M&G Bond Fund

Income

Q3 2024

Market overview

The third quarter of 2024 (Q3) witnessed notable fluctuations in global financial markets, driven by diverse economic signals, a shift among major central banks toward easing monetary policies and geopolitical tension. In mid-September, the US Federal Reserve (Fed) implemented a sizable interest rate cut of 50 basis points, lowering the target range to 4.75%-5.00%. This shift propelled global equity markets to new heights, while weakening the US dollar to major currencies.

In August, the Bank of England (BoE) reduced its main interest rate from 5.25% to 5%, maintaining this level through September. The BoE also announced plans to sell an additional £100 billion in bonds over the next year, thus scaling back its quantitative easing efforts.

The European Central Bank (ECB) also continued the easing trend, cutting its deposit rate by 25 basis points to 3.5% in September. Improved economic data and interest rate cuts in Europe and the US contributed to a recovery in European stocks following a selloff earlier in August.

Equity markets continued to perform well in the third quarter. Global equities (as measured by the MSCI All Country World Index) recorded a total return of 6.6% in Q3 compared to 2.9% in Q2, while emerging market equities (MSCI Emerging Markets Index) rallied another 8.7% in Q3 from 5.0% in Q2 (all in US$).

Emerging market equity returns were led by strong performances from China, South Africa and India. South Africa and India are still benefiting from a market-friendly election outcome while China saw a rebound amid the stimulus measures announced to aid its economy.

In South Africa, improving sentiment from a market-friendly election, better economic conditions, and easing monetary policy led to gains in asset prices and the Rand, with the FTSE/JSE All Share Index rising 9.6% in rand terms. Key contributors included Listed Property (19.1%) and Financials (13.7%), while Resources declined by 1.1%. Industrials was one of the standout performers benefitting from the month-end China rally as Naspers and Prosus prices reacted to the strong move in the Tencent share price. From a South African investor perspective, the move had beneficial implications as Tencent followed the market higher, sending the share prices for Naspers and Prosus up by about 14% in September. In addition, the stimulus announcement led to higher commodity prices, which had a positive impact on the local resource sector.

South African bonds performed strongly, with the FTSE/JSE All Bond Index rising 10.5% (in Rand) over the quarter and adding more positive returns to the total for the year. Bond yields continued the downward move we have seen since the conclusion of the GNU election results.

Meanwhile, CPI decreased to 4.4% y/y in August, below the SARB's target and forecasts of 4.5%, down from 4.6% in July. This marks the third consecutive month of inflation slowdown. Following the Fed's lead, the Monetary Policy Committee (MPC) implemented a widely anticipated 25 basis point rate cut to 8%.

Performance

The M&G Bond Fund delivered a very pleasing absolute return of 10.5% (A-class, net of fees) over the past quarter. This was, however, a whisker behind the 10.5% generated by the ALBI benchmark over this period. On a relative basis the fund continues to perform well, ranking 2nd out of 40 funds over the past three years and 9th out of 33 funds over the past five years (Morningstar).

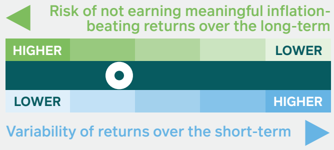
Positioning

The third quarter was a stellar one for South African fixed rate assets. The performance of the ALBI illustrates this well – the 10.5% return of the index for the quarter is the third best quarterly return that it has delivered since its inception in 2001. Furthermore, of the 20+ most liquid emerging and developed markets that we monitor closely, the SA bond market had the best local currency performance over the past month, quarter and year. When one takes into account that the rand has also been one of the best-performing currencies over this period, it becomes clear that the SA bond market has delivered exceptional returns on any constant currency basis. This outcome was underpinned by a number of factors, the most notable of which was the improvement in investor sentiment towards South Africa after the May election and the formation of the GNU.

Another significant driver of returns was the extent to which inflation receded, and the unexpected nature of this move. At the start of the quarter the most recently reported headline inflation print for SA was at 5.2% y/y, still well within the upper half of the SARB's target range. This has since dropped to 4.4% y/y, which moves it into the lower half of the target range. This is the lowest inflation print that SA has seen since the first half of 2021. Similarly, both core as well as producer price inflation have receded significantly. This inflation move has led to a material recalibration of economist forecasts. To use the SARB as an example, they now expect inflation to average 0.5% less for both 2024 and 2025 than what their forecasts suggested at the start of the quarter. Furthermore, they now expect headline inflation to remain below the mid-point of their target range for the remainder of their forecast period (to the end of 2026). Three months ago they were only expecting inflation to sustainably move to the lower half of the target band from the second quarter of 2025.

Annualised performance	A class	Benchmark	B class
1 year	26.5%	26.1%	26.8%
3 years	12.0%	11.1%	12.3%
5 years	9.7%	9.8%	9.9%
7 years	9.4%	9.7%	9.6%
10 years	8.7%	9.1%	8.9%
20 years	8.7%	9.0%	9.0%
Since inception	10.0%	10.2%	-

Risk profile



Fund facts

Fund objective

To maximise income while securing steady capital growth. This is achieved by investing in a diversified portfolio of bonds in the South African market.

Investor profile

Individuals that require a high level of income from their capital investment with relatively low risk. The recommended investment horizon is 1-3 years, or longer when used as strategic exposure to the asset class.

Investment mandate

The Fund invests in a combination of government, semi-government and corporate bonds, and other interest-bearing securities. No duration constraints apply. The Fund is managed to comply with regulations governing retirement fund investments (Regulation 28).

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

R1 089 045 853

Sources: M&G Investments, Morningstar & Deutsche Securities

In line with this improving inflation forecast, the SARB cut the repo rate by 25bps in September, after having kept it unchanged for over a year. The confluence of all these factors (SARB cut, inflation improvement and improved sentiment) led the market to significantly revise its interest rate outlook. At the start of the quarter the FRA market was expecting only a 50bp cutting cycle over the next two years. The market is now pricing in a further 100bps of interest rate cuts (i.e. a total cutting cycle of 150bps).

One of the significant changes to the bond market landscape over the past quarter was the announcement, and subsequent issuance, of two new fixed-rate government bonds, namely the R2033 and R2038. On the day of the announcement, the spread between the R2040 and the R2037 - the two bonds that straddle the new R2038 – reduced by 9 basis points. This was a painful adjustment for the fund, as it went into the quarter with the R2037 being by far its largest holding. The R2037 subsequently recovered some of this lost ground and ended up as one of the best-performing bonds (as measured by change in yield) over the quarter. Nevertheless, the new issuances introduced a lot of chaos into the bond curve over the quarter.

The last time National Treasury introduced a new instrument was when the R2053 was first introduced in the 2nd quarter of 2023. Similarly, the back end of the yield curve sold off significantly on the announcement, presumably due to concerns about the additional back-end issuance. However, long-dated bonds subsequently enjoyed a strong rally later in the year when the new instrument was eventually included in the ALBI, as the market expected this induction to lead to an increase in demand. We might therefore similarly expect a bump in the performance of this part of the curve when the new bonds eventually become sufficiently liquid to be considered for index inclusion. Ultimately, we don't spend too much time positioning the fund for expected issuance trends, as we think these are hard to anticipate, and difficult to take advantage of even in the unlikely event that you are able to foresee them.

Over the quarter the curve bull-flattened, with the R186 yield at the front reducing by 81bps, and the back end R2053's yield moving 132bps lower. As mentioned, the R2037 was our largest holding moving into the quarter, and its yield dropped by 137bps. Only the R214 rallied more (-143bps yield change), and our positioning therefore assisted the fund's performance. Towards the latter part of the quarter, we took profit on some of the R2037 strength, and more than halved the position to take advantage of other opportunities on the curve.

As mentioned previously, the neutral duration position of the fund against its benchmark means that it will naturally lag the most aggressively positioned funds over rallies such as what we saw over the past quarter (although it will also hopefully outperform the most conservatively positioned peers). However, we hope to generate good returns versus peers over the medium to long-term by taking advantage of relative value opportunities on the curve that we come across. We expect this approach to over time to lead to more consistent outperformance of the benchmark than would be achievable by taking significant duration and macro views in the fund.

Fixed rate credit spreads remain at historically low levels and are in fact negative for the better quality issuers. The current challenges that the taxi companies are facing serve as a useful reminder that credit exposure comes with liquidity and default risks, and any credit spread needs to be sufficiently large to compensate an investor for these risks. In the current environment of historically low fixed-rate credit spreads we expect the fund to remain uninvested in credit.

M&G Investments

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities