M&G Investments

M&G 7% Target Income Fund

Target Income

Q2 2024

Market overview

The second quarter of 2024 (Q2) saw a moderation in the bullish investor sentiment towards global equities during the previous two quarters, as stubbornly persistent inflation in the US prevented the US Federal Reserve (Fed) from starting to lower interest rates, despite an expectedly high number of companies reporting strong fundamentals in their results across a variety of sectors. Election uncertainties also weighed on market sentiment in France and the UK, but positive results in South Africa and India encouraged equity rallies. Other central banks like the European Central Bank did enact cuts, however, helping both developed and emerging market equities record moderately positive returns. Meanwhile, global bonds were weaker as US investors moved out their rate cut expectations significantly: the majority now forecast either 25bps or 50bps of reductions starting in September at the earliest.

Global equity (as measured by the MSCI ACWI) recorded a total return of 2.9% in Q2 compared to 8.2% in Q1, while developed market equities produced 2.6% and emerging market equities returned 5.0% (MSCI Emerging Markets Index – all in US$). Global bonds posted -1.1% (Bloomberg Global Aggregate Bond Index, in US$).

Emerging markets led equity returns with strong performances from Turkey, South Africa, India and China. India recorded a surprise election result that helped reinforce democracy, and China saw a rebound amid improving sentiment and economic data.

In South Africa, asset prices rallied, and the rand gained ground on the back of what investors considered to be a successful outcome for the May national elections, in which there was almost no violence, the new Government of National Unity (GNU) was formed timeously, and President Cyril Ramaphosa was sworn in for his second term. Both the FTSE/JSE All Share Index and Capped SWIX Index delivered 8.2% in rand terms, boosted by a notable 17.8% return from Financials, 5.7% from Listed Property, 5.2% from Industrials, and 3.4% from Resources, due to general gains in commodity prices.

South African bonds posted a 7.5% return for the quarter. This saw the yield on the 10-year SA government bond fall from 12% at the beginning of the quarter to end around 11.25%. SA inflation-linked bonds returned 2.4%. Finally, the rand gained 3.7% against both the US dollar and the pound sterling and appreciated 4.5% versus the euro.

United States

In the US, positive investor sentiment toward equities cooled slightly as the US Federal Reserve (Fed) continued to keep interest rates on hold for the quarter amid stubbornly high services inflation. At its 12 June meeting it raised its inflation forecast slightly and the "dot plot" guidance indicated its members' interest rate expectations now comprised only one 25bp rate cut this year, although several members did foresee two 25bp cuts. This important adjustment indicated rates would end 2024 at 5.1% compared to 4.6% in their March guidance.

This came as May CPI was recorded at 3.3% y/y, softer than the 3.4% expected, as goods inflation and certain other CPI components were broadly lower. Core PCE, the Fed's preferred inflation measure, was 2.6% y/y, as expected, down from 2.8% in April and the lowest since March 2021. At the same time, US GDP for Q1 2024 was revised down to 1.3% from 1.6% previously, a disappointing result as manufacturing activity, business investment and demand, and consumer demand are constrained by high borrowing costs. As for 2024 growth, the Fed kept its forecast at 2.1% for the year. For the quarter, the Dow Jones produced -1.3%, the Nasdaq 8.5%, and the S&P 500 4.3% (all in US$).

United Kingdom

In the UK, the Bank of England (BoE) again kept its main interest rate unchanged at 5.25% at its May and June meetings, even as May CPI fell to 2.0% y/y from 2.3% in April. The chances for a cut in interest rates improved, with the market pricing in a 25bp rate cut in August and more expected. The economy emerged from a technical recession: Q1 2024 GDP growth was reported at 0.6% y/y. Meanwhile, with the latest data indicating improving economic conditions, Conservative Prime Minister Rishi Sunak called a National Election for 4 July, much sooner than expected. However, polls show Labour leading by a substantial 20% margin, and expectations are for the Conservatives to lose power, injecting higher levels of uncertainty into the local financial market. In Q2 2024, the FTSE 100 returned 3.8% in US$, but lost 1.8% in June.

Euro area

In the Euro area, the European Central Bank (ECB) lowered its benchmark interest rate by 25bps at its June meeting to 3.75%, as had been expected. May CPI came in at 2.6% y/y, just above the 2.5% consensus and still higher than the ECB's target of 2.0%. However, inflation is projected to soften further despite stubborn services inflation. Meanwhile, GDP growth improved to 0.3% y/y in Q1 2024 versus a downwardly revised -0.1% y/y the previous quarter. The French equity market sold off in June after President Emmanuel Macron announced a snap parliamentary election for 30 June/7 July following his centrist coalition's resounding defeat in the European parliamentary elections by the far-right National Rally party headed by Marine le Pen. The first round of the French parliamentary elections showed both the far-right and far-left parties defeating Macron's centrists, and the election will be completed on 7 July. France's CAC 40 returned -7.3% in Q2 after losing 7.4% in June, while Germany's DAX delivered -2.1% for Q2 (both in US$).

Japan

After having hiked interest rates for the first time in 17 years in March, the Bank of Japan sounded a cautious note at its subsequent policy meetings, saying in June that it would

Annualised performance	A class	CPI	B class
1 year	10.4%	5.2%	10.8%
2 years	9.9%	5.8%	10.3%
3 years	7.6%	6.0%	7.9%
5 years	6.5%	5.0%	6.8%
Since inception	6.5%	5.1%	-

Fund facts

Fund objective

To target an annual income return of 7%, with a secondary objective of growing capital invested. While a 7% annual income return is targeted, the actual income return may vary.

Investor profile

Income drawing investors who want to invest in a fund that aims to earn 7% income per year. Subject to this income return being achieved, investors also want capital growth over time. The very high level of targeted income return means it is most likely that the real value of capital after targeted income drawdowns will be eroded over the long term.

Investment mandate

The Fund invests in a flexible mix of local and foreign equity, bonds, property and cash. The Fund can also invest in derivatives and other collective investment schemes. The Fund is not managed to conform to the regulations governing retirement fund investments (Reg. 28). Besides a max. total equity exposure of 70%, the Fund is not limited in terms of allocation to asset classes, currencies or geographies.

Income distribution

The income earned from the Fund's underlying assets will be distributed quarterly. Typically, investors will reinvest these distributions. Regular drawdowns, which could be made monthly, quarterly, half-yearly or yearly, will be funded through the sale of units.

Fund managers

Sandile Malinga
Michael Moyle
Leonard Krüger

ASISA category

Worldwide - Multi-Asset - Unclassified

Primary objective

7% Income return p.a.

Inception date

2 April 2019

Fund size

R338 497 350

Sources: M&G Investments, Morningstar & Deutsche Securities

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be considered around further hikes given the fragile state of Japanese consumer demand. This came amid downward revisions to GDP growth for both Q1 2024 and Q4 2023: the former was lowered to -2.8% y/y from -1.9% y/y, and the latter to 0.1% y/y from 0.3% previously. May CPI came in slightly lower than expected at 2.5% y/y versus 2.6% y/y. With global economic growth slowing, Japan's export-reliant economy is facing more headwinds. After a strong 13.2% return in Q1, the Nikkei retraced some of its gains in Q2 with a return of -7.6%.

China

In Q2, China's Q1 GDP growth surprised significantly to the upside at 5.3% y/y versus the 4.6% expected. However, the latest fundamental data showed renewed weakness as new bank lending was softer than expected in the wake of the PBOC's key interest rate cuts in Q1, exacerbated by ongoing soft consumer demand, and lower consumer and business confidence, among other headwinds. Declines in new home prices accelerated despite the government's ongoing efforts to reduce oversupply in the property sector and provide support for overleveraged property companies. May CPI was recorded at only 0.3% and calls for more interest rate cuts grew. However, the PBOC refrained from enacting any further cuts during the quarter, constrained by the weakness of the yuan. Chinese equities rebounded in the quarter after the PBOC's Q1 rate cuts, with Hong Kong's Hang Seng returning 9.2% and the MSCI China delivering 7.2%, both in US$.

Emerging markets

The MSCI Turkey was among the strongest performers for the quarter with a robust return of 21.6%, while South Africa and India enjoyed improved sentiment from their successful national elections, delivering 12.5% and 10.4%, respectively (both in US$). The rebound in China boosted the MSCI China and offered investors a 7.2% return. Weakest with a return of -12.8% was Brazil's Bovespa, while South Korea's KOSPI was largely flat at -0.1% (all in US$).

Commodities

Global inflationary pressures were mixed in Q2 as most commodity prices moved higher but the price of Brent crude oil ended the period almost unchanged, rising from approximately US$86/bbl at the beginning of the quarter to around US$ 91/bbl almost immediately, and then falling to US$75/bbl at the beginning of June, and ending the quarter at around US$85/bbl. Sentiment was mixed between slowing global growth, especially in the US, production cuts from OPEC+ members, and an escalation in Middle East tensions which could lead to further supply restrictions. Among precious metals, gold gained 4.2%, while platinum rose 10.4% and palladium dropped 4.2%. Zinc was the largest gainer, up 23.4%, and aluminium, copper and lead were up between 9.0% and 11.1%.

South Africa

In South Africa, sentiment improved as investors deemed the May national elections a success. This caused a re-rating across asset classes, as noted above, as uncertainties around future governance and policies abated significantly.

Meanwhile, the SA Reserve Bank kept its base lending rate steady at 8.25% during the entire quarter, as expected, given the central bank's hawkish stance on inflation. May CPI was steady at 5.2% y/y, only slightly lower from its 5.3% y/y level at the beginning of the year, and still far above the bank's 4.5% target. This highlighted the persistent inflationary pressures that are dogging the economy. Businesses and consumer inflation expectations also remain above the 4.5% target, a trend Governor Lesetja Kganyago is determined to reverse. Finally, despite an improvement in loadshedding, the economy remained in the doldrums as Q1 2024 GDP growth contracted slightly at -0.1% (after a revised 0.3% in Q4 2023), but the SARB maintained its growth forecasts of 1.2% in 2024 and 1.3% in 2025.

Performance

The M&G 7% Target Income Fund returned 5.8% (A class, net of fees) for the second quarter of 2024 and 10.4% for the 12-month period ending 30 June 2024.

Looking at the fund's asset allocation, SA bond holdings added by far the most value to absolute performance for the quarter, followed by SA equity exposure. Global bond exposure was the largest detractor, while other global asset classes were also slightly negative mainly due to rand strengthening.

Within SA equities, the rally in Foschini and Spar shares added good value to the fund, as did the rebound in banking shares. Other notable contributors included globally exposed holdings Prosus/Naspers, and mining counters Anglogold Ashanti and Exxaro. The largest detractors from performance were Multichoice (over concerns around its Nigerian operations) and shares in stocks that we don't hold in the portfolio, namely Capitec, Nedbank and Sanlam.

Strategy and positioning

Starting with our view on **offshore versus local asset allocation** in our house-view portfolios, during the quarter we did not adjust our positioning meaningfully, although the equity valuation gap between the two narrowed somewhat: the rally in South African equities and bonds following the positive election results led to the local assets to outperform global equities and bonds. At the same time, the MSCI ACWI's valuation fell slightly. We are comfortable with our ongoing positioning favouring more attractively valued SA assets compared to their global counterparts.

Within our **global holdings**, we remained broadly neutrally positioned in global equity, with an underlying underweight in the US market, as well as retaining our small overweights to global bonds and global cash. During Q2 we took profits on a portion of our overweight position in Chinese equities following the quarter's rally, which added to portfolio performance. The position remains slightly overweight at quarter-end. Proceeds from the sale went to the purchase of US equities, reducing some of the existing underweight, and to increase our exposure to Mexican equities.

In **global equities**, the MSCI ACWI 12-month forward P/E fell slightly to 17.6X at quarter-end from 17.9X at the beginning of the quarter. As noted above, we took profits on a portion of our overweight position in Chinese equities following the quarter's rally, which added to portfolio performance. The position remains slightly overweight at quarter-end. Proceeds from the sale went to the purchase of US equities, reducing some of the existing underweight, and to increase our exposure to Mexico. However, we remained broadly neutrally positioned in global equity, with an underlying underweight in the US market. With the S&P 500 Index valuation almost unchanged on a high 21X forward P/E for the period, we prefer cheaper markets such as the UK, Mexico and other emerging markets.

We are taking advantage of the many diverse stock-picking opportunities currently available as the gains in global equities recorded so far in 2024 have been pleasingly spread across

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Sources: M&G Investments, Morningstar & Deutsche Securities

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sectors and geographies, and the top performers have produced returns varying between 40% and over 100%.

Within **global bonds**, we did not make any changes to our slightly overweight duration positioning during the quarter. We continue holding some 30-year US Treasuries, which adds duration to our portfolios, as well as moderate levels of local currency sovereign EM bonds where the real yields are high, and the currency is trading at fair-to-cheap levels.

Our house-view portfolios were also still underweight **global corporate credit** at quarter-end, based on our view of credit spreads as very unattractive for the risk involved versus their government counterparts.

Our house-view funds still favoured **SA equities** at the end of Q2 2024. SA equity valuations (as measured by the 12-month forward P/E ratio of the FTSE/JSE Capped SWIX Index) became somewhat less cheap during the quarter, rising from 9.7X to 9.9X, as share prices gained ground amid positive investor sentiment toward the outcome of the May national elections. The portfolios benefited from their overweight in banking stocks, and conditions remain favourable for stock-picking.

In Q2 we did not change our underweight exposure in **SA listed property**, although there are some indications that fundamentals are starting to improve. The sector could also gain some impetus from expected interest rate cuts, but these hopes have been deferred in line with interest rate cut expectations over the quarter, so for now we remain cautious. Property sector risks continue to be high relative to other sectors, and cash yields are at attractive levels. We still prefer exposure to non-property shares that we believe offer better value propositions for less risk.

We also did not change our overweight positioning in **SA nominal bonds** in our house-view portfolios. Despite the fall in bond yields during the quarter, given their very elevated levels, real yields remain attractive compared to history, other global sovereign bonds and other SA fixed income assets. The current yields should more than compensate investors for their associated risks over time.

Our house-view portfolios have no meaningful exposure to **SA inflation-linked bonds (ILBs)**. 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. We also prefer to add value to client portfolios by taking advantage of the changing interest rate outlook reflected in nominal bonds.

Lastly, our portfolios remained tilted away from SA cash at quarter-end, despite the attractive positive real cash rate. This is because we prefer the relatively better prospective risk-adjusted returns on offer from higher-risk asset classes such as SA equity and bonds. Furthermore, bonds should enjoy a re-rating and hence capital gains resulting in additional returns, while returns to cash decline, should interest rates start to fall.

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