M&G Investments

Q4 2022

Market Observations

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In the final quarter (Q4) of 2022, global financial markets recovered some of the ground lost during the past three quarters that were dominated by bearish sentiment and negative news. 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, an easing 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.

Asset class	Total return Q4 2022 (Rand and US$)	Total return 2022 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	15.2%	3.6%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	12.2%	4.4%
SA listed property – FTSE/JSE All Property Index (Rand)	18.2%	-1.9%
SA bonds – FTSE/JSE All Bond Index (Rand)	5.7%	4.3%
SA inflation-linked bonds – FTSE/JSE Inflation-Linked Index (Rand)	2.0%	4.3%
SA cash - STeFI Composite Index (Rand)	1.6%	5.2%
Global equity – MSCI All Country World (Total, US$ net)	9.8%	-18.4%
Global equity – MSCI World (Developed) (US$ net)	9.8%	-18.1%
Global equity – MSCI Emerging Markets (US$ net)	9.7%	-20.1%
Global bonds – Bloomberg Global Agg Bond Index (US$ net)	4.5%	-16.2%
Global property – FTSE EPRA/NAREIT Global REIT Index (US$ net)	6.6%	-24.5%

Source: M&G Investments, Bloomberg, data to 30 December 2022

The risk-on sentiment over the quarter saw equities outperform bonds, while emerging market returns were in line with those of developed markets. For the quarter ended 31 December 2022, the MSCI All Country World Index returned 9.8%, the MSCI World Index (developed markets) also delivered 9.8%, and the MSCI Emerging Markets Index produced 9.7% (all in US$). Bonds also posted meaningful gains: the Bloomberg Global Aggregate Bond Index delivered 4.5% (in US$). Beaten-down property stocks were among the strongest performers, with the FTSE EPRA/NAREIT Global REIT Index returning 6.6% (US$).

Key central banks like the Bank of England and European Central Bank (ECB) followed the US Federal Reserve's lead during the quarter, each hiking interest rates by 75bps in November and 50bps in December – the latter a sign of some slowing in the upward trajectory. However, all of these banks also indicated rates were likely to remain higher for longer than previously expected given their tough inflation stances, and signs that inflation was becoming more pervasive, including rising services costs and wages. Each acknowledged the negative consequences for economic growth in 2023.

In South Africa, the SARB also matched the Fed's 75bp rate hike in November and is expected to follow its 50bp increase in January. Despite continued loadshedding and a spike in political risk in early December on reports that President Cyril Ramaphosa might resign, local equities and bonds benefitted from the more optimistic investor sentiment, outperforming the major global indices. The FTSE/JSE All Share Index (ALSI) returned 15.2% in Q4, and the Capped SWIX 12.2% (both in rands). Listed Property shares were the strongest performers with an 18.2% return (All Property Index), followed by Resources with 17.6% (Resources 10 Index), Industrials (15.7%) and Financials (11.9%).

For the 12 months to 31 December, it was a story of strong outperformance for SA equities, as the ALSI returned 3.6% in rands, and -2.3% in US$, outperforming the -18.4% recorded by global equities (the MSCI All Country World Index), and the -20.1% recorded by the MSCI Emerging Markets Index (both in US$).

SA bonds also significantly outperformed again in Q4: the FTSE/JSE All Bond Index (ALBI) delivered 5.7%, outperforming global bonds yet again (-1.5% in rand terms). For the 12 months to 31 December, local bonds (ALBI) outpaced global bonds with a return of 4.3% versus -11.2%, in rands. Inflation-linked bonds (ILBs) produced 2.0% and cash returned 1.6% for Q4. Finally, the rand posted a mixed performance, gaining 5.8% against a weaker US$ but losing 1.9% against sterling and 2.8% versus the euro over the quarter.

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.

After three quarters of losses, US Treasury bonds posted solid gains in Q4 on the back of their attractive valuations and perceptions of somewhat lower risk as inflation passed its peak in many countries. Although global bond markets remained unusually volatile, the Bloomberg Aggregate US Treasuries Index returned 4.8% in US$, for a total return of -17.5% for 2022. This was its weakest result for many years. Meanwhile, US equity returns were in the black (apart from the Nasdaq) for the quarter: in US$, the Dow Jones produced 16.0%, the Nasdaq delivered – 0.8%, and the S&P 500 returned 7.6%. The S&P 500 recorded a -18.1% total return for 2022, the worst since the 2008 Global Financial Crisis.

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. Finally, new Prime Minister Rishi Sunak's sweeping new budget plan was greeted more favourably than Liz Truss's disastrous September mini budget, proposing higher taxes and lower spending in an effort to reduce the government's substantial debt levels. For Q4 2022, the FTSE 100 returned 17.1% in US$, and -7.0% for 2022 as a whole.

The ECB followed the US Fed and BoE with its own 50bp hike in December after a 75bps increase in late October, 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: it downgraded the region's GDP growth to 0.5% in 2023 (from 0.9% previously), while in 2024 it is still projected at 1.9%. In France, the CAC 40 returned 22.6% in Q4, and -12.4% for 2022 (in US$). Meanwhile, Germany's DAX delivered 25.2% for the quarter and -17.4% for 2022 (in US$).

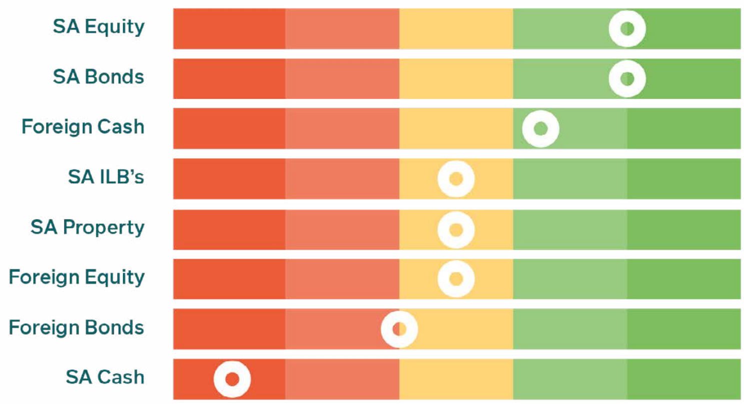
In Japan, the Bank of Japan (BOJ) surprised markets in mid-December with its first effective interest rate hike, raising its 10-year bond yield range by 0.25% to 0.50% after long periods of stability. This triggered equity and bond losses globally over fears that Japanese investors could start moving to hold more Japanese bonds by selling their large holdings of US Treasuries. It also sparked a 3% gain in the yen on the day. 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. Following other global equity markets higher, the Nikkei returned 10.6% in US$ for the quarter but was down 19.1% for the year.

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 new wave of Covid infections was spreading, with some projections that it could result in upwards of 1.0 million deaths, given the vulnerability of the population and fears that it would spread widely during the Chinese New Year travel period. 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. Ongoing property market weakness also undercut consumer and business sentiment.

The People's Bank of China (PBoC)'s benchmark lending rates were unchanged throughout the quarter, after having implemented a surprise rate cut in August. Late in December the Bank pledged to support domestic demand and is working together with the government and its spending initiatives to stimulate growth. The yuan regained some ground against the US dollar in Q4 after having hit a 13-year low against the currency in September, but still ended 2022 roughly

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.

8.5% weaker against the greenback for the year. The ongoing monetary policy divergence between China and the US has placed pressure on the yuan to depreciate and caused some capital outflows.

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. Hong Kong's Hang Seng produced 15.8% for the quarter and -12.6% in 2022 (in US$). The MSCI China returned 13.5% in Q4 and -21.8% in 2022, both in US$.

Larger emerging equity markets posted a broad range of returns over the quarter, led by Turkey (returning 62.9% in US$ due to its own idiosyncratic factors). The MSCI South Africa posted a very respectable 18.5% return, while the MSCI India returned 2.1% and Brazil's Bovespa delivered 2.2% (all in US$). South Korea's KOSPI was deep in the red with 19.4% in US$.

The oil price fell during the quarter on the back of expected lower demand and improved supply, even though in December some supply cuts came from Russia. Brent crude oil lost 2.3% in US$, ending the quarter at around US$83 per barrel. Over the past 12 months the oil price is now only 10.5% higher. Other commodity prices gained ground in Q4 amid the more positive sentiment, apart from palladium, which fell 17.2% after gaining in the previous quarter. Among precious metals, gold rose 9.8% and platinum jumped 24.1%. In industrial metals, Nickel was the strongest gainer at +36.5%, lead was up 23.6%, aluminium rose 8.3%, copper increased 9.7% and zinc was up only 1.3% in Q4.

South Africa

Thanks to the renewed global risk-on sentiment, the final months of 2022 proved to be better ones for South African investors, despite the elevated market volatility. Our local equity and bond returns outperformed global market benchmarks in Q4. SA bonds and the rand even fully recovered their losses from the 1-2 December market sell-off prompted by reports that President Ramaphosa was considering resigning over the Phala Phala scandal. At the party's mid-December elective conference ANC members rallied behind him and he emerged even stronger than before, with more ANC Executive Committee members supporting his economic reform agenda. This helped lower political risk premia on SA assets.

Also in more positive news, November CPI fell to 7.4% y/y from 7.6% in October, primarily attributable to lower energy prices: the SARB forecast it to reach the 4.5% mid-point of its target range by Q2 2024. Equally positive was that Q3 real GDP growth surprised to the upside at 1.6% (q/q annualised), led largely by higher agricultural production. By the end of the period, the size of the SA economy had finally exceeded pre-pandemic levels.

However, in its Medium-Term Budget, the National Treasury lowered its growth expectations for 2022 to 1.9% (versus 2.1% previously), and for 2023 to 1.4% from 1.6%. The SARB's latest projection was for 1.8% GDP growth in 2022. This was due to still-elevated inflation, rising interest rates, subdued consumer demand and slower economic growth, the war in Ukraine and the impact of loadshedding: in its December Quarterly Bulletin, the SARB estimated that Q3 real GDP growth (quarterly) had likely been reduced by 2.3 percentage points due to the high intensity of power cuts. For the year to end-October, it said, loadshedding had occurred 33.4% of the time, or an average of 10.4 calendar days per month.

How have our views and portfolio positioning changed in Q4 2022?

Starting with our view on offshore asset allocation, during the quarter (as in Q3) we gradually increased our global exposure across equities and bonds as their valuations became more attractive relative to SA assets. By year-end we were much less underweight offshore assets versus local assets in our house-view portfolios – roughly neutral – compared to the start of 2022. We also took advantage of the rand strength versus the US$ during the quarter and reduced our forex hedges in rands.

Within our global holdings, we lifted our exposure to global bonds and global equities out of cash as valuations cheapened, with bonds relatively more attractive than equities as yields continued to rise. Within global bonds we are broadly neutral, and have a preference for 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. Within global equities, we remain selective and somewhat cautious, and are still leaning slightly away from US equities. While global equities are trading at relatively cheap levels if valuations are to be believed, in our view there are still unresolved questions around risks to earnings going forward. As such, we are largely neutrally positioned in our portfolios.

Our global cash holdings continue to partially cushion our funds, as well as providing some liquidity to take advantage of new market opportunities that could arise. We are mindful of the risks that exist globally in terms of slower economic growth, rising interest rates and embedded inflation – any negative surprises present downside risks for corporate earnings and bond prices.

Our house-view portfolios like the M&G Balanced Fund still favoured SA equities at the end of Q4. During the quarter, our overall weight in this asset class changed little. SA equity valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) re-rated over the quarter, rising from around 7.8X to around 9.0X at quarter-end. Almost all of this re-rating was attributable to share price gains, as earnings estimates fell only marginally.

Within SA equities, our Resources exposure was a positive contributor to absolute returns for our house-view portfolios during the quarter, given that sector's strong performance. Holdings like Anglo American, Glencore, Sibanye and Northam Platinum added good value, as did Industrials like Richemont and MTN. Lower, but still meaningful, contributions also came from our overweight in banks including Investec, Standard Bank and Absa. Detractors included Sasol (on the back of the drop in the global oil price) and Foschini.

We held a marginally underweight position in SA listed property in Q4 2022, preferring exposure to other 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.

Our portfolios also benefitted from our ongoing preference for SA nominal bonds in the fourth quarter due to their positive returns despite a very volatile period.

The 10-year SA government bond rallied approximately 50bps, falling from 11.4% to 10.9% at quarter-end, still at a relatively high level on a historic basis. It was mid- and longer-dated bonds (seven years and beyond) that outperformed over the period as shorter dates reflected the SARB's rate hikes; this also benefitted our specific holdings. 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.

Although we are not holding inflation-linked bonds (ILBs) to a meaningful degree in our house-view portfolios, we do hold them in our real return portfolios like the M&G Inflation Plus Fund, where we are largely neutral these assets. This view proved to be somewhat beneficial on an absolute basis given that ILBs underperformed nominal bonds in Q4. Although their real yields remain relatively attractive compared to their own history and our long-run fair value assumption, compared to nominal bonds their valuations are less attractive and they have lower return potential.

Lastly, despite the SARB's interest rate hikes during the quarter, our house-view portfolios remained tilted away from SA cash as our least-preferred asset class, given the extremely low base rate off which the SARB has hiked. In our view, other SA assets remain more attractive on an absolute and relative basis. □