M&G (Lux) Global Floating Rate High Yield Fund

The meaning of higher rates for (slightly) longer

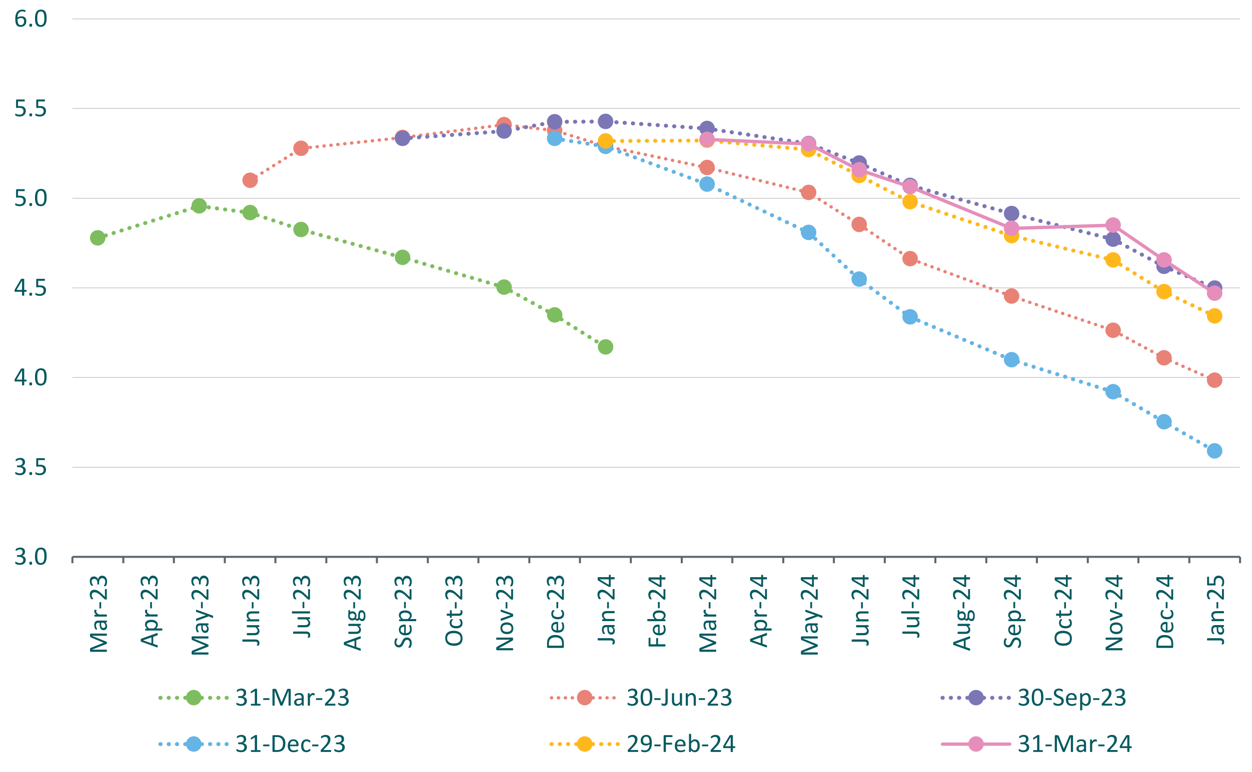
M&G Fixed Income team
June 2024

- In an environment characterised by directionless yields and ongoing credit spread tightening, global high yield floating rate notes (FRNs) have continued to deliver solid returns so far in 2024.
- There is a renewed expectation in financial markets that interest rates may remain somewhat higher for longer, with economic activity re-accelerating and disinflation slowing. This combination of factors is likely to be conducive for short-dated strategies, in our view.
- From a portfolio perspective, we believe that as spreads continue to tighten, selectivity is crucial. We remain focused on resilient businesses, with low cost structures and manageable refinancings, and avoid more stressed sectors.

A delay in rate cut expectations

Central banks are wary of repeating past mistakes by cutting interest rates before inflation is fully under control. Consequently, indications in recent months that economic growth remains resilient and that inflation – while down considerably from the highs in the last few years – remains sticky, have pushed rate cut expectations out further once again.

Figure 1: Interest rate expectations: FOMC – Markets push out expectations of rate cuts



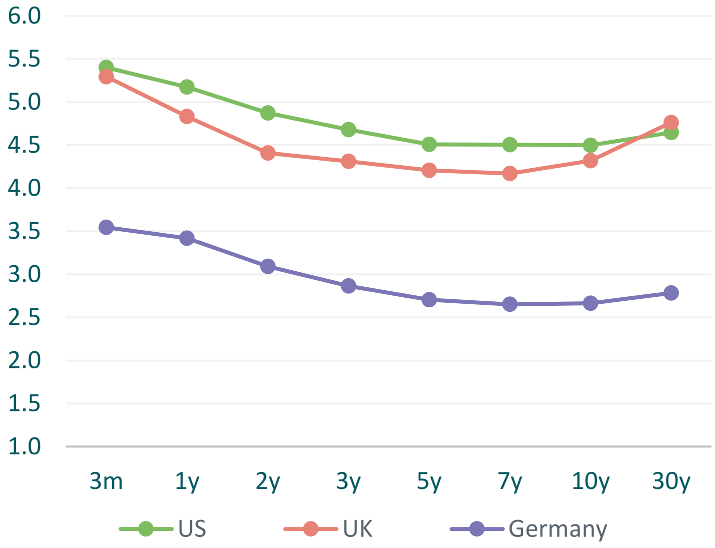
Fed Futures implied rates (%)

Source: Bloomberg, 31 May 2024

The value of investments will fluctuate, which will cause prices to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the original amount you invested. Where performance is mentioned, past performance is not a guide to future performance

Figure 2: Yield curves remain inverted, with significant carry advantage at the front

Past performance is not a guide to future performance



Global government bond yield curves (%)

Source: Bloomberg, 31 May 2024.

US consumer price inflation (CPI) is down substantially from its June 2022 peak of 9.1% year-on-year. However, getting it down closer to 2% is proving much trickier. Month-on-month CPI prints of 0.1%-0.2% would be needed over the next nine months in order to cut it to below 3% year on year. However, if monthly inflation runs at the same level as it did in April (0.3%), CPI could re-accelerate above 4% going into the fourth quarter of 2024. Additionally, unless there is a near-term economic slowdown, wage growth could remain sticky, fuelling services inflation further. This is the trickiest sector of the inflation challenge for central banks today.

While there has been little doubt about the resilience of the US economy, there are now signs that European economic activity is also gathering pace. Monthly Eurozone Manufacturing PMI rose to 47.3 in May 2024, its highest reading since March 2023. The ECB became the first of the major central banks to cut rates in early June, with a reduction of a quarter of a percentage point, but stated that this does not mean it is 'pre-committing to a particular rate path' and that it will keep policy rates 'sufficiently restrictive' to ensure that inflation returns to its 2% medium-term target in a timely manner.

It is also possible that the prospect of elections in the UK (July) and the US (November) may exert some influence over central bank decision-making.

We continue to believe that the ultimate direction of travel for central banks is to cut rates. However, we expect that they will remain cautious until the data is firmly on their side. In our view, a delay in cuts is likely to prolong the high yield environment and ongoing yield curve inversion, which could be positive for high yield FRNs, which sit at the very front of the curve.

Timing the rate cycle has become increasingly difficult, and markets have struggled to do this accurately. Investing in HY FRNs – which due to their effective lack of duration are not that sensitive to changes in interest rates -- gives investors one possible way to insulate their portfolios from interest rate volatility, while removing the need to make a call on the rate cycle themselves.

Performance

HY FRNs performed very strongly in 2023, and so far this year they continue to outperform global investment grade and conventional high yield bonds. The fund has delivered a year-to-date return (to end May 2024) of 3.9%/3.2% in USD/EUR terms.

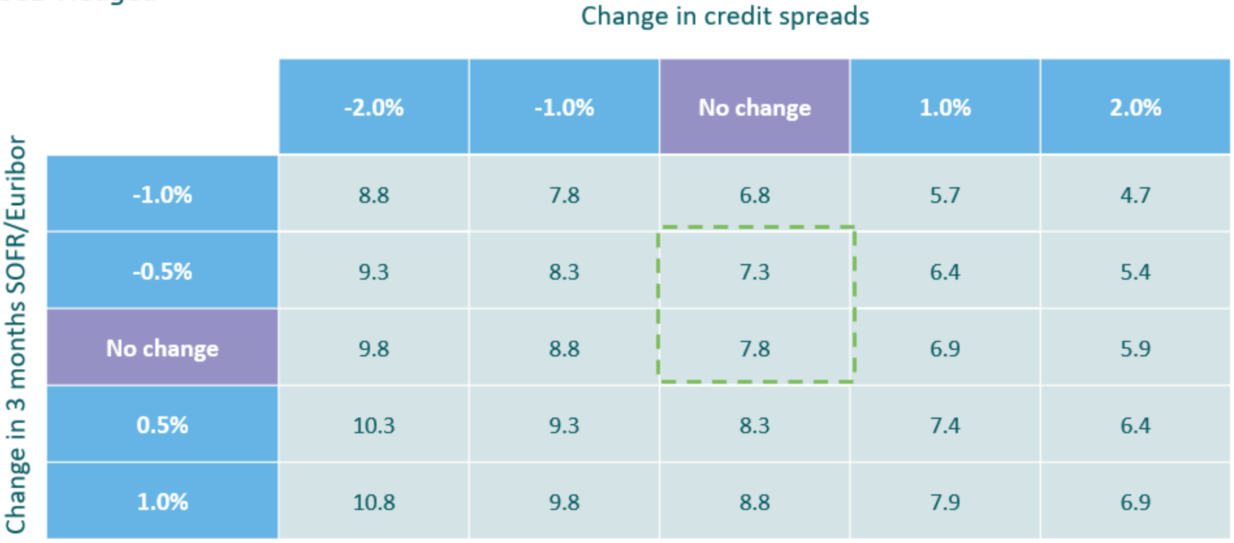
In what remains our base case scenario of mild rate cuts, stable credit spreads and low defaults, we believe the fund could deliver healthy returns for both full year 2024 and the coming 12 months.

Figure 3 & 4: How might Global HY FRNs perform over the next 12 months?

Past performance is not a guide to future performance.

Total return under various rate/spread scenarios based on current market levels

USD Hedged

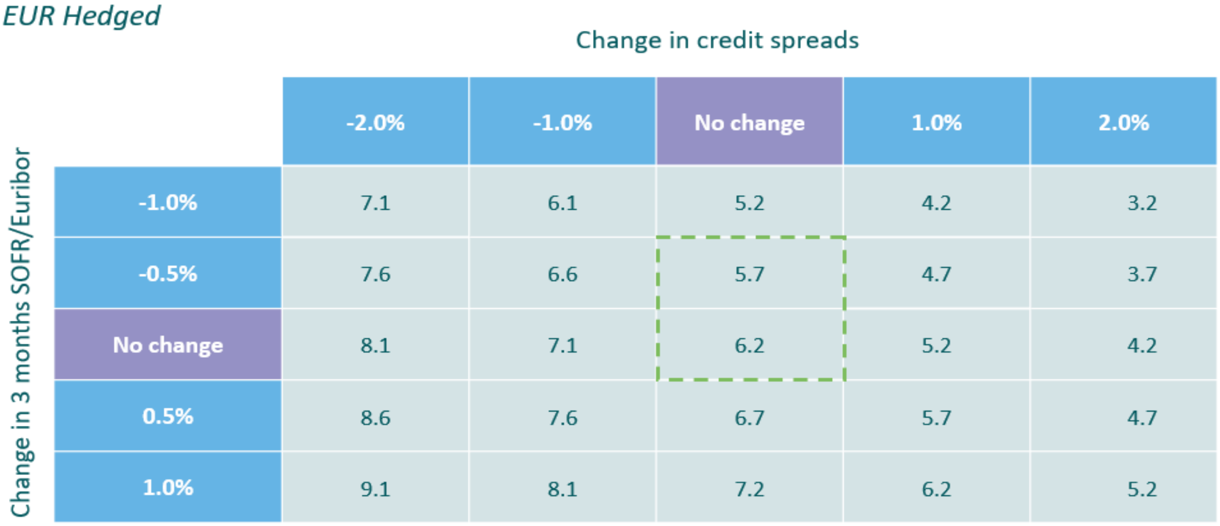


Change in credit spreads

Change in 3 months SOFR/Euribor

	-2.0%	-1.0%	No change	1.0%	2.0%
-1.0%	8.8	7.8	6.8	5.7	4.7
-0.5%	9.3	8.3	7.3	6.4	5.4
No change	9.8	8.8	7.8	6.9	5.9
0.5%	10.3	9.3	8.3	7.4	6.4
1.0%	10.8	9.8	8.8	7.9	6.9

EUR Hedged



Change in credit spreads

Change in 3 months SOFR/Euribor

	-2.0%	-1.0%	No change	1.0%	2.0%
-1.0%	7.1	6.1	5.2	4.2	3.2
-0.5%	7.6	6.6	5.7	4.7	3.7
No change	8.1	7.1	6.2	5.2	4.2
0.5%	8.6	7.6	6.7	5.7	4.7
1.0%	9.1	8.1	7.2	6.2	5.2

⬚ Base scenario

Source: M&G, ICE BoA indices, 31 May 2024. This is not intended to provide expectations of future returns or yield and spread levels. Portfolio analysis based on a one-year holding period, assuming a static portfolio and parallel shifts in yield curves; excludes any exposure to equities. Analysis also assumes that any moves in rates and/or spreads are one-off shocks. Assumption of a 3% default rate with an average recovery of 60% for the floating high yield market. This is for illustrative purposes only and based on representative assumptions.

Fund activity

The fund is positioned to seek to generate returns through a combination of carry, improving market technicals and defensive active views.

We have been putting inflows to work in both the primary and secondary markets. The primary market has been very active since the start of the year. In the secondary market, we have been predominantly looking for relative value opportunities, harnessing the breadth and depth of research that our large credit analyst team provides.

From a technical perspective, the pick-up in demand from collateralised loan obligation (CLO) structures and loan funds (typically important buyers of FRNs) that began in 2023 has continued so far this year, causing HY FRN spreads to tighten. If this trend continues further, as we expect, then spreads can likely tighten further, potentially translating into positive spread performance for the asset class.

We remain focused on what we consider to be resilient businesses, with low cost structures and manageable refinancings, and are avoiding more stressed sectors, such as real estate. We have no exposure to unsecured debt in the commercial real estate sector, where rental yields are currently below the cost of debt for many of these companies.

In our view, our highly experienced team of fund managers and credit analysts are well placed to demonstrate the value that active management can deliver in what remains an uncertain interest rate environment.

Fund description and fund returns

The fund aims to provide a combination of capital growth and income to deliver a return that is higher than that of the global floating rate high yield bond market (as measured by the BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged) over any five-year period. At least 70% of the fund is invested in high yield floating rate notes (FRNs), focusing on FRNs issued by companies with a low credit rating, which typically pay higher levels of interest to compensate investors for the greater risk of default. Part of the fund may be invested in other fixed income assets, such as government bonds. Asset exposure is gained through physical holdings and the use of derivatives. The fund's recommended holding period is five years. In normal market conditions, the fund's expected average leverage – how much it can increase its investment position by borrowing money or using derivatives – is 300% of the fund's net asset value.

Past performance is not a guide to future performance.

Fund performance

Return (%)	Year to latest quarter	YTD	1 Yr pa	3 Yrs pa	5 Yrs pa	10 Yrs PA
Fund EUR A-H Acc	2.3	3.2	9.3	4.1	3.2	N/A
Benchmark (EUR)*	2.7	3.9	11.6	5.8	5.2	4.0
Fund USD A Acc	2.7	3.9	11.1	6.0	5.2	N/A
Benchmark (USD)*	3.0	4.5	13.6	7.7	7.1	5.7

Return (% pa)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Fund EUR A-H Acc	N/A	-0.4	6.5	1.6	-2.6	4.3	-0.8	4.5	-3.3	11.4
Benchmark (EUR)*	2.1	-0.7	11.1	2.7	-1.3	6.8	2.0	6.6	-2.2	13.5
Fund USD A Acc	N/A	0.1	7.8	3.7	0.2	7.4	1.0	5.4	-1.1	13.7
Benchmark (USD)*	2.2	-0.2	12.7	4.8	1.5	10.0	3.6	7.4	0.0	15.8

*For the EUR share class, benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (EUR Hedged) Index. Thereafter, it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (EUR Hedged) Index. For the USD share class, benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (USD Hedged) Index. Thereafter, it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (USD Hedged) Index.

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.

Fund performance prior to 21 September 2018 is that of the EUR Class A-H Accumulation and USD A Accumulation share classes of the M&G Global Floating Rate High Yield Fund (a UK-authorised OEIC), which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 31 May 2024. Returns are calculated on a price-to-price basis with income reinvested. Benchmark returns stated in EUR and USD terms respectively. The performance data do not take account of the commissions and costs incurred on the issue and redemption of units.

Key fund risks

- 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.
- High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.
- The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset’s value vary in an unexpected way, the fund will incur a loss. The fund’s use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.
- 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.
- The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.
- The hedging process seeks to minimise, but cannot eliminate, the effect of movements in exchange rates on the performance of the hedged share class. Hedging also limits the ability to gain from favourable movements in exchange rates.

Further details of the risks that apply to the fund can be found in the fund's Prospectus.

Other important information

The fund allows for the extensive use of derivatives.

Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the fund.

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