

M&G Enhanced Income Fund

Multi-asset

Q4 2023

Market overview

After struggling in October, global markets started November on a strong footing and maintained this momentum through the remainder of the quarter. The initial impetus came from the unchanged interest rate decision of the US FOMC on 1 November. The dovish interpretation of the ensuing press conference supported global bond markets and weakened the US dollar, which had benefits for risk assets in general. This helped convince some that the US rate hiking cycle was over, and that the focus could be shifted to the start of the rate cutting cycle. US Treasuries rallied hard across the curve, with front-end bonds underperforming those further along the term structure, thereby leading to a flattening of the yield curve.

The December FOMC statement and subsequent press conference were also received as overwhelmingly dovish by global markets. Those remaining market participants who expected more interest rate hikes and those who were undecided received a shock as the committee left no one in doubt that the US rate interest hiking cycle was over and that interest rate cuts were on the horizon. Market positioning at the time was not reflective of such a dovish outcome and US Treasuries across the curve rallied hard for the remainder of the month. To illustrate the strength of the year-end rally, 10-year US Treasury yields had been above 5% in late October but ended December below 4%. Despite the continued tensions in the Middle East, Brent crude oil prices declined in the final quarter of the year, falling further from their Q3 2023 peak. After initially weakening to above R19.63/USD in early October, the rand exchange rate strengthened for the remainder of the quarter and ended up showing a gain, helped by a weakening US dollar. The SA sovereign risk premium tightened over the quarter, especially after the FOMC meetings.

South Africa

Monthly economic data releases in Q4 2023 continued to show weakness in the South African economy. The good news was that the general weakness in the rand over 2023 helped see the current account balance print a smaller- than-expected deficit. CPI inflation rates were erratic, driven largely by volatile petrol prices. The SARB released its semi-annual Monetary Policy Review in October and maintained hawkish rhetoric to bring inflation expectations back to the desired target level of 4.5%. Its Monetary Policy Committee (MPC) left the repo rate unchanged for the third consecutive meeting in November. This surprised the market, as it appeared that the two committee members who had been voting for hikes at the previous two meetings threw in the towel. The tone of the MPC remained hawkish and as always is the case, actions speak louder than words, with the MPC now relying on Open Mouth Operations (OMO) to guide inflation expectations lower.

The domestic bond market was anxious heading into the November release of National Treasury’s Medium Term Budget Policy Statement (MTBPS). The widely held expectation was for the MTBPS to show lower revenues (declining mining sector profits), higher expenditure (civil service salary increases) and by implication a larger budget deficit for the current fiscal year. The most pressing issue for bond investors was whether the

announcement of an increase in fixed-rate bond issuance was to be included in the MTBPS, or delayed until the Budget Review next February. This was a narrow short-term focus of the bond market going into the MTBPS release. This risk was embedded to some extent in yields, but it was not possible to gauge to what extent with any precision. Market positioning was also light, considering the anxiety in the build-up to the announcement.

The National Treasury took the highly unusual step of communicating to the market two hours before the release of the MTBPS that weekly issuance would remain unchanged, and this drove a material positive turnaround in the bond market before the actual release. These gains were followed through after the release, as the rand exchange rate strengthened and the sovereign risk premium narrowed. Interestingly, the MTBPS-inspired bond rally was largely a parallel move across all maturities, and thereby had no meaningful effect on the shape of the yield curve in November. The dovishness emanating from both FOMC meetings in Q4 2023 supported the SA bond market rally. Unfortunately for bond bulls, the rally in yields led to a steepening in the yield curve over the quarter as a whole. During December, the SA fixed income market was only fully operational until Thursday, 14 December. Thereafter, the market closed at 12h00 until year end. Most local market participants traditionally take leave over this period since primary dealer market-making obligations are reduced, and weekly government bond auctions are paused. Skeleton staff and shortened trading hours mean that liquidity collapses, and market moves can be exaggerated on relatively thin volume. This makes it very difficult to make significant changes to portfolio positioning over this period and most trades are flow-related.

Performance

The fund delivered 2.1% (net of fees) for the quarter ending For the year ended 31 December 2023, the fund returned 10.2% (net of fees), healthily outperforming both its benchmark, which returned 8.1%, and the ASISA category average of 9.5%. Over the past three years the fund returned an annualised 7.6%, again outperforming both the benchmark return of 5.7% and the category average of 7.3%

Strategy and positioning

Our investment process allows the flexibility to construct the portfolio in favour of the most attractive mix of assets, as well as the ability to be tactical. The volatile macroeconomic backdrop has provided ample tactical opportunities to add and trim interest rate risk (duration) in the fund, adding value for investors. Fixed income assets by their very nature are highly cyclical, susceptible to both domestic and global inflation and monetary policy cycles. We pay particular attention to the interest rate cycle of the SARB. The path of the repo rate, as the base interest rate of the local economy, affects the pricing of all assets along the yield curve. How the SARB navigates the highly uncertain local and global environment is important for us in managing the fund, as it influences our asset allocation decisions between holding fixed-rate, floating-rate or inflation-linked instruments, as well as the overall level of duration and

Risk profile



Fund facts

Fund managers

David Knee
Roshen Harry
Bulent Badsha

ASISA category

South African - Multi-Asset - Income

Benchmark

STeFI Composite Index measured over a rolling 36-month period

Inception date

1 July 2009

Fund size

R760 656 517

Annualised performance	A class	Benchmark	T class	X class	D class
1 year	10.2%	8.1%	10.4%	10.1%	10.5%
3 years	7.6%	5.7%	7.8%	7.5%	7.9%
5 years	6.9%	5.9%	7.1%	6.9%	7.3%
7 years	6.8%	6.4%	7.1%	6.8%	7.2%
10 years	6.9%	6.5%	-	7.0%	7.4%
Since inception	7.7%	6.9%	-	-	-

currency risk in the portfolio. The hiking cycle saw us reduce fixed-rate risk in favour of floating-rate exposure.

We also make a concerted effort to understand the fiscal policy stance adopted by government, as it affects our duration position and government bond exposure. The deterioration in government finances saw us favour the short end of the yield curve.

During the quarter we maintained our light positioning in SA listed property in the fund due to liquidity considerations. Spreads available from offshore credit remained tight and not yet attractive enough for us to allocate offshore. Although the implied real yields from nominal bonds appear more attractive than inflation-linked bonds, we maintained some exposure to inflation-linkers. This is due to the relatively high absolute level of real yields available and the fact that they provide a form of insurance to the portfolio were the inflation outlook to deteriorate. Once again, our preference is in the short end of this yield curve. Over the quarter, duration risk was managed tactically, but the preference was to maintain a decent amount of risk. This proved to be beneficial considering the bond rally that ensued. □

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