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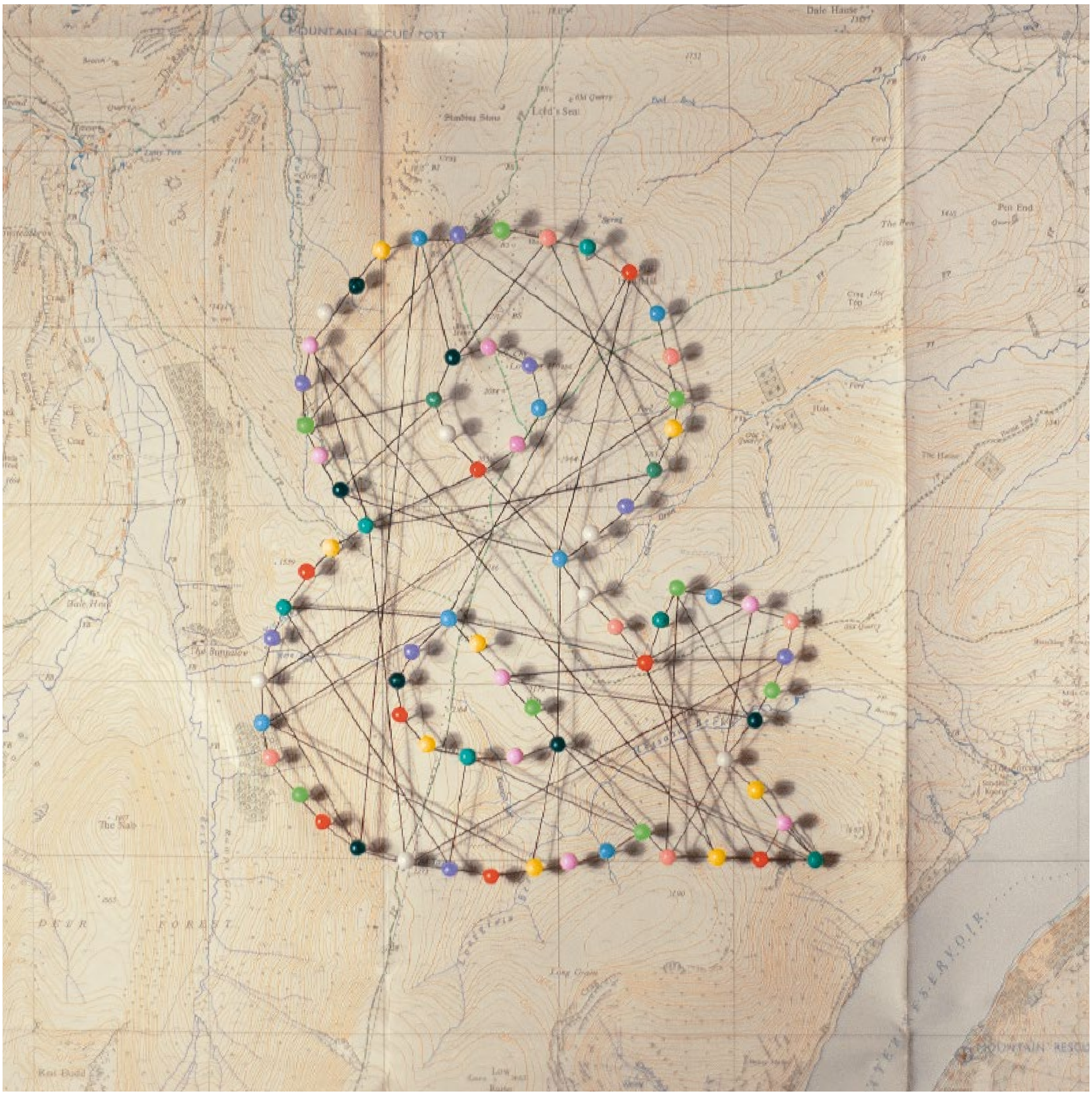

ISSUE 02

M&G Investments

AMPERSAND

Welcome to the second edition of Ampersand, the client magazine for professional investors from M&G Investments. Here we bring you in-depth analysis, wide-ranging expert opinions and thought-provoking content to help you navigate the ever-changing landscape of investment markets, and map out the opportunities and challenges for portfolios today.

In the wake of global upheavals and economic uncertainties, investment markets have become increasingly complex. Equity markets grapple with volatility stemming from geopolitical tensions, technological disruption, and shifting consumer behaviours. However, amidst the turbulence lie opportunities in sectors like technology, healthcare, and renewable energy, where innovation fuels growth potential. Credit markets face their own set of challenges, yet opportunities can be found in investment grade and high yield bonds, and structured credit, offering attractive risk-adjusted returns for investors. This is happening against an exceptional backdrop of a year in which nearly 50% of the world's population will be going to vote. I would emphasise the importance of identifying durable themes and remaining selective while plotting your way through these uncertain times.

When you invest with M&G Investments, you are tapping into a global network of investment teams with world-class research capabilities and expertise across multiple asset classes. In Ampersand, we connect the dots to bring you this 'Intelligence Connected'. From exploring the nuances of investment grade credit, to uncovering the potential in infrastructure, Asia equity, private markets, and asset allocation strategies, we aim to equip you with the insights needed to decode today's dynamic markets. We share our second Bond Vigilantes comic strip, and are also pleased to feature personal perspectives from our CIO, Equities, Multi Asset and Sustainability, Fabiana Fedeli, and Fund Manager, Richard Woolnough.

As we embark on this journey together, we invite you to explore the pages of Ampersand and uncover the treasures that lie within the complexities of today's investment landscape.

Joseph Pinto
CEO, M&G Asset Management

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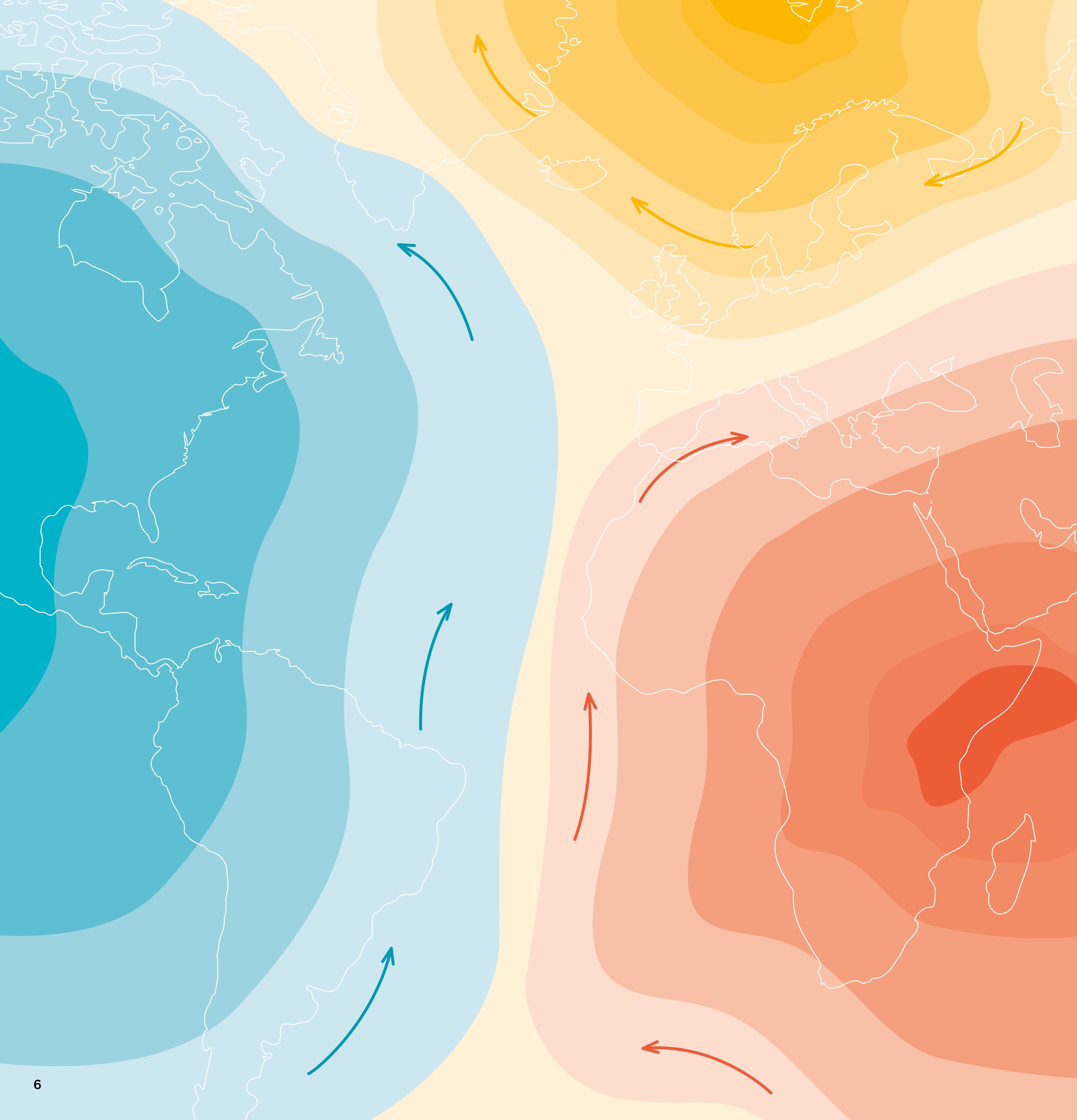
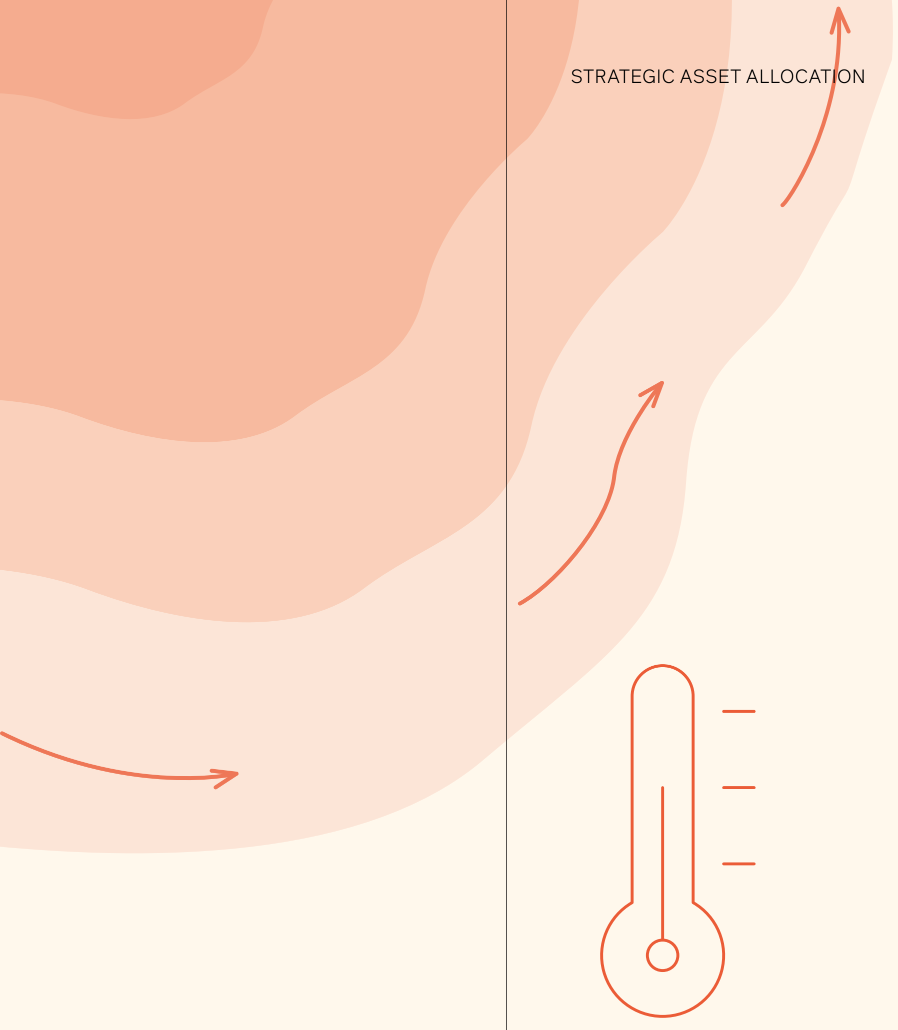


Shifting forces:

Adapting to a new investment landscape

After years of relative economic and political stability, we find ourselves in an environment where many structural forces seem to be shifting simultaneously. Dominic Howell speaks to Parit Jakhria, Director of the Long Term Investment Strategy team in M&G's Investment Office, to discuss recent changes in the investment regime and the themes that are currently influencing their asset-allocation thinking.



In the early 1990s, the end of the Cold War and pre-eminence of Western liberal democracy was said to signal the 'end of history'[1]. A period of 'Great Moderation' followed, characterised by above-trend economic growth and declining inflation, as the global economy underwent a major increase in cross-border trade, connected by the advent and expansion of the internet.

Low and, in some cases, declining inflation allowed central banks to increasingly focus their policies on stimulating economic growth. This led to longer, better-defined and more globally synchronised business cycles; there were 12 years from the Global Financial Crisis (GFC) in 2008 to the downturn triggered by the COVID-19 pandemic in 2020.

However, observes Jakhria, in the aftermath of COVID we've seen waves of structural change, particularly with the modus operandi of central banks focusing on the twin dimensions of growth and inflation (as opposed to mainly growth previously). This has fed through to structural shifts in global markets.

'Central banks' efforts to curb inflation led to interest rates and government bond yields reaching levels last seen before the GFC.'

He explains: "Last year, we experienced a rather violent deviation from the low interest rate environment we were accustomed to prior to the pandemic. Central banks' efforts to clamp down upon soaring inflation led to interest rates and government bond yields reaching levels last seen 15 years ago, before the GFC."

Given this context, Jakhria believes it is important to take a step back and reflect on some of the regime changes that have taken place in global capital markets pre- and post-COVID.

[1]The concept of the 'end of history' was proclaimed by American political scientist Francis Fukuyama in an influential essay titled 'The End of History?', published in the international affairs journal 'The National Interest' in the summer of 1989.

Regime change: 10-year UK government bond yields have returned to pre-GFC levels

Source: LSEG Datastream, 26 February 2024.

Regime changes in global financial markets

Aspect	21st century pre-COVID	Post-COVID
Central bank policy	Mainly focused on stimulating economic growth, including low interest rates and use of quantitative easing[2]. Inflation not deemed to be a concern.	Central banks need to strike a balance between inflation and growth objectives. Higher interest rates, quantitative tightening[3], greater focus on inflation.
Interest rates	Historically low interest rates.	Higher interest rates, but equilibrium yet to be determined.
Business cycle	Longer, globally synchronised.	Shorter, less clear and globally divergent.
Equities and Bonds	For most of the 21st century, central bank intervention in times of stress has led to a negative correlation between bonds and equities, whereby they move in opposite directions, leading to natural diversification in portfolios.	Unexpected inflation can negatively affect both bond and equity markets, which results in higher correlations in some scenarios. As a result, investors need to work much harder to create a diversified portfolio.
Asset allocation	Focusing on broader themes and economic cycle changes.	A continuing focus on themes, potentially requiring greater agility within shorter business cycles. Regional levers and geographical diversification become more critical.

[2]Quantitative easing (QE) is a central bank policy that involves buying assets to increase the money supply and stimulate the economy.
[3]Quantitative tightening (QT) is the process whereby central banks seek to reduce the money supply by selling assets or allowing matured securities to roll off their balance sheet.

40%

of the world's population is entitled to vote in elections in 2024

Geopolitics as a risk factor

Another notable development is the end of the so-called 'peace dividend'. Following the fall of the Berlin Wall in 1989, the world enjoyed an extended period of relative peace and prosperity. However, the current geopolitical climate is marked by rising tensions, instability and uncertainty, as the world faces multiple crises and challenges, with Russia-Ukraine and Israel-Gaza prominent examples.

"The geopolitical environment is extremely fragile, with the world order of the past thirty years increasingly challenged," observes Jakhria.

With 40% of the world's population (contributing to over half of global economic growth) entitled to vote in elections in 2024[4], together with the plausible prospect that Donald Trump will be re-elected president in the US in November, geopolitics is high on the agenda for 2024.

"Of the many factors influencing global capital markets, geopolitical risk is the most challenging to navigate, and arguably has the largest unknown element. Many developments are slow moving, often happening in the shadows, but tensions can escalate suddenly, leading to increased volatility," Jakhria notes.

Over the longer term, a combination of greater strategic rivalry and reduced economic cooperation poses a headwind for potential growth in the global economy, while raising the risk of future shocks to inflation based on supply-side issues.

In the near-term, the "increased instability of the geopolitical order means investors will need to get accustomed to periods of considerable uncertainty", he explains.

Soft-landing ahead?

To navigate this volatile environment, the Long Term Investment Strategy team (LTIS) believes it is necessary for investors to consider both cyclical and structural factors.

In terms of the cyclical outlook, this includes taking stock of how economies have digested rate hikes so far and whether a 'soft landing' – where inflation is normalised without the need for an economic contraction – can be achieved.

> "Monetary policy is said to act with long and variable lags."

With 2024 well underway, there is a clear question that remains unanswered: are economies more resilient than previously thought, with the implication that the sustainable level of interest rates is higher than past estimates, or has the impact of the aggressive tightening merely been deferred by the strong starting position of private sector balance sheets?

"Monetary policy is said to act with long and variable lags," says Jakhria.

Several factors have helped, including greater fixed-rate borrowing, which has delayed the feed-through of higher interest rates to aggregate borrowing costs, and excess savings built up during the pandemic, which have helped to support consumption and provide a buffer to rising interest costs.

"Markets for their part have oscillated for the past year between concerns for financial stability and confidence that the economy is resilient; at present, pricing appears to lean toward a benign outcome," he adds.

"Given these conflicting prospects, the moves of the past two years have reset the valuation outlook, making core fixed income much more attractive in relative terms, and a useful addition to the portfolio. Meanwhile, the varying experiences across different regions highlights the diversification benefit more than ever of maintaining good breadth of coverage in global capital markets across asset classes and geographies."

> 'The geopolitical environment is extremely fragile, with the world order of the past thirty years increasingly challenged.'

[4]Brace for Elections: 40 Countries Are Voting in 2024 – Bloomberg; Eight Key Elections to Watch in 2024 | Brunswick Group.

The promises and challenges of AI

In relation to longer-term structural drivers, LTIS will be watching the emerging technologies, notably generative Artificial Intelligence (AI), that gained traction in 2023 and the scope for them to drive a pickup in productivity growth.

The team believes AI has the potential to change the nature of our economies in the years to come. "Given some of the structural headwinds we face, such as low productivity growth and ageing populations, a leap in technological development may offer a new source of growth," argues Jakhria.

In addition to the predictions that AI could drive innovation, efficiency and productivity growth, there are concerns that AI might take people's jobs.

> "Given some of the structural headwinds we face, such as low productivity growth and ageing populations, a leap in technological development may offer a new source of growth."

"History suggests that humans are incredibly adaptable in aggregate and not nearly as replaceable as one may fear. However, the potential for AI to disrupt the labour market in certain sectors is very material", notes Jakhria.

"Whilst emergence of new technologies can be a source of optimism for investors, there is a risk of complacency, and in particular overestimation of the short-term benefits to the tech sector. We are yet to fully digest future risks (loss of jobs/regulation) and opportunities from AI and asymmetry continues to exist between the public/lawmakers and AI providers," he adds.

> 'Diversification remains critical, both in terms of asset classes and geography, while shorter, more volatile economic cycles require an even more agile, dynamic approach to asset allocation.'

Investing amid uncertainty

With a number of other risks to watch out for this year, including potential financial instability, politics, China's economic outlook and climate change, the current environment is one where uncertainty remains elevated.

Against this backdrop, LTIS is taking a balanced view, cognisant of the remaining risks to the global economy, but acknowledging scenarios where the global economy can successfully navigate the challenges ahead.

The team's thinking can be summarised across four areas: adjusting its starting position for higher bond yields, continuing to pursue geographical diversification, being nimble with strategic asset allocation (SAA) adjustments and going beyond equities and bonds for diversification.

In their view, one of the main investment ramifications of the changing investment landscape is the increased attractiveness of fixed income valuations.

"With bond yields having firmly left behind the lower-for-longer era, the prospective return environment for fixed income has improved considerably compared to the last decade," Jakhria surmises.

Meanwhile, the yield for other asset classes, such as equities, has been more stable, reducing implied estimates of risk premia (the amount of additional return or compensation that investors expect to receive above the return on a perceived 'risk-free' asset such as government bonds).

On balance, the changed relative value environment and ongoing geopolitical concerns warranted a re-weighting within multi-asset portfolios between fixed income and equities, according to the LTIS director.

A key tenet of Jakhria's capital markets assumptions framework is the inherent future uncertainty, ie, there is only one realised past, but many potential futures. To navigate this unpredictable environment, diversification remains critical, both in terms of asset classes and geography, while shorter, more volatile economic cycles could require an even more agile, dynamic approach to asset allocation. □

The team's thinking can be summarised across four areas:

1
Adjusting its starting position for higher bonds yields

2
Continuing to pursue geographical diversification

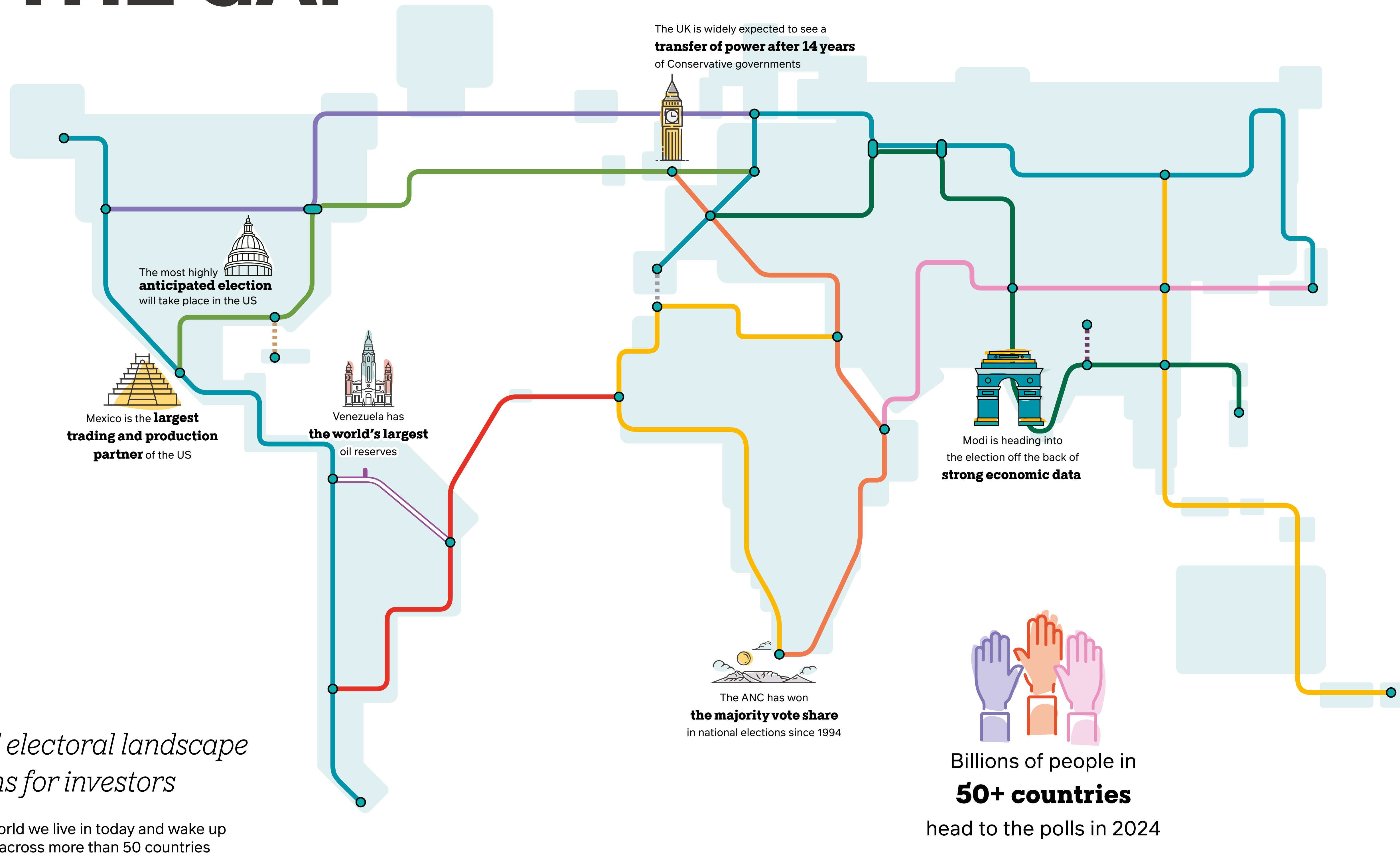
3
Being nimble with SAA adjustments and going beyond equities

4
Bonds for diversification

The Long Term Investment Strategy team, part of the Investment Office at M&G plc, sets the Strategic Asset Allocation (SAA) for internal client savings and investment products as well as providing various economic scenarios and modelling for M&G plc.

GEOPOLITICS AND MACROECONOMICS

MIND THE GAP

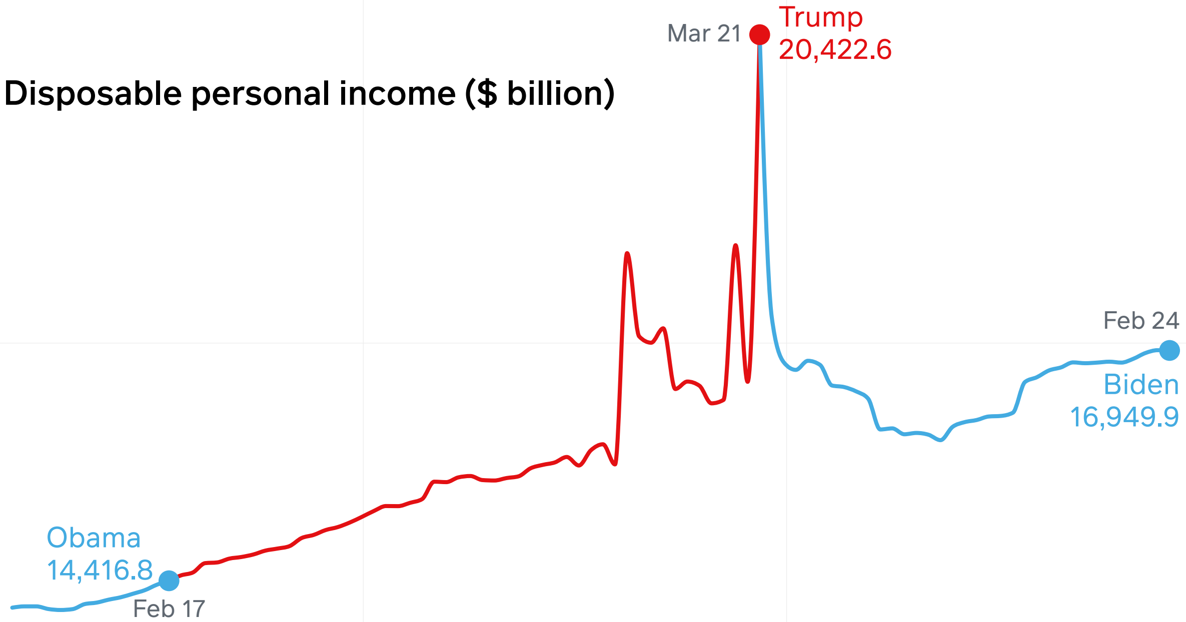


Mapping the global electoral landscape and what this means for investors

It's a defining 12 months for the world we live in today and wake up to tomorrow, as billions of people across more than 50 countries head to the polls in 2024 – although not all national elections will be free and fair. Romil Patel looks at some of the key votes from the world's oldest to its largest democracies, as well as emerging markets – and what this means for investors.

US

Disposable personal income ($ billion)



Source: US Bureau of Economic Analysis, March 2024.

The most closely watched election of 2024 takes place in the US as the country prepares for a Biden-Trump rematch on 5 November. Beyond which candidate wins the presidency, much of the international focus is on the geopolitical consequences in the context of macroeconomic developments. Inflation is a prime example, with policy affecting the direction of travel and even relationships between countries which, by extension, could impact global trade.

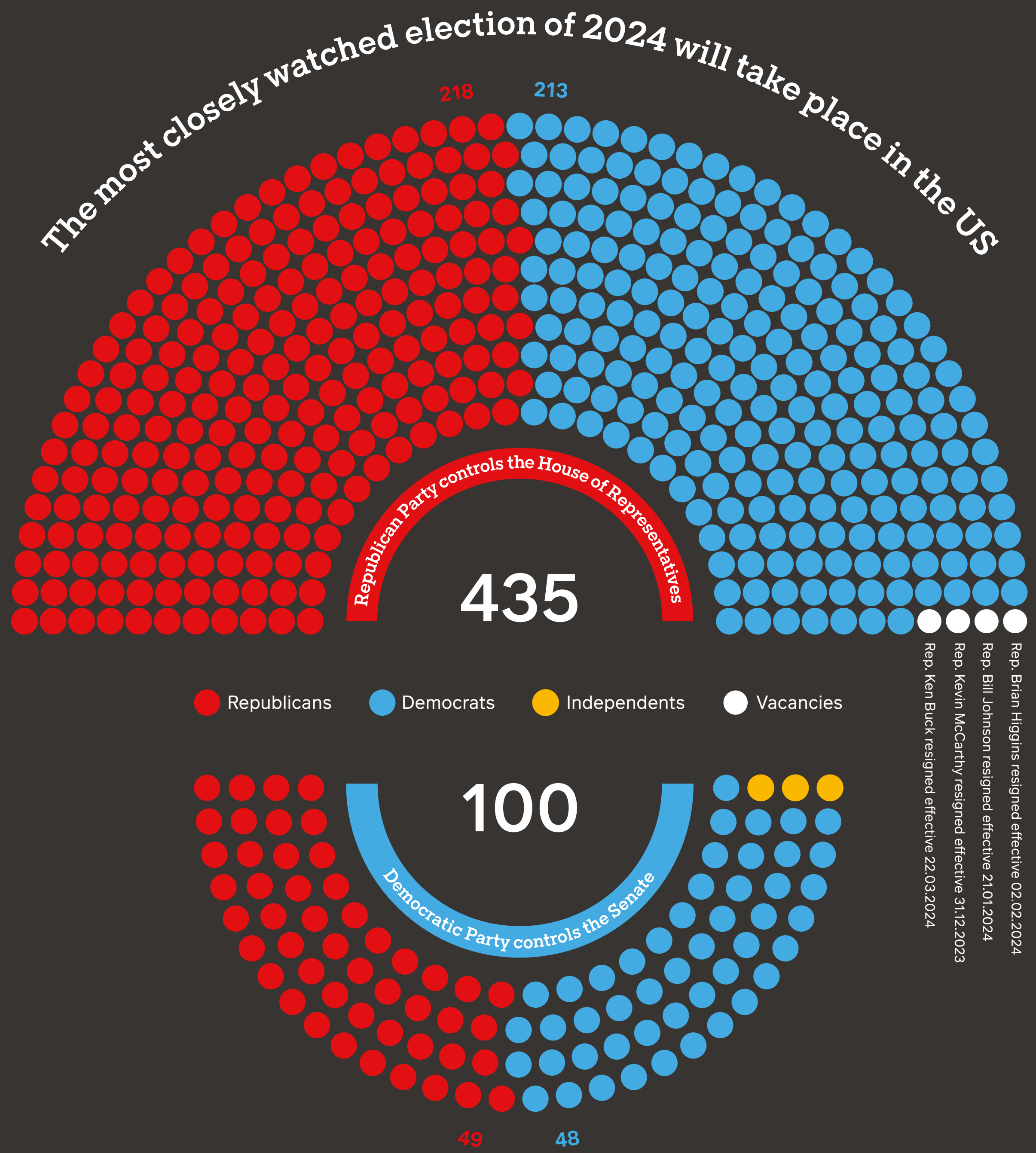
"In the past few years we've seen how quickly inflation can move, so investors ought to look at these developments very closely and expect some potential volatility which they will need to react to," says Maria Municchi, Multi-Asset Fund Manager.

Predicting the future is a futile endeavour, therefore investors cannot – and perhaps would be unwise to – position themselves for hyper-specific outcomes. However, notes Maria, "what we know is that uncertainty around the outcome of the election – and the anticipation of it – tends to create misallocation of capital. We should be watchful of this and try to take advantage of some of the opportunities that might come along the way."

While all eyes are on the White House, the US Congress is also facing a vital showdown. The Democrats require a net gain of four[1] to flip the House with all 435 seats up for election, while on the senate side, the Republicans only need two seats if current President Joe Biden is re-elected, and one if Donald Trump is elected. "It looks like the US elections will shape up to be a very tight one," says Anthony Balestrieri, Chief Investment Officer in the Americas.

"If you think about the 2020 election, Joe Biden won by a very tight 43,000 votes in the Electoral College (across Arizona, Georgia and Wisconsin[2]). This election could be even closer than that. The ability for large-scale legislation to pass will be challenging regardless of who wins, therefore some of the more geopolitical issues where the candidates can use executive actions to affect some changes may be the bigger area to watch," he adds.

[1]CNN Politics, 'Here are the key down-ballot primaries happening on Super Tuesday', (edition.cnn.com), March 2024.
[2]ABC News, 'Where does the 2024 election year stand out?', (abcnews.go.com), November 2023.



Source: United States Senate, 'Party division', (senate.gov).
US House of Representatives Press Gallery, 'Party breakdown', (pressgallery.house.gov), accessed 25 March 2024.

UK

The UK is widely expected to see a transfer of power after 14 years of a carousel of Conservative prime ministers who have presided over a defining era of British politics, with Brexit the most notable example.

We are now in an era where politics is more important to investors than ever before given the range of outcomes that can be produced.

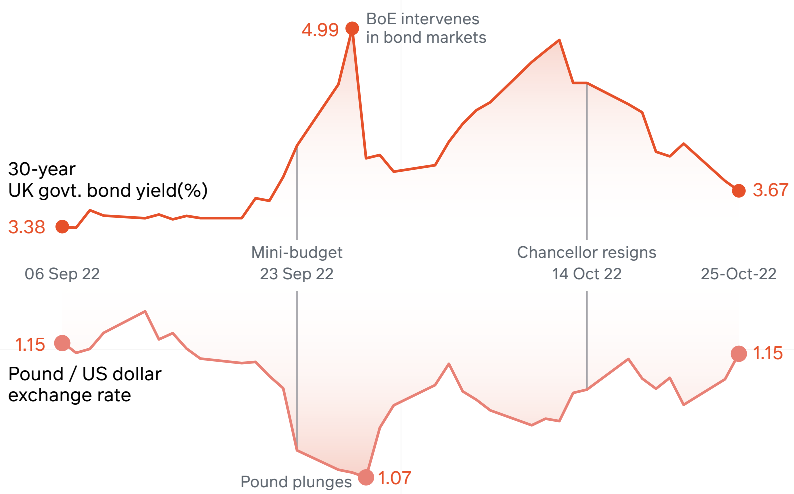
New governments can have a significant impact on financial markets, a near immediate phenomenon that the UK witnessed with the short-lived Liz Truss administration, whose mini-budget had rather mega consequences.

"From an investment perspective, we've seen with the UK how markets can take badly to an ill-thought-through policy," says David Parsons, Head of the Fixed Income Investment Specialist team. "It's not always the result of the election, it's what governments do next, that can often be the trigger point.

"It is, I would suggest, difficult to position speculatively ahead of a lot of these elections. Rather, I would say that from an investment perspective and learning from the Liz Truss experience, it illustrates perfectly the need to be in a position to respond to what happens rather than necessarily to predict," he adds.

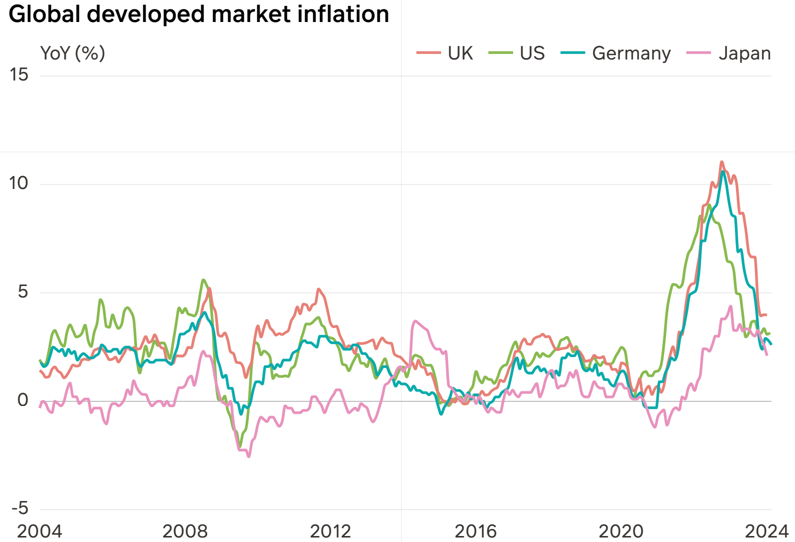
"The response function is key to maintain in portfolios: liquidity, the flexibility to be able to move to take advantage of what occurs, rather than try to anticipate everything that could happen ahead of time."

How markets can react to policy – UK mini-budget



Source: LSEG Datastream, March 2024.

Global developed market inflation



Source: LSEG Datastream, March 2024.

India and South Africa

Over 1.4 billion

people in India

~950 million

eligible voters in India

Voting in the world's most populous country of 1.4 billion people is to take place in seven phases between 19 April and 1 June. Narendra Modi's Bharatiya Janata Party (BJP) appears poised to secure a third term in power. Modi is heading into the election off the back of strong economic data after it was reported that the economy grew 8.4% in the final quarter of 2023 – its fastest pace in one and a half years[3].

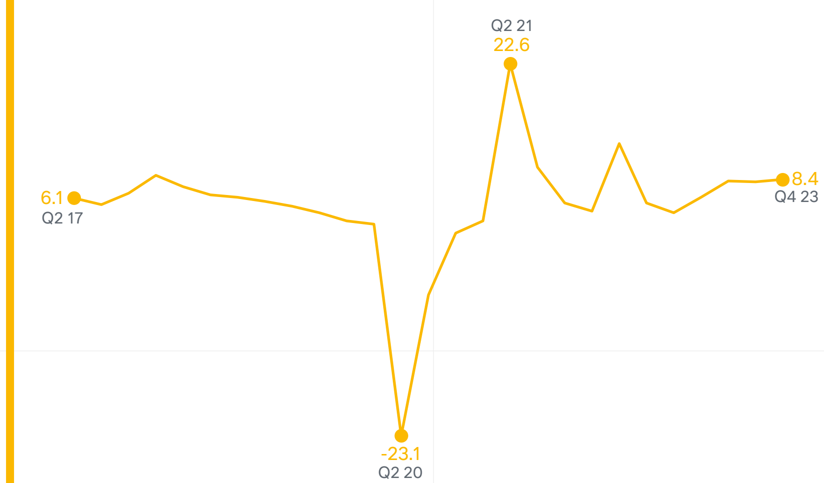
While big elections don't always produce big surprises, what happens in India and beyond will be closely watched by emerging market investors.

"Sometimes when you have very large elections in terms of population, it doesn't necessarily mean that you're going to have a large investment opportunity – by that, I mean impact on asset prices," says Claudia Calich, Head of Emerging Markets Debt.

"In fact, just because expectations that the BJP and the popularity of Prime Minister Narendra Modi remains relatively high, that leads to a potential status quo in terms of economic policies and so on. From that perspective, we're not focusing as much on India as we are in a few other elections where we could see a change on economic policy or any other factors that could impact the economy or risk perception towards that country.

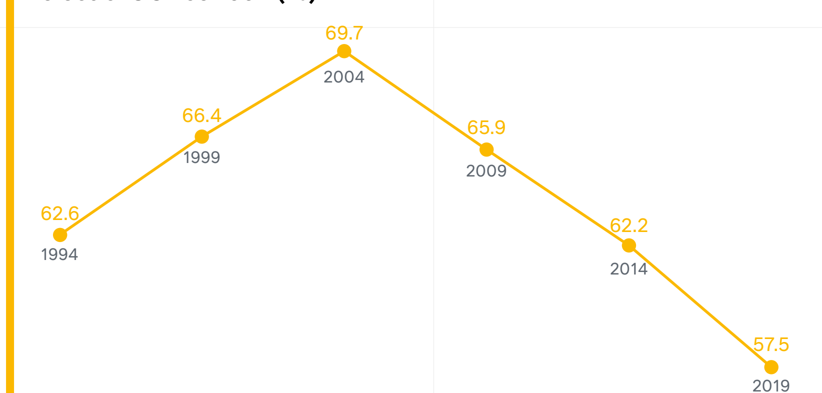
"I would highlight a couple that we're paying a little bit more attention to," adds Calich. "One would be South Africa, where it is expected that the African National Congress (ANC) is going to lose the majority in Parliament. Then the question begs: who do they build a coalition with? That's going to have important implications, potentially on the fiscal side, if the coalition includes a party that may be a little bit more lax in terms of spending and so on, or not."

India ends 2023 on a high (%)



Source: LSEG Datastream, March 2024.

ANC has won the majority vote share in National Assembly elections since 1994 (%)



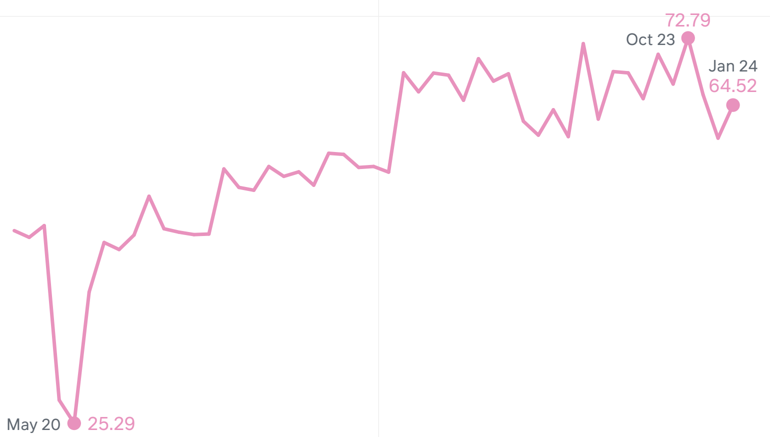
Sources: Electoral Commission for South Africa, 1994 national and provincial elections and Elections portal.

[3]Reuters, 'India's economy grows at its fastest pace in six quarters in election boost for Modi', (reuters.com), February 2024.

Mexico... and US relations

Nearly 100 million
voting at local state and national levels

US-Mexico trade in goods ($ billion)



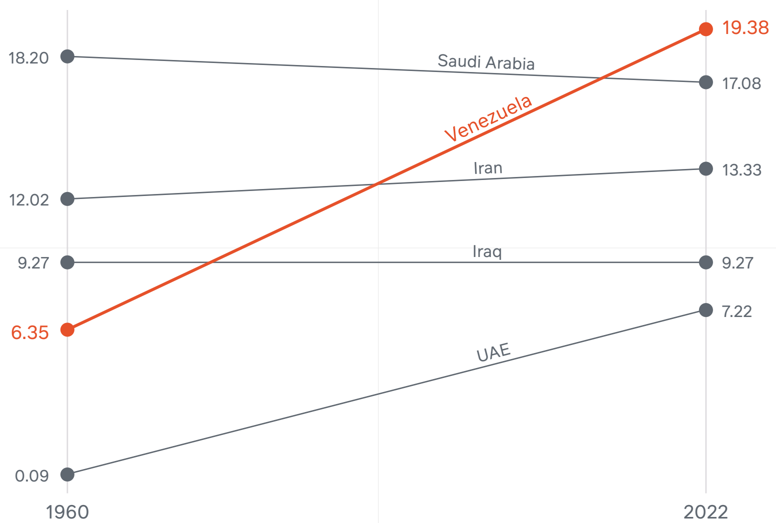
Source: US Census Bureau, 'Top trading partners – January 2024', (census.gov).

Another country where there could be implications on the fiscal side of things is Mexico, the largest trading and production partner of the United States[4]. Elections in June will see nearly 100 million Mexicans vote at the local, state and national levels, and the winner of the presidential race will serve a six-year term.

"US-Mexico relations are extremely important from a trade and migration perspective, for both a Trump presidency and Biden," says Calich. "Whether the US likes it or not, they need Mexico – especially because relations with China are very problematic to say the least. From that perspective, I think the impact is not going to be as meaningful. The Trump administration did renew the Free Trade Agreement between Mexico, Canada and the US so that is pretty much status quo for now."

Venezuela and global asset prices

Venezuela has the lion's share of global oil reserves (%)



Source: OPEC, December 2023.

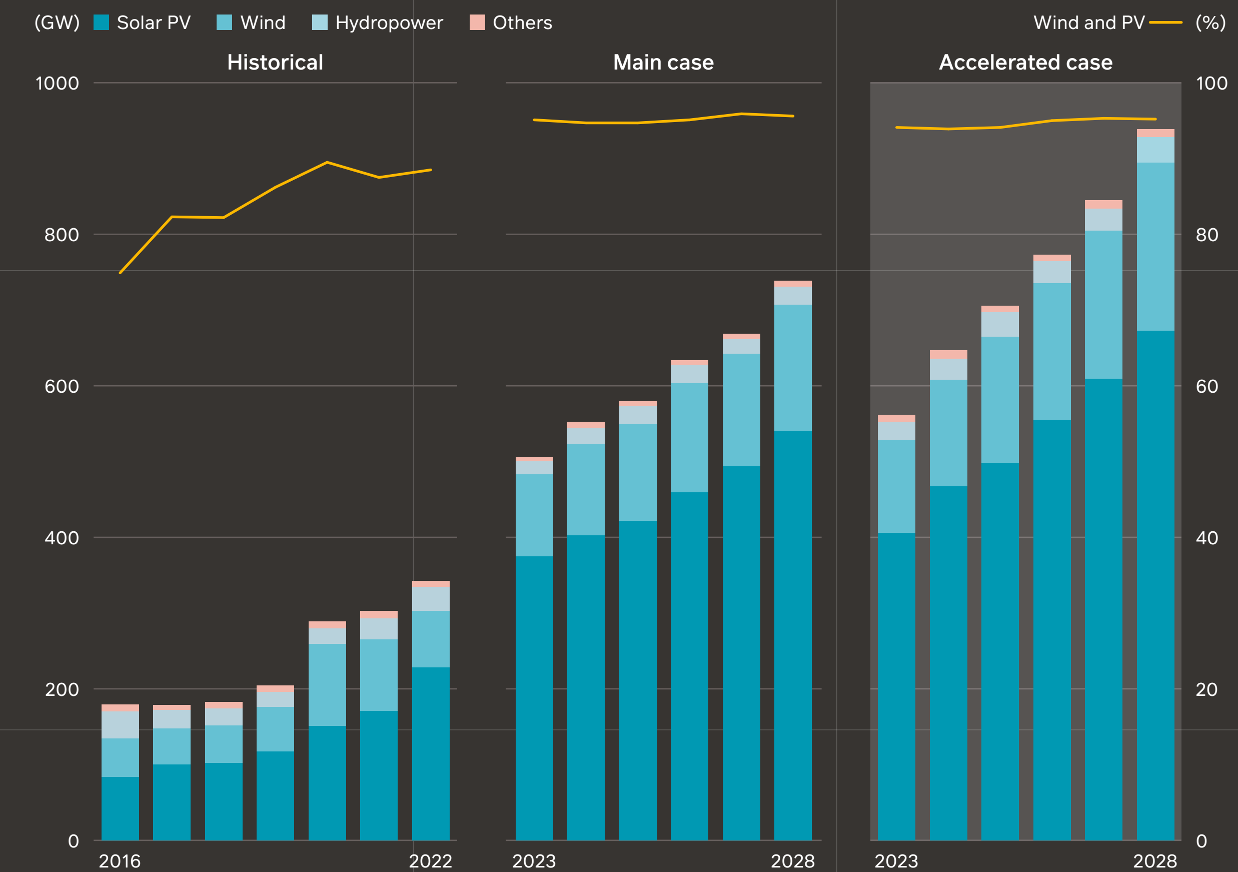
Nicolás Maduro has wielded power in the nation with the world's largest oil reserves since 2013. Annual inflation has exceeded 100% since 2014[5], and between 2014 and 2021 Venezuela's economy shrank by approximately 75%[6] with ordinary people bearing the brunt of the decline.

Calich highlights Venezuela as potentially having the biggest impact on asset prices. "Whether they agree to elections that are deemed to be free and fair by international observers, that could easily have a 20%, 30% impact on prices – either a positive impact or rally if that is the case or a negative impact, a major sell-off, if that does not happen," notes Calich.

[4]Wilson Center, 'Why are Mexico's elections important?', (wilsoncenter.org), January 2024.
[5]Reuters, 'Venezuela's government doubles down on inflation control ahead of election', February 2024.
[6]Congressional Research Service, 'Venezuela: Background and US relations', (crsreports.congress.gov), December 2022.

Climate

Renewable electricity capacity additions by technology and segment



This is a work derived by M&G Investments from IEA material and M&G Investments is solely liable and responsible for this derived work. The derived work is not endorsed by the IEA in any manner. Note: Others category comprises Bioenergy, Geothermal and CSP.

The global climate emergency has long been a political football. The US was originally a signatory to The Paris Agreement before pulling out under Trump and then rejoining under Biden. How much of an issue is this to investors?

"There's definitely a huge focus on what the next administration in the US will bring in terms of climate regulation," says Municchi.

A central observable theme of 2023 was the significant growth of renewable energy capacity at a global level – 50% more compared to 2022's growth[7].

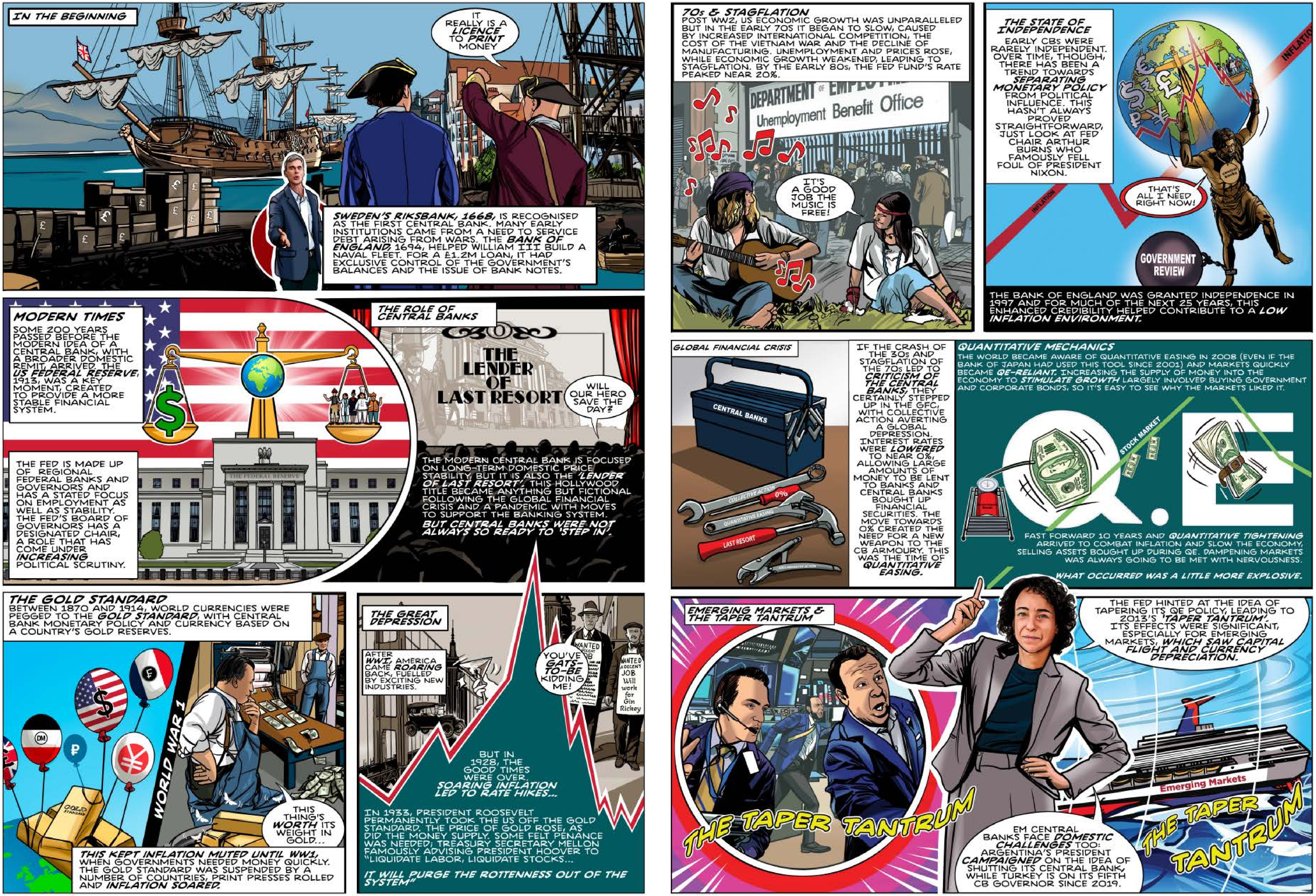
"In this environment, China played a very central role," notes Municchi. "Their installation of solar PV (photovoltaic) in 2023 increased by more than 100% compared to the previous year[8]. If we look at the current trajectory for renewable energy capacity growth, the International Energy Agency's (IEA) expectations are for continued growth that will lead to levels that should not be too far from the target of increasing current renewable energy capacity by three times what was re-iterated at COP28," Municchi notes.

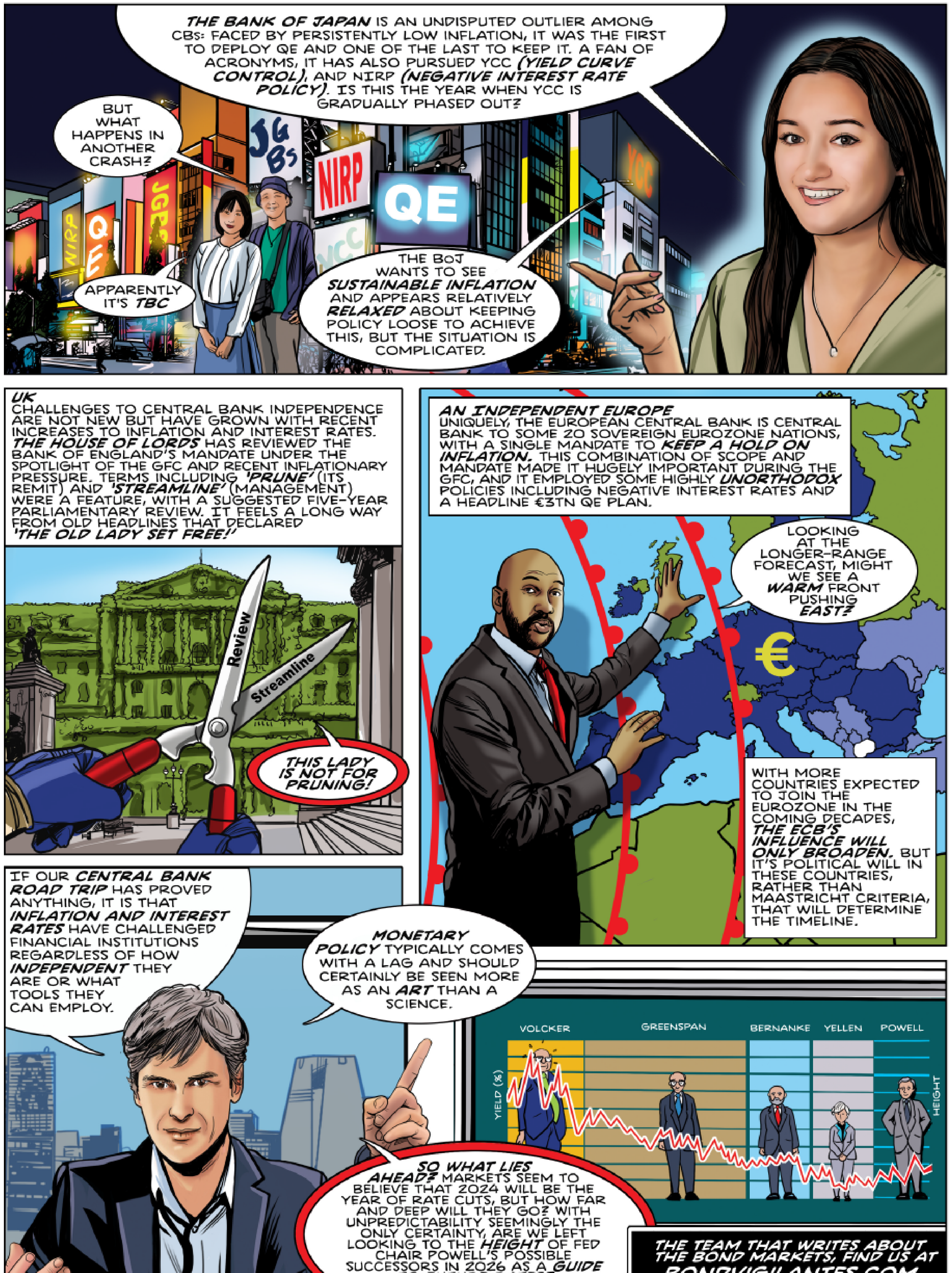
In order to limit global warming to no more than 1.5 degrees Celsius, as called for in The Paris Agreement, emissions need to be reduced by 45% by 2030 and reach net zero by 2050. Policy remains crucial in this endeavour.

Earlier this year, the UK government reported that it halved its greenhouse gas emissions between 1990 and 2022, with renewables now accounting for more than 40% of its electricity[9]. While this is promising, attaining net zero is a global endeavour. □

[7]International Energy Agency (IEA), 'Massive expansion of renewable power opens door to achieving global tripling goal set at COP28', (iea.org), January 2024.
[8]International Energy Agency, 'Renewables 2023', January 2024.
[9]UK Government, 'UK first major economy to halve emissions', (gov.uk), February 2024.

M&G Investments
The Bond Vigilantes
BLOG TEAM
RAMPANT POST-COVID INFLATION HAS RENEWED DEBATE AROUND THE ROLE OF CENTRAL BANKS. LET'S DELVE INTO THEIR HISTORY TO SEE WHAT THE FUTURE MIGHT HOLD.
JIM THE CIO
THE BANK OF JAPAN IS AN OUTLIER AND INNOVATOR, BUT WHERE WOULD THEY GO IN ANOTHER ECONOMIC DOWNTURN?
EVA FUND MANAGER
CLAUDIA FUND MANAGER
CENTRAL BANK DECISIONS HAVE IMPLICATIONS FOR EMERGING MARKETS. EVEN A RUMOUR CAN SPELL TROUBLE.
FEATURING! LOW INFLATION (THEORETICALLY)
HEALTHY, STABLE ECONOMIES (SOMETIMES)
INDEPENDENCE (FOR NOW)
CB
CENTRAL BANKS
THE GUARDIANS OF stability?
EDITION 2


IN THE BEGINNING
IT REALLY IS A LICENCE TO PRINT MONEY
SWEDEN'S RIKSBANK, 1668, IS RECOGNISED AS THE FIRST CENTRAL BANK. MANY EARLY INSTITUTIONS CAME FROM A NEED TO SERVICE DEBT ARISING FROM WARS. THE BANK OF ENGLAND, 1694, HELPED WILLIAM III BUILD A NAVAL FLEET. FOR A £1.2M LOAN, IT HAD EXCLUSIVE CONTROL OF THE GOVERNMENT'S BALANCES AND THE ISSUE OF BANK NOTES.
MODERN TIMES
SOME 200 YEARS PASSED BEFORE THE MODERN IDEA OF A CENTRAL BANK, WITH A BROADER DOMESTIC REMIT, ARRIVED. THE US FEDERAL RESERVE, 1913, WAS A KEY MOMENT, CREATED TO PROVIDE A MORE STABLE FINANCIAL SYSTEM.
THE FED IS MADE UP OF REGIONAL FEDERAL BANKS AND GOVERNORS AND HAS A STATED FOCUS ON EMPLOYMENT AS WELL AS STABILITY. THE FED'S BOARD OF GOVERNORS HAS A DESIGNATED CHAIR, A ROLE THAT HAS COME UNDER INCREASING POLITICAL SCRUTINY.
THE FEDERAL RESERVE
THE ROLE OF CENTRAL BANKS
THE LENDER OF LAST RESORT
WILL OUR HERO SAVE THE DAY?
THE MODERN CENTRAL BANK IS FOCUSED ON LONG-TERM DOMESTIC PRICE STABILITY, BUT IT IS ALSO THE 'LENDER OF LAST RESORT'. THIS HOLLYWOOD TITLE BECAME ANYTHING BUT FICTIONAL FOLLOWING THE GLOBAL FINANCIAL CRISIS AND A PANDEMIC WITH MOVES TO SUPPORT THE BANKING SYSTEM.
BUT CENTRAL BANKS WERE NOT ALWAYS SO READY TO 'STEP IN'.
THE GOLD STANDARD
BETWEEN 1870 AND 1914, WORLD CURRENCIES WERE PEGGED TO THE GOLD STANDARD, WITH CENTRAL BANK MONETARY POLICY AND CURRENCY BASED ON A COUNTRY'S GOLD RESERVES.
WORLD WAR 1
THIS THING'S WORTH ITS WEIGHT IN GOLD...
THIS KEPT INFLATION MUTED UNTIL WW1, WHEN GOVERNMENTS NEEDED MONEY QUICKLY. THE GOLD STANDARD WAS SUSPENDED BY A NUMBER OF COUNTRIES, PRINT PRESSES ROLLED AND INFLATION SOARED.
THE GREAT DEPRESSION
AFTER WW1, AMERICA CAME ROARING BACK, FUELLED BY EXCITING NEW INDUSTRIES.
YOU'VE GATS-TO-BE KIDDING ME!
WANTED JOB Will work for Gin Rickey
BUT IN 1928, THE GOOD TIMES WERE OVER. SOARING INFLATION LED TO RATE HIKES...
IN 1933, PRESIDENT ROOSEVELT PERMANENTLY TOOK THE US OFF THE GOLD STANDARD. THE PRICE OF GOLD ROSE, AS DID THE MONEY SUPPLY. SOME FELT PENANCE WAS NEEDED; TREASURY SECRETARY MELLON FAMOUSLY ADVISING PRESIDENT HOOVER TO "LIQUIDATE LABOR, LIQUIDATE STOCKS...
IT WILL PURGE THE ROTTENNESS OUT OF THE SYSTEM"
70s & STAGFLATION
POST WW2, US ECONOMIC GROWTH WAS UNPARALLELED BUT IN THE EARLY 70S IT BEGAN TO SLOW, CAUSED BY INCREASED INTERNATIONAL COMPETITION, THE COST OF THE VIETNAM WAR AND THE DECLINE OF MANUFACTURING. UNEMPLOYMENT AND PRICES ROSE, WHILE ECONOMIC GROWTH WEAKENED, LEADING TO STAGFLATION. BY THE EARLY 80s, THE FED FUND'S RATE PEAKED NEAR 20%.
DEPARTMENT OF EMPLOYMENT
Unemployment Benefit Office
IT'S A GOOD JOB THE MUSIC IS FREE!
THE STATE OF INDEPENDENCE
EARLY CBs WERE RARELY INDEPENDENT. OVER TIME, THOUGH, THERE HAS BEEN A TREND TOWARDS SEPARATING MONETARY POLICY FROM POLITICAL INFLUENCE. THIS HASN'T ALWAYS PROVED STRAIGHTFORWARD, JUST LOOK AT FED CHAIR ARTHUR BURNS WHO FAMOUSLY FELL FOUL OF PRESIDENT NIXON.
INFLATION
INFLATION
THAT'S ALL I NEED RIGHT NOW!
GOVERNMENT REVIEW
THE BANK OF ENGLAND WAS GRANTED INDEPENDENCE IN 1997 AND FOR MUCH OF THE NEXT 25 YEARS, THIS ENHANCED CREDIBILITY HELPED CONTRIBUTE TO A LOW INFLATION ENVIRONMENT.
GLOBAL FINANCIAL CRISIS
CENTRAL BANKS
COLLECTIVE ACTION
0%
QUANTITATIVE EASING
LAST RESORT
IF THE CRASH OF THE 30s AND STAGFLATION OF THE 70s LED TO CRITICISM OF THE CENTRAL BANKS, THEY CERTAINLY STEPPED UP IN THE GFC, WITH COLLECTIVE ACTION AVERTING A GLOBAL DEPRESSION. INTEREST RATES WERE LOWERED TO NEAR 0%, ALLOWING LARGE AMOUNTS OF MONEY TO BE LENT TO BANKS AND CENTRAL BANKS BOUGHT UP FINANCIAL SECURITIES. THE MOVE TOWARDS 0% CREATED THE NEED FOR A NEW WEAPON TO THE CB ARMOURY. THIS WAS THE TIME OF QUANTITATIVE EASING.
QUANTITATIVE MECHANICS
THE WORLD BECAME AWARE OF QUANTITATIVE EASING IN 2008 (EVEN IF THE BANK OF JAPAN HAD USED THIS TOOL SINCE 2001) AND MARKETS QUICKLY BECAME QE-RELIANT. INCREASING THE SUPPLY OF MONEY INTO THE ECONOMY TO STIMULATE GROWTH LARGELY INVOLVED BUYING GOVERNMENT AND CORPORATE BONDS, SO IT'S EASY TO SEE WHY THE MARKETS LIKED IT.
STOCK MARKET
FAST FORWARD 10 YEARS AND QUANTITATIVE TIGHTENING ARRIVED TO COMBAT INFLATION AND SLOW THE ECONOMY, SELLING ASSETS BOUGHT UP DURING QE. DAMPENING MARKETS WAS ALWAYS GOING TO BE MET WITH NERVOUSNESS.
WHAT OCCURRED WAS A LITTLE MORE EXPLOSIVE.
EMERGING MARKETS & THE TAPER TANTRUM
THE TAPER TANTRUM
THE FED HINTED AT THE IDEA OF TAPERING ITS QE POLICY, LEADING TO 2013'S 'TAPER TANTRUM'. ITS EFFECTS WERE SIGNIFICANT, ESPECIALLY FOR EMERGING MARKETS, WHICH SAW CAPITAL FLIGHT AND CURRENCY DEPRECIATION.
Emerging Markets
EM CENTRAL BANKS FACE DOMESTIC CHALLENGES TOO: ARGENTINA'S PRESIDENT CAMPAIGNED ON THE IDEA OF SHUTTING ITS CENTRAL BANK, WHILE TURKEY IS ON ITS FIFTH CB GOVERNOR SINCE 2019.
THE TAPER TANTRUM



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Infrastructure redefined

From railways *to* renewables

Once known to serve the transportation and communication needs of an increasingly industrialised and urbanised population, infrastructure as a sector has evolved drastically in response to major drivers like the climate crisis and demographic change. Its current phase entails creating resilient, inclusive systems that prioritise sustainability and accommodate fundamental societal shifts. Noura Tan explores the most influential structural trends shaping future-forward opportunities across the asset class.

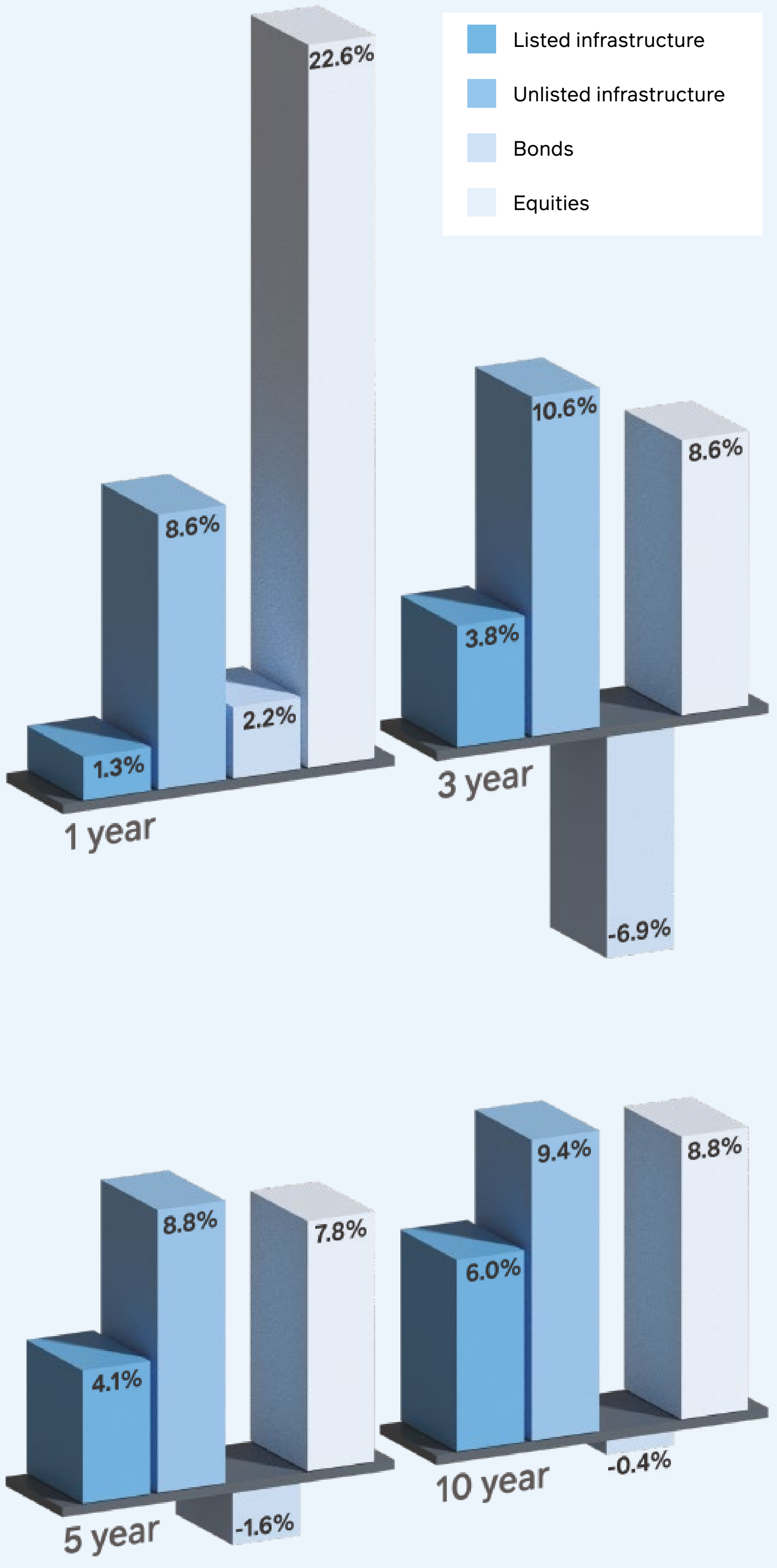
In recent years, a series of global disruptions have revealed deep-rooted vulnerabilities in our current infrastructure, underscoring the repercussions of shortfall investment and the consequent urgency to meet this gap. To fulfil basic infrastructure needs globally, approximately $15 trillion will be needed between 2022 and 2040[1], while an even larger amount of $139 trillion will be required to achieve net-zero targets by the same year[2]. It was thought that safeguarding the natural world meant slowing down infrastructural development, when in reality, addressing our most critical environmental challenges calls for us to build new things. To this end, private infrastructure markets are seeing significant growth alongside well-established public markets.

Like most other asset classes in 2023, infrastructure faced a challenging macroeconomic environment marked by high interest rates, inflationary pressures, market volatility, and an overall mixed economic outlook. Despite underperformance in select subsectors, both listed and unlisted infrastructure have demonstrated strong returns relative to equity markets while maintaining bond-like stability.

Escalating pressure to fulfil climate commitments, reshore supply chains in response to geopolitical tensions, and capitalise on major policy enablers is driving the enduring demand for infrastructure assets. Meanwhile, shifting macroeconomic dynamics and innovative business models are resulting in decentralisation across the sector, creating new pockets of opportunity in an asset class once dominated by monopolies.

[1]Amin Mohseni-Cheraghlou and Naomi Aladekoba, 'The global infrastructure financing gap: Where sovereign wealth funds and pension funds can play a role', (atlanticcouncil.org), October 2022.
[2]International Federation of Consulting Engineers (FIDIC) and Ernst & Young (EY), 'Closing the sustainable infrastructure gap to achieve net zero', (issuu.com), June 2023.
Chart source: Listed infrastructure: FTSE Global Core Infrastructure 50/50 index in USD as of Q3 2023, Unlisted infrastructure: Burgiss Global Private Capital Performance in USD as of Q3 2023, Bonds: Bloomberg Barclays Global Aggregate index in USD as of Q3 2023, Equities: MSCI World Index in USD as of Q3 2023).

How does infrastructure measure against other asset classes?



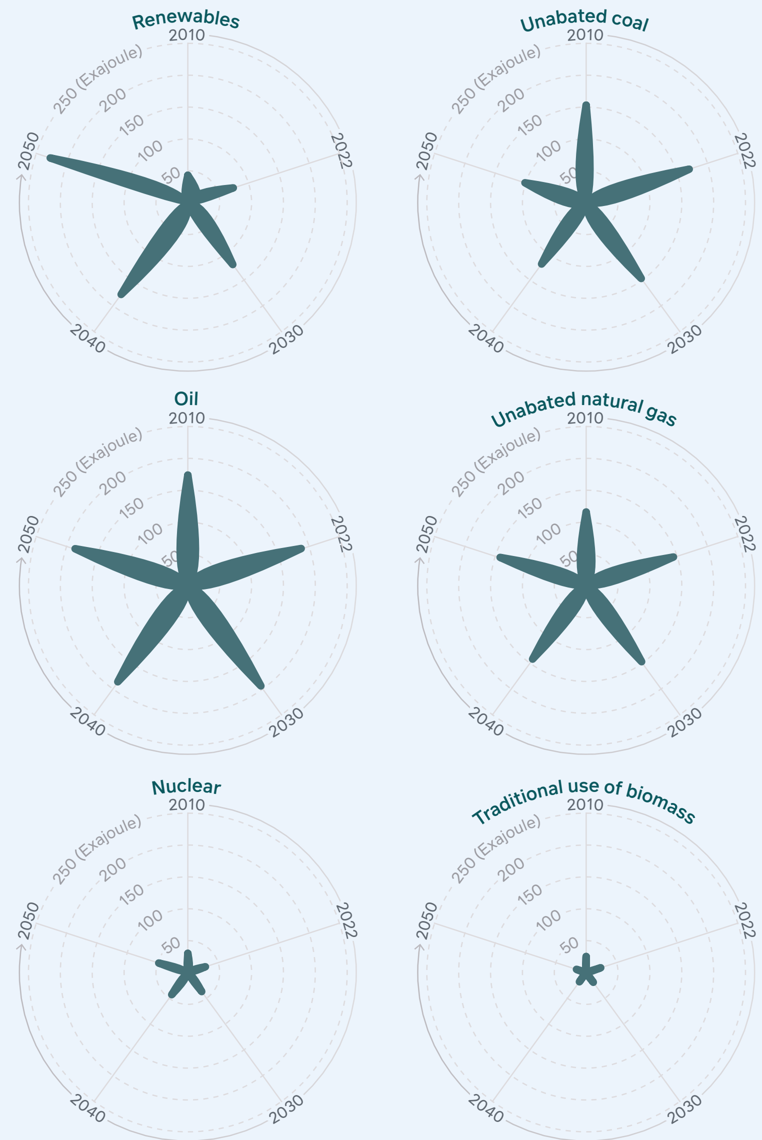
How bright is the renewable future?

In light of the historic agreement at COP28 to transition away from fossil fuels and triple renewable energy capacity by 2030, investors must ensure their portfolios adapt to evolving energy needs. The demand for fossil fuels is expected to slow, with 50 oil and gas companies pledging to reach near-zero methane emissions by 2030[3] and renewables expected to make up 80% of new power capacity in the same year[4].

Ed Clarke, Co-Founder, Infracapital, elaborates: "The backdrop has not been this complex since the global financial crisis, and it has created much uncertainty. 2024 will see many major political elections across the UK, Europe, and the US, but what is evident is that infrastructure remains firmly on the agenda. The current landscape does create attractive opportunities to invest in energy infrastructure that is sustainable or to transition existing assets to cleaner solutions."

As we transition to a new energy mix characterised by a higher share of renewable energy sources, we must confront the challenges of intermittency and variability inherent to renewables. Alongside renewable energy generation, the development of energy storage facilities and improvement of grid resilience are equally important segments in our net-zero journey.

The rise of renewables in the new global energy mix



Case study
Driving decarbonisation

Accounting for about 10% of the world's carbon emissions, the transport industry is a key focal point for decarbonisation efforts[5]. The last two years have seen the US and India join 31 other countries in a pledge to achieve 100% zero-emission new bus sales by 2040[6]. Today, electric buses are the most electrified road segment, excluding two/three-wheelers[7].

Supporting over 1,000 electric vehicles (EV) worldwide, Zenobe has emerged as a leading UK player, operating across three key business segments: electric fleets, network infrastructure, and second-life batteries. The global EV fleet is expected to consume between 950 terawatt hours (TWh) and 1,150 TWh in 2030, which is roughly equivalent to the total electricity consumption in the Middle East in 2023[8,9]. This surge will need to be supported by adequate energy storage facilities that can supply secure and affordable power to a resilient grid.

In a bid to save over one million tonnes of carbon emissions over 15 years, Zenobe's landmark 100 megawatt Capenhurst project is the first to have a commercial contract for reactive power services and is the largest battery directly connected to the transmission network in Europe. In a dynamic energy market, investors stand to benefit from leveraging technological advancements and growing policy support to realise the broader spectrum of energy transition infrastructure needed.

[3]Eklavya Gupte, Claudia Carpenter, Ivy Yin, and Jennifer Gnana. 'COP28: Fifty oil and gas companies sign net zero, methane pledges', (spglobal.com), December 2023.
[4]International Energy Agency (IEA), 'World Energy Outlook 2030' , (iea.org), October 2023.
[5]International Energy Agency (IEA), 'Breakthrough Agenda Report 2023', (iea.org), September 2023.
[6]Global Commercial Vehicle Drive to Zero, 'Memorandum of Understanding (MOU) on Zero-Emission Medium- and Heavy-Duty Vehicles', (globaldrivetozero.org).
[7,8]International Energy Agency (IEA), 'Global EV Outlook 2023', (iea.org), April 2023.
[9]International Energy Agency (IEA), 'Electricity Market Report Update', (iea.org), July 2023.
Chart source: International Energy Agency (IEA), 'World Energy Outlook 2030', (iea.org), October 2023.

Case study

Does money grow on trees?

As a critical ecosystem with the potential for long-term carbon capture and sequestration, forests sit at the intersection between decarbonisation and conservation efforts. Investors looking to diversify their private market allocation are increasingly considering sustainable forestry investments as an emerging opportunity that pairs the defensive risk-return profile of traditional forestry investments with innovative capital growth strategies.

Landowners previously dependent on income from logging might now look for potential returns from carbon and biodiversity markets by enrolling into nature protection and restoration schemes. These long-term income streams can present a diversified source of revenue that is expected to become more valuable over time given the growing urgency for countries and companies to consider net-zero targets. Long-term contracts with large companies and regulated markets can provide an opportunity to turn these critical ecosystems into infrastructure-like assets. These trends have sparked a noticeable surge in private deal volumes as asset owners look to leverage emerging revenue streams.

In November 2022, we witnessed the largest private conservation-focused forest investment in US history when Aurora Sustainable Lands acquired a $1.5 billion timberland portfolio. The joint venture between Anew Climate and equity investors led by Oak Hill Advisors saw the purchase of 1.5 million acres of commercial timberland sites that would be repurposed for improved forest management-based carbon credits projects.

A year since its acquisition, the company has generated and sold carbon credits representing 7.5 million tonnes of carbon emission removals. The initiative represents just one example of how private sector players are tapping into new markets and policy enablers to capture risk-adjusted returns while meeting the call for decarbonisation and conservation outcomes.

[10]World Economic Forum, 'Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy', (weforum.org), January 2020.
[11]S&P Global Sustainable 1, 'How the world's largest companies depend on nature and biodiversity', (spglobal.com), May 2023.

Why bank on nature?

Throughout history, land has been acknowledged as one of the three factors of production, along with labour and capital. The natural world supports an estimated $44 trillion of economic value generation[10], with 85% of the world's largest companies' direct operations being heavily dependent on nature[11].

Yet, the concept of 'natural capital' – the world's stock of natural resources and related ecosystem services – is still an emerging theme for investors. While live opportunities exist in the space, we expect the range of investable assets to expand exponentially as natural capital is increasingly aligned with infrastructure as an integrated solution to address challenges like high capital cost and insurance risk.

Natural capital assets encompass forests, wetlands, rivers, oceans, and other biodiversity-rich areas that play a crucial role in supporting essential ecosystem services like clean air and water generation, climate regulation, and habitat preservation.

The establishment of carbon and biodiversity markets is popularising a new investment approach known as 'stacking', where multiple ecosystem services are monetised from a single site. The integration of natural capital assets into infrastructure will uncover a new range of investment opportunities, spanning areas such as renewable energy generation, regenerative farming, and sustainable land management.

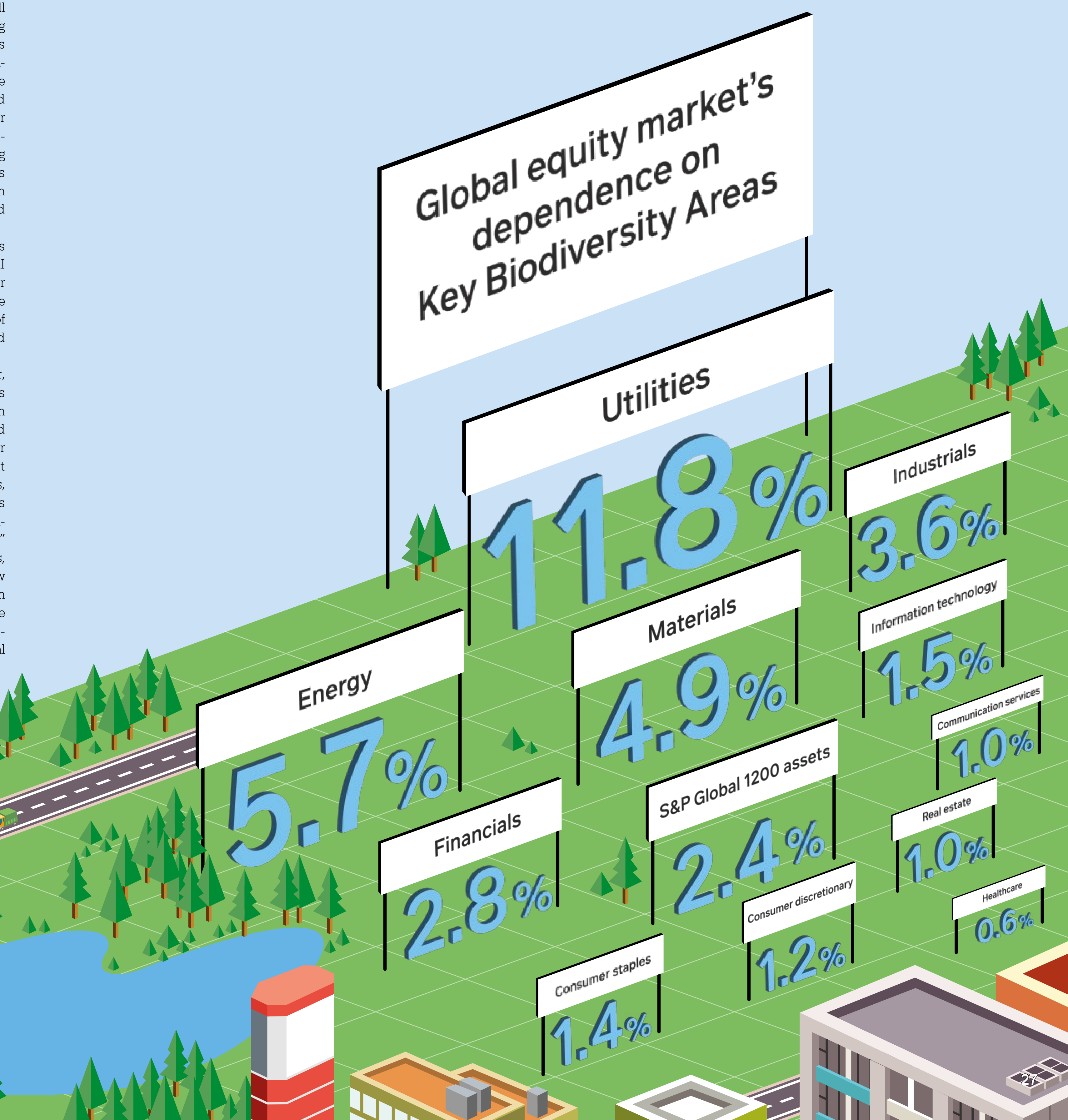
One example is converting organic waste generated from timber harvesting into biomass feedstock for bioenergy production. In addition to produce and renewable energy sales, cashflows can be secured through mitigation banking credits, payments for ecosystem services schemes, land leasing, and ecotourism and recreation. When structured appropriately, natural capital assets can exhibit similar defensive characteristics as infrastructure assets.

Are we 'smartifying' everything?

From the smart meters to the smart cities that are making up a progressively digitalised world, it seems all aspects of our lives are undergoing 'smartification'. Modern technologies like the Internet of Things (IoT), location systems, and artificial intelligence (AI) are increasingly being integrated into physical infrastructure assets for performance optimisation. In agriculture, for example, farmers are applying data analytics to predict crop yields by collecting and analysing data on weather conditions, soil quality, and management practices.

The pursuit of smartification across industries, accelerated by the AI boom, is securing the demand for digital infrastructure assets like fibre optic networks and data centres – of which are increasingly considered critical infrastructure.

Johnny Hughes, Investment Director, Listed Infrastructure, comments: "It's about offering a modern approach to an ancient sector. Railroads and shipping ports have been around for centuries but secure digital payment networks, data storing warehouses, financial exchanges, and fibre optics networks are now integral to the infrastructure fabric of modern societies." Once considered high-risk assets, digital infrastructure assets are now known to generate stable, long-term cash flows, having delivered positive returns in 2023 despite macroeconomic conditions and a general transaction slowdown.



Source: S&P Global Sustainable 1, 'How the world's largest companies depend on nature and biodiversity', (spglobal.com), May 2023.

Case study
Turning bricks into bytes

With data prized as the new oil, the demand for storage and processing facilities is on the rise. Despite a tough macroeconomic backdrop last year, the first nine months saw $80 billion injected into global digital infrastructure, of which $16 billion was allocated to data centre projects[12].

The need for data centres is leading to higher revenue growth and better pricing power for data centre operators like Equinix which own and operate 242 of the world's data centres. The company also sits at the forefront of data centre sustainability, having achieved over 96% renewable energy coverage for its global portfolio in 2022 and being the first data centre operator to commit to using 100% clean and renewable energy.

However, the availability of sufficient power and cooling infrastructure to support greater loads poses a challenge to the expansion of new supply. Data centre operators like Equinix, which have integrated energy efficiency considerations into well-developed pipelines, are well positioned to unlock significant earnings growth.

[12]Linklaters, 'Data centre momentum continues as $16bn is invested in first nine months of 2023', (linklaters.com), November 2023.

Mapping the new terrain

As a relatively young asset class responding to an evolving sector, a more nuanced understanding of infrastructure assets is required. Between forests and data centres, the universe of investable assets across public and private infrastructure markets has expanded rapidly, creating confusion around what qualifies as an infrastructure asset these days.

What characterises an infrastructure asset is not necessarily its physical attributes, but its risk-return profile as an essential service provider, as Anish Majmudar, Head of Real Assets, Impact and Private Equity, points out: "As an infrastructure investor, you're always thinking about characteristics like hard asset protection, high inelasticity of revenue, preferably with inflation linkage, the essentiality of those assets to a particular ecosystem, so that overall you've got a resilient asset with defensive characteristics that can perform across market cycles." In this view, including infrastructure assets as part of a wider investment portfolio continues to offer stability, diversification, and long-term returns.

Despite encompassing a vast range of themes, these remain interconnected opportunities where a whole supply chain approach across regions and sub-sectors can unlock diverse entry points for investors. Martin Lennon, Co-Founder, Infracapital, speaks to this: "We have the benefit of owning quite a large and diverse portfolio of businesses."

"Whilst some of these might be in the same sectors, they could be in different countries. We can bring that experience and knowledge together as we do periodically to really share best knowledge and ideas and try to ensure that we act as more than a bunch of individual investments, but as a collective infrastructure community, if I can put it that way. I think that's the best way forward to address some of these quite challenging systemic issues that we face and to identify the opportunities present in the market."

From railways to renewables, the sector's continued evolution means that the asset class has never benefitted from as much diversification underpinned by robust market fundamentals. The current scenario is giving rise to future-forward opportunities that embrace innovation while retaining the defensive characteristics historically associated with the asset class. With the volume of new infrastructure that needs to be developed, the asset class not only offers a hedge against uncertain market cycles, but also significant return potential by supporting its growth. The opportunity – and responsibility – to redefine our landscape now lies with us.

IN CONVERSATION WITH...

FABIANA FEDELI

An 'optimist who plans for the worst,' Fabiana was named one of the 100 Most Influential Women in Finance in 2022 by Financial News. Here, M&G Investments' Chief Investment Officer for Equities, Multi-Asset and Sustainability, tells Antonia Oprita about her love for markets and why she thinks of herself as a 'data junkie'.

What do you consider to be the most important traits of your personality, which help you in your investing activity?

I am intellectually curious and have a thirst for knowledge. Investing is my job and also my hobby. In my spare time I love reading about markets, economics and geopolitics. I am an optimist who plans for the worst. As a portfolio manager, I used to always think of what could go wrong in an investment, and try to make a plan A, plan B and plan C of what I would do given different circumstances. Of course, we don't have a crystal ball, and we cannot prepare for everything, but having a plan of action has helped maintain discipline, limiting emotional reactions and behavioural biases.

What do you think are the most important qualities for your profession in general, and for being a CIO in particular, and why? And, what are your favourite sources of information?

Respect and consideration for other people, and a good dose of humility are important qualities. Being self-centred and believing that you are always right are unsuitable and sadly often still too common traits of many in our industry. You need to be able to admit to yourself that you don't always have the best ideas nor the right answers, and it is important that you listen to others, particularly your team members. Also, having loads of mental resilience, enough for yourself and for your team, is crucial.

I love markets, and I am a data junkie. I studied econometrics at university, so I love a good data series and a good chart. Many of my sources of information are conventional for someone working in finance: Bloomberg, Barron's, The Economist, the FT. Alongside this, I love to talk to my team members, colleagues who invest in other asset classes, and to clients. I believe I learn a lot from these interactions. Having worked in a number of countries, I also maintain a network of peers across the UK, Europe, the US, Asia and Africa. We brainstorm about what we see in markets, and we use each other as sounding boards. Getting a broad range of diverse perspectives helps to achieve a more faceted and nuanced view of what is happening out there.

What market signal or indicator do you watch the most, and what is it currently indicating?

The indicators that I follow will necessarily change over time and with market circumstances. Inflation indicators such as Core CPI (consumer prices index), PPI (producer prices index), wages and, most importantly, their sub-components, are some which I closely follow at the moment. While inflation across most of the world has declined since its highs, it is still not at target levels for the Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank (ECB). There is a meaningful chance that the last leg of that decline to target levels will prove slower and less straightforward than the market has been expecting. That said, the direction of travel, given current data on inflation and economic activity, points to the first Fed, BoE and ECB interest rate cuts sometime in 2024. Any volatility across fixed income and equity markets caused by a slower path to cuts can represent a significant opportunity for active investors like ourselves.

Please describe the process by which you derive investment ideas with your team.

Over the last few years, we have made a strong effort in creating centres of knowledge excellence across equities, multi asset and sustainability, where knowledge and ideas are shared across the whole investment floor and become the inspiration for new differentiated investment opportunities. I draw from this high-octane research and expertise pool for my role on the Investment Committee of our Crossover strategy, in which we invest in companies when they are still private, supporting them through the path of listing, and eventually hold them as public companies. In addition, with the Multi Asset team we get together once a week to discuss markets and the macro backdrop, and we are not afraid to challenge – respectfully – each other's thinking. The results are captured in a monthly piece which is now sent also to other teams outside of Multi Asset.

We also have regular portfolio discussions with all of the heads of our Equities desks, where we discuss ideas and often uncover similar trends and opportunities at opposite sides of the globe.

We live in an interconnected world where depth of research provides a real edge in the investment process, and I want to make sure that my teams have all the tools they need to deliver alpha to our clients.

How would you describe your current leadership style and how did you develop it? How did you build the current teams you lead, and how do you approach the development of talent within your teams?

My team is far better placed than me to describe my leadership style. My hope is that I am fair, transparent, and that my team feels that I have their back. While I currently do not manage equities portfolios as I used to, as mentioned, I sit on the Investment Committee of our Crossover strategy, and I have portfolio oversight meetings with my team members. I have experienced and therefore understand the challenges my team goes through, and I hope such experience helps me support them better.

IN CONVERSATION WITH...

Importantly, I strongly believe in the power of teams, where the whole is bigger than the sum of the parts. No one is – or should be expected to be – 100% good at everything. Rather, there are some individuals that are 70% good at something and 120% good at something else. The key is to combine the different strengths of individuals, which allows for a stronger, interconnected and longer-lasting team. I also believe that there are personalities who detract from a team's dynamic. You may have the best goal scorer in the world, but you still may lose the championship if everyone else around them is unable to function at their best, perhaps because they feel their energy drained out of them due to the self-centred personality of the goal scorer. There is only one decision to be made in that case as that person does not belong in the team.

What is the one thing that worries you about the market/global economy at the moment, and the one thing that gives you hope (and which one do you think will dominate the months ahead)?

As an investor, I worry about many things. Trying to understand where the downside of our investment decisions can come from is a big part of the job. We are constantly monitoring the known unknowns as well as trying to figure out what unknown unknowns could come out of left field.

At the moment, geopolitics and the rise of extremism and populism are two potential sources of market volatility. It is important to realise that not all geopolitical upheaval hurts markets. It has to have an actual impact on the functioning of the economy on which that market relies. Think of the current conflict in the Middle East. While it touches us all profoundly, it has had limited impact on global markets. It would be different if the conflict were to affect countries that are significant oil producers, sending energy prices higher.

As an individual, I am also concerned about climate change and the loss of biodiversity. As an investor, I believe it is important to understand the risks and invest accordingly. When it comes to hope, the world awakening to the importance of diversity gives me a lot of hope for the future of our world. This is a cause very close to my heart not only as a woman who started 25 years ago in the financial industry, but also as someone who has worked in many different countries with colleagues from very different cultural backgrounds. And one thing that excites me are the incredible opportunities that generative Artificial Intelligence (AI) is able to unlock. Of course, we have to ensure that such opportunities are used wisely and for the good.

What do you find inspiring?

Human resilience in the face of adversity is something that I have always found inspiring. I also feel humbled by those who are willing to fight and die for their beliefs in the hope for a better world. We should not be afraid to voice our opinions, even when they put us in an uncomfortable situation. Of course, even when voicing our thoughts, we should always be respectful of others. The way we deliver those opinions is key.

What is your favourite book?

I have many 'favourite' books, as a number of them have had different meanings at different times of my life and my career. One that reminds me of my early start in asset management is *Reminiscences of a Stock Operator*, which many believe is based on the life of stock trader, Jesse Livermore, in the early 20th century. It is a book that was given to me when I made the career change from sell-side research analyst to working for a hedge fund. It is a good reminder of the power of patience, the importance of timing, and the privilege of learning on a daily basis as an investor. It is also a reminder that fortunes can be made and then easily lost. It is important to be aware of downside risk as we are entrusted with our clients' assets.

Do you have a hobby outside work? How often do you do it and how does it feel to do it?

I love outdoor sports. I swim and go for long walks and hikes in the summer, and ski in the winter. Of all the sports I practice, skiing is the one that is able to take my mind off markets. I need to focus on what I am doing to avoid getting hurt. It is also a passion that I share with my husband, and we enjoy skiing together. Swimming, on the other hand, is more of my sport than my husband's. Particularly longer distance swimming. It will often happen that I will be swimming along the coast while my husband walks on the beach alongside me. I am sure it is funny to see for other people! ☐

Photography by Daniel Lewis.

THE BIG PICTURE

With trillions looking to come off the subs bench is this the year of the bond?

For bond investors, predicting the timing of a pivot in central bank's monetary policy cycle can be simultaneously profitable and futile. With both growth and inflation slowing, the direction of travel for interest rates points downwards over the course of 2024, providing a strong tailwind for the asset class and offering an opportunity for the trillions of dollars sat on the sidelines in cash and money market funds to re-enter the market.

Amid a myriad of uncertainties, including prolonged inflation, geopolitical risks and supply and demand dynamics, Harriet Habergham speaks to the specialists across M&G Investments' fixed income universe to find out whether the investment grade credit space has evolved such that it could deliver returns despite market noise.

Macro: Geopolitics and Trump

Views from Jim Leaviss, CIO Fixed Income, in London and Anthony Balestrieri, CIO Americas, in Chicago.

After two years of negative returns for fixed income markets and the most aggressive central bank hiking cycle in recent history, the tail end of 2023 saw investors rush to the asset class in anticipation of rate cuts in the new year. The fourth quarter rally was an important case study of FOMO (Fear of Missing Out) where investors, not wanting to miss out on capital gains, flooded into the bond market, with the Bloomberg Global Aggregate Bond Index rising 10% from October to the end of the year.

While consensus has been that the direction of travel for interest rates is downwards, economic data continues to send mixed messages, and markets are still eagerly awaiting an initial move from central banks. There is $6 trillion currently sat in money market funds[1] (as of February 2024) waiting to be deployed as soon as the speed and strength of cuts becomes clear, and as holding cash becomes less profitable, offering a strong structural support for fixed income markets.

Historically, peak rates signal strong returns for bonds. On average, if you bought a 10-year US Treasury 63 days before the first Federal Reserve (Fed) cut, you would see a 7% capital gain from a 1% fall in yield, plus the carry. However, attempting to time the market is a thankless task and there remain some key macroeconomic risks.

Inflation

The first of these is that inflation is not yet beaten, and a combination of short-term shocks and longer-term structural factors could result in stickier inflation figures than expected.

The US Consumer Prices Index (CPI) number surprised to the upside in February, rising 3.2% year-on-year, more than the 3.1% expected[2]. Combined with a resilient jobs market and strong economic data, there are still questions over whether inflation will make its way down to the 2% target.

Even as inflation gradually slows towards target, consumers continue to feel the pressure on their wallets; price levels of everyday items such as rents and food remain substantially higher than before the pandemic. Over the last four years (2019-2023), grocery prices have risen 25% in the US[3,4]. Not only is this significantly higher than the cumulative headline inflation rate over the period of 19%, but these everyday items are front of mind for consumers; 67% of voters highlight food as the area in which they have been most impacted by inflation[5].

With households spending an average of 11.3% of disposable income on food in 2022[6], prices rises of everyday items, such as milk and eggs, have a meaningful impact on consumers' pockets. However, food inflation is not necessarily dictated by central bank policy, with a combination of factors including labour shortages, supply chain disruptions and climate contributing to sticky price levels. Rents, which make up 35% of the CPI index in the US, are also a contributing factor to more persistent inflation with US rental prices 29.4% higher than they were before the pandemic[7].

3.2%
rise in US headline CPI in February 2024

25%
increase in grocery prices in the US between 2019-2023

67%
of voters highlight food as the area most impacted by inflation

11.3%
of disposable income spent by the average household on food in 2022

29.4%
increase in US rental prices since before the pandemic

[1]Investment Company Institute (ICI), 'Release: Money market fund assets', (ici.org), February 2024.
[2]Bureau of Labor Statistics, 'Consumer Price Index Summary', (bls.gov), February 2024.
[3]US Department of Agriculture, 'Food Prices and Spending', (ers.usda.gov), February 2024.
[4]The Washington Post, 'Inflation has fallen. Why are groceries still so expensive?', (washingtonpost.com), February 2024.
[5]Ipsos, 'Registered voters are feeling pessimistic about the state of the US economy', (Ipsos.com), November 2023.
[6]US Department of Agriculture, 'Food Prices and Spending', (ers.usda.gov), February 2024.
[7]Zillow, 'Pandemic to Present: The Evolution of Rental Prices and Affordability', (Zillow.com), February 2024.

> 'Monetary policy lags can feed through to the real economy in many different ways and for different reasons.'

There are also longer-term structural factors that could result in inflation settling at a persistently higher rate, and consequentially a higher interest rate for an extended period of time.

These include trends such as the green transition, which requires significant capital expenditure and investment, with government policies such as the Inflation Reduction Act in the US and the European Green Deal providing fiscal support.

Other long-term factors which could have inflationary implications include further geopolitical tension, which could result in protectionist policies and increased military spending, as well as demographic trends where an ageing population reduces the tax base, empowers workforces in wage negotiations and creates a need for greater social welfare spending.

Recession

While a soft landing – a scenario where inflation falls without a decline in economic activity – has been the prevailing narrative of late, history shows this is very difficult to achieve. Sustained growth, inflation coming down to target and labour markets remaining reasonably strong at the same time is rare; one of those factors almost inevitably starts to wobble.

Inflation has fallen rapidly from a peak of 9.1% in the US in June 2022, to 3.1% in January 2024. Inflation is serially correlated – the best indication of the next month's reading is the previous month's. Over the last six to nine months inflation has surprised everybody by the speed and strength of the downward move. There is a risk of central bank policy overshooting, through a combination of higher interest rates and quantitative tightening, as well as supply shocks dissipating.

Investors typically look to the yield curve for an indication of a recession, where an inverted yield curve signifies investors' expectations that long-term interest rates will decline, normally as a result of a recession.

US Treasury yields have been inverted since 2022, presaging a recession which has not yet transpired in the US. However, it has since flattened as investors price in the first central bank cuts. This would suggest that the likelihood of a recession has receded. However, it is not unusual for the curve to steepen again before a recession as a result of market pricing in anticipation of a slowdown.

Similarly, if we were to look to market narratives as an indicator of a recession, historically discussions of a 'soft landing' often spike shortly before a recession.

Monetary policy lags can feed through to the real economy in many different ways and for different reasons.

Typically, monetary policy can take between four and 29 months to take effect[8]. Looking, for example, at the labour market, while jobs data appears to show strength on the surface, there are some signs of cooling; February's data showed the US unemployment rate increased to a two-year high of 3.9%[9].

US INFLATION

9.1%
June 2022

↓

3.1%
January 2024

[7]Zillow, 'Pandemic to Present: The Evolution of Rental Prices and Affordability', (Zillow.com), February 2024.
[8]Federal Reserve Bank of St Louis, 'What are long and variable lags in monetary policy?', (stlouisfed.org), October 2023.
[9]Reuters, 'US labor market cooling' (reuters.com), March 2024.

Furthermore, other indicators, including credit card delinquencies which have surpassed pre-pandemic levels[10], are starting to show some signs of economic weakness. Meanwhile in January, US retail sales fell 0.8%, versus expectations of a 0.1% drop[11], and industrial production also fell[12].

Therefore, there is a scenario where we enter an economic slowdown and central banks are forced to cut rates swiftly, acting as a strong tailwind for fixed income markets as investors look to lock in higher yields.

Elections

Adding further uncertainty to the mix, almost half the world's population are heading to the polls in 2024, including major economies such as the US. The results could have profound long-term impacts on the global economy.

While markets are typically relatively immune to elections, experiencing only short-term volatility, there have been examples in recent years where the actions of politicians or central banks have rocked bond markets.

Liz Truss's mini-budget in September 2022, resulting in the UK Gilt Crisis, was a notable recent example of how political decisions can spook markets. The episode acts as a stark warning for governments seeking to be elected on substantial spending or tax-break promises, but it could also act as an opportunity for fixed income investors.

It is quite rare that euro, sterling and dollar investment grade (IG) fixed income markets move in dramatically different directions, but in the case it does happen, active managers can take advantage of relative value opportunities.

Although at least 64 countries have elections in 2024, all eyes will be on the US presidential election in November. Despite a strong economy, low unemployment and falling inflation, many voters still feel dissatisfied, with affordability, crime and migration surfacing as top concerns for voters[13]. As a result, markets should consider the potential implications of a Trump victory.

For example, in 2016, Trump's election saw bond markets experience a sell off of $1 trillion based on fears over Trump's spending promises, tax cuts and plans for trade tariffs.

During his last term, Trump cut the federal corporate tax rate from 35% to 21% and has indicated he would lower it further to 15% upon re-election. While initially tax cuts could prove positive for risk assets, they would increase the US debt burden and likely result in a huge amount of Treasury bond issuance, calling into question the US' debt sustainability.

Other proposed policies include a universal 10% trade tariff on US imports or the "Trump Reciprocal Trade Act", which would enable tariffs of 100%, both of which could spark an upswing in inflation.

[10]Philadelphia Federal Reserve Bank, 'Large Bank Credit Card and Mortgage Data', (philadelphiafed.org), January 2024.
[11]Trading Economics, 'U.S. Retail Sales', (tradingeconomics.com), February 2024.
[12]Federal Reserve, 'Industrial Production', (federalreserve.gov), February 2024.
[13]Gallup, 'Most Important Problem', (news.gallup.com), January 2024.

Issuance

Regardless of whether a second Trump term transpires, US government debt issuance is likely to be vast this year with one-third of US government debt due to be refinanced and continued expansionary fiscal policy even during this period of relative economic strength, with policies such as the Inflation Reduction Act and the CHIPS Act adding to the deficit, as well as the overhang from pandemic measures.

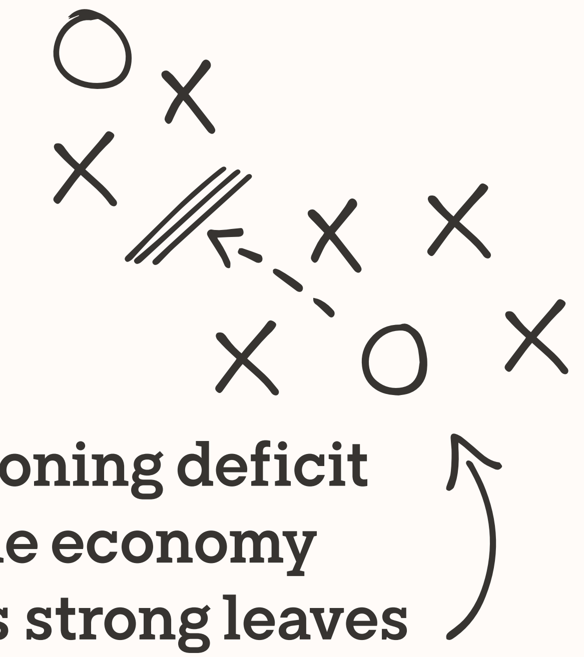
A burgeoning deficit when the economy remains strong leaves the US with little fiscal room to manoeuvre in the case of an economic downturn. Furthermore, a wave of issuance could test bond investors' appetite and potentially have a detrimental impact on sovereign credit ratings, with Fitch downgrading the US from triple-A to AA+ in August 2023.

Having said this, economic principles state that as the quantity increases, price decreases. However, in the case of government bonds, the opposite has tended to be true; there is an inverse relationship between debt-to-GDP and bond yields as governments typically borrow more when the economy is weak, inflation is weak and interest rates are generally falling so bond yields fall.

However, given the extent of borrowing while the economy has been strong, the worry lies in a world where governments borrow more when growth is weak and central banks are no longer buying up vast quantities of government bonds as part of quantitative easing programmes.

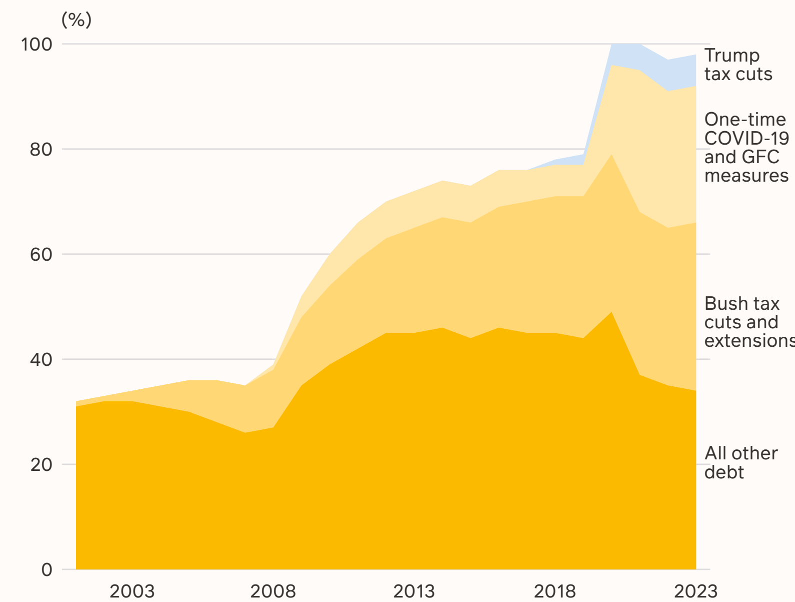
However, these concerns may be overblown as only a small part of the overall debt was issued during the low interest rate period following the financial crisis. The majority of the debt was issued at interest rates similar to – if not higher than – those today, meaning the refinancing stress may not be as drastic as might be expected.

THE BIG PICTURE



'A burgeoning deficit when the economy remains strong leaves the US with little fiscal room to manoeuvre in the case of an economic downturn.'

Tax cuts, the GFC and COVID are responsible for the growth in the US debt ratio



Source: Center for American Progress, 28 March 2023.

Bond market boom: An expanding opportunity set for active managers

The corporate bond market has expanded significantly with the investment grade universe growing from just under $2 trillion in 1999 to just under $14 trillion in 2023. This ever-evolving and diverse universe provides ample hunting ground for active investors. A selective credit research team can leverage this vast market to identify value opportunities.

Expanding credit markets provide a diverse investable universe

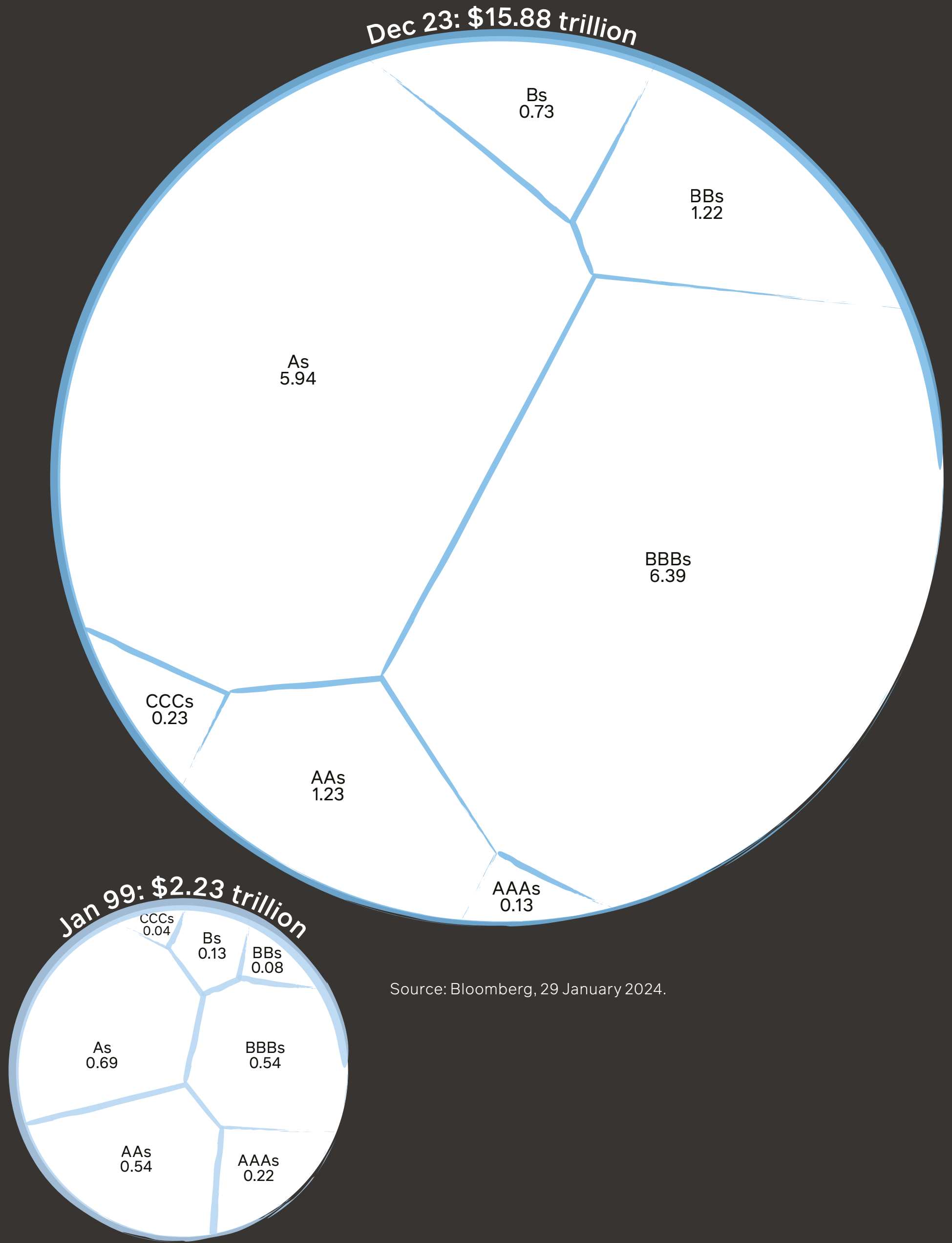
Global corporate bond market (face value) 1999 versus 2023

CREDIT

612%
increase
over 24 years

The market
requires skilled investment decision-making

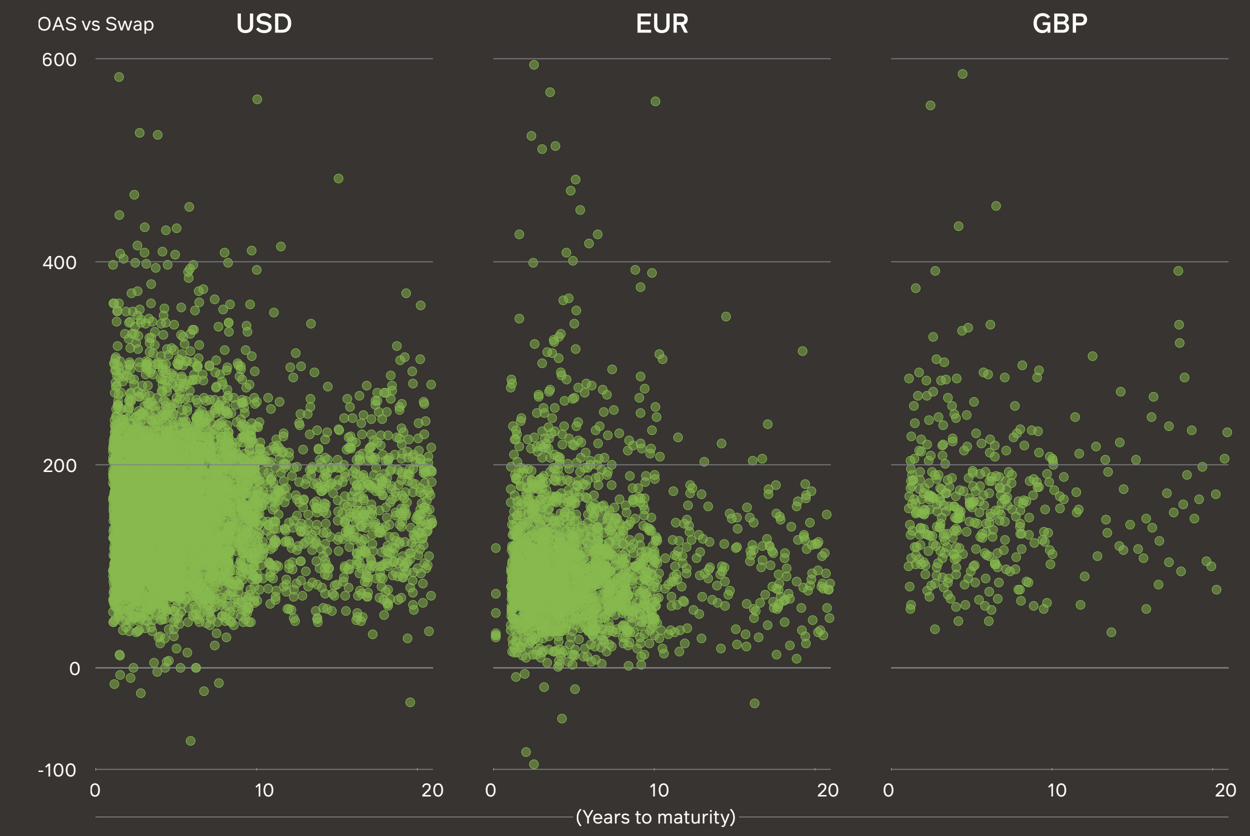
86%
of today's corporate bond market is investment grade



Source: Bloomberg, 29 January 2024.

Spread dispersion creates value opportunities

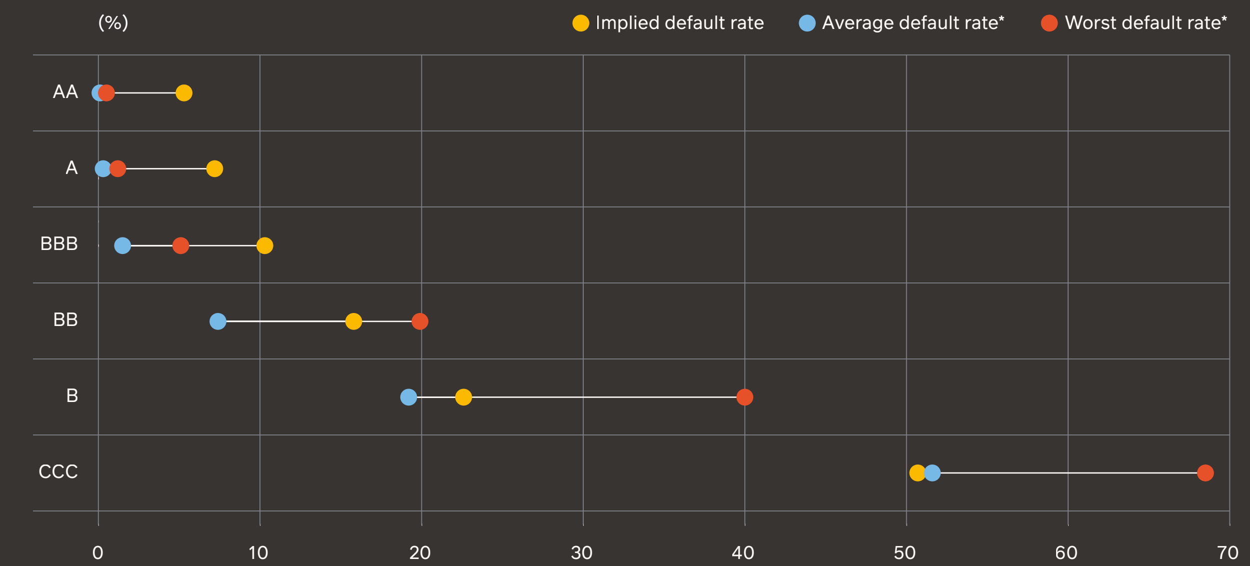
Active managers can identify mispricing among highly dispersed BBB-rated corporate bonds



Source: Bloomberg, 29 January 2024.

Market default expectations for IG credit outstrip historical average

Markets are pricing in six times more defaults for BBB-rated credits than typically experienced in a five-year cycle



Source: Bloomberg, 29 January 2024.

Dispersion = opportunities for active managers

Views from Richard Woolnough, Fund Manager, and Gaurav Chatley, Fixed Income Director.

Bond markets as a whole have expanded considerably in recent decades, reaching a total valuation of around $130 trillion[14] today, creating a wider and more diverse universe for active managers to take advantage of.

The corporate bond market in particular has seen a dramatic evolution, growing substantially and presenting investors with a huge variety of instruments to invest in today that didn't exist 20 years ago.

The quantity and magnitude of the change over the last 20 years is remarkable. The investment grade (IG) universe is skewed much more towards being heavily BBB-rated; companies took advantage of lower borrowing costs following the global financial crisis (GFC) to lever up, with little incentive to remain AA- or A-rated.

However, we believe as the cost of borrowing rises, companies will opt to improve their balance sheets. Between 2020 and 2023, there was a net $40 billion of 'rising stars' (companies upgraded from high yield (HY) to investment grade), including notable names such as Ford Motor Company, as companies whose balance sheets were in doubt during the COVID-19 pandemic are upgraded. In 2023, there were 14 issuers, totalling 45.88% of market value, that were removed from the fallen angel index (an index of bonds previously rated as IG but subsequently downgraded to HY) as they were upgraded back to IG.

We are seeing this in HY as well; contrasting the HY universe with the IG universe, it is the best quality it has ever been, with data showing that we have never had more BB-rated bonds relative to B- and CCC-rated than we have today.

‘There is a high level of dispersion within BBB-rated bonds meaning that there are significant value opportunities to be uncovered.’

Dispersion

One result of there being a substantially larger opportunity set is that there's greater dispersion, where bonds with the same credit rating trade at different credit spreads over government bonds. High levels of dispersion are often found during periods of market volatility such as today and can provide a rich source of opportunities to identify mispriced securities through in-depth credit analysis.

There is a high level of dispersion within BBB-rated bonds meaning that there are significant value opportunities to be uncovered. We believe we can capture higher spreads while taking the same level of credit risk. For example, you can buy a security with a 10-year duration and if spreads were to rally 50 bps, yields were to come down half a percent, that will deliver a 5% capital return. Making these decisions can produce some attractive outcomes for fixed income investors; we often think of equities delivering capital upside, while fixed income delivers the yield on the tin, but for active investors, this does not have to be the case.

Weathering the storm

In the case of a downturn, we believe IG credit is well placed to weather the storm, with strong fundamentals reducing the risk of default.

Looking at default rates in corporate bond markets, markets are pricing in 12% worth of defaults over the next five years for BBB-rated credits – six times more than typically experienced in a five-year cycle and twice the level that was experienced during the GFC.

While we believe default rates will rise, this will be from historically very low levels. In the coming years, we believe default rates will gently rise back to pre-financial crisis levels of 3-4% as a relatively standard long-term average default rate.

Currently, we believe we are being overpaid for the credit risk of BBB-rated bonds; while spreads on a historical basis are currently fairly tight, compared to what you are being paid for default probability, they still appear to offer good value.

This is because balance sheets of IG firms remain strong in our view. Many companies took advantage of low financing costs during the pandemic to refinance and so benefit from a long maturity runway and the short-term risk of having to refinance at higher rates is diminished.

Inflation can also have positive effects on firms indebted at fixed rates; put simply, inflation at 5%, for example, for five years, could reduce their debt by a quarter in real terms.

However, going down the rating scale, there are heavily leveraged companies that are more susceptible to defaults and the compensation for risk falls away. This is where a rigorous credit analysis team is essential, both to take advantage of the opportunities and to avoid the pitfalls. We want to hold IG credit where we believe those specific names and sectors can weather a worst-case scenario storm.

Pockets of value

As ever, for those looking beyond market noise and hunting for value, there are underlying issues and sectors which we can benefit from; having a credit research team to conduct the bottom-up fundamental analysis is instrumental in identifying these pockets of value. We see strong opportunities within certain sectors including European financials, certain segments of real estate and emerging market debt.

In our view, European banks are in a positive position today compared to where they have been. We believe there is value, especially within second tier banks within European marketplaces. We see opportunities particularly within those that struggled with balance sheet issues during the financial crisis and had to deal with bad debts and restructurings, as well as operational restrictions. These have benefitted from a strong tailwind in recent years as rates increased, growing their net interest income (NII), and in turn, generating profits.

Furthermore, capital is much higher than it has been and in the years since the GFC, banks have proven themselves to be better able to withstand macroeconomic shocks. While banks continue to be viewed as high beta risky entities, we would argue that since the GFC, regulation has made them safer, better capitalised and well supported by proper risk management, resulting in strong fundamentals.

We also believe there are opportunities within real estate, an area that has suffered somewhat in recent years.

Looking at real estate valuations, the price-to-book of real estate investment trusts (REITs) fell to about 60%. Essentially the equity market was indicating it did not believe real estate valuations, and so spreads began to balloon out. As yields and spreads rose, these highly leveraged companies suddenly found themselves in a position where they could not refinance, and so spreads blew out further.

However, these are specific IG REITs which are the best quality within that marketplace. This trend has been turbocharged by interest rates; once people begin to think interest rates are coming down, valuations will rise back up and refinancing will also become easier. There are companies out there that look like very good value within that sector for a credit research team who can identify where the asset valuations are mispriced.

Emerging market debt saw a strong rally in 2023 but it remains one of the most diversified asset classes within fixed income, offering diversification by region, country, sector, currency and commodity. It also exhibits a high level of disparity from an economic and monetary policy cycle perspective too.

'Markets are pricing in 12% worth of defaults over the next five years for BBB-rated credits – six times more than typically experienced in a five-year cycle and twice the level that was experienced during the GFC.'

'We see strong opportunities within certain sectors including European financials, certain segments of real estate and emerging market debt.'

You don't need to make a long-term call, de-risk if necessary and stay nimble

Views from Richard Ryan, Director of Fixed Interest Portfolio Management, and Ben Lord, Portfolio Manager.

While the current environment – volatility, uncertainty and the question of where interest rates should be – presents challenges, we believe it is important to look beyond the noise to identify the opportunities in fixed income. We also want to stay flexible to be in a position to invest when the timing is right. The need for skilled investment decision-making in fixed income is particularly acute at this stage of the economic cycle.

Corporate bonds: An inherent hedge?

Investment grade corporate bonds provide natural diversification benefits due to their separate interest rate and credit spread components.

Credit spreads and interest rates typically move in opposite directions, providing a hedge against market movements. For instance, while credit spreads may be expected to widen during a recessionary period as company fundamentals deteriorate, we would normally expect this to be offset by a fall in government bond yields as markets anticipate a cut in interest rates to boost growth. We believe these separate interest rate and spread components can provide a more diversified source of returns throughout the economic cycle.

The asset class has been on quite a journey over the last decade or so with periods such as the Global Financial Crisis, where duration was an investor's friend, but credit spreads blew out massively and owning credit risk was perceived to be dangerous.

We saw a similar environment in 2020 as the COVID-19 crisis generated a huge amount of uncertainty around how companies would fare; spreads blew out, yields came down and there was an inverse correlation between the two. Conversely, 2022 saw spreads moving wider and yields moving up as well, creating a tough environment for fixed income. We have since had a much friendlier tailwind during 2023 with a huge amount of opportunity to differentiate between those two income streams in credit.

Furthermore, as valuations reprice higher, there is an inbuilt level of protection where yields can rise without a bond investor losing money. As an income producing asset class, prices can fall by the same amount as the income to effectively cover yourself. This is known as a corporate bond breakeven.

With yield and spread curves both flat currently, risk-adjusted returns continue to look more favourable at the shorter end at present.

Be prepared – and stay nimble

Markets are not static; valuations change and continuously reprice. As such while we cannot forecast the future, we can only dispassionately assess valuations today and how much we will be compensated for taking risk. This can act as an important steer as to which segments of the market are attractive.

Markets are not stable, and liquidity is ephemeral; the recent swim into the marketplace has driven spreads tighter, with B- and BB-rated credit at levels we have only seen a few times since the financial crisis.

However, credit spreads can, and do, move aggressively and often without warning. While this can be concerning, we believe this is the prime time when active management pays as cheap markets do not sell off, but expensive markets do; all it takes is a catalyst which the market often fails to see. As such, having the flexibility and foresight to be able to retrench from that risk allows you to take the risk on again when you are in a position to be paid for it.

The most important factor is protecting yourself such that you can come back out to play. The last man standing in the marketplace can capture the

'Credit spreads can, and do, move aggressively and often without warning: the prime time when active management pays.'

bargains. In this scenario, having a fundamental credit research team is essential to identify the most compelling opportunities across global credit markets.

The differentiators

We maintain a positive outlook for fixed income markets as we move further into 2024, with the end of the interest rate hiking cycle offering a strong tailwind for the asset class. However, there continue to be significant risks, including potentially stickier than expected inflation, recession, shockwaves from elections and supply and demand dynamics.

In this environment, we believe flexibility and active management will be a differentiator to capitalise on attractive opportunities. Furthermore, agility and fundamental research will be increasingly important to avoid the pitfalls such a volatile market can bring, maintaining the ability to deploy capital when the risk/return pay-off arises once more.

The investment grade (IG) bond market has expanded over the past decade to provide a broader and deeper opportunity set for active managers to invest in, with high-quality IG companies strong enough to weather a potential economic downturn. The concentration of BBB-rated bonds means there is a high level of dispersion for active managers to take advantage of market mispricing, while corporate bonds themselves offer an inherent hedge against potential downturns, in our view. ◻

PRIVATE MARKETS

EVALUATING RISK AND REWARD *in an ever-changing world*

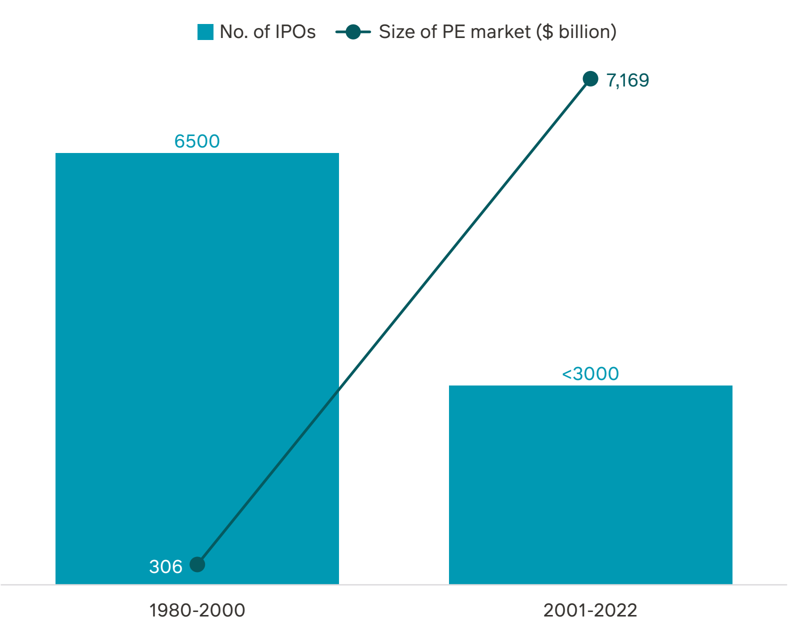
Private markets have grown exponentially since the Global Financial Crisis as investors have increasingly been drawn to the potential for higher returns compared to traditional public markets, as well as diversification benefits. Here, Alex Rolandi explores the risks and rewards that this often complex world may present, and why expertise is crucial in order to achieve tangible results as the evolving democratisation of private asset classes opens the doors for a wider investor base.

Stock exchanges have been steadily decreasing in size over the last several decades. In the US – widely considered the home of publicly traded companies – the number of listed firms peaked at over 8,000 in 1996, but by 2019 that number had shrunk by nearly 50%[1]. The UK has followed a similar trend, where there are less than 2,000 listed companies on the main market of the London Stock Exchange compared with 4,400 in the early 1960s[2].

Many businesses are choosing to stay private for longer due to complexities in the listing process, but an increasing pool of capital also means they are finding it easier to raise significant funds allowing them to grow without the need to list and face the rigid regulatory requirements and scrutiny of the public realm. As a result, private markets are often an incubator for new and disruptive business models, providing investors with the chance to tap into the next generation of enterprise and unleash innovation.

According to EY estimates, 75% of global companies that generate at least $1 billion in annual revenue are privately owned[3]. By the time these firms even consider listing there is a good chance that their strongest growth years are behind them.

Level of IPOs has halved



Source: Nasdaq August 2022 (latest available data). 'As Companies Stay Private Longer, Advisors Need Access to Private Markets', McKinsey Annual Private Markets Review.

'Investors are increasingly wanting to allocate to assets that can offer optimal performance, but aligning investments to a moral compass has also become more important.'

The private markets growth story is far from over. Indeed, private assets are forecast to reach $29 trillion by 2027, up from $20 trillion in 2022[4], driven in part by the shifting sands between the public and private realms. As this tendency to stay private for longer continues, an enlarging opportunity set – across private debt, private equity and real assets in particular – is emerging for investors beyond the public eye.

A different premium

Investor appetite for private assets has been driven by the quest for potentially higher returns compared to traditional markets, a need for diversification amidst challenging economic conditions, as well as the possibility of aligning portfolios with sustainability considerations.

Data from Cambridge Associates shows that US private equity produced a 13.8% annual return in the 25 years to the second half of 2022. By contrast, the S&P 500 managed 8.3% and the Nasdaq composite achieved 10.4% respectively over that timeframe[5].

Since the lows following the Global Financial Crisis, private markets generally enjoyed strong tailwinds in an era of lower-for-longer rates, consistently rising valuations, and high credit availability. The status quo shifted again in 2022 as higher inflation and interest rates set in, and geopolitical headwinds developed, but wherever there are challenges, potential opportunities can still be found.

Regardless of the changing macroeconomic backdrop, we believe private assets have tended to outperform their publicly-traded counterparts over the longer-term. This outperformance can be put down to two key drivers: the 'illiquidity' and 'complexity' premiums.

The lack of liquidity may be seen as a risk factor for certain types of investor profiles, as investing in private markets tends to require locking up funds for extended periods of time. Nevertheless, investors may have historically been compensated with higher returns in exchange for committing this 'patient' capital, in our view.

The complexity premium revolves around the skill-intensive nature of sourcing, analysing and managing private assets. Knowledge and relationships are key in what can often appear to be an opaque world. Deals require structuring and engaging with company management of these assets to achieve better outcomes, and not every investor has the capacity to do so.

Meanwhile, the inherent exposure to assets that carry the potential to address key global issues may promote a sense of ownership for investors concerned about how their capital is being put to use. Many of the world's most pressing challenges such as halting climate change, improving energy efficiency, embracing a circular economy and improving social mobility, are being tackled by private companies and projects.

Early-stage access to these potential opportunities is mostly confined to private markets, where innovation is more likely to be driven by smaller companies with new technologies or ideas, and private capital may provide the necessary resources to drive their transformational growth.

"Investors are increasingly wanting to allocate to assets that can offer optimal performance, but aligning investments to a moral compass has also become more important," explains George Rooke, Investment Specialist, Alternatives. "Private assets may provide tangible and relatable examples that end investors can get to grips with."

Exploring mispriced mid-market risk

Without the right skillset, determining the value of private assets can be challenging, especially given the lack of transparency surrounding pricing compared to listed companies. Unlike public markets, which are prone to bouts of volatility throughout the economic cycle, private markets can often appear more stable. Despite the wealth of potential opportunities and diversification benefits available in private markets, the space requires a set of unique skills and resources to navigate risk, and these cannot be formed overnight. Expertise developed through time in the market and deep research capabilities are crucial to identify areas – in the mid-market particularly, where risk is often mispriced – which other investors may miss.

"In our experience, there are fewer investors looking into the mid-market space where transformation is driven, businesses scaled, and value created. For the next stage of a company's journey there remains a broad church of investors to whom these assets can be exited," says Rooke. "But there are risks to consider and these must be mitigated."

Indeed, while the mid-market may often be less explored, it could present a fertile ground for diligent investors looking to uncover mispriced risk and potentially take advantage of undervalued or overlooked assets. This might involve in-depth analysis of financial statements, assessing the capabilities of management teams, and a thorough understanding of market dynamics as well as the wider business landscape.

Scaling up the ecosystem

Developing sector-specific knowledge plays a crucial role in allowing investors to gain a competitive edge. Engagement is par for the course. By understanding the nuances of any particular industry in the context of an interconnected world, investors may be able to identify mispriced opportunities more effectively, as the knowledge that comes with specialisation enables them to identify potentially undervalued assets and business growth prospects.

As active investors, we engage with portfolio companies, often providing strategic guidance and operational support. There is a chance to build a network and cultivate strong relationships within the mid-market ecosystem. We believe investors who actively participate in management and decision-making processes may be able to unlock hidden value and mitigate risks within private markets, thereby enhancing the potential for higher returns. We believe a long-term view is necessary: by focusing on the intrinsic value of assets and their growth prospects, investors can ride out short-term volatility and capture the full value of their investments.

Through this deployment of patient capital, fund managers are able to help scale businesses in different ways such as through operational change, bolt-on transactions, platform development, and internationalisation. This can potentially lead to strong exits or refinancing situations that ensure deep sources of capital remain available to fund the next stage of a company or project, maintaining a continuous cycle of capital deployment and reinvestment that can help support growth and development across the private market ecosystem.

Financing growth in turbulent times

Multiple shocks to economic stability over the last four years have forced the world to think on its feet as various crises unfolded in real time. Meanwhile, dramatic fiscal and macro-prudential policy changes have been implemented as asset valuations have continued to fluctuate amid ongoing uncertainty. If there's one lesson that has been re-iterated in multiplicity over the last decade, it's that market conditions can change rapidly and without warning.

In an ever-changing world increasingly dominated by polarising politics, asset class resilience is an ever more appealing attribute for investors as geopolitical tensions develop. Adopting a flexible approach to investing could prove vital in navigating any further turbulence on the horizon.

'We believe investors who actively participate in management and decision-making processes may be able to unlock hidden value and mitigate risks within private markets, thereby enhancing the potential for higher returns.'

[1]The American Council for Capital Formation, 'The declining number of public companies and mandatory reporting requirements', (accf.org), 24 June 2022.
[2]Oxford Business Law Blog, 'Resuscitating the London Stock Exchange', 1 June 2022.
[3]EY, 'Are you harnessing the growth and resilience of private capital?', 21 August 2023.
[4]BCG, 'Global Asset Management Market Sizing', May 2023.
[5]Cambridge Associates, 'US PE/VC Benchmark Commentary: First Half 2022', January 2023.

‘In a changing world increasingly dominated by polarising politics, asset class resilience is an ever more appealing attribute for investors as geopolitical tensions develop.’

Banks retrenching (%)

Source: Oliver Wyman, Eurostat, AFME, SIFMA.

One particular segment of the private markets universe has managed to consistently prove its resilience in the face of adversity in recent times, offering the potential for diversified, stable income and uncorrelated returns. Once considered a niche asset class, private debt – which can encompass direct lending, leveraged loans, real estate debt and more – has gone from strength to strength, hitting $1.5 trillion assets under management by the end of 2022[6].

The asset class plays a fundamental role in financing companies through their growth cycle. Indeed, economic growth overall could be seen as contingent on this form of non-bank lending, particularly as banks retrench and companies are increasingly relying on private markets. The US has largely gone through this retrenchment cycle, with capital markets the first port of call for almost 80% of companies.

We therefore see more growth potential in European private debt where there is much more scope for bank retrenchment. Currently 70% of companies turn to banks first, but this is quickly changing. However, there are regional variations[7]. The UK is largely capital-markets driven, whereas the Nordics is much more bank driven. According to Preqin, European Private Debt is forecast to be the fastest growing regional segment of private debt[8].

“Private debt isn’t a monolith and has multiple access points ranging from investment grade to high yield, corporate to real assets, senior to junior,” notes Robert Scheer, Senior Direct Lending Originator at M&G Investments.

“But divisions between asset classes are not as distinct as many might lead you to believe. For example, there’s a continuum in the corporate credit space and a blurring of lines that is particularly heightened at this point of the cycle,” he adds.

[6]Broadridge, ‘Prism: Global Private Markets: Private Debt’, August 2023.
[7]McKinsey Annual Private Markets Review. Oliver Wyman, Eurostat, AFME, SIFMA.
[8]M&G, based on quant analysis of Preqin data, 2023.

This blurring of the lines means that companies can enjoy the flexibility of prepay ability, customisation and close relationships with lenders, as well as certainty of the execution of new deals, paid for through higher spreads. From an investor perspective you also need to look holistically across the spectrum from mid-cap to large-cap and liquid to illiquid private credit to source the best opportunities. This doesn't come overnight, access matters. Scale, tenure and on-the-ground presence is critical to sourcing and can only be built over time.

Meanwhile, despite the risks entailed – especially with the possibility of defaults on the horizon – investors may be able to take advantage of the return premium in private credit, where we believe potential yields of 8-10% are currently available[9], as well as diversification from public credit. The largely floating rate nature of the asset class could provide further stability in the face of uncertainty from an asset pricing perspective. Rising rates, whilst increasing yields available are also an area of consideration for investors because of the rising interest burdens they create. Interest cover ratios have come down for many companies, determining whether the meticulous stress tests undertaken prior to investment have worked.

"Private credit is sub-investment grade comprising asymmetric returns, so avoiding losers in the space is key given increased defaults are expected down the line. A credible workout capability and track record will contribute to this differentiation," highlights Scheer.

"Valuations are important, and scrutinising how managers are marking their positions to ensure distress isn't hidden. Our process is independent from a credit risk rating perspective and asset valuation perspective."

Winners and losers in a downturn

When hard times fall, it is often a question of sink or swim. When it comes to private equity, market downturns can widen the divide between the winners and losers.

Exit activity has declined significantly in recent times as global uncertainty took its toll on markets. In H1 2022, exit values fell by 45% following a bumper year in 2021 which was driven by record-high valuations creating the ideal environment for exits to take place. Throughout H1 2023, however, the downward trend continued as exit values fell by a further 32% overall, with IPO exit values experiencing the largest reduction (down 90% compared to 2021[10]).

> 'The very core of active investing is about being hands on and growing businesses.'

According to Broadridge, this is the main factor of falling total exit value, with 2023 seeing less than 2,500 deals compared to more than 6,000 in 2021.

Private equity assets continued to rise in 2023, reaching $10 trillion. In this challenging environment, a landscape defined by multiple headwinds, going back to the basics of the asset class could be vital in terms of good deal sourcing.

The prolonged era of artificially low interest rates is over, for now, and money is not cheap anymore. These are hard times: the cost of living crisis has impacted many businesses and people's lives. Unfortunately, many businesses lack the robust fundamentals necessary to stay afloat amidst a turbulent macroeconomic backdrop, while others with precarious business models could still struggle to survive even with the support of distressed debt or rescue finance. When faced with these conditions, private equity investors need to make well-researched decisions to separate the wheat from the chaff as the divide widens between the winners and losers the longer any economic – and geopolitical – instability endures.

There are headwinds, the outlook is uncertain, many unknown challenges are hidden just over the horizon – but now is an optimal moment for active investors to thrive and find potential deals within private equity that may not only survive volatility, but continue to shine even after the storm is long gone. We see through the noise. By actively seeking out the best of breed managers with a track record of driving transformative change for value creation, the current landscape still offers potential opportunities in private equity.

"This for me is the very core of active investing," says Rooke. "It's about being hands on and growing businesses."

In challenging times, private equity is arguably all the more important for businesses to survive and grow, especially those providing a product or service that can make a positive material difference in the world. Without that capital, there would be little hope for them to pull through.

Although fundraising has struggled to surpass the record highs of the post-COVID surge in 2021, private companies are still in need of capital – especially in a stricter lending environment – and a slowdown of rate hikes may support private equity fundraising down the line. Good deal sourcing remains crucial given money isn't cheap in the current environment, and a different set of core principles is at play compared to the previous 15 years with interest rates remaining higher for longer.

This presents a possible opportunity for investors to take a hands-on approach, reshaping companies, redefining strategic direction and employing financial and operational levers to set companies up for future growth. Access to this universe provides investors exposure to businesses of the future, many of which are well placed to help solve the challenges of our times, enabling them to drive transformation.

[9]M&G, illustrative as at January 2024. Target returns are not guaranteed. Subject to change.
[10]Broadridge, 'Prism: Global Private Markets: Private Equity', October 2023.

The acceleration in required real assets spending ensures a strong opportunity set over the long term

Digitisation

- Digital's key role in the economy offers major growth across sectors
- Data surge and network expansion present new opportunities

Food systems

- Food systems emit 1/3 of global GHGs, hiding $12T[11] in social, environmental costs
- Climate shifts push for sustainable food systems with vast investment needs
- Higher costs spotlight precision agriculture and tech innovations

Natural world

- Protecting ecosystems is vital for climate and economic health
- Policies aim to attract private funds to carbon and biodiversity markets
- Limited capital is allocated, with the expectations of a growing opportunity over time

Energy transition

- By 2030, energy transition investment needs to rise from $2T to $4.5T for net zero[12]
- Energy security concern and climate goals create a supportive backdrop
- Tech advances and policy aid in transport and heating decarbonisation

Accelerating real assets

The energy transition and other megatrends such as digitisation and food systems are driving the need for an acceleration in capital deployment.

Whether it's the impact of geopolitics, net-zero needs, or simply the recognition of ageing infrastructure, support for infrastructure and real assets spending is widespread. Governments have enacted meaningful policies to support investment, and corporates are increasingly entering into partnerships with knowledgeable capital providers to support their transition.

An increasing need to invest in real assets could ensure a strong opportunity set for years to come, in our view. After all, investing in real assets is fundamental to long-term societal development. Whilst the overall size of the opportunity set remains vast and supportive of returns, capital has not entered the asset class uniformly. In an environment of higher capital costs, it's increasingly important to select the right partners who can effectively drive operational value and source attractive assets.

We believe real assets have shown their strength through both the COVID-19 pandemic as well as recent macroeconomic shocks. In our view, revenues have been protected and, in some cases, grown either contractually or because the assets are providing essential services to their customers. This ability for real assets to pass through rising prices offers protection from any increases in capital cost. Nevertheless, carrying out stress tests is an essential element if investors are to make the most of the asset class's potential.

Meanwhile, the dynamics of high capital investment needs and specialist operational expertise are proliferating across a broader set of industries as they look to adapt to a changing world. Climate (adaptation, the energy transition and sustainable food systems), geopolitics (reshoring, energy and food security) and digitisation provide a need for businesses to seek investment to help them transition.

A more sustainable world

The selection of businesses available in private markets is broad, spanning multiple industries and sectors. Not only do these companies offer investors the possibility to harness higher, risk-adjusted returns that could outperform traditional public market investments, they could also contribute to building a more sustainable world. But without the capital to back them, many may struggle to scale up in order to make any tangible difference. Investment in private markets will play an increasingly crucial role in shaping how society develops over the long-term, in our view. There will be leaders and laggards.

Through private assets, the diligent investor may be able to capitalise on the new industrial revolution, focusing on climate and technological solutions seeking to decarbonise economies, thus creating new jobs and opportunities, driving the change needed to ensure a better future.

[11]Food and Land Use Coalition, September 2019.
[12]IEA, Net Zero by 2050 Roadmap, May 2021.

Accessing an evolving landscape

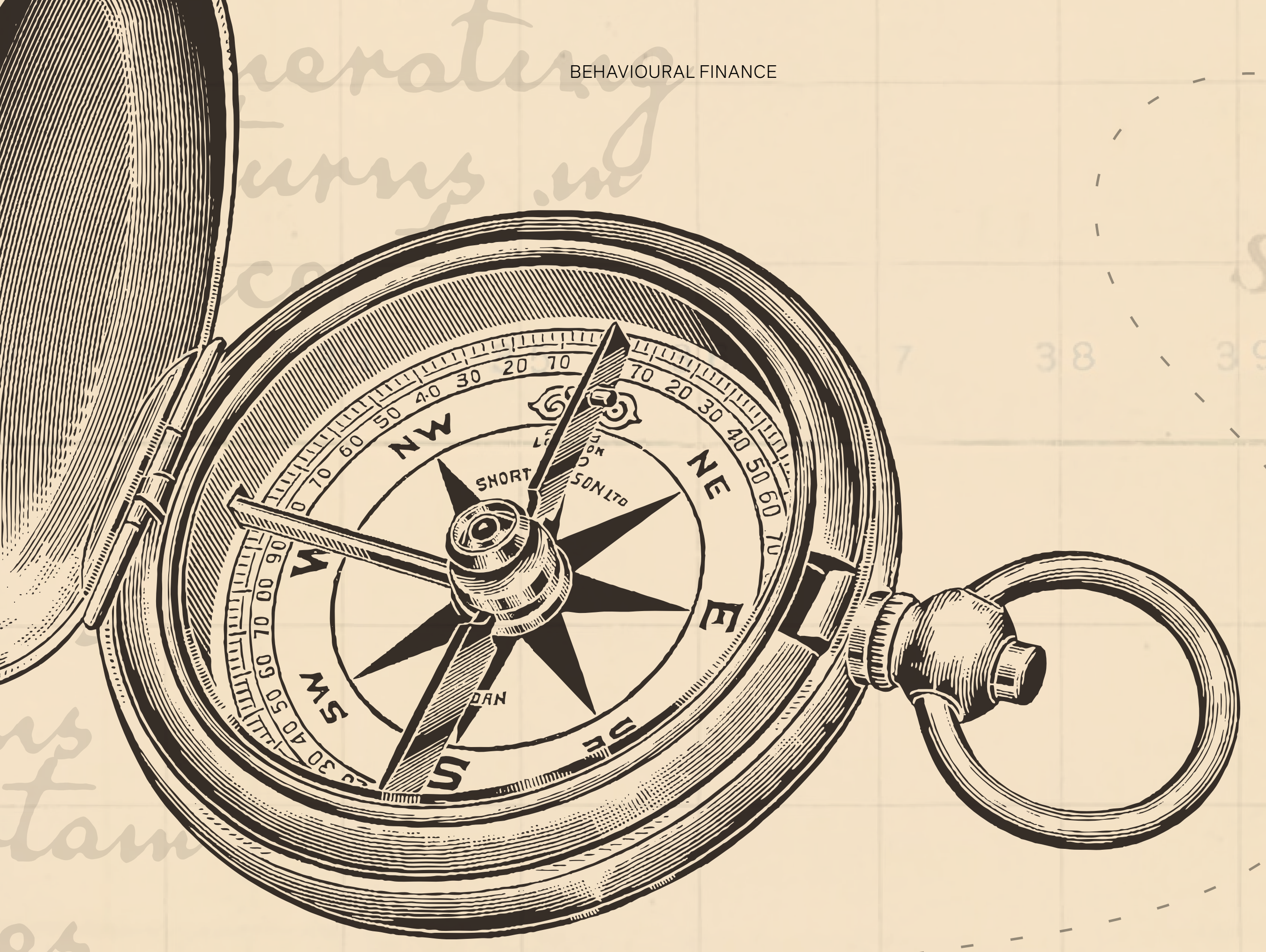
Gaining entry to this exciting space can seem challenging for many investors. By their nature, private markets appear opaque and difficult to access, especially given the liquidity restraints and perceived barriers to entry entailed.

Private assets can be more difficult to invest in, while the large number of different asset types available within the investable private markets universe adds to this complexity. As private markets have been largely inaccessible for many investors, they have gained an unwarranted reputation of lacking transparency. This is not the case. Where public disclosure is lacking, a closer relationship with borrowers allows better access to management information on the public side. This means there is a great level of transparency throughout the pre-investment process, which is supportive for decision-making, and also after the investment has taken place. But investors need to be in the flow, Rooke highlights.

"Getting in the flow is supported by having a track record of consistently deploying while also having a weight of capital from a differentiated source, so having patient capital at hand is beneficial," he explains.

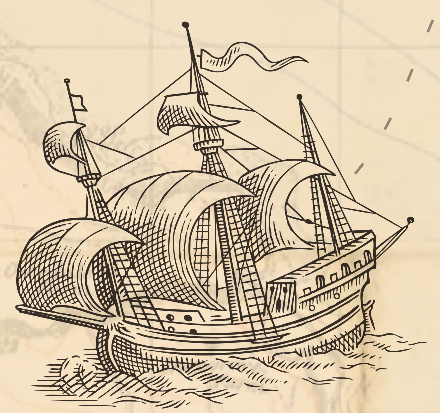
Connections are valuable, providing access to deal flow, information, capital, sector knowledge, and exit opportunities. But expertise is also crucial, as is meticulous risk evaluation and management.

The alternatives landscape – historically dominated by institutions such as endowments, sovereign wealth funds, and family offices – is continuing to evolve and accessibility is improving. The regulatory landscape is shifting with evolving regimes such as ELTIF 2.0 in Europe and the Long-Term Asset Fund in the UK. These are driving the creation of a greater number of semi-liquid vehicles and are therefore opening the doors to a broader investor base, enabling them to harness the innovation and yield potential of this expanding investment universe and fundamental engine of economic growth, in our view. ◻

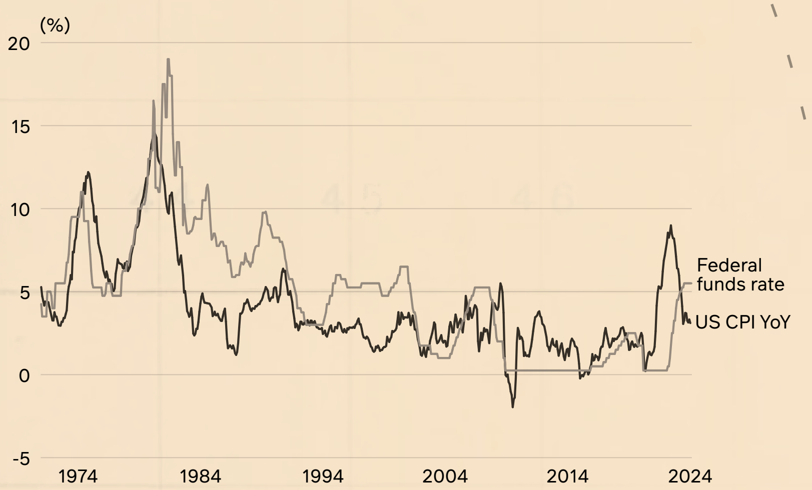


GENERATING RETURNS IN **UNCERTAIN REGIMES**

AS THE LAST FEW YEARS HAVE APTLY DEMONSTRATED, PANDEMICS, WARS AND WILDLY FLUCTUATING ECONOMIC VARIABLES SUCH AS SURGING INFLATION AND SWEEPING INTEREST RATE HIKES HAVE ALL CONTRIBUTED TO HEIGHTENED PERIODS OF UNCERTAINTY AND VOLATILITY IN FINANCIAL MARKETS, OFTEN AT THE EXPENSE OF PATIENT AND UNASSUMING LONG-TERM INVESTORS. STUART CANNING, FUND MANAGER IN M&G'S MULTI ASSET TEAM, ASSESSES THE VALUE OF DYNAMIC MULTI-ASSET ALLOCATION IN A WORLD OF SHIFTING EXPECTATIONS.

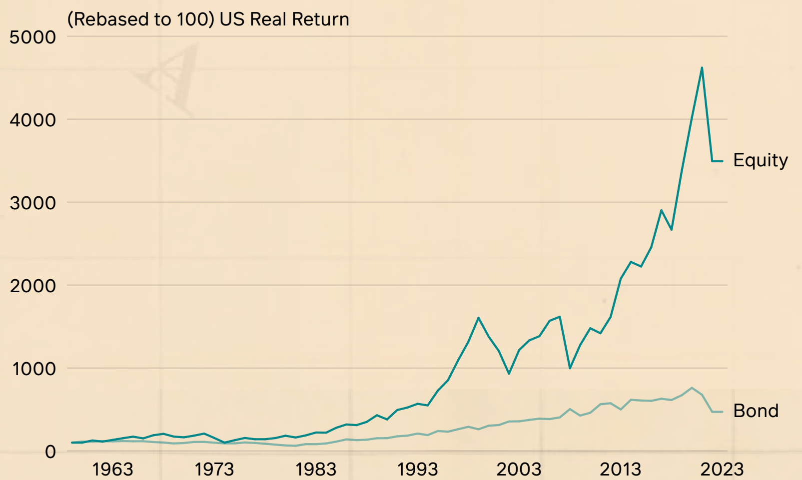


US policy rates and inflation



Source: M&G, 31 January 2024.

The wealth race: Bonds vs. Equities over 60 years



Source: M&G, 31 January 2024.

It is a truism that investors are always beset by uncertainty, but the post-pandemic period has brought uncertainty of a specific type: that of assessing the regime.

For the M&G Multi Asset team, the investment 'regime' refers to the general environment for long-term dynamics, such as inflation, policy and demographics. In today's environment, it necessitates asking the following questions:

- 'Is inflation high and unstable, or anchored?'
- 'Is there free trade between nations or are there impediments?'
- 'Is the environment supportive for companies to make profits, and return those profits to shareholders, or do incentives or the power of labour put a check on those forces?'

The answers to these questions have important implications for asset allocators. When the regime was one of high and rising inflation in the 1970s both equities and bonds delivered negative real returns (and often with positive short-term correlations). The notion of fixed income assets as safe havens in that period would have seemed a strange one to many.

By contrast, the transition to a low and stable inflation and rate regime led to strong gains from almost all major assets, as well as diversification when required. While it never felt like it at the time, particularly with financial crises and global pandemics, the regime has been very supportive during the working careers of many of today's investment professionals.

Swaying confidence

Last year demonstrated what happens when confidence in the regime is shaken. Uncertainty over whether we were entering a 'higher for longer' regime or not resulted in the biggest US bond market sell-off since the 19th century, according to a Bank of America research note[1], only for yields to almost entirely reverse course in the last two months of the year.

This volatility can be seen in the chart overleaf. The MOVE index, a measure of bond volatilty, remains highly elevated, at levels comparable to the sell-off from ultra-low yields immediately post-pandemic and the 2008 financial crisis. Focus on regime issues like the US fiscal position, the impact of spending to tackle climate and other issues in October 2023 quickly reverted to the usual guessing game of shorter-term cyclical dynamics, ie, how many cuts will the US Federal Reserve (Fed) make in 2024?

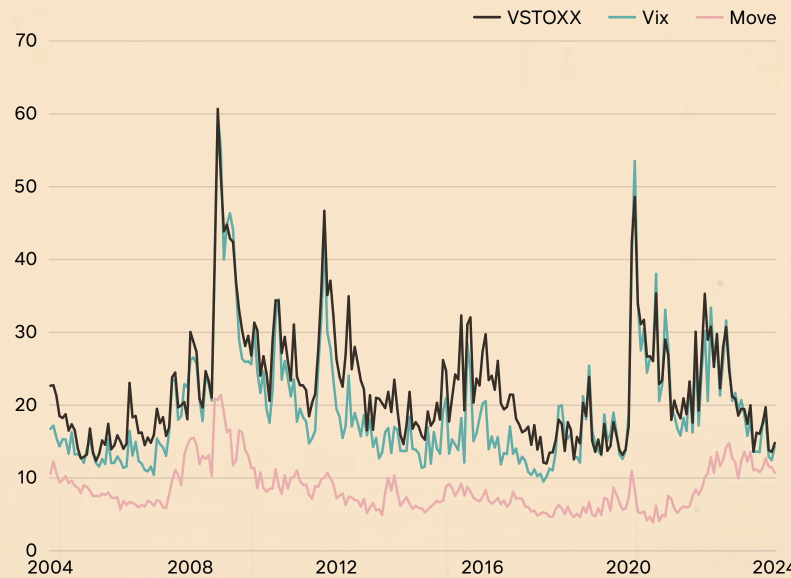
[1]Business Insider, 'The rout in US Treasurys is now the worst bond bear market of all time', (markets.businessinsider.com), 9 October 2023.

What is interesting against this backdrop has been the relative resilience of equity markets, and not just in the US (as illustrated by the Vix) where both delivered earnings and optimism about the future of AI (Artificial Intelligence) have dampened much possibility for price weakness, but also in Europe (as illustrated by the VSTOXX European volatility index).

Rising rates had a huge impact on the valuation of equities in 2022, but only briefly in Q3 2024. This is consistent with a view that, although there has been a lot of talk about regime change which has served to exacerbate the extent of bond volatility, most investors subconsciously feel that we will ultimately return to the 'low and stable' regime. This can be seen not only in the apparent stability in equity markets, but also the inverted yield curve in the US, and longer-term 'breakeven inflation', which has remained at around 2%.

Does last year's reversal in bonds and relative stability in equities mean the regime question was a false alarm and is now resolved? Almost certainly not; markets can take many years to acknowledge structural change and shake off old anchors and rules of thumb. Indeed, it took markets a long time to accept that we were in a low inflation world in the decade following the GFC, ushering in a period of stellar returns for fixed income assets.

Equity and bond volatility



Source: M&G, Bloomberg, 31 January 2024. *MOVE index divided by 10 to make units comparable with VIX.

The 'fair value' anchor

Faced with the uncertainty around regimes, volatility emerges because investors lose their sense of an anchor for where 'fair value' lies for an asset.

This challenge can create all kinds of mistakes. Human beings are averse to uncertainty and a sense of losing control. However, in many aspects of life, uncertainty can be reduced by collecting data, analysing it, and making predictions.

This is far less true in investment markets where the most meaningful information is available to all, where many outcomes are possible, and where investors seek to pre-empt each other's actions. It doesn't just matter what the facts say, but how others will interpret those facts.

As a result, investing is one area of our lives where gathering more information can be dangerous. It runs the risk of believing that we can be more certain than we actually are, and it is this overconfidence that arguably drives a large proportion of the bubbles and crashes that are still a hallmark of investment markets.

The last few years have been a classic example. When we think about the 'folly of forecasting' what comes to mind is often events that come out of the blue ('exogenous' shocks) – the COVID pandemic being a standout example. However, the dangers of forecasting also apply even when we don't have the excuse of an external shock. The failure of widespread and confident predictions of a recession in the US economy to materialise last year is well known. With hindsight, experts may talk of US government spending or excess savings as holding off the recession, but ultimately the failure is not one of a lack of information, but overconfidence.

Moreover, as we constantly emphasise, even if one's forecasts are correct, it doesn't mean asset prices will respond as one might expect. A host of economic contractions took place in 2023: Germany entered a recession early in the year, while the UK and Japan experienced these later in the year. However, this didn't stop the Japanese and German equity markets being among the strongest in the calendar year. Most bond markets also did well, though not because of the anticipated recession, but due to easing inflation pressures and attractive starting yields.

'Faced with the uncertainty around regimes, volatility emerges because investors lose their sense of an anchor for where 'fair value' lies for an asset.'

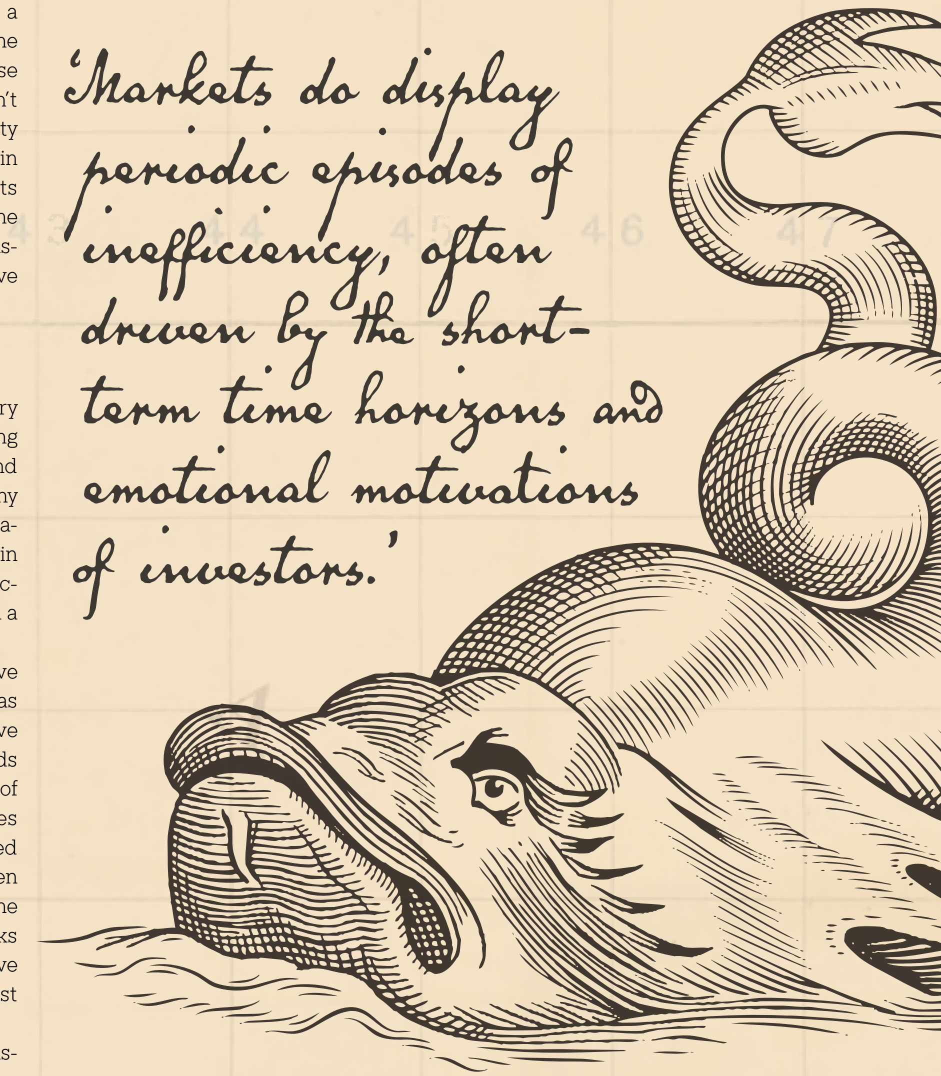
BEHAVIOURAL FINANCE

Dealing with uncertainty

Most sensible investors are very aware of the dangers of forecasting macro-economic fundamentals and the market gyrations that accompany them. This is why, despite the temptations to do otherwise, most believe in investing for the long-term and reducing the risks of having all your eggs in a single basket.

This forms the rationale for passive multi-asset investing. However, as the 1970s demonstrated, positive returns over significant time periods are not guaranteed, nor is the type of diversification across asset classes that people have become accustomed to in recent decades. Indeed, when the United States makes up 70% of the MSCI World, and the top ten stocks (all US) make up 20%, the passive option need not be the option that most spreads risk[2].

Most importantly though, while passive 'set and forget' asset allocations are almost certainly superior to trying to time every twist and turn of the market, they can be indifferent to the starting point of value, holding the same equity weight during the tech bubble as in 2009, or holding the same amount of bonds yielding 4% as they did when yields were zero.



'Markets do display periodic episodes of inefficiency, often driven by the short-term time horizons and emotional motivations of investors.'

The 'Episode' approach

The M&G Multi Asset team do believe there is a role for active asset allocation, and that significant flexibility is an important part of this.

Importantly their view is that markets do display periodic episodes of inefficiency, often driven by the short-term time horizons and emotional motivations of investors. That these emotional influences are no less evident in apparent experts is evident in the experiences of the last few years and the periodic booms and busts in asset prices. Nor does the rise of quantitative strategies seem to have driven greater market efficiency at a macro level; indeed, the rise of short-term trend following and the use of similar risk models and stop losses can arguably exacerbate excess short-term volatility.

This offers benefits to investors, who do not have to make a correct forecast of the future regime here and now, but rather, can watch the facts as they emerge and wait for the market to either deny them because they are anchored to the old regime, or ignore them because whatever is grabbing the headline that month is so much more salient. One didn't need to predict a coming regime of low and stable inflation in 1981, it was enough to see that there had already been a decade of lower rates by the late 1990s, and then be sceptical every time the market feared 'a return to the 1970s' or the impacts of 'excessive money printing' after the GFC.

Even better, with a clear framework it may be possible to enhance returns and reduce risk by taking advantage of the opportunities provided when markets swing from one overconfident view to the next – and compensate well for taking the other side. Responding to these short-term 'episodes' in markets has been a key part of the teams' approach for over two decades and were particularly valuable in COVID and its aftermath. More fears of regime change, and particularly a regime change itself, could create the type of volatility that is a positive for that type of approach. ◻

[2]MSCI, 'MSCI World Index (USD)', (MSCI.com), 31 January 2024.

CHARTING ASIA'S ASCENT

A burgeoning force in the global economic order

Asia's future looks bright. It has some of the world's fastest-growing economies and some of the most innovative companies globally. Dominic Howell caught up with David Perrett, Co-Head of Asia Pacific Equities, to discuss Asia's growing importance in the global economy – and why he is excited about the prospects for Asian equities.

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> 'The growing importance of Asia has been driven primarily by the emergence of China as an economic powerhouse.'

Over the past few decades, Asia has experienced a remarkable transformation. Dramatic economic growth has seen the region become an increasingly important part of the global economy. According to consultants McKinsey, Asia accounted for 57% of global growth between 2015 and 2021[1].

Asia is now a major player in world trade, a hub of innovation and cutting-edge technology and home to world-class brands. Significantly, the region's development has delivered a huge reduction in poverty. Rising wealth has also fuelled a massive increase in consumption.

[1]'Asia on the cusp of a new era', (mckinsey.com), September 2023.

The dragon re-awakens

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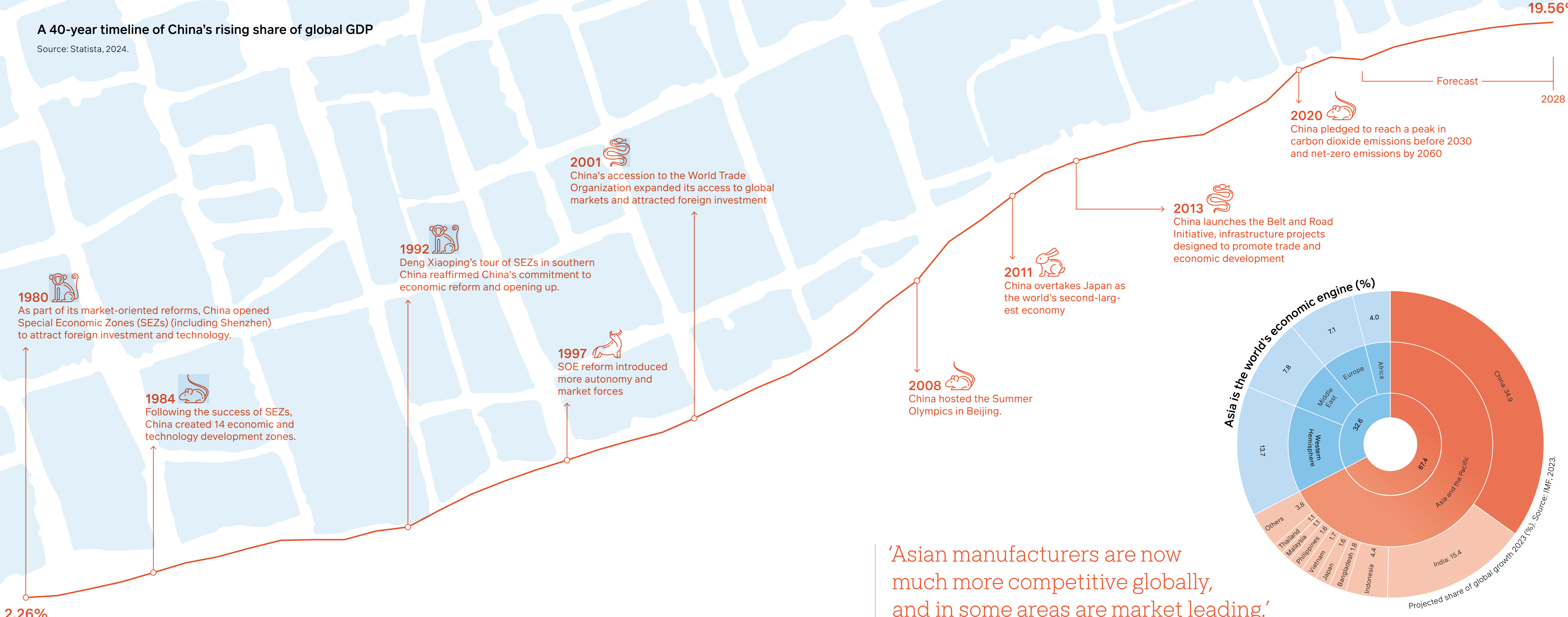
The growing importance of Asia has been driven primarily by the emergence of China as an economic powerhouse. The catalyst was arguably China's accession to the World Trade Organization in 2001. With greater access to global markets for its exports and increased foreign investment, China's economic growth accelerated in the 2000s and it quickly became one of the world's biggest economies.

David Perrett has been a keen observer of the changes that have taken place in China over this time. He first visited the country in 1993 when China was adapting to more market-orientated policies and the economy was already growing rapidly. "Thirty years ago, there were just a handful of listed companies in China," he says. "Today, China is the second-largest stock market in the world. More importantly, since then China has grown rapidly and is now the second-largest economy in the world and the dominant one in Asia."

China's ascent has arguably provided a boost to the rest of Asia by stimulating intra-region trade. Historically, Asia was dependent on the US as a destination for its exports, but that has changed. "The US remains important, but what's more significant is internal demand and growth within Asia itself," notes Perrett.

A 40-year timeline of China's rising share of global GDP

Source: Statista, 2024.



A promising future

While it has become Asia's largest economy, it is important to remember that there is much more to the continent than just China. The region comprises an extremely diverse range of dynamic economies with exciting prospects. There's India, the world's fifth-largest economy, South Korea and Taiwan, famed for their advanced technological enterprises, and rapidly developing nations like Indonesia, the Philippines and Vietnam, to name a few.

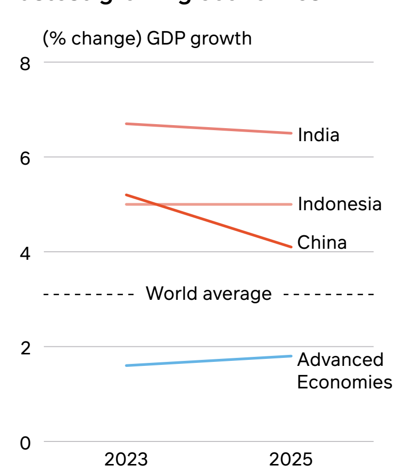
In its 2024 World Economic Outlook, the International Monetary Fund forecasts emerging and developing Asia to be the fastest-growing region globally in the next two years, with India and Indonesia leading the way[2].

Asia has made great progress in recent years, and its future looks just as promising. As the largest and most populous continent in world, with rapidly expanding economies, there are good reasons to expect that Asia will continue to grow in prominence. Thanks to positive demographic and economic trends, the 21st century has often been dubbed the 'Asian century'.

Labels aside, the ongoing rebalancing of the global economy from the West to the East in the coming years could be a compelling reason for long-term equity investors to look for opportunities in Asia.

[2]International Monetary Fund, 'World economic outlook update: Moderating inflation and steady growth open path to soft landing', (imf.org), January 2024.

Asia is home to the world's fastest-growing economies



Source: IMF, 2024

> 'Asian manufacturers are now much more competitive globally, and in some areas are market leading.'

'Smarter growth'

One of the big changes which Perrett has observed during his three decades investing in Asia is the continual improvement in technology and 'value add' within Asian manufacturing. "Some of the most cutting-edge technology firms are based in Asia, which wasn't the case 25 years ago. Asian manufacturers are now much more competitive globally, and in some areas are market leading," he observes.

Another development relates to the way companies are run. "We are finding that many Asian companies have a greater focus on profitability than in the past", a change Perrett refers to as 'smarter growth'. "Encouragingly, firms are increasingly recognising the importance of shareholder returns shown by the delivery of greater dividends and share buybacks".

According to Perrett, investors with a future focus should be excited by the fact that Asian companies appear well placed to benefit from the powerful structural trends in the region and are increasingly sharing this success with shareholders. Critically, many Asian companies now realise it is not just growth that matters, but it is profitable growth that is key to sustainable success.

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China's falling stock market

Past performance is not a guide to future performance.

Source: LSEG Datastream, 14 March 2024.

Has China fallen out of favour?

As the dominant economy in Asia, it is impossible to ignore China when considering investing in the region. However, it would be fair to say that a number of concerns about China have significantly dampened investor sentiment in recent years.

Disappointment that the economy didn't rebound as strongly as expected last year when China reopened after COVID-19 has fuelled worries about the macroeconomic outlook. However, investors' main concern about China's economy arguably relates to the troubled real estate sector. After years of debt-fuelled growth, rising prices and speculative investment, the property sector had become a major source of potential financial instability.

In 2020, policymakers stepped in to 'burst the property bubble' and stabilise the sector. "The process has been messy and painful and probably a lot worse than policymakers expected when they started", says Perrett. While the effects could be felt for another year or more, he is encouraged that "the biggest issue that investors were worried about is now being addressed."

Besides the macroeconomic outlook, ongoing geopolitical tensions with the US over issues such as trade and Taiwan are unsettling investors. These factors have added to investors' nervousness about Chinese policymaking, following unexpected government crackdowns on technology firms and education providers in recent years.

The result is that both overseas and domestic investors have become very cautious about Chinese equities. China's stock market has declined for three consecutive years and has lost $7 trillion in value since its peak in 2021. There have been numerous headlines describing China as 'uninvestable'. This situation is a stark contrast to the optimism seen a decade ago.

Opportunities amid uncertainty

While accepting there are risks associated with investing in China, Perrett suggests that investors' fears are creating attractive opportunities for selective, long-term investors.

"Valuations of Chinese stocks are currently extremely low, and we think some good businesses have been unfairly caught up in the negative sentiment," says Perrett.

In times of uncertainty, stocks often get sold indiscriminately across the board. In the current market, Perrett highlights stocks that are trading below the value of the net cash on their balance sheet, non-cyclical companies (not economically sensitive) with high dividend yields, as examples of companies that are being overlooked.

"We also see some excellent global companies, either globally competitive in China, or maybe even global companies that just happen to be listed in Hong Kong, that trade at huge discounts compared to their global peers. Given what is being priced in and the risk of ownership, we think there are plenty of interesting opportunities from a bottom-up point of view."

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"We think some good businesses have been unfairly caught up in the negative sentiment."

全球化的

Leading the energy transition

According to Perrett, the pre-occupation with the economic outlook is leading investors to overlook some of the long-term structural opportunities that exist in China. A key area is energy transition, where China is the global leader. "If the world is going to succeed in combatting climate change, Asia will be the key battleground," Perrett observes. "Very encouragingly, in 2020 China pledged a net-zero goal by 2060 and since then it has been investing heavily in renewables."

China's shift to a cleaner energy future is likely to present a number of opportunities in areas such as solar, wind power, electric vehicles (EVs) and supply chain management. The market already offers world-leading firms in environmentally friendly technologies such as solar panels and EVs, which will likely have a tangible impact on global markets over the next decade.

Perrett points to EV maker BYD, which is China's best-selling car brand and, in the final quarter of 2023, was the world's number one selling EV company, ahead of Tesla. "In other markets, these businesses would trade at much higher multiples but in China the macroeconomic concerns mean structural 'winners' are being thrown out with the bath water, " he comments.

Many investors have lost confidence in China and are hoping the government will take steps to support the economy and boost sentiment. Irrespective of whether policymakers introduce stimulus measures to revive confidence, as a patient stock picker, Perrett believes that China offers plenty of companies with exciting long-term prospects at attractive valuations.

Investors have flocked to India

Pivoting from China to India, the other economic powerhouse in the region, we find a very different picture. India has been extremely popular with investors and the stock market has soared in recent years. The country has experienced a decade of economic progress, modernisation and rising wealth since Narendra Modi became prime minister in 2014.

From an investment perspective, India offers a broad and deep opportunity set, spanning a wide range of sectors such as automotive, cement, hospital, infrastructure and financial services. However, at the present time finding value is more difficult as "the market has become expensive, particularly consumer-related stocks," according to Perrett.

Favourable demographics

In contrast, Indonesia is an interesting source of bottom-up ideas for Perrett. "This is a fast-growing economy with favourable demographics in terms of the young population," he says.

"We think the banks are well run and there is scope for credit growth as the economy develops. The country is also resource rich and strategically it is well placed between China and the US, which could be valuable diplomatically."

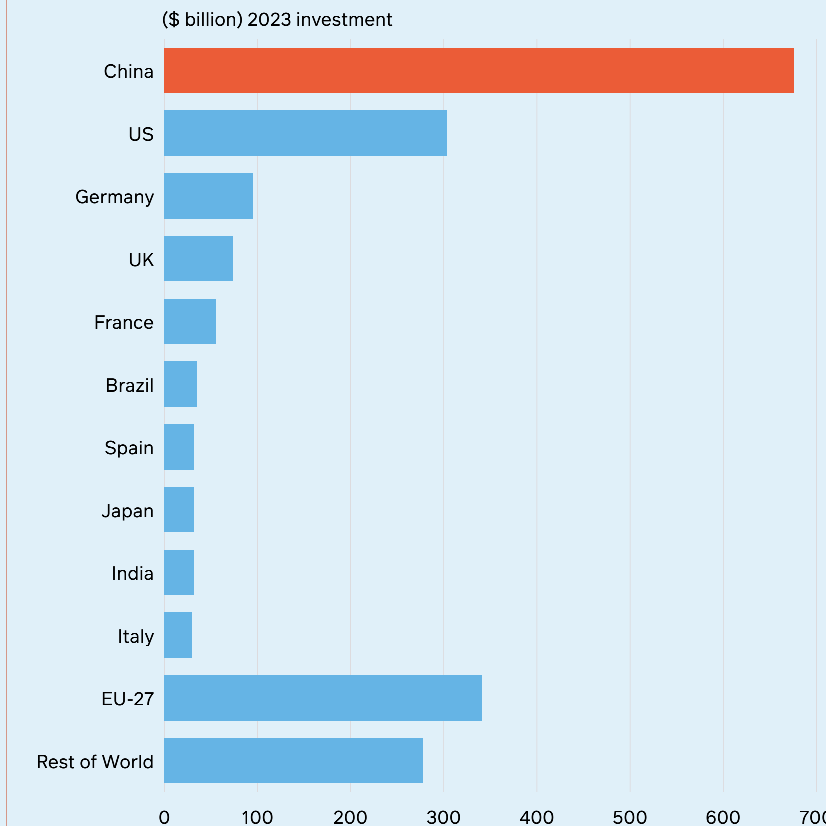
VAT: Value-added thinking

One of the most positive changes which Perrett has witnessed over the past decade in Asia is a shift among corporates towards becoming more open to engagement with shareholders, and a greater willingness to accept suggestions.

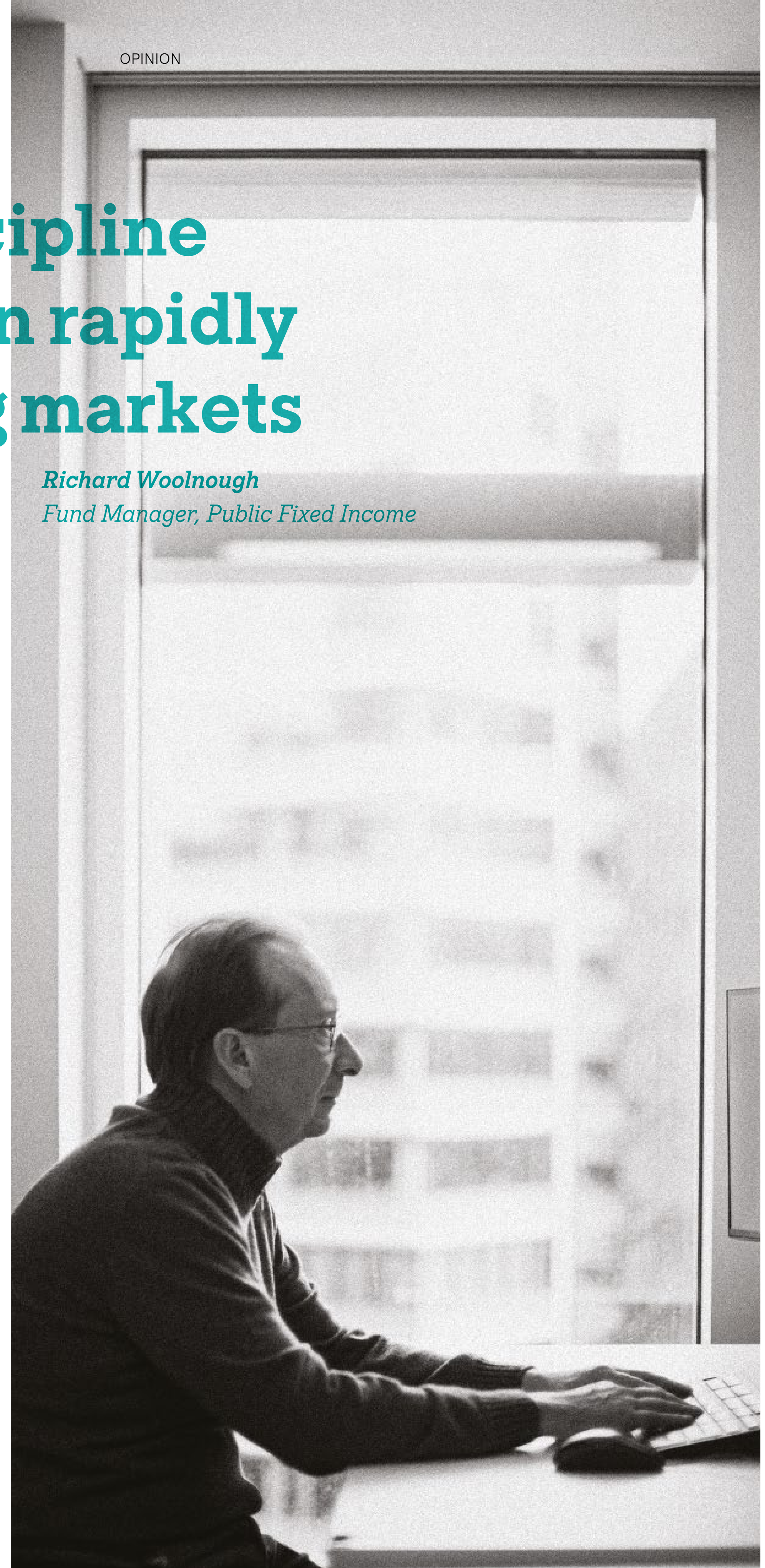
"By engaging respectfully as a long-term investment partner, it is possible to help firms improve in various ways, ranging from capital allocation to corporate governance or sustainability actions. We call this 'value-added shareholdership' and we think it can be a powerful way of adding value to our investments," he says.

Against a backdrop of dynamic economic growth and improving corporate behaviour, Perrett remains optimistic that the potential rewards for patient, engaged stock pickers in Asia in the coming years could be very exciting indeed. □

China is leading the energy transition



Source: BloombergNEF, January 2024.



Why discipline matters in rapidly changing markets

Richard Woolnough
Fund Manager, Public Fixed Income

In the 20 years that I have been working at M&G Investments, the financial system has markedly changed, as has the nature of bond markets. Unlike the equity market, which has essentially stayed static in its structure, bond markets have been dynamic, meaning that we are constantly learning as new opportunities present themselves.

While this is great because it means we can add value, what hasn't changed is our process, which is underlined by discipline. It drives our basic principle of getting involved in the market where we are being paid to take risk, but equally we are also happy to sit back and not get involved where we are not being paid.

Being disciplined is important because markets change rapidly – and even more so in a world driven by the constant 24/7 news cycle. Let's say we have an economic view that there isn't going to be a recession. For three months, the market may think that there's going to be a recession, and that interest rates will come down and credit spreads will go up as the probability of default increases. That is then followed by three months where the market thinks there isn't going to be a recession. For those three months, we look clever, but for the previous three months we looked foolish. While the market goes from panic to pleasure, from fear to greed, we try to stay a steady course.

Going against the grain

Our fundamental value anchors around credit, yields and interest rates – the things that effectively drive what we do – stay more or less consistent, it's the marketplace that doesn't. This is good for us as we don't want an efficient market.

If I were to give one piece of advice to an investor at the start of their career, or indeed anyone looking to find an edge, it would be to think for yourself. If you always follow the consensus of the market, then you will only ever deliver the market beta. In order to outperform, you need to be comfortable in having a view that is against the consensus. You need to trust your own judgment. You can't really do that when you are starting out though because you don't know if you have judgment. You only get it through experience and testing yourself.

Regardless of exactly what is happening in markets, when I come into the office my first job is to look at the structure of the portfolios that I manage to make sure they are positioned as I want them to be. I look at the UK and European bond markets in the morning and then move on to look at the US once it has opened in the afternoon. Our Emerging Market team also helps me stay on top of what is going on outside Developed Markets.

In the investment bunker

Throughout the day, I maintain a constant dialogue and interaction with the rest of the team. Everyone specialises in different areas, so talking to those who are strong in certain areas where there is action that day, or where I am worried about something, can be really helpful.

I like to think that there is no such thing as an 'older' or 'younger' guy on the team, as we are all learning together every day. I enjoy working with those who are a bit newer to the industry as they provide interesting ideas and are always prepared to challenge me. In a job like this you want to surround yourself with the kind of people who will point out the weaknesses in any argument.

I have always found it fascinating going along with our analysts to visit companies. We have some great analysts at M&G and I particularly enjoy watching them question company management. Often management will try to avoid certain questions, but the good analysts keep on asking if they don't get their answers, and watching them wheedle the information out of company management is always a treat.

'In order to outperform, you need to be comfortable in having a view that is against the consensus. You need to trust your own judgment.'

I find it really interesting when people in a given industry are challenged by those outside that industry. It can show how well people know their own businesses and, occasionally, can highlight where they are not being quite truthful.

This kind of challenge can be particularly interesting during the more difficult times, for example during the financial crisis. I used to enjoy challenging people in this way when I was an analyst, but I mostly leave it to the specialists now.

Career challenges

The financial crisis was probably the biggest challenge in my career so far. We were in unprecedented times and the challenge was to constantly keep thinking about things, re-evaluating and looking forward to see what would happen next. In fact, our portfolios did very well and the temptation, having had some good performance, was to close out all our positions and take everything neutral but that wouldn't have been the best thing to do for our clients.

As every month passed we thought that things had got as bad as they were going to get, but of course most of the time they hadn't. It was difficult but you had to keep forcing yourself to look forwards at what could come next and not back at what had been.

Some of my hardest moments have come more recently, as bond yields headed towards zero. As a value investor, this made life difficult as the opportunity to find mispricing in the market narrowed. However, after navigating through that tricky period, we now find ourselves back in a situation where fixed income has an attractive entry point in my opinion, and we can take advantage of dispersion in the markets.

The other big thing to have really changed in my two decades here at M&G is that some conversations have moved from the theoretical to the practical. In earlier days, when yields were at 3%, we talked about how they could theoretically go to 0%, and what we should do to protect ourselves in case that happened. Nowadays, we know from experience that yields can go to zero. So we also know that the upside is real not just theoretical. □

Investing towards the Paris Agreement? It’s more than just clean energy

You may associate investing towards the goals of the Paris Agreement with owning companies providing clean energy and climate technology, but this simply isn’t true. John William Olsen and Philip Kemp discuss how equity investors can contribute towards tackling climate change by holding a balanced portfolio of companies across sectors and industries.

We must first acknowledge the fact that achieving the goals of the Paris Agreement requires significant, absolute greenhouse gas (GHG) emission reductions. With this in mind, we believe investors must take a company-specific approach, with a focus on real-world outcomes.

Some approaches to alignment with the Paris Agreement focus solely on predetermined annual reductions to portfolio-level emission metrics, such as carbon intensity. However, prioritising such metrics above all else can be counterintuitive. For example, a fund manager could simply hold a portfolio of low-emitting companies, such as software developers, or gradually reduce their stake in the biggest emitter. While progress would look good on paper, this wouldn’t necessarily contribute towards the absolute emission reductions necessary to limit global temperature increases. The same level of emissions would still exist, but they would simply be outside of the fund.

We believe that a far more effective approach to alignment with the Paris Agreement is to focus on the concrete action being taken by individual companies. In particular, investing in companies that have set, or are in the process of setting, ambitious targets to reduce their own emissions, and/or those providing climate solutions that allow others to reduce their emissions.

‘We believe that a more effective approach is to focus on companies either reducing their own emissions or providing solutions for others to do so.’

Emission reduction targets

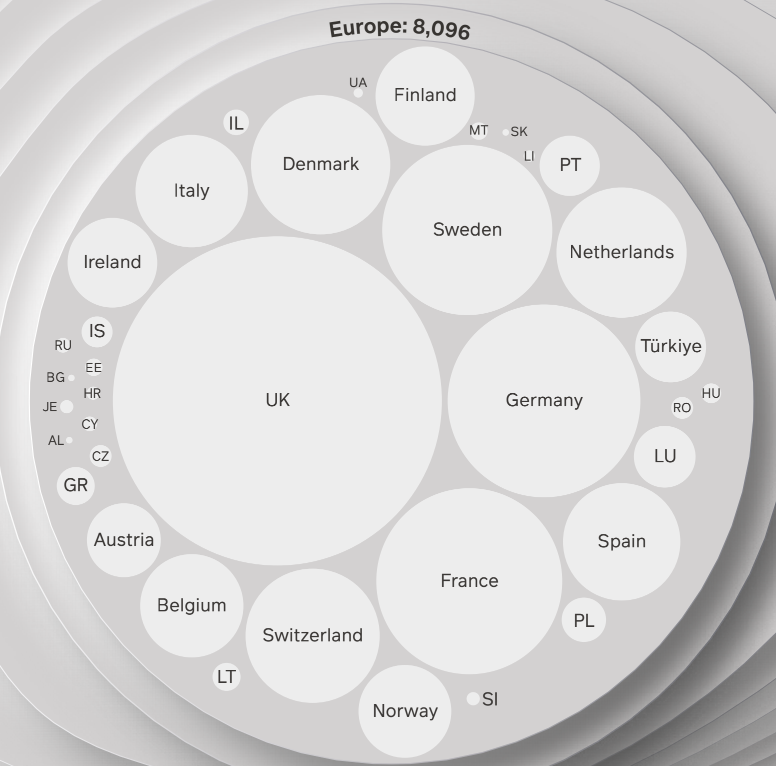
A good indication that a company is committed to the Paris Agreement is the setting of a science-based target. These are emission reduction targets, which are considered to be at a pace necessary to limit global warming to well below 2°C above pre-industrial levels, and ideally towards a 1.5°C target, in line with the goals of the agreement.

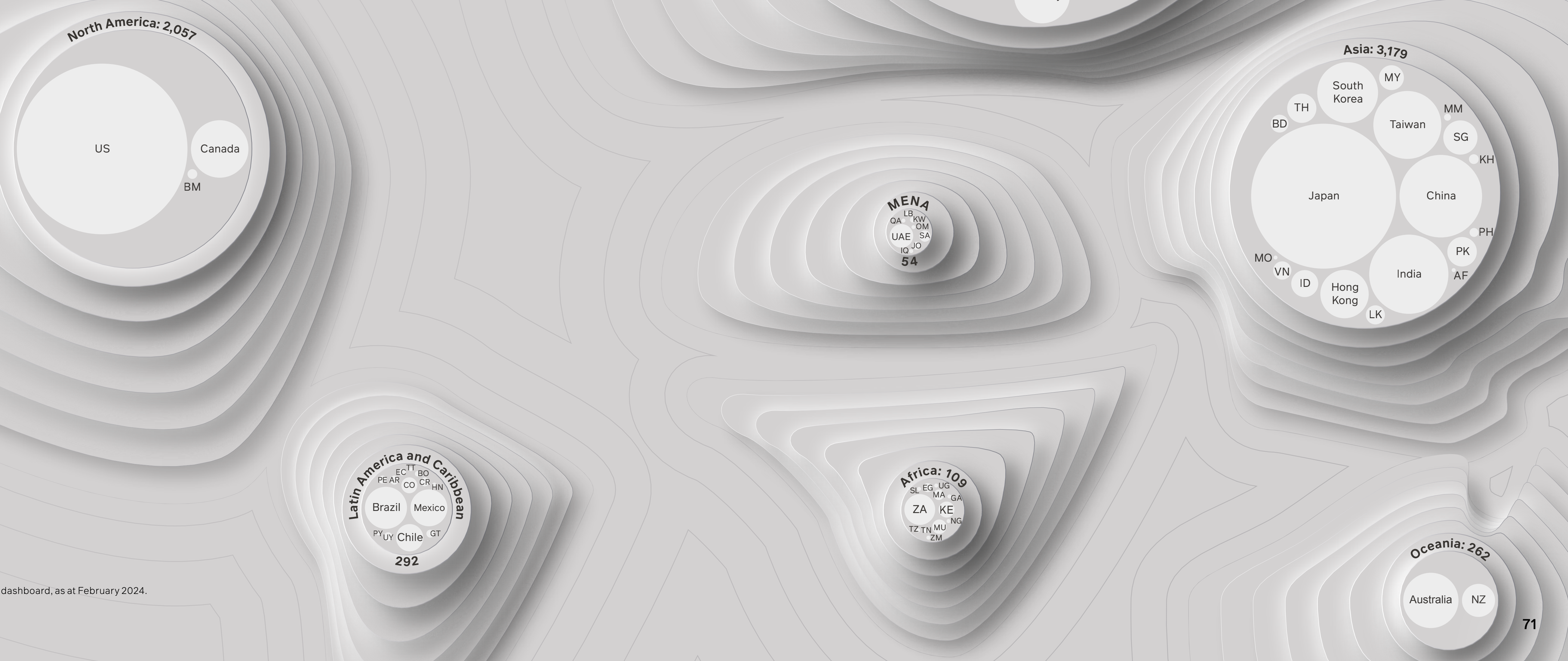
A widely accepted framework for assessing the validity of these targets is the Science Based Targets initiative (SBTi). Companies from a huge variety of sectors and geographical regions can set science-based targets, and on this page, we have highlighted the global footprint of every committed or ratified science-based target that has been set with the SBTi.

Targets are generally set with a baseline year, from which the company measures its progress, and a target year (usually between 2030 to 2050), by which the emission reductions must be achieved. The process of setting a science-based target usually involves developing a specific decarbonisation plan with actionable steps. Companies must then report on progress annually. These requirements help to ensure companies are committed to decarbonisation, rather than simply setting a distant target with little accountability.

'Investors can be confident that these companies are serious about reducing emissions, not just setting distant targets with no accountability.'

Science-based targets: **a global phenomenon**





14,000+

Science-based targets have been set globally

Source: Science Based Targets initiative dashboard, as at February 2024.

Case study
Novo Nordisk

Novo Nordisk, a Danish company specialising in diabetes and weight-loss medication, had its emission reduction targets ratified by the Science Based Targets initiative in 2018.

The company aims to reduce emissions from its own operations (also known as Scope 1 and 2 emissions) by 100% by the year 2030, in line with a 1.5°C temperature pathway.

To achieve this, the company aims to design its product ecosystem so that items can be recycled or re-used, minimise consumption and waste, and work with suppliers that share its commitment to decarbonisation.

Case study
Linde

Linde is a heavy-emitting producer of industrial gases, which helps its customers towards saving or avoiding an even greater amount of emissions. In 2022, the company generated almost 40 million tonnes of emissions through its own operations, but helped its customers to avoid approximately 90 million tonnes.

One of Linde's key climate solutions is the production of hydrogen. This is an alternative fuel that, when produced from renewables, is expected to become a clean energy source across a range of industries in the coming years. It has other well-established applications, including desulphurising highly pollutive diesel fuel.

Linde's other climate solutions include the production of oxygen gas, which helps to reduce energy use in the steelmaking industry, and the company's carbon-capture-and-storage solutions also help to decarbonise other industrial processes.

'Investors can hold a portfolio of companies that is balanced and fundamentally well diversified, while still contributing towards tackling climate change.'

Climate solutions providers

Some companies contribute towards the goals of the Paris Agreement by providing climate solutions. These companies provide products or services for their customers, that can help towards saving or avoiding emissions and reaching their decarbonisation goals.

Of course, companies involved in the production of renewable energy fall into this bucket by definition. By facilitating the integration of clean energy into the wider energy mix, they help to avoid millions of tonnes of emissions that would otherwise be generated by the burning of highly pollutive fossil fuels. However, emissions could be saved or avoided via a huge variety of products and services, such as:

- Cloud-based digital storage powered by renewables
- Automation and energy-saving products for buildings
- The re-use and recycling of food or industrial waste
- Sustainable shipping and logistics solutions

Building a balanced portfolio

Companies with science-based targets and those providing climate solutions can be found across all geographical regions and industries. They also exhibit different maturities of business model – ranging from small companies developing cutting-edge technologies, to stable, market-leading behemoths pouring significant investment into cutting their operational emissions.

While the former tend to be riskier investments than the latter, investors can ensure that both provide smoother contributions to overall risk by focusing on position sizing. In other words, by taking relatively larger positions in companies that are deemed to have less risk, and smaller positions in those where they foresee a wider range of potential outcomes. This helps to keep overall portfolio risk in check without hampering the ability to find opportunities in the market.

"Investors can hold a portfolio of companies that is balanced and fundamentally well diversified, while still contributing towards tackling climate change."

Importantly, companies within each of these different buckets will perform better or worse, in relative terms, during different market conditions. This means that investors can hold a portfolio of companies that is balanced and fundamentally well diversified, which could exhibit similar risk and return characteristics to the wider stock market, while still contributing towards tackling climate change. ☐

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