M&G Investments

Q2 2023

Market Observations

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The second quarter (Q2) of 2023 brought mixed results for investors, with global bonds losing ground but global equities performing relatively strongly in developed markets, even surprisingly so given the ever-changing outlook for global growth over the three months. A more positive growth outlook prevailed for the US, even as China's deteriorated, pushing US and other developed market equities higher while keeping emerging market equities relatively weaker. Meanwhile, global bonds were also weaker as the US Federal Reserve, along with other central banks, surprised with their ongoing hawkish stance by confirming the necessity of additional rate hikes. Investors continued to juggle the risk of the Fed's extra tightening bringing on a short-term recession versus the resilience of consumer spending and other economic growth factors, but June brought a healthy equity rally that helped erase weakness earlier in the quarter.

Asset class	Total return Q2 2023 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	0.7%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	1.2%
SA listed property – FTSE/JSE All Property Index (Rand)	1.0%
SA bonds – FTSE/JSE All Bond Index (Rand)	-1.5%
SA inflation-linked bonds – FTSE/JSE Inflation-Linked Index (Rand)	-0.7%
SA cash - STeFI Composite Index (Rand)	1.9%
Global equity – MSCI All Country World (Total, US$ net)	6.2%
Global equity – MSCI World (Developed) (US$ net)	6.8%
Global equity – MSCI Emerging Markets (US$ net)	0.9%
Global bonds – Bloomberg Global Agg Bond Index (US$ net)	-1.5%
Global property – FTSE EPRA/NAREIT Global REIT Index (US$ net)	0.6%

Source: M&G Investments, Bloomberg, data to 30 June 2023

Other major economies continued their rate hiking cycles as well, with the Bank of England making headlines for its higher-than-expected 50bp increase in June, and Canada and Australia also implementing surprise hikes. Meanwhile, China and Japan maintained their easy monetary policies to support their expansions. Global equity returns outperformed bonds for a second quarter, while developed equity markets outperformed emerging equity markets. For the three months ended 30 June 2023, the MSCI All Country World Index delivered 6.2%, and the MSCI Emerging Markets Index produced 0.9% (in US$). At the same time, the Bloomberg Global Aggregate Bond Index delivered -1.5% (in US$) and global property stocks (the FTSE EPRA/NAREIT Global REIT Index) returned 0.6% (US$).

In South Africa, financial markets were even more volatile, with growth prospects continuing to be weighed down by loadshedding. In addition, the country was hit hard by a sell-off of SA bonds, banking shares and currency in May amid reports that South Africa was selling weapons to Russia and adopting a supposedly pro-Russian stance in its war against Ukraine and more generally. This prompted fears of retaliation from the West through trade and/or financial sanctions, leading to elevated investor risk perceptions for local investments. In June, however, these fears abated somewhat and the assets regained ground (especially bank shares), but risk perceptions did remain higher compared to Q1 as reflected by a weaker rand and elevated bond yields.

The SA equity market was dragged down in Q2 by losses in Resources shares amid fears of slower demand (particularly from China), offsetting good gains in Financials (after rebounding in June) and respectable returns from Industrials. The FTSE/JSE All Share Index (ALSI) returned 0.7% in Q2, while the more locally exposed Capped SWIX delivered 1.2% (both in rands). Industrial counters returned 3.4%, while Financials produced 5.9%, Resources -6.4% (Resources 10 Index) and the All Property Index 1.0% (all in rands).

For the quarter, SA nominal bonds (the FTSE/JSE All Bond Index) delivered -1.5% in rands after largely retracing May's

significant losses, while inflation-linked bonds (ILBs) produced -0.7% and cash returned 1.9%. Finally, despite regaining some 4.6% against the US dollar in June as sentiment improved, the rand still lost 6.5% against the greenback for the quarter, and depreciated 6.9% against the euro and 9.5% versus the UK pound as sentiment toward SA remained depressed. So far this year the rand has lost 11.6% versus a weakening US dollar.

In the US, the Fed hiked its repo rate by 25bps at its May FOMC meeting and then paused in mid-June to assess the economic impact of its cumulative hiking cycle, moves that were expected by the market and brought temporary relief to interest rate markets. However, unexpectedly hawkish comments by Fed Governor Jerome Powell and other Fed Presidents subsequent to the meeting surprised markets by indicating another 1-2 increases ahead, equivalent to a potential additional 50bps. This "higher for longer" view, on top of more hawkish sentiment coming from most other central banks that hiked in late June, weighed on global bond markets, leading to losses. For example, the 10-year US Treasury yield ended the quarter yielding 3.8% compared to 3.5% at the start.

US inflation news was positive, with sharp drops in both CPI and PPI seen in May on the back of lower energy and food prices: CPI fell to 4.0% y/y from 4.9% y/y in April, while PPI dropped to 1.1% y/y versus 2.3% y/y previously. Still, this was well above the Fed's CPI 2.0% target, and core CPI (excluding food and energy) remained high at 5.3% y/y. Good news also came in late June in the form of a sizeable upward revision in US Q1 2023 GDP growth to 2.0% from 1.3% previously, underpinned by resilient consumer spending. The labour market also remained strong, defying predictions. These developments helped buoy US equity markets, even though signs of a slowdown multiplied, such as a lower May Manufacturing PMI. For the quarter, US equity returns were robust: the Dow Jones produced 4.0%, the Nasdaq 13.1%, and the S&P 500 8.7% (all in US$).

In the UK, the BOE's higher-than-predicted 50bp hike in June brought its base lending rate to 5%, the highest level since 2008, as the UK battled a stubbornly high CPI of 8.7% y/y in May, unchanged from April and the highest among major developed economies. Markets anticipate further rate hikes with no pause as the central bank has lagged others in its tightening cycle. The UK economy eked out 0.1% q/q growth for Q1 2023, avoiding a recession, but investors fear it could be tipped into contraction by the BOE's aggressive stance. Similar to the US, resilient consumer demand and a tight labour market are keeping growth buoyant but also fuelling inflation. For Q2 2023, the FTSE 100 returned 2.5% in US$.

At its June meeting, the European Central Bank (ECB) announced a 25bp rate rise to 3.5%, in line with expectations, while also raising its inflation and growth forecasts and ruling out any pause in its hiking cycle. As such, markets widely anticipate another 25bp hike at its July policy meeting and the chance of another increase in September, before a possible pause towards year-end. Euro area CPI stood at 6.1 y/y% in May, triple the Central Bank's 2% target, while core CPI was sticky at 5.3% y/y. Seven Euro area economies contracted in Q1 2023, putting the region in a mild technical recession with -0.1% GDP growth. In European equity markets, France's CAC 40 returned 4.0% and Germany's DAX delivered 3.8% (in US$) in Q2.

Japan impressed investors with its continued recovery during Q2, reporting much better-than-expected revised GDP growth figures at 2.7% (versus 1.9% forecast) for Q1 2023. CPI rose to 3.2% y/y in May, high for the economy. However, the Bank of Japan continued its easy monetary policy, keeping its key lending rate at -0.1% as widely expected, saying that while they noted the rise in inflation, they would maintain policies designed to lift the country out of decades of deflation. Price increases have been driven by strong consumer demand and a weaker yen. These positive developments lifted enthusiasm for Japanese stocks, which saw the Nikkei return 9.1% in US$ for the quarter, making it one of the best-performing developed equity markets in the first half of 2023, along with the Nasdaq.

During the three months, China reported somewhat disappointing GDP growth of 4.5% for Q1 2023. The country's rebound clearly lost momentum in Q2, with inflation falling, new borrowing declining and retail sales growth slowing amid declining consumer confidence. Other reports showed lacklustre May industrial production growth at 3.5% y/y from 3.6% y/y previously. The data prompted analysts to revise lower their growth forecasts for 2023 as a whole, now ranging from approximately 4.5%-6.5%. Pent-up consumer demand continues to underpin the current (weaker) expansion, along with consumer services, while the property sector remains weak and youth unemployment high.

In a bid to spur growth and meet the government's 5% growth target for 2023, the People's Bank of China (PBOC) cut both short- and medium-term interest rates, and analysts now expect further cuts and stimulus measures from the central bank such as expanded infrastructure financing and easing in lending requirements (like mortgage downpayments). The slowdown and growing pessimism around growth weighed on local stock markets, with Hong Kong's Hang Seng returning -5.9% for the quarter and the MSCI China delivering -9.6%, both in US$.

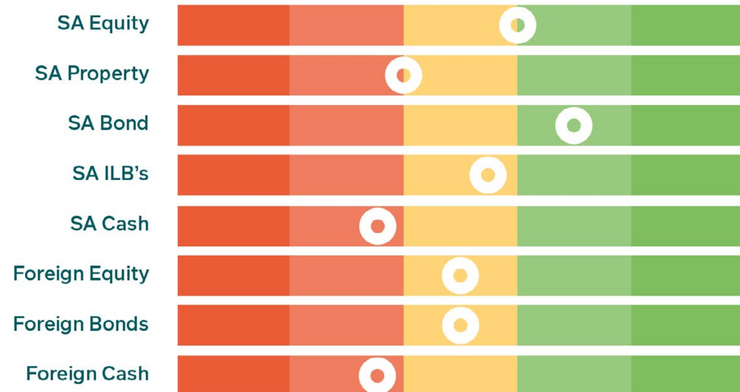
Larger emerging equity markets posted a broad range of returns over the quarter in US$, led by Brazil's Bovespa with 21.8% and the MSCI India at 12.4%. South Korea's KOSPI was also in the black with a 2.5% performance. The MSCI Turkey recorded a

-10.6% return, the MSCI South Africa -4.7% and the MSCI China -9.6% for the period (all in US$).

The international oil price trended lower during the quarter, with Brent crude ending at around US$76 per barrel from around US$80 per barrel at the start of the period on the back of expected lower demand as global growth slowed, even as producers like Saudi Arabia announced plans for further supply cuts. Brent crude oil has lost approximately 13% in US$ terms since the beginning of 2023. Other commodity prices also moved lower in Q2 amid the uncertain outlook; even the price of gold fell 2.5%. Zinc was the largest loser, down 18.7%, while nickel lost 12.7%, aluminium fell 10.3% and copper was down 8.1%. Among platinum group metals, palladium fell 16.0% and platinum lost 9.1%.

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.

South Africa

In South Africa, the SARB surprised the market at its May MPC meeting by hiking the repo rate by an aggressive 50bps to 8.25%, worried about still-high inflation and the future inflationary impact of the weaker rand. And following the central bank's hike, SARB governor Kganyago remained tough in his anti-inflation stance, saying in late June that interest rates might need to go higher and stay there for longer. As such, the market is now expecting another 25bp hike at the MPC meeting in July and a possible extra 25bps in September. This in the face of slowing CPI, which fell markedly to 6.3% y/y in May from 6.8% in April, and expectations of a further decline in June as energy prices continued to ease and the rand rebounded. The SARB forecasts CPI to fall within its 3-6% target band in either Q3 or Q4 this year.

The SARB also revised upward slightly its economic growth expectations for 2023, to 0.3% from 0.2% in March, following the release of better-than-expected Q1 GDP data showing growth at 0.2% y/y, meaning South Africa had avoided a technical recession following a 1.1% contraction in Q4 2022. Still, the figures showed loadshedding and logistical issues were depressing fixed investment and consumer and business sentiment, with the important contributor of household spending rising only 0.4% during the quarter. June reports revealed the FNB/BER Consumer Confidence Index fell to -25 points for Q2, its second-lowest level on record after the -36 points seen during the Covid hard lockdown period of Q2 2020. At the same time, the country's Manufacturing PMI fell to 49.2 points in May, indicating a contraction in activity, due largely to weak demand.

How have our views and portfolio positioning changed in Q2 2023?

Starting with our view on offshore vs local asset allocation, during the quarter we increased our global exposure slightly at the expense of our local cash exposure as a risk mitigation measure.

Within our global holdings, we bought both global equities and global bonds out of global cash during the quarter as the risk outlook started to improve, but remained neutral in these asset classes. We are also now tilted away from global cash, partly due to our forex positioning favouring the rand after its May sell-off.

While many global equity markets are still trading at relatively attractive levels, they became more expensive over the quarter, especially in the US: the MSCI ACWI forward P/E rose to 16.4X from 15.8X at the beginning of the quarter. Company earnings reports were mixed, with some starting to reflect downward revisions as the effects of central banks' aggressive monetary tightening began to appear. Because there are still unresolved questions around risks to earnings going forward, we remain selective: we are still leaning away from US equities due to their relatively expensive valuations versus other markets, and are also underweight Canada and Australia. We prefer the UK, Japan, China and other emerging markets that are relatively cheap, and we added to our Japan and China holdings out of global cash during the quarter.

For example, in China an additional risk premium has been priced into equities, with depressed multiples on depressed earnings, largely as a consequence of geopolitical factors such as the Russia-Ukraine war and Taiwan. Yet the economy is recovering – albeit not as strongly as hoped – and the yuan is weak, inflation is low, and the government has low foreign debt, all making the country very competitive. Equally, more stimulus is expected from the government.

Within global bonds, we stayed broadly neutral in our funds and added to our position in 30-year US Treasuries and 30-year UK gilts as yields rose. We also prefer sovereign EM bond markets where the real yields are high and the currency is trading at fair-to-cheap levels. Real global bond yields became more attractive over the quarter and offer more-than-fair compensation for the risk involved, which primarily can be seen as "higher for longer" interest rates. These global bonds are also solid diversifiers for SA equity risk.

Our house-view portfolios like the M&G Balanced Fund still favoured SA equities at the end of Q2 2023, with our position largely unchanged. SA equity valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) re-rated marginally over the quarter, rising from around 9.5X to around 9.6X at quarter-end due to lower earnings expectations.

Within SA equities, our holdings of strongly performing shares like Richemont, MTN, Textainer, Reinet and Naspers/Prosus added value to our portfolios during the quarter, as did our collective overweight exposure to SA banks like Standard Bank, First Rand and Investec. Resources holdings broadly detracted from performance, such as Implats, Northam Platinum, and Anglogold Ashanti, as did Multichoice and Spar (both dependent on SA consumers).

During the quarter we remained tilted away from SA listed property as property sector risks remained high. We still prefer exposure to non-property 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.

Following their sharp-selloff in May, we increased our already-preferential positioning in SA nominal bonds, buying them at very attractive yields out of SA cash. The 10-year SA government bond yield reached a high of 12.1% at the end of May, compared to 10.7% at the start of the quarter, before retracing some losses to end June at around 11.4%. We continue to believe SA nominal bond valuations are attractive relative to other fixed income assets and to their own longer-term history and will more than compensate investors for their associated risks.

Although we do not hold inflation-linked bonds (ILBs) to a meaningful degree in our house-view portfolios, we hold them in our real return portfolios such as the M&G Inflation Plus Fund. Here we are marginally favouring these assets. Their real yields remain relatively attractive (compared to their own history and to our long-run fair value assumption, but their valuations are less attractive than nominal bonds, giving them lower return potential.

Lastly, the SARB's interest rate hikes during the quarter made SA cash relatively more attractive as an asset class. However, apart from SA property, we still prefer other local asset classes for the higher real yields available on both an absolute and relative basis. In Q2 our SA cash holdings declined as we opted to buy more SA nominal bonds. As such, our house-view portfolios remained tilted away from SA cash.

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