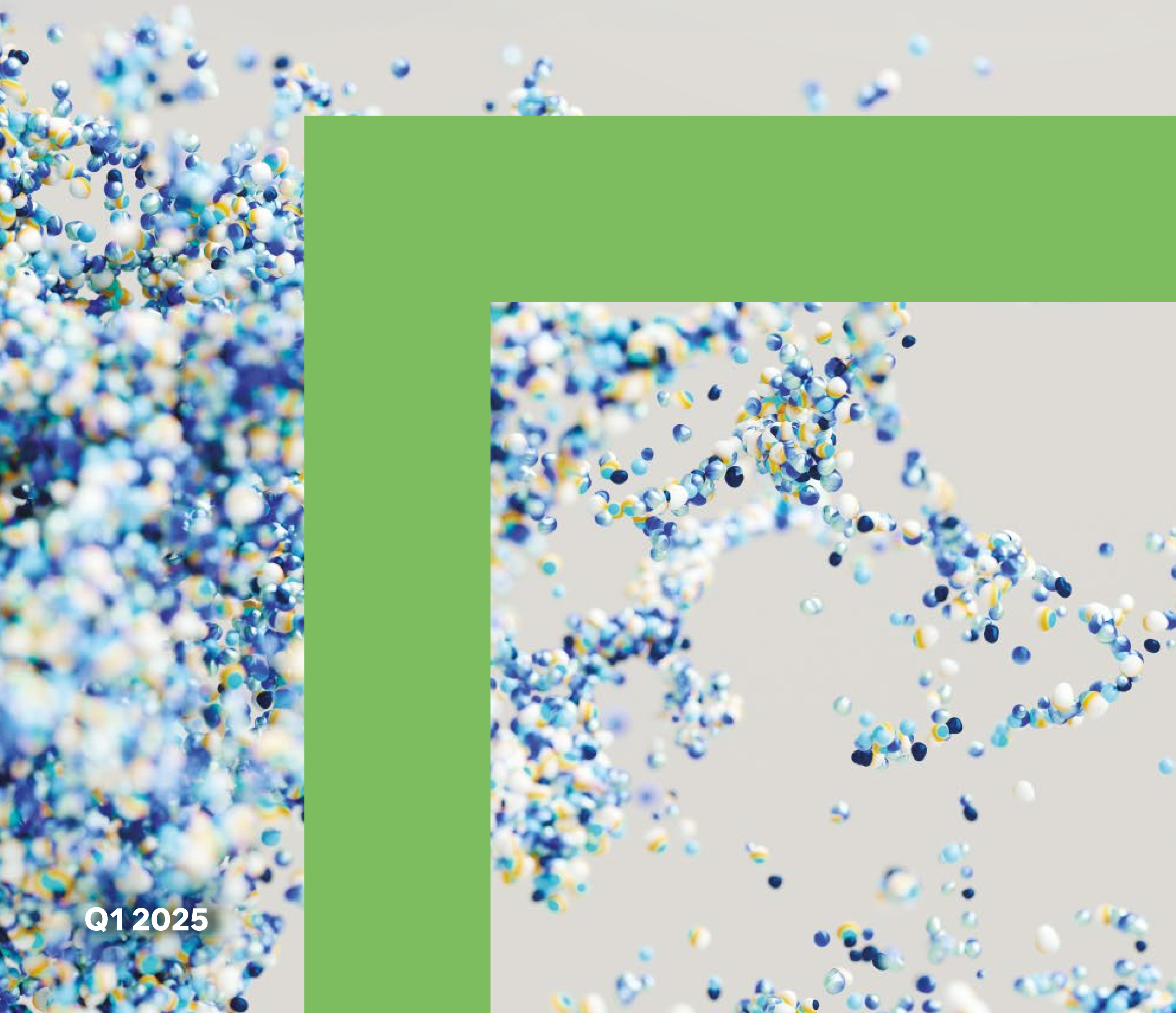
M&G Investments

Quarterly Equities and Multi Asset Outlook

Debunking the macro myth

Equities follow businesses not the big picture



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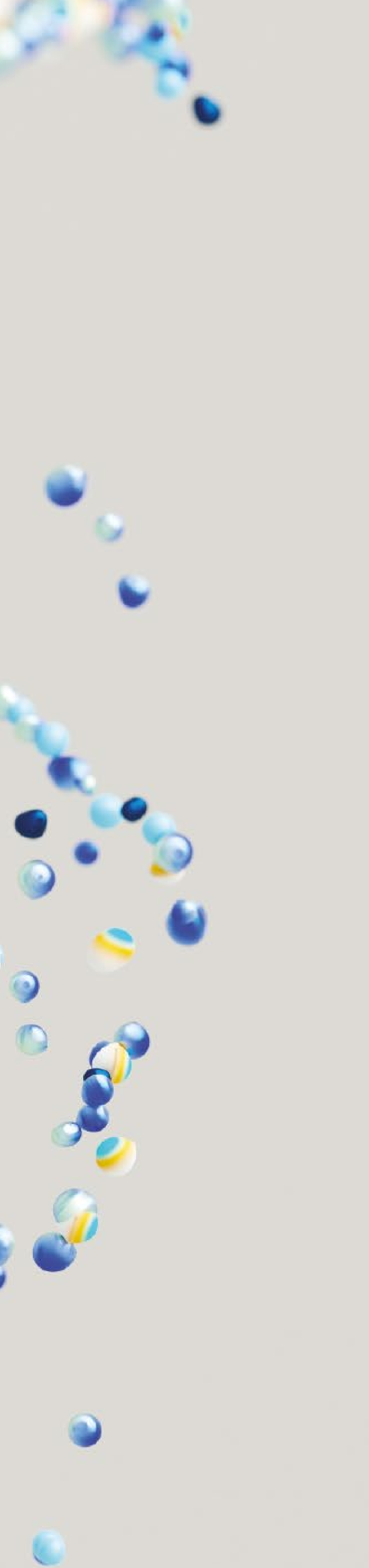


Debunking the macro myth

The assumed correlation between macro growth and equities performance is far from straightforward, and a misplaced understanding of it can significantly affect investors' ability to generate returns.

Macro and geopolitics only matter for equities if they have a tangible impact on companies' operational and financial performance. There are companies that are able to grow earnings even with a poor macro backdrop.

Macro can, however, have a meaningful indirect effect via foreign exchange and the translation of returns in a stronger currency.

From the Fed's 'higher for longer' to Germany's 'sick man of Europe', broad-brush reactions to macro datapoints create investment opportunities for active investors.

Equities follow businesses not the big picture

I like reading, and I love markets. Every year end, I save a few market outlooks on my laptop and look forward to reading them during my holidays, much to my husband's annoyance. This year the topics covered were easy to guess even before glancing at the Executive Summary: What will Trump tariffs mean for the US and the rest of the world? What will central banks do and are we in for higher-for-longer interest rates? Will US exceptionalism and equity market outperformance continue with the backdrop of a weak Europe and an even weaker China?

After making forecasts on the bigger picture, most publications would follow with extrapolations on market performance in 2025. First, let's take fixed income. Fair enough, higher rates and government paper supply (or concerns thereof) affect the yield curve. Clear.

Then, for equities. I would pause. Does a weak or strong economy really determine the opportunity set in equity markets? Yes to some extent, but not to the degree that many seem to believe. In our opinion, the assumed correlation between macroeconomic (macro) growth and equities performance is far from straightforward, and a mis-placed understanding of it can significantly affect investors' ability to generate returns from stocks.

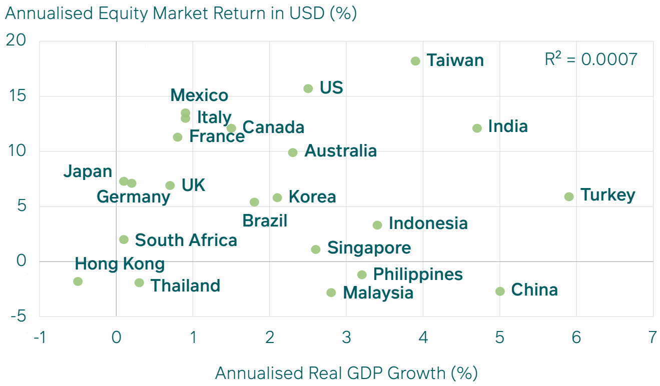
Take a look at equity markets in 2024. The best performing major market in the world was not the US, it was China. The Hang Seng China Enterprises Index delivered a total return of 31.2% in HKD and 32.0% in USD terms, respectively, versus the Nasdaq Index's 29.6% total return. Arguably, China has been the weakest of all major global economies over the past year[1].

And then there is Germany. Over 2024, the DAX Index generated a total return of 18.9% and 11.7% in EUR and USD terms, respectively. Behind the S&P 500 Index's 25.5%, but not bad for an economy that has been dubbed the 'sick man of Europe'. How could this happen? Because 13 stocks out of the 40 that comprise the DAX Index returned more than 20% in EUR terms. In USD terms, the number is 12. These stocks were the drivers of index performance[2].

The Italian and Spanish stock markets each delivered total returns of 18.9% in EUR terms, and 11.7% in USD terms given the greenback's recent strength[3]. Interestingly, just over one third of the returns for both came from dividends. Perhaps a good topic to explore in our next Quarterly.

This relative dissonance between general economic growth and equity markets' returns is not new to 2024. The chart below plots the relationship between a country's real GDP growth and the annualised returns of its domestic equity market over the last full 5-year period for which we have the GDP data.

Real GDP growth vs. equity market returns: annualised data over 5-year period through 31 December 2023



Source: M&G Investments, LSEG Refinitiv. Annualised data 31 December 2018 - 29 December 2023, total return basis in USD, based on daily data points. Past performance is not a guide to future performance.

Equity markets returns are shown in USD for ease of comparison. A simple glance shows low correlation between equity returns and GDP growth, with some low GDP growth markets performing relatively well and some high GDP growth markets performing relatively poorly. The R^2 value indicates just as much[4]: the equivalent of less than 1% of the variation in equity market performance was explained by domestic GDP growth over that period.

[1] Source: Bloomberg, 31 December 2024.
[2] Source: Bloomberg, 31 December 2024, total return basis.

[3] Source: Bloomberg, 31 December 2024, Madrid Stock Exchange General Index (MADX) and FTSE MIB Index, total return basis.
[4] R^2 is a measure of how well a linear regression model 'fits' a dataset.

The explanation?

Equity markets are driven by earnings, expectations thereof, and whether these are already discounted in valuations. Therefore, the most direct way for macro growth to impact equity market performance is through earnings growth. Our Multi Asset team has tried to dig behind the reasons why such impact turns out to be muted. Three of the key factors highlighted are:

First of all, **timing**, as macro data is mostly backward-looking while equity markets move on expectations. Secondly, **accuracy**. Macro data can be very difficult to collect, and is often revised. Thirdly, **complexity**. Macro data does not exist in a vacuum but intersects with other datapoints, making the evolution of consequences far from linear.

For example, in January 2024, with the highest interest rates in 20+ years, it was entirely reasonable to expect the US economy to suffer on the back of it. This turned out to be wrong.

With my former fund manager hat on, I would also add a fourth reason. Many companies are able to grow earnings in a relatively poor macro environment. As our Global investment team points out, earnings growth will not only depend on the market or markets a company actually operates in (which could be different from the country of listing), but also on product relevance, innovation and quality, operational and balance sheet strength and efficiency, and, ultimately, a strong management team. Of course, the macro backdrop should always be accounted for, but not as a generic and all-encompassing barometer of equity market performance.

Case in point is the performance of consumer companies over the last year. Our Consumer research team reminds us that, throughout 2024, household budgets were strained by inflation and elevated interest rates, particularly at the lower-income end. It was logical, therefore, to expect low consumption appetite. However, consumers have also become more discerning in their spending habits, and a number of companies have been able to take advantage of this.

> "...the macro backdrop should always be accounted for, but not as a generic barometer of equity market performance"

While the dollar stores, Dollar General and Dollar Tree, lost more than 40% of their market value in 2024, Walmart's investments in price competitiveness, product range and convenience created a proposition that increasingly resonated with a wider cohort of consumers, driving market share gains, sales growth and improved profitability. The share price was up 72% in 2024[5].

In the UK, Marks & Spencer (M&S) has beaten the odds of a weak consumer down-trading. Compelling products at reasonable prices and convenient omnichannel distribution drove market share gains and profitable sales growth, and shares were up 39% in 2024[6].

And then, there is structural growth that comes from disruptive innovation and the creation of new markets, think Artificial Intelligence. Our Thematic Technology investment team explains how, through exceptional products and services, innovation can create revenue that doesn't necessarily correlate to the broader economic growth.

Of course, equity markets do react to macro data in the short term, as happened at the end of the second week in January, when a strong US jobs report triggered expectations for higher yields, and US equities reacted negatively. This is the same equity market that sailed through the 'higher for longer' fears just about one year ago, delivering 20%+ returns for a second year in a row. Indiscriminate reactions to macro datapoints create investment opportunities for active investors.

So, have I managed to convince everyone that macro doesn't matter? Hopefully not, because while we believe there are plenty of examples of strong equity market performance in weak economic environments, and that the macro backdrop is far from an indicator of future equity market performance, macro can still influence equity market returns. This is the case when macro

[5] Source: Bloomberg, 31 December 2024, price returns in local currency.
[6] Source: Bloomberg, 31 December 2024, price returns in local currency

conditions have an actual or expected impact on a company's business and financial performance.

Take France. For 2024, the total return of the CAC 40 Index was disappointingly flat in local currency and down 6.0% in USD terms. Concerns on the need to raise taxes, including for corporates, and cut public spending to fill the deepening budget deficit, coupled with continued consumption weakness in China and in the auto market, raised doubts on the profit growth prospects of many of the stocks in the index. There were, in truth, still a number of index constituents (nine in local currency and six in USD terms to be precise) that returned more than 20% in 2024. But there were not enough in number and size to drive the rest of the index into positive territory. Of course, as active investors, we have the luxury of being able to choose the stocks we invest in and, hence, the index performance has less bearing on our portfolio returns.

One other impact that macro has on equity markets is indirect, through currency. A weak macro backdrop, concerns on fiscal health, and interest rate differentials can have a meaningful impact on a currency, affecting the translation of returns. This has recently been the case for Japan, where the TOPIX Index delivered total returns of 20.4% in JPY and 7.9% in USD terms[7].

Of course, as our Japanese Equities investment team reminds us, in 2024 there were still plenty of strong performing stocks for an active investor to choose from, as nearly one quarter of the names in the MSCI Japan Index delivered total returns of 25% or more in USD terms[8].

What are the implications for our equities investment strategy?

As our Head of Impact Equities observes, the flip side of US exceptionalism appears to be a consensus that Europe is doomed. It is indeed difficult to get excited about the macro picture, and innovation in AI is far more developed in the US. However, we have seen that GDP growth in any particular country or region is rarely the driver of equity markets, and Europe has no shortage of well run and strongly moated companies, from global champions to dominant niche players and local structural growers. Taking advantage of the weak sentiment and low valuations, we have found opportunities across a range of sectors including industrials, consumer staples and basic materials.

Mispriced opportunities also remain plentiful in Asia. In South East Asia, where markets are worried about the impact of higher-for-longer US interest rates, there are a number of high-quality companies with structural, bottom-up, growth tailwinds, trading on high single-digit dividend yields. Similarly, across the rest of Asia, many exporters have been sharply de-rated due to fears of Trump tariffs. However, a handful of such companies have either changed their supply chains away from China or have even added material capacity in the US itself, leading to attractive upside potential in our view, as a result of recent market fears.

Last but not least, our long-term view on Japanese equities remains: we believe the market offers an attractive long-term risk-reward opportunity. Listed Japanese equities remain attractively priced versus intrinsic value, and changing corporate behaviour leaves us confident that the 'self-help' opportunity-set will be harvested in support of both earnings growth and market returns. If we are to make one prediction for Japan in 2025, it will be this: we are about to see another record year for M&A and investor activism.

And by no means do we ignore the US market. We like the innovation angle and technology, including the stocks that benefit from the AI ecosystem. Given the concentration and narrow leadership of the market, we have been tilting away from US mega cap stocks and finding interestingly-valued opportunities across a range of different sectors and end markets. Recent new additions include companies within consumer discretionary, healthcare, housing and banking.

Over the next pages, our Equity and Multi Asset investment teams will discuss how macro has or has not impacted their respective investment universes, and where they are currently finding investment opportunities, often in the least 'straightforward' macro backdrops.

We wish you an enjoyable and – hopefully – interesting read, and a successful 2025.

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

[7] Source: Bloomberg, 31 December 2024.
[8] Source: Bloomberg, 31 December 2024.

Multi Asset

Maria Municchi
Fund Manager, Multi Asset

The most important macro data for asset allocators

It is often the case that macroeconomic (macro) data is at odds with market returns. So how much can/should we rely on macro data for asset allocation?

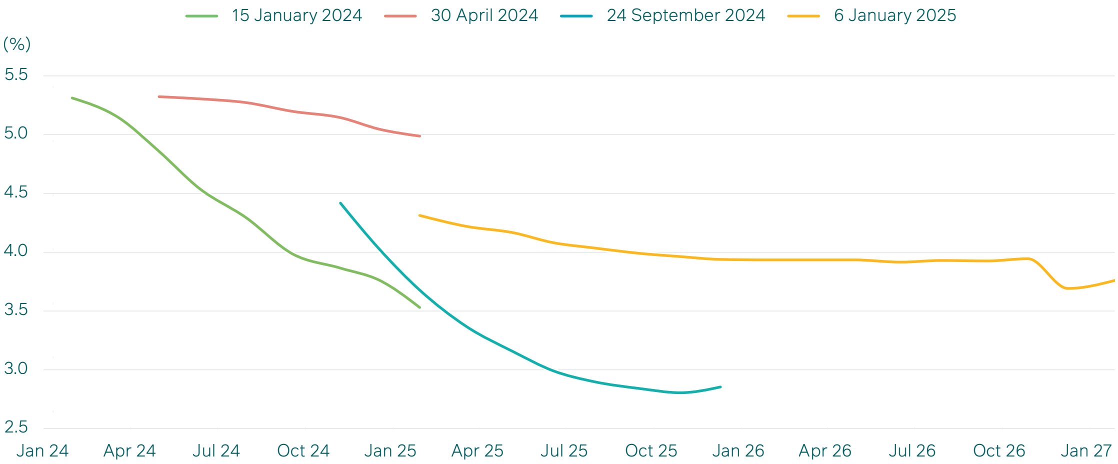
It is useful to remind ourselves why, even if we were to be extremely good at forecasting the next US GDP datapoint, we might be none the wiser (or should we say, none the richer).

First of all, **timing**. Macro data is mostly backward-looking. That is, it measures what has already happened. On the other hand, markets move on hopes and expectations of future events and are, therefore, more responsive to the latest developments. For example, the S&P 500 Index rallied after Trump's election victory, on anticipation of lower taxes and deregulation under the new administration, and the expectation that these will support earnings going forward.

Secondly, **accuracy**. Macro data can be very difficult to collect, and is often revised. For example, in August 2024, the US Bureau of Labor Statistics' annual benchmark revision adjusted down the March 2024 total nonfarm employment figure by 818,000. Rewriting history by erasing, statistically speaking, nearly one million jobs makes it challenging for anyone to develop a coherent view on what's going on currently in the labour market. That is until the 'final data' has its say in February 2025 – a whole year after the fact!

Thirdly, **complexity**. Macroeconomics is a social science, and as such, its models are subject to the changes in social structure and behaviours over time. In January 2024, looking at the highest interest rates that the US has had in 20+ years, it was entirely reasonable to expect the economy and the consumer to suffer on the back of it. This turned out to be wrong. Healthier corporate and household balance sheets, demographic and immigration trends, and maybe a shift in spending behaviour post the pandemic years, created a very different environment where interest rates have been able to remain elevated for longer than many anticipated, without the corresponding economic fallout.

Fed funds futures implied rate



Source: Bloomberg, 7 January 2025.

Finally, and most importantly, macro beliefs and behaviours. Even central banks, leveraging on the best data and minds, are unable to predict what will happen to their own economies in the next few years. However, investors will face macro uncertainty by generating a set of beliefs and reflecting them in their behaviours.

Also, investors' risk preferences can be influenced by evolving macro regimes, with characteristics such as cyclicality, variability of macro data, profit share of GDP, and changes in monetary policy and leverage all potentially weighing on risk appetite. For example, equity risk premiums (ERPs) in developed economies shifted higher post the global financial crisis (2008-09), driven by lower valuations and real yields, while they trended down post the subsequent quantitative easing phases[9].

As asset allocators, we can aim to achieve a good understanding of where we are today, by looking at a diversified set of macro data and at trends, as well as analysing macro beliefs and corresponding investors' behaviours – by assessing changes in expectations, prices and valuations, and market narratives. And, if the market starts to make too many confident assumptions about the future and/or decides to pay exaggerated attention to specific data, this is when potential opportunities could arise for active investors.

Today, we are still observing a very benign macro environment in the US, where equity markets might continue to thrive. However, with the S&P 500 Index priced for a rosy macro and micro environment, and the equity risk premium versus US treasuries somewhat limited, we prefer to diversify our equity exposure. We favour more attractively-valued equity markets in Asia and Europe, where we believe investors are better compensated for taking risks, and where sentiment is subdued. We also maintain exposure to US treasuries to diversify our portfolios and have gradually increased our exposure to UK gilts. After recent volatility, we have taken advantage of more idiosyncratic opportunities in Brazilian bonds and equities.

[9] Source: UBS, Bloomberg, MSCI. UBS Global Research, 29 October 2024; 'Is Equity Risk Premium about to Inflect?' – looking at ERPs in equity markets in the US, Eurozone, Japan, UK, Australia and Canada.

> **"Macroeconomics is a social science, and as such, its models are subject to the changes in social structure and behaviours over time"**

Global

Daniel White
Head of Global Equities

Navigating the ‘Three-Body Problem’

Three-Body Problem: A quantum mechanics theory describing the motion of three celestial objects that exert gravitational forces on each other. Orbits of three or more objects become increasingly chaotic, making it difficult to predict their long-term trajectories.

There is no known general solution.

This complex dynamic mirrors the predicament facing investors and asset allocators today. The dominant influence of the US equity market – with three somewhat conflicting characteristics – has created an almost astronomical-sized investment challenge.

Characteristic #1 Valuation

The aggregate US equity market currently exhibits elevated valuations on most relevant metrics. These premium valuations can be observed on an absolute basis, relative to most other asset classes and versus its own history.

Although valuation is a poor predictor of short-term performance, there is historically a strong relationship over the longer term.

R-squared of market valuations vs forward returns

Source: UBS HOLT. Universe: Largest 1000 US companies by market cap.

Put simply – the higher the valuation, the lower the expected long-term returns.

Characteristic #2 American exceptionalism

Speaking of investment returns, it has been widely observed that the US equity market has delivered very strong performance over many different time horizons. These returns have occurred on a remarkably consistent and persistent basis.

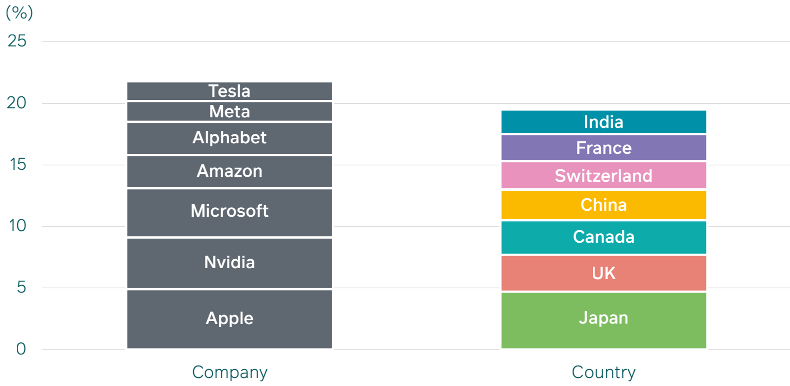
Whilst ‘past performance is not indicative of future results’ there are several plausible reasons why this could continue. Compared to many other countries and companies, the US economy and corporates continues to be characterised by higher levels of productivity, higher profit margins, higher earnings growth and higher levels of innovation.

It is difficult to bet against the American economic exceptionalism.

Characteristic #3 Too big to ignore

The US equity market is truly enormous. The total market capitalisation of the US equity market is around 70% of the global equity universe. Seven US companies make up a bigger weight in the MSCI All Country World Index than the next seven biggest countries combined.

Weight in MSCI AC World Index (%)



Source: M&G Investments, Bloomberg, 19 December 2024.

> “The US equity market is Jupiter in a solar system where every other planet is the size of Pluto”

The US equity market is Jupiter in a solar system where every other planet is the size of Pluto.

So how should investors navigate the three-body problem that is the US equity market: an asset class on a premium valuation, that has historically been a source of strong investment returns, and has become so large and important that it has become almost impossible to ignore?

Hyperbolic tangles

If you exclude the largest companies, then US valuations are at a significantly lower premium. And excluding the largest companies doesn't necessarily mean missing out on attractive fundamentals.

The smaller index constituents, and so called 'value stocks', are generally more exposed to the relatively buoyant US economy (and the attractive domestic fundamentals that come with it) than their mega cap peers. It's worth remembering that these smaller index constituents are still substantially sized companies in their own right.

If one believes in the durability of American economic exceptionalism, 'US small cap value' is perhaps not a bad place to start – especially given valuations here look attractive in our view.

Across our global and US specific strategies we've been tilting away from US mega caps for some time. Within the US we have been finding opportunities across a range of different sectors and end markets. Recent new purchases and additions include companies within consumer discretionary, healthcare, housing and banking. And – despite the strong performance– we're still finding new ideas within the US technology sector.

Outside the US, we have found many attractive investments within Europe. The opportunity set is broad, with new holdings coming from a range of sectors including industrials, consumer staples and basic materials.

Just as the three-body problem in physics highlights the inherent unpredictability of complex systems, so too does today's global equity market and the interplay with the US.

Embracing this uncertainty, adapting to changing conditions, but maintaining a long-term perspective considering valuations and fundamentals, is key to navigating this challenging investment landscape.

Thematic Technology

Jeffrey Lin
Head of Thematic Technology Equities

Company innovation matters more than the economic cycle

Innovation creates revenue growth with exceptional products and services. Innovation in this century has been exceptional, and we expect more to come. Looking back at earlier periods of the modern information age, we can find many examples of structural outperformance led by innovation. We believe this trend will continue.

The broader investable universe is affected by the economic cycle in the near term. Year-to-year changes in the economic environment can create headwinds or tailwinds to growth but, over the long term, companies that create or participate in new large addressable markets grow revenue at large multiples of economic growth and earnings even faster. These special opportunities can be impacted by near-term headwinds as well, but long-term growth and capital appreciation remains intact.

While there have been periods of drawdowns, innovation leaders continue to grow at a high rate and their share prices reach new highs because the companies continue to grow at a high multiple of GDP growth. Investing in high-growth companies with high multiples on near-term metrics, may seem risky to some investors, but we would argue that not investing in long-term secular winners creates the risk of structurally underperforming. We believe that focusing on multiples based on near-term metrics can cause investors to miss the potential long-term gains. Active management plays an important role in identifying opportunities that can create significant outperformance over the longer term. Here are two examples from the past where innovation created 'megatrends' and stock outperformance.

Personal computer era and the WinTel (Windows-Intel) paradigm

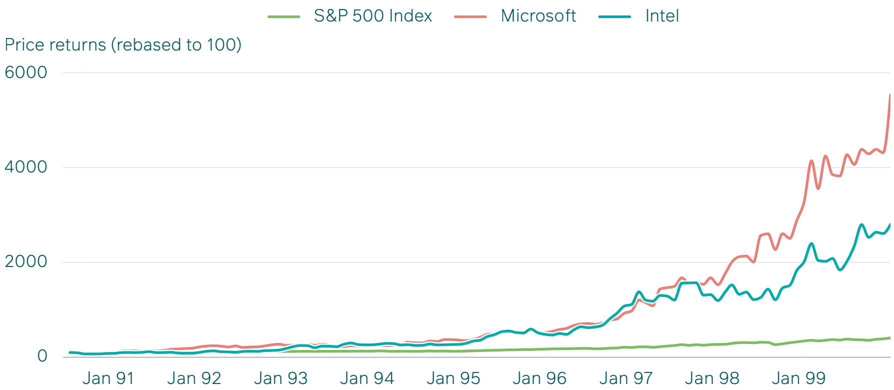
The personal computer emerged in the mid-1970s as a product developed by hobbyists. Apple introduced its Apple II in 1977 and IBM launched the IBM PC in 1981, bringing the personal computer into the workplace. In 1984, Apple introduced the Macintosh with its Graphical User Interface.

> "...we would argue that not investing in long-term secular winners creates the risk of structurally underperforming"

The 1990s would see the tipping point of adoption for personal computers – driven by usability, accessibility and affordability, and further growth acceleration with access to the internet as a key demand driver. The key event was the launch of Windows 3.0 by Microsoft in May 1990, which offered a much improved Graphical User Interface over Windows 1.0 and 2.0. This led to Windows becoming a software platform for Applications using its Graphical User Interface.

Windows 3.0, was very compute intensive and the experience was better with the fastest available processors. At the time, Intel brought the fastest processors for personal computers to market ahead of its competitors and enjoyed high growth and high margins because of its ability to innovate.

WinTel and S&P 500 Index performance: June 1990-December 1999



Source: Bloomberg, 9 January 2025. Price returns. Rebased to 29 June 1990.

Video streaming with Netflix

In 1997, Netflix started as a video rental business that fulfilled rentals through mail. The emergence of DVDs created an opportunity to move content affordably because of the size and weight differences versus VHS tapes. As broadband become more prevalent in residential homes, Netflix announced its streaming video product on 15 January 2007, seizing an opportunity to create a significantly larger catalogue for consumers and instant on-demand content. The convenience of on-demand streaming increased the addressable audience for content.

Netflix and S&P 500 Index performance: January 2007-present

Source: Bloomberg, 9 January 2025. Price returns. Rebased to 29 June 1990.

Of course, stocks will outperform as long as the 'edge' is maintained. Arguably, at some point that was not the case for Intel, for example, and the stock started underperforming the broader market. Intel lost its 'edge' as an innovation leader when it lost its time-to-market advantage for the latest processors. It is up to us, active investors, to select the innovation winners and understand if and when they lose their edge. Experience and a deep understanding of innovation are key foundations to generate those higher and macro-independent returns.

Impact

John William Olsen
Head of Impact Equities

Identifying less obvious micro opportunities

The AI revolution and US exceptionalism are the elephants in the room for investors right now, but it's probably fair to say that they have been spotted by most. These two key trends will most likely persist throughout 2025, and the momentum behind them as investment themes has been incredibly strong.

Momentum can be strong, long lasting, FOMO[10]-inducing and painful for investors who are not participating. The timing of when to leave the party and risk losing out on the pumped-up fun is tricky, but great market excitement and increasing evidence of frothy speculation has increased the risk of losing money. We prefer to stay humble at times when money-making in other parts of the market seems glaringly obvious. It is often when the macro picture is most obvious that micro mispricing happens, making this a good time to look for alternative and less obvious opportunities.

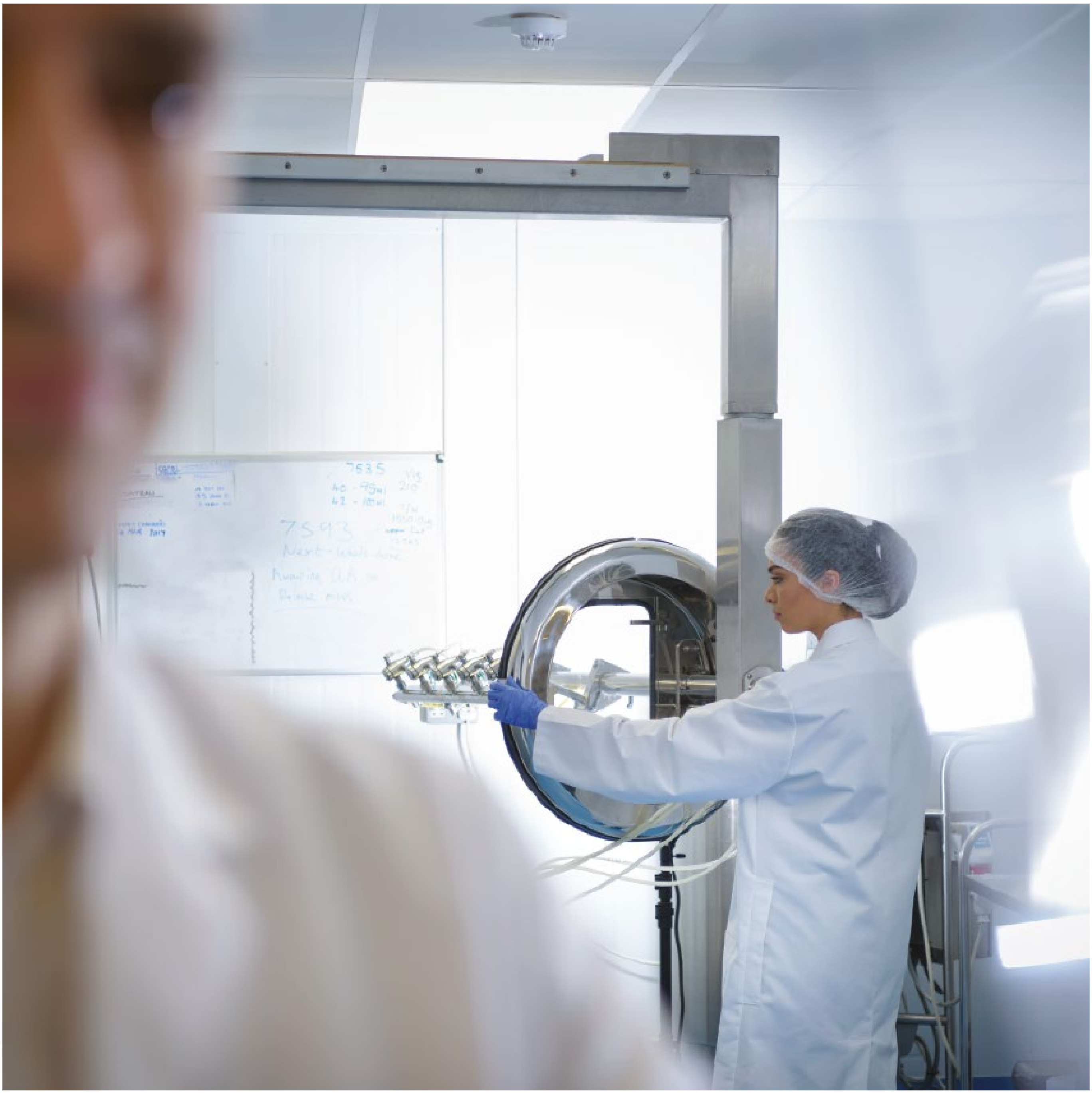
The flip side of US exceptionalism seems to be a consensus that Europe is doomed. It is indeed difficult to get excited about the macro picture, and innovation in AI is nowhere compared to the US. However, GDP growth in any particular country or region is rarely the driver of equity markets, and Europe has no shortage of well run and strongly moated companies, from global champions to dominant niche players and local structural growers.

> “Europe has no shortage of well run and strongly moated companies, from global champions to dominant niche players and local structural growers”

There is unique heritage to be found in Europe such as French and Italian luxury brands, big global food brands or country-specific spirits brands from the likes of France, Ireland and Scotland, an exceptional industrial culture in Sweden and Germany, a great design tradition in Northern Europe, as well as successful innovation hubs such as Oxford University and the ecosystem around Novo Nordisk in Denmark.

Most of the European winners are truly global and will benefit from economic growth outside of their own country or region. The current macro-induced rotation out of Europe into the US leaves some of these champions trading on very reasonable prices.

[10] FOMO = Fear of missing out.



Another area that has been left behind in the frothiness of the last two years is healthcare. The sector size in the MSCI World benchmark is now similar to the combined market capitalisation of just two companies: Apple and Nvidia. This includes the two GLP-1[11] juggernauts (Novo Nordisk and Eli Lilly), massively profitable large pharmaceutical companies, the recently scolded health insurance companies, and the entire biotech sector which is working on solving some of our most pressing health and environmental challenges.

The healthcare sector has underperformed severely on the back of a noisy US presidential campaign, post-COVID destocking, a slowdown in biotechnology investor appetite and the general lack of excitement outside of the GLP-1 space. The US healthcare system can be inefficient and expensive, but good value can be found amongst companies that drive innovation and patient reach.

[11] GLP-1 (Glucagon-like peptide-1) is a naturally occurring hormone, and GLP-1 medications mimic this hormone to help control blood sugar levels and appetite. Used for treating Type-2 diabetes and aiding weight loss.

UK

Michael Stiasny
Head of UK Equities

Debunking the macro myth

As we look ahead to 2025, we retain a modestly positive view on prospects for the UK economy – GDP is forecast to grow and interest rates are still anticipated to fall. Also, compared to many other countries, the UK political backdrop now looks extremely stable following a long period since the Brexit vote in 2016 of political and economic uncertainty.

However, it is important not to confuse prospects for the UK economy – good or bad – with prospects for UK stock market returns. Clearly, the domestic backdrop is all important for companies operating in the UK but it is much less relevant for the majority of companies listed in the country, given their international exposure.

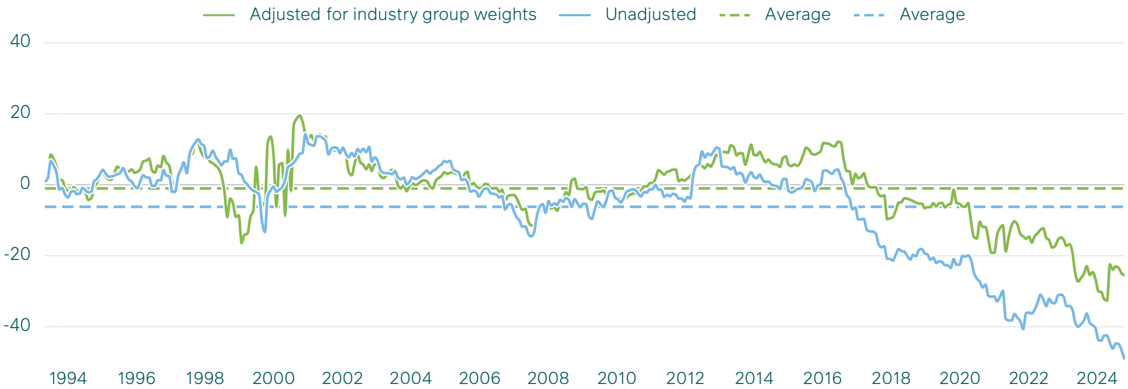
The composition of the revenues of the FTSE All Share is instructive – at least 75% of revenues come from outside the UK – and even for the more domestically-oriented FTSE 250 Index, 50% of revenues are from overseas. Unsurprisingly, given these statistics, there is little correlation between UK GDP and UK stock market returns.

In our view, the real drivers of UK stock market returns are likely to be the strength of the global economy, especially the US, the bottom-up ability of management teams to execute their business plans, and, crucially, the starting valuation for any investment.

It is on this latter point that the UK market screens particularly well. Even after a decent absolute performance in 2024, the valuation of the UK market is still near multi-decade relative lows, and is one of the most lowly-valued markets globally (using metrics such as price-to-earnings). This is despite many companies being carbon copies of their peers in other markets that are often valued at much higher levels.

The chart below indicates that, on a blended basis of price-to-earnings (P/E), Enterprise Value to EBITDA (EV/EBITDA), and price-to-book (P/B) ratios, the UK has never experienced such a significant discount to the rest of the world, both when adjusted for sector differences and when unadjusted.

UK relative to RoW – valuation spread



Source: LSEG Refinitiv. *Blended (equal weight) average P/E, EV/EBITDA and P/B. MSCI UK and World indices. 1 November 2024.

Rather than GDP or other macro factors, one of the best metrics for determining the next 10 years of potential investment returns for the UK market is actually the P/E multiple of the market at the time of purchase. If we look at the UK market over the past 65 years we can see that there has been a strong correlation between starting valuation and subsequent returns – the cheaper the market the better your returns opportunity is, and today we are standing at near a 50-year low.

UK starting PE and future 10-year annualised return (%)

Source: Datasteam, Datastream indices, using 12m forward PE and resultant 10-year annualised return figures. Historical data back to 1965. Past performance is not a guide to future performance.

There are many high-returning companies listed in the UK, operating in sectors as diverse as banking, staples, retail and media, that are trading at very low levels. The past 12 months of M&A activity, and the historic level of share buybacks, reminds us that if equity investors don't recognise value others will – and also provides us with a reminder that macro factors take a back seat when there is value on offer.

The de-rating of the UK market over the past few years is a classic example of how macro or political factors can come to drive dislocations in the near term....but, in time, we believe bottom-up fundamentals will reassert themselves, and that when we look back on the UK with the benefit of hindsight, it may well end up representing a text-book example of the absence of correlation between economic metrics and stock market performance.

> "The past 12 months of M&A activity [and share buybacks] reminds us that...macro factors take a back seat when there is value on offer"

Japan

Carl Vine
Co-Head of Asia Pacific Equities

When strategy trumps tactics

Japan offers a good example of how a country's macroeconomic performance can be distinct from its microeconomic performance. Over the last decade, Japanese nominal GDP has grown by just 0.9% annualised. Nominal GDP in the US, by comparison, has grown by 5.2% annualised over the same period. In contrast to Japan's relatively anaemic economic growth, its stock market has delivered a 10% compound total return in local currency terms (6% compound in USD terms), driven mainly by high single-digit compound growth in stock market earnings, with additional help from dividends[12].

In terms of how the macroeconomic backdrop can 'uninform' stock market prospects, last year was another case in point. In this same piece a year ago, we noted a plethora of macro factors that might result in volatility for the Japanese equity market over the course of 2024. We also noted that modest valuations and a lack of euphoria in terms of investor sentiment inclined us away from taking any pre-emptive action. We decided to let strategy trump tactics, and continue to position our portfolio for our long-term view: that Japan is well positioned to deliver long-term equity returns in the mid-teens (in local currency) and that Japan is a good market for esoteric stock alpha.

> "[Our] prediction for Japan in 2025...we are about to see another record year for M&A and investor activism"

As it turned out, there was indeed plenty of macro-driven volatility during 2024, including a brutal market sell off in August. However, when all was said and done, the MSCI Japan Index finished the year with a total return of 21%, in local currency terms[13]. The market's performance over the year was in line with our structural optimism in the longer-term outlook for self-help driven earnings growth, dividend growth and value-releasing M&A activity.

MSCI Japan operating profits grew in the first half of the fiscal year (ending September 2024) by 11% year-on-year, and dividends grew by an equally-weighted average rate of 21%[14]. Meanwhile, M&A activity reached a new high in the year, helped of course by the largest attempted foreign takeover of a Japanese company in history (Alimentation Couche-Tard's bid for Seven & I Holdings).

Whilst yen weakness brought USD-based total returns down to 8% on the year, nearly one quarter of the names in the MSCI Japan Index delivered total returns of 25% or more in USD terms, providing ample choice for global active investors[15].

[12] Source: Bloomberg, returns over the last decade through 31 December 2024.
[13] Source: Bloomberg, January 2025, Data: total returns in local currency.
[14] Source: Bloomberg, January 2025.
[15] Source: Bloomberg, January 2025.

So what of 2025?

Once again, there are several known unknowns on the macro front. With Trump in office, will US tensions with China heat up or thaw out? This single factor alone will likely play a major role in global equity risk premia in 2025. Besides geopolitical uncertainties, what will the Bank of Japan do now that Federal Reserve watchers have moved to a higher-for-longer stance, and what are the implications for the Japanese yen exchange rate? As stock pickers, we consider macro permutations as risks that require careful portfolio navigation rather than things we should try to predict.

Our long-term view on Japanese equities remains; we believe the market offers an attractive long-term risk-reward opportunity. Listed Japanese equities remain attractively priced versus intrinsic value, and changing corporate behaviour leaves us confident that the 'self-help' opportunity-set will be harvested in support of both earnings growth and market returns. If we are to make one prediction for Japan in 2025, it will be this: we are about to see another record year for M&A and investor activism.

Asia Pacific ex Japan

Dave Perrett
Co-Head of Asia Pacific Equities

Plentiful mispriced micro opportunities in Asia

Markets can be like people. They love a good story. Looking across Asia Pacific ex Japan at the present time, three stories dominate the current market narrative. What will Trump tariffs – whatever they may be – mean for Asia? Does the latest Federal Reserve rhetoric mean that we are in for higher-for-longer US interest rates? Will China's domestic economy show signs of improvement or will it continue to struggle?

These are, indeed, weighty macroeconomic questions. However, at M&G, our sense would be that one's time is better off spent analysing stocks from a bottom-up perspective and looking for large gaps between the underlying value of a business and the current share price, rather than pondering the answers to the big macroeconomic questions of the day.

Why do we say this?

Macroeconomic forecasting is incredibly difficult and competitive. Many people globally are wrestling with the issues outlined above. The ever-changing sentiment on the extent of rate cuts through 2024 is an excellent example of the inherent complexity. Even if one is 'right', what matters is how one's forecast compares to broader market expectations.

In 2024, most commentators would have said that the Chinese economy was weak and faced deflationary pressures. Yet in 2024, the MSCI China Index outperformed the booming Indian economy's Nifty 50 Index. Major Chinese banks returned between 30% to 50% during 2024[16]. How does that fit with the narrative of a deflating, doomed Chinese economy? The key question, of course, is what was being priced in at the end of 2023, and how did that compare to underlying corporate fundamentals?

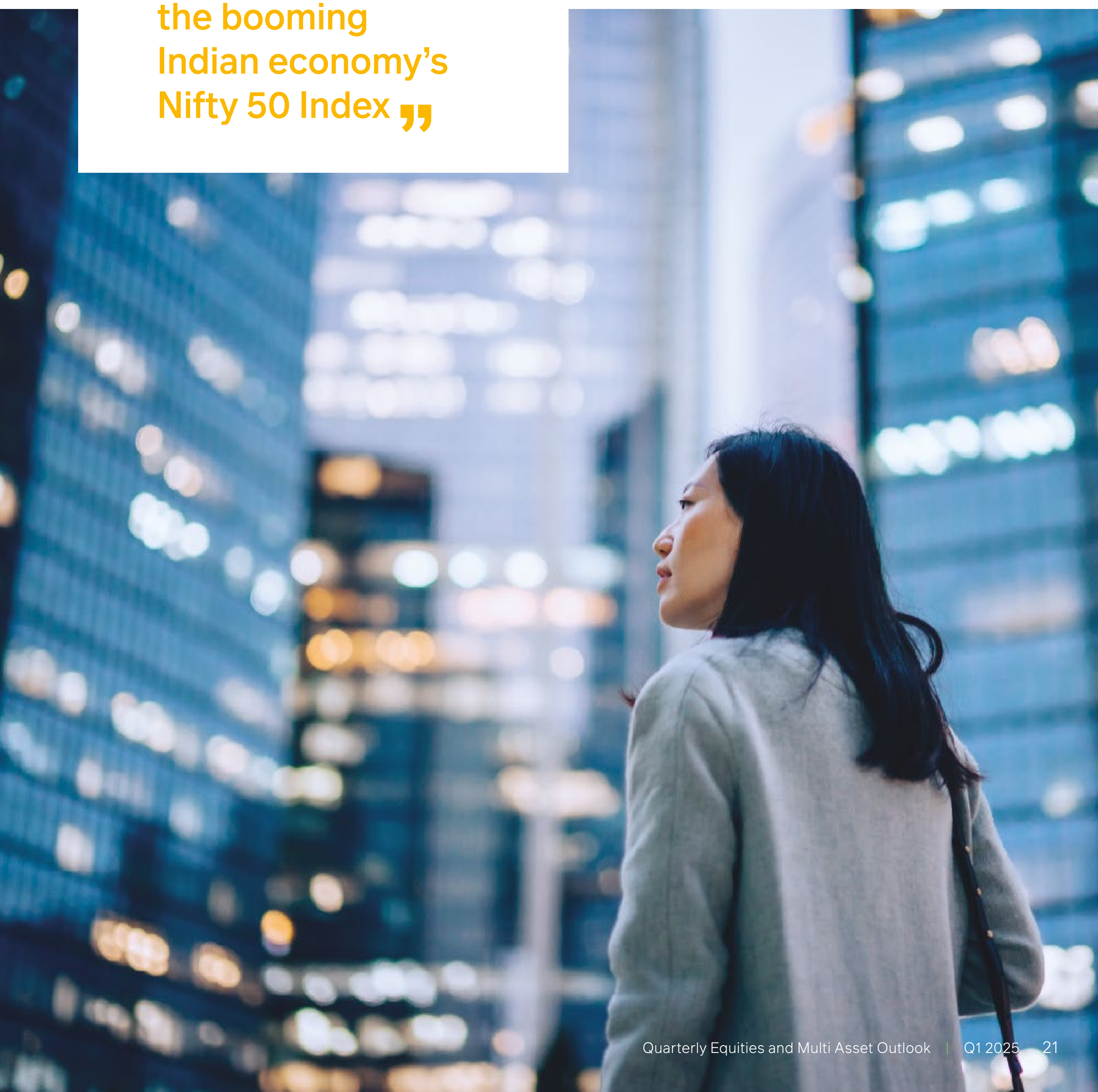
There are a large number of stocks in our portfolios that are likely closely followed by only a small handful of investors, and a large percentage of those investors are focused on more near-term developments – offering a favourable landscape, in our view, for generating a superior longer-term investment perspective. We are, of course, macro-aware, knowing what the key debates of the day are, and how macro changes could impact specific businesses, but we choose to spend the vast majority of our time focusing on bottom-up opportunities, where we aim to bring true perspective in identifying mispriced opportunities.

Encouragingly, such mispriced opportunities remain plentiful in Asia today. In certain South East Asian countries, where markets are worried about the impact of higher-for-longer US interest rates, there are a number of high-quality companies with structural, bottom up, growth tailwinds, trading on high single-digit dividend yields. Similarly, across Asia many exporters have been sharply de-rated due to fears of Trump tariffs. However, a handful of such companies have either changed their supply chains away from China or even have added material capacity in the US itself, leading to attractive upside potential as a result of recent market fears.

We love a good story as well. Especially if the story in question leads to swings in sentiment and excessive price volatility, that creates opportunity for bottom-up investors with a medium-term time horizon.

[16] Source: Bloomberg, 31 December 2024, MSCI China Financials Index (38%), Industrial & Commercial Bank if China (45%), China Construction Bank (35%), Agricultural Bank of China (47%), Bank of China (38%) – price returns in local currency in 2024.

> “In 2024, [many] would have said that the Chinese economy was weak [yet] the MSCI China Index outperformed the booming Indian economy’s Nifty 50 Index”



Emerging Markets

Michael Bourke
Head of Emerging Market Equities

Micro vs macro

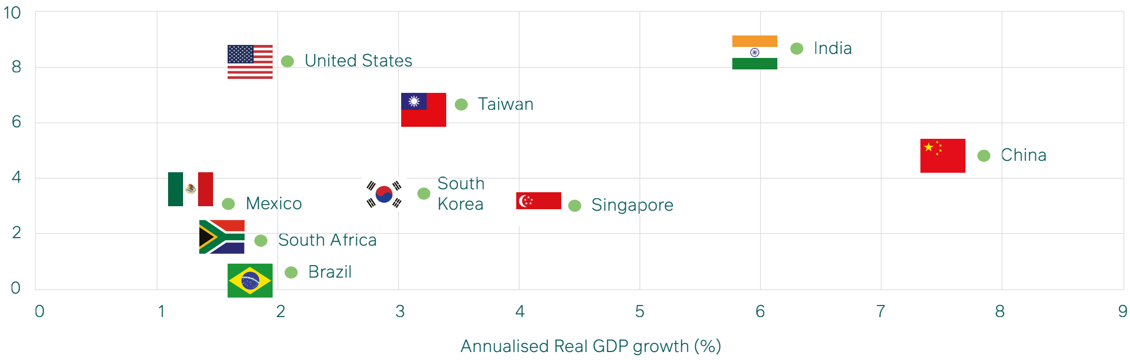
Developments associated with the evolution of individual economies have long had a perceived impact on price formation and market volatility in emerging equity markets.

The nature of macro crises in Emerging Markets (EM) has evolved over time; with fewer traditional balance-of-payments funding crises stemming from lower external debt and reduced vulnerability to capital outflows. Asia in particular, is a much less cyclical region than historically; benefiting from the discipline adopted following the Asia financial crisis with sovereign debt-to-GDP caps and mostly floating exchange rates.

As can be seen in the chart below, China is an idiosyncratic case with very high levels of economic growth failing to translate into shareholder returns. This is due to the nature of the Chinese growth model with very elevated levels of investment spend and an imbalance of savings over spending – driving over-capacity and excessive competition across sectors. It has led to a collapse in the return on equity (RoE) of China Inc. As mentioned in our **Q3 2024 Equities and Multi Asset Outlook**, we strongly believe that the model is changing following the real estate crisis with much higher levels of corporate distributions to shareholders via dividends and buybacks.

Value creation, not economic growth, drives markets –
High GDP growth did not translate into stock market returns...

Real GDP growth and annualised returns* for the a 20 year period through 31 December 2023.



Past performance is not a guide to future performance. Source: MSCI, IMF, LSEG Refinitiv, December 2024 *All country returns are MSCI index returns except the United States which uses the S&P 500 Index as a proxy *All in USD.

One mechanism through which EM equity returns have been indirectly impacted by macro concerns, has been currency. After a decade or more of EM currency weakness, currencies in aggregate are well below fair value in inflation-adjusted terms[17].

That said, the nature of EM currency vulnerability has changed with fewer external imbalances, lower external debt and largely market-determined currency levels. In general, Latin American currencies remain more sensitive than Asian currencies to market concerns about fiscal, debt and inflation dynamics.

[17] Source: Bloomberg, December 2024, JPM EM Currency Index, live spot price 2010-2024.

Brazil

Macro jitters still impact EM equities in the near term, which we believe represents an opportunity for active investors. Case in point, and very current, is Brazil. After two years of currency strength induced by the carry trade, policymakers in Brazil have taken the market's confidence for granted. The currency is the worst performer among all EM in 2024, down around 20% versus the US dollar as investors baulked at the lack of fiscal consolidation; with the deficit running close to 10% of GDP. The central bank has reacted conventionally by reversing rate cuts and increasing rates to 12.25% in order to stabilise the currency and ward off heightened inflation expectations.[18] Further hikes are expected.

The asset class correlation implicit in a bond/currency market sell-off directly influences the direction if not the quantum of equity market returns in the short term. In such environments, equity multiples typically drop[19]. Markets behave in predictable fashion with, for example, stocks in capital intensive sectors and/or with heightened leverage falling more than defensives. Such moves can drive mispricings, as positive bottom-up ('micro') individual stock fundamentals will drive long-term out-performance. Often, a very weak macro environment can induce corporate change as we see today in China; a positive reflexivity.

The local Ibovespa stock index in Brazil is down around 10% in local currency terms in 2024. Real yields are close to record highs over 7%; also the highest across EM[20]. We think that, long-term, such dislocation is an opportunity.

The job and advantage the equity investor has is to find opportunity among the volatility by navigating the macro; deciphering the cyclical from the structural and taking advantage of the dispersion to capture value over the longer term. We diversify our stock holdings within each country to balance our risk exposures and move slowly as each macro downcycle evolves; sizing positions conservatively.

Roll on 2025...

[18] Source: Bloomberg, 31 December 2024.
[19] Source: M&G Investments, Bloomberg, December, 2024 – looking at MSCI EM country returns in 2023 and 2024, noting positive double-digits returns in 2023 for Brazil versus negative double-digit returns in USD and negative single-digit returns in local currency terms in 2024.
[20] Source: M&G Investments, Bloomberg, 31 December 2024.

> "The job, and advantage, the equity investor has is to find opportunity among the volatility by navigating the macro"

Global Research

Catherine Lock and James Doogan
Global Consumer Analysts

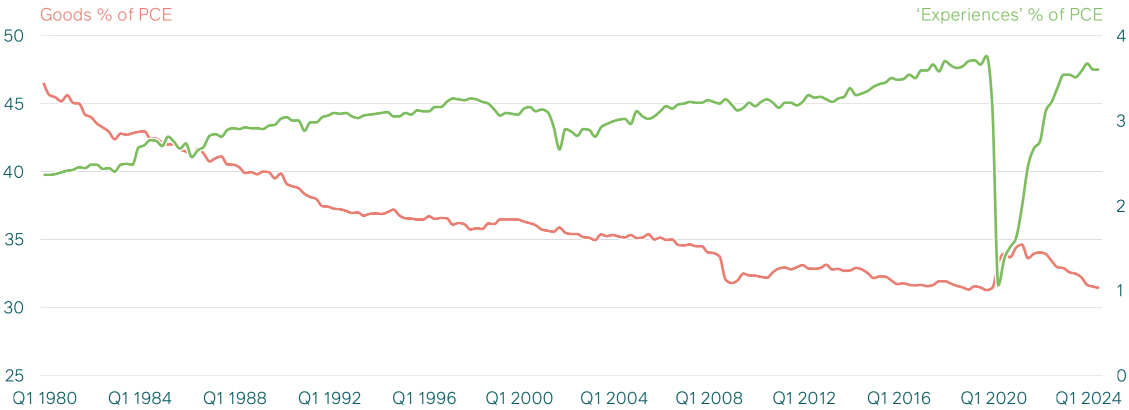
The consumer is always right, whatever the macro backdrop

Throughout 2024, household budgets have been strained by inflation and elevated interest rates, while economic and geopolitical uncertainties have suppressed consumer sentiment. Consumers have, therefore, become more discerning in their spending habits.

In this environment, the consumer sector has underperformed the broader market but with significant divergence in stock performance, both between, and within sub-sectors.

The long-term trend has been for consumers to allocate more of their spend to 'experiences' rather than goods.

US consumer spending on goods vs experiences



Source: Bureau of Economic Analysis, Percentage of Personal Consumption Expenditure (PCE) spend on Goods and Services (including recreation services, food services, hotels, and foreign travel). Based on Quarterly, seasonally-adjusted data as of 27 November 2024.

Consumers have pulled-back expenditure on big-ticket, discretionary items, but global hotel chains and cruise operators saw continued growth throughout 2024, which translated to share price outperformance. The S&P Hotels, Resorts and Cruise Lines Index was up c31% in 2024[21].

Even in a challenged environment for US retail, there have been pockets of strong performance. The dollar stores, Dollar General and Dollar Tree, lost around 40% of their value over the last year. In contrast, Walmart's investments in price, product range and convenience created a proposition that increasingly resonates with consumers, driving market share gains and sales growth. Growth in e-commerce and advertising sales contributed to improved profitability and this has been compounded by multiple-expansion, driving the share price up c72% in 2024[22].

[21] Source: Bloomberg, 31 December 2024, price returns in local currency.
[22] Source: Bloomberg, 31 December 2024, price returns in local currency.

In the UK, a consumer slowly digesting the 'cost of living crisis' has shown that 'value' does not always mean 'cheap'. Instead of down-trading to low-cost food and clothing retailers, Marks & Spencer (M&S) has proved that (finally) having compelling products at reasonable prices and convenient omnichannel distribution can drive market share gains and profitable sales growth. M&S shares are up c39% in 2024[23].

Recent spending data suggests some improvement in US consumer spending through November and expectations are that household available cashflow will grow at a faster rate in 2025, across the income spectrum. Yet geopolitical tensions remain and the imposition of tariffs could both increase direct costs on consumer companies and put further upward pressure on inflation.

We are hesitant to believe that a 'rising tide' will benefit consumer discretionary as a whole, yet we remain convinced that there are companies across leisure, retail and branded goods able to create value for shareholders. Scale, route to market advantages (for example, efficient omnichannel operations), supply chain strength and agility, data richness, product innovation and balance-sheet quality are characteristics we believe can allow companies to navigate changing consumer preferences and evolving cost pressures. Where the market is slow to attribute value to these qualities due to the prevailing macro environment can provide fertile ground for active investors.

[23] Source: Bloomberg, 31 December 2024, price returns in local currency.

"Recent data suggests some improvement in US consumer spending... yet the imposition of tariffs could both increase direct costs on consumer companies and put further upward pressure on inflation"

Convertibles

David Romani
Deputy Fund Manager, Convertibles

'Thematic' drivers rather than 'Macro' factors

We believe that markets are currently driven by enthusiasm and grand narratives about AI (Artificial Intelligence), techno optimism, US exceptionalism, structural growth, Trumpism and deregulation, rather than by macroeconomic factors such GDP growth or inflation.

This manifests itself in high equity valuations, for example the S&P 500 and Russell 2000 (small cap) indices are trading at multi decade highs of 22x price-to-earnings (P/E) and 28x P/E respectively[24].

Crypto creeps into the convertibles market

We have seen a large amount of new crypto-related bond issuance. We do not think this is due to macro inflation / monetary debasement fears. Instead, we would argue that an incoming Trump administration in the US, bringing with it the prospect of a more favourable regulatory regime for crypto assets (and leading to mass institutional adoption), has become the dominant narrative. This has greatly increased the valuation of cryptocurrencies[25], as well as crypto stocks along with their propensity to issue convertibles.

Crypto convertible new issuance

Source: Bloomberg, M&G Investments, 20 December 2024.

In addition, the need for substantial investments to host the HPC (high-performance computing) data centres required for AI has led many cryptocurrency miners to reallocate resources towards AI infrastructure, fostering the sentiment that cryptocurrency miners are a great way to play the AI wave. Just as we commented in our **Q3 2023 outlook**[26], we foresaw that there would be a spate of AI-related issuance but we just didn't anticipate it would come from the crypto mining sector.

[24] Source: Bloomberg, 10 January 2025. Bloomberg BEst P/E ratio (blended 12 months).
[25] Source: Bloomberg, 30 December 2024. In 2024, Bitcoin rose more than 120% to smash through the $100,000 barrier, Dogecoin was up 246.5% and Binance Coin was up 122.6%.
[26] Source: M&G Investments, Equity and Multi Asset Outlook – Q3 2023; Expect a wave of AI-related issuance, but beware the lagging productivity boost.

With crypto stocks accounting for 14% of US new convertibles issuance in 2024[27] and approaching c6% weight of our benchmark[28], avoiding the crypto sector is currently proving difficult. We remain cautious and aim to invest where we are comfortable with the credit risk involved. This is very important at this stage in the cycle when spreads are close to a 20+ year tight[29], equity valuations have been boosted by the thematic narratives described above, and the feeling that the US is the only game in town. TINA (or 'there is no alternative') forces investors into increasing their exposure to US-listed names. Furthermore, we also run the risk that the technical features (the option terms and conditions) start to become stretched and unfavourable to investors as it happened during the 2020-21 period.

Hence, we will continue to be highly selective and adhere to our usual long-term approach, seeking good fundamentals, solid credits, undemanding equity valuations and attractive technicals, rather than investing on expectations of a Trump-driven crypto windfall. While we are cautious on crypto-related convertibles, we have indirect exposure through a cryptocurrency exchange which is agnostic to which cryptocurrencies are outperforming at any given point in time, and has invested in compliance – positioning itself to become a key beneficiary of crypto going mainstream. We also invest in a company that is well positioned to be a major beneficiary of AI expansion and the build out of AI data centres for high-performance computing.

[27] Source: Barclays Global Research, 11 December 2024.
[28] Source: M&G Investments, 6 December 2024, our estimate for the January 2025 index rebalancing.
[29] US IG spreads sat at 75bp at the time of writing (18 December 2024) and US HY spreads were close to 260bp as of Friday 13 December 2024.

"We have seen a large amount of new crypto-related issuance [that] we do not think this is due to macro inflation [or] monetary debasement fears"