M&G Equity Fund

Equity

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.

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.

South Africa

In South Africa, the equity market was dented by risk aversion and weakness in Listed Property and Resources stocks during the quarter 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).

The South African Reserve Bank (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. 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 stable from positive, 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.

Performance

During the quarter, the fund returned -0.3% compared to its benchmark's 2.3% return, while for the 12 months to 31 March 2023 it returned 3.7%, outperforming its benchmark (the average of the ASISA General Equity category) by 2.4%.

Some of the largest contributors to performance were companies we didn't own: Anglo American Platinum, Transaction Capital and Sibanye. Overweight positions in Naspers/Prosus and Datatec also contributed to performance.

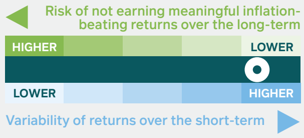
Overweight positions in Thungela and Impala Platinum, together with the underweight positions in gold companies Goldfields and Anglogold, all detracted from performance.

Strategy and positioning

Risk sentiment took a step up in the quarter, with Silicon Valley Bank and Signature Bank, both regional banks in the United States, having essentially been forced to shut operations by the Federal Deposit Insurance Corporation. In Europe, Credit Suisse was acquired by UBS under instruction from the Swiss regulators. The Credit Suisse takeover resulted in US$17.1b worth of subordinated debt being written off to nil.

Together with the potential of lower yields on the prospect of a global recession, the risk-off sentiment resulted in the gold price rising above $2,000 per ounce, having started the year at just over $1,800 per ounce. Unsurprisingly, the top four performing companies on the local market were all gold stocks. We have written in the past about our aversion to gold stocks due to the capital allocation histories of the companies, their need to 'grow' in order to replace mined reserves, short mine lives and the resultant

Risk profile



Fund facts

Fund managers

Chris Wood
Yusuf Mowlana

ASISA category

South African - Equity - General

Benchmark

ASISA South African - Equity - General Category Mean

Inception date

2 August 1999

Fund size

R4 838 257 581

Awards

Raging Bull: 2006, 2007, 2008
Morningstar/Standard & Poor's: 2007, 2008

Annualised performance	A class	Benchmark	B class	F class
1 year	3.7%	1.2%	4.2%	5.1%
3 years	27.1%	20.9%	27.6%	28.3%
5 years	10.6%	7.0%	11.1%	11.7%
7 years	9.4%	5.9%	9.9%	-
10 years	10.4%	7.2%	10.9%	-
20 years	17.4%	13.6%	-	-

Sources: M&G Investments, Morningstar & Deutsche Securities poor free cash flow generation to shareholders. We think this time is no different and that once speculative interest in the metal wanes and fundamentals drive the share price (free cash flow and shareholder returns on capital), share prices may not be where they are currently. There are several good arguments for having an allocation to gold as a metal asset, but one has to draw a clear distinction between the metal and the miners themselves (and we are somewhat sceptical about the latter).

Closer to home, the impacts of loadshedding are manifesting, with retailers and property companies highlighting the impact on their earnings.

In terms of positioning, the fund retains a healthy exposure to miners and the energy sector in particular. These companies are cheap on free cash flow yields and attractively priced even under a scenario of downward normalisation of commodity prices.

Other key positions are an overweight in the banking sector, and underweight positions in the insurance and real estate sectors. South African banks are well-regulated, well-funded and well-capitalised. The oligopolistic nature of the South African banking industry doesn't lend itself to irrational competition. Furthermore, we are satisfied that the banks' capital is appropriately invested in such a way that it is unlikely that the events that unfolded at Silicon Valley Bank will happen in South Africa.

We remain optimistic on the potential for returns on the market.

M&G Investments

Contact us

info@mandg.co.za

mandg.co.za

0860 105 775

Invest now

Application forms

An electronic copy of this document is available at www.mandg.co.za

Disclaimer

Sources: M&G Investments, Morningstar & Deutsche Securities