Quarterly Commentary

M&G Inflation Plus Fund

Multi-asset

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 stable from positive 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.

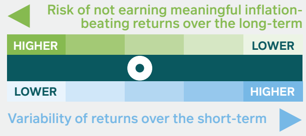
The SA equity market was dented by risk aversion and weakness in Listed Property and Resources stocks during the quarter, and the sell-off in global Financials, but buoyed by Industrial shares. The FTSE/JSE All Share Index (ALSI) returned 5.2% in Q1, while the more locally exposed Capped SWIX delivered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

Annualised performance	A class	Objective[1]	T class	X class	B class
1 year	7.6%	10.4%	7.8%	7.6%	8.1%
3 years	14.6%	8.6%	14.8%	14.6%	15.1%
5 years	5.9%	8.3%	6.2%	6.0%	6.5%
7 years	5.3%	8.4%	5.7%	5.5%	6.0%
10 years	7.0%	8.6%	-	7.2%	7.7%
20 years	10.7%	9.0%	-	-	11.4%
Since inception	10.9%	9.3%	-	-	-

[1] Objective: CPI + 5% p.a. over rolling 3 years gross of fees; less long-term TIC of applicable class. For A class objective above a TIC of -1.6% was used.

Risk profile



Fund facts

Fund managers
David Knee
Michael Moyle
Sandile Malinga
Leonard Krüger

ASISA category
South African - Multi-Asset - Low Equity

Objective (before fees)
CPI+5% p.a. over a rolling 3-year period

Inception date
1 June 2001

Fund size
R20 333 190 573

Awards
Raging Bull: 2013
Morningstar: 2015

Sources: M&G Investments, Morningstar & Deutsche Securities late-March gains on the back of the SARB's larger-than-expected 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 Fund returned 3.5% (after fees) for the first quarter of 2023 and 7.6% for the 12-month period ending 31 March 2023. The Fund has delivered a return of 10.9% per annum since its inception in 1999 (after fees), compared to its objective of 9.3% per annum over the same period.

Looking at the fund's asset allocation, SA nominal bond holdings added the most value to absolute performance for the quarter, while global and SA equities also added good value, as did global bonds. To a lesser extent, SA ILBs and SA cash contributed value, while SA listed property was the only (small) asset class detractor from absolute returns for Q1.

Within SA equities, the fund's Industrials exposure was a positive contributor to absolute returns during the quarter, 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, 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 the fund's overall level of global exposure fell slightly as we lowered its hard currency exposure by selling US$ futures. We still prefer SA assets given that their valuations continued to be more attractive than their offshore counterparts.

Within our **global holdings**, we remained largely neutral in global equities and global bonds, preferring to hold global cash for liquidity purposes, to take advantage of any mis-pricing opportunities that might arise. Despite the volatility over the quarter, corporate earnings were mixed and reasonably resilient, beating expectations in developed markets. With GDP forecasts being revised upwards, equity prices rallied, but in our view it is still too soon to be taking large directional bets, since no one knows the extent and depth of any global downturn that might occur.

While **global equities** are still trading at relatively attractive levels, they became more expensive over the quarter: the MSCI ACWI forward P/E rose to 15.4X from 14.7X previously. Because there are still unresolved questions around risks to earnings going forward, we remain selective. We are still leaning away from US equities due to their relatively expensive valuations versus other markets. We prefer Japan, the UK, China and other markets that are relatively cheap.

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.

The fund still favoured **SA equities** at the end of Q1 2023. 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, with the proceeds going into local cash. 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 further 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. 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 are marginally favouring **SA inflation-linked bonds (ILBs)** in the Inflation Plus Fund after adding more to our holdings in the previous quarter. Their real yields remain relatively attractive (that of the 10-year ILB is at 4.5%) compared to both their own history and our long-run fair value assumption; however, compared to nominal bonds their valuations are less attractive and they have lower return potential.

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.

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities