Quarterly Commentary

M&G Bond Fund

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.

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. Global bonds also posted meaningful gains: the Bloomberg Global Aggregate Bond Index delivered 3.0% (in US$). 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%.

In the US, the US Fed hiked its repo rate by 25bps at both its February at March meetings, moves that were expected by the market. However, uncertainty was created by surprisingly robust economic data, including strong retail sales data, a higher than-expected January CPI at 6.4% y/y, and a still-strong jobs market. February's core CPI, at 5.5% y/y, showed inflation was more deeply entrenched than thought. This data, combined with hawkish language from the US Fed, led investors to expect higher interest rates for longer and sparked global equity and bond sell-offs. This bearish sentiment was later reversed by the global banking turmoil, which led investors to expect central banks to move less aggressively in their rate increases in order to support the banking sector. While banking stocks did sell off, March's confirmed "small" 25bp increase by the Fed appeared to reinforce the idea that US rate hikes might be close to an end, and that therefore uncertainty had eased to an extent. February CPI came in unexpectedly high at 10.4% y/y, and financial markets are still pricing in another 25-50bps of increases by August 2023.

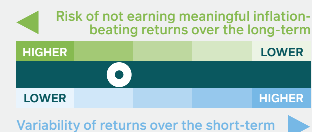
Despite banking sector weakness, the ECB continued its relatively aggressive pace of rate hikes in Q1 as it found itself faced with still high, albeit falling, levels of inflation. It hiked by 50bps in March as CPI surprised to the upside at 8.5% y/y in February versus 8.2% expected, with core CPI (excluding food and energy) at 5.6% y/y versus 5.3% expected. The bank also signalled its readiness to supply the banking system with extra liquidity should it be required. Financial markets now expect further hikes will be less aggressive going forward, having cut back their forecasts by a full 1.0%.

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 loadshedding and the fragile economy as the primary drivers. 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. Finally, South Africa was grey-listed by financial watchdog

Annualised performance	A class	Benchmark	B class
1 year	7.6%	5.8%	7.9%
3 years	11.7%	11.6%	11.8%
5 years	6.5%	6.9%	6.7%
7 years	8.4%	8.8%	8.6%
10 years	6.8%	7.3%	7.1%
20 years	8.6%	8.8%	-
Since inception	9.6%	9.9%	-

Risk profile



Fund facts

Fund managers
Roshen Harry
René Prinsloo

ASISA category
South African - Interest Bearing - Variable Term

Benchmark
FTSE/JSE All Bond Index

Inception date
27 October 2000

Fund size
R802 793 697

Sources: M&G Investments, Morningstar & Deutsche Securities

M&G Investments

Financial Action Task Force (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

The fund delivered 4.0% (class A, net of fees) for the quarter, outperforming its benchmark by 0.6%. Most of the government bonds on the yield curve ended the quarter at stronger levels, and the curve moved significantly steeper: the front of the curve strengthened by 38 basis points over the quarter, while the ultra-long R2048s ended 19 points weaker. This steepening took place in spite of more aggressive hiking than expected by the SARB and can be partly explained by National Treasury's announcement of a new ultra-long bond, the R2053, that will be introduced into the market during the second quarter.

Although the fund failed to benefit from the move lower in the curve (due to relatively neutral duration positioning), the steepening of the curve worked in our favour. We had no exposure to the back end of the curve (over 20 years in maturity), thereby avoiding the losses suffered in those bonds.

Another interesting development over the past quarter (apart from the new R2053) was the maturity of the R2023 bond, leaving the R186 as the shortest bond on the curve. National Treasury has not indicated any other changes to its bond curve constituents, apart from the introduction of a new 7-year floating rate instrument.

The additional government support for Eskom, announced in the February budget, led to a notable compression of the credit spreads of Eskom bonds. We maintain insignificant credit exposure in this fund, and the fund therefore did not participate in these gains.

Strategy and positioning

We continue to favour fixed-rate government exposure over fixed-rate corporates and view the historically low levels of fixed-rate credit spreads as insufficient compensation for the credit and liquidity risks that such bonds come with.

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities