

M&G 2.5% Target Income Fund

Target Income

Q1 2023

Market overview

So far in 2023, global financial markets have experienced wild swings – particularly in the normally less volatile fixed income markets – dictated by the guessing game over the path of US interest rates, inflation and growth. January’s sentiment was relatively bullish, dominated by expectations of a weaker US economy going into 2023, which would have increased the likelihood of softer inflation, lower-than-expected interest rates and a relatively imminent pause to the US Federal Reserve’s rate hiking cycle. This was all up-ended in February by surprisingly strong economic data, including more widely embedded inflation than previously thought. With the Fed signalling its intention to continue hiking, this sent market uncertainty higher and global asset prices lower, an environment that continued well into March.

Then the emergence of banking sector turmoil sparked by the sudden failure of specialist Silicon Valley Bank and the engineered buyout of Swiss banking giant Credit Suisse by UBS shocked markets even further, with swift central bank and government interventions preventing contagion to other sectors. Gold benefited and risk-off sentiment prevailed as global financial stocks sold off. Central banks suddenly had an even tougher policy balancing act, having to choose between their duties of fighting inflation, safeguarding national banking systems and supporting growth and employment. Ironically, this led back to more positive expectations of lower interest rates and sooner-than-expected rate pauses.

In fact, the US Fed hiked by a measured 25bps in March, as expected, as did the Bank of England (BOE), while the European Central Bank (ECB) and SA Reserve Bank (SARB) announced relatively robust 50bp increases given their higher inflation threats. Looking back, investment managers have rarely seen such sharp changes in market views in such a short period of time. US Treasury bonds, for example, experienced high volatility of around 10%, with the 10-year UST yield falling by 50bps from around 4.0% to 3.5% between February and March – an exceptionally big move in that market.

While the growth outlook improved in several key economies, making equities more attractive, risk aversion still made itself apparent over the quarter. Global equity returns outperformed bonds, while developed equity markets outperformed emerging equity markets. For the three months ended 31 March 2023, the MSCI All Country World Index returned 7.3%, the MSCI World Index (developed markets) delivered 7.7%, and the MSCI Emerging Markets Index produced 4.0% (all in US\$). Bonds also posted meaningful gains: the Bloomberg Global Aggregate Bond Index delivered 3.0% (in US\$). Global property stocks continued to generate among the weakest returns, with the FTSE EPRA/NAREIT Global REIT Index returning 1.4% (US\$).

South Africa

In South Africa, the SARB surprised with a larger-than-expected 50bp interest rate hike on 30 March, citing strong inflationary pressures from food, administered prices and a depreciating rand. February CPI came in at 7.0% % y/y, aided by substantial increases in food, transport and medical services prices. Many had thought the Bank would follow the US and UK with a 25bp rise, especially given very weak local economic growth: Stats SA reported that Q4 2022 GDP contracted by 1.3%, more than expected, due to intensifying load-shedding. At the same time, National Treasury revised downward its projection for annual real GDP growth, now expected to average 1.4% from 2023 to 2025, versus 1.6% previously.

The 50bp rate increase did help to reinforce the SARB’s global credibility, while the rand reacted by strengthening below the key R18/1USD level, at least temporarily. The SA forward rate market is now pricing in a further 50bps in interest rate hikes from the SARB this year before the central bank pauses and then starts cutting rates again. Meanwhile, S&P Global downgraded the sovereign credit rating outlook to negative from stable, citing load-shedding and the fragile economy as the primary drivers.

Also during the quarter, investors welcomed the 2023 National Budget’s improved fiscal trajectory and the government’s plans for Eskom debt relief, as markets reacted marginally favourably. Eskom remained in the spotlight for much of the period as its departing CEO reported high levels of corruption within the utility, prompting more intensive investigations from journalists and the government.

Meanwhile, South Africa was grey-listed by financial watchdog FATF, so that more scrutiny of the country’s international transactions is necessary to root out money laundering and financing of terrorism. Higher costs and administrative hurdles will likely result, experts said, and banking shares fell 2% in reaction to the announcement. Bonds and the rand were little moved, however.

The SA equity market was dented by risk aversion and weakness in Listed Property and Resources stocks during the quarter, and impacted by the global sell-off in Financials, but buoyed by Industrial shares. The FTSE/JSE All Share Index (ALSI) returned 5.2% in Q1, while the more locally exposed Capped SWIX delivered 2.4% (both in rands). Industrial counters returned 13.6%, while Financials produced 0.4%, Resources -4.4% (Resources 10 Index) and the All Property Index -4.8% (all in rands).

For the quarter, SA nominal bonds (the FTSE/JSE All Bond Index) delivered 3.4% in rands, while inflation-linked bonds (ILBs) produced 0.9% and cash returned 1.7%. Finally, despite some late-March gains on the back of the SARB’s larger-than-expected

Fund facts

Fund managers

David Knee
Michael Moyle
Sandile Malinga
Leonard Krüger

ASISA category

Worldwide - Multi Asset -
Unclassified

Objective (before fees)

2.5% Income return p.a.

Inception date

2 April 2019

Fund size

R102 966 886

Annualised performance

	A class	CPI	B class
1 year	7.2%	7.0%	7.6%
2 years	11.6%	6.3%	12.0%
3 years	20.1%	5.2%	20.5%
Since inception	7.3%	4.9%	-

rate hike, the rand moved weaker against the major global currencies, losing 4.8% against the broadly weaker US\$, 7.3% against UK sterling and 6.5% versus the euro over the quarter.

Performance

The M&G 2.5% Target Income Fund returned 4.5% (after fees) for the first quarter of 2023 and 7.2% for the 12-month period ending 31 March 2023.

The fund's global and SA equity exposure added the most value to its absolute return for Q1, by far, followed by its global and SA bond holdings. SA listed property was the only small asset class detractor for the quarter.

In terms of specific equity exposure for the quarter, the fund's Industrial holdings were a positive contributor to absolute returns, given that sector's strong performance. Holdings like Naspers, Prosus, Richemont, AB InBev and other stocks with global earnings added value. Detractors from absolute performance stemmed largely from Resources holdings (Northam Platinum, Glencore, Implats, Exxaro and Sasol, for example) and certain bank shares to a lesser extent.

Strategy and positioning

Starting with our view on **offshore asset allocation**, during the quarter our global holdings remained largely unchanged versus South African holdings.

Within **global bonds**, we stayed broadly neutral in the fund and maintained our exposure to 30-year US Treasuries, as well as sovereign EM bond markets where the real yields are high and the currency is trading at fair-to-cheap levels. Real global bond yields are now relatively attractive and offer compensation for the risk involved – that of higher-than-expected interest rate hikes. US Treasuries are also solid diversifiers for SA equity risk.

Within **global equities**, we remain selective and we are still leaning away from US equities. While global equities are trading at cheap levels relative to recent history, in our view there are still unresolved questions around the effect of rising real rates on valuations and the risks to earnings going forward.

Our **global cash** holdings continue to partially cushion our funds, as well as providing some liquidity to take advantage of new market opportunities that could arise. We are mindful of the risks that exist globally in terms of slower economic growth, rising interest rates and embedded inflation – any negative surprises present downside risks for corporate earnings and bond prices.

The fund still favoured **SA equities** at the end of Q1. Early in the quarter we trimmed our SA equity exposure slightly to take some profit after the roughly 20% rally in the local market in late 2022 and into January, using the profits to increase our SA bond exposure. SA equity valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) re-rated slightly over the quarter, rising from around 9.2X to around 9.5X at quarter-end. Much of this re-rating was attributable to share price gains, as earnings estimates changed only marginally.

During the quarter, we trimmed our **SA listed property** exposure in favour of SA cash, as cash yields became more attractive on a risk-adjusted basis, while property risks remained high. We still prefer exposure to non-property shares that we believe offer better value propositions for less risk. Conditions in the local property sector remain uncertain given the rising local interest rate cycle (many property companies are reliant on finance to expand their portfolios) and relatively weak growth prospects, among other fundamental factors.

The fund also benefitted from our ongoing preference for **SA nominal bonds** in Q1 2023 due to their positive returns despite a very volatile period. During the quarter we added slightly to our SA bond holdings out of SA property. The 10-year SA government bond rallied approximately 20bps during the quarter, falling to 10.7% at quarter-end, which is still at a relatively high level on a historic basis. Meanwhile, the 20-year bond lost 20bps, leading to a steepening of the yield curve in the long end, even as the curve below 10 years flattened as a result of the SARB's interest rate hikes. We continue to believe SA nominal bond valuations remain attractive relative to both other income assets and their own longer-term history and will more than compensate investors for their associated risks. We hold no **SA inflation-linked bonds (ILBs)** in the fund.

Lastly, the SARB's interest rate hikes during the quarter made **SA cash** relatively more attractive as an asset class. However, apart from SA property, we still prefer most other local asset classes for the higher real yields available on both an absolute and relative basis. Therefore, the fund remained tilted away from SA cash. □

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