M&G Investments

Q1 2022

Market Observations

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The first quarter of 2022 was full of unpleasant surprises, starting with high levels of financial market volatility as January uncertainty over global inflation and interest rate policies, and risk-off investor sentiment, were reflected in broad weakness across both global equities and bonds. Then the tragic and destructive Russian invasion of Ukraine in the last week of February, and the unprecedented level of sanctions imposed against Russia, created even further uncertainty, along with rocketing commodity prices and inflation concerns. This combination of developments meant that many global asset returns, even from usual safe-havens like US Treasuries, were squarely in the red.

Asset class	Total return Q1 2022 (ZAR and US$)
SA equity – FTSE/JSE All Share Index (Rand)	3.8%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	6.7%
SA listed property – FTSE/JSE All Property Index (Rand)	-1.6%
SA bonds – FTSE/JSE All Bond Index (Rand)	1.9%
SA inflation-linked bonds – FTSE/JSE Inflation-Linked Bond Index (Rand)	0.3%
SA cash - STeFI Composite Index (Rand)	1.0%
Global equity – MSCI All Country World (Total, US$ net)	-5.4%
Global equity – MSCI World (Developed) (US$ net)	-5.2%
Global equity – MSCI Emerging Markets (US$ net)	-7.0%
Global bonds – Bloomberg Global Agg Bond Index (US$ net)	-6.2%
Global property – FTSE EPRA/NAREIT Global REIT Index (US$ net)	-3.8%

Source: M&G Investments, Bloomberg, data to 31 March 2022

Commodity-producer South Africa was among the few beneficiaries of the spikes in precious metals and other commodity prices. In contrast to most other countries, both local equity and nominal bond markets registered respectable returns for the quarter, and the rand appreciated substantially against the major global currencies. However, this was offset to some extent in March by widespread bearish investor sentiment and weakness in Naspers/Prosus shares resulting from a further sell-off in Tencent amid a renewed Chinese government regulatory crackdown.

With global energy, food and most other commodity prices soaring amid speculation over the impact of the war and tough sanctions on Russia, it was investor concerns over inflation and the US Federal Reserve's reaction via more aggressive interest rate hikes that drove markets, which worried about the prospects for slower growth -- or even recession. Even as the US and European economies loosened restrictions further amid a waning of the Coronavirus, many investors were anxious that the economic recoveries underway would be too fragile to handle a sharp rise in interest rates, especially outside the US.

US February CPI rose to 7.9% y/y in February, the highest rate since 1982, as the key Energy Price Index in the energy-hungry US market recorded a 25.6% y/y increase. The US Federal Reserve (Fed) lifted its base rate by 25bps at its March meeting, but with inflationary pressures rising and energy prices now likely to be higher for longer due to extended sanctions, the Fed's outlook for interest rate increases became much more hawkish. US Treasuries reacted badly to the deteriorating conditions, selling off heavily in March (particularly in the shorter end of the curve – the Bloomberg Aggregate US Treasuries Index returned -6.2%). Fed policymakers have been able to be more aggressive amid the robust US economic recovery, with unemployment falling to 3.8% in February and GDP growth registering a solid 6.9% y/y for Q4 2021.

US companies continued to report strong earnings in Q1 2022, but poor sentiment, combined with high starting valuations, saw US equity markets recording weak first-quarter performances: in US dollars, the Nasdaq delivered - 8.9%, the S&P 500 returned -4.6% and the Dow Jones produced -4.1%.

In the UK, with Q4 2021 GDP growth also strong at 6.5% y/y, the Bank of England implemented its third 25bp interest rate hike in a row in March, and warned of inflation reaching 8.0% y/y in April. However, the central bank was less aggressive on its outlook for rate hikes compared to the Federal Reserve, noting that the price shocks from the war were already taking a toll on consumer wallets. For Q1 2022, the UK FTSE 100 was flat.

The Eurozone experienced a weaker recovery from the Coronavirus crisis than the US and UK, with Q4 2021 GDP growth at 4.6% y/y, hurt by further waves of the Omicron variant of Covid-19 at different levels across the region. As such, the European Central Bank (ECB) kept its policy rate unchanged in March, but did accelerate its winding down of bond purchases to Q3 this year in the face of CPI jumping to 6.2% y/y in February. ECB President Christine Lagarde reassured that any hike would be gradual, and would start after the bank's bond buying programme came to an end. Market speculation centred around one 25bp hike in 2022. In France, the CAC 40 returned -8.7%, while Germany's DAX delivered -10.9% for the quarter in US dollars.

In Japan, the Bank of Japan (BOJ) was further behind other central banks in tightening its policy, leaving its policy rate unchanged as its economy proved to be even more sluggish than previously thought. Q4 2021 GDP growth was revised down to 4.6% y/y vs 5.6% y/y previously reported due to weaker-than-expected consumer spending as Covid's influence was still being felt. The Russia-Ukraine war had increased the risk of economic contraction in Q1, the still-dovish BOJ said, with the economy still needing accommodative policy to support growth. The market is forecasting no interest rate hikes through 2023. Japan's Nikkei returned -7.5% for the quarter.

Chinese markets saw remarkable volatility in Q1 2022. Q4 2021 GDP growth was relatively slow at 4.0% y/y due partly to Covid infections and partly to ongoing debt problems in the property sector with giant developer Evergrande still causing waves, and other developer defaults. However, January and February saw strong improvements in retail sales (+6.7% y/y), industrial production (+7.5% y/y) and fixed asset investment (+12.2%), only to have this growth reversed by a worsening, widespread outbreak of Covid infections that prompted harsh shutdowns in major cities that disrupted economic activity during the latter part of the quarter. The government announced its GDP growth target for 2022 at "around" 5.5%" for the year, and pledged to support the economy by further ramping up its infrastructure spending, easing bank reserve requirements to prompt greater lending activity, and implementing more tax cuts, among other measures. The People's Bank of China (PBOC), after lowering its key 1- and 5-year lending rates by 10bps in January, left rates unchanged at its March meeting, but did pledge to cut rates further as necessary.

Hong Kong and China's equity markets sold off sharply on these developments, as well as on additional investor concerns over the news of further strict regulatory crackdowns on businesses, and a possible rift with Western countries over China's "pro-Russian" stance on the war. For the quarter, Hong Kong's Hang Seng produced -6.1%, while the MSCI China returned -14.2%.

Among other large emerging equity markets, in US$ terms, it was another commodity producer, Brazil, which was the best performer for the quarter: the Bovespa returned 34.2%. The MSCI South Africa delivered 20.5% thanks to the stronger rand, and Turkey produced 13.2%. Meanwhile, Russia wasn't able to produce a final return, with the equity market having been shut down for several days. In the red were South Korea's KOSPI at -8.7% and the MSCI India at -1.8% (in US$).

The soaring price of Brent crude oil shocked markets during the quarter, up 38.7% by the end of March, and reaching over US$133 per barrel on 8 March before subsequently easing somewhat on news of the planned release of more US (and some European) government oil reserves. On 31 March it was trading at US$123 per barrel. Looking at precious metals, gold was up only 5.6% for the quarter, having initially spiked on the safe-haven effect but then falling back, while palladium also jumped (up 19.4%) given Russia's position as the only major supplier outside of SA. Other commodities like coal and tin soared, and even industrial metals were higher: zinc gained 17.4%, nickel 59.6%, aluminium 24.8%, lead 4.5% and copper 6.7%.

South Africa

South Africa experienced a fragile economic recovery in Q4 2021, recording GDP growth of 1.7% y/y and bringing full-year 2021 growth to 4.9%, slightly better than expected. In Q1 2022, the Omicron variant of the Coronavirus proved to be less disruptive to economic activity than originally feared, helping lift business and consumer sentiment. However, a larger boost came from ever-rising global commodity prices, benefiting most SA mining companies and government tax revenues alike. While the high oil price did hurt local growth prospects, the country's terms of trade improved, consequently supporting the rand, which appreciated significantly against the three largest global currencies: it was 8.6% stronger vs the US dollar, 11% higher versus the UK pound sterling and 10.3% up against the euro in Q1 2022. This would have detracted meaningfully from local investors' offshore foreign currency returns.

SA's relatively slow growth and the stronger rand meant that local inflation was more subdued than that in many other countries, with February inflation unchanged at 5.7% y/y and inflation expectations not rising above the South African Reserve Bank (SARB)'s 6% ceiling. This quarter marked the first time in many years that South African CPI was lower than that of the US. Even so, with CPI at the higher end of the SARB's 3-6% target range and well above the 4.5% midpoint, the SARB hiked the repo rate by 25bps at both its March and January MPC meetings, as expected, to reach 4.25%, citing inflation and the war as the biggest threats. In March the Bank raised its expectations for economic growth to 2% for 2022 from 1.7% at the January meeting, but also lifted its 2022 inflation forecast to 5.8% from 4.9% previously.

The quarter brought other good news in the form of a 2023 National Budget which signalled the government's commitment to fiscal discipline by reducing the budget deficit using part of its revenue windfall from higher commodity prices, as well as cutting some spending and making progress with economic reforms. With future government bond issuance pared back, this also underpinned rand and local bond strength.

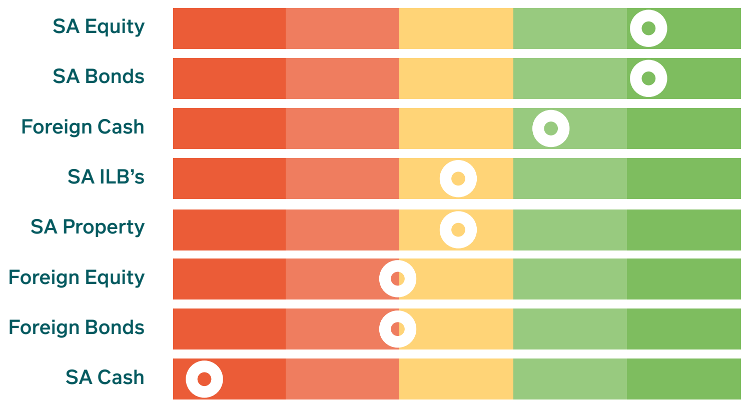
SA equity performance diverged widely during the quarter, but the overall FTSE/JSE ALSI emerged with a relatively respectable return of 3.8%, underpinned by the Resources sector's 18.2% return and 20.3% from Financials. The FTSE/JSE Capped SWIX ALSI, which we use as the equity benchmark for most of our client mandates, returned 6.7%. The All Property Index returned -1.6% and Industrials -13.1%, the latter hurt by over 30% declines in the values of Naspers and Prosus on the back of a further sharp sell-off in Tencent shares amid renewed Chinese government regulations.

Despite a 50bp increase in interest rates by the SARB during the quarter, SA nominal bonds still managed to return 1.9% over the quarter as shorter-dated bonds weakened but longer-dated bonds gained a little ground, resulting in a flatter yield curve. With SA inflation appearing not to be as much of a threat as earlier feared, inflation linked-bonds underperformed their nominal counterparts with a 0.3% return (FTSE/JSE Inflation-Linked Index), reversing the longer-term trend, and cash (as measured by the STeFI Composite Index) posted a return of 1.0% in Q1 2022.

Asset Class Preferences

5-year period

Best investment view*



*Our best investment view preferences are implemented where fund mandates allow. Positioning will differ in portfolios with constraints in their mandates.

How have our views and portfolio positioning changed in Q1 2022?

Starting with our view on **offshore asset allocation**, we maintained our portfolio positioning favouring local assets over global assets, which proved to be supportive for portfolio returns due to the relative outperformance of SA assets versus their global counterparts.

Within our global holdings, we continued to prefer global cash over both global equities and bonds in order to keep risk relatively low, while also being able to take advantage of market mis-pricing episodes that might arise. This positioning also turned out to be favourable for our portfolios on a relative basis for the quarter, based on the weakness in both global equity and bond markets compared to global cash. Within our **global equity** positioning, we remained cautious on US equities; our portfolios favour selected European and other developed market equities, and some emerging market equities. Our exposure to a broad mix of assets with diversified return profiles has also helped to partly cushion our funds against the unexpected market shocks brought on by the war and sanctions.

At the same time, we kept a marginal preference for **global government bonds** in Q1 compared to **investment grade corporate credit**, keeping our small selective exposure to emerging market government bonds as yields remained attractive. We believe that corporate yield spreads are not sufficiently high for the risk involved.

Our best investment view portfolios like the M&G Balanced Fund still heavily favoured SA equities at the end of Q1. However, we did reduce our overall weighting in this asset class by 1%-2% (depending on the portfolio) in order to bank some profits and to lower portfolio risk as a result of the rising market volatility. We consequently increased our SA cash holdings by a small amount. Helped by the strong performance from Resources and Financials, SA equity market valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) re-rated slightly over the quarter, moving up from around 9.5X to around 9.8X at quarter-end.

Within **SA equities**, during the quarter we raised our exposure to the Resources sector slightly in view of the improved valuations for many of our miners on the back of the much-increased likelihood of the "higher prices and margins for longer" scenario. Our large active Resources holdings in our House View portfolios include Sasol, a significant beneficiary of the higher oil price and a very good hedge for rising SA inflation. Northam Platinum is a higher-quality active position and our primary exposure to PGMs. Glencore and Exxaro are other large overweights, the first being very well diversified with no iron ore, coal or PGM exposure, and Exxaro offering potential above-market returns at an attractive valuation.

Another change during the quarter was to trim our Retail sector exposure due to company valuations deteriorating on the back of the higher inflation and interest rate outlook, which represent daunting headwinds for retail sales. We do hold Foschini, however, based on our belief that they have multiple levers to use to record good growth in these conditions. Otherwise we maintained our overweight in Banking shares, which performed very well during the quarter.

In broad terms our positioning in Resources stocks, banks, and our diversified positioning, worked in favour of our fund performance in Q1 2022. Also adding to value was our avoidance of most retail stocks. We believe the above holdings, as well as others like MTN, British American Tobacco, Richemont, Investec, Standard Bank and ABSA will underpin fund returns going forward.

During the quarter, fund performance was hurt by, most notably, the sharp drop in Naspers/Prosus shares, and our relatively lower holdings in precious metals miners. The latter is due partly to our long-held views that gold miners have a poor track record of returning cash to shareholders and the price of gold has no fundamental underpin.

We continued with our neutral positioning in **SA listed property** in Q1 2022, preferring to hold other shares that we consider 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.

Our portfolios benefited from our ongoing preference for **SA nominal bonds** in the first quarter thanks to their resilient performance. Although the shorter end of the SA yield curve was weaker on the back of the SARB's rate hikes, the longer end rallied, supported by these instruments' exceptional cheapness relative to most other markets, SA's improving fundamentals and the fact that SA inflation has remained relatively moderate. This curve flattening was also favourable for our bond positioning in the 7-12 year area of the yield curve. We still believe nominal bonds remain attractive relative to both other income assets like ILBs and their own longer-term history, and will more than compensate investors for their associated risks.

Although we are not holding **Inflation-linked bonds (ILBs)** in our best investment view portfolios to a meaningful degree, we do hold them in our real return portfolios like the M&G Inflation Plus Fund, where we currently have a neutral view. We still believe that ILB real yields remain relatively attractive compared to their own history and our long-run fair value assumption, but they experienced a strong re-pricing in 2021 and in our view are less attractive and have lower potential returns than nominal bonds.

Lastly, despite the SARB's two 25bp interest rate hikes in Q1, our best investment view portfolios remained tilted away from **SA cash** as our least-preferred asset class, given the extremely low base rate off which the SARB hiked. We did increase our cash exposure by 1-2% during the quarter at the expense of SA equities, but this was as a risk adjustment measure; other SA assets remain more attractive on a relative basis. □