

M&G Equity Fund

Equity

Q2 2022

Market overview

Investor concerns over a major slowdown in global growth, and therefore corporate earnings, escalated during the second quarter (Q2) of 2022, especially in June. This came as steep interest rate hikes in the US and strict Chinese Covid-19 lockdowns, as well as the ongoing destructive Russia-Ukraine war, led to downward revisions in economic growth expectations for the world's biggest economies. Further rises in energy and food prices also led to more speculation over extended inflationary pressures and stagflation and/or recession, even as other commodity prices lost ground. This combination of factors resulted in losses across most financial markets – equities, nominal bonds and inflation-linked bonds. For the quarter ended 30 June 2022, the MSCI All Country World Index returned -15.7%, the MSCI Emerging Markets Index produced -11.4%, and the Bloomberg Global Aggregate Bond Index delivered -8.3% (all in US\$).

In the US, inflation hit 8.6% y/y in May, the highest since 1981 and above market forecasts of 8.3% y/y. At the same time, US economic growth shrank by 1.6% y/y in Q1 2022 as consumer incomes and corporate profits were hit by higher prices for food and energy and the end of Covid-related stimulus payments. The US Federal Reserve's 75bp rate hike in June was an aggressive response to this accelerating inflation, a move which prompted more market-watchers to predict a recession ahead. Many noted that, given that inflation has largely stemmed from supply-side factors, higher interest rates were not likely to be as effective in curbing inflation as with demand-driven factors. Fed policymakers now see rates reaching 3.4% in 2022, well above the 1.9% forecast in March, as well as increased chances of recession.

US equity markets were deeply in the red for the quarter: in US dollars, the Nasdaq delivered -22.3%, the Dow Jones produced -10.8% and the S&P 500 returned -16.1%. The S&P 500, the broadest benchmark for the US equity market, produced its worst performance for the first six months of any year since 1970, down 20.0%.

In the UK, the Bank of England implemented another interest rate hike in June, taking its main bank rate to 1.25%, the highest level in 13 years. This came against inflation of 9.1% y/y in May. However, the central bank remained less aggressive on its outlook for rate hikes compared to the Federal Reserve. For Q2 2022, UK equities were also deeply in the red: the FTSE 100 returned -11.2% in US dollars.

Meanwhile, the European Central Bank (ECB) largely stuck to its Q1 plans, saying it would accelerate the winding down of its bond purchases from July, and signalling an upcoming 25bp rate hike. This was largely in line with market expectations. The Bank also revised its economic growth outlook lower to 2.8% for 2022 (from 3.7%) and 2.1% for 2023 (from 2.8%). Despite an acceleration in Q1 GDP growth to 5.4% y/y in the Eurozone, market watchers are more worried about a coming recession in the region due to its less-flexible economic structure; it continues to recover more slowly from the Coronavirus crisis than the US and UK. In France, the CAC 40 returned -14.4%, while Germany's DAX delivered -16.7% for the quarter in US dollars.

In Japan, the Bank of Japan (BOJ) continued to be the only major central bank to maintain an ultra-easy monetary policy during the quarter, as it left its policy rate unchanged at -0.1%. The market continues to forecast no interest rate hikes through 2023. Japan's Q1 2022 GDP growth was reported at -0.5%, slower than the 1.0% expected, and the equity market also lost ground with the Nikkei returning -15.1% in US dollars for the quarter.

Chinese investors became more upbeat towards the end of the quarter as Covid infection rates started to slow, allowing the government to ease some of its ultra-strict lockdown conditions in Shanghai and certain other areas. The country recorded better-than-expected GDP growth of 4.8% y/y in Q1, up from 4.0% y/y the previous quarter, and the latest data showed a surge in manufacturing and non-manufacturing PMI in June, accelerating to 51.7 (up from 48.1) and 54.7 (up from 47.8) respectively. The People's Bank of China (PBOC) left interest rates unchanged at its June meeting, in line with expectations. The central bank is concerned not only about growth, but also about the widening divergence between local and US interest rates, which has put Chinese bonds and the yuan under selling pressure. For the quarter, Hong Kong's Hang Seng produced 0.7%, while the MSCI China returned 3.5%, both in US dollars.

Other large emerging equity markets were in the red for the quarter, all in US\$ terms, with Brazil's Bovespa the worst performer at -25.4%. The MSCI South Africa was close behind with -22.9%, while South Korea's KOSPI was down 20.8%, the MSCI India fell 13.5% and the MSCI Turkey recorded a -10.9% return.

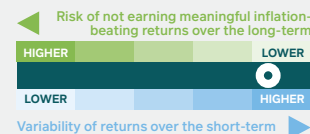
Energy prices continued their rise, but at a moderated pace: Brent crude oil gained 6.4% during the quarter after experiencing some softness in June. Year-to-date the price is up some 47% in US dollars. Looking at precious metals, gold fell 6.0% for the quarter, while platinum lost 7.7% and palladium was down 13.2%. Other industrial metals prices lost between 20-30% amid heightened worries of a global growth slowdown.

South Africa's fragile economic recovery came under increasing pressure in Q2: growth prospects took a downturn due to the renewal of national Stage 4-6 loadshedding, severe flooding in KwaZulu-Natal, rising inflation and higher-than-expected interest rate hikes, as well as the retreat in commodity prices. The South African Reserve Bank (SARB) lowered its GDP growth forecast for 2022 to 1.7% from 2.0% previously.

With CPI rising to 6.5% y/y in May – the first time since January 2017 that it has broken through the upper limit of the SARB's 3%-6% target range – the SARB hiked the repo rate by 50bps at its May meeting to 4.75%. The Bank is widely expected to hike by another 100bps at a minimum this year in an effort to both fight inflation and to keep our interest rate differential versus the US as high as possible in a bid to avoid more pressure on the rand and SA bond yields.

South African markets were less insulated from the global inflation and growth concerns than in the previous quarter. This was due to the fall in commodity prices, accelerating inflation, and forecasts for more aggressive local interest rate hikes in July, plus even slower growth ahead. Stage 4-6 loadshedding also weighed on

Risk profile



Fund facts

Fund managers

Chris Wood
Yusuf Mowlana

ASISA category

South African - Equity - General

Benchmark

ASISA South African - Equity - General Category Mean

Inception date

2 August 1999

Fund size

R4 290 983 019

Awards

Raging Bull: 2006, 2007, 2008
Morningstar/Standard & Poor's: 2007, 2008

Annualised performance

	A class	Benchmark	B class	F class
1 year	11.0%	6.4%	11.4%	12.2%
3 years	12.5%	7.1%	12.9%	13.3%
5 years	10.2%	6.1%	10.6%	11.1%
7 years	8.0%	4.4%	8.4%	-
10 years	11.4%	7.8%	11.9%	-
Since inception	15.9%	12.7%	-	-

growth prospects. However, local bond and equity losses were somewhat less severe than developed markets, and more in line with those in other emerging markets. The FTSE/JSE All Share Index (ALSI) returned -11.7% for the quarter and the Capped SWIX -10.6%, dragged down by Resources with a -21.9% return, -15.8% from Financials, -12.1% from Listed Property (All Property Index) and -3.0% from Industrials. For the six months of 2022 so far, the ALSI has returned -8.3%, outperforming the -18.2% recorded by global equities (the MSCI All Country World Index), both in rand terms.

Performance

For the second quarter of 2022, the fund returned -6.1% (net of fees), outperforming its benchmark by 3.0%. For the 12 months ending 30 June 2022, the fund generated a return of 11.0% (net of fees), outperforming its benchmark by 4.6% over the same period.

The fund has continued to add demonstrable value for investors in South African equities, with it recently being awarded 5 PlexCrowns for its risk-adjusted returns over three and five years.

Among the main contributors to performance over the quarter was the fund's holdings in Naspers and Prosus. During the last week of the quarter, Naspers and Prosus announced that they would commence a share repurchase programme, whereby they would aim to take advantage of the large discount at which the Group trades to its net asset value, by buying up shares in both companies, funded by sales of shares in their largest investment, Tencent. It was announced that this would be an open-ended repurchase programme. We think that this is an excellent strategy as the group would be able to effectively buy itself back at a substantial discount, thus creating more value for shareholders. The market agreed and in the last week of June, the share prices of Naspers and Prosus were up over 30%.

It was pleasing to see some of the fund's mid- and- small-cap stocks continue to contribute to performance. During the quarter Datatec announced the sale of their Analysys Mason business on a 14x EBITDA multiple, whereas the group had traded on a multiple of just 3x EBITDA prior to the sale. The subsequent re-rating of the company only accounts for the sale price of Analysys Mason, with the remainder of the business remaining as inexpensive as it was before.

Rising bond yields globally and the spectre of stagflation have placed pressure on the gold price and gold mining stocks. During the quarter, Gold Fields announced an all-stock acquisition of Yamana Gold, which saw the share price decline significantly. The fund's underweight position in Gold Fields contributed to relative performance over the quarter.

Strategy and positioning

The fund retains clear preferences within sectors. Key differentiators within the Resources sector include a preference for Glencore (coal, base metals) over Billiton (iron ore) and Anglo American (diversified). Exxaro is preferred to Kumba, while Northam is preferred to Anglo American Platinum. The fund retains and overweight to the Energy sector, including Sasol and Thungela. Within the SA Industrials sector, the fund holds some well-priced stocks, such as Motus, Altron, Mpact and Oceana, which all trade on single digit multiples of spot or normalised earnings. In the Financials sector, Investec, Standard Bank and ABSA are our preferred banks. The fund retains no exposure to the Life Insurance sector, with a preference for capital-light asset gatherers, such as Ninety One.

We believe that the fund's holdings are attractively priced and well-positioned to deliver inflation-beating returns over the long term. □

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