M&G Investments

Quarterly Equities and Multi Asset Outlook

Vol-Agility

Agile investing in volatile times

Q4 2024

Contents

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever mentioned, past performance is not a guide to future performance.

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Vol-Agility: Agile investing in volatile times

Market volatility in the third quarter was a reminder that nothing should be taken for granted in markets. There are lessons to be drawn from what we witnessed. Much should not have been surprising if market participants had considered the current context, rather than applying commonly-believed market rules.

When the market turns, portfolio diversification, process flexibility and preparation, with a deep understanding of our investment universe, become essential ingredients.

In the following pages, our Equities and Multi Asset investment teams have given some evidence of how the process works in action, talking about the steps they have taken, as the volatility of the third quarter ensued, to generate returns ahead.

Looking ahead to 2025, US fixed income has the potential to start outperforming again in an environment where the Fed cuts rates in response to weaker US macroeconomic data, and with the backdrop of lower inflation. Such a scenario is probable, but by no means certain. It wouldn't be the first time that the US economy has defied the odds.

A market where macroeconomic conditions remain resilient and rates are declining would support equities.

Drawing lessons from recent volatility

If we needed another reminder that nothing should be taken for granted in markets, we got one during the third quarter of 2024; weakening activity and labour data in the US over the summer, two assassination attempts on a presidential candidate, a last-minute change in the US Democratic Party's nominee, an increase of the policy rate to 0.25% by the Bank of Japan (BOJ) – clearly signalling a change in direction from its ultra loose policy stance – and rate cuts by all three major developed market central banks, including a much discussed 50 basis point (bps) cut by the Federal Reserve (Fed). To close the quarter, China surprised with a set of coordinated stimulus measures reminiscent of Mario Draghi's 'Whatever it takes' commitment during the 2012 Euro crisis when he was European Central Bank (ECB) President. And, at the time of writing, the conflict in the Middle East has meaningfully escalated.

Markets have responded with a significant increase in volatility. In Japan, we witnessed the biggest three-day equity drawdown in the market's history. The short-lived volatility spike that ensued, was only exceeded on two occasions in the last 50 years – The Crash of 1987 and The Lehman Brothers' Crash in 2008[1]. The near unprecedented drop followed a de facto 15bps rate hike that had been fairly consistently flagged by the BOJ since December 2022, and the episode reversed almost as quickly as it happened. By the end of August, Japanese equities had recovered most of their losses in local currency, and were up in US dollar terms over the month[2].

Elsewhere, during the July/August volatility, fixed income markets staged a period of outperformance versus equities, with correlation between the two squarely back in the negative camp. Equities experienced a technology-driven set-back, despite a relatively solid reporting season.

The function of the market reaction to the geopolitical events and macroeconomic datapoints was far from straightforward, and unlikely to be predicted based on commonly-accepted market 'truths'. In the US, we saw a counter-intuitive reaction to the Fed's 50bps rate cut, with the short end of the yield curve mostly unmoved, and a sell-off at the long end following the announcement. In equities, Value outperformed Growth, even as bond yields dropped materially[3].

There are lessons to be drawn.

The first lesson is to appreciate that history may rhyme, but doesn't necessarily repeat itself with every related condition just as it was. None of the above reactions would have been surprising if, instead of taking the manual of commonly-believed market rules, market participants had considered the current context.

The pullback in technology came after a strong run, as investors started questioning the Return on Investment (ROI) from all of the AI-related infrastructure spending. Then recession fears started to creep in, resulting in a very low margin for error for the technology companies heading into third-quarter earnings season. Market concerns on future returns trumped any pre-defined positive impact from declining rates on long-duration equities. Actually, the increase in rate cut expectations were driven by the same recession concerns.

And the muted reaction to the Fed's 50bps cut was driven by bond pricing having already run ahead of the Fed with steep yield declines ahead of the decision.

The second lesson is that we should always invest with the understanding that we don't hold any undisputed truth, and that we are bound to be surprised, either by events or by the market's reaction to events. Therefore, we should always put ourselves and our portfolios in the best position to deal with the inevitable balls coming out of left field. When the market turns, portfolio diversification, process flexibility and preparation, with a deep understanding of our investment universe, become essential ingredients. In the following pages, our Equities and Multi Asset investment teams have given some evidence of how the process works in action, talking about the steps they have taken, as the volatility of the third quarter ensued, to generate returns ahead; from buying in Japan and adding to highly cash-generative Chinese stocks to selling US treasuries – particularly at the shorter end of the curve – to adding Northern European banks and high-quality

[1] Source: Bloomberg, 26 September 2024. Data: TOPIX, annualised standard deviation of 10-day price moves over the last 50 years.
[2] Source: Bloomberg, TOPIX price returns, 7 October 2024.

[3] Source: LSEG Workspace (Refinitiv), style indices refer to Russell 1000 Value and Growth Indices.

global consumer names that have proven resilient to consumption trends.

As investors, our aim is not to produce precise economic forecasts, but rather – based on our knowledge, perspective and experience – to judge when market participants have taken their macroeconomic or company fundamentals concerns to extremes, and valuations have deviated significantly from what the scenario of future outcomes is likely to be.

It often happens that in periods of uncertainty market participants become exceedingly short term-focused, responding to every new data point and often extrapolating its impact. Such short-termism creates a compelling opportunity for investors who are willing to look beyond near-term volatility. As our Multi Asset team reminds us, and as demonstrated over the summer period, volatility – though scary at the time – can also be a major source of opportunity and returns.

Looking ahead

In our last Quarterly Equities and Multi Asset Outlook, published in mid-July, we shifted our preference from equities, which we had maintained for a long time, to fixed income. The better risk-reward was driven by the US, after a strong equity market performance, and given modestly weakening domestic data and higher odds of rate cuts.

Since then, US fixed income markets have run hard, pricing in a significant amount of yield decline ahead of the Fed's September rate decision. This was clear by the muted 'after the fact' reaction of the US treasury yield curve to the Fed's 50bps cut. Since then, yields have been on the rise again.

Going into year end, yields are likely to come down, at the very least in the US, Europe and possibly the UK, but conflicting expectations on inflationary pressures, fiscal policy and the health of the global economy ahead could make the path less straightforward. We are at a juncture where the market is expressing clarity of forecast when there is neither clarity of data nor visibility. Importantly, shifts in rate cut expectations are likely to add intermittent volatility in fixed income far more than in equities. Hence, within our multi-asset

> **"We are at a juncture where the market is expressing clarity of forecast when there is neither clarity of data nor visibility"**

portfolios, we have now dialled down to a more neutral stance in fixed income versus equities going into year end.

Within fixed income, we shifted some weight from US treasuries to UK gilts and credit, which had not rerated as much as US treasuries and credit. We also continue to like South African bonds which have performed well but likely have some more upside potential, driven by rate cuts. We have kept exposure to the long end of the US treasury curve, where we saw a sell off after the Fed rate cut announcement. The long end should also provide an ''insurance'' role should the macroeconomic picture significantly deteriorate. Importantly, this is a good market environment for tactical asset allocation, responding to short-term market gyrations based on excessive expectations in either direction.

Looking ahead to 2025, US fixed income has the potential to start outperforming again, and regain its diversifying qualities, in an environment where the Fed cuts rates in response to weaker US macroeconomic data and with the backdrop of lower inflation. Such a scenario is probable, but by no means certain. It wouldn't be the first time that the US economy has defied the odds. And a market where macroeconomic conditions remain resilient, and rates are declining, would support equities.

Importantly, even when fixed income markets have outperformed broader equity markets in the summer, we have learned that there are pockets of equities that can generate much higher returns compared to fixed income markets. Areas of equities that we like are those that have been affected by higher rates, for instance in infrastructure. Admittedly, some pockets have already started to turn around meaningfully, for example utilities. But there are still opportunities, including in long-forgotten areas such as renewables. As always, selection remains important as some of these stocks may be affected by issues other than just rates, such as supply gluts or permanently-weakened balance sheets.

Another area to note is industrials. As we enter the fourth quarter, we believe de-stocking will soon be behind us, and many of our meetings with automation equipment suppliers and truck manufacturers around the globe suggest exactly that. Whatever happens to underlying demand from here, it won't be compounded by de-stocking and we see opportunities in many beaten-up shorter-cycle stocks.

And then there is the technology and AI-related stocks. This would not be the first time in the last 20 years that instances of significant technology-related market sell-offs turned into buying opportunities for investors. Clearly, not all technology stocks are created equal, but growth and profitability trends remain durable for leading technology companies. Moreover, we believe the AI theme is largely 'macro agnostic' as hyperscalers have hundreds of billions of dollars in cash and the ability to invest through economic cycles. In our view, it would take a severe recession to cause these large hyperscalers to adjust their plans. Our Global Thematic Technology investment team sees the growth in AI not as optional but in many ways existential.

While the dispersion in valuations within the US equity market is such that we can still find attractive domestic opportunities, from a regional standpoint, we find more reasonably-valued companies outside of the US equity market, for example the UK, Japan and, within Emerging Markets, Brazil.

We would be remiss if we did not mention China after such a strong run. Following the coordinated stimulus from Chinese authorities, the market has sky-rocketed. At the time of writing, the MSCI China Index is 53% up from this year's trough[4]. It would not be surprising if the market were to take a pause in the near term and, for gains to be sustained, we would need to see some clear impact of the stimulus on economic activity and demand. Yet, on a longer-term view, Chinese equities are still below long-term average valuations and, more importantly, we continue to find inexpensive names with high cash generation, being deployed in higher dividends and buybacks.

Market volatility is likely to persist with upcoming elections in the US and an escalating conflict in the Middle East. Higher US import tariffs and geopolitically-linked oil supply bottlenecks could feed into future inflation data and, if not revert, at least stall central banks' paths to lower rates. Activity and labour data in the US have started to weaken but the path is not straightforward, with some strengthening in the most recent datapoints. For now, a recession does not appear imminent. Nonetheless, we have learnt that jobs data can unravel quickly and, starting with a 50bps rate cut, the Fed must have felt that risks were on the horizon. Also in Japan, with former defence and agriculture minister, Shigeru Ishiba's, unexpected win at the end of the quarter to be Japan's next Prime Minister, we might well expect further volatility.

We remain ready to take advantage of any price dislocations that take valuations below what the long-term outlook would warrant.

Volatile markets can be unsettling and emotionally draining. However, through careful portfolio construction and disciplined fundamental analysis, these instances can create compelling opportunities for investors with a longer-term horizon.

We wish you an enjoyable and – hopefully – interesting read.

[4] Source: LSEG Workspace (Refinitiv), MSCI China Index price returns in local ccy. YTD trough to peak return, 22 January 2024 – 4 October 2024.

Fabiana Fedeli
Chief Investment Officer, Equities, Multi Asset and Sustainability

Global

Shane Kelly
Fund Manager, Global Strategic Value

Embracing the chaos: with volatility comes opportunity

Two assassination attempts on former US President Donald Trump, the sudden change in the Democratic Party's nominee for the 2024 election, and a sharp yet brief plunge in Japanese equities ensured that markets had a turbulent, rather than sleepy summer. All that before the US Federal Reserve announced its 50 basis point rate cut and China surprised with more aggressive stimulus measures.

Not the usual winners from a weak consumer

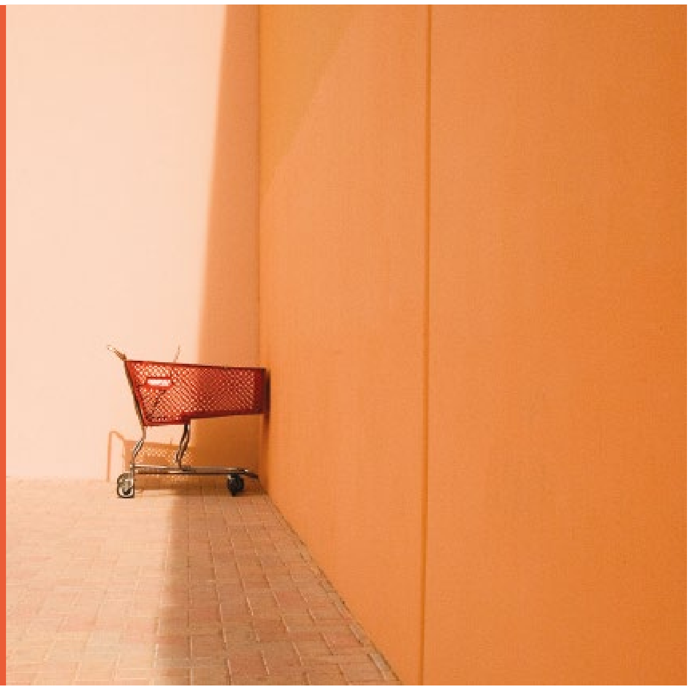
A key theme from the recent US earnings season was the ongoing slowdown of the consumer, particularly at the lower-income level.

How companies have navigated these headwinds, however, shows an interesting contrast. Shares of discount retailers such as Dollar Tree and Dollar General – typically poised to benefit in challenging economic environments – dropped sharply after reporting disappointing earnings. In contrast, Walmart outperformed, buoyed by stronger-than-expected results.

Walmart's real advantage lies in its solid balance sheet, which has allowed it to invest and adjust its business model over the past few years in the face of challenging conditions – a luxury its more debt-laden competitors, like the dollar stores, can't afford. This isn't just a US phenomenon either. We're seeing a similar story in the UK, where Tesco is thriving compared to its heavily leveraged, private equity-owned rivals.

For us, this means that only looking at broader market trends is not sufficient to pick the winners. Instead, we must take a more selective approach, examining individual companies and their unique circumstances.

> "Only looking at broader market trends is not sufficient to pick the winners... we must take a more selective approach"

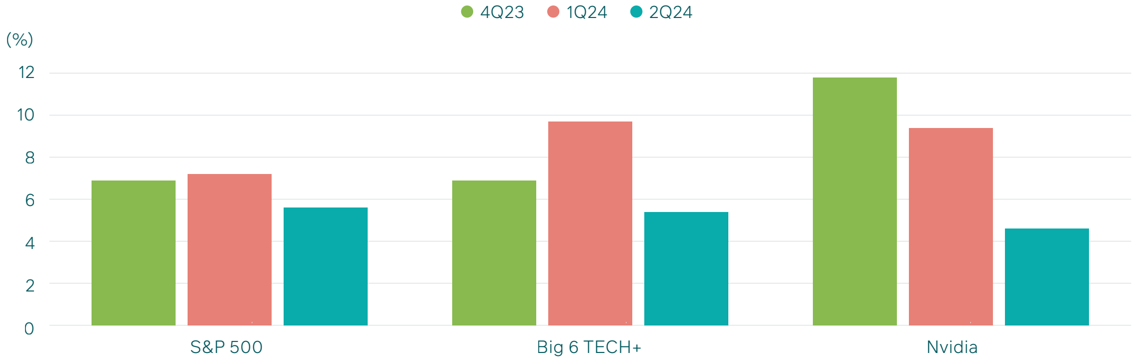


Rejoining the pack?

Mega-cap tech firms continued to deliver positive earnings surprises during the quarter, although the scale of these beats tapered off.

The lack of outsized surprises coupled with an environment of increasing uncertainty and wide valuation dispersions provided a fertile backdrop for style and factor rotation over the period, especially in the US where Value outperformed Growth, even as bond yields dropped materially[5].

Earnings surprise



Source: Standard & Poor's, Refinitiv, FactSet, UBS. Report: UBS Global Research and Evidence Lab – US Equity Strategy, Earnings Brief 2Q24, 29 August 2024. Big 6 TECH+ includes Apple, Microsoft, Alphabet, Amazon, Meta and Nvidia.

Seizing the opportunity

George Soros once said, 'Short-term volatility is greatest at turning points,' and with so many macroeconomic and political factors lining up, we could well be at one of those junctures.

In the US, we're still light on policy details from both presidential candidates, but there are clear differences when it comes to taxation and regulation that could have a meaningful impact on various sectors or stocks. Plus, the closeness of the race itself adds another layer of unpredictability as we head towards the end of the year.

When volatility spikes, you often hear people preach the benefits of diversification. While we agree that a well-diversified portfolio is a key part of navigating uncertainty, we see it as just one piece of the puzzle. To benefit from volatility you need more.

Equally important is staying flexible. The world is unpredictable, full of surprises and we see little merit in holding fixed views. Predicting outcomes or trying to price them in advance is a futile exercise. The other crucial element is preparation. Just as it's hard to predict events, it's just as tricky to know how long their effects will last. Our bottom-up approach, aimed at having the knowledge needed to invest when the opportunity arises, is key.

Volatility is a great opportunity for active investors. The constant flip flopping of interest rate expectations at the start of the year, and the sharp but short-lived drop in Japanese equities, provided opportunities to add new positions in the country across our global equities portfolios. Meanwhile, in our European portfolios, we continue to be comfortable going against what might be called a 'fixed view' that bank stocks in the region will suffer as interest rates decline. Over the quarter, we increased our exposure to this sector by adding northern European banks where we felt price declines were unwarranted, also considering their more limited exposure to declines in short-term interest rates.

[5]Source: LSEG Workspace (Refinitiv), style indices refer to Russell 1000 Value and Growth Indices.

UK

Michael Stiasny
Head of UK Equities

At these valuations, we'll settle for boring

Equity market performance has remained strong across markets year to date, despite heightened volatility. This is particularly the case here in the UK. Not only has the UK equity market delivered competitive returns compared to other global indices, it has also offered valuable diversification for global asset allocators.

During the summer's volatility episode – marked by the S&P 500 Index's peak-to-trough decline from 16 July 2024 to 5 August 2024 – the UK market saw a relatively modest drawdown of -2.5%, significantly outperforming global indices, which fell by c8% over the same period[6]. This relative outperformance highlights not only the strength of the UK market but also its ability to serve as a safe haven in times of global instability.

When markets are turbulent, price dislocations and sentiment-driven sell-offs can create attractive entry points that may not have otherwise existed. For instance, during recent periods of market stress, larger companies within the FTSE 100 Index outperformed mid- and small-cap stocks, as investors gravitated toward the relative safety of globally-diversified firms[7].

The FTSE 100 Index, filled with multinational companies, benefits from broader geographic exposure, which tends to cushion against domestic economic concerns. However, the FTSE 250 Index derives nearly 50%[8] of its revenues from overseas markets, yet often experiences sharper sell-offs in volatile times. This disconnect between the FTSE 250 Index's underlying strength and diversification, and its market performance, can create compelling buying opportunities for active investors. As market stress leads to valuation gaps, attractive companies within the FTSE 250 Index become available at discounts, offering opportunities to capitalise on long-term upside once stability returns.

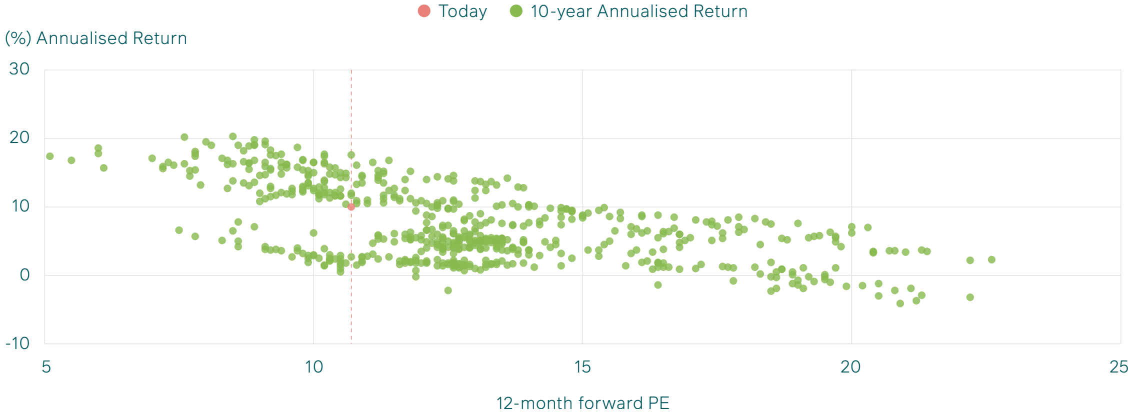
> **"The UK equity market has offered valuable diversification for global asset allocators"**

During the summer, the UK team saw opportunities in companies as diverse as a genomic sequencing company, a commercial broadcaster, a hotel and restaurant owner and a firm providing precision measurement solutions. Volatility can present opportunities, however it is important to remain cautious of stocks that appear to ride out turbulence but become increasingly expensive in the process. These companies may seem like safe havens but, over time, inflated valuations can become unsustainable leading to potential corrections. This is particularly relevant when considering how attractive the UK equity market is in the context of global markets; with the FTSE All Share Index currently trading on c11x 12-month forward PE (price-to-earnings) versus the S&P 500 Index trading on c21x 12-month forward PE.

[6] Source: Datastream, Datastream Indices in local ccy.
[7] Source: Datastream, FTSE100 Index outperformed the FTSE250xIT by 22% in 2022.
[8] Source: Factset, September 2024.

As shown in the below chart, historical data going back to 1965 shows that when the UK market has been priced at a PE of 11x, it has delivered annualised forward returns of c10% over the next 10 years. This is considerably higher than the expected return from the US market at today's higher valuation of c21x PE.

UK starting PE and future 10-year Annualised Return (%)



Source: LSEG Datastream, September 2024. Datastream indices, using 12m forward PE and resultant 10-year Annualised Return figures. Historical data back to 1965. Past performance is not a guide to future performance.

As always, valuation discipline is key, and even the most robust companies must eventually justify their price levels – making the UK market an appealing option for long-term investors seeking both value and growth potential. The recent volatility in markets has allowed us to buy attractively-valued stocks within a wider market, that is itself relatively good value, and compared to other markets presents the potential for outperformance both in short-term periods of drawdown, and also potentially over the longer term given the starting valuation.

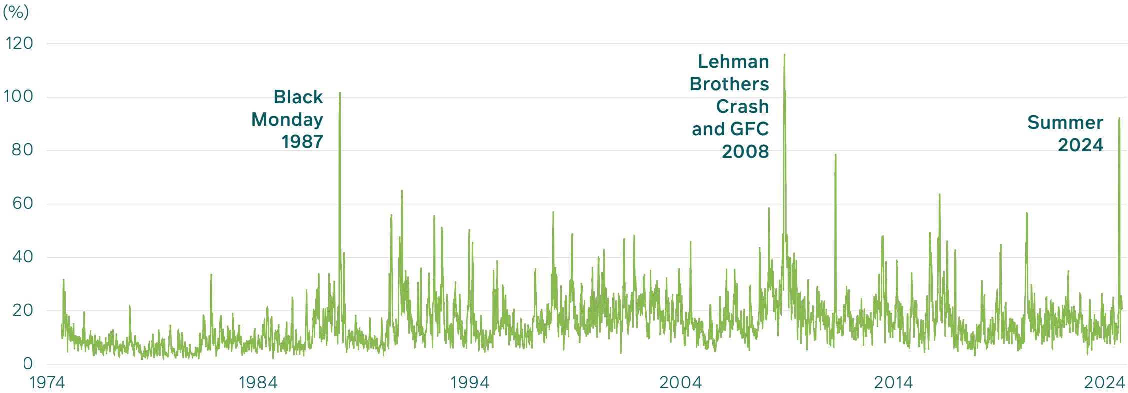
Japan

Carl Vine
Co-Head of Asia Pacific Equities

Finding opportunity in short-term 'volatility fits'

Mr and Mrs Risk paid an impromptu visit to the Japanese Equity market during the third quarter. Seemingly, they were in a bad mood. The result was one of the biggest three-day drawdowns in the market's history. On-point with the thematic of this Quarterly then, the Japan market showed exceptional volatility during the quarter. As a matter of fact, in the last 50 years, short-term volatility spikes have exceeded this one on only two other occasions – The Crash of 1987 and The Lehman Brothers' Crash in 2008.

TOPIX – historic timeline of short-term volatility



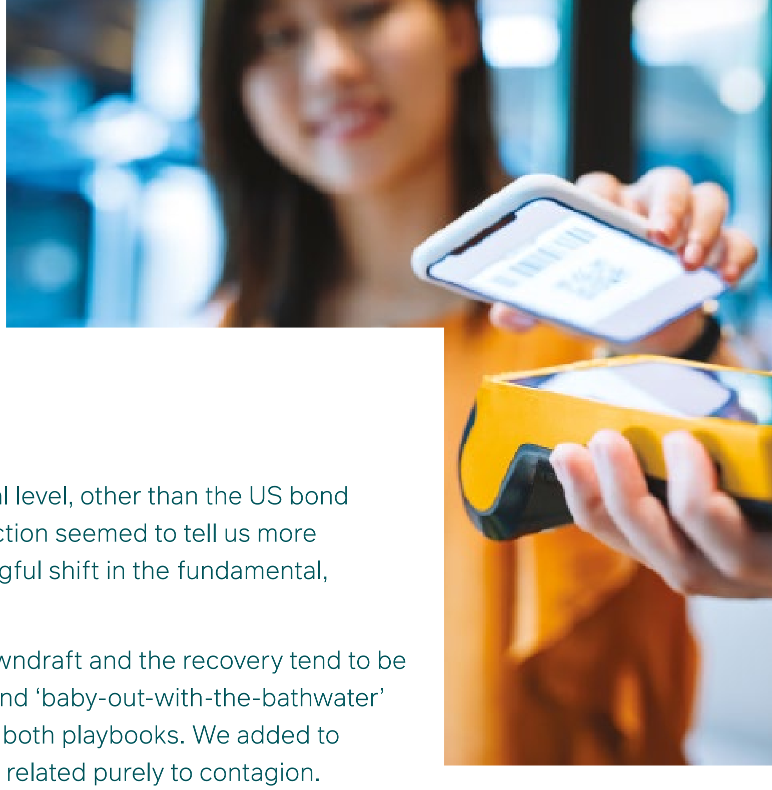
Source: Bloomberg, 26 September 2024. GFC = Global Financial Crisis Data: TOPIX, annualised standard deviation of 10-day price moves over the last 50 years.

> "The shockwaves were not all macroeconomic-driven… last quarter saw the largest ever foreign take-over attempt of a Japanese company"

Market drawdowns of this magnitude are typically associated with major and unexpected economic events: The Lehman Brothers' Crash, The Great East Japan Earthquake, The COVID-19 crisis and so on. In this case, rather than an economic iceberg, it would appear that we witnessed the 'butterfly effect' of complicated, global, cross-asset correlations; more 1987 than 2008.

On 31 July 2024, the Bank of Japan (BOJ) raised the policy rate to 0.25%. Having flagged the possibility of higher rates consistently since December 2022, this should not have been a huge surprise. At the same time, whilst the Federal Reserve (Fed) itself said nothing, economic releases in the US resulted in a dovish shift in Fed Funds rate expectations. The confluence of the two reverberated through FX markets and the yen, finally, started to strengthen. As this unfolded, short-term and aggressive volatility-contagion ensued. Japanese equities were seemingly at the tip of this spear, suffering a two-day collapse.

The episode reversed almost as quickly as it happened. Within a little more than a week, Japanese equities had recovered most of their 'flash-crash' losses, at least in US dollar terms.



What can we decipher from these moves?

Was there a signal here or was it all noise? At the fundamental level, other than the US bond market signalling slower growth in the US, the violent price action seemed to tell us more about financial market positioning than a sudden and meaningful shift in the fundamental, economic reality.

As is typical of such 'volatility fits', correlations in both the downdraft and the recovery tend to be very high. The opportunity for the investor, then, is to either find 'baby-out-with-the-bathwater' situations, or to add portfolio beta. In our case, we have used both playbooks. We added to some names where undue selling was seemingly illogical and related purely to contagion. We also tilted modestly away from defensive names towards stocks that, in our view, were being sold indiscriminately.

The shockwaves in the quarter were not all macroeconomic-driven however. At the company specific level, last quarter saw the largest ever foreign take-over attempt of a Japanese company. Canada's Alimentation Couche-Tard announced an near $US60 billion bid (enterprise value basis) for Seven & I holdings, the operator of the 7-Eleven convenience store chain.

Japan's governance regime, while still in need of improvement, has made tremendous strides in recent years. The upgraded institutional and legal framework surrounding Japanese corporate behaviour has clearly lowered barriers to 'out-in' M&A. Many Japanese companies with globally relevant business footprints, modest valuations and globally acceptable governance structures will be closely watching the Seven & I case.

In the West, and in the US in particular, corporate action is seen as the ultimate arbiter of listed-market value. If something is too cheap versus its private market value, it eventually gets bought. In Japan, this has not been the case. Historically, there has been no market for corporate control. We are all familiar with so-called Japanese 'value-traps' – but this is changing. Corporate reform in Japan has already sparked several years of record M&A activity, albeit from a low base. This has improved the market's price-setting mechanism. However, the M&A boom has been mostly domestic. The missing part of the puzzle has been overseas acquirers. Couche-Tard's bid opens up a new chapter.

We've witnessed both macro- and micro-economic driven surprises, and ensuing volatility in the third quarter, and with former defence and agriculture minister, Shigeru Ishiba's, unexpected win at the end of the quarter to be Japan's next Prime Minister, we might well expect this volatility to continue. We remain ready to take advantage of any volatility that takes equity valuations far below what their long-term outlook would warrant.

Asia Pacific ex Japan

Dave Perrett
Co-Head of Asia Pacific Equities

Resorting to rules of thumb can be misleading

Investors always have things that worry them, the summer and fall of 2024 feels like it has served up an especially crowded agenda of concerns. US election-related policy uncertainty, US rate cut speculation, Chinese consumer worries and general confusion about the state of the global economy – to name but four.

As bottom-up focused stock pickers, we are not in the business of economic forecasting and certainly would never pretend to be in a position to have answers to the market's laundry list of fears. However, we would argue that we are in a position, based on our knowledge and perspective from following some listed companies for a prolonged period, to judge when investors have taken their macroeconomic concerns to extremes. At these points in time, individual stock valuation seemingly begins to price in very unlikely outcomes in our view – based on an objective assessment of comparable historic periods or underlying company valuation.

Asian markets, rightly, have a reputation for being more volatile than their global brethren. However, in the last few months it feels as if the region has outdone itself in terms of relatively violent price swings.

Why is this?

Of course we can only speculate on key drivers, based on what we observe in terms of market commentary and behaviour. However, it would appear that in a period of uncertainty, investors are becoming incredibly short term-focused, responding to every new data point and often extrapolating its impact. Such short termism creates an excellent opportunity for long-term investors like M&G. For example, data points tracking near-term consumer activity in China indicated very weak activity this summer. In response a number of high-quality consumer staple companies, with a long history of steady growth, cash generation and strong balance sheets, saw their shares sold down almost 50%[9]. Resultant valuations implied an incredibly bleak long-term outlook, and thus created favourable risk of ownership for a long-term investor like M&G.

> "[Investors'] short termism creates an excellent opportunity for long-term investors like M&G"

Another factor potentially explaining excessive volatility is the tendency for investors to resort to rules of thumb to try and bring some semblance of order in their minds in an uncertain world. Examples of such behaviour would be how one of our bulk shipping companies has been sold off in response to global growth fears and a textile manufacturer we own declined in response to the threat of higher 'Trump tariffs' in China.

[9] Bloomberg, September 2024.

Such sell-offs took place in previous periods – so a repeat is fair enough? Actually, not really. The shipping company has gone from having net debt to being positive net cash. At the same time, the bulk shipping industry, despite strong profitability, has delayed ordering new ships as owners wrestle with energy transition challenges. This is in stark contrast to the last shipping boom, when ship owners ordered new ships aggressively and thus planted the seeds for an eventual shipping bust. As a result, the fundamental set up is very different from last time. Similarly the textile company has grown its production capacity outside of China materially in the last six years, so it would now be unaffected by additional tariffs on Chinese goods being sold into the US. We have taken advantage of both these episodes to grow our holdings in the companies involved.

Volatile markets are not always fun. Sharp equity price moves can be unsettling and emotionally draining. However, through careful portfolio construction and disciplined bottom-up stock analysis, these periods of volatility can create excellent opportunities for M&G to add value for our clients.

Emerging Markets

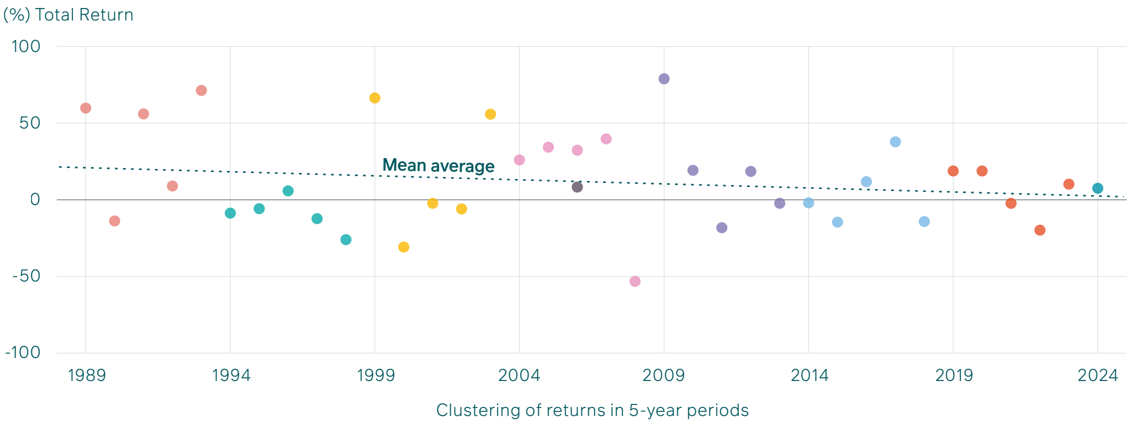
Michael Bourke
Head of Emerging Market Equities

Lessons in volatility

Volatility is the standard deviation of share price returns; in other words, how widely prices differ from the average movement. The chart below neatly captures this dispersion – while the average annual total return in Emerging Market (EM) equities over the last 35 years has been 8.35%, we can see that the level is rarely achieved in any single calendar year. In fact, the index return spends more time away from the average than close to it; meaning that the volatility is higher than the return.

MSCI Emerging Markets Index – Total return by calendar year

Past performance is not a guide to future performance



Source: Bloomberg, Refinitiv DataStream, MSCI, June 2024. Performance period annualised: 30 December 1988 - 28 June 2024. Colour code = clustering of returns in 5-year periods. Past performance is not a guide to future performance.

Earnings for all companies are derived from the business cycle movements of the underlying economy; but the market cycle dwarfs the magnitude of movements in either the earnings or business cycle. What drives this behaviour? Market participants. We do.

Stock price changes do not observe a normal distribution – the mean is higher and tails fatter than a normal distribution. Such return outliers can provide the opportunity for active investors to make alpha.

Specifically, in EM, we can make two observations:

- Due to the compositional effect, the realised volatility has fallen in recent years, with diversification and high country-level dispersion driving different share price patterns of returns. For example, India versus China and Asia versus Latin America.
- Changes in volatility are often precipitated by changes in US equities.

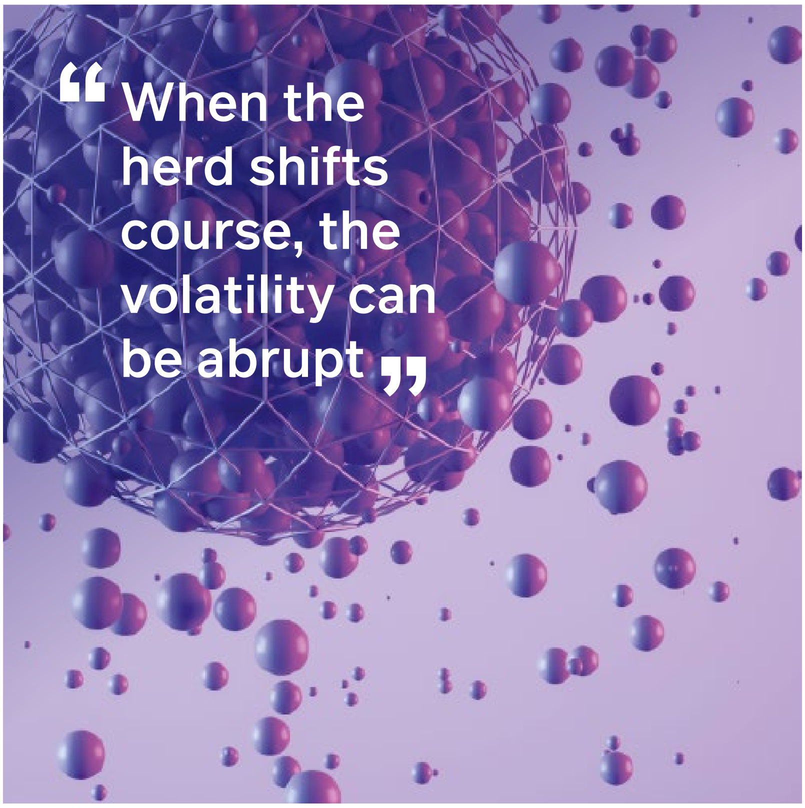
We use our asset class experience to navigate both features in our quest to provide alpha for our investors. This year alone has seen evidence of both in action.

A growing cohort of quantitative and hedge fund investors behave similarly in pursuit of trends, influencing a strong momentum effect in markets; one which is embedded by passive investors. When the herd shifts course, the volatility can be abrupt. Buyers become sellers overnight as leveraged positions unwind in a sell-off. This year's trend has been Artificial Intelligence (AI). Until late June, any stock remotely related to AI exhibited strongly-correlated gains. Since then, doubts have emerged regarding the pace of AI adoption and the actual timing of returns versus expectations, and the market reaction has been swift. For example, shares in AI memory chip company, Hynix, fell 35% from their peak[10].

Our advantage as long-term investors is time horizon. We can take advantage of those moments when abrupt shifts cause market prices to fall rapidly, and well below our assessment of fair value. Our disciplined value-sensitive approach saw us take profits on a number of AI-related names during the first half of 2024, and in the third quarter we were able to step back and analyse these names afresh from the vantage point of lower valuations – focusing on our understanding of earnings and corporate returns to interpret the nature of the stock-level market volatility. Vol-Agility in action. At the margin, we also topped up our exposure to Chinese consumer staples and discretionary names.

Volatility can emanate from different sources. Historically, the biggest source in EM is macroeconomic-induced volatility. The Federal Reserve (Fed) has started cutting rates, with implications for EM currencies and equities alike. EM equities are a local currency asset class. The potential for a lower US dollar in reaction to Fed actions will ease funding conditions and lower borrowing costs for EM borrowers, governments and corporates alike. We have already seen sharp movements in EM currencies year-to-date; notably Thailand and South Africa. Elsewhere, very elevated real yields in Brazil, and the divergent nature of the central bank in raising rates 25 basis points, may warrant the return of the carry trade, with implications for all Brazilian Real assets.

[10] Source: Refinitiv Workspace, 30 September 2024. Period peak to trough (11 July 2024 to 5 August 2024).



Thematic Technology

Jeffrey Lin
Head of Thematic Technology Equities

Volatility in technology is par for the course – compelling opportunities lie ahead for AI leaders

The summer proved to be a volatile period in the technology space, with stalwarts Alphabet, Microsoft, and Nvidia experiencing their share of volatility in the third quarter of 2024.

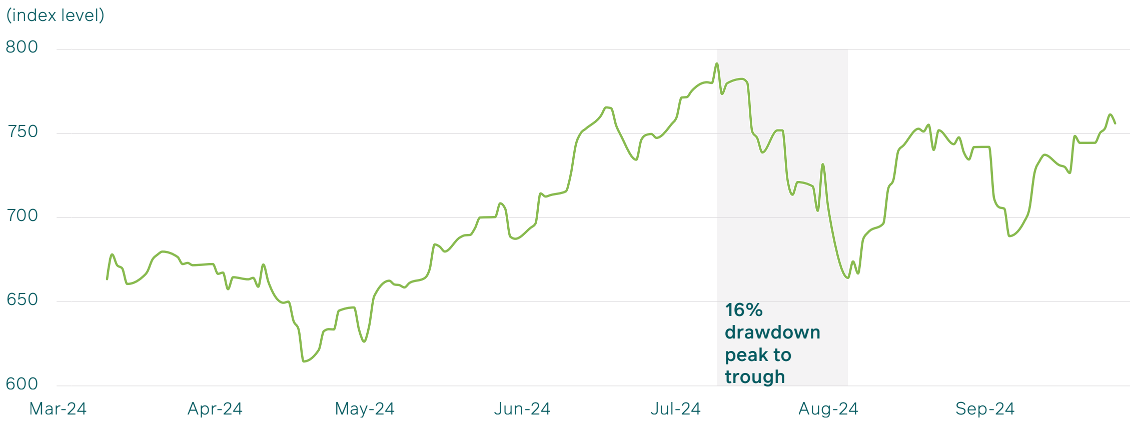
Since 2016, when we first started managing Artificial Intelligence (AI) equity strategies, we have seen several instances of significant technology-related market sell-offs; consider the trade war and rate hike fears in 2018, COVID-19 pandemic in 2020, and the rising inflation and higher interest rate environment in 2022. All subsequently proved to be excellent buying opportunities for investors, primarily due to the durability of growth and profitability trends for leading technology companies, resulting in outsized returns over the long term.

What drove the recent correction?

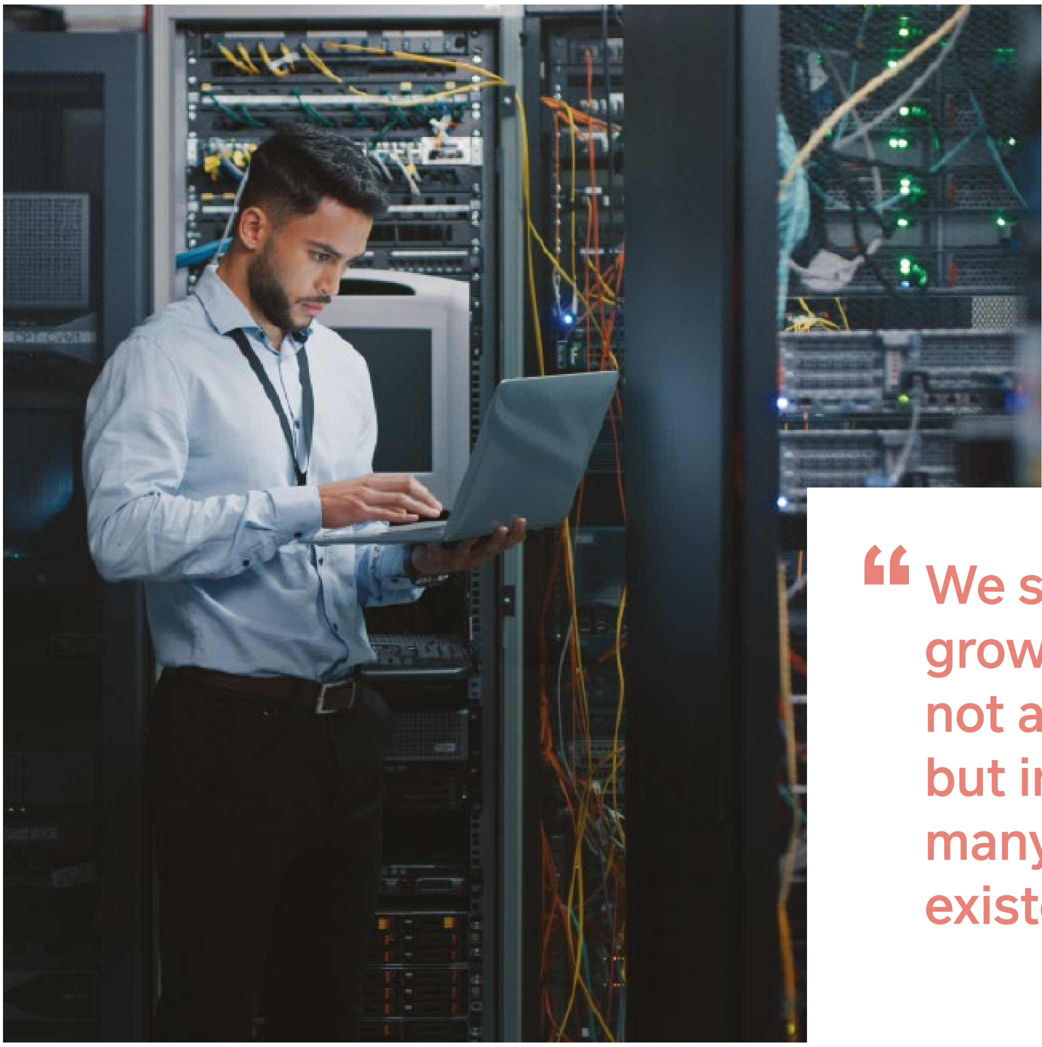
Before looking at what went wrong, we think it is helpful to frame what drove the strong performance in 2023 and the first half of 2024. Essentially, we witnessed an arms race from the largest technology companies globally to build out AI infrastructure such as AI data centres. Collectively, the hyperscalers were spending hundreds of billions of dollars on AI infrastructure and this was boosting the fundamentals of AI enablers such as Nvidia and a large number of semiconductor companies.

After a strong run, investors became skittish and started questioning the Return on Investment (ROI) from all of this infrastructure spending. Then recession fears started to creep in, resulting in a very low margin for error for the technology companies heading into third-quarter earnings season. Despite a relatively solid reporting season in technology, the weakening sentiment resulted in a large sell-off starting in early/mid July through early September.

MSCI World Information Technology Index



Source: Bloomberg, 30 September 2024. Past performance is not a guide to future performance.



> “We see the growth in AI, not as optional, but in many ways existential”

Why we believe the recent correction is a buying opportunity

Firstly, we think the ROI concerns (lack of monetisation) on AI investments are overblown. In our view, we are too early in the AI cycle to make any meaningful assessment on this. We would compare this to the smartphone cycle in its early days before the app store ever appeared. We would also note what the leading technology leaders have said on this subject. Elon Musk recently mentioned that the rate of improvement in AI is the ‘fastest of any technology I’ve ever seen by far’ which justifies the spending. This was echoed by Oracle’s CEO Larry Ellison.

Secondly, we believe the AI theme is largely ‘macro agnostic’ as the hyperscalers have hundreds of billions of dollars in cash and have the ability to invest through economic cycles. In our view, it would take a severe recession to cause these large hyperscalers to adjust their plans.

Finally, we see the growth in AI, not as optional, but in many ways existential. This was echoed on the recent third-quarter earnings calls by many of the large hyperscalers. These large hyperscaler companies will invest in AI infrastructure regardless of the onset of a recession or not. The fact that AI models are getting exponentially larger, the compute power and cooling required to run these models will likely grow a thousand fold every couple of years. This may very well precipitate the biggest arms race in technology that we have ever seen. What’s more, this is just the first phase of growth.

Beyond this, we have enterprise adoption, which will see large frontier models with trillions of parameters, trained on tens of thousands of GPUs (Graphics Processing Units), replaced with custom-trained models, trained for specific applications. For these reasons, we believe there is so much growth ahead of us, which gives us confidence that the recent market correction presents a very compelling investment opportunity for our strategy.

Impact

John William Olsen
Head of Impact and Sustainable Equities

Being 'non-fragile' when volatility hits

"Not seeing a tsunami or economic event coming is excusable; building something fragile to them is not." Nassim Nicholas Taleb, Antifragile

Volatility of markets has always been the opportunity and danger for active managers. Some stock market swings are driven by herd behaviour, provoked by excessive fear and greed. As active managers we try to take advantage of episodic swings to provide long-term gains for our clients. It is a key part of the value we can add. For example, during the summer volatility we topped up on beaten down consumer-related names, that have since rebounded through quarter end.

Most volatility in markets is simply driven by uncertainty around potential turning points and events. The swings can make sense. They secure a longer term-equilibrium between valuations and the eventual outcomes, because some changing fundamentals do shift the underlying value ascribed to asset classes and assets with certain characteristics. The effect of a change in the long-term trend for interest rates is a good example. Difficult to predict, but clearly meaningful to asset values.

In sustainable investing we are looking into the next quarter with extra caution and interest, because of a US election that could have longer-term implications for general stock market conditions, world trade, health care, renewables and ESG investing. The market has already been flipflopping between 'Trump trades' and 'Harris trades' and mostly presenting a fair reflection of the odds ascribed to each candidate. For us to take more than a wishful position on a win by either candidate seems like a fools game, and the market is rapidly reflecting a probability-weighted effect of something basically unpredictable.

We invest with a view to holding stocks for a decade or longer, so why does it make sense for us to study future sources of volatility and disruption?

Preparedness is the main reason, much more than trying to actively position our portfolio to gain from any particular near-term outcome. Part of our job as active managers is to create a portfolio of stocks that will create superior returns, but most of our clients also prefer for us to do that in a risk-adjusted fashion. Even more importantly, heading into volatility well prepared, and with a robust (non-fragile) portfolio, helps to put us psychologically, and in practice, in a much better situation to explore, and possibly exploit, the price swings. Creating the foundation for future returns.

“...heading into volatility well prepared [allows us] to explore, and possibly exploit, price swings”

Global Research

Mark Wilson
Global Industrials Analyst

De-stocking is a fading headwind that could mark the start of recovery

It's been a tricky year for investing in industrials. The more cyclical stocks have materially underperformed more defensive companies. Companies involved in electrification, datacentres, grid spending, and commercial aerospace have been stand out positives, but many shorter (earlier) cycle companies have been increasingly downbeat as hopes for late-2024 demand improvements have faded away.

During conference season this quarter, the tone from companies was underwhelming, with no shortage of industrial bellwethers reporting anaemic trends. A widespread tone of frustration persists around 'feeling stuck on a ship to nowhere', rocking from side to side on waves of hope and fear.

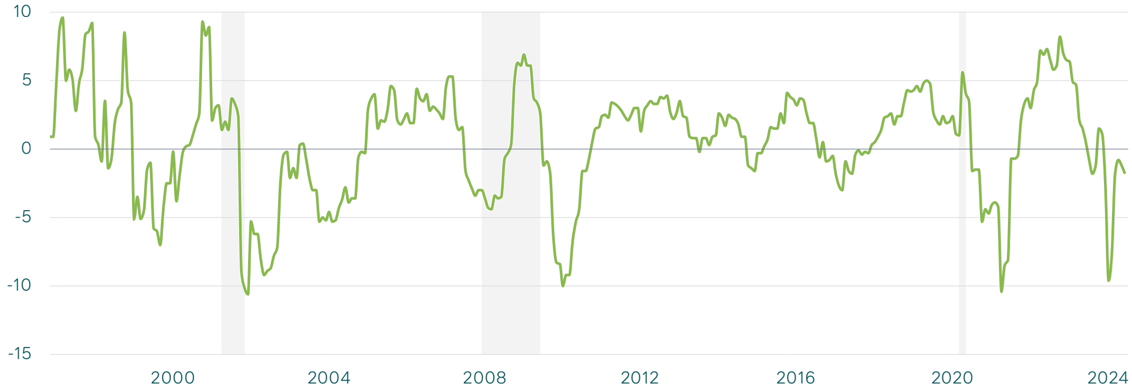
The US Federal Reserve's (Fed) 50 basis point rate cut and news of a China stimulus package have brought new waves of hope, but lead indicators have only served to reinforce pessimism, with the widely followed US ISM Purchasing Managers' Index (PMI) extending its near two-year phase in contraction territory, honing in on the pre-financial-crisis record. Japan machine tool orders had suggested that PMIs might soon inflect positively but, in August, they also returned to negative territory after three consecutive months of positive prints. Labour data seems to be weakening too, though at least here we know the data is typically a lagging indicator.

While indiscriminate bouts of market volatility haven't helped, much of the industrial weakness has been driven by the inventory cycle. Supply-chain shortages post-COVID quickly gave way to gluts, and by the end of 2023, many industries were sitting on too much inventory. The de-stock in 2024 has been as aggressive as any witnessed during previous recessions.

> "While indiscriminate bouts of market volatility haven't helped, industrial weakness has been driven [primarily] by the inventory cycle"

Days sales of inventory

(YoY % change), grey bars are recession periods



Source: BofA US Equity & Quant Strategy, Factset, August 2024. *Select industry groups include Automobiles and Components, Capital Goods, Consumer Discretionary, Distribution and Retail, Consumer Durables and Apparel, Consumer Staples Distribution and Retail, Food, Beverage and Tobacco, Health Care Equipment and Services, Household and Personal Products, Materials, Pharmaceuticals, Biotechnology and Life Sciences, Semiconductors and Semiconductor Equipment, Technology Hardware

Does that suggest we're heading for, or indeed already in recession? Perhaps, though there's no doubt that the signalling from these indicators has been clouded by the unusual experience of COVID shutdowns and post-COVID disruption.

As we enter the fourth quarter, what we can say with confidence is that de-stocking will soon be behind us, and our most recent meetings with automation equipment suppliers and truck manufacturers around the globe, suggest exactly that. Whatever happens to underlying demand from here, it won't be compounded by de-stocking.

To take advantage of idiosyncratic opportunities, agility is key. If 2024 so far has been a year of a thousand cuts, the next phase offers scope for much better progress, in our view, including for many beaten-up shorter-cycle stocks. Therein lies the opportunity for active investors like us.

Multi Asset

Craig Moran
Fund Manager, Multi Asset

Exploiting the opportunity created by volatility across asset classes

Coming into 2024, as discussed in our monthly Asset Allocation views back in January 2024, we observed there was a high chance of elevated volatility in the year ahead across a number of asset classes. This observation was based on prevailing valuations, increasing macroeconomic uncertainty, an expected shift in the direction of monetary policy, observable geopolitical factors, and of course an awareness that events will always have the potential to take markets by surprise. The third quarter, in particular, saw a significant pickup in observable market volatility, particularly in equity markets, interrupting what had previously been a very pleasant ride for equity investors up until mid-July.

The most significant bout of volatility occurred in the first few days of August, where we saw steep declines in global equities and a strong rally in government bonds. The sharp jump in equity market volatility can be observed through the VIX Index, which temporarily spiked to 65 intraday[11].

The most extreme manifestation of this price action and volatility was seen in Japanese equities, which over the course of five days fell nearly 25% in value, an unprecedented decline. Other equity markets also fell, however none to the same extent.

Topix Index

Source: Bloomberg, 20 September 2024. Past performance is not a guide to future performance.

During this phase, market commentators scrambled to explain and understand what was causing the volatility, with suggestions ranging from unwinding carry trades to concerns about the global economy being offered as plausible reasons; none of which were sufficient to explain such violent price action. Our sense was that given the extent and speed of the move, there was evidence of non-fundamentally driven selling pressure as a result of short-term de-risking of portfolios.

For our tactical portfolios, this represented an opportunity to exploit the short-term volatility by adding exposure to Japanese equities, which only weeks earlier had become somewhat of a market darling on the back of strong profits delivery, increased shareholder returns and a positive

[11] Source: Bloomberg, 30 September 2024.

economic outlook. As the episode unwound and prices recovered almost back to where they had started, we removed the tactical capital, locking in gains.

During this same phase at the start of August, we saw a significant repricing of interest rate expectations and bond yields decline materially, most significantly in shorter-dated bonds. Tactical portfolios that had added exposure in this part of the curve during the April sell off were able to take profits and scale back those positions in response to the significant price gains in bonds.

Volatility has subsided...for now

As we enter the fourth quarter of 2024, the panic and volatility of markets appears to have subsided for now. Global equities are close to all-time highs and credit spreads remain tight.

Risk assets appear to expect benign outcomes for growth, profits and inflation going forwards. At the same time, we have seen a dramatic repricing of interest rate expectations over the summer.

Viewed together, the repricing of risk assets alongside the repricing of interest rate expectations seem to convey the market is expecting benign economic outcomes: the once thought impossible perfect soft-landing scenario appears to now be the central case.

As ever, it is challenging to predict what macroeconomic outcomes will occur over the period ahead as the current picture remains mixed. However, should markets revisit some of the growth concerns over the summer or the inflation concerns of earlier in the year, it is likely that volatility will return to major asset classes. This is before we even begin to consider possible volatility from ongoing geopolitical tensions, plus significant elections on the horizon – all taking place at a time where we are seeing major shifts and possible divergences in economic growth and monetary policy globally.

As demonstrated over the summer period, volatility – though scary at the time –can also be a major source of opportunity and returns. This can only be achieved with an approach designed to exploit such bouts of volatility, often very rapidly, and with portfolios well positioned to be able to respond. For instance, alongside risk assets which can continue to do well in a benign or positive growth environment, we also own significant exposures in long-dated treasuries that can protect the portfolio should a more sinister growth shock emerge. We remain well diversified at present, but with ample capacity to be able to respond to short-term volatility, should opportunities present themselves in the weeks and months ahead.

> **“Should markets revisit some of the growth concerns over the summer or the inflation concerns of earlier in the year, it is likely that volatility will return to major asset classes”**

Convertibles

David Romani
Deputy Fund Manager, Convertibles

Looking beyond the 'macro' to identify intrinsic value

In the third quarter, financial markets marched to the drumbeat of shifting interest rate expectations and Artificial Intelligence (AI)-related stories, much as they did during the preceding quarters. Neatly illustrating this type of price volatility was the 20% flash sell-off of Japanese equities over a matter of days, after the yen appreciated by 10% and the US 10-year treasury yield fell below 4%[12].

How can we manage a convertibles strategy amid this volatility?

With a large number of factors influencing convertibles' returns: equity prices, credit spreads, interest rates and foreign exchange, along with external factors such as political events, geopolitical risks and natural disasters – the answer is to focus on company fundamentals, which are far less variable than prices.

We assess where prices and valuation have deviated significantly from those fundamentals. We do not waste energy trying to predict macroeconomic outcomes as we are unlikely to have any degree of accuracy.

> "While wider external influences can generate price volatility, it is essential [to] look deeper to understand the fundamental drivers of businesses"

Instead of estimating Chinese GDP growth, for example, we observe the yield and spread on the USD-denominated 2028 convertible bonds issued by a Chinese food delivery, local eCommerce and online travel platform company, and judge that it offers an attractive credit valuation. The convertibles are puttable and can be redeemed (within four years), and are yielding over 6.5% (or over 200 basis points in excess of the equivalent treasury bonds). Regardless of what happens with the Chinese economy, given the low delta there is no equity risk and it offers an attractive risk-reward for a firm that is rated BBB+, has a net cash position and is showing strong performance revenue and earnings growth – thanks to margin improvements in core local commerce and reduction in losses in new initiatives.

Another example is a US provider of cloud-based software that is a beneficiary of generative AI. The stock sold off in the middle of the third quarter, in sympathy with Nvidia, and amid a change in US interest rate expectations. Looking at company fundamentals, though, the firm has a unique position in the technology stack and is gaining market share and new clients. It has strong financial metrics, a focus on profitability and cost discipline.

[12] Source: Refinitiv Workspace, 30 September 2024. TOPIX Index, price returns, 31 July 2024 to 5 August 2024.

The company is attractively valued versus peers and offers considerable equity upside in our view. The firm has low leverage and abundant free cashflow generation. We do not have to think about near-term Federal Reserve (Fed) rate decisions or the US election opinion polls to recognise value.

While wider external influences can generate price volatility, it is essential to strive to look deeper to understand the fundamental drivers of businesses, earnings and cashflows, and ultimately intrinsic value. By doing so, we believe it is possible to identify the right assets to achieve superior risk-reward characteristics.