M&G Investments

Low duration could protect against rising inflation

Public debt update

M&G Wholesale Public Fixed Income team

September 2021

The value and income from the funds' assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the funds will achieve their objectives and you may get back less than you originally invested.

Potential scenarios

MACRO

US TAPERING
(hopefully without the tantrum)

Reduced monthly purchases of assets (potentially from late 2021)

Rate hikes (potentially from late 2022)

ECB TAPERING

Early days, but **noise expected in 2022**

GROWTH

Expected peak in 2021

2.8%
6.0%
4.9%
-3.2%
2019 2020 2021 2022E
World

LABOUR MARKET

US: Slack is not there

More unfilled jobs than ever

Potential wage rises could create inflation

EUROPE: still plenty of room to improve

ACTIVITY

Savings rates coming down

Labour market healing → **prospect for consumption**

Covid variants/re-stocking

INFLATION

High US and UK numbers appear transitory for a number of reasons post-lockdown.

Likely inflation above target until year end

VALUATIONS

INVESTMENT GRADE (IG)

Spreads in the US at all-time tights

We prefer Europe over US

HIGH YIELD (HY)

Supporting factors, in our view:

1. Positive real yield
2. Fundamentals look good
3. Less sensitive to rate rises

However, a lot of good news is priced in

EMERGING MARKETS (EM)

HY sovereigns still offer potentially attractive value on a selective basis

EM companies: healthy credit metrics, in our view

AAA
AA+
AA
AA-
A+
A
A-
BBB+
BBB
BBB-
BB+
BB
BB-
B+
B
B-
CCC+
CCC
CCC-
CC
C

Sources: M&G, September 2021; IMF World Economic Outlook (growth data), July 2021

What's on the horizon for public debt investors?

This year has been an eventful one – but, at the same time, many fixed income investors will feel that market conditions have not really changed much. They are therefore asking: what's next for public debt markets?

In this overview, we provide our latest insights into the current investment environment across the public debt spectrum and offer our thoughts on how low duration strategies could continue to play a key role in investment portfolios.

Focus on low duration for 2021-22

Economies are still supported by central banks, and many of the facilities to bolster the global economy remain in place. In our view, this means interest rates can be kept low and monetary policy conditions easy.

Looking at the year so far, within our range of portfolios, short- and low-duration strategies have largely generated superior returns to other public debt strategies[1].

We have seen rampant equity markets, partly fuelled by low discount rates, despite inflation ticking up substantially. This poses a threat to real yields, both now and going forward.

[1] Source: M&G, Morningstar; comparison of M&G product returns; 31 August, 2021.

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Government bonds look to be experiencing a 'tantrum-less taper': markets having sold off at the start of the year, yields have not risen much since. Considering investors are focused on potential tapering and with rate rises on the table for 2022/23, this is somewhat surprising.

This environment has been supportive for credit and lower-duration strategies. Investment grade (IG) spreads have been grinding tighter in the credit index and cash markets. High yield (HY) spreads, with easy monetary conditions continuing and default probabilities falling, have tightened significantly, particularly in the cash markets.

In our view, investors will still look to low duration strategies for the rest of 2021 and in 2022, as interest rates and therefore yields could increase as central banks withdraw support, or inflation continues to rise.

Macro environment

Tapering
The US Federal Reserve ('the Fed') appears likely to reduce the pace of asset purchases sometime before the end of the year, with the announcement expected in September or October. US tapering could end by mid-2022, to retain the option to raise rates at the end of next year if needed. In Europe, Christine Lagarde announced at the ECB's September meeting a "moderately lower" pace of purchases under the special Pandemic Emergency Purchase Programme (as widely expected), and it is likely there will be some more tapering noise from 2022.

Activity
We continue to see savings rates coming down, which is positive. If the labour market continues healing faster than expected, as we are seeing in the US, the prospects for consumption will improve.

There are two downside risks here:

1) The evolution of the Delta variant of the coronavirus; and

2) Supply-side issues. Re-stocking would be a driver of growth in the US

Growth
We expect it to peak in 2021.

Labour market
Recent disappointment in US payrolls was largely driven by a small number of sectors. The situation is improving and there is a scarcity of willing workers, which could lead to higher wages if the COVID situation stabilises.

Inflation
The high inflation we are seeing in the US and UK appears temporary to us, although it is likely that inflation will continue to run above target for the rest of 2021.

Valuations

- **IG –** spreads are tight, but the economic recovery, supported by low rates and fiscal stimulus, remains as a positive factor. We prefer euro IG over US IG, as we believe the risks of the central bank tightening policy sooner than expected is lower in the eurozone.
- **HY –** we see three pros for HY debt: 1) positive real yields; 2) currently low corporate default rates; and 3) lower duration. However, a lot of good news in terms of economic recovery is already priced in.
- **EM –** we are finding value on a selective basis in HY sovereigns and, if EM credit continues to surprise on the upside in terms of fundamentals, we could see some further spread tightening. We believe EM credit also has the potential advantage of typically lower duration.

Inflation linking

Central banks believe inflation will only be temporary and are pointing the finger towards supply issues. However, this is just one side of the equation; demand is the other. There is huge real demand as economies reopen and people have more money to spend. This is unlikely to disappear any time soon, in our view, given central banks' commitment to keep rates low.

Globalisation, one of the key disinflationary factors of recent years, appears likely to slow. Global supply issues will incentivise companies to bring production closer to home. This, in turn, could result in more expensive production and therefore higher inflation.

Inflation may not be as temporary as central banks believe, and we think this risk should be taken seriously. Low duration strategies and/or inflation-focused funds could be a potentially good solution to protect against the harmful effects of inflation going forward, in our view.

Our inflation-linked corporate bond strategy – what makes it different?

1. **Specific inflation objectives:** our inflation-linked corporate bond strategy is specifically designed to seek to generate a return in line with or greater than inflation over time.
2. **Structurally low duration:** having a low duration positioning can help to protect investors against rising rates, which are common in an inflationary environment.
3. **Credit exposure:** leverages our credit expertise to seek to enhance returns for investors.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

Short-dated corporate bonds

The M&G (Lux) Short Dated Corporate Bond Fund has attracted significant inflows over the past year[2], and with tight valuations, the risk of rising rates and low cash returns, we believe the potential opportunity for the asset class is greater than ever.

Tight valuations, potential rate rises, low cash returns… could short-dated credit be the answer?
Tight valuations and the risks of inflation and rising rates are key investor concerns right now. Investors may look to allocate a portion of their portfolios to something more defensive. But with low and even negative cash rates, where can they go?

One option, for those willing to take some credit risk, is short-dated credit, which offers a potentially attractive risk-reward profile.

Keep it simple
We saw what happened to overly complex funds in the market in March 2020. We believe one of the key advantages of M&G's short-dated credit strategy is that it is simple to understand – a clear, defensive proposition with upside potential, in our view, and a long-term track record.

- Duration typically 0-3 years
- Majority of the portfolio in short-dated, IG credit
- Low volatility strategy

Access to active management
Though our proposition is very simple, that doesn't mean we can't add value through active management – like all good cooking, we use simple ingredients. It's the way you prepare them that matters!

- Leading research capabilities – the strategy gives clients access to M&G's leading in-house credit research and dealing teams. Unlike a passive index fund, we can take exposure to a global opportunity set to seek optimum value.
- ABS research premium – M&G is a leader in investing in European asset-backed securities (ABS), in which the strategy can invest. The complexity of researching ABS is a key reason, in our view, why this asset class offers investors a risk premium well in excess of regular corporate bonds. Investing in AAA rated ABS offers a similar level of credit spread to investors as BBB rated corporate bonds.
- Floating rate exposure – the strategy also take exposure to floating rate notes with coupons that rise with increasing interest rates. This further protects the funds from rising rates and adds upside potential, in our view.

A potentially attractive opportunity
We believe the opportunity for short-dated credit is there and we have an excellent long-term track record in this asset class. Currently, the M&G (Lux) Short Dated Corporate Bond Fund is second quartile over one year and top quartile over three- and five-year periods.

Performance: M&G (Lux) Short Dated Corporate Bond Fund

Returns (%)	YTD	1yr	3yrs pa	5yrs pa	Since inception pa*
Fund (Euro A)	0.53	1.32	1.18	0.73	1.07
Benchmark	0.31	1.00	N/A	N/A	N/A
Sector	0.45	1.45	0.62	0.38	0.84

Returns (%)	2020	2019	2018	2017	2016
Fund (Euro A)	1.90	2.68	-2.44	1.00	2.34
Benchmark	0.71	1.37	N/A	N/A	N/A
Sector	0.28	1.98	-1.66	0.96	1.25

Past performance is not a guide to future performance.

The fund allows for extensive use of derivatives.

Source: M&G, Morningstar, 31 August 2021. Fund performance shown is for the M&G (Lux) Short Dated Corporate Bond Fund EUR A share class. Returns are calculated on a price to price basis. Benchmark returns stated in EUR terms. Benchmark: Markit iBoxx € Corporates 1-3 Index. Sector: Morningstar EUR Corporate Bond - Short Term. The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction. The fund is actively managed. The fund manager has freedom in choosing which assets to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

*Fund performance prior to 26 October 2018 is that of the EUR Class A Accumulation of the M&G Short Dated Corporate Bond Fund (a UK-authorised OEIC), which merged into this fund on 26 October 2018. Tax rates and charges may differ. The Markit iBoxx EUR Corporates 1-3 year Index was introduced as the fund's benchmark on 13 March 2018. *Inception date of the UK-authorised OEIC - 26 July 2013.*

High yield floating rate notes (FRNs)

HY FRNs have delivered results – year-to-date, the asset class is the best-performing area of HY, with returns of +5.7%[3] driven by credit spread compression and, especially, its low duration. The HY FRN market has not been affected by some of the headwinds that higher yields have brought for other fixed income assets. High

[2] Source: M&G, 31 August 2021.
[3] Source: ICE BofA – comparison of Global High Yield Index, ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index, ICE BofA US High Yield Index, ICE BofA European High Yield Index, 31 August 2021.

yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Potential opportunity in physical FRNs – our increased allocation to physical FRNs over the last year or so has paid off. The spread differential between fixed and floating HY debt has almost closed and the trade has therefore delivered attractive spread returns. Still, we believe HY FRNs offer some price dispersion, for example through low price bonds, and a healthy primary market.

Potential liquidity advantage over loans – flexible HY bond strategies can offer potential liquidity advantages over alternative floating rate HY instruments, notably loans. This can be a potential benefit to investors who, for example, want daily trading, which is a core feature of the M&G Global Floating Rate High Yield Fund.

Why do HY FRNs make sense in today's macro environment?

Strong growth and low rates should support company fundamentals and we expect a benign environment for corporate defaults. Similarly, the strong demand for positive real yield assets and low-duration strategies favours HY as an asset class, and FRNs in particular. In our view, these still offer potentially attractive yields whilst providing capital protection against any potential rates-driven sell-off.

Emerging markets (EM)

We expect inflation pressures to moderate from here, as many EM central banks show more willingness to hike rates and output gaps are expected to close later than in DMs.

Expected growth is also still higher than in DMs in 2021 and 2022, but the rebound is likely to be less spectacular than in the US, leading to lower growth differential in the short term. We expect the growth differential to increase again after 2022, which we believe supports the case for long-term investment in EM debt.

To us, valuations still look attractive in the hard currency sovereign HY market, where we are overweight in our blended and hard currency EM debt strategies. Spreads are still above 550bps and higher than pre-COVID, which can't be said for most asset classes. EM debt also looks cheap relative to US HY, with spreads 230bps above, which is significantly higher than the long-term average[4]. However, selectivity is important.

EM currencies (FX) have underperformed in 2021, with rising US yields and talk of tapering. However, we think the situation is quite different from what it was in 2013. External vulnerabilities, such as current account deficits, for example, are lower. EM FX has never recovered post-2013. It was overvalued at the time, but now looks undervalued, in our view, which should provide downside protection. We are finding interesting opportunities in local currency bonds providing high nominal yields.

Our EM debt assets under management have grown in 2021, and our team is still expanding. We are in the process of enhancing our coverage of Chinese and Asian credits by strengthening our resources in Singapore.

In hard currencies, the M&G (Lux) Emerging Markets Hard Currency Bond Fund has a strong track record vs. its benchmark and peer group. The fund is first quartile since its inception in May 2017 and has grown to over $200m in assets under management[5].

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Performance: M&G (Lux) Emerging Markets Hard Currency Bond Fund

Returns (%)	YTD	1yr	3yrs pa	Since launch pa*
Fund (USD A)	1.95	7.26	6.69	4.53
Benchmark	0.73	4.59	6.93	4.71
Sector	0.29	5.51	5.81	3.23

Returns (%)	2020	2019	2018	2017	2016
Fund (USD A)	3.30	15.87	-5.68	N/A	N/A
Benchmark	5.26	15.04	-4.26	10.26	10.15
Sector	5.32	12.17	-6.62	10.20	9.53

Past performance is not a guide to future performance.

The fund allows for extensive use of derivatives.

*Source: M&G, Morningstar, 31 August 2021. Fund performance shown is for the M&G (Lux) Emerging Markets Hard Currency Bond Fund USD A Acc share class. Benchmark: J.P. Morgan Emerging Markets Bond Index Global Diversified. Performance is stated in the share class currency, which may differ from your domestic currency. As a result, the return may rise or fall due to currency movements The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction. The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents. Sector: Morningstar Global Emerging Markets Bond Sector. *Launch date – 22 May 2017.*

M&G Wholesale Public Fixed Income
September 2021

[4] Source: JP Morgan Emerging Markets Bond (EMBI) Global Diversified Index, ICE BofA US High Yield Index, 31 August 2021.

[5] Source: M&G, Morningstar, 31 August 2021.

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