M&G Multi Asset team

Potential drivers of performance in the current environment

FOR INVESTMENT PROFESSIONALS ONLY
October 2020

- *The M&G Multi Asset team consider possible sources of performance within their portfolios that could drive returns in the coming months as economies and governments learn more about the impact of COVID-19.*
- *These can be found within three main investment themes in our multi asset portfolios: equities, emerging market bonds and currencies, and tactical asset allocation.*

The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

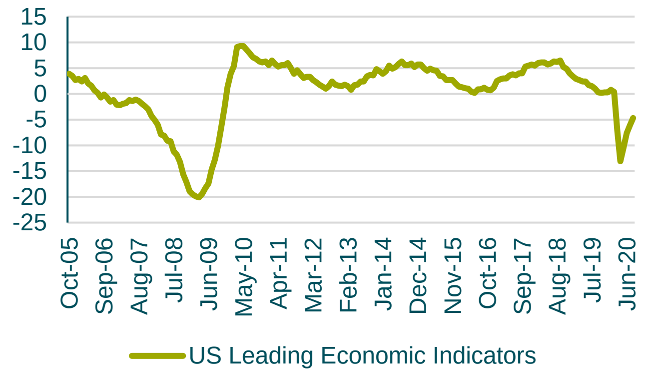
1. Equities

Given the economic, monetary and fiscal backdrop, we believe that there remains significant potential for upside from equity exposures if investors were to turn their attention to the positive evolution of economic data over recent months and project growing optimism on the ongoing recovery. However, investors have been turning more bearish. In recent weeks we have seen several analysts revise their growth forecasts downwards. Whilst the size of these revisions is not meaningful, the cooling off of growth expectations is usually an indication of a deeper change in sentiment. Interestingly, most of the arguments put forward to justify these downward revisions are centred around concerns of a second wave of COVID-19 cases in developed economies.

We think this fear is unlikely to be sustained for two main reasons. Firstly, despite **the 'second wave' of the virus seemingly being well under way, it is not leading to the same degree of economic paralysis that ensued when the challenge was first presented**: now, money supply growth, retail spending, household financial activity and savings, corporate robustness and more **economic indicators all point to the continuation of a gradual recovery, in our view**.

We believe that the cyclical data released over the past few weeks (see Figure 1) has made it increasingly clear that the worst fears for global economic activity, and therefore corporate earnings, are less likely to materialise. The extent of the monetary and fiscal interventions, together with the nature of the lockdowns being put in place across countries, have led to more 'cash rich' households and corporates in the short term. While corporates have increased their overall debt levels, albeit at very low rates, households' debt service ratios remain at all-time lows

Figure 1: US Leading Economic Indicators



Source: M&G, Bloomberg, 31 August 2020.

Secondly, we believe **some of the potential downside has been removed by the fact that the market now has a better understanding of the risks to the economy** from the spread of COVID-19 and the impact of lockdowns than it did earlier in the year. In other words, there is less room for negative surprises, in our view.

Policy support has improved and the perceived potential downside risk to the major economies as a consequence of dealing with the pandemic have diminished. Therefore, the range of outcomes that was considered plausible by the market at the beginning of the summer is now considerably less skewed to the downside, in our opinion.

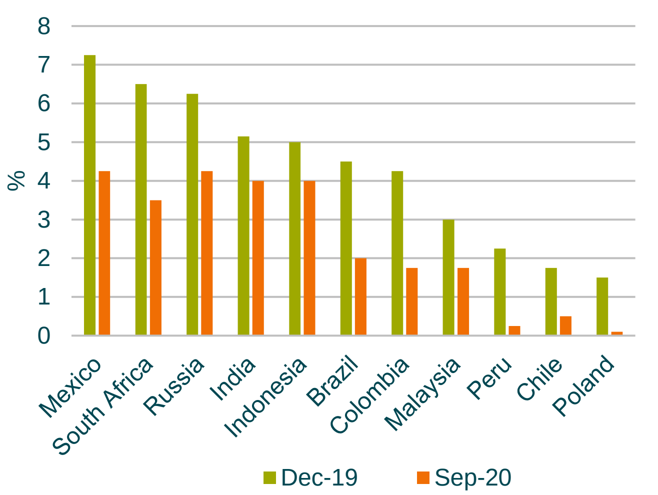
Given the current monetary and fiscal environment, and the evolution of economic data over recent months, we believe that there remains significant potential for upside from equity exposures.

2. EM bonds and currencies

Despite the lack of pressure from US interest rates and several interest rate cuts, many emerging market (EM) government bonds have yet to respond meaningfully to the easing stance adopted by most central banks, in our view. We therefore believe that **there is still upside for the asset class, thanks to a combination of supportive fundamentals and compelling valuations. In an environment of loose financial conditions and a backdrop of stable and declining inflationary dynamics, we feel prospective returns continue to look relatively elevated, both in the form of higher yields compared to those available from mainstream government bonds, and cheaper currencies.**

Moreover, monetary policy is also supportive, in our opinion: central banks have already cut rates and have scope to do so further, following the path pursued by their developed market counterparts (see Figure 2).

Figure 2: Emerging markets central bank base rates

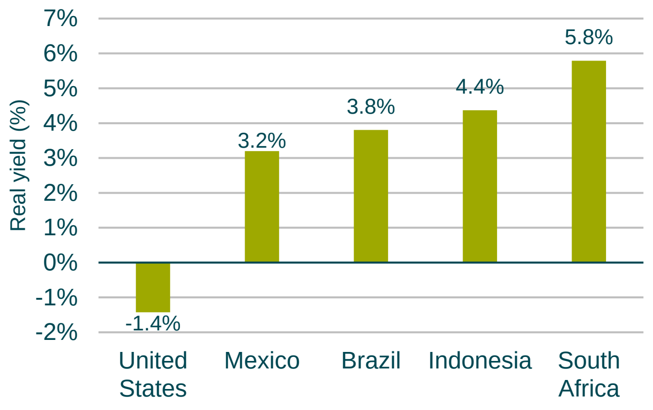


Source: Bloomberg, as at 30 September 2020

In terms of valuations, we continue to think that these bonds offer among the highest yield levels, especially on longer-dated bonds (see Figure 3), given the steepness of the curves.

Investors are reminded that 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.

Figure 3: Real yield of 10-year government bonds in local currency



Source: Thomson Reuters Datastream, 5 October 2020. Based on long-term inflation expectations.

We also like selected emerging market currencies, given their elevated level of carry.

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.

3. Tactical asset allocation

In line with the views we have expressed in recent months about the current challenging investment environment, we expect tactical asset allocation to continue to play a more prominent role in driving future returns.

Much of the optimism that dominated market sentiment over the summer has evaporated, making way for renewed uncertainty and slight pessimism. During the optimistic phase, we elected to take a ‘neutral’ stance in our portfolios, as we believed this gave us capacity to respond to further price moves. Today, with uncertainty returning to markets, we see this as an ideal contrarian opportunity to tactically tilt the portfolios towards risk.

The shift in sentiment that caused widespread weakness in equity markets in September happened despite the fact that there had been no material change in fundamentals. There was also a more favourable economic outlook than had been expected over the past four or five months. For this reason, we think it presented us with a good opportunity to position the funds more aggressively by adding 5-10% to the equity exposures in our long-only funds.*

The equity additions were deliberately diversified. Around half were additions to exposures such as broad US equities and mining stocks, which had performed very strongly over the summer months and subsequently fallen rapidly in September. For the rest, we incrementally added capital to more cyclical exposures, in European equities and US banking positions, where prices had been broadly unchanged since May.

This is a short-term tactical move, so, should we see a meaningful increase in equity prices, we are equally willing to subsequently remove this additional capital.

*For further details please refer to Monthly Fund Reviews for the month of September.

Summary

Since the summer, our focus has been on identifying opportunities for the more prominent use of tactical asset allocation to try to generate returns in the current investment environment. In September we saw such an opportunity and we were in a position to act upon it. At the same time, we retain the capacity to react further should it be necessary and maintain significant amount of exposure to long-dated US and Australian government bonds to try to help us navigate possible bouts of volatility.

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