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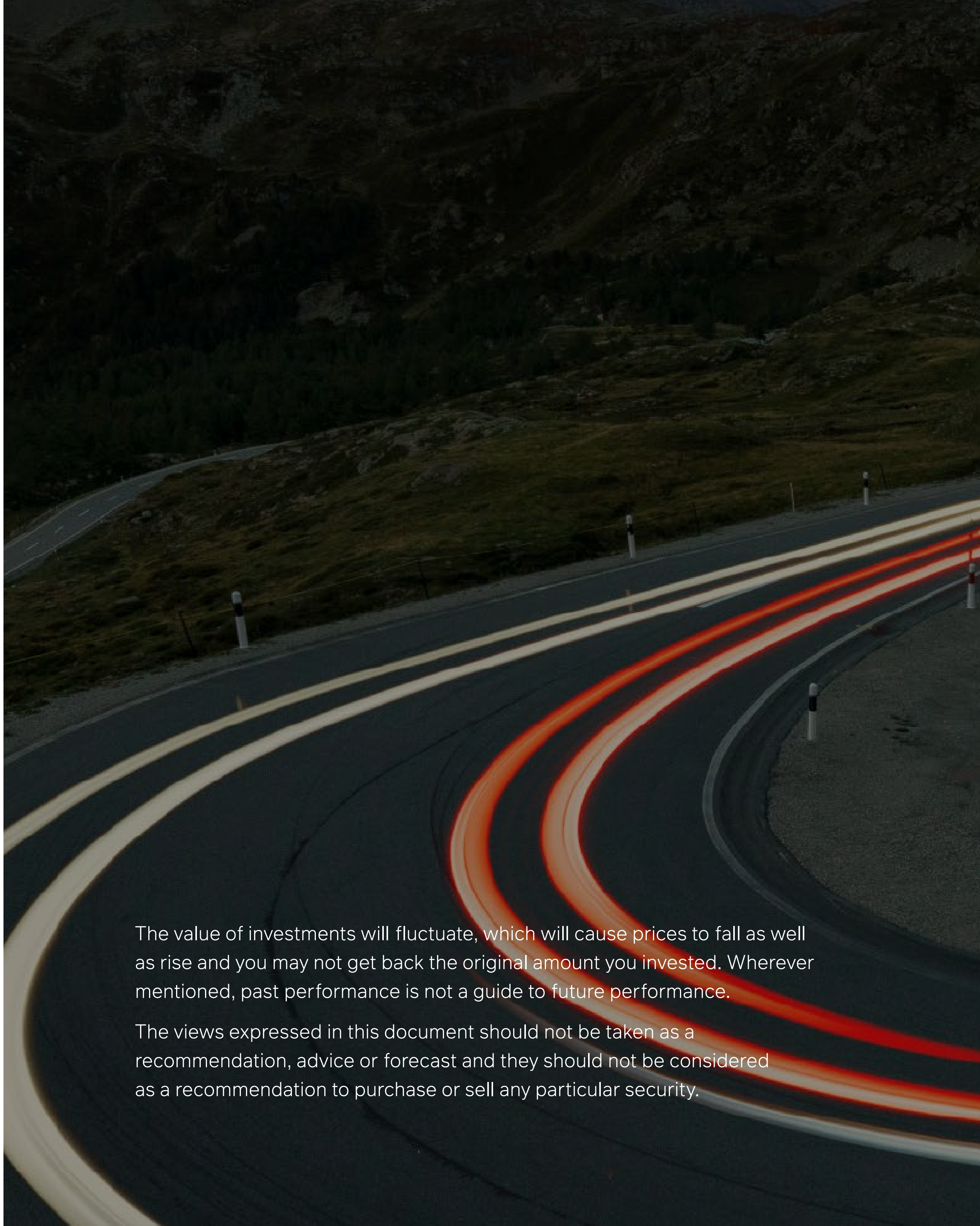
M&G Investments

Investment Perspectives
Mid-Year 2024 Outlook

Descent from the peak

Contents



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Shifting narratives and diverging policies

Welcome to the Investment Perspectives Mid-Year 2024 Outlook. With major central banks moving closer to, or in some cases already implementing, interest rate cuts, M&G Investments' Chief Investment Officers (CIOs), fund managers and investment experts explore what this new policy direction might mean for financial markets.

Amid a complex macroeconomic backdrop and political and geopolitical uncertainty, the descent from the peak could be bumpy, but we believe there is currently a wide array of promising opportunities for disciplined selective investors, across public and private markets.

Bringing together expert views from different asset classes, we seek to illuminate for our clients the investment landscape and map out potential opportunities.

The outlook for monetary policy has continued to dominate financial market commentary this year. At the start of 2024, markets were implying multiple interest rate cuts, but since then the narrative has shifted dramatically as investors have pushed out their expectations for when those cuts will take place.

However, in contrast to much of the previous two years, changing rate expectations have resulted in different outcomes for fixed income and equity markets. So far this year most bonds have been weak, but because this has been the result of resilient growth and stubborn – not rising – inflation, equities have moved higher.

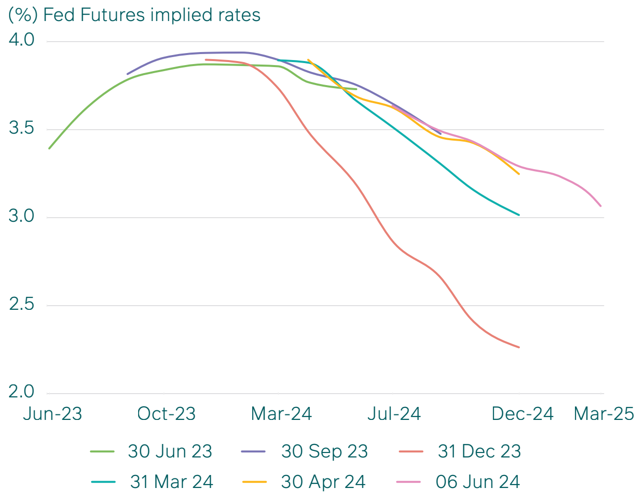
Global stock markets have reached record highs, initially driven by continued excitement about the potential of artificial intelligence (AI) but ultimately broadening out beyond the US and technology. Investors have even returned to formerly unloved stock markets in the UK and China.

In her **'Hidden gems of innovation'** section, **Fabiana Fedeli**, CIO Equities, Multi Asset & Sustainability, discusses this trend, observing that the market is broadening and stock-specific drivers are coming to the fore. In her view, share price performance has been driven by companies beating earnings expectations and successfully delivering innovation.

The combination of undemanding expectations and the power to innovate will be among the best hunting grounds for the creation of alpha in future, according to Fabiana.

As the valuations of many innovative companies have risen spectacularly, in order to harness the potential of innovation and new technologies, Fabiana believes investors need to dig deeper and broaden their search to discover the hidden gems of innovation that are delivering differentiated products and solutions across the globe.

Expectations of US rate cuts have been pushed out



Source: Bloomberg, 6 June 2024.

Focus on central bank policies

As we look ahead to the second half of the year, the main focus for investors may well continue to be central bank policies and the path of interest rates. With the experience of the last couple of years and policymakers' "data dependent" approach, it is perhaps not surprising to see significant market myopia: investors obsess over every relevant data release to try and anticipate the Federal Reserve's (Fed) policy moves. This 'guessing game' has arguably contributed to short-term volatility, such as the wild swings in bond markets seen in the second half of 2023, and could continue to be a source of opportunity for longer term investors.

CIO Jim Leaviss and the Fixed Income team believe that inflation will continue to ease, providing hope for the prospect of rate cuts by the Fed this year. However, they caution in **'Approaching the descent'** that we could be entering a new era of structurally higher inflation, which might mean interest rates settle at a higher level than they were before this rate-hiking cycle.

The team also notes that we are beginning to see central bank policy diverge. Some central banks, notably the European Central Bank (ECB), have begun easing monetary policy ahead of the Fed. In their view, this divergence offers potential opportunities for fixed income investors to diversify across geographies and sectors.

Significantly, the prospect of rate cuts provides a potential opportunity for fixed income investors to capture attractive gains, according to the team. In particular, they believe the current macroeconomic environment is relatively supportive for investment grade (IG) credit, as many IG companies remain in a strong position, having locked in low financing costs for an extended period.

The rise in real (inflation-adjusted) interest rates has had a significant impact on many private markets, says **Emmanuel Deblanc**, M&G Investments' new CIO of Private Markets. On a long-term view, Emmanuel suggests this has actually been a positive for private markets: it avoids the misallocation of capital, fundamental in correctly pricing assets.

Despite a challenging environment, Emmanuel believes opportunities persist in the 'value-add' and opportunistic areas of private markets, including real estate and infrastructure. Structured credit also looks attractive, in his view, with growth driven by the ongoing retrenchment of banks.

For Emmanuel, there are grounds for optimism but investors need to have a clear focus and be selective in their approach to private markets

Politics and markets

So far, "the year of elections" has not proved to be especially dramatic, with few surprise results. However, this could change with the US presidential election in November. While the possible re-match between Joe Biden and Donald Trump is inevitably attracting plenty of media attention and speculation, the impact of the vote on markets is near impossible to forecast. It is worth remembering that the Trump victory in 2016 resulted in market moves that were almost the total opposite of those predicted by pundits.

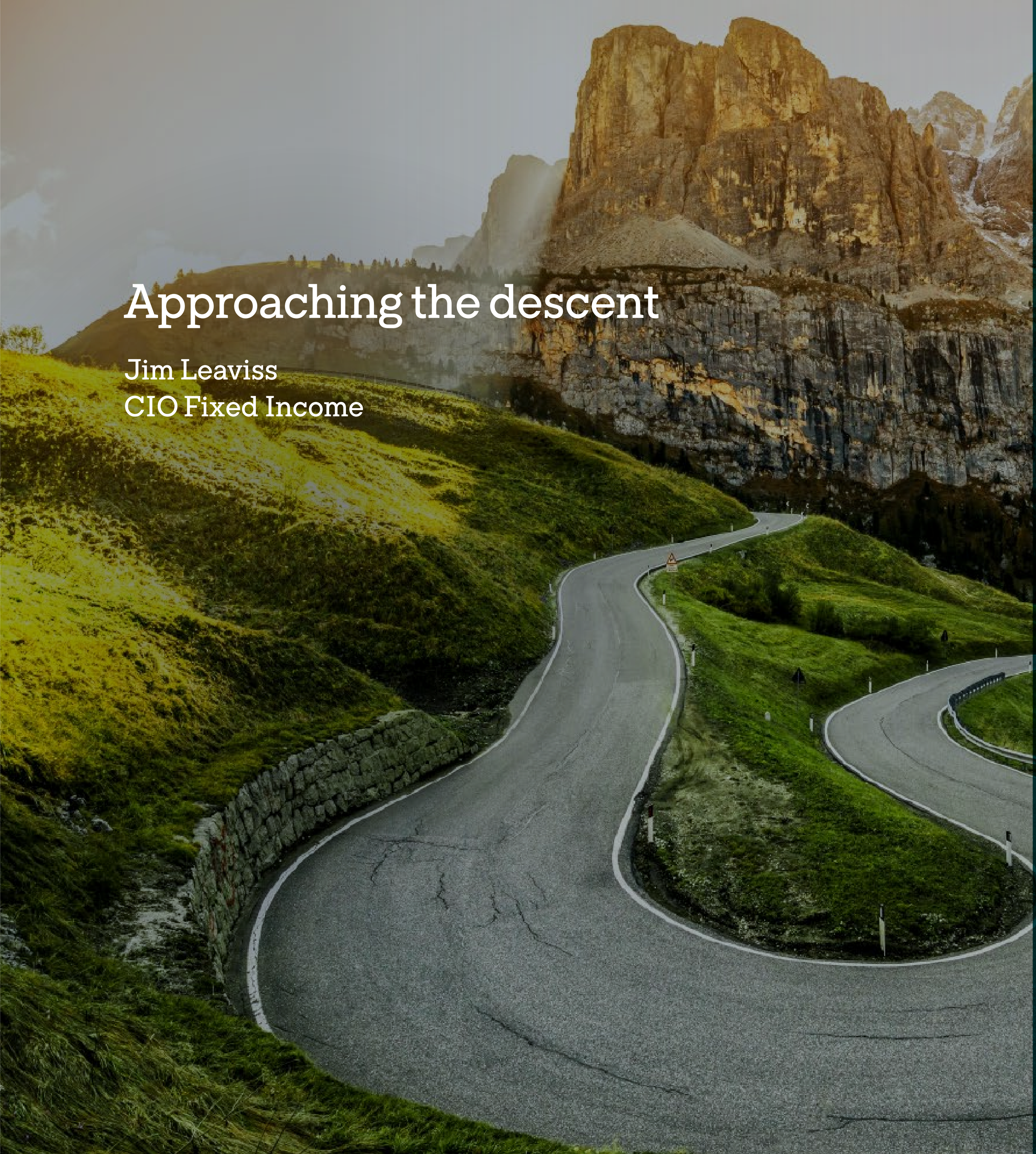
As the election approaches, we will inevitably learn more about the candidates' policies. Although it will be hard to ignore the political clamour, it is worth bearing in mind that, from a long-term investment perspective, what really matters is meaningful policy changes that could have a significant impact on the economy. The rest is just 'noise' that could create tactical opportunities for long-term active investors to exploit.

Embracing the long-term

After a positive start to the year, the investment landscape remains challenging, with major macroeconomic and political events looming in the coming months, as well as the broader backdrop of geopolitical tensions.

By looking beyond the day-to-day noise and adopting a longer-term investment horizon, we believe active selective investors can position themselves for future success and even reap rewards when volatility is elevated.

Patience is a valuable aspect of investing. In the current environment of heightened unpredictability and as the world continues to adapt to a higher interest rate regime, staying focused on long-term goals is arguably more important than ever.



Approaching the descent

Jim Leaviss
CIO Fixed Income

Key takeaways

- While we believe inflation and interest rates are on a downward trend, the descent could be bumpy and they could settle at higher levels than previously.
- Central banks are approaching rate cuts cautiously but as policies diverge there could be opportunities for active bond investors to diversify across geographies and sectors.
- The prospect of rate cuts is a potential opportunity for fixed income investors and we believe the current macroeconomic environment remains relatively supportive for investment grade credit.

Since the beginning of the year, investors' hopes of significant rate cuts in 2024 have been dented by data points showing that inflation was proving stickier than expected, as well as resilient growth and a strong jobs market in the US.

As we enter the second half of the year, markets are now pricing in two cuts of 25 basis points each by the Fed for this year. The Fixed Income team explores how long might rates stay elevated for and what the final landing point might be.

Where do we think inflation will go from here?

After ticking up for three consecutive months, April's US Consumer Price Index (CPI) numbers landed in line with expectations, with year-on-year core inflation registering at 3.6%, the smallest number in three years, while headline inflation decreased to 3.4% year-on-year[1].

This number offered a relief for markets, indicating that inflation is continuing to ease and restoring hopes that rate cuts are once more on the horizon.

We believe that inflation is on a downwards trajectory. We view stubbornly high rents as one key contributor to the recent higher than expected US inflation numbers. Rents are typically 'stickier', in part due to the calculation methodology used by the Bureau of Labor Statistics and the nature of the rental market. Historically, housing market trends have been a leading indicator for rent inflation with house prices typically leading rent inflation by about 18 months. House prices have stabilised following a recent surge, suggesting that rent inflation is likely to continue moderating throughout 2024. Therefore, we believe that one of the stickiest categories in the CPI basket is trending in the right direction.

Furthermore, one of the key drivers of inflation is money supply, with periods of significant inflation characterised by excessive money printing. The Fed undertook significant quantitative easing (QE) in response to the COVID-19 pandemic. However, since June 2022, the central bank began the process of quantitative tightening (QT). As a result, its balance sheet has been reduced by about $1.6 trillion from a peak of near $9 trillion in early 2022. Money supply tends to lead inflation by approximately 18 months and therefore we believe this reduction supports the assumption that inflation will continue to ease throughout the year.

Bumpy path to inflation target

However, while we believe inflation is moving in the right direction, there may yet be some bumps along the road.

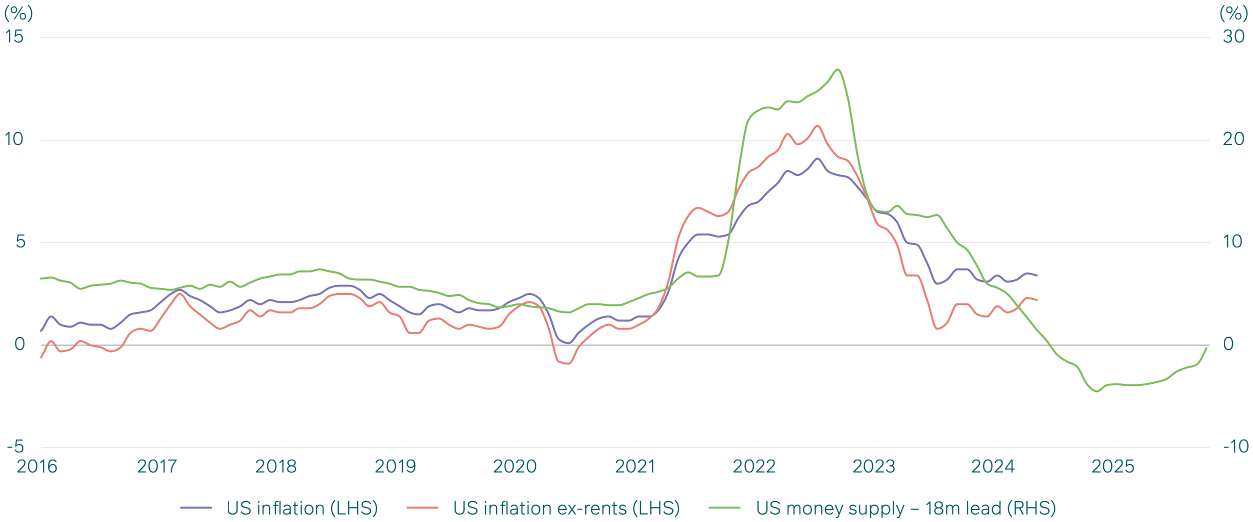
While April's inflation data offered markets a slight reprieve, 3.6% is still well above the Fed's 2% target and several Fed policymakers have adopted 'higher for longer' rhetoric following the release. For example, Atlanta Fed President Raphael Bostic commented that the new "steady state" for interest rates is likely to be higher than experienced over the last decade.

The road to lower rates is littered with obstacles with potential impacts from a still resilient economy and jobs market, as well as the US presidential election in November.

Both geopolitics and the US election raise the potential risk of a resurgence of inflation. With US Treasury interest payments on a 12-month cumulative basis hitting $1 trillion in March and both presidential candidates campaigning on potentially inflationary policies, such as increased tariffs, there are some concerns about US fiscal sustainability.

[1] Source: US Bureau of Labor Statistics, May 2024.

Inflation trending downward as money supply has fallen



Source: M&G, Bloomberg, 30 April 2024.

Furthermore, there is an argument that inflation, and interest rates, have entered a new era and will remain higher. Factors such as the green transition, prolonged periods of heightened geopolitical tension and demographic trends could see the so-called 'neutral rate' – the level at which interest rates neither stimulate nor hold back the economy – settle at a higher level.

While we believe interest rates and inflation are heading downwards, questions linger over the speed at which they will ease.

Policy divergence

Since the beginning of the current rate hiking cycle in 2022, most developed market central banks have moved in step with one another. However, with the path of inflation and growth moving at different rates globally, we are beginning to see central bank policy diverge, with developed market (DM) central banks now beginning to act independently of the Fed.

Following the Swiss National Bank, Sweden's Riksbank and the Bank of Canada, the European Central Bank (ECB) has become the latest central bank to start easing monetary policy. The ECB has cut interest rates from record highs, in response to inflation falling close to the bank's 2% target. Markets are pricing in another rate cut this year.

These early moves are in contrast to the scaled back expectations for Fed cuts. ECB president Christine Lagarde has emphasised that the ECB was "data dependent", not "Fed dependent". She added that the two inflations (eurozone and US) are not the same. Eurozone annual inflation fell to 2.4% in April, close to the ECB's target, while economic growth in the bloc was stagnant in the fourth quarter of 2023 before recovering slightly to grow 0.3% in Q1 2024.

However, central banks are proceeding cautiously as cutting rates ahead of the US risks currency depreciation, which in turn could spark an upswing in inflation from more expensive imports.

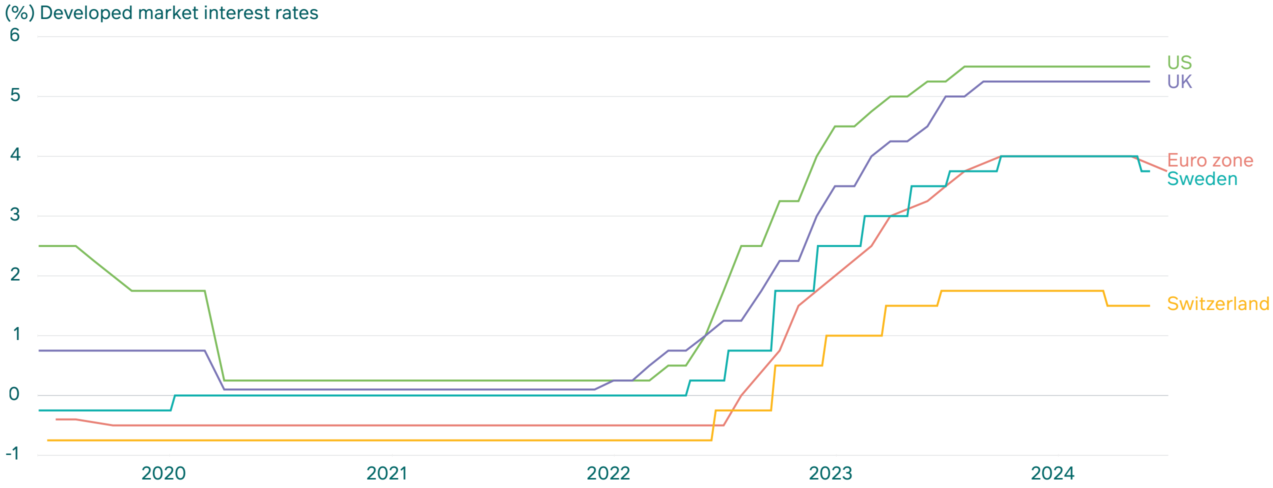
The Bank of England is also largely expected to reduce interest rates with futures pricing in an almost 100% chance of a cut at its August meeting[2]. This comes following a sharp fall in the UK's inflation rate to 2.3% in April.

Emerging market central banks led the cycle by hiking faster and further than developed market central banks in an initial response to the uptick in inflation. As a result, these banks subsequently began their cutting cycle earlier, with Brazil making its first cut in August 2023.

As central banks diverge on the path down from the peak, we see potential opportunities for investors to diversify across geographies and sectors. Diverging paths could also make the descent from peak rates more perilous, making active management especially important, particularly within fixed income.

[2] https://www.reuters.com/world/uk/with-inflation-falling-fast-will-boe-quickly-cut-rates-2024-05-21/

Central bank policy divergence



Source: LSEG Datastream, 7 June 2024.

What does the current environment mean for bonds and where are the opportunities?

Fixed income markets saw a strong and rapid rally in the fourth quarter of 2023, leading many investors to fear that they had missed out.

However, as it became clear that the 7 interest rate cuts originally priced in for the US for 2024 were unlikely to materialise, DM sovereign markets gave back some of their gains in the first few months of the year.

[3] Source: Deutsche Bank, December 2023.

As such, for those who missed out on the bond rush in Q4 2023, the prospect of rate cuts on the horizon provides another potential opportunity to capture attractive gains. As we highlighted in the previous edition of Investment Perspectives, the beginning of the easing cycle can be highly supportive of fixed income markets.

Historically the 10-year US government bond (Treasury) tends to rally after the end of the Fed's hiking cycle. For example, on average, if you bought a 10-year Treasury 63 days before the first Fed cut, you would see a 7% capital gain from a 1% fall in yield, plus the carry, according to research by Deutsche Bank[3]. As such, investing in Treasuries at the peak of the cycle has the potential to deliver a healthy capital gain from a credit risk-free asset.

Supportive environment for credit

While we are looking to position more defensively, we believe the current macroeconomic environment remains relatively supportive for investment grade (IG) credit, with inflationary pressures slowly easing, while growth remains supported by a healthy labour market.

Many IG companies remain in a strong position, having locked in low financing costs for an extended period and thereby insulating themselves from interest rate increases. Additionally, their large cash balances are earning attractive interest rates, allowing them to benefit from higher rates and providing them with a liquidity cushion. As a result, despite higher rates, most IG corporates' balance sheets remain healthy with cash balances and profit margins remaining high.

The enthusiasm for IG credit is demonstrated by the record volumes of new issuance in the first quarter of 2024, as companies seek to take advantage of strong investor demand. Corporate borrowers issued $606 billion worth of dollar bonds in the first quarter of 2024, the highest total since at least 1990[4] as investors sought to secure high yields before the Fed begins loosening policy.

[4] https://www.ft.com/content/2b16f721-007d-4148-b4b7-bca15d054bed

Actively seeking value in short-dated credit

Matthew Russell
Fixed Income Fund Manager

The US Treasury yield curve has been inverted since July 2022, the longest continuous inversion ever[5]. Yield curve inversion is when short-term bonds yield more than longer-dated bonds. This occurs as investors expect the Federal Reserve (Fed) to hold short-term interest rates higher before cutting in the longer term. An inverted yield curve is widely considered as an indicator of an impending recession.

However, an environment where the yield curve is highly inverted also means bond investors could benefit from higher yields at the front end of the curve, without taking as much interest rate, or duration, risk. (Longer dated bonds are more sensitive to changes in interest rates).

The Fed and other central banks have raised borrowing costs aggressively in the past couple of years, in response to soaring inflation. This has been a challenging environment for bonds. However, at the end of last year fixed income markets rallied on expectations that the rate hiking cycle was at an end. There was a substantial opportunity for returns. However, for investors to profit from this was highly dependent on making the correct duration call.

In such an uncertain environment, investing in short-dated bonds can reduce duration risks, decrease downside risks and bring down volatility. By reducing duration, there is less pressure to make a correct call on the timing of the Fed's interest rate decisions. The current curve inversion shows that the market is still expecting rate cuts ahead, in our view. If these were to be adjusted and yields rise, it could result in losses for long duration assets. (Yields move in opposite directions to prices).

As a result, we believe active bond management is as important as ever. As we move through the cycle, spreads will likely tighten on different sectors and bonds, which can provide a rich source of alpha-generating opportunities for active managers; credit selection capabilities are crucial as a volatile market environment can increase dispersion between individual credit valuations.

Furthermore, M&G's credit research capabilities help to ensure that credits we invest in look robust, especially when spreads are tight. This can help avoid credits which are likely to lose value.

Adding value

Our investment universe is not restricted to euro-denominated debt, giving us a wider opportunity set to look for excess returns. For example, a company may issue bonds in sterling, euros and dollars and have the same maturity, duration and credit risk; we have the potential to capture the widest spread and highest yield after hedging back to euros. These plays incrementally add to performance which is how an active manager can add alpha.

We are also able to add value by investing in floating rate notes (FRNs), debt instruments with coupons that fluctuate with interest rates, and asset-backed securities (ABS).

Investing in FRNs enables us to take credit risk with a low level of interest rate risk. Meanwhile, AAA-rated ABS can offer a similar risk premium to BBB unsecured credit. Our approach is to take risk when we believe we are being paid for doing so. With one of the biggest teams of ABS analysts in Europe, we believe we can effectively conduct due diligence and hunt for relative value.

[5] https://www.reuters.com/markets/rates-bonds/us-treasury-key-yield-curve-inversion-becomes-longest-record-2024-03-21/#:~:text=The%20part%20of%20the%20Treasury,ones%20%2D%20since%20early%20July%202022.

A proactive, disciplined approach to credit

Wolfgang Bauer
Fixed Income Fund Manager

While we avoid taking an overall macroeconomic view, we cannot ignore the overall picture; we take an assessment of perceived risks and opportunities.

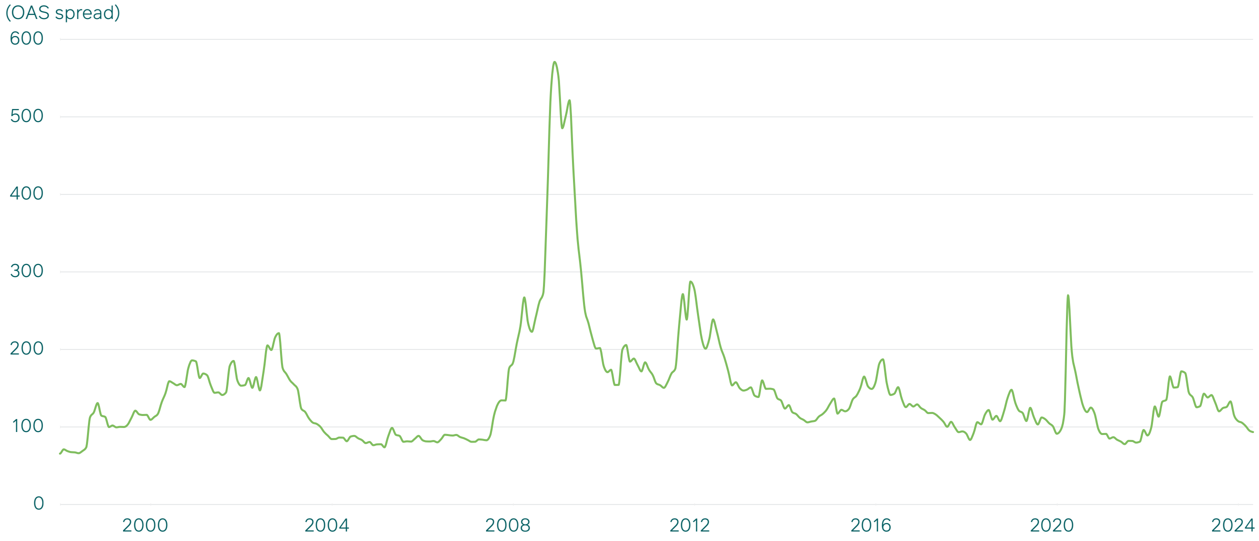
Currently, we believe there is a mismatch between the risks and what is priced in many parts of the credit world; in our view, there are many areas where there is not adequate compensation for these risks and therefore, we believe it is important to derisk in certain areas, ready to deploy capital once there is sufficient compensation.

Lingering inflation

One of the risks facing markets at the moment is lingering inflation; while the inflation picture has improved over the last 12 months, core inflation has proven to be a lot stickier than hoped by both central banks and markets. We believe we have probably seen peak rates and we are unlikely to see a meaningful reacceleration in inflation or higher rates. However, the main risk is that core inflation lingers significantly above target, which in turn could slow down the pace of central bank rate cuts.

This brings its own risks; interest rate markets have already experienced a reality check since December 2023, as it became apparent the scale of rate cuts priced in was unlikely to occur. Yet, this was largely ignored by credit markets.

Global IG credit spreads have narrowed



Note: Spread is adjusted for rating and maturity changes over time.
Source: Bloomberg, ICE Bank of America indices, 30 April 2024.

Pressure of higher refinancing costs

However, higher rates mean higher refinancing costs for companies. While many companies are in a strong position to tolerate higher refinancing costs, the riskier parts of the market may experience pressure should the "higher for longer" scenario play out. This is a risk which we don't see as fully priced in.

Default rates have slowly started to rise, especially in the US. While still at reasonably low levels, they are trending higher as would be expected given higher refinancing rates. The longer higher rates persist, the more likely we will see an acceleration in default rates as some companies may be merely playing for time.

As such, it is important to take a selective, active approach by looking at individual companies and understanding which are suited to survive and thrive in this environment, and which might be challenged with too much debt.

Tight spreads

In Europe, while there has been some tentatively good news in the latest data points for the purchasing managers indices (PMI), the manufacturing component remains in contractionary territory. Therefore, there remains a risk that Europe will continue to flirt with recession for longer than anticipated, which might pose a challenge for some companies' profitability.

Despite these risks, credit spreads have done very well, not least due to the relentless inflows into the asset class. Many institutional investors re-entered the asset class as yields increased sharply throughout 2022 and 2023.

These inflows into the asset class have put strong downward forces on credit spreads, leading to the current spread compression. While this trend may continue for some time as yields remain reasonably high compared to where they have been historically over the last five years, flows into the asset class may ultimately start to stutter due to diminishing risk premiums.

Proactive approach

Currently we have been taking a measured derisking where we feel that valuations no longer justified the risks. In turn, we have built up defensive assets that fulfil three conditions; they should be short-dated, default remote (highly rated) and highly liquid. If the market begins to sell off, we would want to be in a position to swiftly liquidate these positions and buy riskier credit at better valuations. However, we still believe there are pockets of value, particularly within financials and real estate.

We will never be able to perfectly time the market; instead, we have to steer cautiously and be proactive, rather than reactive. We need to be disciplined and sell risk when it is getting expensive. We prefer to derisk into strength and build up liquid "war chests" so if markets sell off and valuations become more attractive, we can deploy capital quickly. The beauty of this approach is that we are not dependent on market timings.

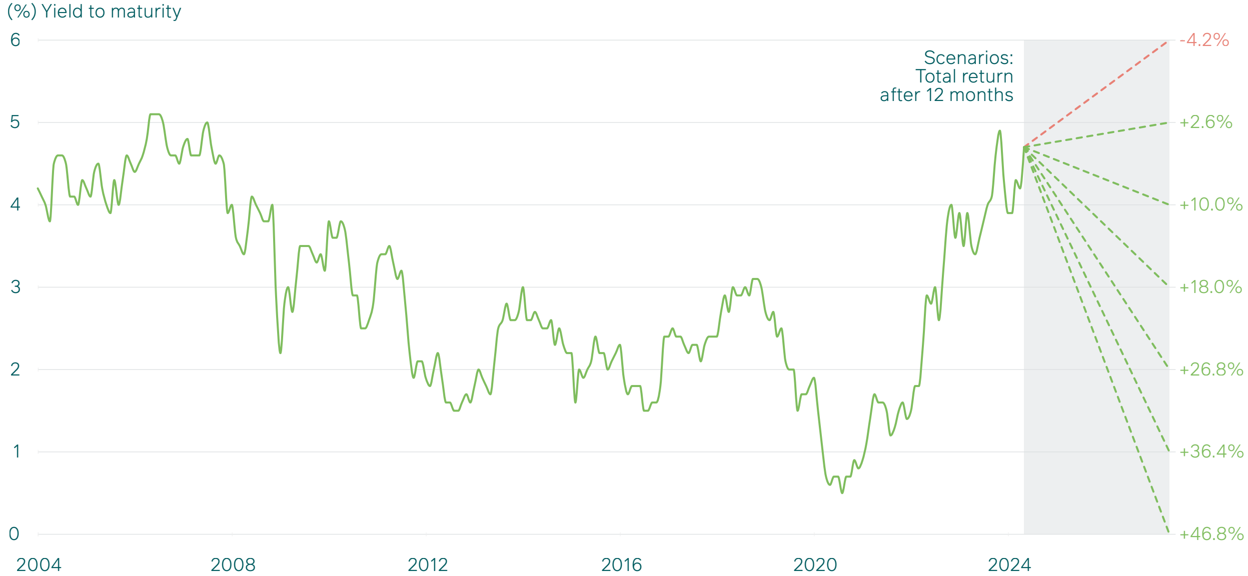
Prospects for optimal income

Richard Woolnough
Fixed Income Fund Manager

The opportunity to deploy cash and increase duration in investment portfolios has re-emerged for the second time in the space of just under a year, in our view. In October 2023, yields on US 10-year Treasuries surged to 5% as higher-than-expected inflation drove investors to rethink their interest rate predictions (smaller-sized cuts – and fewer). Currently, yields are once again approaching the highs seen in this cycle.

But back then, the surge in yields – and subsequent decline – occurred rapidly, leaving many investors behind. Since then, many of these investors have held onto cash with the intent to deploy it when valuations become attractive again. While the market doesn't often offer second chances, it seems that investors may have another opportunity this time around – and we argue it really is time to be active, flexible and well-informed in your bond selection, because of this unique rates-inflation dynamic.

Risk-reward in 10-year US treasuries



Note: The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.
Source: Bloomberg, 30 April 2024.

We think there are three key reasons why duration should be added in the coming months:

1. Rate cuts have almost been priced out: Market movements often fluctuate between extremes rather than following a smooth path. While the Fed has maintained a consistent message, market participants have been mainly erratic, shifting from expectations of 'higher for longer' rates to forecasts of multiple rate cuts in 2024-25. Presently, investors have mainly returned to the higher for longer mindset, with almost no cuts, or very few, priced in for this year. Consequently, while this can change in the coming months, we still believe most of the negative news has already been factored into the market.

2. The recent upside surprises in US inflation have spooked some investors to believe that pricing pressures are making a comeback. We have argued against this view for a while now: As long as money supply remains constrained, it is difficult to achieve a sustained and significant inflation 'reacceleration'. At present, money supply is still contracting and it would seem that we are now moving into an environment of "too little money chasing too many goods". This scenario is disinflationary and therefore typically a positive for duration. While some level of 'sticky inflation' may persist, we suggest that there is no need to be overly concerned about inflationary pressures.

3. We believe the risk-reward proposition for owning duration (eg, US government bonds) remains strong. In our view, the downside risk associated with holding government bonds appears limited, while the potential upside offers the possibility of double-digit returns. The chart above – which is based on M&G's internal scenarios of expectations for total returns of 10-year US government bonds – illustrates our belief that risk-reward for duration-bearing assets has improved.

In summary, we believe the opportunity to deploy cash and increase duration in investment portfolios has re-emerged as a result of a unique rates-inflation dynamic, one that has largely come from the central bank response to the COVID pandemic of 2020-21. This may be the final chance for investors to take advantage of the situation, however. In our view, the Optimal Income strategy remains well positioned in this environment with a historically high duration position of 7 years within a high credit quality portfolio (average rating of A).

Hidden gems of innovation

Fabiana Fedeli
CIO, Equities, Multi Asset and Sustainability

Key takeaways

- We do not believe the backdrop lends itself to either trying to time the market with short-term trading or taking broad index exposure.
- Equity performance is broadening and stock-specific drivers are coming to the fore – this year, stocks that have beaten expectations and successfully delivered innovation have outperformed.
- We believe investors need to dig deeper and broaden their search to discover those hidden gems of innovation that are delivering differentiated products and solutions across the globe.

With rates most likely having reached a peak and a resilient growth backdrop, we think equity markets are still a good place for investors to put capital to work, particularly if you consider the approximate $6 trillion[6] parked in money market funds globally[7], part of which we expect to see flowing back into risk assets once interest rates eventually start to decline. That said, with potential volatility coming from macroeconomic and geopolitical news, and some areas of equity markets having performed strongly over the past year, we do not believe the backdrop lends itself to either trying to time the market with short-term trading or taking broad index exposure.

[6] US dollars.
[7] Source: Bloomberg Intelligence, 28 May 2024.
[8] Source: US Bureau of Labour Statistics, Unemployment Rates for States (bls.gov), 17 May 2024. Data for April 2024.
[9] The so-called Magnificent 7 are large US stocks, Apple, Microsoft, Alphabet, Amazon.com, Nvidia, Tesla and Meta Platforms.

Timing of rate cuts

Firstly, while it is likely that we are at peak rates (with the ECB having just cut by 25 bps), the timing of cuts is uncertain and difficult to gauge. The US Federal Reserve (Fed) itself is data dependent and even it doesn't seem to know when the next cut will come. Looking ahead, it will be important to see how the labour market, consumption and core inflation data develop. While core inflation remains stubbornly sticky, we are close enough to that 2% target that the Fed could consider cutting rates should the economy take a turn for the worse.

That said, for now, there are no signs that a rate cut is either imminent or necessary. With real rates as high as they are now, we should expect some further slowdown in the US economy – although a recession in the US doesn't appear in the cards for this year at least – hence, we could see one or two cuts before year end. Importantly, one rate cut will not necessarily mean a sequence of cuts will immediately follow as central banks, particularly the Fed, may decide to pause after the first one to assess the impact.

It's also worth keeping an eye on US state-level job data, which may offer more clues than the country-wide data. One thing that we know, as does the Fed, is that – once unemployment starts to tick up – the job market can unravel at pace. Two states (California and Nevada) and the district of Washington DC are currently sitting with over 5% unemployment[8]. Again, no reason for panic, but reason enough to keep a watchful eye.

Stock-specific markets

Secondly, on equity index investing: after a strong overall performance, the market is broadening and becoming more stock specific. We continued to see this in the recent earnings season where, even within the same sectors, there were companies able to stand out and differentiate themselves, while others were left behind – observable with companies that, for example, have not invested in product innovation.

Importantly, consumers are becoming increasingly discerning with their purchases, sometimes trading down, but certainly being more selective about what they are willing to spend their money on. For instance, during the recent earnings season we learned that high-spec trucks were all the rage in the US, beauty products… not so much.

The Magnificent Seven (Mag 7)[9] were credited with lifting S&P 500 gains in 2023, given their outsized weight in the index – despite only two of the seven making it into the Top 10 performers in the MSCI AC World Index in 2023. By the same token even a small underperformance can have the opposite effect, dragging the US indices down. We witnessed the impact of these drawdowns in January and April this year, leaving the S&P 500 and Nasdaq trailing other market indices year-to-date.

Interestingly, of the Mag 7 only Nvidia is among, not only the top 10 but also the top 40, best performing stocks in the world year to date:

Table 1: Top 10 performers in the MSCI AC World Index year to date

Past performance is not a guide to future performance

Security	Country	Sector	Market Cap. (US$ bn)	% Return
Super Micro Computer	US	IT	45.6	173.7
Nvidia	US	IT	2976.6	144.3
Hanmi Semiconductor	South Korea	IT	11.1	138.1
Vistra	US	Utilities	30.0	127.7
China Hongqiao Group	China	Materials	15.6	106.5
Yutong Bus Co	China	Industrials	7.7	94.0
Pop Mart International	China	Cons. Disc	6.6	93.3
Siemens Energy	Germany	Industrials	20.0	90.3
COSTCO Shipping	China	Industrials	36.4	89.5
Brilliance China Automotive	Hong Kong	Cons. Disc	4.5	89.0

Source: Bloomberg, 6 June 2024, MSCI AC World Index, USD Currency terms.

Selectivity in technology

And speaking about technology, this is one area where selectivity has proven crucial to investment returns this year. We are witnessing a changing-of-the-guard moment. During the last earnings season, overall we saw softer results from tech companies exposed to legacy products. With tighter money supply and worries about the economy, spending on older products has been challenging and corporates are making choices (just as consumers are), and preferring to spend on Artificial Intelligence (AI).

For some companies that benefit from AI-related sales, however, the increased spending on AI is not able to offset the decline in their legacy business. We are at a juncture here where, despite the upside potential for some companies that are able to access significant AI-related growth opportunities, the same companies' legacy businesses have the potential to drag on some of the benefits of that exposure. Hence, it is important to understand all of the drivers of a company's business, no matter how innovative they are on the AI front. This is a typical dilemma when we have a disruptive change in the market.

Innovation driving price performance

For many market participants, the biggest surprise of the first half of 2024 has been the outperformance of equities versus fixed income markets. This is similar to what we experienced in 2023. In H1 2024, equity markets have defied the higher-for-longer fears and delivered solid returns, with the MSCI AC World Index up 8.5% as of 3 June 2024[10]. The reasons are clear and, more importantly, the most recent earnings season has charted the path for what could come in the remainder of 2024.

In our view, there were two key drivers of positive price performance: a beat of expectations and the successful delivery of innovation. The outperformance of European and Chinese stocks was one example of expectations having become too pessimistic, while the dispersion in results from companies in the same sector, even within US technology, has been driven by companies on the right side of innovation trends and their ability to deliver.

In cases where undemanding expectations met with the power to innovate, this created some of the strongest outperformance. Going forward, this will continue to be among the best hunting grounds for the creation of alpha, in our view, with opportunities deriving from investors' tendency to converge around a narrower set of brand names.

[10] Source: LSEG Refinitiv, price returns in US dollars, 4 June 2024.
[11] Source: NTT website, Innovating a Sustainable Future for People and Planet NTT R&D Initiatives | NTT Technical Review (ntt-review.jp)
[12] Source: M&G Investments, Toray, 2023 (communicated in meetings with company management).

Broadening the search for innovative companies

We firmly believe in the power of innovation as a driver of business and investment returns. However, the valuations of many companies at the forefront of innovation have seen a spectacular rise over the past year. Some may still warrant further upside, but others may be due a pause for business fundamentals to catch up with investors' excitement.

This, however, does not mean that the equity market has exhausted its opportunities. To harness the transformative potential of innovation and new technologies from here, we believe investors need to look beyond the 'headliners', and seek opportunities across the wider market; across sectors and geographies. In a nutshell, we need to dig deeper and broaden our search.

While, in the US, Nvidia has been the poster child for tech innovation, and an eye-catching success story, there are many less visible pioneers and innovative companies globally that are offering differentiated products and solutions, and creating a competitive edge for themselves.

In truth, some of the most innovative companies are hiding in plain sight. These may be large multinational conglomerates, where the complexity of their operations means that it can often be a challenge to identify the key business drivers. **Siemens**, for example, which has traditionally been considered a large industrial manufacturing company, has quietly transformed its factory automation business into an industrial software and productivity colossus.

Japan is a rich, if underappreciated, source of innovative companies that are dominating in their respective fields. The country's largest telecommunications firm **NTT** is also the world's third largest data centre owner, and at the forefront of cutting-edge 'photonics' technology, based on light waves. As data creation and transmission increases exponentially, particularly as the use of AI becomes more ubiquitous, the processing of information using the company's optical technologies has the potential to increase energy efficiency by a factor of 100 (as well as increasing transmission capacity by a factor of 125 and reducing latency by a factor of 200)[11].

When we think about the wider physical infrastructure required to power this digital revolution, we will also require greater renewable energy capacity to meet our power generation needs. Top of mind are companies with a dominant market share developing large wind and solar farms, but less frequently mentioned are the material sciences companies like Japan's **Toray**, providing advanced composite materials and components to support the roll-out of these projects. The Japanese company provides approximately 50% of the global composite material used to manufacture wind blades, along with the cutting edge carbon fibre used in aircraft – creating lighter, more fuel-efficient vehicles[12].

And while all eyes are on the technology rift between the US and China, some Chinese companies are quietly innovating in less newsworthy areas of the market. In the consumer sector, we are seeing apparel retailers seeking to strengthen ties with innovative original equipment manufacturers (OEMs). For example, as sporting goods companies seek to compete on the strengths of their more technical product offering, they are increasingly turning to, and valuing, the OEMs with the strongest offer in terms of fabric and product development.

Hong Kong-based **Crystal**, for instance, provides technical materials to the likes of Uniqlo and Lululemon. The OEMs are increasingly focusing on sustainable materials, production techniques and supply-chain traceability to improve market share, with the likes of Crystal increasingly leveraging large language models (LLMs) and Generative AI (GenAI) to improve efficiencies throughout the value chain.

We can even still find hidden gems among technology stocks, where many of the headline AI names have seen staggering price rises. For example, software solutions company **SAP**, headquartered in Germany, is embedding AI in its software product and using AI to enhance its research and development (R&D) efforts. And, as demand for cloud services continues to grow, SAP's transition of its core enterprise solutions business to the cloud is moving in lock-step with this trend. In our view, the company's prominent position in enterprise software, value-enhancing AI initiatives, steady core business (with more than 70% recurring revenues in most of its software end segments), and ongoing commitment to innovation and improved client experience, could set SAP on course to drive solid growth over the coming years.

There are more hidden gems across industries, including many that are starting to emerge in the financial and healthcare sectors. If we go by recent earnings season results, with consumers and corporates making increasingly deliberate choices about where to spend, companies that are not only meeting their customers' current needs but also improving their products and services to meet their future needs, have been able to beat market expectations and grow – even with the backdrop of higher-for-longer rates. To find them, we just need to dig deeper and broaden our search.

An inflection point for emerging market equities?

Michael Bourke
Emerging Market Equities Fund Manager

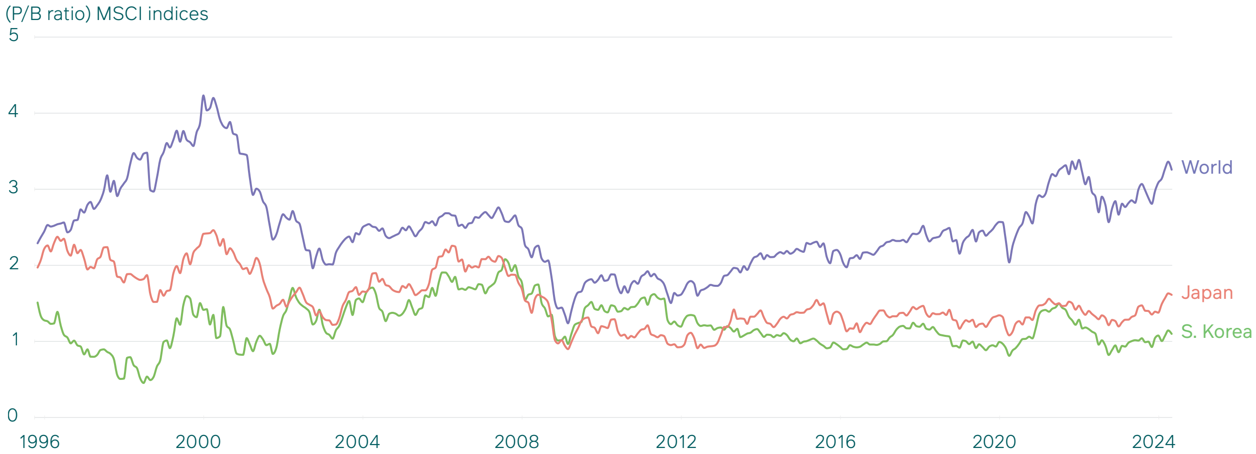
Emerging markets (EM) have faced their fair share of challenges this year (and for the last decade), with the strength of the US dollar, for one, posing a significant hurdle. However, amid this backdrop, EM has witnessed encouraging developments which could capture investors' attention and offer compelling opportunities.

China

Chinese equities have rebounded from their lows in January after valuations became extremely depressed. This recovery can be attributed to a combination of factors, including the introduction of government stimulus measures and stock market reforms, improving economic indicators, as well as growing consumer demand.

As China continues to chart its course towards economic stability, we see investors cautiously embracing the move by Chinese corporates to increasingly focus on returns on capital over growth at all costs. As bottom-up stock pickers, we are excited about the opportunities, but will remain vigilant in a market that is volatile and often trades on sentiment rather than fundamentals. If we witness a recovery in earnings over the upcoming quarters, we hope a fundamental-driven approach will take hold in China once more.

'Japanification' of the Korean discount?



Source: Refinitiv, MSCI, May 2024.

South Korea

The South Korean stock market has traded up strongly this year, driven by corporate reform expectations that followed the announcement of the 'Value-up' programme which launched in June. South Korean companies often trade at lower valuations than their global peers due to a weak corporate governance record, poor returns on capital, and geopolitical challenges with its northern neighbour.

To address the so-called 'Korea discount', regulators are taking cues from their Japanese counterparts and urging companies to establish plans and targets aimed at enhancing shareholder value. We believe these measures have the potential to reshape the investment landscape and unlock new opportunities in the market. The early signs have been promising, in our opinion, and we anticipate a more comprehensive understanding of the programme's impact to emerge over the rest of the year.

Promising signs ahead?

Emerging markets still offer enticing growth prospects, in our view; however, the search for value creation amid these growth engines is what we look for. There are encouraging signs as corporates in large economies like China and Korea are increasingly beginning to understand this dynamic. We believe the next cycle could be dominated by Asian and broader EM companies delivering higher returns on capital.

2024 potentially represents an exciting inflection point because the asset class is still attractively valued, the end of the dollar rate cycle appears to be looming large and we believe geopolitical concerns are already reflected in share prices, particularly in China.

Value investing is still alive in Europe

Richard Halle
European Value Equities Fund Manager

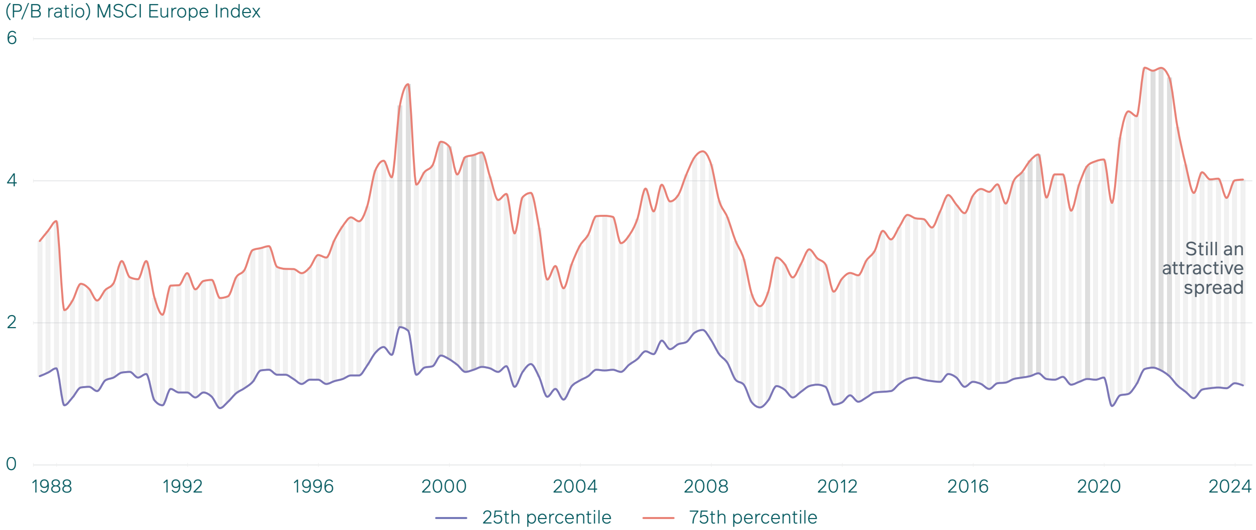
Value investing appears to have fallen out of favour in recent years, most notably in the US, where investors have shifted towards growth stocks. However, the style headwinds in the US have overshadowed the resilience of value in other regions such as Europe.

As dedicated European value investors, we believe the prospects for this long-unloved asset class are extremely promising. For a start, we see a market backdrop that has changed considerably since the pre-COVID era. Instead of a world defined by long-running trends of stability and predictability, where investors could thrive without caring about fundamental valuations, we are now in a world subject to increased volatility, disruption and surprises.

Recent examples of instability include the banking crisis in the US (and its subsequent contagion to Europe); macroeconomic worries; and the impact of rising bond yields on equity ‘bond proxies’. All of these have created opportunities for us as contrarian value investors. We believe this world of unpredictability will persist, and being in a position to take advantage of mispriced stocks could lead to good alpha opportunities.

Valuation dispersion in Europe

Past performance is not a guide to future performance



Highlighted bars indicate periods where price-to-book spread is greater than the current price-to-book spread.
Source: LSEG Datastream, 30 April 2024.

Another positive aspect, in our view, is that the European equity market is two-tiered. Valuations of quality growth stocks reached elevated levels during the zero-interest rate environment. The big-name growth stocks have also benefited from passive investors and global investor interest. In contrast, the cheaper part of the market has been overlooked and remains attractively valued, in our view. As a result, the valuation dispersion in Europe is among its widest ever levels.

In a world where valuations of out-of-favour value stocks look attractive and different trends have emerged within the investment regime, we believe different stocks could do well compared to what has led markets previously. Today’s value stock may be tomorrow’s growth stock, for example. We are seeing cases where this is already happening. Over time, we remain optimistic that investors will look more favourably on value stocks and pay more for companies that were better than they originally thought.

Capturing the power of global dividend growth

Stuart Rhodes
Global Dividend Fund Manager

Dividend investors have experienced headwinds over the past couple of years. The emergence of AI as a major theme has led to a very narrow market, driven mainly by US technology and 'new economy' mega-cap stocks, many of which do not pay dividends.

This has been compounded by the underperformance of traditional defensive areas like consumer staples, utilities and healthcare in a higher interest rate environment. However, the prospect of rate cuts in the coming months could be helpful for dividend-paying stocks and create a powerful tailwind for the strategy.

Encouragingly, today, we are potentially seeing better value in the out-of-favour consumer staples and healthcare sectors than we've been used to in recent years. The severity of the declines in some areas is creating attractive entry points, in our view, for some companies with decades-long track records of paying a growing dividend. This is very important because we believe most of the long-term successful track records within dividend investing have a focus on growth.

Not only does a growing dividend provide a defence against the corrosive effects of inflation, it can put pressure on the share price to move up alongside the dividend.

Dividend investing is not simply restricted to defensive companies. It is possible, albeit harder, to find companies that are growing quickly and pay rising dividends at the same time. We would highlight the surprise decision by Facebook owner Meta Platforms to start paying a dividend this year as a great example of the broad range of dividend opportunities.

Although Meta's prospective dividend yield is less than 0.5%[13], we see a long runway for that dividend to get a lot bigger in the future, and it could represent the start of an interesting trend among technology and new economy companies to incorporate dividends as part of their cash returns to shareholders.

After a challenging time for dividend investing, we are encouraged by the wide range of opportunities we are finding and the developments unfolding in the market. We think the headwinds we currently face with a narrow US equity market are likely to dissipate in time and, therefore, from a longer term perspective we feel optimistic about the future.

We remain resolutely focused on dividend growth as a compelling strategy over the long term, without losing sight of the reality that the global economy faces challenging times ahead. Dividend cuts will be inevitable for companies not equipped with the financial armoury to withstand a cyclical downturn. Balance sheet strength is a key consideration in our company research to ensure that dividends can be sustained in the current climate.

[13] Source: Morningstar, Meta's First Dividend Explained, Feb 2024.

Spotlight on listed infrastructure

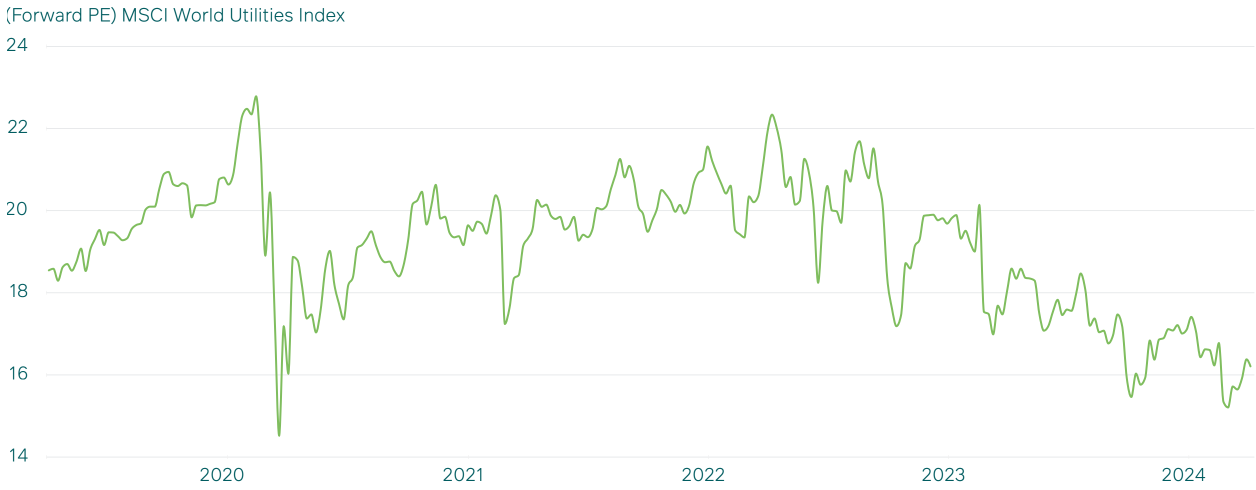
Alex Araujo
Global Listed Infrastructure Fund Manager

There is no question that the recent macroeconomic backdrop has been unfavourable for listed infrastructure. In a world where investors have chased more "exciting" technology stocks and penalised dividend-paying stocks, the asset class has encountered headwinds.

Listed infrastructure tends to have a large allocation to the utilities and real estate sectors, both of which are perceived to be interest sensitive. The market narrative around 'higher for longer' interest rates has been challenging but with inflation moving in the right direction, and recent rate cuts in Europe (and potentially more on the horizon in the US), we are optimistic about the outlook for infrastructure investing.

We see attractive valuations across the asset class currently. One area that is compelling, in our view, is utilities where valuations remain at near record low absolute and relative levels. Simply by virtue of being dividend-paying stocks they have been punished by the market, despite the sector continuing to deliver consistent earnings growth and higher dividends.

Valuations of utilities have fallen significantly



Source: Bloomberg, 31 March 2024.

Another sector that has been caught up in this trend is companies structured as real estate investment trusts (REITs). These companies have real assets at their core and those with robust and growing earnings are very attractive, in our view. The REITs we hold are not in structurally-challenged areas such as offices or retail. We have invested in data towers, data centres and logistics warehouse operators, which continue to demonstrate strong growth fuelled by the inexorable demand for digital communications and the evolution of artificial intelligence (AI).

Infrastructure could play a critical role in supporting our digital future in other ways too, for instance by providing the power sources and grid networks needed to meet increased demand for data and power.

While we wait patiently for the macroeconomic backdrop to shift, we see companies continuing to grow their dividends, offering an income that helps offset and protect against inflation. With attractive valuations, the potential for compounding income growth and access to powerful structural trends, we believe the outlook for listed infrastructure is promising.

Addressing the income challenge

Stefano Amato
Multi-Asset Fund Manager

Income is king, especially in an environment of persistently higher prices. But how to address the income challenge without sacrificing growth, the irreplaceable ingredient for satisfactory investment outcomes over the long run?

We believe that the answer lies in a combination of disciplined adherence to evergreen investment principles and an active approach to tactical asset allocation.

On one hand, in our multi asset income funds we purposefully aim to diversify sources of returns and income generation across a broad range of asset classes. This can allow us to build robust portfolios that can benefit from medium-term asset appreciation but are also able to withstand unforeseen economic shocks.

In the current environment, this translates into a well-diversified approach to income generation across asset classes which – as per the chart on the right – also features dynamic shifts as we react to new investment opportunities that arise over time.

Additionally, we actively monitor global markets with the aim of harvesting tactical investment opportunities when we can spot attractive fundamentals, unusual price action and extremes in investor beliefs as per our ‘patient opportunism’ philosophy.

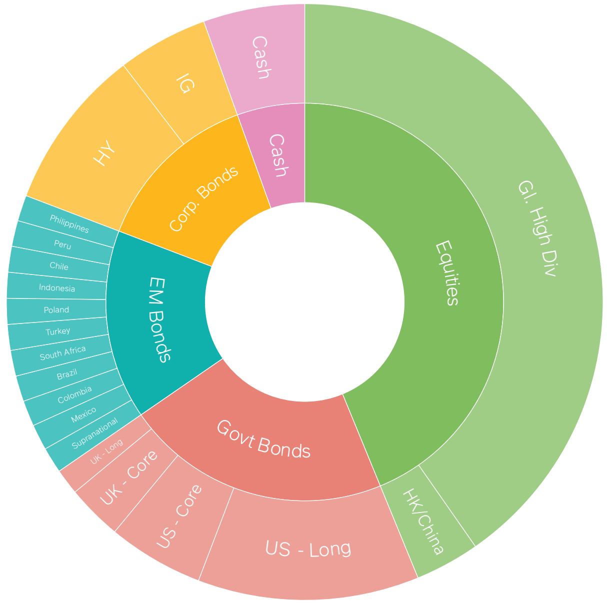
A recent example of this would be our choice to buy Chinese equities in January, when they were lowly valued and we could observe many signs of antipathy among investors.

Presently, our confidence in the potential to deliver both income and growth is partially restored as we observe tentative signs of decoupling between equities and bonds.

At prevailing yields, bonds already provide a meaningful contribution to the strategy’s income. If their ability to provide portfolio insurance is even only partially restored – as policymakers now have a lot of ‘dry powder’ to counteract any growth shocks – we can then have more (guarded) confidence in pursuing opportunities in the equities space, therefore retaining exposure to potential growth appreciation over time.

A combination of robust diversification plus ‘patient opportunism’ should therefore serve investors well, potentially enabling the generation of meaningful levels of income without sacrificing prospects for capital growth.

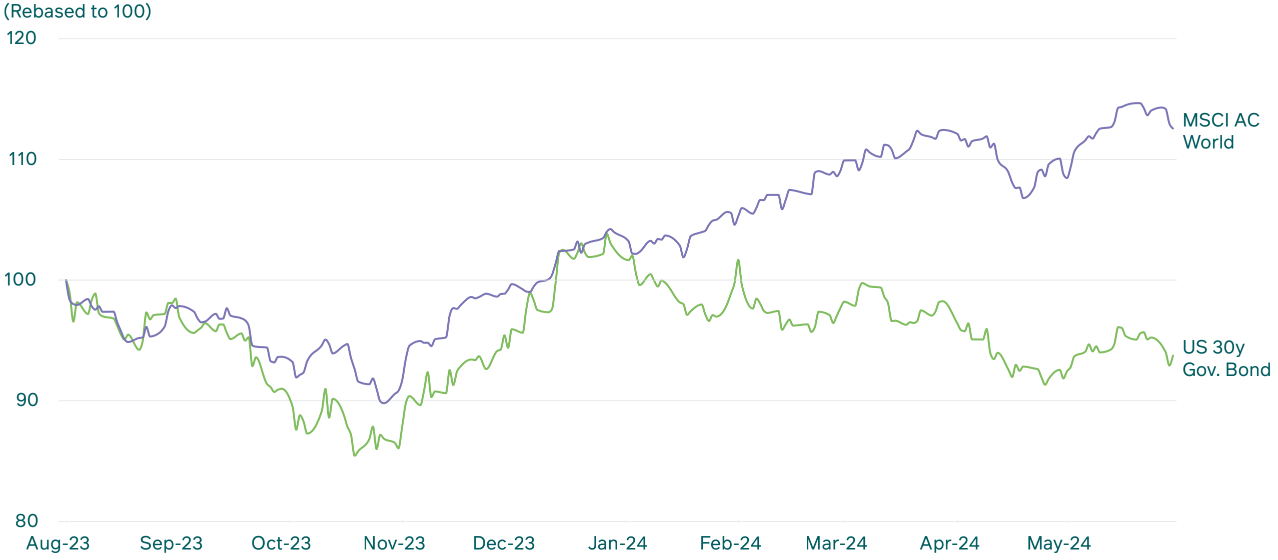
A diversified approach to income generation



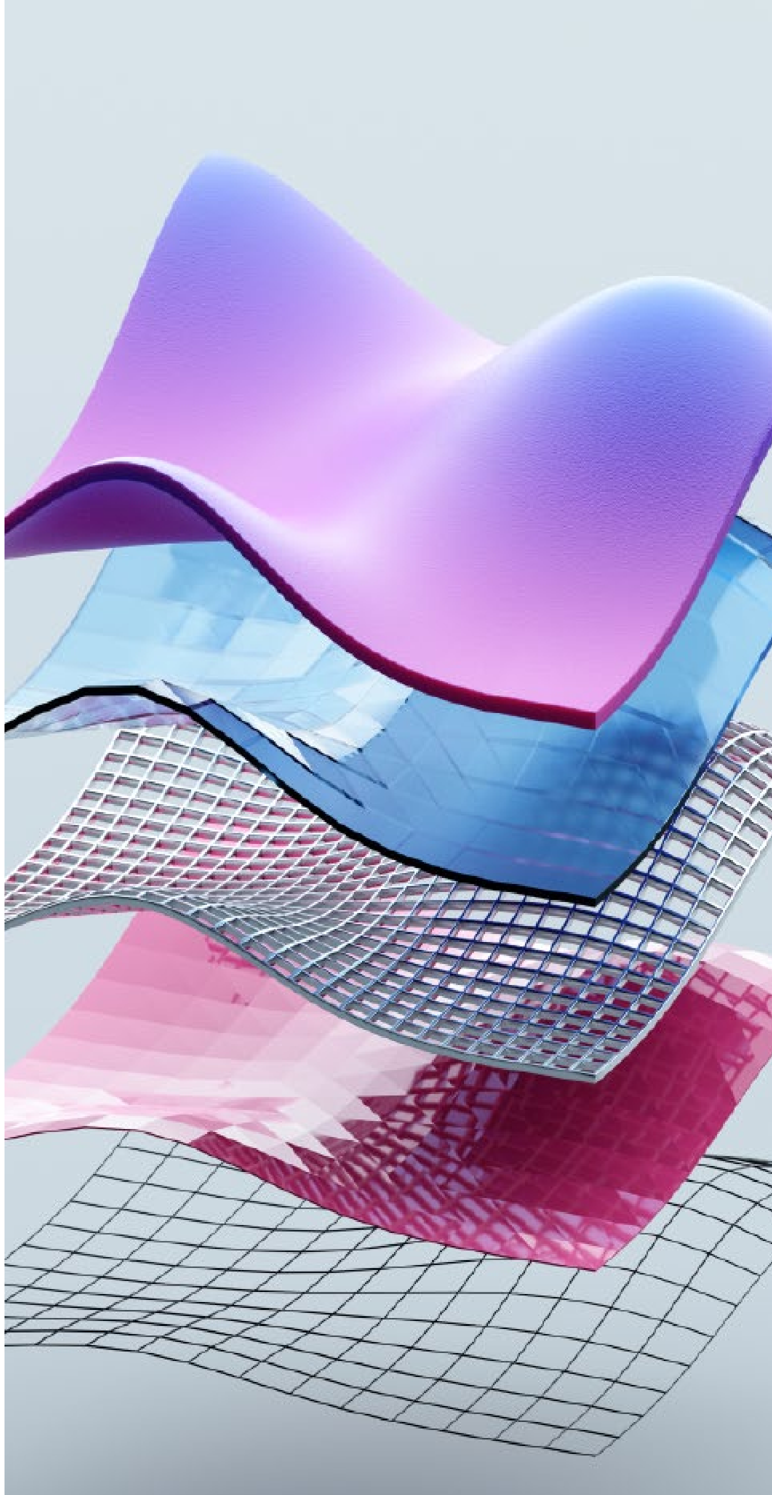
Source: M&G, 15 May 2024. For illustrative purposes only, chart shows the portfolio breakdown of the M&G Multi Asset Episode Income Strategy.

Divergent equity and bond performance in 2024

Past performance is not a guide to future performance



Source: Bloomberg, as at 31 May 2024. Returns in US dollars.



A strong focus on private markets

Emmanuel Deblanc, CIO, Private Markets

Key takeaways

- Private markets have faced challenges due the rise in real interest rates and the decline in M&A activity.
- We see opportunities in the 'value-add' and opportunistic areas, particularly real estate and infrastructure, while structured credit looks attractive due to ongoing retrenchment by banks.
- We believe there are grounds for optimism but investors need to have a clear focus and be selective in their approach.

Private markets have remained a strong focus for investors over recent years. However, the current macro-led backdrop for private markets has certainly proven challenging. Of course private markets are not a singular investment area, rather a collective of strategies, and the impact of these macro factors has not been uniform.

The most significant issue impacting many private markets has been the rise in real (inflation-adjusted) interest rates. These have risen considerably in Europe, the UK and the US and now sit around 200 basis points. This matters within most private markets as higher rates reduce distributions to investors and put pressure on valuations. However, the reality is a bit more nuanced and I believe, long term, this has actually been a positive for private markets. It avoids the misallocation of capital, fundamental in correctly pricing assets.

It is also worth noting the decline in merger and acquisition (M&A) activity within private markets over the last couple of years. This is important for private equity investors who are looking for exits as well as new opportunities to re-deploy their capital. The number of infrastructure fund closes has also halved over the last 5 years with a commensurate fall in total capital raised.

We believe opportunities persist however within the value-add and opportunistic areas of private markets. Over the very short term, I would flag real estate, infrastructure and opportunities with a clear climate theme. It is also apparent that both renewables and climate-tech remain buoyant and could offer an array of opportunities.

Looking to other private market areas, within the corporate area, loan issuance is beginning to recover, whilst on the equity side, the worst fears have not materialised. Private equity has been saved with a less deep economic downturn than many predicted.

Lastly I would highlight the attraction of structured credit. Several themes are driving growth in this area, not least retrenchment of banks from certain areas of lending due to regulatory and capital requirements. This has opened up more space for structured credit, particularly in Europe.

To conclude, while private markets have faced their challenges recently, we believe there are definitely grounds to remain optimistic – opportunities clearly exist. The key take-away I would make is that investors need a clear focus and adopt a highly selective approach to where within private markets they chose to focus.

Significant momentum in structured credit

James King
Head of Structured Credit

The prevailing market consensus is that both interest rates and inflation in developed economies are on an eventual downward trajectory. However, the actual outcome remains uncertain. Amid this lack of clarity, investors are understandably asking where they should be deploying their capital. Structured credit is an area that M&G Investments believes offers rich and diverse opportunities in a variety of market and macroeconomic environments, providing many options for investors depending on their risk/return and liquidity preferences. The market and macro background is important, but the case for structured credit is not dependent on any particular environment and indeed has demonstrated robust through-the-cycle performance.

The structured credit market has seen significant momentum in recent years, driven by both demand and supply-side factors. Notable of these supply drivers has been the pullback by banks from certain lending activities due to stricter regulatory capital requirements which have been brought in following the global financial crisis (GFC). This regulatory pressure has been coupled with episodes of disruption within the global banking sector, led by and large by higher interest rates, which has shone the light once again on bank balance sheets and the critical need to deleverage.

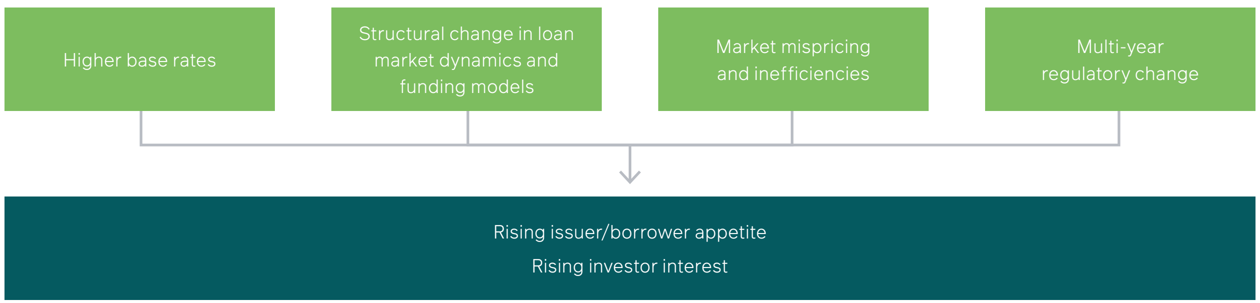
Private, non-bank finance has consistently stepped in to fill this funding void to the real economy, either as providers of debt capital, or as buyers of loan portfolio assets.

The array of available investment opportunities across the asset class has grown exponentially but we believe this growth is set to continue. Offering investors the ability to access high quality performing loan pools originated by core banks and non-bank lenders alike, structured credit has the potential to target different parts of the capital structure and source investments from both public and private markets depending on risk-reward. The asset class has consistently offered excess returns and reduced return volatility relative to traditional fixed income investments, together with the strong structural protections inherent within the asset class, which we believe should prove particularly attractive to investors in the face of an ever-changing investment landscape.

The ability to access such compelling opportunities requires a very specific skillset and suite of capabilities. In particular a manager needs to demonstrate deep structured credit experience in order to access unique and differentiated deal flow. Within this investment arena, a vast network of relationships matter, with well-established managers best placed to secure a robust pipeline of deals across a unique and evolving opportunity set.

Active in private and alternative debt markets for over 40 years, M&G Investments is an originator and investor spanning the entire asset universe and referencing a range of diverse collateral types. We have a large structured credit team comprising over 40 professionals managing €7.5bn[14] of dedicated structured credit assets. We believe this provides M&G Investments with both the resources and expertise to successfully leverage this exciting area of the wider fixed income complex now and going forward.

Investment conditions could benefit from a confluence of factors



Source: M&G Investments.

[14] Source: M&G, as at 31 December 2023.

A well-timed entry for real estate debt?

Dan Riches
Head of Real Estate Finance

With equity-like returns for credit investing, real estate debt is attracting increasing attention from investors globally, as well as new market entrants.

In our view, the benefits of the asset class stand out in the current economic environment, given that debt benefits from a significant equity cushion, in addition to typically predictable cash flows. The ability to lend at lower debt bases, based on a reduction in property values, can further improve risk dynamics. Loan margins also appear attractive on an absolute and relative value basis. We believe investing in real estate debt today therefore looks well-timed.

Traditional bank lenders continue to retrench from the asset class as a result of increasingly onerous regulatory capital requirements, while falling values and higher interest rates mean banks' focus is likely to turn towards performance and existing loan books. However, we are cautiously optimistic that systemic risk remains an unlikely scenario given generally lower leverage and higher underwriting standards throughout the last lending cycle, and a more diverse lender base.

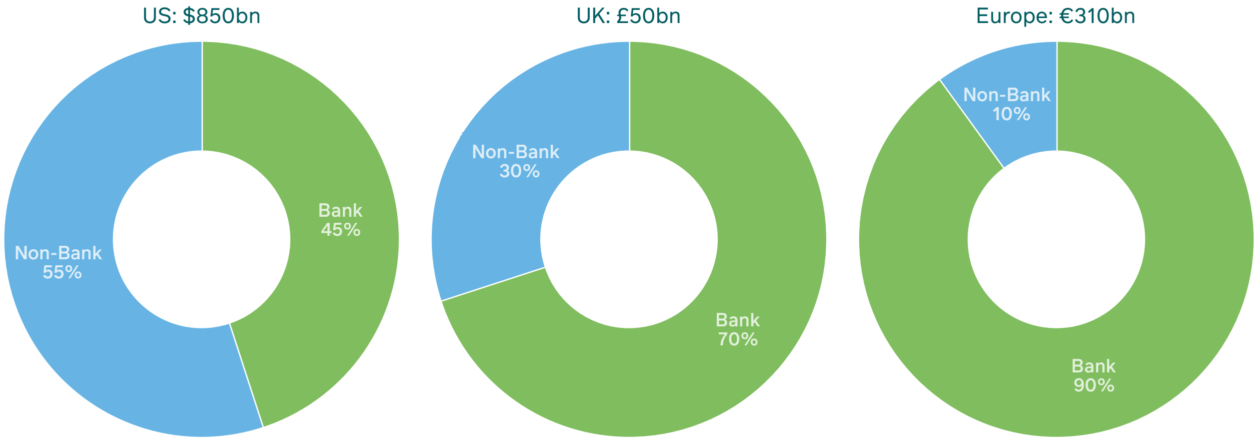
For non-bank lenders, the opportunity to continue to grow market share remains significant. The UK will likely remain a key focus as one of Europe's largest property markets, with a favourable loan enforcement regime. Further reduction of bank lending in markets such as Germany and France, where bank lenders represent a large share of the market, could also offer a pronounced deployment opportunity for non-bank capital. A granular understanding of country-specific issues is necessary, however, given the complexities involved in navigating nuanced property market dynamics and legal regimes.

Banks' retreat coupled with downward property valuations is likely to create a sizable debt funding gap over the coming years – estimated at €93 billion by 2026[15] though it is an evolving picture, with changing rates and capital values starting to stabilise.

In our view, refurbishments and new developments represent a compelling opportunity for non-bank lenders to provide moderate leverage at potentially attractive returns. Regulation has made this type of lending unviable for some banks, while others are pulling back over concerns about the impacts of cost inflation and increased insolvency risk in the construction supply chain. Another consideration is the fact that projects can often take longer and be more costly than anticipated to complete. However, these risks can be factored into loan metrics through rigorous due diligence.

In particular, we are seeing an increasing requirement for 'brown to green' property transitions, with the potential to create assets that meet modern occupier requirements and help to regenerate city centres. A solid understanding of sustainability costings is necessary as part of these financings, since the capex required to complete heavy refurbishment of this kind can be challenging to quantify.

Annual loan origination volumes and sources of capital



Source: Bayes Business School Commercial Real Estate European Lending Report – H1 2023, Macfarlanes: The growth of real estate debt, November 2023.

[15] AEW Capital Management, August 2023.

An ongoing recovery for global real estate?

Richard Gwilliam
Head of Global Real Estate Research

Following a challenging couple of years, we expect global real estate markets to continue to recover throughout the rest of 2024, with stabilising capital values and largely positive rental growth prospects. Nevertheless, we believe a focus on income and asset quality will be important in the new cycle, as investors and lenders become more selective, and investment performance differentials become apparent between assets of higher and lower quality. New investments made in the next 6-12 months are likely to be recognised as a robust vintage in the long term, benefiting from high entry yields and strong occupational profiles.

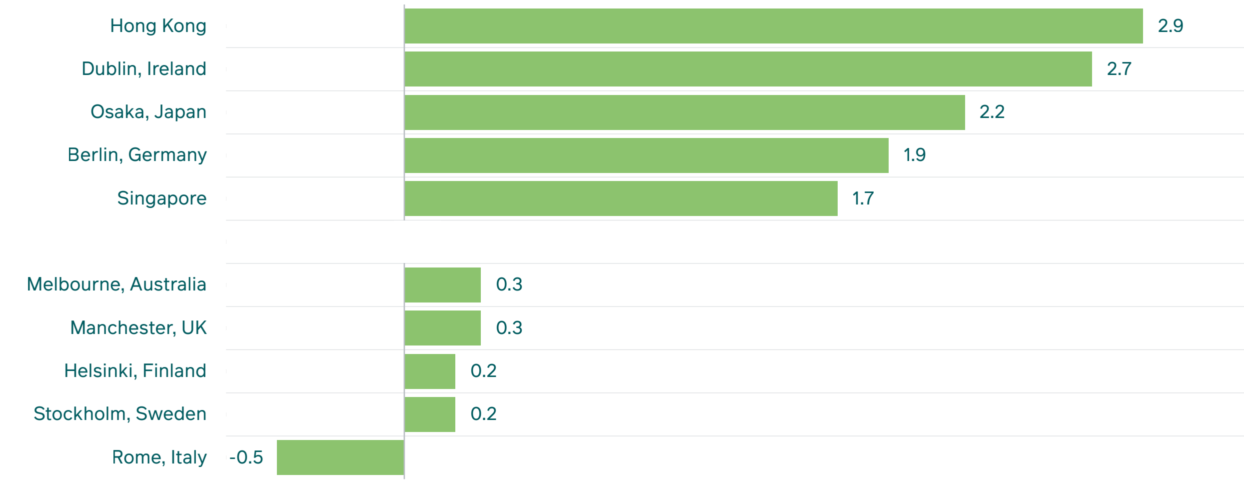
Nominal rental increases are expected to be driven by a stronger economy – particularly in Asia – or at least an uptick in economic growth, which will spur occupier demand. Challenged development viabilities have limited the supply pipeline in most geographies – though there are some examples of the converse – which should help to stimulate rental growth over the next few years, in light of acute supply-demand imbalances.

Though refinancing challenges remain, the risks within banks are largely well understood and appear modest. The risk of wider systemic stress is unlikely, in our view, but lender behaviour and financing availability will be a key determinant of asset bifurcation and performance moving forward.

Despite some challenges and risks on the downside, with investment market stabilisation in sight and the global economy appearing set to recover, the outlook for property is looking increasingly optimistic, in our view. As such, 2024 may present the most attractive buying opportunity for real estate that has been seen for some time.

New supply looks set to be restrained in most markets... but not everywhere

Office net additions as a % of stock (2024–25 pa average)



Source: PMA, Spring 2024.

Digital infrastructure – an energising opportunity

Toby Rutterford, Associate Director
M&G Real Assets, Impact and Private Equity

The world is becoming increasingly digitalised and data has been called the lifeblood of the knowledge-based economy. This shift is made possible by digital infrastructure, the physical infrastructure required to support the delivery of digital technologies in the everyday lives of global communities.

The M&G Real Assets team believes that digital adoption represents a multi-billion-dollar investable opportunity. Significant capital expenditure (capex) will be required to keep pace with technological change, and evolving business and consumer practices globally.

However, the digital infrastructure market is at an intersection. Demand for digital services is increasing at a pace beyond the market's ability to build the critical infrastructure required to promote their delivery. For private market investors, this creates a nuanced and, in our view, compelling investment opportunity with long-term, persistent and systemic tailwinds.

Rising demand for data centres

The digital infrastructure market has evolved over the past decade. From mobile network towers to the evolution of 5G technology and fibre internet networks, we have seen a new wave of investment opportunities that offer stable cashflows, often with escalating rates during the contract life, and defensive characteristics, making them attractive to infrastructure buyers.

As the demand for data has increased, data centres, a collection of servers in a dedicated structure, has become an increasingly investable asset class, key to the delivery of digital services. This demand, driven by growing use of outsourced IT capabilities (the Cloud) and widespread adoption of artificial intelligence (AI), is expected to grow rapidly in the coming years.

Like towers, data centres offer hard-to-replace, contractual cashflows which, given their critical nature, are highly attractive to infrastructure investors.

A key challenge of digital adoption and greater demand for data centres, is the accompanying increase in power consumption. Generative AI, in particular, is seen as a "game-changer" when it comes to demand for electricity. According to the International Energy Agency, on average, a single ChatGPT request is nearly 10 times more power intensive than a simple Google search[16].

In our view, the data centre market is at an inflection point where demand has accelerated beyond the market's ability to absorb new capacity. We observe near record low vacancy rates across the US and Europe. We believe this makes it an attractive time to deploy capital.

However, we would argue that practical challenges and market nuance mean that not everyone deploying capital into this theme today will be successful.

Practical considerations

The International Energy Agency estimates that 460 terawatt-hours (TWh) of electricity was consumed by data centres in 2022. Growth in consumption is projected to reach more than 1,000 TWh in 2026 due to the aforementioned growth drivers.[17] That increase is greater than the annual electricity demands of Germany[18].

This level of demand, at a time when supply is constrained in key markets, creates several practical execution considerations which we believe will shape the investment opportunity.

There are several key diligence items we believe investors should be focused on, namely: grid capacity constraints which are a limiting factor in many markets; competition for skilled labour and availability of key components which continues to be a challenge; sustainability considerations associated with the delivery of power (water and energy use as well as carbon intensity); location and counterparty creditworthiness.

As we stand today, there is a risk that the rising tide lifts all boats; however, locational specific factors and strength of contract underpinning the assets are key to delivering long-term value and minimising stranded asset risk, in our view.

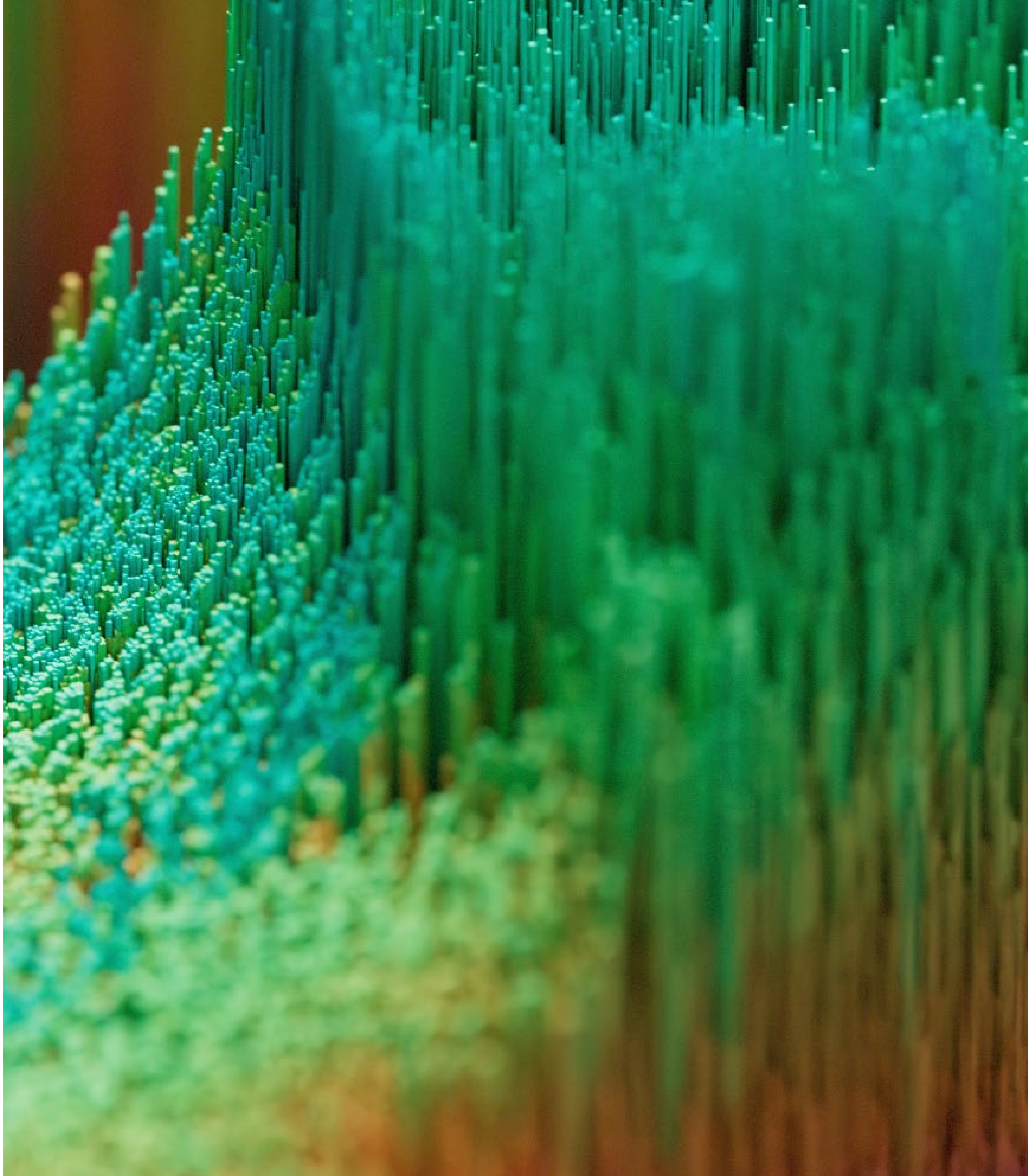
[16, 17] Source: International Energy Agency (IEA), "Electricity 2024: Analysis and Forecast to 2026", January 2024.
[18] Source: Statista, April 2024.

Accessing themes through private markets

We believe there are two significant investment themes emanating from the current paradigm: providing digital capacity through selective investment in data centres and adjacent infrastructure; and providing energy solutions which unlock capacity constraints and, in the process, decarbonise the energy mix.

In our view, private markets are the optimal way to access this significant growth opportunity today. Public markets tend not to reward capex heavy strategies in infrastructure where the focus can be on delivery of quarterly earnings and yield.

In contrast, we believe the long-term patient nature of private markets offers investors an attractive route to participate in this once in a generation opportunity. We do not believe the heightened take-private activity in the data centre market over the past few years to be co-incidental, and likely where a significant proportion of the growth will be observed.



A spectrum of possibilities within private credit

Catherine Ross
Head of Private Credit

While the global economy may be experiencing a downturn, we believe investment opportunities exist that could allow investors to both mitigate risk and secure attractive long-term returns. Private credit is a strategy which potentially has these characteristics. Indeed, one of the largest areas of private credit, direct lending, can be capable of delivering reliable income stream potential together with high risk-adjusted returns.

With balance sheet restraints restricting lending by public banks, direct lending has stepped in to fill the void. Together with a trend by both small and larger corporates to remain private for longer, the direct lending market has expanded significantly. However, we believe its attractions have enduring appeal. As direct loans typically are floating rate, they naturally provide a hedge when interest rates rise. Coupled to this, the asset class may provide portfolio diversification benefits due to the contractual nature of returns offered and mitigate equity market volatility given limited mark-to-market price risk.

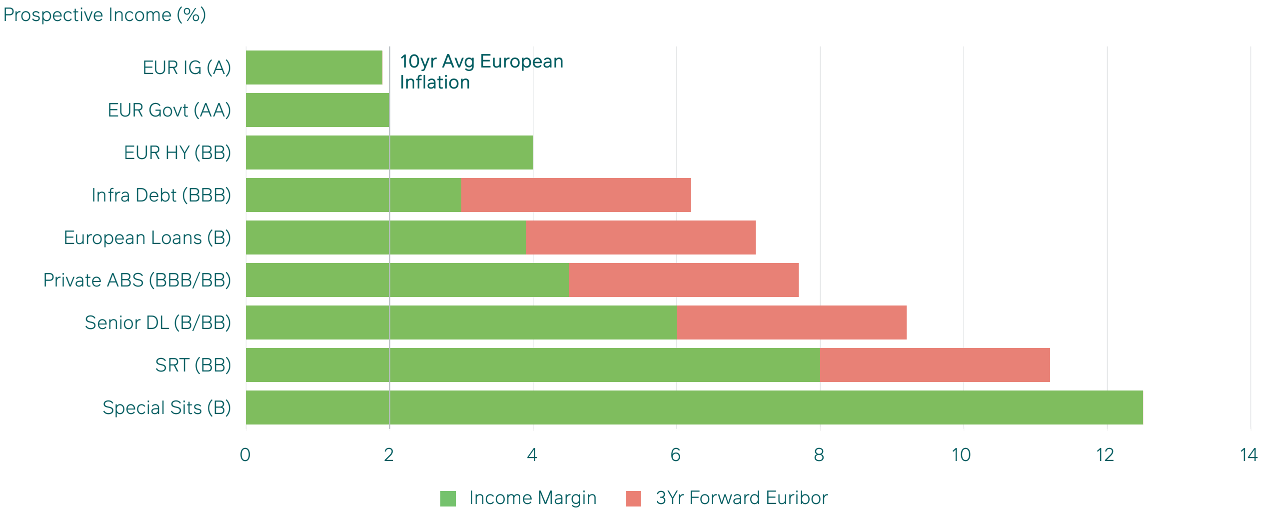
With global economies unsettled, direct lending is not risk free. It is not immune to weaker overall business conditions and any serious recession would lead to higher default rates. However, tighter documentation of direct lending deals via maintenance covenants, together with the advantage of a greater depth of access to both company management and financial information, give the asset class a clear advantage. In our experience, this deeper due diligence can limit the risk of borrower default.

A final compelling characteristic of the wider private credit universe, in our view, is its ability to typically generate real income returns over long term inflation (c.2%). More traditional credit classes, such as investment grade corporate debt and government bonds, struggle to achieve this.

Success within private credit, and direct lending specifically, depends on the expertise and experience of the private corporate lender. M&G Investments has been investing in direct lending since the emergence of the asset class in 2009 with a large and highly experienced investment team with over 50 professionals.

For investors prepared to broaden their investment horizons, we believe private credit offers deep attractions given its ability to deliver both real income and high risk-adjusted long-term returns.

Prospective annual income over 3 years



Note: The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.
Source: M&G, Bloomberg, Credit Suisse and ICE BofA as of May 2023.