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M&G Investments

Quarterly Equities and Multi Asset Outlook

Landing in the dark

Q4 2023

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Landing in the dark

- As abhorrent as recent events in the Middle East have been, financial markets have, for now, taken these events in their stride, with some flight to safety in public markets, but fairly mild reactions overall.
- If the situation escalates, potentially from a declared or assumed involvement of Iran, it could lead to a tightening of oil export sanctions. Given the current tight supply/demand dynamics, this would put further upward pressure on oil prices.
- Investors remain focused on the impact of 'higher for longer' interest rates. Given elevated interest rates, expectations of further demand contraction appear logical due to higher financing costs affecting consumers and corporates.
- Amid rising equity risk premia, our Tactical Allocation Multi Asset strategies have reduced wider equity market exposure and added to fixed income.

The macroeconomic backdrop is proving more resilient than many had expected, particularly in the US, where higher interest rates have not affected many consumers and corporates yet. However, with excess savings falling and student loan repayments restarting in the US, we could see future erosion of disposable income. Amid rising equity risk premia, although we still see pockets of future positive performance in equities, we have turned more cautious on the overall equity market in the near term. Our Tactical Allocation Multi Asset strategies have reduced wider equity market exposure and added to fixed income.

Within equities, given the uncertain macroeconomic backdrop, we prefer investments where structural drivers are stronger than cyclical exposure, and continue to favour long-term themes such as infrastructure, the low-carbon ecosystem, and innovation, including AI. In the short term, the compression in performance differential in the recent sell-off potentially offers a fresh opportunity to harvest alpha from selection. With fears of 'higher for longer' rates bringing valuations of utilities and real estate companies to multi-year lows, we see a timely prospect to add to the infrastructure space. Elsewhere, long-forgotten to some investors in a low rate environment, convertible bonds (CBs) could be beneficiaries of a 'higher for longer' backdrop, with looming debt maturities and higher financing costs potentially prompting corporates to seek cheaper alternatives to straight bonds.

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

Changing market narratives

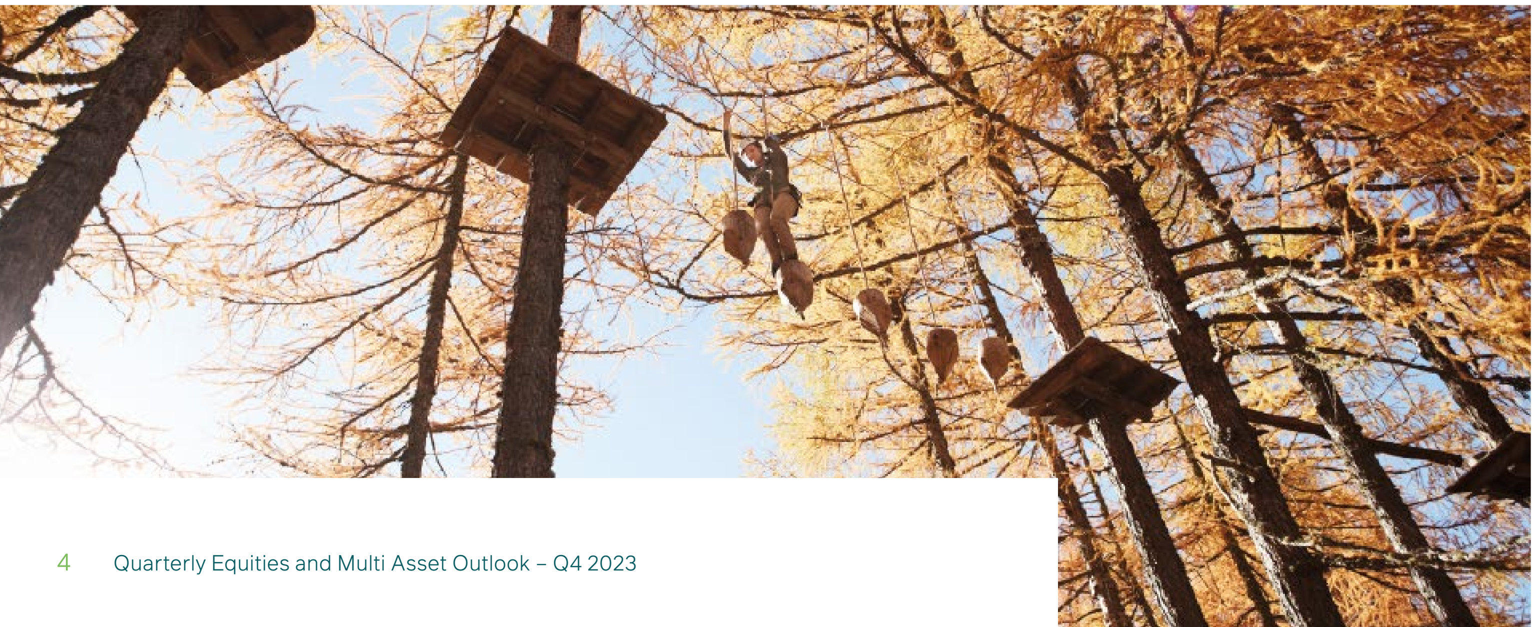
I had planned to start this Quarterly with a dive into the impact of 'higher for longer' and the odds of a recession. However, something more pressing needs to be acknowledged. The new quarter has begun with horrifying images from the Middle East. Our thoughts go out to those affected by such senseless violence.

As abhorrent as the recent events have been, financial markets, for now, have taken them in their stride. There has been some flight to safety in public markets with treasury yields declining, but overall markets have had fairly mild reactions, with many regional equity markets concluding the week following the start of the violence slightly higher.

Judging from their behaviour, investors appear to have taken the view that the events in Israel and Gaza are contained and there is no broader contagion. Should that change, the most likely and immediate impact could come from a declared or assumed involvement of Iran that could lead to a tightening of oil export sanctions. While there seem to be different estimates in the media, JP Morgan puts Iranian exports at 1.7mnb/d[1]. M&G Investments' Equity Research team believes that any decline in supply would have to be met mostly by Saudi Arabia. In our opinion, Saudi Arabia wants a higher oil price but not at the level of creating demand destruction and dragging the world into a recession. Hence, the country would be likely to reverse the most recent cuts and possibly add. That said, the current supply/demand situation is already tight, and we should expect oil prices to rise further. As of the time of writing, we have not seen any steps toward further Iranian oil sanctions but – as we know – the situation can change quickly.

While the Middle East is – rightly so – capturing our thoughts and news headlines, markets remain focused on a different topic. A quick check of Bloomberg's News Trends story count shows how topics such as recession and inflation, after peaking in the second half of 2022, are now back to early 2022 levels. The topic that is proving increasingly popular, unsurprisingly, is 'higher for longer'.

[1] Source: Bloomberg, October 2023.



Investors' realisation that 'higher for longer' interest rates are more of a reality than they previously thought is the most likely driver behind the declines that we have seen in most asset classes over August and September.

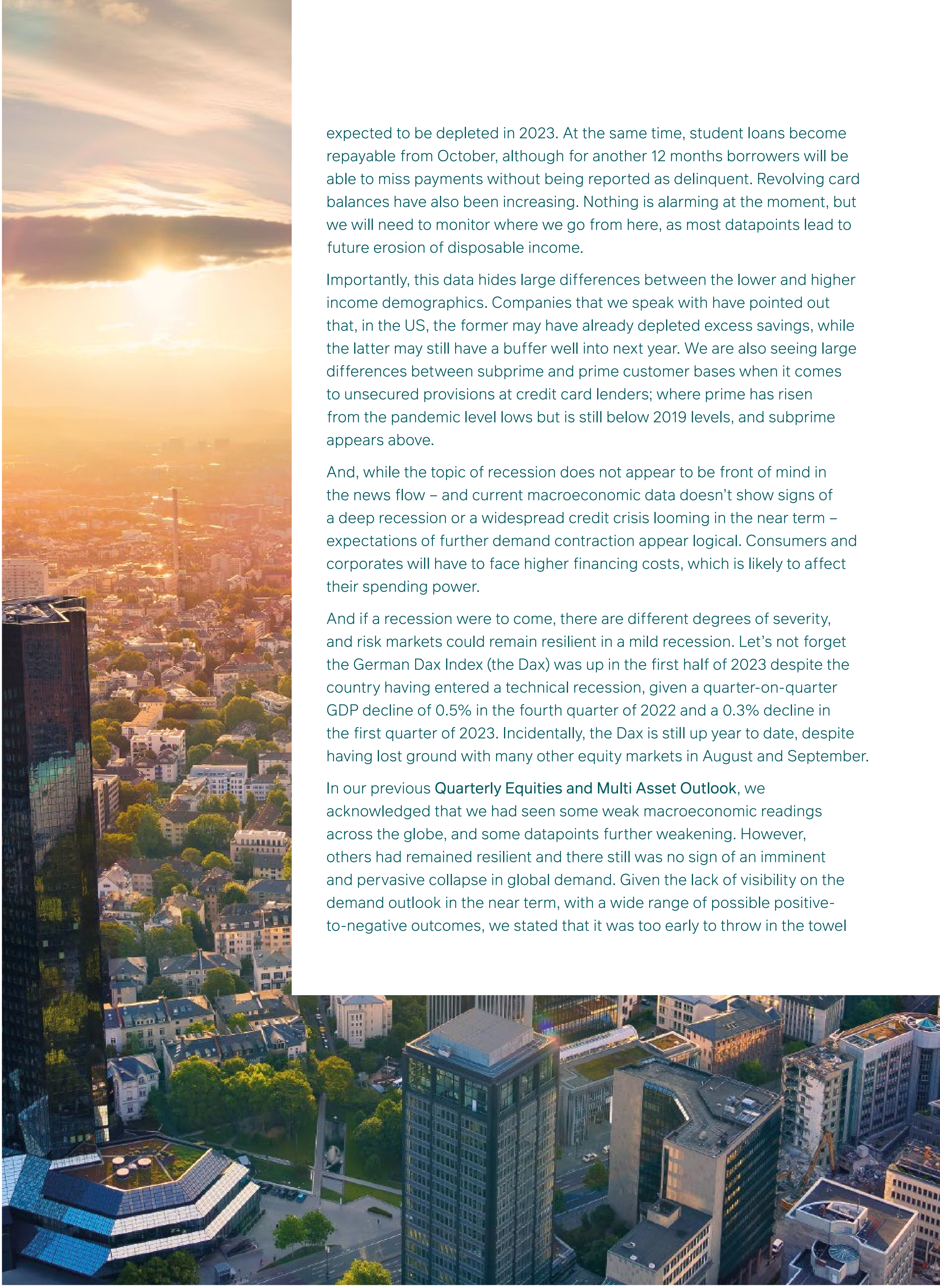
Pause, if not a stop

After having witnessed declines in the US, core inflation has also started to decline in the UK and in the Eurozone. It is, however, still high compared to central banks' targets, whether you believe that they are set in stone at 2% or somewhere under 3%. The big change has been the rapid rise in yields at the long end of the yield curve across both developed and emerging markets. The higher yields may be doing some of the tightening work for the Fed, the Bank of England (BoE) and the European Central Bank (ECB), and a pause from central bankers to monitor the impact of previous hikes on the economy is increasingly likely. Given the more rapid decline in US core inflation, the Fed may be the closest to the end of its rate hike cycle, with a declining chance of another rise, and most likely not, at the November meeting. That said, until either inflation moves closer to target or we see a very pronounced slowdown, central bank rates are unlikely to be cut to a level that would make markets more comfortable.

The elusive recession

Our investment teams meet regularly to discuss markets, each from the point of view of their different investment universes. One of the most heavily debated topics is that of the 'elusive recession'; or one that has been announced many times over the last year, but has yet to arrive. Indeed, the macroeconomic backdrop is proving more resilient than many had expected, particularly in the US. There is a valid explanation. The higher interest rates have not affected many consumers and corporates yet. In the US, many households are paying fixed long-term mortgage rates (unlike many UK households) and companies with longer refinancing schedules have yet to pay higher rates on their debt. That said, data from the Federal Reserve (the Fed) indicates that the pre-pandemic excess savings of US households are

> "We will need to monitor where we go from here, as most datapoints lead to future erosion of disposable income"



expected to be depleted in 2023. At the same time, student loans become repayable from October, although for another 12 months borrowers will be able to miss payments without being reported as delinquent. Revolving card balances have also been increasing. Nothing is alarming at the moment, but we will need to monitor where we go from here, as most datapoints lead to future erosion of disposable income.

Importantly, this data hides large differences between the lower and higher income demographics. Companies that we speak with have pointed out that, in the US, the former may have already depleted excess savings, while the latter may still have a buffer well into next year. We are also seeing large differences between subprime and prime customer bases when it comes to unsecured provisions at credit card lenders; where prime has risen from the pandemic level lows but is still below 2019 levels, and subprime appears above.

And, while the topic of recession does not appear to be front of mind in the news flow – and current macroeconomic data doesn't show signs of a deep recession or a widespread credit crisis looming in the near term – expectations of further demand contraction appear logical. Consumers and corporates will have to face higher financing costs, which is likely to affect their spending power.

And if a recession were to come, there are different degrees of severity, and risk markets could remain resilient in a mild recession. Let's not forget the German Dax Index (the Dax) was up in the first half of 2023 despite the country having entered a technical recession, given a quarter-on-quarter GDP decline of 0.5% in the fourth quarter of 2022 and a 0.3% decline in the first quarter of 2023. Incidentally, the Dax is still up year to date, despite having lost ground with many other equity markets in August and September.

In our previous Quarterly Equities and Multi Asset Outlook, we acknowledged that we had seen some weak macroeconomic readings across the globe, and some datapoints further weakening. However, others had remained resilient and there still was no sign of an imminent and pervasive collapse in global demand. Given the lack of visibility on the demand outlook in the near term, with a wide range of possible positive-to-negative outcomes, we stated that it was too early to throw in the towel on risk assets. Since then, from a macroeconomic standpoint, growth has remained feeble but has not collapsed.

More cautious

With real rates now in positive territory even in the US, equity risk premia have risen, putting pressure on equity markets. This could continue for a while, and, although we still see pockets of future positive performance in equities, we have turned more cautious on the overall equity market in the near term. Our Tactical Allocation Multi Asset strategies have reduced wider equity market exposure and added to fixed income.

We find the long end of the developed sovereign bond markets (including US, UK and German 10- and 30-year government debt) more attractive following the recent price sell off. It is always difficult to find the perfect entry point in the midst of market volatility. That said, with the Fed closer to the end of its hiking cycle, historically this has been a precursor of peak rates at the long end of the curve. The long end of the curve also serves as an 'insurance' should a macroeconomic slowdown ahead be more significant than the market expects.

To be clear, we are not running for the exit in equity markets. We still find attractive pockets (a gift that we often get from fearful markets) but selection remains key. Given the uncertain macroeconomic backdrop, in equities we prefer investments where structural drivers are stronger than cyclical exposure. We remain selective and high on the quality spectrum. We invest in companies with strong moats, pricing power, balance sheets and cashflow generation. We continue to favour structural long-term themes that should prevail, independent of near-term volatility; infrastructure, the low-carbon ecosystem and innovation, including AI.

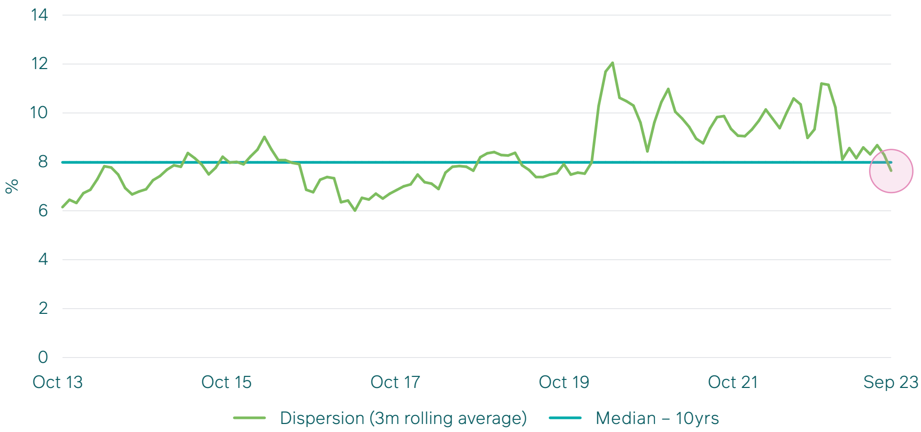
Importantly, we still don't believe this is the time to buy broad markets. As companies deal with a high interest rate (and a positive real rate) environment, weak demand, and relentless innovation, there will continue to be winners and losers. We think less and less in terms of buying whole sectors or countries. We need to go one layer deeper. This will appear very clear from our desks' insights on how they are navigating current markets.

> **“In equities, we prefer investments where structural drivers are stronger than cyclical exposure”**

Seeking opportunities when markets are fearful

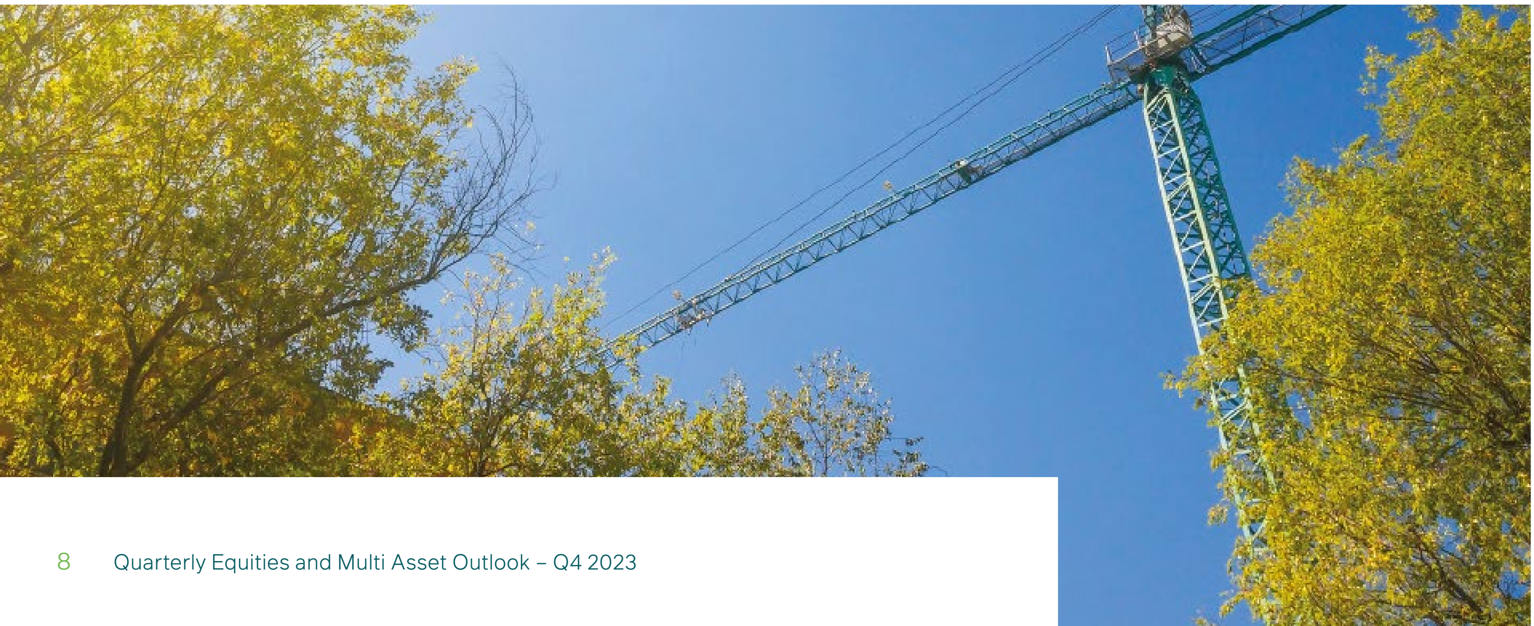
One change that we have witnessed in the August and September equity market sell off, is that after three years of equity return dispersion running above its 10-year median, we have seen a compression in performance differential. This, in our opinion, offers us a fresh opportunity to harvest alpha from selection.

Figure 1. MSCI AC World Index: Cross-sectional return dispersion (3m rolling average)



Source: M&G Investments, 30 September 2023. 3m rolling average stock return dispersion relative to 10-year median.

In particular, we see a timely prospect to add to the infrastructure space as the fears of 'higher for longer' have brought companies in the utilities and real estate space to multi-year valuation lows. For a number of these companies it is a case of the 'baby been thrown out with the bathwater' in the panic around so-called 'bond proxies'. However, many of these companies have solid balance sheets, with fixed rate debt, long-term maturities, cost pass-through in their pricing agreements, and many pay attractive dividends. As always, selection is key.



One final thought on a market that investors seem to have forgotten after years of low interest rates: Convertibles. Over the past fifteen years, lower rates meant that corporates could find attractive funding in straight bonds. Higher financing costs and looming debt maturities in 2025-26 across all types of issuers should force corporates to issue new debt and contemplate convertible bonds (CBs) as a cheaper alternative to straight bonds. Given the vastly larger size of the corporate debt market versus the convertibles market, it could mean additional CB issuance equivalent to the typical one-year run rate. This should offer more opportunities, particularly higher on the quality scale, as investors will have a wider choice of issuers to select from.

In the following pages, our Multi Asset and Equities teams will offer insights into how they are navigating markets as we all wait to understand where we will ultimately land.

I wish you a strong fourth quarter and a good close to 2023.

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

> **“Higher financing costs and looming debt maturities should force corporates to issue new debt and contemplate convertible bonds as a cheaper alternative to straight bonds”**

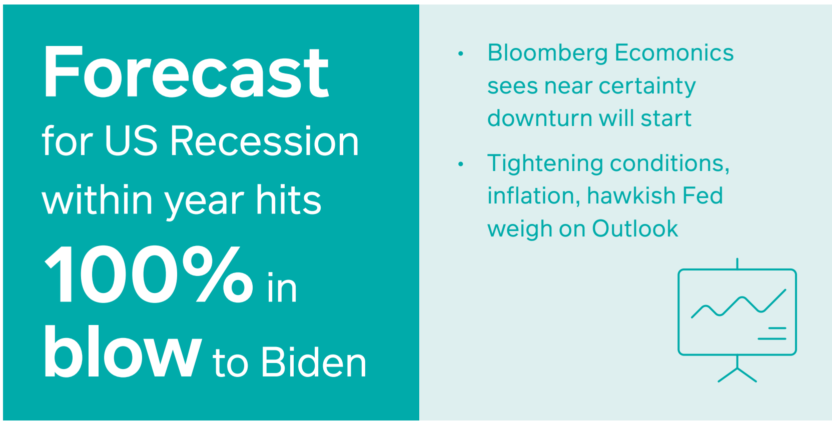
Multi Asset

Gautam Samarth
Fund Manager, Multi Asset

An Episode in developed market (DM) bonds

The ‘obvious’ recession

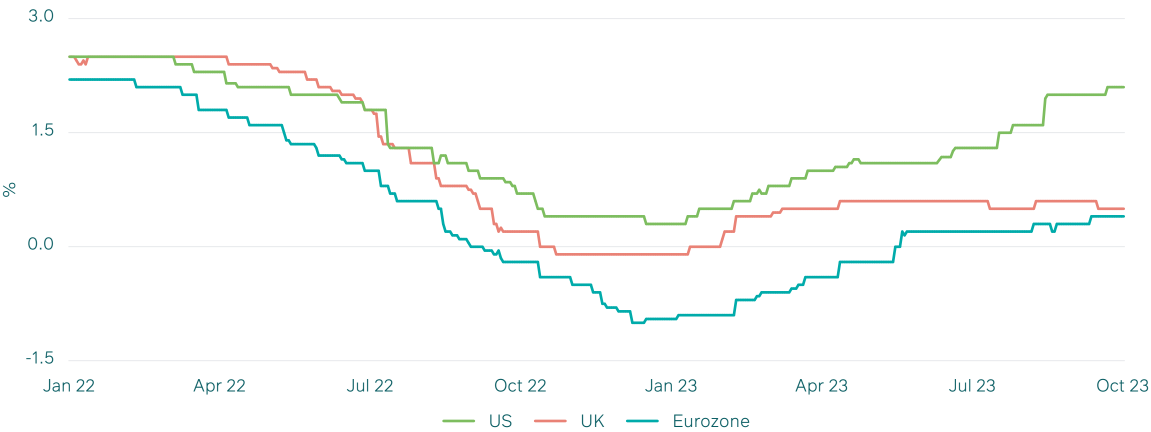
What a difference a year makes! Heading into the end of last year, many blue chip economists were forecasting a global recession in 2023. They argued that the global system wouldn’t be able to handle a surprise 500 basis point plus rise in interest rates. The below headline from 17 October 2022 highlights just how bearish sentiment was at the time, on the back of what had been an extremely damaging year for global assets.



Source: US Recession Forecast Within Year Hits 100% in Blow to Biden Before Midterms – Bloomberg.

As it turns out, the relative resilience of economies, especially the US, to interest rate hikes over the past year has caught many market strategists off guard. As the year progressed, we’ve been presented with data of moderating inflation (albeit still at uncomfortably high levels), a strong labour market and robust economic growth. It caused a slew of Wall Street economists to capitulate on their bearish views and revise up their 2023 growth forecasts.

Figure 2. Bloomberg Consensus 2023 GDP growth forecasts



Source: Bloomberg, 5 October 2023.

How did market participants get it so wrong?

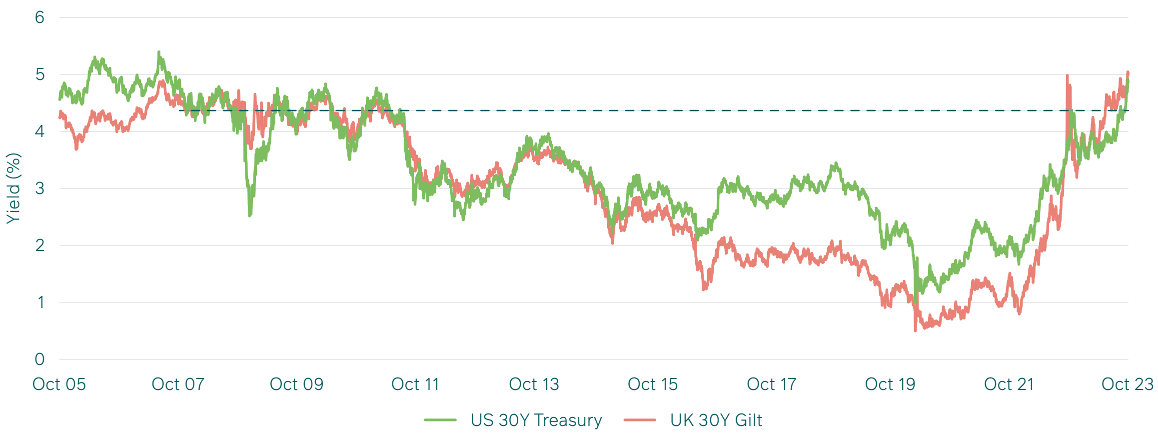
It remains to be seen whether the monetary tightening measures put in place by central banks do eventually tip the global economy into a recession. The reality is that economies are complex, dynamic systems and our ability to understand the interplay between key economic variables such as interest rates, aggregate demand and supply, and inflation is limited. We should not expect to be able to predict economic outcomes with a high degree of certainty and as such the 'error' lay in having such high conviction in a recession to begin with.

The opportunity in government bonds

Big shifts in underlying economic beliefs are often times accompanied by violent asset valuation shifts. We witnessed this in 2022 as the market reassessed its beliefs about inflation being a temporary phenomenon or 'transitory' to something much more enduring, causing a sharp adjustment across all financial assets. We are currently witnessing something similar, with the market seemingly latching on to the idea that interest rates remain elevated for an extended period of time. The move has taken bond yields in some developed markets to levels last witnessed prior to the Global Financial Crisis (GFC).

Past performance is not a guide to future performance.

Figure 3. Long-dated Developed Market (DM) bond yields: now at pre GFC levels



Source: Bloomberg, October 2023.

> [In reality], economies are complex, dynamic systems and our ability to understand the interplay between key economic variables...is limited

As mentioned earlier, such confidence in a particular economic outcome ('higher for longer' interest rates in this case) is generally misplaced, and such rapid price adjustments are often caused by behavioural factors (such as fear) rather than anything more fundamental. It remains just as likely today as it did a year ago that lagged effects of monetary policy start to cause stresses in the economy. Under such circumstances, long-dated DM debt could offer meaningful diversification. However, given recent price moves, and current levels of yield, they offer compelling value regardless, in our opinion.

Having been positioned relatively cautiously and carrying high cash balances through much of the year, our most flexible Multi Asset strategies have responded meaningfully to this episode. More specifically, these strategies have added significant duration through an increase in exposure to US 30-year treasuries, alongside initiating positions in 10-year gilts and 30-year bunds.

Global

Daniel White
Head of Global Equities

Fasten your seatbelts

My Bloomberg terminal informs me that the forecast probability of a US recession within the next 12 months currently stands at 55%. Although down from the recent peak of 65%, this remains elevated[2].

However, as often is the case, there appears to be a dissonance between forecasts and asset prices. Despite the recent pull back, the S&P 500 Index is up over 13.0% year to date[3]. Some European equity indices have performed similarly well, with the Eurostoxx 50 and MSCI EMU Indices up 13.4% and 11.0% respectively[4]. If we really are heading into some sort of slowdown, the market has become remarkably comfortable with the idea.

It would appear a 'soft landing', at least in the US, is increasingly the base-case for many investors.

Recent history

It's worth reminding ourselves that just over a year ago, FedEx – an economic bellwether – issued a sizeable profit warning, blaming signs of a global economic slowdown. This was so noteworthy we even wrote about it **here**.

How have FedEx's shares performed since their September 2022 profit warning? They're UP over 85%![5]

Whilst this share price performance may be surprising to many, it serves to highlight that investor expectations at the time were too bearish.

The global economy has undoubtedly ended up being more resilient than many expected. But as we wrote in our October 2022 publication, risks and uncertainties were 'beginning to create opportunities'. Twelve months ago we commented that 'the long-term risk/reward for certain parts of the market appear[ed] attractive'.

> **"If we really are heading into some sort of slowdown, the market has become remarkably comfortable with the idea"**

[2] Recessions have historically occurred once every seven years or so. Thus a 'baseline' probability of recession is about 15%.

[3] Source: Bloomberg, S&P 500 Index total returns in USD – data through 30 September 2023.

[4] Source: Bloomberg, Eurostoxx 50 and MSCI EMU Indices total returns in EUR – data through 30 September 2023.

[5] Source: Bloomberg, 16 September 2022 to 30 September 2023.

Turbulence

Fast forward to today. Whilst the market's 'soft landing' slowdown scenario is entirely plausible, it is not a certainty. There are a number of potential headwinds that could cause some turbulence for the US, and de facto, the global economy.

Consumers' excess savings, built up during the COVID era, are rapidly diminishing. The resumption of US student loan repayments will put incremental pressure on disposable incomes. Banks are tightening their lending criteria, at a time when customers are feeling the pinch from higher interest rates.

The United Auto Workers Union strike shows no sign of any immediate resolution, and while a government shutdown has been averted for now, the can has been kicked down the road rather than disposed of. Meanwhile, the ousting of the leader of the House of Representatives has further complicated the US political landscape.

Elsewhere, oil prices remain a wildcard, having crept back up towards $100 a barrel recently before falling back to around $80/barrel at the time of writing. Inflation has moderated but remains elevated, and the yield curve remains steeply inverted. Yet, rates across the curve have continued to march upwards. The market's 2022 'Fed Pivot' narrative has been replaced with a 2023 'Fed Pause' thesis.

This all paints a highly confusing and somewhat contradictory picture. And one that is arguably not reflected in the valuations or earnings estimates for many companies today.

We think it's the right time to exercise caution and remain selective. Trading on our global portfolios has been idiosyncratic. There has been no one particular theme or sector where we've seen increased opportunities or have reduced exposure. Stock specific purchases have included a French media conglomerate (in our Value strategies), and a unique infrastructure company with long concession, favourable regulation across key assets and good growth potential.

Ultimately, we favour idiosyncratic opportunities as opposed to the more macro sensitive names, and robust cash flows along with strong balance sheets rather than unsustainable cash burn and leverage.

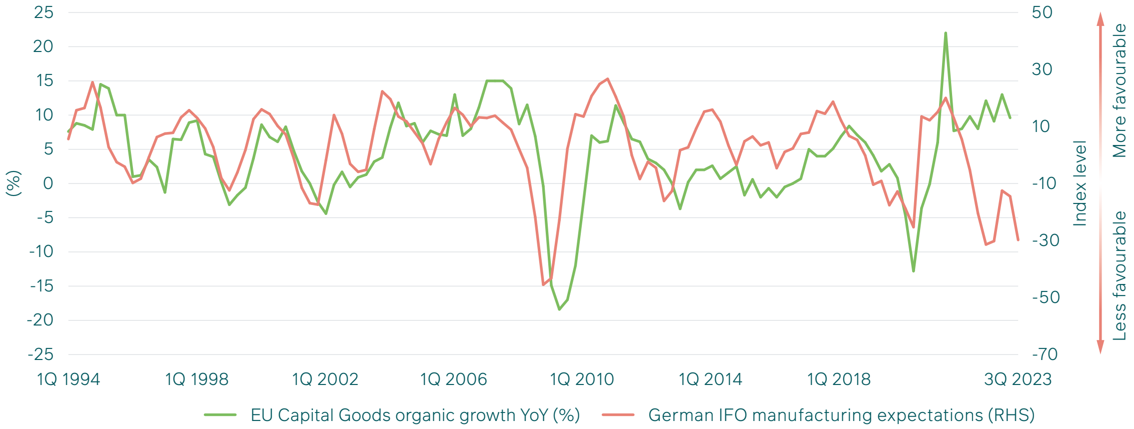
Research insights

Industrials: Earnings forecasts resilient despite weakening lead indicators

Mark Wilson, Global Industrials Analyst

There are numerous lead indicators at levels implying a recession is ahead. A number of companies already talk of materially weakened demand from post-COVID supply chain normalisation, and the tailwind from inflation-driven price recovery is well behind us. And yet earnings forecasts for the sector remain very resilient.

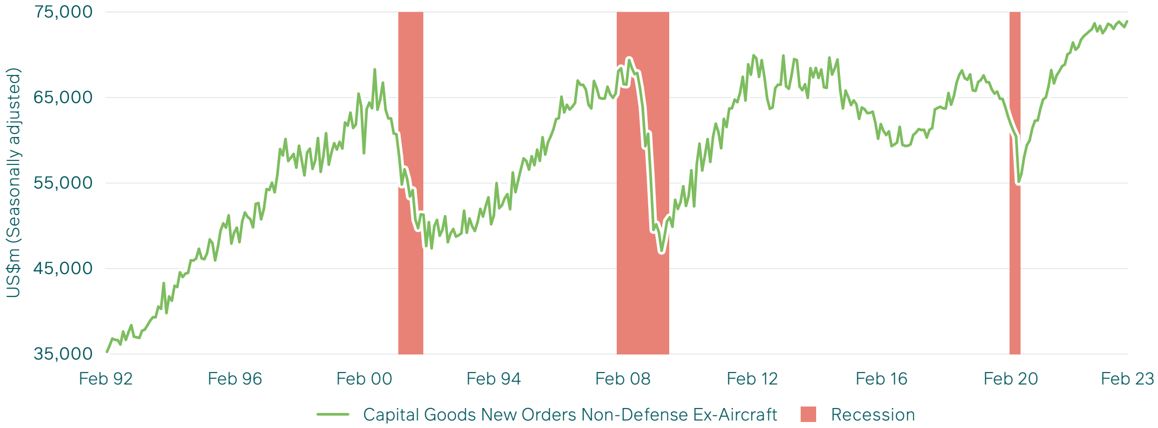
Figure 4. German IFO manufacturing expectations vs. EU capital goods organic growth (%YoY)



Source: Bloomberg, Data as at September 2023.

At the same time, some lead indicators are already looking less bad, and there are notable positive data points, with companies raising expectations into 2024, and all sorts of narrative to support that more positive outlook and earnings consensus.

Figure 5. US Capital Goods New Orders at all-time highs, beyond prior cycle peaks



Source: Bloomberg, 31 August 2023.

We don’t know the answer, but it’s hard to ignore bearish signals from near-term indicators with strong predictive track records. Like the excess savings helping consumers weather inflation, industrials have probably been helped by a brief period of pent-up demand from the supply chain bottlenecks post-COVID. Our fear is that many positive indicators are either backward looking, simply lagging the economy, or only a partial mitigation to the threat of broader slowdown.

But industrials is a heterogenous sector. There are always sub-industries more capable of side-stepping a downturn (such as aerospace and mining in this cycle), and there are always industries pricing in more weakness than their peers (freight operators, truck manufacturers and bearing companies spring to mind). We just have to continue to be careful in our choices and keep an eye on the longer term too. In a cyclical sector, periods of weakness can be brief, and can also provide good opportunities for investment in longer-term themes. The next ten years looks like they might be more exciting for industrial companies than the decade of balance-sheet repair and commodity busts we experienced post-GFC, with re-emphasis on local production, growing infrastructure investment in the US and Europe, and investment in de-carbonisation from copper mines to auto factories, to grid improvements and building energy efficiency. We take advantage of these longer-term structural tailwinds in a number of our global portfolios that are exposed to, for example, either providers of the technology (eg, e-mobility) or the infrastructure (eg, efficient resource management and recycling) to help the transition to a low-carbon global economy.

Retailers: Consumer resilience, but for how long?

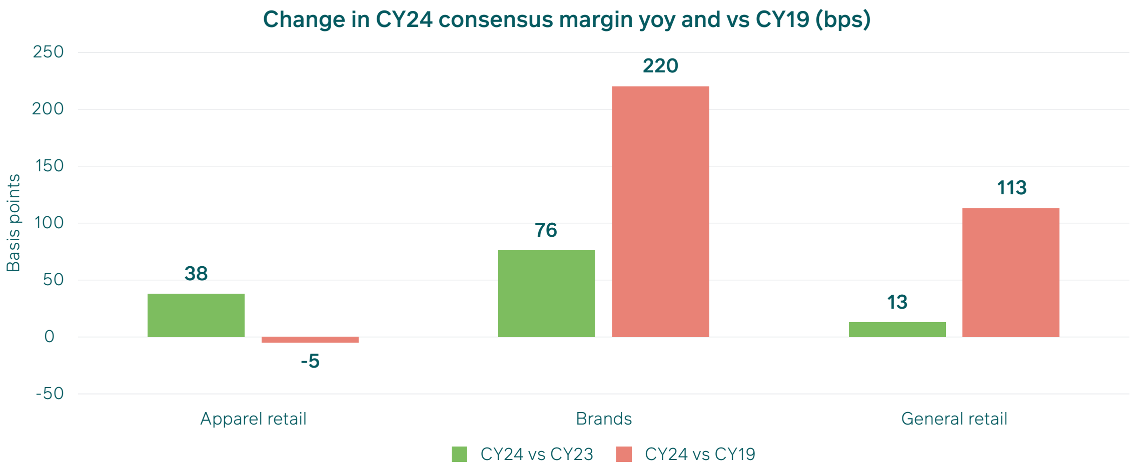
Catherine Lock and James Doogan, Global Consumer Analysts

Consumer discretionary spending has continued to demonstrate resilience despite a confluence of factors, not least inflation, over the past 18 months. Consumer savings still appear elevated, which should support further spending in the near term. That said, savings have been depleted among lower-income demographics. Credit card delinquencies appear to have merely normalised to pre-pandemic levels. However, this data is backward looking and the market has been reactive to those data points, and we are hearing management comments that suggest consumer weakness could be appearing. Macy's shares fell 15% on back of the CEO's comment that the company had seen delinquencies rise across its credit card portfolio at a faster rate than expected[6].

While certain stocks have de-rated sharply, valuations in aggregate are not demonstrating value versus history. The US retail index (XRT) is down 11% since the start of August but flat year to date[7] as sentiment has improved from the lows of the third quarter of 2022.

Looking at expectations for US retailer year-on-year (YoY) margin expansion this year and next, we think these are optimistic, given the risk of weakening consumer spending, which would likely increase competition for a smaller pool of dollars.

Figure 6: US retail consensus expectations are for margin expansion in 2024



Source: Bloomberg consensus for 18 Apparel retailers, 18 general retailers and 16 brands annualised and market cap weighted.

There are interesting and resilient retail models and brands. Nonetheless, current market expectations combined with our longer-term caution on the structural challenges to retail cause us to maintain our carefully selective approach to investment. Where the opportunity presents itself, we have been topping up existing names where demand looks to have stabilised for particular product categories and/or where companies have worked through post-COVID supply-side issues.

[6] Source: Bloomberg, October 2023.

[7] Source: Bloomberg, 30 September 2023.

Thematic technology

Jeffrey Lin
Head of Thematic Technology Equities

Opportunities in uncertain economic times

Technology sector revenue growth is correlated to macroeconomic conditions, but innovation continues even in uncertain economic times. Overall market conditions have been challenging for the sector in 2023, as evidenced by weak demand for personal computers, smartphones, weak IT services growth and cautious signals in much of the technology supply chain.

Nonetheless, there have been pockets of strong growth for technologies that can significantly improve productivity. Generative AI, for example, has the potential to significantly increase productivity which is driving strong demand for Nvidia's processors to build out the technology for mass deployment. We also remain bullish on the prospects for electrification and autonomous vehicles that could further drive demand for the technology sector.

Providers of Enterprise software have already begun to enhance their products with Generative AI features to make their software easier to use and improve user engagement. Microsoft, ServiceNow, Workday, Adobe, Oracle and Intuit among others are incorporating Generative AI into their products.

“Providers of Enterprise software have already begun to enhance their products with Generative AI features to make their software easier to use and improve user engagement”

It's fair to say that spending for Enterprise IT has been slower more recently, on the back of softer business growth, pressures to contain costs due to higher inflation, and the uncertain economic backdrop causing companies to scrutinise projects (often delaying, but not necessarily derailing them) despite often times offering a strong Return on Investment (ROI) case. Projects that can deliver immediate benefits at low cost are faring relatively better.

Despite this near-term downward pressure on spending from enterprises, the potential for Generative AI has driven significant growth especially for the infrastructure to build AI models. In a year when IT budgets have been constrained by the economic outlook, we believe that Generative AI infrastructure sold into the Enterprise segment is coming at the expense of other IT capital expenditure (Capex) such as servers and storage. We have heard of IT departments delaying refreshes to existing storage and server infrastructure because of the economic conditions and increasing utilisation rates of existing infrastructure. Some enterprises are interested in building their own Large Language Models (LLMs) internally to have control of the data.

As the economic conditions rebound, we expect a sharp reacceleration of enterprise demand, with projects that were delayed restarting, promised new technology deployed, and maintenance Capex for legacy infrastructure resuming.

Over the medium to long term, we believe the new technologies and features being developed by enterprise software companies will increase user engagement and provide opportunity to extract additional revenue from customers because of the productivity gains. While commercial revenue for the technology is just beginning, the interest level has been strong. Accenture on its most recent earnings call said it has been involved in 300 early deals for Generative AI at approximately US$1 million each. Its customers are very interested in using the technology to increase productivity in many business areas including customer service, back office, marketing, sales and accounting, among others. This bodes well for large Generative AI projects in the future.

Ultimately, we believe continued innovation and positive adoption trends are providing a tailwind for the sector. In the meantime, there are technology companies selling their products on a durable subscription basis that drives revenue and cashflow even in uncertain times. Past experience tells us that technology growth rapidly accelerates after a macroeconomic slowdown ends, and sharp corrections in the technology sector have the potential to create attractive investment opportunities for long-term investors.

UK

Michael Stiasny
Head of UK Equities

Perception, patience and potential opportunities

Over the past 18 months, anyone could have been forgiven for thinking there was only one side to the ‘soft landing’ versus ‘hard landing’ debate in the UK. The economy’s lagging post-COVID recovery has been highly publicised, while the stock market has not hesitated to punish domestic-facing companies. In September, media outlets reflected the national mood by marking the one-year anniversary of the infamous Liz Truss-Kwasi Kwarteng mini-budget, reminding us of the event’s lingering effects on global investor sentiment towards the UK.

Like much of the Western world, the UK may now be approaching a turning point in the inflation cycle, whereby central banks, including the Bank of England, consider pausing interest rate hikes due to softening economic data. Yet, regardless of whether or not the UK eventually enters a recession, there are some reasons for UK equity investors to be cautiously optimistic.

There are reasons for UK equity investors to be **cautiously optimistic**

Firstly, the UK’s recent economic performance been revised upwards by the Office for National Statistics (ONS) – GDP at the end of 2021 was adjusted to 0.6% above pre-pandemic levels, compared to a previous estimate of 1.2% below[8]. This means the UK has lost its crown as the worst G7 performer and implies the economy may be more resilient than people have feared. Secondly, as many investors are already aware, even if the UK’s domestic economy does take a turn for the worse, this would not necessarily drive equity market performance.

The UK market was resilient in the third quarter, with the FTSE All Share Index delivering a positive total return of 1.9%, ahead of many other developed market peers. This was driven by the FTSE 100 Index’s oil and gas majors (+2.2%) against a backdrop of tightening supply going into winter and a weaker sterling (around three quarters of FTSE 100 revenues are earned overseas)[9]. Longer term, we continue to believe the UK market is relatively well placed for a higher interest rate environment. As seen in Figure 7, UK companies’ return on equity (ROE) has been steadily rising, driven by oil companies and banks, reversing a long-term downward trend during the era of ultra-low rates and inflation. Dividend cover also remains strong at 1.76x, which is higher than December 2019’s pre-pandemic level, when the cover was only 1.39x[10]. This is particularly notable given that around one third of FTSE All Share constituents yield 5% or higher[11].

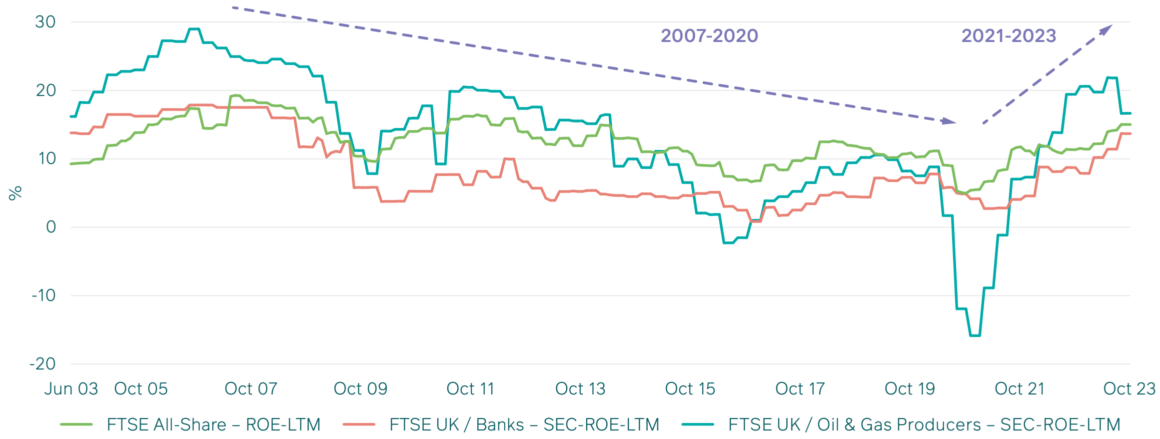
[8] Impact of Blue Book 2023 changes on gross domestic product – Office for National Statistics (ons.gov.uk).

[9] Refinitiv Datastream, 29 September 2023.

[10] Financial Times, 3 October 2023.

[11] Refinitiv Datastream, 29 September 2023.

Figure 7. UK ROE: long-term negative trend is reversing



Source: LSEG Datastream, 30 September 2023.

The mid-cap focused FTSE 250 Index has borne the brunt of investor pessimism, delivering a total return of -17.8% versus the FTSE 100 Index total return of 10.5% since the end of 2021[12]. One might argue that these companies have already taken more pain than many of their larger or overseas-listed counterparts, which could potentially mitigate further discounts or even leave room for upside. Indeed, we saw some big revisions in the market's expectations in the third quarter, with 39 of the 250 constituents delivering total returns of 10% or higher[13]. The index is also less domestically focused than its reputation would suggest – around half of FTSE 250 company revenues are now derived internationally[14].

> **"Longer term, we continue to believe the UK market is relatively well placed for a higher interest rate environment"**

We are likely to see further swings in sentiment across global equity markets, given the prevailing economic uncertainty, as well as rapidly unfolding political and technological developments. For investors, this is likely to require some patience – however, as always, it is also likely to present potential opportunities.

Our UK portfolios are beginning to find some buying opportunities in sectors perceived as being sensitive to interest rates such as real estate and utilities, and also in selective consumer-exposed stocks from across the market. During the last quarter, some constituents of these sectors have started to discount higher rates for longer and, in specific cases, value is surfacing.

[12 and 13] Refinitiv Datastream, 29 September 2023.

[14] Source: M&G Investments, Factset, October 2023.

Japan

Carl Vine
Co-Head of Asia Pacific Equities

Notable intra-market return dispersion

Despite the deterioration we witnessed in global equity market sentiment over the course of the third quarter, Japanese equities were relatively resilient versus other major equity markets, notably in yen terms where a modest positive return was achieved. Beneath the surface, however, there was aggressive divergence in return behaviour. Large-cap growth stocks were relatively weak, reflecting global sentiment concerns, whilst mid-size and so-called value stocks performed well.

The differential in performance between growth and value was exceptionally stark in the period. Compared to its Growth sibling, the MSCI Japan Value Index notched up its third biggest quarterly outperformance in three decades, a 2.5 standard deviation event. Further illustrating the point, a ranking of Japanese stocks at the start of the year by their simple price-to-book ratio (PBR) reveals a meaningful subsequent performance gap depending on the starting PBR cohort. For example, the top decile stocks (high PBR) returned an average 3% year to date to the end of September. By comparison the lowest decile (low PBR) returned an average of 45%. The last time we recall such stark performance differential around a single valuation metric like this was at the height of the growth-boom late last decade[15].

> “[Earnings] continue to reflect robust performance from the corporate sector [and] Japanese equities have been relatively resilient...despite aggressive divergence in return behaviour”

In terms of fundamentals, June quarter earnings that were reported across July and August came in ahead of expectations and have continued to reflect robust performance from the corporate sector. These results have been, in fairness, flattered by the ongoing weakness in the Japanese yen, a factor that we suspect will be a major determinant of intra-market behaviour in the year ahead. The weakness is looking increasingly at odds with improving economic fundamentals in Japan, particular at a time when growth concerns in the rest of the world are rising.

[15] Source: Bloomberg, October 2023.

As for the corporate reform dynamic that excites us so much about the structural outlook for Japanese equities, our engagements with companies continue to improve conviction in our self-help-driven earnings story. Boardroom discussions are now increasingly tackling the 'best-owner' question. This is to say that companies are increasingly looking across their business portfolios to assess which business lines can drive global leadership positions and which business lines would be better off under the ownership of a different company. This may seem straight-forward from a Western perspective, but this is new behaviour in Japan where excessive diversification is common. We see the foundations being laid for a meaningful uptick in corporate M&A in the years ahead, a key ingredient to the corporate-optimisation project we see unfolding.

Strategy-wise, the third quarter was relatively quiet in terms of activity. We have taken profits here and there, where returns have been strong and redeployed to more compelling opportunities. However, for the most part, we remain intent on keeping portfolio construction tight, with portfolio risk firmly centred around esoteric, company-specific risk. The macroeconomic environment is confusing and style-based returns continue to show fairly wild swings in Japan. We have high conviction in a positive mid-term outlook for the market overall, but we are not certain at all about which style or which sector drives these long-term returns, and in what sequence. As such, we remain focused on building a non-correlated collection of company-specific prospective-return asymmetries and building portfolios around them that are agnostic to the yen, interest rates, global growth or style risk.

Asia Pacific ex Japan

Dave Perrett
Co-Head of Asia Pacific Equities

Taking advantage of sentiment-driven market volatility

We remain of the opinion that volatile markets driven by macroeconomic concerns can create interesting opportunities for disciplined, bottom-up stock pickers. Such opportunities to add value through stock picking do not typically arise from an ability to forecast the future course of economic events, but rather from being able to spot inconsistencies in market pricing that can be created by periods of volatility. One recent example would be the divergence in valuation between Hong Kong and Taiwanese banks. In recent months, Hong Kong banks have de-rated on the back of concerns surrounding a weak Chinese economy, a global slowdown and the impact of higher interest rates on the economy. Against this backdrop, a number of Taiwanese banks still trade at a premium to book value, while a Hong Kong bellwether like Bank of China Hong Kong (BoC HK) trades at a material discount to book value and on a much lower price/earnings multiple. The inherent inconsistency is that if future events prove that BoC HK should indeed trade at this distressed level of valuation, then the share prices of Taiwanese banks – whose clients rely on China and global demand for growth – will prove to be very vulnerable.

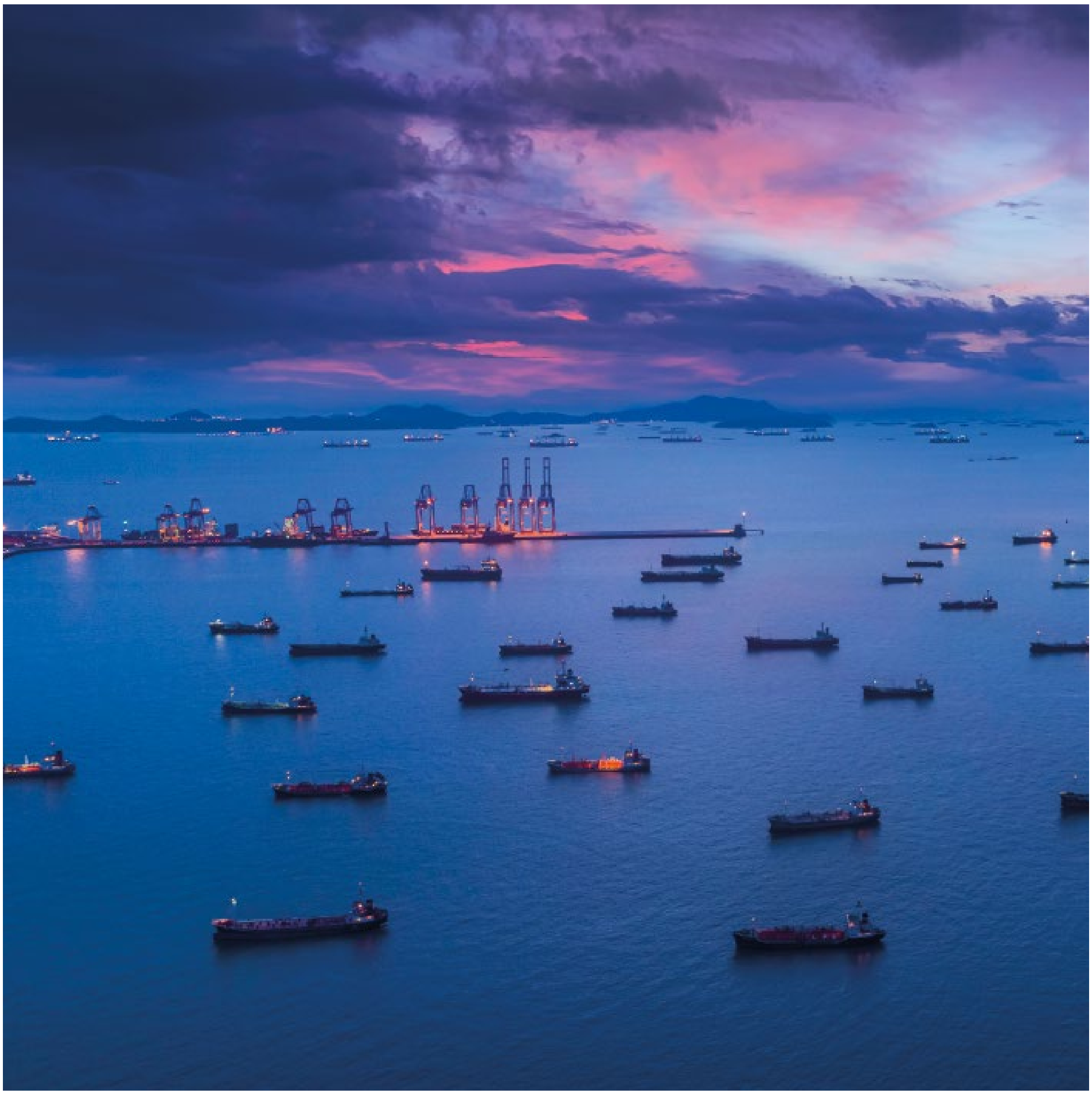
Another potential source of opportunity during periods of recessionary concerns arises from the tendency for investors to re-visit historic rules of thumb, by buying and selling stocks that respectively performed well or badly during similar periods in the past. This approach can work, but the danger is that it can overlook underlying changes in individual stock or sector fundamentals.

One current example is that the market would, typically, view ship building and bulk shipping as cyclical industries, which should be avoided during periods of slow growth. However, given the ongoing energy transition that needs to occur in shipping over the next decade or more, the supply-demand characteristics are more structurally favourable today than they have been for almost 20 years. Certainly the last decade has been tough for ship builders and as a result many have gone bust and global capacity has declined. Currently, the industry is seeing a renaissance tied to the container shipping boom of the last three years (which is now fading) and demand for LNG ships.

> “...ever tighter environmental standards will require a wholesale rolling replacement of the existing global shipping fleet, as carbon intensive engines are replaced with LNG”

Most yards are full to 2025 and, beyond that period, ever tighter environmental standards will require a wholesale rolling replacement of the existing global shipping fleet, as carbon intensive engines are replaced with first LNG, and then methane and potentially hydrogen-driven vessels. All this at a time when ship building capacity has been diminished. We believe the market is overlooking this structural tailwind. As a result, we have sought to take advantage of any selling tied to cyclical fears to grow our exposure in bulk shipping and ship building.

Finally, cyclical concerns, particularly in Asia, can have a tendency to drag down equity market valuations across the board, as investors fear weaker profits. This general rise in equity risk premia can create opportunities to buy companies that have strong structural tailwinds, especially those tied to niche areas of renewable energy and electric vehicle demand. In recent months, we have sought to use any sell-off to increase exposure to companies that we believe to be winners from the trend towards increased adoption of renewable energy sources.



Emerging Markets

Michael Bourke
Head of Emerging Market Equities

"History never repeats itself, but it does often rhyme"

Perhaps Mark Twain would have made a good investor in cyclical companies. Study of the past has typically helped analysts in thinking about how economic cycles vary and affect the earnings power of individual companies in their respective sectors. That analysis is more challenging currently, given the disruption wrought by COVID in many economic sectors. Semiconductors and chemicals, for example, have been in recessionary territory for well over a year now with year-on-year revenue declines. The auto sector underwent a severe de-stocking globally in the immediate aftermath of COVID and, arguably, inventories remain well below normalised levels. The challenge for investors, therefore, is how to unpick that dynamic from the background rhythm of the macroeconomic cycle. As ever, the value we, as active investors, seek to add is not in speculating on how the economy may evolve but to decipher where the earnings power of a company sits relative to their cyclical potential and the market's current valuation versus our estimate of fair value.

> "The challenge for investors is in [unpicking the legacy impacts of COVID disruption] from the background rhythm of the macroeconomic cycle"

In Emerging Markets (EMs), we also have to account for the variation in cycles. Not all EMs are in the same place. China continues to beguile and challenge investors with mixed evidence of a stabilisation offered by recent Purchasing Managers' Indices (PMI) and other housing-related data, while India and Indonesia offer comparatively higher and more resilient growth. In Latin America (Latam), the early embrace of higher rates has insulated economies from inflation pass-through and currencies have warmed to the carry advantage offered by local rates vis-a-vis the US dollar. That has come at a cost, though, of sluggish domestic demand. As the market waits with baited breath for the Federal Reserve to pronounce an end to this dollar rate cycle, so Latam central banks wait to press the trigger on lowering rates from here (Mexico is yet to begin rate cuts and, while Brazil has started cuts, concerns regarding recession in the US may arguably help the country move faster in reducing rates).

That cyclical variation between different EMs, the degree of sensitivity to US dollar rates (and associated risk of US recession), as well as the market's interpretation of those conditions, provide opportunities for active EM investors. We have been adding to positions in Brazil, while tempering exposure to Mexico, for example. We continue to see Brazil as relatively insulated from US economic conditions with the potential for a stronger consumer recovery as rates fall.

Elsewhere, South Africa has undergone a torrid period with intermittent power outages (the so-called load-shedding) shredding domestic growth. Companies there are heroically resilient though; we have turned incrementally positive and been adding to positions, given the attractive valuations on offer.

At a sector level, we continue to see opportunities across the technology and financial sectors within Asia, taking advantage of the de-rating of insurance companies, in particular, on excessive fears of exposure to China real estate woes. The technology sector, especially semiconductor companies therein, have weathered a lot of earnings pain over the past 12 months. In the third quarter, we saw NAND prices move materially – spot memory prices were up 25% from their end of June lows. For both DRAM[16] and NAND[17], we are seeing expectations for memory prices in the fourth quarter moving materially higher from current levels, and we are hearing from companies that contract pricing is 10-20% higher.

More generally, we believe the inherent diversification available within EM equities affords us the opportunity to diversify our sector and geographic exposures across cycles.

[16] Dynamic Random Access Memory (DRAM) is a volatile memory that stores data temporarily when a device is on – short-term memory.

[17] NAND is a non-volatile long-term memory that allows devices and applications to store large datasets permanently even when the device is off.

Impact

John William Olsen
Head of Impact Equities

Where's that recession I was promised?

I recently read a headline akin to: 'Where's that recession I was promised?'. We would obviously all rather be without those miserable slumps in the economy, but many believed that one was coming – sooner rather than later.

But what now?

The AI optimism and a strong jobs market seem to have led to a degree of complacency amongst investors. Cyclical sectors have recovered alongside the tech companies, and they have outperformed the more defensive sectors over the last 12 months. The probability of a recession is, however, still not negligible as high interest rates and inflation really start to bite. The challenging effect of higher mortgage rates and funding costs has now been swiftly reflected in some areas of the market. Renewable energy stock prices for companies involved in rooftop solar and offshore wind, for example, have taken a serious hit as the fundamental effects of higher rates have begun to impact the cost of debt, increasing project costs for renewable energy and extending the payback periods for rooftop solar projects. It may just be the early signs of worse things to come, but at least the fears of rising or persistently high interest rates are now being better reflected in valuations in this part of the market.

Defensive stocks such as those in the healthcare sector have lagged the wider market as high cash flow yields are challenged by alternative returns on long-dated bonds. This would not be the expected trend if we were on the brink of a recession.

If, or when, the economy turns sour is yet to be determined, but it seems that higher rates are now being priced in more efficiently in certain areas than the possible future effects of those rates on consumption and the broader economy. We continue to look towards areas of the market where we find a good margin of safety, and where long-term growth might be being overshadowed by shorter-term worries. Healthcare and renewables are interesting areas to look for relative value, in our view.

> "The probability of a recession is, however, still not negligible as high interest rates and inflation really start to bite"

Convertibles

David Romani
Deputy Fund Manager, Convertibles

Soft, hard or no landing, debt falls due

Maybe the economy will continue to levitate forever, maybe gravity will be restored, but we believe convertible bond issuance will remain of heightened interest to corporates and investors alike.

Regardless of the vagaries of the economic cycle, higher financing costs and looming debt maturities in 2024-26 across all types of issuers should force corporates to issue new debt and contemplate convertible bonds (CBs) as a cheaper alternative to straight bonds. Debt needs to be refinanced, typically 12 to 18 months and often up to 24 months before maturity. Hence, 2025-26 maturities have already started to come to the market and their importance will only grow during the next two years.

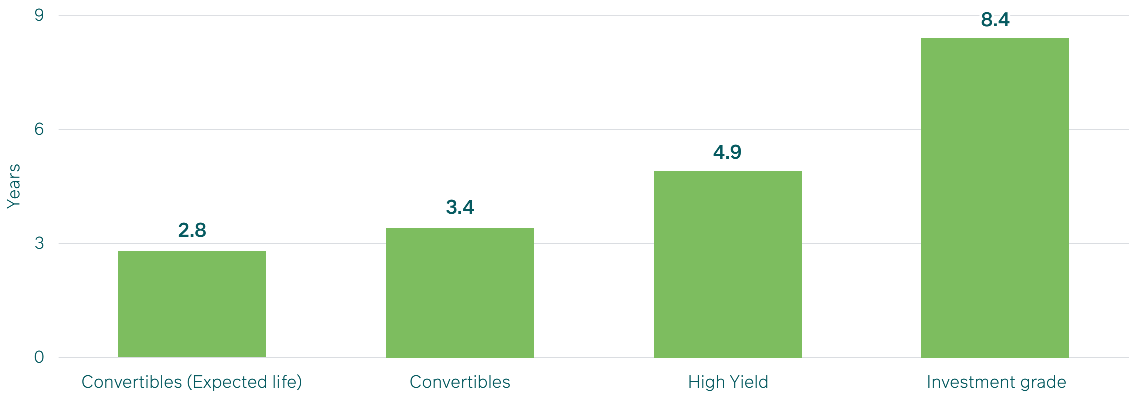
Should higher-for-longer inflation and interest rates prevail, the incentives for companies to save on interest expense by issuing lower coupon CBs will be even more powerful. Should a recession materialise, lower rates will reduce these incentives, but earnings declines, higher leverage and impending maturities will still likely force some firms to resort to CBs for financial relief.

The passing of time favours the issuance of CBs

Until recently, many firms held off from issuing debt, reasoning that rates were peaking and would come back down later. Now that 'higher for longer' is keeping hold, they have no option but to issue at higher rates.

CBs are shorter-dated when compared to other fixed income instruments, as seen in the chart below. They currently have an average maturity of 3.4 years and with an even shorter (less than three years) expected life[18].

Figure 8. Average years to maturity for various Fixed Income instruments



Source: M&G Investments, ICE Bank of America Opscore.

[18] Expected life takes into account the probability of the bond being called, put or converted ahead of maturity.

> We expect the combined drivers outlined to increase CB market size and variety over the medium term, creating a wider opportunity set

Due to their shorter maturities, more than 50% of global convertible bonds (ca. US$185 billion) and 35% of global high yield bonds (ca. US$620 billion) will mature in 2025-26. For global non-financial investment grade bonds, maturities are less concentrated in 2025-26, although, being a much larger market, they exceed US$1.6 trillion.

Changes to accounting standards in the US, reducing the interest expense recognised for CBs (boosting earnings versus straight bonds) is also providing a tailwind for CB adoption.

Convert migration

To assess the potential for having straight debt replaced by CBs for the reasons outlined, we conservatively assume that 10% of global high yield 2025-26 maturities migrate to the convertible market. Further, we also assume that 5% of the global BBB-rated investment grade, capital-intensive sectors[19] 2025-26 maturities are refinanced with converts. Together this would amount to a sizeable US$87 billion contribution, or nearly 25% of the existing convertible market. This compares favourably with a 'typical' level of CB issuance of US$80-100 billion per annum.

We expect the combined drivers outlined above to increase CB market size and variety over the medium term, creating a wider opportunity set. And, in an environment of greater financing needs, and more constraints for issuers, we expect increasingly advantageous terms for investors. We are already seeing a shift in pricing power towards providers of capital, with higher coupons and lower premiums, and we also see potential for better dividend protection and less aggressive structures.

We welcome the breadth of opportunity that greater CB issuance presents but, with issuers of varying quality entering the market, detailed fundamental analysis, discrimination and careful selection becomes increasingly important.

[19] Investment grade (IG) capital-intensive sectors (Utilities, Energy, Telecom, Basic Materials, Transportation, Real Estate Dev) amount to 48% of the global IG market, or US$4.25 trillion outstanding, with US$780 billion maturing in 2025-26 (under 9% of the total). Source: ICE BofA, M&G.