefully – interesting read.

Fabiana Fedeli
Chief Investment Officer, Equities & Multi Asset

Fabiana Fedeli

Chief Investment Officer
Equities & Multi Asset

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Multi Asset

Maria Municchi
Sustainable Multi Asset Portfolio Manager

Rolling into autumn with an active asset allocation approach

Valuation and market psychology

We have come a long way from the market complacency at the start of the year; today the potential downside risks to economies and asset prices are well established. Longer-dated government bonds in developed economies are at yields that (with hindsight) would have been considered attractive for much of the 2010s. Equity and credit markets generally offer levels of compensation for growth risk that are relatively elevated, though not at levels we saw in periods of extreme panic such as the end of 2018 or in early 2020.

However, such valuation signals are always conditional on their underlying assumptions and there is reason to suggest that implicit assumptions today are more than usually vulnerable. The policy and societal backdrop derived from the pandemic years is very different to that which prevailed in the 2010s, and the profits expectations that feed into equity and credit valuations are at odds with increasing expectations for a material growth slowdown to come. Moreover, the interplay of monetary and fiscal policies across the globe provides an additional element of uncertainty, as recent events in the UK would suggest.

Therefore, our long-only multi asset funds are positioned for the fourth quarter of the year with a neutral exposure to equities (with a preference for Europe versus the US) and underweight in fixed income, where we continue to favour the long end of the curve.

Sustainability

The underperformance of sustainable investments versus other areas over the last year has driven investors' sentiment (and valuations) lower at a time when the world's renewed focus on energy security should, ultimately, be good news for sustainably-focused companies and investors over the long term.

Technological advancements, a lower cost base and the ease of installation, compared to nuclear and traditional carbon-intensive sources, might continue to accelerate renewable energy adoption across different countries and regions moving forward. This trend is also supported by robust government policies like the Inflation Reduction Act in the US, which became law in August and brought about numerous incentives for the adoption and expansion of renewable energy.

Over the long term, current valuations of sustainable investments might represent a good entry point to benefit from some of the multi-year trends linked to the energy transition and are, therefore, an interesting part of our portfolios' investment selection.

Navigating market moves

It remains an environment in which *selectivity*, *tactical responses* (to opportunities created by near-term volatility), and appropriate uses of *higher cash* holdings (or short positions where possible) are likely to be extremely important to the delivery of investment returns.

This was particularly true in the last weeks of the third quarter, when we experienced extreme and historical price moves in the UK government bond market. The recent (fiscally expansive) budget, announced by the newly-led Tory government, triggered a sell-off that increased gilt yields across the curve by more than 150 bps in only a few days.

The rapidity of the price move, together with the market focusing on the fiscal policy package (and largely ignoring the deteriorating economic data or potential impact on the housing market and pensions system), felt inconsistent with fundamentals. Historically, in developed markets, there is very little relationship between balance-sheet health and government yield as this is mainly reflected in the currency, which arguably, had already deteriorated.

This represented an interesting tactical opportunity to deploy readily available cash across our long-only multi asset portfolios. While volatility continues to characterise the UK gilt market, following the Bank of England intervention on 28 September, yields rapidly retraced to significantly lower levels, providing us with an opportunity to close this tactical trade after only a few days.

The more attractive valuations and growing negativity mentioned above have not, so far, been accompanied by the extreme panic that characterises some of the most fruitful opportunities for long-term investors, but there have been signs of intensifying stress in recent weeks. An ability to respond to such stresses will continue to be key to generating returns.

Global

Daniel White
Head of Global Equities

Down in Memphis

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know".
John Kenneth Galbraith

The main equity indices have all fallen dramatically during 2022 and, in a number of instances, are back close to their lows for the year.

The continued sell-off has largely been driven by a number of macroeconomic factors. Most recently, the 'Fed pivot' narrative has imploded. Peak inflation has failed to materialise. Recession and stagflation fears have been resurrected.

Despite all the top-down pessimism, bottom-up earnings forecasts (that is, what market analysts expect underlying companies to generate in terms of future profits) have largely continued to improve and increase.

Whilst it is not usual for earnings forecasts to lag share prices, they are essentially two sides of the same coin. It would be almost impossible for them to move in opposite directions indefinitely. At some point one (or both) has to catch up with reality.

This brings us to a recent announcement from the US company FedEx (headquartered in Memphis, Tennessee).

The company shocked the market recently by announcing that its quarterly profits would be over 30% lower than anticipated. FedEX blamed deteriorating global 'macroeconomic trends' that 'significantly worsened later in the quarter'[1].

As one of the largest global couriers, freight and logistics providers, FedEx handles around 16.5 million packages a day, operates in over 220 countries and connects approximately 99% of global GDP[2]. The company is rightly seen as an economic bellwether.

If – as the FedEx profit warning suggests – the global economy is worsening, then overall earnings forecasts are likely too high and not a reliable gauge.

But what does this mean for investors? Do they wait for the inevitable earnings cuts? Or have share prices and indices already reached a level at where 'bad news is priced in'?

These are complex questions with no single or simple answer.

One solution is to instead focus on valuation metrics that are less reliant on near-term future expectations. Book values and dividends can be particularly helpful in this regard.

Using this framework, we see value in sectors like chemicals (trading at, or below, book values and offering high single-digit dividend yields), parts of the semiconductor supply chain (highly-cash generative with growing dividends) and pharmaceuticals (also highly-cash generative with attractive dividends).

And, as my colleagues note elsewhere in this update, corporate balance sheets are generally a lot stronger than they were in the Global Financial Crisis (GFC). The chance of permanent capital loss is significantly lower than it was then.

Another solution to the earnings forecast issue, is to invest in themes or trends that can better withstand (or are less susceptible to) economic shocks and slowdowns. Infrastructure and the low-carbon ecosystem – as highlighted previously by CIO Fabiana Fedeli – very much fit within this category.

The near-term macroeconomic environment looks to be more challenging and more uncertain. But this uncertainty is beginning to create opportunities. Even in a downturn scenario, the long term risk/reward for certain parts of the market appears attractive.

[1] https://investors.fedex.com/news-and-events/investor-news/investor-news-details/2022/FedEx-Reports-Preliminary-First-Quarter-Financial-Results-and-Provides-Update-on-Outlook/default.aspx

[2] https://www.fedex.com/en-us/about/company-structure.html

Impact

Don’t disagree with a market that hasn’t made up its mind

Trying to figure out what the stockmarket will do in the short term is always an extraordinarily difficult exercise. Right now, probably even more than usual. A global recession seems more likely, not favouring risky assets – including equities. However, the combination of roaring inflation, rising interest rates, cash carrying a very expensive negative real yield and liquidity concerns in alternatives, makes equities look more attractive by comparison.

Fortunately, when managing equity strategies our job is not necessarily to predict the direction of the market. We are generally fully invested in stocks, manage portfolio risk, and then focus on finding longer-term opportunities in our markets.

There are several good arguments for staying invested in equities, but also for keeping a balanced portfolio.

Making the right call on the economic backdrop when investing in equities can, at times, be very rewarding – when it’s the right call. There’s currently a tug-of-war in the market between traditional ‘value’ (low P/E but volatile earnings) and ‘quality growth’ (higher P/E but more stable earnings growth).

Rising inflation will typically hand the advantage to value over quality growth, but when rapidly rising prices create demand destruction, then the pendulum tends to swing back towards stable companies with pricing power. Stock prices of unprofitable growth companies are likely to remain challenged for a while, but the re-rating has already been brutal.

We are maintaining a balanced approach and are poised to take advantage of the indiscriminate share price action if fear spreads in markets. We continue to favour robust companies – which are often supported by decade-long growth trends – that are able to weather the near-term volatility, and that we can feel comfortable holding through economic cycles.

Staying invested, balanced and prepared when the market offers some clearer, longer-term relative opportunities, like it typically does in panic sell-offs or periods of exuberance, might appear boring for active managers but it looks like a sensible option right now. Disagreeing with the market makes more sense when the market has made up its mind.

UK

Michael Stiasny
Head of UK Equities

Silver linings despite weakness

The UK market showed relative resilience over most of the third quarter, before falling away in the wake of the new Chancellor's 'mini-budget' at the end of September. Many of the major constituents of the FTSE 100 Index benefited from the ongoing themes of sterling weakness, elevated commodity prices and rising interest rates.

By contrast, the more domestically-focused FTSE 250 Index performed poorly, weighed down by recessionary fears, with the only relief provided by consistent takeover interest for a number of the mid-cap stocks.

Looking ahead, it is difficult to see why this narrative will change soon: interest rates continue to rise and recessionary fears continue to deepen. On top of this, the recent 'mini-budget' has heightened market fears around fiscal management of the economy, leading to falls in sterling and the gilt market. This has led to significant share price corrections.

Despite this backdrop, corporate balance sheets are generally stronger than they were pre-pandemic, the UK Government has intervened to help mitigate the impact of rising energy costs and the FTSE All-Share Index derives the majority of its revenues from outside the UK. All of these factors may curtail relative downside from the UK market.

As we think about the shape of any forthcoming downturn, comparisons with the Global Financial Crisis (GFC) are often made.

As already mentioned, corporate balance sheets are now stronger and we would contend that the impact on the UK market will be quite different this time. In particular, two of the largest UK sectors look very different today versus 15 years ago.

Chart 1: Core tier 1 capital ratios. More resilient today

Source: Numis, PRA regulatory returns, 2022. Aggregate CET1 capital ratio of major UK banks

The banks are fundamentally recapitalised and if we look at Chart 1 we can see a marked difference in Tier 1 capital ratios compared to 2007, pre-GFC.

The same is also true of the miners which carried much higher levels of debt than they do today.

We can already see from the reaction to the 'mini-budget' that the focus is on the government balance sheet and the extent to which sterling will continue its recent slide. The much higher levels of UK government debt-to-GBP, currently sitting at around 95%[3], is unlikely to change in the short term given the cap announced on energy prices and the tax concessions revealed by the Chancellor.

In aggregate, the UK market is long the dollar, given the disproportionate weighting of oil companies, miners, pharmaceutical companies and tobacco stocks in the index. We expect these sectors, along with the banks, to pay just over 50% of all UK dividends in 2023, which provides support for the overall market yield forecast of around 4%, even before any ongoing benefits from sterling depreciation. So, even though the UK economy may suffer a recession we don't anticipate the impact on the UK market being as severe as during the GFC.

Finally, weak sterling also supports inbound M&A so we would expect to see ongoing takeover activity in the mid-cap stocks and, if sterling weakness continues, probably in the FTSE 100 Index as well. We are likely to continue to be unwilling sellers as valuations are already distressed and we are reluctant to give away valuable businesses even if there are short-term economic headwinds.

[3] Source: DataStream, UK ONS, 2022

Emerging Markets

Michael Bourke
Head of Emerging Market Equities

Brazil in focus

Equities are currently caught in a perfect macroeconomic storm, buffeted by soaring inflation and rate tightening, which is slowing global demand dramatically. What happened to 'The Roaring 20s' expected post COVID? In a word, Russia.

But the picture is more complex than that. Central banks (with hindsight) over-stimulated during the pandemic. They have subsequently been slow to react to inflationary pressures shifting from supply concerns to wage pressures, have not withdrawn that liquidity, and have thus been forced into seemingly panicky rate hikes.

From our perspective, bright spots are potentially lost amidst all of the noise. While many emerging markets are hostages to the fortunes of global demand (eg, Korea and Taiwan, given their large dominant export bases), other emerging market (EM) countries are more closed and/or commodity-linked so are feeling the siege less keenly. Countries like Indonesia and South Africa have been resilient and, regionally, LatAm looks very interesting.

Rates: remember those? Markets have seemingly forgotten what higher interest rates are and how they affect companies differently. Banks have been out of favour for so long that many investors started the year blithely underweight. Yet banks continue to outperform other sectors in the EM year-to-date. A slowdown, as opposed to a deep recession, is not a bad environment for banks – they enjoy the upside in terms of higher margins due to the sluggish pass through to funding and more accelerated repricing of loan books, without worrying unduly about asset quality risk. The exception to this is China, where investors continue to fear the implications of the Zero-COVID policy and a potential property crisis.

Just as the market has become accustomed to fearing inflation again, up pops China with a reminder of why global inflation has been so low for the last two decades. As policymakers allow the renminbi to weaken, and Asian currency peers have been sliding relative to US dollar strength, China continues to deflate.

De-globalisation, near-shoring, regionalisation are much-discussed but extremely difficult to pin down. We see it happening in EM but plants and equipment, unlike markets, cannot move so quickly. We see, for example, Foxconn build in India to satisfy local demand and Samsung doing similar projects in Vietnam. We do think this trend is real with ASEAN/India likely to benefit and Mexico another big winner given US near-shoring.

While our focus is on employing a consistent bottom-up stockpicking process, we have been keeping an eye on Brazil's presidential elections. Should markets fear the second coming of Lula? An extremely close first round, saw former president Lula (who spent time in prison on corruption charges) just ahead of his rival, incumbent president Jair Bolsonaro, as both advance to a second round of voting scheduled for late October. Yet markets in Brazil remain calm – the Bovespa is one of the standout performers in global equity markets with the strong Real adding to foreign investors' dollar returns. Unless we see a narrow outcome which might inspire Trump-like claims of fraud by the Bolsonaro camp, we think the market is right not to worry unduly.

We note that Lula is said to favour respected former Sao Paolo Governor Gerardo Alckmin as his economics minister, which would reassure markets that he is not going to suddenly abandon fiscal discipline. Brazil's long-term debt sustainability remains full of danger and the country needs growth. At least in the short-term, the current account deficit is stable, assets are cheap, and the central bank has ensured stability in a world of higher rates by pushing real rates to among the highest in the EM. Indeed, we think the market is beginning to look forward to the end of rate hikes by the Fed with the likely results that Brazil may be the first EM central bank to begin cutting rates, perhaps as soon as next year.

Asia Pacific

Dave Perrett
Co-Head of Asia Pacific Equities

Pockets of attractive valuation

The third quarter of 2022 was characterised by ongoing volatility within regional markets. Ebbing and rising global interest rate expectations, US dollar strength, worries about weakening technology demand, European war, weak Chinese growth and Taiwan Strait tensions are just some of the key developments that impacted Asian markets during the quarter. Markets most exposed to these trends were weakest, with China and Hong Kong markets falling nearly 20% in US dollar terms, while Korea and Taiwan fell a little less than 10%. In contrast, India, which is seen as a more domestically-driven market, and thus something of a safe haven, rose almost 10%.

Through 2022, the narrative around global growth has transitioned from growth, to muddle through, to now an expected material recession in global activity. As bottom-up stock pickers we have little insightful to say about future economic outcomes.

Where we can add value is to look at valuation, underlying stock fundamentals and add some perspective on how these variables stack up compared to previous periods of economic dislocation. We are fortunate to have team members who were actively investing during both the Asian Financial Crisis in the late 1990s, as well as the more recent Global Financial Crisis (GFC).

Asia ex-Japan's financial system remains dominated by banks for its credit needs and so is a good place to start to compare relative health in a historical context. Analysing the five largest individual banks in China, Korea, Singapore, Thailand and India, the first thing to note is that loan growth in the three years leading up to mid-2022 has been between a half to two-thirds of that leading up to mid-2008. In essence, banks came into this downturn on a more cautious footing.

On other measures such as bad debt provisioning and shareholding equity-to-loans, banks are generally in a much, much stronger position. Importantly, all of the five banks are trading at valuation discounts to where they were going into the GFC, in most cases materially so.

This valuation discount also applies to non-financial companies. With the exception of specific industries in some parts of technology and climate-related industries, companies have been very cautious in expanding capacity given geo-political and COVID-related uncertainties. In addition, most regional corporates do not appear to be running significant currency mismatches between their revenue and debt and are, thus, not vulnerable to dollar strength in the same way as they were in 1997 and 1998.

Despite this relatively-strong position, there are pockets of valuation that are more distressed than in the depths of the GFC, particularly in Chinese markets.

Indeed, there are a number of profitable companies trading below the valuation of the cash on their balance sheets. Mid-to-high single digit dividend yields are commonplace.

Overall, there are many factors weighing on sentiment and the outlook feels, potentially, very bleak. Our perspective is that such a poor outlook has been increasingly discounted by many regional markets, evidenced by pockets of very attractive levels of valuation at a time of historically strong bottom-up corporate and financial fundamentals.

As a result, the asymmetry around prospective returns feels increasingly attractive for long-term investors.

Japan

Carl Vine
Co-Head of Asia Pacific Equities

Micro-driven stock opportunities

As referenced elsewhere in this note, macroeconomic and geo-political gyrations during the third quarter provided significant headwinds for capital markets. In this context, and along with other equity markets globally, Japanese equities lost ground. Whilst a ca 2% fall in local currency terms over the quarter looks relatively modest in a global context, this of course ignores the elephant in room, the yen. Thanks to a 10% fall in the value of the yen versus the dollar in the quarter, in USD terms, Japanese equities fell nearly 8%[4]. By the end of 3Q 2022, the yen had lost 20% of its value versus the dollar year to date and is down nearly 30% since the start of 2021.

Given that the notable divergence between US and Japanese central bank policy seems to have driven this JPY depreciation, it is notable that during the quarter two Bank of Japan board members were changed, with the incoming members decidedly more hawkish than the their predecessors.

Japanese equities at the end of September, looked at in USD terms, were close to the lows of the March 2020 COVID crash. Outside of that, we have to go back to 2016 to find the same USD market cap for the Topix Index, a time when stockmarket earnings were approximately 30% lower than today. With many Japanese companies having significant US and global sources of earnings, the USD value of the Japanese stockmarket now looks notably attractive.

Meanwhile, whilst the macroeconomic environment remains troublesome, the microeconomic environment in Japan continues to improve. The corporate reform topic, that we talk so frequently about, gathered several new supporting datapoints in the quarter. Restructurings, M&A and ESG improvements all continued to gather pace. We continue to believe this is a self-sustaining and structural trend that will deliver meaningful profit margin and return-on-equity (ROE) improvements in the years to come. Given our excitement about the micro-driven stockpicking opportunity set in Japan, we continue to build our portfolios around esoteric, single-company risk whilst simultaneously looking to take as little macro and factor risk as possible.

[4] Source: Bloomberg, TOPIX Index Price returns 30 June 2022 to 30 September 2022.

Convertibles

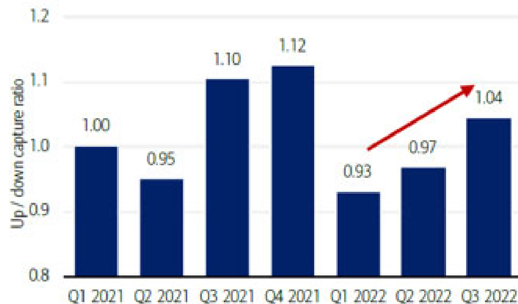
Leonard Vinville
Head of Convertibles

Convertible convexity

The quarter just ended has been volatile; with rates going up, the crossover spread finishing at levels similar to early July, having tightened materially until mid-July, and equity markets erasing earlier gains to fall for the third successive quarter. Convertible bonds, while reflecting the weakness of equity markets, did not fall to the same extent.

Chart 1: US convertible bonds vs underlying stock average up/down capture ratio

Past performance is not a guide to future performance



Source: BoA Global Research, ICE data indices, LLC data, as at 26 Sept 2022.

This 'convexity' (participating more when the underlying equity price rises than when it falls) is one of the most important characteristics of convertibles. Given the high degree of uncertainty in the markets at the moment, the asymmetric nature of returns available from convertibles could, in our opinion, make having some exposure to this area of the market particularly worthwhile.

While convertibles traditionally outperform their underlying equity stocks in a bear market phase, it is interesting to see that convertible convexity has improved in the second-half of the year to date. If we look at the US convertible bond market only as a reference, the US convertible bond Sharpe ratio since early July is the best on a cross-asset basis in contrast to the first half when convertible bonds underperformed equities. This underperformance was due to the widening of credit spreads and falling equity prices, as well as the sectoral composition of the convertibles market. With its high representation of technology and growth-orientated stocks, the convertibles market suffered relative to the broad market in the earlier parts of the year. These sectors now seem to have found some stability.

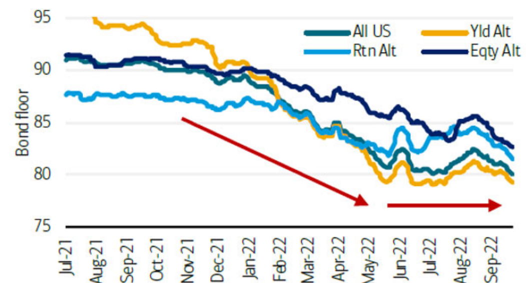
The convertibles that have exhibited the highest levels of convexity recently have been the higher-yielding areas of the universe that trade near or below their bond floor value (the bond floor is the value of a convertible as a fixed interest instrument ie, the present value of the coupon payments and redemption at maturity.) While this area of the market has a reduced sensitivity to changes in the underlying equity price (a low delta), we believe these low delta names offer value as they are trading at a very large implied credit spread.

As shown in Chart 2, the convexity of the yield alternative area of the convertibles market has improved over the past quarter and, compared to the earlier part of the year, these 'busted' convertibles have proved much more resilient in recent months.

Obviously, more spread widening could occur in a scenario of severe recession, hence stockpicking remains key, especially for busted convertibles, where investors have to be as confident as possible that the bond floors will hold.

Chart 2: Convertible bond floors by delta bucket

Past performance is not a guide to future performance



Source: BoA Global Research, ICE data indices, LLC data, as at 26 Sept 2022.

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