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M&G Investments

Quarterly Equities and Multi Asset Outlook

What comes next

Q3 2024

Contents

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What comes next

Many market participants have been caught by surprise by the strength of equities this year, and their outperformance versus fixed income markets. Valuations have risen globally. However, luckily for us, the tide did not lift all boats, leaving opportunities on the table. Where undemanding expectations have met with the power to innovate, this created some of the strongest outperformance. We think the 'Hidden Gems of Innovation' will continue to be among the best hunting grounds for alpha generation.

And remember when we were all concerned about the Magnificent 7's unstoppable rise? Well, we are now down to a Magnificent 1. By the second quarter of 2024, only Nvidia was in the top 100 performing stocks in the world, making the 55th place.

We had an eventful start to July, with the UK elections and the second round of the French elections. Depending on policies and their implementation, the new UK government could bring some solace to UK mid and small caps, while French bonds may remain volatile.

While we still believe there are pockets of relatively more attractive return opportunities in equities, we could be closer to an inflection point between equities and fixed income in terms of near-term overall relative performance.

Fears of higher long-term inflation and a budget deficit, particularly in the event of a Trump administration, would render the long end of the US Treasury yield curve more volatile. A front or belly of the curve positioning may provide more sleep at night, albeit lower potential returns.

From Mag 7 to Mag 1

We had an eventful start to July, with the UK elections and the second round of the French elections. In the quest to understand what is likely to come next in markets, we have decided to wait for the results and delay this Outlook by a few days. And as we were waiting, we got some other meaningful datapoints: signs of a softening US job market, and a lower-than-expected US core Consumer Price Index (CPI) print, both important for a possible path ahead for the US Federal Reserve (Fed).

Against this backdrop, equities have continued to rise, outperforming fixed income markets. In the second quarter of 2024, the MSCI AC World Index (ACWI) was up 3.00% versus a 1.10% decline for the Bloomberg Global Aggregate Index. Admittedly, the equities leadership narrowed during the first two weeks of July, with the total return of the MSCI ACWI clocking a 3.16% rise versus a 2.21% increase in the Bloomberg Global Aggregate Index[1].

Many market participants have been caught by surprise by the strength of equities this year, and their outperformance versus fixed income markets, repeating what we saw in 2023. Equities have defied fears of 'higher for longer' and volatile geopolitics, and have marched to their own tune. Valuations have risen globally. However, luckily for us, the tide did not lift all boats, and certainly not to the same extent, leaving opportunities on the table. Stocks that have outperformed in the first half of this year, have had two key drivers in common: a beat of expectations and the successful delivery of innovation. The bout of outperformance of Chinese stocks between January and May of this year was one example of expectations having become too pessimistic, in our opinion, 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. We have called these stocks the 'Hidden Gems of Innovation' and discussed these in our recent Mid-Year Investment Perspectives publication.

To some extent, the market has already expanded its horizons and, under the surface, equities have been quietly changing course. In 2023, of the top 100 performing stocks in the MSCI ACWI, 32 were listed in the US. Sector concentration was even higher as 46 out of those 100 names belonged to either information technology or communication services. But the market has been progressively broadening throughout the first half of 2024. In the second quarter of this year, only six of the top performers in the MSCI ACWI were listed in the US – with more than 70 listed in Asia, and 24 belonged to the information technology and communication services sectors. The performance of the Magnificent 7 (Mag 7) from a global perspective, is also interesting. And remember when we were all concerned about the Mag 7's unstoppable rise? Well, we are now down to a Magnificent 1. In 2023, Nvidia was the fifth top performing stock globally, with Meta in eighth position, and Tesla 49th. Microsoft, Alphabet, Apple and Amazon did not make it to the top 100. By the second quarter of 2024, only Nvidia was in the top 100, making the 55th place. In our opinion, this indicates that investors' horizons have been progressively broadening, looking beyond the US and beyond the Mag 7.

The direction of travel can, of course, change at any time. We've had plenty of news-driven volatility over the last few weeks as the market digested a number of events. First, the results of the UK elections. The Labour party won an impressive 412 parliamentary seats out of 650, ending 14 consecutive years of Tory party leadership. The new administration assumes office amid a pervasive sense of pessimism regarding the UK's economic outlook and national finances. The new government appears to be viewed positively by market participants, driven by a more centrist approach

[1] Source: Bloomberg, 15 July 2024.

compared to the past by the Labour party leadership, an active dialogue with the business community during the campaign, and a general dissatisfaction with the instability of the previous administration.

As my UK investment team reminds me, for the first time in eight years or so, the UK looks to be one of the more stable geopolitical jurisdictions globally. As a consequence, the UK market may look more attractive to global investors over the next few quarters. Of course, much will depend on the policy execution in the months to come. An increase in domestic growth could prove a boon for the more domestically-exposed UK mid and small cap companies, as corporates in the FTSE 250 Index had been trailing their larger and more globally-exposed counterparts in the FTSE 100 Index for the best part of the past two years. While excluding a return to the Customs Union, the Labour party has also expressed its intention to drive deeper relations with the European Union, which could potentially provide a boost to supply chains and GDP growth.

As we have often reminded our readers, history shows us that elections and referenda can be market-moving events in the short term, but that short-term volatility tends to normalise over the medium-to-long term. The real drivers of performance will be in the success – or lack thereof – of policy implementation. With this viewpoint, 'noise' around a vote often provides opportunities to take advantage of short-term price dislocation. While the UK election seems unlikely to fundamentally alter the direction of the UK equity market until policies are known and implemented, there is a reasonable chance that the perception of change could encourage investors who have maybe taken a break from the UK market to revisit it once again – particularly given their less demanding valuations relative to the rest of the world.

If Labour's landslide victory was widely expected, the final outcome in France was anything but.

After a clear victory of the far-right Rassemblement National (RN) party in the first round, a surprise to many, the left coalition New Popular Front (NFP) came first in the second round of French elections with just under 200 seats, followed by the Presidential Bloc, Ensemble, and in at third was Le Pen's RN. At the time of writing, a new government has yet to be formed. While at this point no outcome is ideal from a market standpoint, the more market-friendly result would be a grand coalition between Ensemble and the more centrist parties of the NFP. Even in this best case, governing with a fragmented Parliament is likely to be difficult, public spending is likely to remain high and the French budget deficit is likely to worsen. Importantly, the fight for tax revenue is going to be much tougher than it has been in the past.

> **“We think the hidden gems of innovation will continue to be among the best hunting grounds for the creation of alpha going forward”**

Volatility in the French bond market is likely to persist until we get more clarity, and currently we don't own positions in our Multi Asset portfolios. With regards to our positioning in equities, we believe there are stocks still worth owning in the French market, particularly in areas that are driven by company-specific improvements. These include, for example in the consumer and energy space, a number of which are trading at undemanding valuations. As policy risks remain elevated, we need to monitor new information coming to light, for example looking at the potential impact of any cuts in fiscal spending on companies that depend on it.

Although French government bonds could remain volatile for the time being, other fixed income markets appear more attractive. The recent weakening of both labour and inflation data in the US is now delivering a stronger chance that the Fed will start cutting as early as September, for a total of two cuts this year. Of course, nothing is certain and markets have been caught by surprise before, as stronger datapoints have dashed dovish hopes.

However, the chances appear higher that global interest rates have reached a peak and should start declining (further for some) later this year. With this point of view, the opportunity for fixed income markets is significant, especially as some of the US$6 trillion of money currently parked in money markets, as rates decline, is likely to flow to assets that are perceived to be less risky, such as government bonds. While we still believe there are pockets of relatively more attractive return opportunities in equities, we could be closer to an inflection point between equities and fixed income in terms of near-term overall relative performance.

And while a drop in the US 10-year Treasury yield to 3% could pocket us a price return of c10% and c5% in the US 5-year, possibly lower than the potential returns from some of those equities hidden gems, from an overall market perspective the relative risk-reward after such a strong equity market performance and some modestly weakening US data is moving in favour of fixed income. While further out in the US yield curve, duration can provide higher returns, we need to be mindful that fears of higher long-term inflation and a budget deficit, particularly in the event of a Trump administration, would render the long end of the curve more volatile. A front or belly of the curve positioning may provide more sleep at night, albeit lower potential returns.

In our Multi Asset portfolios, our most tactical strategies have pared back equity exposure which had recently moved to a small overweight, and are now running a relatively neutral directional equity exposure. The portfolios have also increased exposure to Western government debt after the mid-April sell off, having scaled these positions back towards the end of last year.

As our tactical asset allocation team reminds us, in assessing 'what comes next', we have learnt from our many collective years in the market that none of us has a crystal ball. We have, however, also learnt that looking through short-term noise and weighing the probability of outcomes, without taking large one-sided bets as events and datapoints are still unravelling, remains the best course of action.

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

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

Global

Daniel White
Head of Global Equities

Johnny Hughes
Investment Director

The Equity Era

This summer a huge cultural event has taken place in Europe. It's been watched by millions...

No... we are not talking about the European Football Championship but the stadium-busting Taylor Swift and her record breaking 'Eras' tour.

In financial markets, the stage was set this year for a storming performance by that aging rock star fixed income, but so far it has been Taylor, and equities, that have stolen the show.

The 'Equity Era' is here and despite valuation concerns in some sectors and regions, we believe equities still offer compelling return opportunities.

The tortured investors department

Another global megastar with a burgeoning stage presence has single-handedly defined the markets play list so far this year. Jensen Huang, Nvidia's iconic CEO has also been dazzling enthralled audiences with multiple product launches that propelled his company to, briefly, become the largest on earth.

It took Warren Buffett 60 years for his company Berkshire Hathaway to top a $1trn market cap. Nvidia added $1trn to its valuation in just a matter of weeks this year.

With one company single-handedly contributing over one third of US market returns in the first half of the year[2], such acute market concentration has proved a challenge for most active managers. It can feel like The Tortured Investors Department.

> “We're seeing increased value in a number of stocks and sectors that have lagged the strong – albeit concentrated – market rally”

The arch nemesis of FOMO (Fear Of Missing Out) is diversification. Whilst market participants have been increasingly drawn into polarised positions in passive products with an ever-greater bias to just a handful of stocks, the cost of, and ability to prepare, portfolios for the next Equity Era has rarely been more attractive, in our view.

Mr. Perfectly Fine

The Equity Era ahead looks set to be defined by a broadening out of the corporate profit pool with a return to the 'market of many' as companies beyond the dominant big tech firms see their earnings positively inflect. This would be (Mr.) Perfectly Fine.

However, Taylor also warns of a 'Cruel Summer'. This could well characterise the US economy as the consumer starts to retrench and, whilst Europe's rate-cutting cycle has commenced, the region's viability has once again become an issue with the snap French elections.

[2] Source: LSEG Datastream, 30 June 2024.

… Ready for it?

Volatility and dispersion require full band support rather than solo artists. Investors need to be ready for what comes next. This means capitalising on opportunities, whilst also being aware of the risks.

From a global equity perspective, we're seeing increased value in a number of stocks and sectors that have lagged the strong – albeit concentrated – market rally. Portfolios have increased their exposure to areas like pharmaceuticals, US housing related names, and 'quality at a reasonable price'. The future is unknown, but attractive valuations could help provide increased certainty.

We could be about to enter a new equity era. Are you… ready for it?

Thematic Technology

Jeffrey Lin
Head of Thematic Technology Equities

AI presents a multi-decade opportunity with the potential to broaden over time

We believe the Artificial Intelligence (AI) investment opportunity has been a strong theme for the last seven years and has accelerated tremendously in the last 18 months since the launch of Open AI's Chat GPT. Going forward, we see the AI investment opportunity broadening across other participants in the technology sector as well as other sectors of the economy.

Nvidia's revenue and stock performance over the past 18 months, and year to date, has been remarkable – driven by the exceptional growth of its products for AI data centres to train AI models. The quarterly revenue of Nvidia's data centre business has increased nearly seven times since the introduction of Open AI's Chat GPT[3]. On an annual basis, the data centre business is expected to grow over 100 times in fiscal year 2025 compared to fiscal year 2017[4]. The company's revenue performance is consistent with the addressable market for computing, which is growing as computing becomes more powerful.

While prior AI use cases for image recognition and predictive analytics that emerged in the middle of the last decade were powerful, the potential for Generative AI (which enables computers to engage in a more natural way with humans) is orders of magnitude more useful, but is also extremely compute intensive. So far, there has been a massive investment for Generative AI training since early 2023. Companies that provide the foundational technology to train AI have seen strong revenue performance year to date[5].

Going forward, we expect Generative AI to become embedded in enterprise software to improve the human-to-machine interface leading to higher levels of productivity and better customer service. Enterprise software companies are just starting to offer Generative AI enhancements and IT services companies are poised to deploy solutions for their clients.

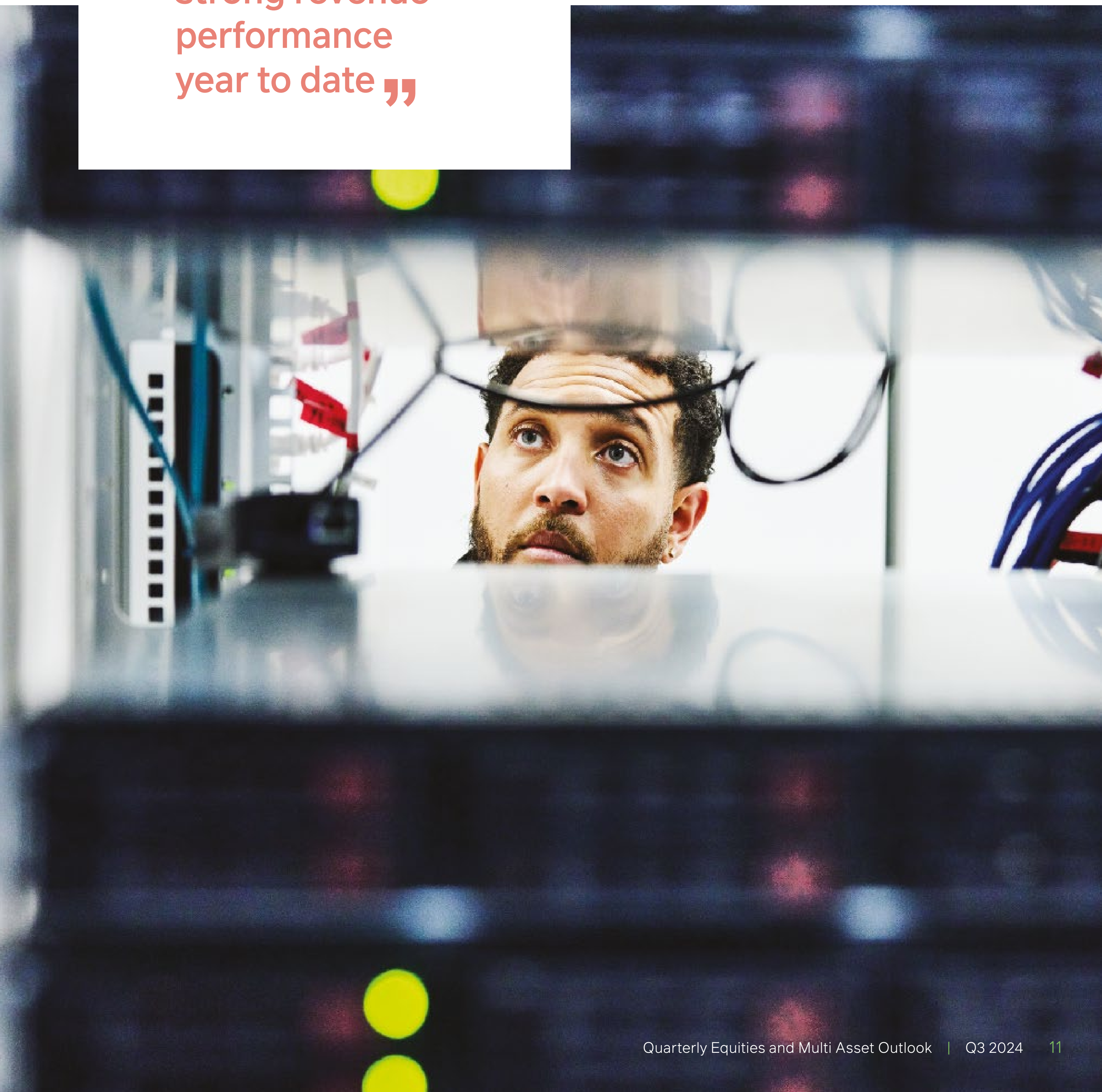
We are seeing tremendous interest from large companies globally around Generative AI, but the software is not yet fully mature and companies are still grappling with how to use it 'holistically' – tying in data governance and security, and re-engineering business processes. This will take some time, but we expect deployments to accelerate as the offerings mature. We are encouraged by the strong AI-related bookings we've witnessed from one of our holdings, a leading IT services company. This bodes well for the trajectory of future AI deployment, in our view.

We believe that companies that embrace AI solutions are likely to improve business results with faster top-line growth and better operational efficiency, supporting capital appreciation.

Beyond Generative AI, there are other potential use cases of AI such as self-driving vehicles and humanoid robots that could continue to drive growth for AI for multiple decades.

[3] Source: NVIDIA Corporation – Financial Reports.
[4] Source: Bloomberg consensus estimates, 2024.
[5] Source: M&G Investments' analysis of a proprietary 'basket' of qualifying stocks including eg, Nvidia, Broadcom, Super Micro Computer, and memory stocks, June 2024.

> “Companies that provide the foundational technology to train AI have seen strong revenue performance year to date”



UK

Michael Stiasny
Head of UK Equities

Reasons for optimism

In the first half of 2024, despite the negativity surrounding the UK, the FTSE All-Share climbed 5.2%[6]. Last quarter we discussed the potential for an election in the back half of this year to influence the direction of the UK equity market. With an earlier-than-expected polling day for the country, the UK population has now cast their votes.

The outcome is less surprising than the timing – with the election resulting in a change of governing party for the first time in 14 years. The new administration assumes office amid a pervasive sense of pessimism regarding the UK's economic outlook and national finances. As we look ahead to the latter half of this year, what can we anticipate for the UK-listed market? Despite the doom and gloom headlines, we see many reasons to be optimistic.

Geopolitical events

For the first time in eight years or so, the UK looks to be one of the more stable geopolitical jurisdictions globally. Events of the past few months have only increased this perception. As a consequence, the UK equity market may look quite attractive to global investors over the next few quarters, particularly if we see further uncertainty and volatility in Europe (and the US), as political developments give rise to domestic upheaval. History shows us that elections and referenda can be market-moving events in the short term, but that short-term volatility tends to normalise over the medium-to-long term. The 'noise' around a vote often provides opportunities to take advantage of short-term price dislocation. This UK election seems unlikely to fundamentally alter the direction of the UK equity market but there is a reasonable chance that the perception of change could encourage investors who have maybe taken a break from the UK market to revisit it once again – particularly given the valuations available relative to the rest of the world.

UK resilience, despite it all

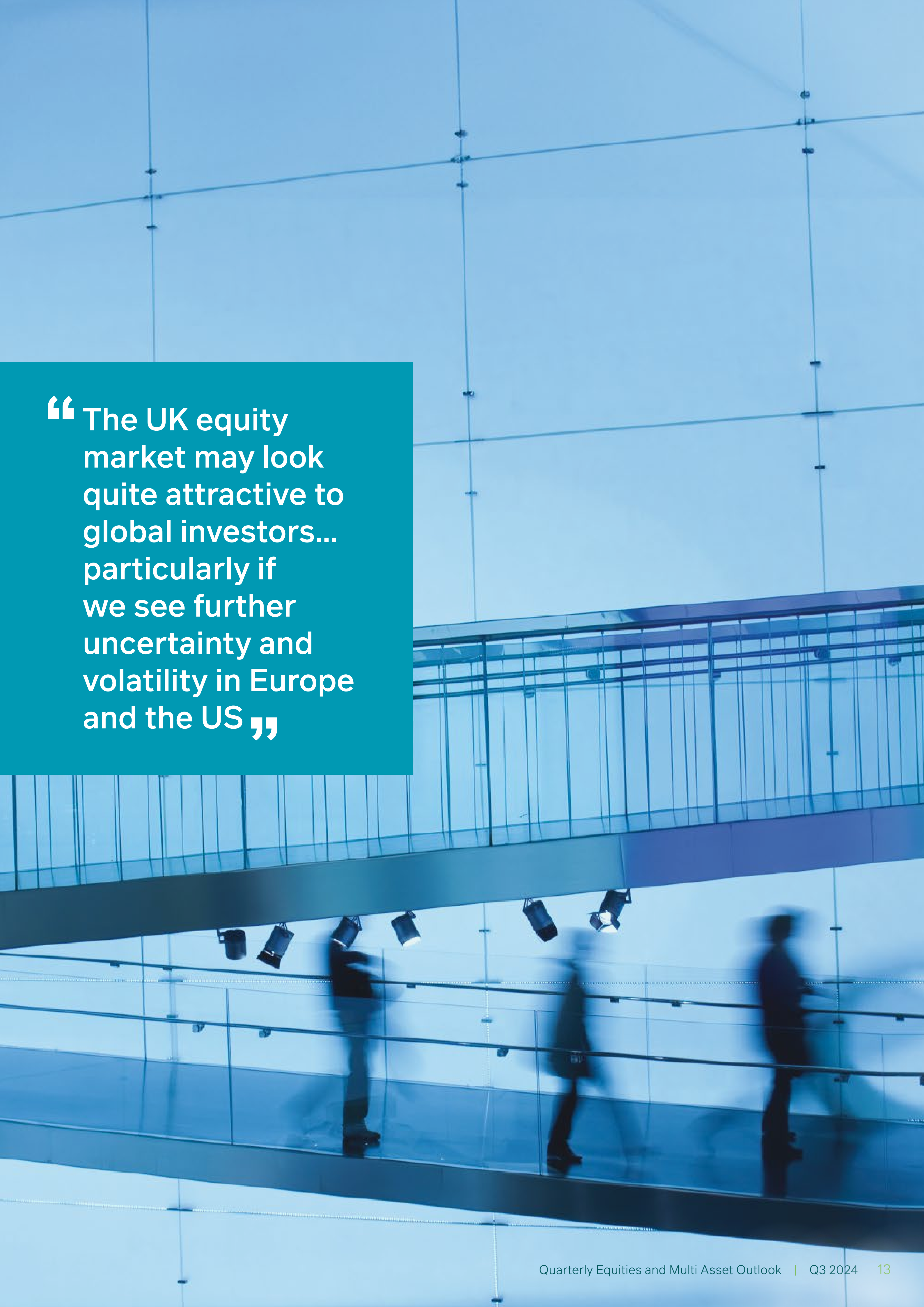
The British economy has shown remarkable resilience, with Britons holding more excess savings than their American or European counterparts[7]. Despite the cost-of-living crisis, data indicate that the population is managing well. Like the US, the UK benefits from strong immigration of younger people, even after the end of 'freedom of movement' with the EU.

Furthermore, we believe the UK's historical role as a European finance hub provides it with unique advantages, including access to talent, significant existing capital, and a common law system. While a new government can bring its own risks, the Labour party has expressed its intention to drive deeper relations with the EU, providing a potential boost to both GDP and supply. The prospect of closer ties could help to unwind some of the UK market's Brexit discount and could be of particular interest for global investors.

Where next for UK equities?

Coming into the second half of the year, with the election behind us, the UK equities market is already attractively priced in our view, so the 'twin benefit' for investors is the opportunity to invest in a market that is cheap on a relative basis, coupled with the offer of a likely more stable range of future outcomes than other regions.

[6] Source: Bloomberg. Price return year to date through 28 June 2024.
[7] Source: OECD, Deutsche Bank, Deutsche Bank Research | UK resilience: Despite it all | April 2024.



> "The UK equity market may look quite attractive to global investors… particularly if we see further uncertainty and volatility in Europe and the US"

Japan

Carl Vine
Co-Head of Asia Pacific Equities

Double-digit return potential for modest risk

Since the beginning of 2023, arguably the beginning of the recent bull market, Japanese equities have delivered a c56% local currency total return (through 30 June 2024) – 2023 delivered c28%, followed by a robust 19% in the first quarter of 2024. Momentum slowed in the second quarter, however, with the market delivering a modest c2%[8]. Has the market run out of steam? We address below how we got here and then move on to ask what might be next.

If we think back to 2022, it was a year where investors were worried about global recession. This negatively impacted stocks in Japan; the market delivered a negative total return of c5% over the year in local currency terms[9]. Despite the global growth concerns, however, Japanese net profits actually grew 8% year-over-year[10]. By the end of 2022, the Japanese equity market was barely above its pre-COVID levels despite earnings having proven themselves resilient. The market was coiled.

In December 2022, the Bank of Japan told the world that the war on deflation/disinflation might finally be over. In early 2023, Warren Buffett bought significant stakes in the Japanese trading companies and the Tokyo Stock Exchange went viral with its demand that listed companies improve returns on equity and devise strategies for valuation repair.

The market responded favourably, as detailed above. Earnings-wise, the 8% net profit growth delivered in 2022 was backed in 2023 by a further 16% year-over-year income growth[11].

The 50% capital return since the beginning of 2023 (c56% total return) is clearly above the earnings growth of c20% over the same period[12]. However, the starting point was one of depressed valuation. As such, whilst valuations have risen, they still do not appear especially demanding today in our view, from an absolute or relative perspective.

> “Whilst valuations have risen, they still do not appear especially demanding today in our view”

The 1-year forward price-to-earnings (PE) ratio of the market is a little under 16x (average 19x, median 16x, market-cap weighted 20x) and more than 40% of the stocks in the MSCI Japan Index have a forward PE of less than 15x[13].

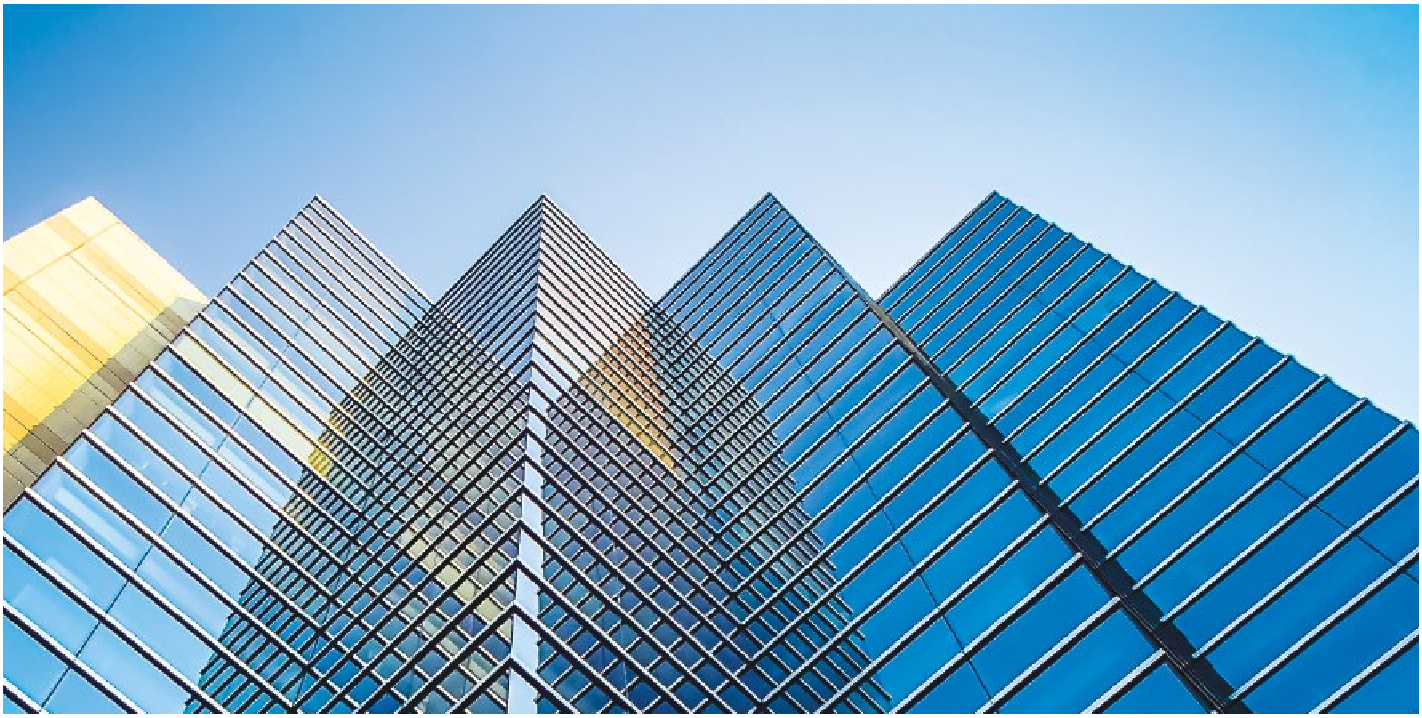
Furthermore, it is a comfort that the increase in market cap since the start of 2023 has been broad based from a sector perspective. Impressive Japanese equity performance has not simply been about artificial intelligence and semiconductors. Financials, autos, trading companies, machinery, services and chemicals firms, and more, have all made significant contributions.

[8] Source: Bloomberg, 4 July 2024. MSCI Japan Index. Total returns in local currency.
[9] Source: Bloomberg, 4 July 2024. MSCI Japan Index. Total returns in local currency.
[10] Given the outsized contribution to index profits and losses from Softbank Group's reported earnings, we have excluded Softbank from the combined profit growth figure.
[11] Source: Bloomberg, 4 July 2024. MSCI Japan Index.
[12] Source: Bloomberg, 4 July 2024. MSCI Japan Index. Total returns in local currency.
[13] Source: Bloomberg, 4 July 2024. MSCI Japan Index.

Looking ahead then, with overall valuations at reasonable, but no longer depressed, levels we should expect Japanese equity returns to be driven by earnings per share growth and dividends. As we have discussed before, we remain upbeat about the structural earnings growth story in Japan, driven by ongoing corporate reform efforts where significant low-hanging fruit remains.

For the current fiscal year, the consensus is presently forecasting a 10% rate of growth in net profits and 12% rate of growth for dividends per share. As in recent years, dividends continue to grow above earnings[14]. So looking ahead, we see a market that is likely to grind away solid double-digit local currency returns for relatively modest risk of ownership.

Perhaps the elephant in the room is the yen. Having passed 160 versus the dollar very recently, Japan's currency continues to confound most observers. With negative real interest rates seemingly undermining the exchange rate, perhaps the market needs to prepare for 'higher rates sooner'. It would not be surprising if USD-based returns from Japanese equities are set for a particularly strong period in the coming 1-2 years.



[14] Source: Bloomberg, M&G calculations 4 July 2024. Consensus forecasts for cap weighted rate of growth for dividends for constituent members of the MSCI Japan Index.

Asia Pacific ex Japan

Dave Perrett
Co-Head of Asia Pacific Equities

Much to mull over in Asia

Asian markets experienced strong returns in the second quarter of 2024, rallying a little over 5% in US dollar terms[15]. Taiwan – particularly AI-driven stocks such as TSMC – rallied very strongly on the back of robust results and guidance. Indeed, TSMC, Asia ex-Japan's largest company by market capitalisation, rose by almost a quarter in value.

Elsewhere in the region, China rose more than 5% in US dollar terms[16], although there was a divergence between Hong Kong-listed China shares that rose high single digits, versus mainland listed A-shares that actually fell modestly. Indian equities ended the quarter comfortably in the green, despite volatility around the recent national election results.

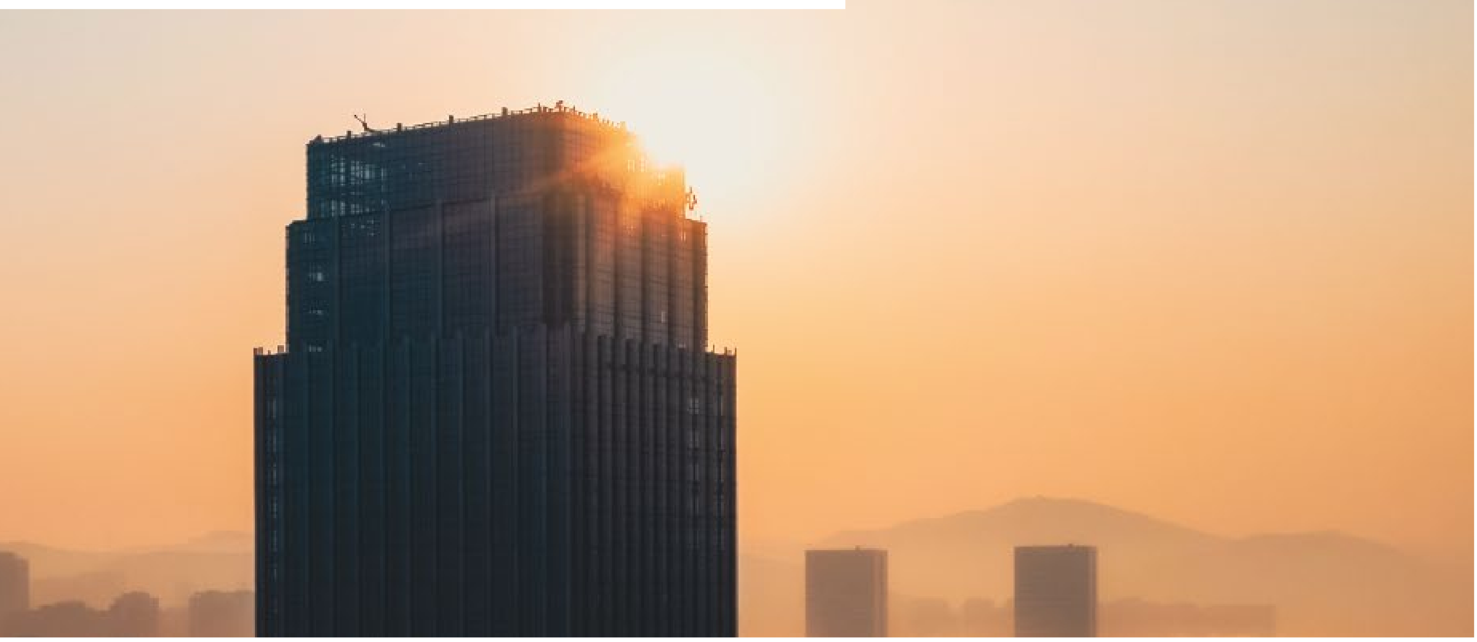
Looking forward, we would expect Chinese equities to remain volatile as the market wrestles with the strength of the underlying economy and whether assorted government stimulus measures will prove successful or more easing will be required. The market will also remain sensitive to geopolitical tensions as the US election approaches in November, with China policy a key area of focus, along with ongoing tensions in the South China Sea. The market will also continue to debate the speed of AI adoption and likely use cases, with a period of consolidation possible for AI-related stocks after very strong recent performance.

[15] Source: Bloomberg. Total returns in USD – MSCI Asia ex Japan Index, 31 March 2024 – 28 June 2024.
[16] Source: Bloomberg. Total returns in USD – MSCI China Index, 31 March 2024 – 28 June 2024.

For the rest of Asia, we would expect most regional banks to continue to benefit from robust net interest income and relatively low bad debt experiences. Given very strong capital positions, we believe there is a high probability that bank shareholders could benefit from rising dividend payments.

After a tough period for telecommunications, we are beginning to see capital expenditure peak out for a number of regional telecom companies, implying higher free cash-flow going forward. At the same time, there is some evidence that competitive pressures are easing and mobile tariffs are drifting higher. This is potentially exciting given that, due to poor investor sentiment, a number of telecom companies are already trading on mid-single digit dividend yields, with room for actual dividend payments to rise further from current levels. As always in Asia there is likely to be plenty of market, economic and corporate developments evolving to give investors much to mull over.

> **“Chinese equities [will likely] remain volatile as the market wrestles with the strength of the underlying economy and [the impact] of government stimulus measures”**



Emerging Markets

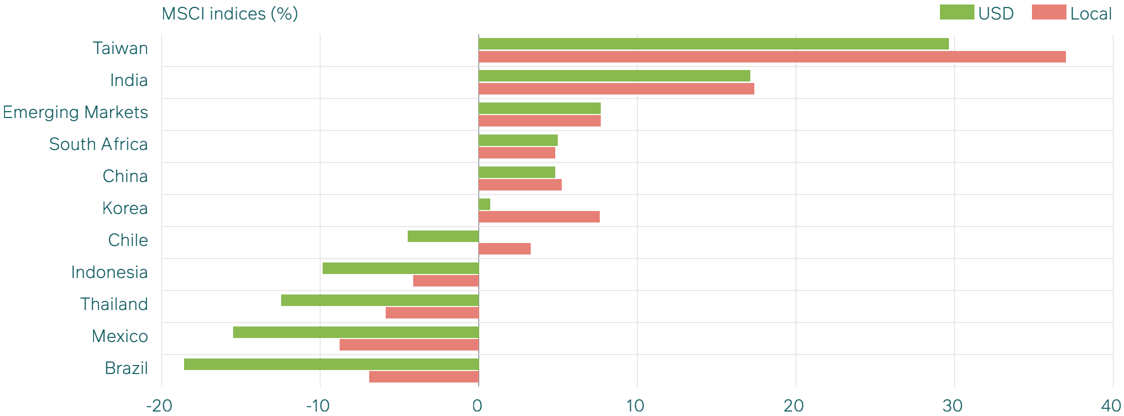
Michael Bourke
Head of Emerging Market Equities

Potential market shift in the second half of 2024

A quick glance at country-level returns year to date in Emerging Markets (EM) explains much of the key drivers on price formation in the market thus-far.

EM country returns, H1 2024 (%)

Past performance is not a guide to future performance



Source: LSEG Datastream, 28 June 2024. Data; total returns in local and USD currency.

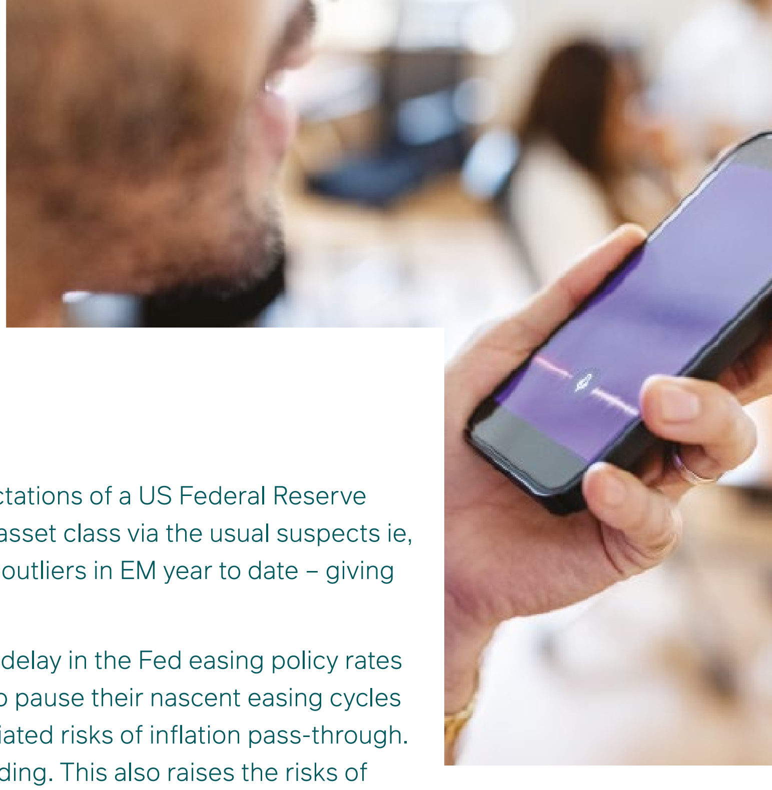
I'll focus on three here – AI, US interest rates, and China – that we believe are key to how the second half of the year will likely pan out.

AI

Given the very heavy dominance of TSMC in the Taiwanese Index (c50% of the MSCI Taiwan Index[17]) and the wider technology weight, the equity market has been driven heavily by excitement around AI, and specifically Nvidia's burgeoning GPU growth. TSMC's share price is up more than 65% year to date[18]; the company is Nvidia's (and the world's) key chip fabricator. The same is true of SK Hynix, Nvidia's key HBM (high bandwidth memory) provider with HBM prices c.10x that of a normal equivalent DRAM chip. At the same time, there is growing expectation regarding an improvement in the consumer electronics cycle, with the next generation of laptops and smartphones being AI-enabled.

There's been a noticeable increasing correlation between the share price performance of key Nvidia-suppliers and Nvidia itself this year. Therein lies the risk: any pullback in Nvidia will likely see an equivalent pullback in the supply chain, given the elevated level of expectations. SK Hynix, for example, has trebled in price since the end of 2022[19]. But the AI tide has not lifted all boats. For example, the scepticism surrounding Samsung Electronics, which has only gained c3% this year[20]. There is a potential opportunity there in the second half of 2024, with Samsung also likely to start supplying Nvidia with HBM chips.

[17] Source: MSCI Taiwan Index Factsheet, June 2024.
[18] Source: Bloomberg, 4 July 2024. Price returns in local currency.
[19] Source: Bloomberg, local currency reference as of 3 July 2024.
[20] Source: Bloomberg, data in local currency, year to date total returns through 3 July 2024.



US interest rates

Obviously, the market has been disappointed by fading expectations of a US Federal Reserve (Fed) pivot. That disappointment has ricocheted through the asset class via the usual suspects ie, Latin America and South East Asia. Brazil and Mexico are the outliers in EM year to date – giving back some, not all, of their 2023 outperformance.

Interest rates in both regions are extremely elevated, and the delay in the Fed easing policy rates has precipitated similar reactions, with central banks opting to pause their nascent easing cycles in order to avoid excessive currency weakness and the associated risks of inflation pass-through. Equities have faded given the prolonged elevated cost of funding. This also raises the risks of political intervention – for instance, in Brazil, President Lula becoming ever more vocal about his displeasure with central bank policy.

We are seeing similar market reactions across Thailand and Indonesia; with currency weakness dragging down equity markets. There is value in equities across these markets, in our view, and we have been leaning into this weakness and adding to existing positions.

Fed turning points are historically associated with better performance by EM assets, as the simultaneous pressure from US rates and the dollar eases. While the US economy has remained more robust than observers expected, the risks of such elevated rates have increased and the Fed could start cutting as early as in September.

China

Volatility among Chinese assets has been elevated all year; the equity market fell precipitously in January before rallying c29%[21] only to fade again since mid-May. We believe the market continues to digest macroeconomic concerns and the haphazard policy response to date. Policy measures have picked up with record-low mortgage rates and QE-like funding from the PBOC[22] to stimulate bank loans to developers and city governmental bodies in order to encourage stabilisation in the real estate sector.

China is not immune to US policy either – elevated US rates, with regard to the yuan, have prevented the PBOC from easing rates more aggressively for fear of losing control of the currency. Here again, Fed easing could see a more expansive policy response. We continue to be highly selective in adding to our China positions and have trimmed earlier adds during the rally to May. But, we do still see compelling value. It's noticeable how more and more corporates continue to guide for higher dividends and/or buybacks. We are seeing this from both State-owned enterprises (SOEs) and private companies. Companies with higher yields have experienced better performance year-to-date in 2024.

> **“Fed turning points are historically associated with better performance by EM assets, as the simultaneous pressure from US rates and the dollar eases”**

Overall, while AI has been the bull trade in the first half of 2024, we may see the market shift focus in the second half and a potential tailwind for EM assets, if we start to see US rates coming down and Chinese corporate and policy measures taking effect.

[21] Source: Bloomberg, 4 July 2024. MSCI China Index. Data; total returns in local currency.
[22] People's Bank of China.

Impact

John William Olsen
Head of Impact Equities

Wasn't it obvious?

"The idea that the future is unpredictable is undermined every day by the ease with which the past is explained" – Daniel Kahneman

Wasn't it obvious that life science stocks would suffer from post-COVID hangovers, or that renewables stocks would underperform dramatically on the back of rising interest rates and falling electricity prices? In hindsight, that was clearly the case. Predicting it before the fact, and before it gets baked into share prices, is a different matter.

When we look for high-quality sustainable opportunities in the market, we try imagining the world through a probabilistic lens. We build out scenarios based on research to estimate the margin of safety on offer in the market. That margin of safety is determined by a collection of probability-weighted cash flow scenarios held up against the market value of a specific stock – a market value shaped in part by other investors' moods, recent experiences, and predictions.

Rather than trying to predict where stock prices will go from here, we try to identify long-term opportunities where we can get a margin of safety, linked to what we believe might be shorter-term shocks or behavioural factors.

Post-COVID slowdown and destocking in the life science value chain is one example. An area of the market that we believe has a high likelihood of long-term growth, it was hit on both earnings and sentiment by what we believe (with a high likelihood) will be a shorter-term setback.

Rooftop solar technology companies, meanwhile, have been crushed by a sudden slowdown in demand on the back of rising mortgage rates and lower electricity prices. Inventories held by distributors and installers were very significant, because of the previous years of hyper growth, and destocking and slow end-market demand caused a downward spiral in both earnings and multiples. We believe solar is most likely a long-term growth market, and inventories will eventually clear.

Offshore wind also experienced a fall from grace, as certain US projects got abandoned due to lack of profitability and too aggressive contract terms, lots of political noise in one of the biggest election years ever, and less general investor interest after rates have risen. Offshore wind operator stocks went from being priced as high-growth assets to no growth assets. We believe that there's a high likelihood of the offshore wind market staying on its growth trajectory – unprofitable projects have been, or are being, renegotiated and electricity demand will see a boost from the rapid buildout of power-hungry datacentres.

So, we don't exactly know what comes next, but some decent long-term growth prospects now come with a much cheaper price tag, as the initial excitement and attention has shifted.

> "After [a shift in] the initial excitement and attention, [we are seeing] some decent long-term growth prospects...with a much cheaper price tag"

Global Research

Neil Millar
Global Energy Analyst

As patience wears thin on the energy transition, the Majors are participating

We are now nearly a decade on from the Paris Agreement and five years on from when the European major oil companies added the Energy Transition to their strategic thinking. The newly available incentives are even prompting their US counterparts to participate.

It has been a tumultuous time with COVID and the war in Ukraine causing extreme swings in energy prices. Supply chains, inflation and interest rates have challenged project returns. And the encouragement given by domestic politics has been very varied. Investors have been given every reason to be negative on energy transition activities.

In the face of this, the oil companies strategies' continue to evolve to find acceptable returns within the nascent demand pools and government support. We are close to seeing the energy transition investments contribute more noticeably; and the companies will continue with selective M&A where valuations have retrenched.

Hydrocarbons are likely to remain at the heart of these companies' profitability for the foreseeable future but, slowly, platforms and know-how are being built to participate in new opportunities. The uncertainty means there is a high probability of mis-steps and it will be important, in our view, not to over-commit capital.

But investors should start to notice the profitability from these energy transition activities, even if we should not yet expect differentiated valuations. Perhaps it will take the next downturn in oil prices to appreciate the diversification benefits?

> “Oil companies have many of the skills necessary for energy transition activities”

Oil companies have many of the skills necessary for energy transition activities. Most obviously, they have experience in big projects and the balance sheets to underwrite them. Much of the expertise required for CCS[23], hydrogen, offshore wind and biofuels has adjacencies in oil and gas activities. Their trading arms are also a big differentiator. In businesses with skinny returns, enhancing project profitability through finding the best price is an important enabler.

BP have taken advantage of lower valuations, bolting on smallish acquisitions like Archaea, TravelCentres of America and Lightsource BP. Most recently, they bought ethanol production in Brazil for a lowly multiple of trough ebitda[24]. Buying cheaply and building effectively is an interesting platform.

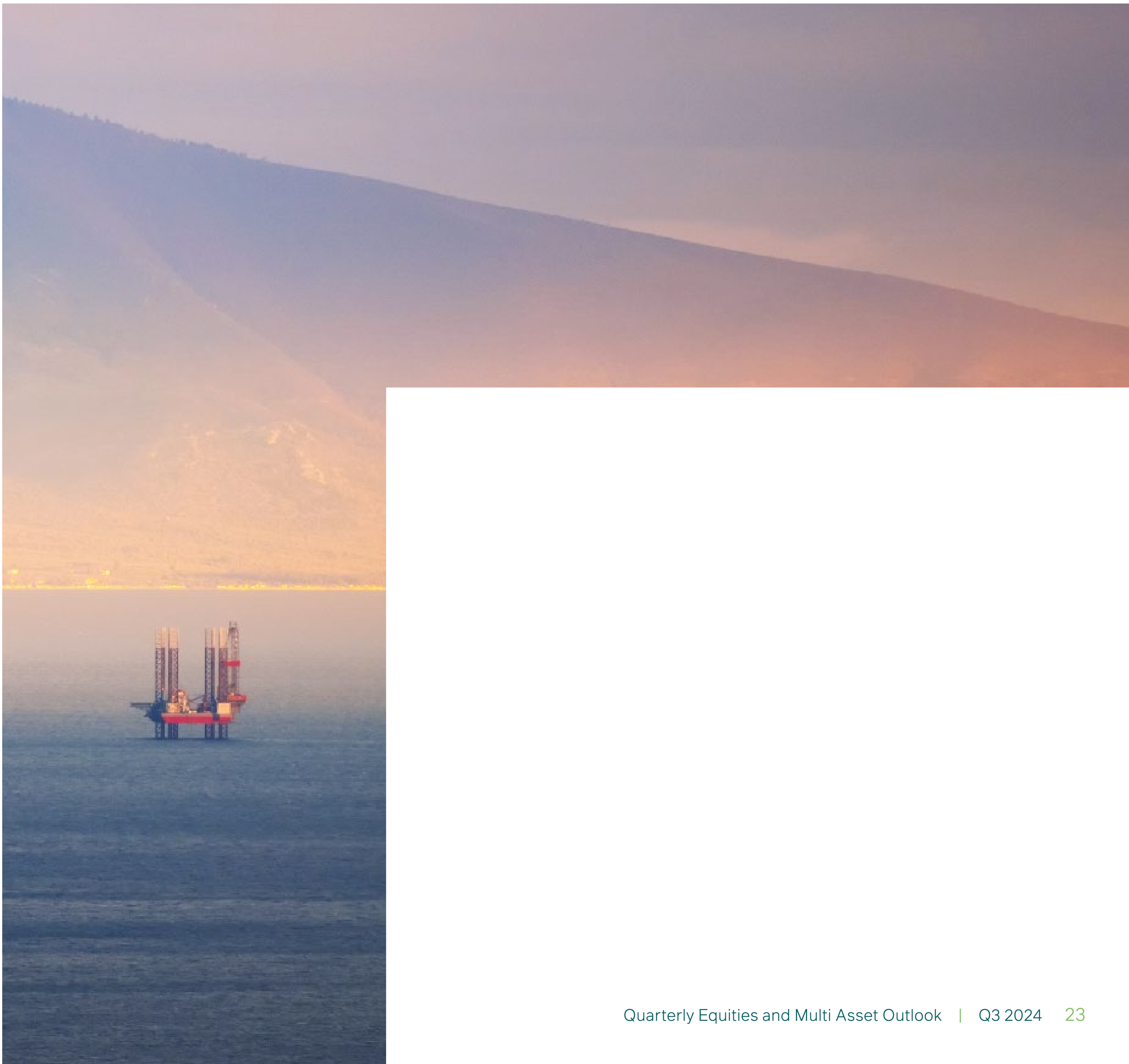
[23] CCS = Carbon Capture and Storage.
[24] Ebitda = Earnings before income, tax, depreciation and amortisation.

Total Energies has deployed c$25bn in their Integrated Power division, finding a way to combine renewables, gas generation, storage and trading to generate a 10% Return on Capital Employed (ROCE). The division is expected to grow towards a meaningful $5bn of operating income in 2028[25].

Even ExxonMobil (Exxon) is seeing opportunities, driven by government stimulus. Exxon is investing $20bn in lower emissions solutions between 2022-27, on top of the recent $5bn acquisition of Denbury (which owns the largest network of CO_2 pipelines in the US)[26]. With the help of President Biden's subsidies, Exxon is advancing a massive hydrogen and ammonia project at their Baytown chemicals plant which will capture 98% of the emissions. The hydrogen will decarbonise the chemicals plant by 30%[27].

Share prices will likely continue to be driven by capital returns and commodity prices. But, at some stage, it should become noticeable that Big Oil is already participating profitably in the energy transition.

[25] Source: Total strategy presentation 27 September 2023 – TotalEnergies_2023_Strategy_Outlook_presentation.pdf
[26] Source: Denbury, Exxon acquisition announcement, 13 July 2023 – ExxonMobil announces acquisition of Denbury.
[27] Source: Exxon project announcement, 30 January 2023 – ExxonMobil awards FEED for world's largest low-carbon hydrogen facility.



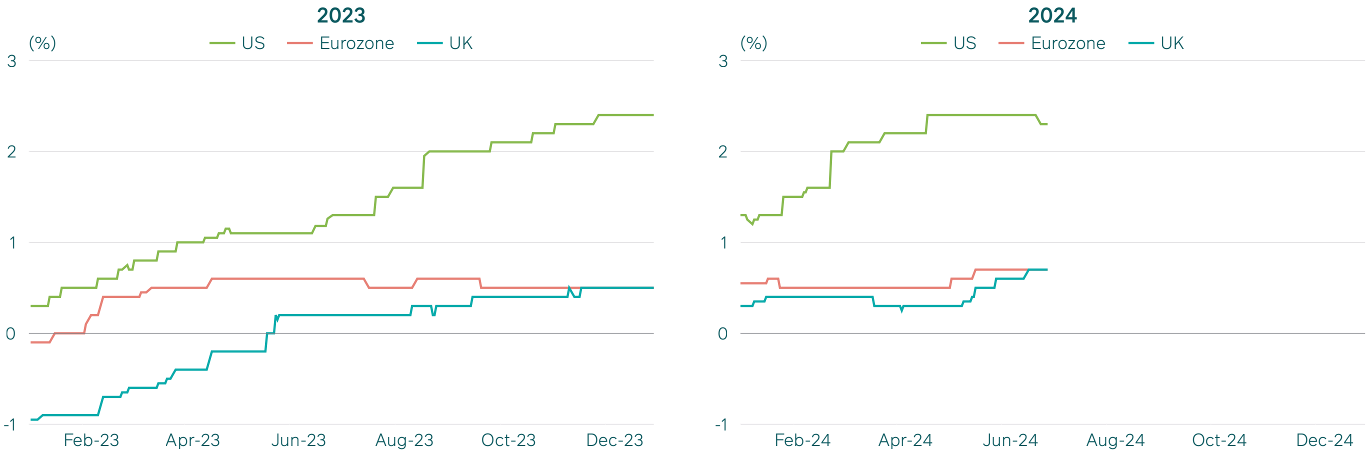
Multi Asset

Gautam Samarth
Fund Manager, Multi Asset and Systematic Equites

Disaster myopia and attitudes to risk

2024 has proven to be another surprising year thus far. In similar vein to 2023, we started the year with consensus calling for a significant slowdown in GDP growth. Back then it was the speed of monetary tightening that was feared to be too much for economies to handle. This year economists pointed to the waning fiscal impulse in the US and depleting consumer savings as added headwinds. Yet growth, especially in the US, has proved robust thus far. Financial markets have adjusted with equities re-rating and bonds re-assessing the number of interest rate cuts expected in the western world.

Bloomberg Consensus GDP Forecast



Source: Bloomberg, 28 June 2024.

To be sure, there are signs that monetary policy measures may be starting to cause stresses in interest-rate sensitive parts of the economy. Moreover, some members of the US Federal Reserve have suggested that the labour market might be at an inflection point, where further slowing could translate into 'higher unemployment, as firms need to adjust not just vacancies but actual jobs'.

However, the general mood in financial markets appears to be one that is much more comfortable with risk. A curious observation is that the beliefs around recession, which appeared a near certainty during the early parts of 2023, seem to have completely disappeared. This is most clearly observed in the rerating of risk assets we have seen so far this year. Behavioural finance literature would use the term 'disaster myopia' to explain such phases in markets whereby the longer the passage of time without a disaster, the more we as human beings underestimate the risk of a shock occurring in the near future.

In assessing 'what comes next', we'd suggest, as we usually do, that we have no idea. However, we can offer a little more in terms of what current behaviour might mean for financial assets going forward. Using the aforementioned 'disaster myopia' framework, the market appears to be much more complacent about, and therefore vulnerable to, any future potential disasters. While recent volatility around elections (Mexico, India, the European Parliament, France to name a few) have exposed some of these vulnerabilities, risk premia still appear to be narrow.

Our response within our most tactical strategies has been to dial back risk, running a relatively neutral directional equity exposure alongside modest currency carry trades. We have also increased our exposure to Western government debt after the mid-April sell off, having scaled these positions back towards the end of last year. While government bond yields now appear to offer reasonable compensation over inflation outright, they have the added allure of a potential insurance policy against some of the 'disasters' the market only recently fretted about (such as recession) as well as those it hasn't yet thought of. Across the broader range of multi–asset strategies, this view is reflected in neutral net equity exposures, with a preference for relative value opportunities within the equity mix. Within fixed income, there is a preference for longer dated Western government bonds alongside elevated cash levels to take advantage of any future volatility should it materialise.

“The general mood in financial markets appears to be one that is much more comfortable with risk”

Convertibles

David Romani
Fund Manager, Convertibles

Positive outlook on Asian activity

We were (pleasantly) surprised by the large volume of new convertible issues coming out of Asia during the second quarter of 2024, despite our previous expectations of exiguous issuance. We revise our views and believe Asian new issues volumes will continue to be strong in the second half of 2024. We are still optimistic on US deal flow and, to a lesser degree, Japanese, but do not harbour high hopes for European new bonds.

Earlier in the year, we anticipated a strong pace of new issuance driven by interest rates staying higher for longer, refinancing needs, rising stock prices and thematic stories (eg, Artificial Intelligence). We had differentiated drivers of issuance by geography, expecting the greatest volumes in the US and Japan, anticipating tepid issuance in Europe and sparse volumes in China (mainly due to poor sentiment on Chinese equities).

Our previous expectations, revised

Drivers	Our H2 revised view on issuance volumes	Levels		
		Equity	Spreads	Rates
US – higher rates, significant coupon savings. High equity valuations	Positive	+	+	+
Europe – lower rates, spreads tight, smaller savings	More negative	~	–	~
Asia – improving issuance levels from China on balance sheet restructuring, need for offshore funding, equity valuation no longer at troughs	More positive	~	–	~
Japan – rising markets, restructuring, rates beginning to rise?	Positive	+	+	+

Source: M&G, July 2024.

While the other regions followed our roadmap, we did not foresee a spate of corporate/balance sheet restructuring activity in Asia. The defining feature of the last quarter was very large deals from Chinese companies used to raise offshore funds at very low cost. Alibaba issued the largest single-tranche convertible bond ever, at $5bn, with a zero coupon. JD.com, another ecommerce giant, issued $2bn with a 0.25% coupon. Travel booking firm Trip.com added a further $1bn with a coupon of 0.75%[28]. In all three cases, the firms' main business activities are in mainland China and they generate copious cashflow onshore, but their stocks are listed as ADRs[29] in the US.

Convertibles have been used to access offshore capital markets to get around restrictions on cross-border capital flows and to buy back stock at cheap valuations in order to support the share price. An additional $2bn bond was issued by gold and copper miner Zijin (which is listed in the Hong Kong market) with a 1% coupon to fund international expansion and M&A.

[28] Source: Bloomberg, June 2024.
[29] American Depositary Receipts (ADRs) are certificates issued by US banks that represents shares in non-US stocks. Typically used as a liquid way for investors to own non-US stocks.

Having seen this activity and the recovery in Chinese equity prices, we now think that more firms will follow the template already set and issue more convertibles in the second half of the year for share repurchases or acquisitions. Indeed, Bank of America has raised its Asian issuance forecast from $10-12bn to $17-19bn, a 64% increase[30]. It is unlikely we will get another jumbo deal such as Alibaba, but offshore funding access will remain interesting for Chinese issues, and the share buyback motive may be of interest to Korean and Taiwanese tech-related names.

From our conversations with banks, we understand that there is already a pipeline of potential Chinese issuers waiting for the relevant government authorisations to raise funds offshore, which we think could start to materialise from September onwards.

For Japanese issuers, the offshore funder access is not a concern. Instead we think moves to improve shareholder returns and balance sheet efficiency through buybacks are more likely, although not on a scale of the Alibaba deal. Rising Japanese share prices would also increase issuance, which stalled in the second quarter as the Nikkei plateaued.

By contrast, lower rates, tight spreads and less elevated equity valuations versus the US, do not represent as favourable a backdrop for European issuance in our view. The recent placing of a new Schneider convertible suggests that most new deals will be simple refinancings/exchanges to roll over existing bonds, at terms perhaps not that appealing to investors.

We will continue to sift through the new issues in a highly-selective way to identify the best combination of technical features, credit soundness and equity valuation that can deliver the optimal risk-reward characteristics we seek in convertibles.

[30] Source: Bank of America, June 2024.

“The defining feature of the last quarter was very large deals from Chinese companies used to raise offshore funds at very low cost”

M&G Investments