High yield floating rate note (HY FRN) outlook

M&G Global Floating Rate High Yield Fund

M&G Wholesale Public Fixed Income team

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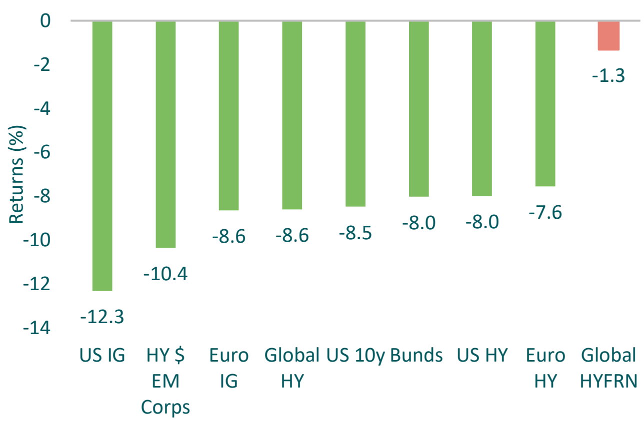
- High yield floating rate notes (HY FRNs) have significantly outperformed fixed rate bonds during the monetary policy tightening cycle, thanks in no small part to their low duration risks.
- We believe the investment environment remains favourable to the asset class, given we are still in the early stages of the central bank rate hiking cycle and future rate rises are yet to feed into HY FRN coupons.
- Credit spreads are wider than their long-term average, with downside scenarios already priced in. We believe this presents some attractive potential opportunities, particularly given the additional security of senior-secured debt.

The value of investments will fluctuate, which will cause prices to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the original amount you invested. Where performance is mentioned, past performance is not a guide to future performance.

HY FRNs continue to outperform

While 2022 has been brutal so far for many fixed income assets, floating rate bonds have held up well, thanks in no small part to their variable coupons, which move in line with cash reference rates. As Figure 1 shows, HY FRNs have posted slightly negative year-to-date (YTD) returns due to credit spreads widening; however, their lack of duration risk (sensitivity to changes in interest rates) has resulted in significant overall outperformance.

Figure 1. Fixed income assets, returns (%), 2022 YTD



Past performance is not a guide to future performance.

Source: ICE Bank of America Indices, 30 April 2022. Index performance shown hedged in USD. Information is subject to change and is not a guarantee of future results. Global HY: ICE BoA Global High Yield Index. Global HY FRN: ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index. US HY: ICE BoA US High Yield Index. Europe HY: ICE BoA European High Yield Index.

This outperformance is even more pronounced when measured from the end of 2020, by which time markets had begun to price in tighter future monetary policy. Over the [16-month] period, HY FRNs have delivered a positive total return of +6.4%, while fixed rate US and European high yield bonds have posted negative returns of below -3% in the same period.

We believe the current environment remains favourable for HY FRNs, with interest rates and consumer prices expected to rise substantially further. In particular, we believe HY FRNs possess three characteristics, which – in our view – mean the asset class should continue to offer potentially attractive diversification properties for fixed income investors in the period ahead.

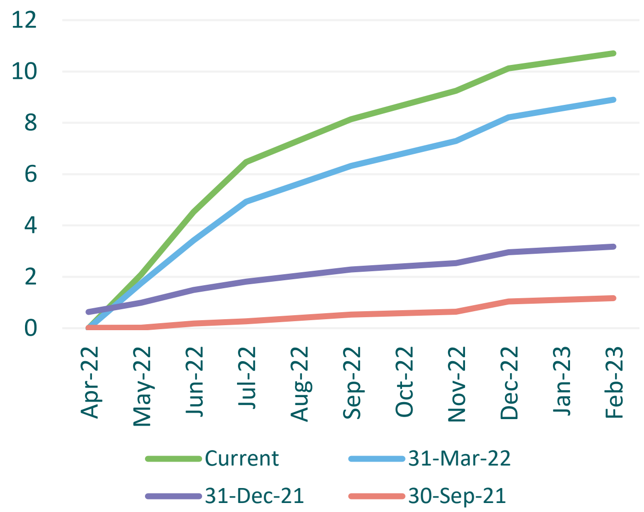
1. Low duration

HY FRNs have close to no duration, which means that all other things remaining equal, interest rate rises should not result in any capital losses for bondholders. This makes HY FRNs potentially more attractive than the broader global high yield bond market for investors who may be worried that future central bank rate rises could lead to further sell-offs in fixed rate assets.

2. Floating rate income

HY FRN coupons typically reset in line with cash interest rates every three months. Given we are still in the early stages of central bank rate hiking cycles – with the US Fed Funds Rate at 0.75%-1.00% and the European Central Bank deposit rate still at -0.5% – expected future rate rises are still yet to feed into HY FRN coupons. As such, higher interest rates are likely to benefit HY FRN investors through higher potential income, with their high yield coupons offering significantly higher potential to offset the effects of inflation than their investment grade counterparts. Markets currently anticipate multiple rate rises over the next year, as shown in Figure 2.

Figure 2. Number of 25 basis point (bps) rate rises priced in to US Fed Funds futures

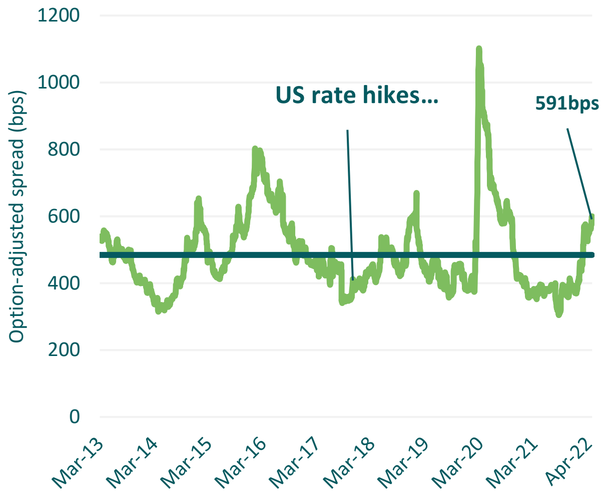


Source: M&G, Bloomberg, 30 April 2022. Information is subject to change and is not a guarantee of results.

3. Elevated credit spreads

In 2022, we have seen a significant revaluation in credit spreads (the difference between corporate bond yields and government bond yields). As shown in Figure 3, spreads are now wider than their long-term average of 484bps. In our view, high yield spreads could be approaching their wide point for the cycle, with much bad news already priced in due to slowing growth and potentially higher defaults in the coming period. However, HY FRNs are typically senior-secured in the capital structure, which provides additional levels of downside protection. If credit spreads were to widen further, we would likely look to add some risk to the portfolio given these potentially attractive levels.

Figure 3. HY FRN spreads potentially attractive, above long-term average of 484bps



Past performance is not a guide to future performance.

Source: Bloomberg, ICE BofA Indices, 30 April 2022. Global HY FRN: ICE BoA Global High Yield Floating Rate Loan (3% Constrained) Index.

Outlook

We believe companies have entered this economic slowdown in healthy positions, with net leverage and interest coverage having been strong in recent periods. As

Figure 4. Potential return scenarios for changing credit spreads and interest rates, GBP hedged (base-case highlighted)

Change in interest rates (%)	Change in credit spreads (%)								
	-2.0	-1.5	-1.0	-0.5	0.0	0.5	1.0	1.5	2.0
-1.0	13.4	11.5	9.7	7.9	6	4.2	2.4	0.5	-1.3
-0.5	13.5	11.6	9.8	8	6.1	4.3	2.5	0.6	-1.2
0.0	13.6	11.7	9.9	8.1	6.2	4.4	2.6	0.7	-1.1
0.5	14.1	12.2	10.4	8.6	6.7	4.9	3.1	1.2	-0.6
1.0	14.6	12.7	10.9	9.1	7.2	5.4	3.6	1.7	-0.1

Source: M&G Global Floating Rate High Yield Fund, ICE BoA, 30 April 2022. Assumed 1% default rate with an average recovery of 60% for the floating high yield market and 30% for the global fixed high yield market. It is assumed 70% of the fund’s positions have a 0% SOFR floor. A parallel shift in the yield curve is assumed. This is for illustrative purposes only and based on representative assumptions. This is not a projection or guarantee of future results.

such, we anticipate defaults will likely be lower than in previous recessions should one materialise. At current spreads, we therefore feel that HY FRNs offer potentially attractive compensation relative to credit risks.

Our base-case scenario over the next few months is for spreads to remain flat or to tighten slightly. As shown in Figure 4, our portfolio remains positioned to cope with a range of potential scenarios, should interest rates and spreads change. If the market stabilises while interest rates rise, this would be expected to result in mid-to-high single-digit returns from the asset class.

Performance of M&G Global Floating Rate High Yield Fund

Return (%)	YTD	1 Yr pa	3 Yrs pa	5 Yrs pa	10 Yrs PA
Fund I-H GBP Acc	-3.99	-0.99	1.66	1.48	N/A
Benchmark*	-2.50	0.61	3.40	3.05	N/A

Return (%)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Fund I-H GBP Acc	N/A	N/A	N/A	0.34	7.34	3.07	-1.54	7.01	-0.02	5.83
Benchmark*	N/A	N/A	2.48	-0.16	12.12	3.58	-0.19	8.09	2.13	7.21

Past performance is not a guide to future performance.

*Benchmark = : BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged Index. Benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (EUR Hedged) Index. Thereafter it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (EUR Hedged) Index.

The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Fund performance prior to 21 September 2018 is that of the EUR Class A-H Accumulation of the M&G Global Floating Rate High Yield Fund (a UK-authorised OEIC), which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 31 May 2022. Returns are calculated on a price to price basis with income reinvested. Benchmark returns stated in EUR terms.

Key fund risks

- Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.
- High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.
- The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.
- Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.
- The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.
- The hedging process seeks to minimise, but cannot eliminate, the effect of movements in exchange rates on the performance of the hedged share class. Hedging also limits the ability to gain from favourable movements in exchange rates.

Further details of the risks that apply to the fund can be found in the fund's Prospectus.

The fund allows for the extensive use of derivatives.

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