Quarterly Commentary

M&G Investments

M&G Global Bond Fund

Global Income USD-denominated

Q4 2022

Market overview

In the final quarter (Q4) of 2022, global financial markets recovered some of the ground lost during the past three quarters. Although the outlook remained gloomy, some light emerged: in October and November buyers were attracted by cheaper asset valuations and somewhat improved clarity on company earnings prospects, as well as falling fuel and food prices. By mid-December, a slowdown in the pace of the interest rate hiking cycle added to the better sentiment. However, caution returned in December: still causing uncertainty were unknowns such as the severity of the expected 2023 global growth slowdown, the impact of the massive new Covid wave in China, the ongoing tragedies of the Ukraine-Russia war, and the stickiness of inflation in large economies. As such, markets retraced some of their earlier gains in December.

The risk-on sentiment over the quarter saw equities outperform bonds, while emerging market returns were in line with those of developed markets. Bonds posted meaningful gains: the Bloomberg Global Aggregate Bond Index delivered 4.5% (in US$).

Hopes of fewer interest rate increases helped bond markets, although bunds were hit by a new hawkishness from the European Central Bank. Corporate bonds performed well, with high yield and emerging market bonds doing even better.

In the US, the US Fed hiked its Federal Funds rate by a combined 125bps in Q4 to 4.25%-4.5%, still considered an aggressive policy tightening by historic standards, even though its 50bp December hike represented a slower pace. The central bank also lifted its rate forecast for end 2023 by 0.5%, to 5%-5.25%, a more hawkish signal. This came despite falling CPI (at 7.1% y/y in November), as price increases became more widespread.

Meanwhile, after rising 3.2% y/y in Q3 on the back of surprisingly strong consumer spending, US economic growth for all of 2022 is forecast at around 1.9%, before slowing to below 1% for 2023. Data showed the US housing market is already slowing meaningfully and is expected to be a significant factor in the slowdown. However, consensus projections are for a relatively mild and brief recession lasting for the first three quarters of next year.

In the UK, the Bank of England (BoE) finished off the year by raising its key interest rate by 50bps to 3.5% in December, in line with forecasts. Meanwhile, November CPI eased to 10.7% y/y vs October's 11.1%, largely due to falling energy prices. The Bank indicated more hikes are likely into 2023 in its bid to curb inflation at the expense of growth: the Office for Budget Responsibility (OBR) estimated that the U.K. economy was already in recession and that GDP will contract by 1.4% in 2023, while inflation is predicted to hit 9.1% in 2022 and 7.4% in 2023.

The ECB followed the US Fed and BoE with its own 50bp hike in December, while also suggesting similar-size hikes at its next two meetings. Eurozone inflation fell to 10.1% y/y in November from a record 10.6%, as energy costs eased. However, the ECB still expects a short and shallow recession in 2023 as the energy crisis is seen weighing heavily in the shorter-term while the Ukraine-Russia war drags on.

In Japan, the Bank of Japan (BOJ) surprised markets in mid-December with its first effective interest rate hike, raising its 10-year bond yield range by 0.25% to 0.50% after long periods of stability. The market had been pricing in no rate increases through 2023. Finally, the BOJ revised downward its real growth outlook for 2022 to 2.0% from 2.4% previously, and for 2023 to 1.9% from 2.0%, but no recession is expected.

In China, it was a fairly chaotic end to the year as the government responded to widespread social protests against its strict zero-Covid policy by removing almost all restrictions. However, this came as a large new wave of Covid infections was spreading. Although economists welcomed the move to help free up the economy and kick-start growth, the uncertain impact of the virus weighed negatively on markets. Meanwhile, consensus forecasts for China's economy call for only 3.3% GDP growth in 2022, far below the government's 5.5% target and the slowest since the 1970s. For 2023, a new government target of 4.5%-5% is reported to be most likely, but many consider this optimistic.

Performance

For Q4 2022, the fund returned 7.0% (in US$, net of fees), outperforming its benchmark, the Bloomberg Global Aggregate Bond index, which returned 4.5 %. For the 12 months ending 31 December, the fund delivered -15.1% compared to the benchmark's -16.2% (both in US$).

For absolute performance, the fund's holdings in US government and corporate bonds, as well as global investment-grade bonds, added value to returns. The main detractors were its exposure to German and French government bonds.

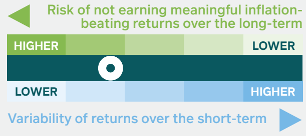
Strategy and positioning

During the quarter we took profits on the fund's tactical position in UK gilts that was initiated at the end of Q3, closing the position. We also sold emerging market hard currency government bonds to add to our position of 30-year US Treasuries after yields rose above 4.3%. This took the fund long of duration temporarily, since following the subsequent rapid rise in US government bond prices, we again reduced our exposure, returning the fund to a neutral duration stance relative to the benchmark.

The fund continues to hold a relatively high level of cash, as we believe it is a valuable asset in the current environment of heightened volatility. Within currencies, we have started to add again to the US dollar, while cutting EM local currencies in order to reduce risk.

We remain highly active within the global bond asset class, responding to the significant price movements we have seen this year. Price behaviour remains consistent with that of market participants, being sharply focused on the direction of interest rates: markets are changing direction at every inflation data release or FED governor's statement.

Risk profile



Fund facts

Investment manager
M&G Investment Management Limited (UK)

Fund managers
Craig Simpson

Morningstar category
Global Flexible Bond

Benchmark
Bloomberg Global Aggregate Bond Index

Inception date
9 June 2017

Fund size
USD 152.6 million

Annualised performance

	B Class	Benchmark
1 year	-15.1%	-16.2%
2 years	-10.5%	-10.7%
3 years	-4.2%	-4.5%
5 years	-1.7%	-1.7%
Since inception	-1.4%	-1.3%

Sources: M&G Investments, Morningstar & Deutsche Securities

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As highlighted above, in these extremely volatile, narrative-driven times we remain alert to opportunities that are created by 'episodic', or sentiment-driven, changes in asset prices. The effect of recent asset price weakness has been to restore valuations to more interesting levels in certain areas, in our view. However, the assumptions behind these valuation signals appear even more vulnerable than usual to shifting economic conditions.

We believe the economic and policy background we are facing now is very different from the last decade and risks today are much more established. As the likelihood of an economic downturn has increased, particularly in Europe, we remain cautious and continue to hold an elevated level of cash, providing scope to respond to future volatility as it arises.

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities