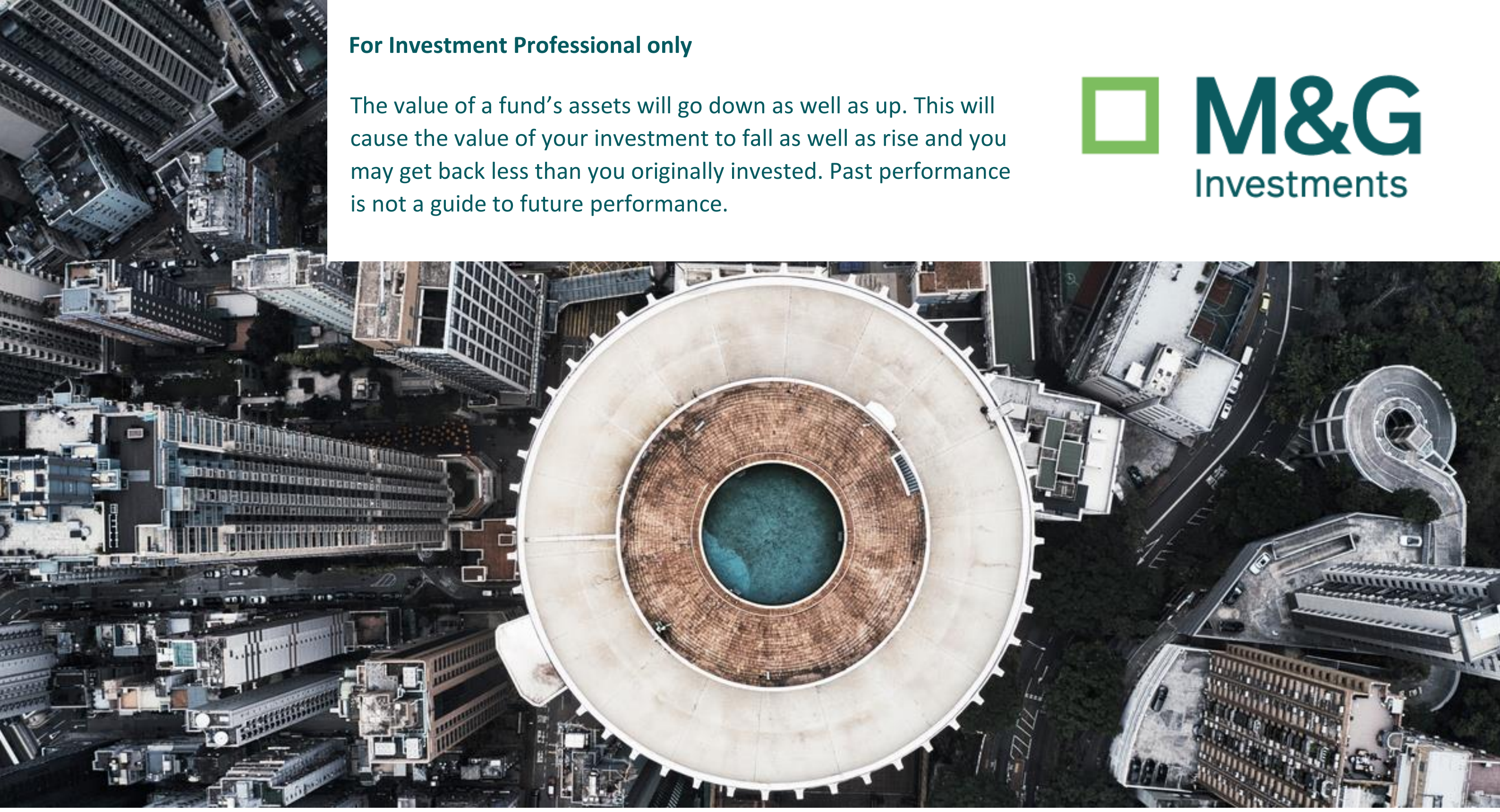

Quarterly Outlook – Q3 2022

A market that defies stereotypes

- After steep price declines, a lot of the heavy lifting has been done but the risk is still to the downside.
- The current market is defying traditional stereotypes of 'value' vs 'growth' and 'defensives' that are not so defensive. Stock selection remains key.
- Second-quarter earnings season will be the great leveller and sift the wheat from the chaff. Consensus forecasts remain too high.
- The sell-off has provided selective opportunities, particularly among technology names, more to come.
- We continue to favour long-term themes, such as infrastructure and the low-carbon ecosystem, able to benefit from investment ahead, independent of the vagaries of markets.

It has not been an easy few months for markets, and we have just witnessed some signs of relief. So, have we passed the big dip or is there more to come? Our stance is that a lot of the heavy lifting has been done from a market downturn perspective, but there is likely to be further volatility ahead as the risks remain to the downside. The key question is: 'what is now priced in by markets and how should investors position themselves for the range of outcomes ahead?'.

Quarterly Outlook – Q3 2022
July 2022

M&G Equities Team

After a period of denial (which we discussed in our 'Market Complacency'[1] note in April 2022), market participants are finally facing up to the macroeconomic and geopolitical risks ahead: a weakening consumer confronted with rising inflation, persisting – albeit slightly improved – supply bottlenecks, the impact of the zero-COVID policy in China, the likelihood of further pressure on commodity prices brought by the Ukraine war, as well as the impact that all of the above will have on corporate earnings. On top of this, looms the risk of central banks overtightening in the inflation versus growth balancing act. Depending on geographies, a recession, to varying degrees, is now considered a high likelihood.

As investors, it is important that we understand the range of macro scenarios ahead. Importantly, we have learned that there is a right price for everything. The key question to answer is: 'what is now priced in by markets and how should investors position themselves for the range of outcomes ahead?'.

The calls on stagflation and recession are widespread among market commentators, and we have even heard mentions of depression and a 2008-style credit event. In our opinion, a worsening growth outlook and a meaningful growth slowdown are priced in. There may be more downside, particularly in some equity names where valuations remain elevated, or an earnings decline is yet to be factored in.

A meaningful recession, perhaps emanating from Europe, caused by embargoes on natural gas, would bring some further downside – particularly in equities. A depression or a 2008-style collapse of credit markets, where companies and individuals struggle to pay back debt, is not priced in and is not our base-case scenario. That said, markets don't seem to have been overreacting on the downside. Any market bounce is bound to be data-driven and news-flow dependent – and could potentially be short lived.

Importantly, there are two key considerations when gauging current equity market behaviour, both of which will play a role in determining our positioning ahead and the timing of any 'buy the dips'.

The first one is that this is a market that is defying traditional stereotypes, blurring the lines between the common definitions of growth, value and even what constitutes a defensive stock.

Following the sell-off in the technology sector, we have seen stocks that had traditionally been part of growth indices move to value indices. This has been the case in both Developed and Emerging Markets equities. For some stocks, the move was a full transfer, while other stocks are part of both value and growth indices.

The second consideration is how we define traditional 'defensive' stocks. To be fair, this has changed over time. When I was a young analyst – far too long ago – consumer staples and utilities were the 'go-to' defensive stock sectors. Fast forward a couple of decades, and parts of the technology sector had also joined the cohort of 'safe havens', given the perception of visible, compounded earnings and high ROE (return on equity). These stocks have in the past outperformed in various instances of macro weakness and market volatility. Not this time.

We all know about the poor performance of the technology sector (the MSCI AC World Technology Index is down 30% year to date). Many companies with high quality (high ROE) or high growth (high future earnings expectations) have underperformed significantly. But consumer staples and utilities have also not fared well. Year to date, consumer staples in the MSCI EM Index have declined more than financials (falling by 12.1% and 9.3%, respectively). In the MSCI Europe Index, utilities are down 10.4% year to date, just a whisker ahead of the 11.4% decline of financials, while the communication services sector has managed to deliver marginal gains of 0.7% over the same period.[2]

There are a number of very logical reasons to account for the not-so-defensive behaviour of defensives, not least the pressure on margins due to raw material price increases, at the one end, and the inability to pass a sufficient proportion of these price hikes onto a weakening consumer at the other. We have seen a number of these stocks (many of which were priced for perfection) disappoint during the last earnings season, with investors not being willing to give the companies the benefit of the doubt.

Interestingly, over the last two weeks we have seen a rebound of many of the old safe havens, with utilities (ex Europe) and consumer staples enjoying a revival of sorts. We would caution on taking a broad stance and buying into sectors as opposed to stocks. One lesson that we learned from the previous earnings season is that companies in the

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[1] https://www.mandg.com/investments/professional-investor/en-gb/insights/mandg-insights/latest-insights/2022/04/market-complacency

[2] Source: Bloomberg. Total returns in index base currency. Year-to-date returns through to 30 June 2022.

same sector can post very different results. In a world of complex macroeconomic challenges, effective corporate management and market positioning can make a significant difference to the way companies will be able to withstand the headwinds.

All of the above implies that, in this market, we need to adjust the traditional mindset of looking at equities in broad buckets. Focusing on traditional definitions of 'value', 'growth', or 'defensive' stocks and only looking at an index or sector level, rather than at individual stocks, may lead to overlooking companies with strong fundamentals where valuations have been hit indiscriminately, or conversely, could lead to blindly believing in the ability of a company to withstand the macroeconomic headwinds solely based on its past ability to deliver a stable and visible earnings path (and in a very different environment).

We believe that the upcoming earnings season will help us sift the wheat from the chaff. Some of the chaff is likely to be surprising, and investors who have recently bought the dip of concept stocks and perceived defensives may well receive negative surprises. More so because, after a relatively benign first-quarter earnings season, sell-side analysts have made some downward revisions to their forward estimates, but these still appear to be far from the likely real outcomes.

As it stands, in the US, analysts are still expecting calendar year 2022 revenue and earnings growth of 11.6% and 10.8%, respectively, for the S&P 500 Index. For the Stoxx Europe 600 Index, sell-side analysts are calling for 2022 revenues to rise by 12.3% and earnings by 15.2% over the previous calendar year. Consensus figures for the MSCI Emerging Markets Index are 11.7% and 10.4% revenue and earnings growth, respectively.[3] While the market may have anticipated some of the likely earnings disappointments in the most recent share price declines, for some stocks there is still some way to go, in our opinion.

As our Head of Global Equities reminds us in his section, we believe we are seeing the beginnings of a new, multi-year investment regime anchored in valuation, fundamentals and – ultimately – reality.

Our positioning: although we have seen sharp declines in both bond and equity markets over the quarter, it remains hard to suggest that they represent an overreaction on the part of investors. Rather, moves look to be a reasonable reflection of the risks ahead, particularly as the decline began from valuation levels that in many cases did not look compelling to start with.

When comparing equities to bonds, the path of positive or inverse correlation between the two asset classes will depend on whether growth or inflation is at the forefront of bond investors' minds. From a relative valuation standpoint, when comparing yields, equities are still looking optically cheap versus bonds. However, much depends on the earnings outlook from here. As mentioned, moving forward we are likely to see more disappointment in companies' results.

For this reason, from a Multi Asset standpoint, having benefited from avoiding developed market government bonds (or shorting in mandates capable of doing so), the extent of these underweights have been reduced. Aggregate equity exposure is now neutral to modestly overweight and diversified across regions and sectors. We remain cautious and our belief is that this is not a market to take outsized directional positions. Rather, it is a market to preserve capital and wait for a better opportunity. Where possible, portfolios maintain high cash levels so as to be reactive to tactical opportunities.

In this environment, alpha is bound to come from selection. When investing at a company level, we continue to focus on companies with pricing power and strong balance sheets, those able to better withstand the inflationary and rising rates environment. It is too early to move back into concept stocks, promises of future earnings, and cash burn.

Within Equities, we continue to favour long-term themes that we believe have longevity and will benefit from investment ahead, independent of the vagaries in the macroeconomic outlook – such as infrastructure and the low-carbon ecosystem.

That said, the sell-off is starting to create some new investment opportunities and we have taken advantage of market volatility by selectively buying into some names that have significantly de-rated, particularly in the established parts of the technology sector across both Developed and Emerging Markets. There has been a case of 'babies being thrown out with the bathwater', and we have picked up some of those names, but have been very selective in our choices,

[3] Source: Thomson Reuters Eikon, July 2022.

given the uncertainty ahead. The wide disparities in earnings results within the same sectors during the latest earnings announcements are a reminder of the need for careful sifting. We have initiated new positions and built on existing positions in some of the enterprise software providers and also some semiconductor companies (both manufacturers and capital equipment suppliers).

A large part of the equity market, however, is still trading at valuations that remain unappealing – in view of the macroeconomic scenarios ahead and the potential impact on earnings.

From a regional perspective, in our search for idiosyncratic ideas (where earnings and shareholder return upside surprises are coming from company-specific fundamental factors), we have been finding a number of opportunities in Japan. This is a market often forgotten, where we are witnessing corporate structural reform leading to improved operational and balance-sheet efficiency, earnings upside surprises and record buybacks.

In the following pages, you will find views from the various M&G 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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Global

Daniel White
Head of Global Equities

Not yet hopeless

In the real world, things generally fluctuate between 'pretty good' and 'not so hot'. But in the world of investing, perception often swings from 'flawless' to 'hopeless'.

Howard Marks, Oaktree Capital, January 2016

The second quarter of 2022 was another challenging quarter for most global equity indices. The S&P 500 Index and the Euro Stoxx 50 Index both fell by just over 16%. Meanwhile, the Nasdaq index (which is heavily weighted towards technology and biotech companies) collapsed by a staggering 22%. The Nasdaq has fallen by nearly a third since the end of 2021[4].

This dramatic sell-off has been driven by a multitude of factors. Alarming inflationary pressures, recession concerns, breath-taking upward moves in bond yields, and increasingly restrictive monetary policy stances have all driven negative market sentiment.

Against this immensely challenging backdrop one might have reasonably expected so-called 'safe havens' (technology, growth and quality companies) to have held up well.

But this has not been the case.

The technology sector is amongst the worst performing. Many companies with high quality (high ROE, return on earnings) or high growth (high future earnings expectations) have underperformed significantly. The traditional 'recession investment playbook' has not been working.

In order to explain this performance, we must first consider the starting point. By late 2021 many tech, growth and quality companies were 'priced for perfection'. Or – in Howard Marks' parlance – investors perceived them as being 'flawless'.

This elevated perception left them vulnerable to bad news – of which there has been plenty so far this year.

Having been out of favour for so long, the market has begun to appreciate the importance of cashflows, tangible assets and strong balance sheets. Concept stocks, cash burn and heavily adjusted non-GAAP earnings no longer get a free pass, a turned blind eye or a premium valuation.

We don't expect this recent trend to reverse. Instead, we believe we are seeing the beginnings of a new, multi-year investment regime anchored in valuation, fundamentals and – ultimately – reality.

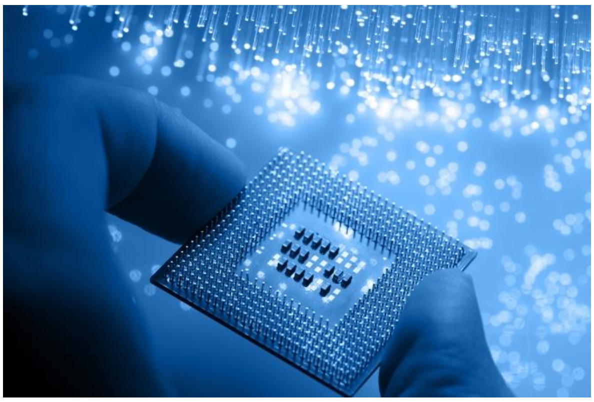
The good news is that the sell-off is starting to create some new investment opportunities – particularly in the established parts of the technology sector.

As a result, we have started new holdings and built up existing positions in some of the enterprise software providers and also some semiconductor companies (both manufacturers and capital equipment suppliers).

Nearer term cyclical concerns have created the chance to invest in some companies with attractive, longer-term structural opportunities.

But in many other instances – especially the super high growth end of the market – many valuations remain unappealing. The market has yet to properly digest the impact from the end of free central bank money, and what this likely means for the future investing landscape.

In other words, the market's expectations are – in many instances – still too optimistic… and certainly not yet 'hopeless'.



[4] Source: Bloomberg: Index returns represent price return in US dollars.

UK

Michael Stiasny
Head of UK Equities

Market bifurcation: trading places

We have historically commented on the multi-year underperformance of the FTSE 100 Index vs. FTSE 250 Index. The FTSE 100 Index has underperformed its midcap sibling in 14 out of the past 20 years. Over the last 20 years to 30 June 2022, on a total return basis, the FTSE 250 has returned investors 483.9% compared to the FTSE 100 returning 222.6%.

With the steep falls we have seen in global stock markets since the start of 2022 (driven by worries of war, inflation and recession), the UK market as a whole looks to be reasonably defensive, with the FTSE All-Share Index only falling 4.6%. However, the underlying performance tells a different story and, unlike the last two decades, the largest companies have performed much better than their smaller stablemates year to date. The FTSE 100 Index has been largely flat while the FTSE 250 Index has seen substantial falls – down 19.4%[5].

What is driving this reversal?

What has been interesting is the narrow leadership so far in 2022. Even within the FTSE 100 Index, only 28 companies have had a share price increase, while 41 are down more than 20%. Within the energy, materials and financial sectors, some of the largest companies have performed strongly given the various macro drivers (high oil prices, interest rate rises, supply-chain issues, surging inflation).

Another factor magnifying this outperformance is that 79% of FTSE 100 company revenues come from overseas[6]; the near record depreciation of sterling in 2022 has, therefore, had a big positive impact for the mega-cap foreign earners. Comparatively, FTSE 250 companies are much more exposed to risks of a weakening UK economy, and by extension, the consumer.

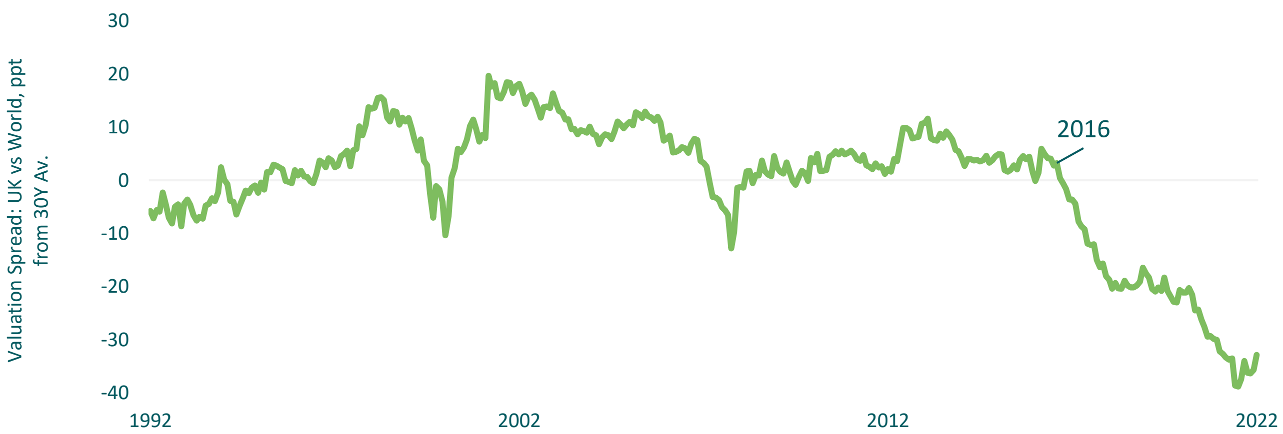
Where does this leave UK equities?

Strong performance of the FTSE 100 Index is only just turning the dial on the multi-year valuation discount between the UK and the rest of the world (see Figure 1).

UK equities still look historically cheap on a relative basis to global peers and, even with the headwinds, we continue to see excellent relative value across the UK with the mid-cap part of the market hit particularly hard but masked by the strong performance of their largest peers.

Figure 1: MSCI UK relative to MSCI World – Valuation spread

Past performance is not a guide to future performance



Source: Panmure Gordon, MSCI, Refinitiv, June 2022 *blended (equal weight) average P/E, EV/EBITDA and P/B *GBP for UK and World to 11/05/2022

[5] Source: Bloomberg. Total returns in GBP terms.

[6] Source: Factset, 1 July 2022.

Asia Pacific

Carl Vine
Co-Head of Asia Pacific Equities

Dave Perrett
Co-Head of Asia Pacific Equities

Asia: reopening boost

Eastern hemisphere equities performed relatively well during the quarter, led by Chinese equities that rebounded from heavily depressed levels. China's outperformance is notable given weaker-than-expected economic fundamentals that arose from strict COVID-lockdowns.

Investors began to look through current Chinese economic weakness and instead focused on supportive growth initiatives, with a particular emphasis on the real estate, auto and infrastructure sectors.

Whilst COVID, and indeed the general geopolitical backdrop, surrounding Chinese equity investment remains complicated, valuations have reached levels where the asset class is now highly vulnerable to good news.

In South East Asia, the reopening theme gathered pace, as countries such as Singapore and Thailand materially reduced travel restrictions, moves which were welcomed by a strong uptick in travel demand.

With core inflation, for the most part, much better behaved in Asia than in many western economies, regional central banks have felt confident enough to pursue independent monetary policies suited to their own internal needs, which is supportive of regional domestic demand.

Japan: political and corporate tailwinds

The quarter to June was relatively eventful for Japan. The yen continued its slide versus the dollar, losing a further 12% of its value on top of the 9% lost in the March quarter[7]. The Bank of Japan (BOJ) continues to believe that higher domestic rates are not yet appropriate. With the Fed having become increasingly hawkish in 2022, the interest-rate differential between the two has led to ongoing yen weakness. On the one hand, this is positive for export-related earnings. On the other, it has the potential to damage domestic consumption through higher energy and food costs.

On the policy front, Prime Minister Kishida unveiled an encouraging and wide-ranging set of economic policies in April. We are encouraged by his pro-market stance and positive on his plans to drive wage growth through improved labour productivity. His ambition to engineer a major shift in household asset allocation out of low-yielding assets and into equities is also favourable for the Japanese stock market.

At the micro level, the quarter continued to deliver evidence of positive structural reform. Corporate earnings continue to show resilience in the face of challenging macro headwinds and companies delivered a record level of share buybacks. Ongoing reform of balance sheets and business portfolios in Japan continues to be a major theme for our stockpicking efforts in Japan.

[7] Source: Bloomberg, July 2022.

Emerging Markets

Michael Bourke
Head of Emerging Market Equities

Value vs growth. Lazy debate?

The narrowly led recovery from the depths of COVID tested our valuation mettle in 2020 when it seemed that unloved areas of the market (financials, materials) would be out of favour indefinitely. Fast forward to 2022 and we can see that emerging market (EM) banks have outperformed the EM consumer discretionary index over the period (see Figure 2).

While not immediately obvious, many of the Chinese internet mega-caps are categorised as consumer discretionary. Quite a fall from grace from the 'COVID winners' status they had previously re-rated on.

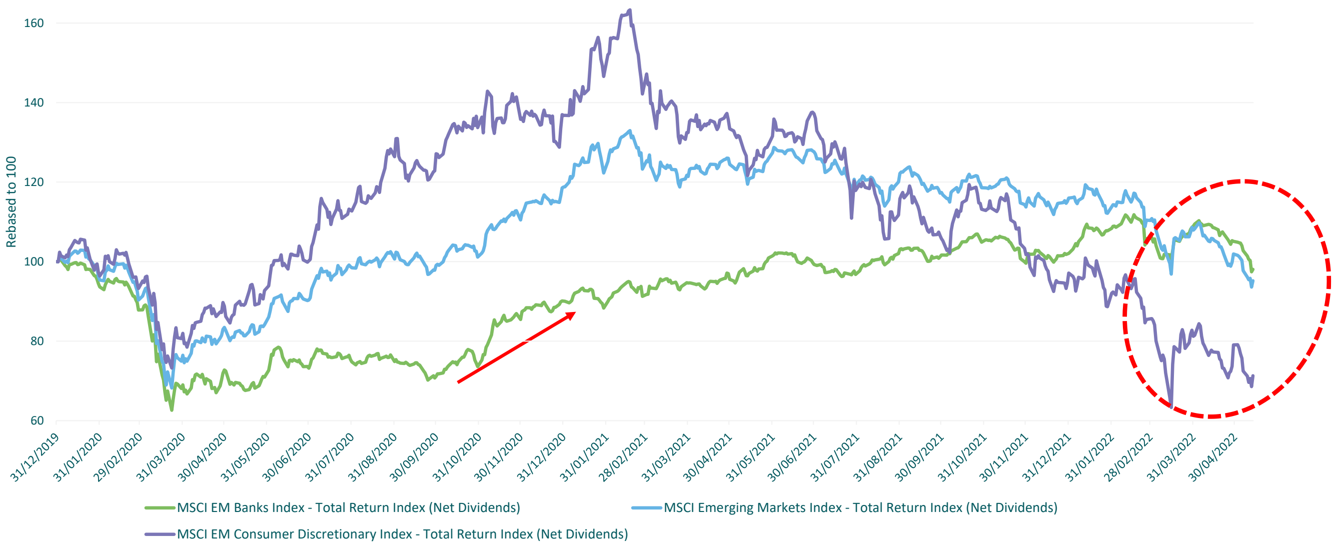
Perhaps more interesting is the change in composition of the MSCI EM Value Index which, given the subsequent de-rating from peak valuations in February 2021, contains many of companies that previously were heavily concentrated in the MSCI EM Growth Index. As at 31 March 2022, Alibaba and Samsung Electronics were 3.9% and 3.7%, respectively, of the MSCI EM Value Index. Simultaneously, these two companies are 2.1% and 2.7%, respectively, of the MSCI EM Growth Index. It has led to quips around Alibaba moonlighting as a value stock; however, on a serious note, it highlights to us why it was lazy or perhaps easy in a world where momentum ruled, to focus on index definitions of value versus growth.

Contrarian approach to China

As value-oriented investors, we are often drawn to out-of-favour, unloved parts of the market. China has certainly been shunned by many investors this year,

Figure 2: MSCI EM banks vs MSCI EM consumer discretionary

Past performance is not a guide to future performance.



Source: Bloomberg, MSCI, May 2022, all total returns and in USD. Rebased to 100 at 31 December 2019.

but our contrarian instincts led us to look beyond the negative headlines about COVID-19 restrictions and a slowing economy to search for promising investments there. In our view, China's stockmarket had become extremely lowly valued and by combining a rigorous fundamental approach with a consideration of valuations, we found some attractive opportunities. We have been underweight China relative to the benchmark for many years, but this has been pared back as we have found more opportunities there as other investors have been more pessimistic about developments in the country.

China's recent reversal towards the end of the second quarter has been very narrowly led by large internet stocks, such as the aforementioned Alibaba, and has yet to broaden out to the wider market. This prompts the question whether it is a tech rally rather than a China rally. If investor sentiment towards the outlook for China continues to improve, we believe that some of our other Chinese holdings within other sectors should stand to benefit.

Looking beyond China

For an EM investor, China is simply too big to ignore regardless of the prevailing sentiment, but an effective EM equity investor thinks globally. Away from China, we think Latin America (LatAm) can benefit from the near-shoring phenomenon as US corporates move supply chains closer to home. We are seeing this play out in the burgeoning demand and no vacancies in industrial real estate in Northern Mexico, for example. Interest in LatAm assets has also been showcased by the second largest stock sale globally in 2022: a US$6.5billion, multiple times oversubscribed, raise by Brazilian utility company Electrobras. It certainly feels like there is interest here.

LatAm has only marginally benefited from globalisation in the last 30 years, and it feels like that may be about to change. With the removal of Russia from EM indices following the invasion of Ukraine and the geopolitical and growth concerns on China, LatAm may well be becoming a safe port in a global storm. We like the dynamics and find interesting investment opportunities in the region.

Impact

John William Olsen
Head of Impact Equities

Shift in sentiment

Sustainability and Impact strategies generally experienced heavy relative headwinds in early 2022, with expectations of high inflation and healthy economic growth prompting an indiscriminate sell-off of quality growth stocks and a rotation towards lower-multiple stocks and commodities.

Consensus shifted after Russia invaded Ukraine, as inflationary pressures remained but concerns grew over a possible recession. The combination of high energy prices and economic slowdown is a markedly different scenario, that provides a more constructive environment for our strategies.

We look for companies with defensive business models and strong pricing power. These are companies that can deal with inflation and weather a recessionary storm.

In addition, in an environment where input prices continue to rise, we would expect increased demand for products and services that provide efficiency gains and energy savings, as other companies look to reduce their costs.

It's worth noting that the relative price point of alternative energy has also become more attractive, and the move towards energy independence in the wake of the Ukraine war is likely to provide additional support for renewable infrastructure and the companies enabling it.

With near-term uncertainty distracting investors from focusing on the opportunities provided by longer-term sustainability trends, many growth-orientated small- and mid-cap companies – even those with robust forecasted revenue growth and strong pricing power – have seen share prices weaken year to date, and the lower valuations in our investment universe are now offering some attractive entry points for long-term investors.

We have been taking advantage of this shift in sentiment, and the share price weakness, to top up on quality growth stocks in the financials, industrials, utilities and healthcare sectors – companies that are aligned with long-term structural sustainability trends and offer strong growth potential over the longer term.

Convertibles

Leonard Vinville
Head of Convertibles

Attractive entry points

We believe the current market conditions offer great entry points in the convertible market.

Several market developments in the last few months have resulted in attractive valuations for large pockets of the convertible universe. The recovery from the COVID pandemic, stronger economic growth and rising bond yields drove a rotation out of what investors have labelled 'growth' stocks – for example, technology and online consumer discretionary stocks perceived as long duration assets – to 'value' stocks, which has corrected the elevated valuations of many convertible names.

Subsequently, higher inflation has raised the possibility that central banks will raise interest rates further to cool the economy and possibly trigger a recession. This has led to an even more generalised sell-off in risky assets with substantial falls year to date, as seen in the decline of equities and high yield bonds. Convertibles have experienced similar dynamics.

Due to these large declines in valuations in both equity and credit, many convertible bonds have cheapened even further, as their options have fallen too far out of the money and are not priced as desirable by many convertible participants (for instance, arbitrage hedge funds). Convertible valuations are thus pricing in very significant deterioration of earnings, either macro-induced or company-specific.

As a consequence, we have seen material cheapening of convertibles versus their theoretical or fair value, especially in the US and to a lesser degree in Europe. The cheapening has been less pronounced in emerging market convertibles (dominated by Chinese issuers), mainly because they had already cheapened substantially during 2021. Also, Japanese convertible bonds, which are a small part of the market, have not seen such extreme swings as inflation and government bond yields have remained stable.

What is particularly interesting is that these violent market moves have left large amounts of convertible bonds trading at very wide implied credit spreads, unjustified by their business and credit quality, or already pricing a recession scenario. This gives us the opportunity to invest in free cashflow-generative, quality businesses with good credit metrics in the BB/BBB area.

Their convertibles may be out of the money, but they have the potential to offer attractive yield returns in the mid-to-high single digit range. These yields are typically superior to many crossover or high yield names of similar maturities. By focusing on good quality names, we also enjoy the potential opportunity that other investors (eg, private equity or strategic buyers) may recognise the value available and bid up the prices substantially. If these company takeovers were to materialise, they would trigger a change of control clause, giving the holders the right to sell the convertible bonds back to the issuer at face value (100). Thus, the 10 to 25 points gain on the bond (the difference between where the bonds are trading now and the face value) could materialise much more quickly than in the two to three years to maturity.

To be clear, this is not the traditional investment strategy of focusing on balanced, at-the-money convertibles with sufficient equity sensitivity (delta) to benefit from rising stock prices. Yet it is an exciting opportunity to improve the risk/reward of our portfolio. We believe this type of convertible bond will outperform the market in its bear phase whether we are heading into a mild or more severe recession.

While out-of-the-money convertibles do not constitute a dominant part of our portfolio, we can be flexible to exploit the opportunities made available by the indiscriminate sell-off. To navigate this uncertain environment, we remain diversified by name, industry and region, and also by type of convertible (in-the-money, balanced, out-of-the-money). In doing so, we aim to deliver attractive risk-adjusted returns, comparable with long-term equity returns, but with lower volatility or risk than investing directly in equities.

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