

M&G Inflation Plus Fund

Multi-asset

Q4 2023

Market overview

The final quarter of 2023 saw a synchronized rally across global bonds and equities as falling inflation in many economies led central banks to continue to pause or effectively end their interest rate hiking cycles and start to look towards rate cuts, particularly in the US. And, although a growth slowdown is still expected in 2024, this and the gradually improving outlook buoyed investor sentiment, resulting in strong gains in November and renewed bullishness in December, to end the year with unexpectedly good asset performance.

December's returns were dominated by the US Federal Reserve's unexpectedly positive forecasts at their 13 December policy meeting as, besides leaving interest rates on hold, they clearly indicated their expectations for three 25bp interest rate cuts in 2024. This was very good news for both equity and bond markets, helping bolster the 2024 outlook despite the uncertainty still surrounding the cumulative negative impact from the steep rate hiking cycle. Other large central banks also left interest rates on hold at their December policy meetings as expected.

Global equity (as measured by the MSCI ACWI) delivered 11.0% in Q4, emerging market equities returned 7.9% (MSCI Emerging Markets Index) and global bonds produced 8.1% (Bloomberg Global Aggregate Bond Index) all in US\$. In South Africa, the FTSE/JSE Capped SWIX Index posted an 8.2% return in rand. Gains were propelled by a 15.9% rebound in the All Property Index over the quarter and 11.8% from Financials, while Industrials delivered 5.9% (hit by a sharp fall in Naspers/Prosus shares in December) and Resources stocks were flat (0%). South African bonds delivered an impressive 8.1% for the quarter. This saw the yield on the 10-year SA government bond tumble from just over 11% at the start of the quarter to 9.8% by the end. Meanwhile, the rand gained 2.7% against a weaker US dollar in Q4, but in total lost 8.2% against the US dollar, 14.1% versus the UK pound and 12.1% against the euro in 2023.

For 2023 as a whole, global equities returned an excellent 22.2% in US\$ and 32.3% in rand (due to rand depreciation), with gains fairly concentrated around a handful of giant global AI-related US companies. These outpaced other US shares and, indeed, most other equity markets for the year, making the US meaningfully more expensive than its global counterparts. This also reflected the relative vitality of the US economy versus most other large economies. By contrast, Chinese growth disappointed and equities were in the red.

Global bonds experienced a very volatile year, marked by rapid shifts in the interest rate outlook that pushed the yield on the benchmark 10-year US treasury bond to 5% (briefly) in October and left it trading around 3.8% at year-end, presenting opportunities for active investors to harness attractive above-inflation yields. Ultimately, global bonds returned 5.7% for the year.

United States

In the US, the Fed's December forecasts for 2024 showed inflation falling gradually toward its 2% target amid a slowdown in growth, without steep job losses – in other words, a “soft landing” as investors have hoped for. Unemployment is seen rising to 4.1% from its current 3.7% level, still low from a historic perspective, and GDP growth is forecast to average 1.3% for the year. Meanwhile, at 3.1% y/y, November CPI was in line with expectations and down from October's 3.2% y/y, helped by lower energy prices over the period.

For the quarter, the Dow Jones produced 11.7%, the Nasdaq 13.1%, and the S&P 500 13.8% (all in US\$). The Nasdaq was the top-performing developed equity market in 2023 with a remarkable return of 44.6%.

UK

In the UK, the Bank of England (BoE) kept its main interest rate unchanged at 5.25% at its December meeting, saying its next move would remain data-dependent, but the market is pricing in the start of rate cuts from June 2024. November CPI fell sharply to 3.9% y/y from 4.6% in October. The UK economy is on the verge of recession, having recorded zero (0%) GDP growth in Q3 2023, and with the BoE downgrading its growth forecast for 2024 to 0% from 0.5% previously. For Q4 2023, the FTSE 100 returned 14.4% in US\$, and for the 12 months it produced 14.4%.

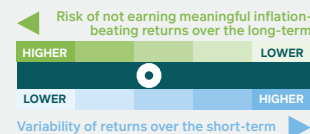
Eurozone

In the eurozone, inflation continued to fall during the quarter, with the latest November CPI at 2.4% y/y nearing the ECB's 2% target rate. However, the central bank's latest forecasts show inflation improving only very slowly going forward and averaging 2.7% in 2024 from 5.3% in July. GDP growth in the area registered a paltry 0.1% y/y in Q3 2023, and is expected to remain very subdued at 0.8% y/y in 2024. In contrast to the Fed, the ECB remained hawkish, continuing to warn of upside inflation risks from energy prices and labour costs, and discounting the possibility of interest rate cuts in the foreseeable future. In European equity markets, France's CAC 40 returned 10.5% in Q4 and 24.4% for 2023 as a whole, while Germany's DAX delivered 13.6% in Q4 and 24.5% for the year (all in US\$).

Japan

After impressive growth in the first half of the year, Japanese GDP shrank by a more-than-expected 2.9% in Q3 2023 (annualised, revised) as consumer and business spending contracted and real wages fell due to prolonged relatively high inflationary conditions. The sharp slowdown came despite the Bank of Japan maintaining its ultra-easy monetary policy, which had provided firm support previously and also helped push the local equity market to 33-year highs in December. The latest conditions suggested that the BOJ will continue to

Risk profile



Fund facts

Fund managers

David Knee
Michael Moyle
Sandile Malinga
Leonard Krüger

ASISA category

South African - Multi-Asset - Low Equity

Objective (before fees)

CPI+5% p.a. over a rolling 3-year period

Inception date

1 June 2001

Fund size

R19 620 339 610

Awards

Raging Bull: 2013
Morningstar: 2015

Annualised performance	A class	Objective ¹	T class	X class	B class
1 year	9.9%	8.9%	10.2%	9.9%	10.4%
3 years	10.9%	9.5%	11.1%	10.9%	11.4%
5 years	7.6%	8.4%	7.9%	7.6%	8.1%
7 years	6.0%	8.4%	6.4%	6.2%	6.7%
10 years	6.6%	8.6%	-	6.8%	7.3%
20 years	10.3%	9.2%	-	-	10.9%
Since inception	10.8%	9.3%	-	-	-

¹ Objective: CPI + 5% p.a. over rolling 3 years gross of fees; less long-term TIC of applicable class. For A class objective above a TIC of -1.6% was used.

keep interest rates exceptionally low, in line with the central bank's goal of keeping inflation sustained at around 2% and avoiding deflationary conditions. The Nikkei returned 11.4% (in US\$) for Q4, and 22.6% in 2023.

China

During the three months, the Chinese economy gained traction with Q3 GDP growth reported at a stronger-than-expected 4.9% y/y (vs 4.4% y/y forecast). Although this means that the government is likely to meet its 5% GDP growth target for 2023, the absolute level of growth has continued to disappoint. The country's exports remained under pressure from relatively weaker foreign demand, but looser monetary policy from the People's Bank of China (PBOC) has added stimulus through lower bank rates for its medium-term lending facilities.

There was positive news with November data showing industrial production grew faster than expected at 6.6% y/y (versus 5.6%), up from 4.6% y/y in October, and retail sales growth of 10.1% also improving significantly from 7.6% the previous month. Pent-up consumer demand continues to underpin the expansion, along with consumer services, while the property sector remains in crisis and youth unemployment high. Chinese markets were still in the red in Q4, with Hong Kong's Hang Seng returning -3.7% and the MSCI China -4.2%, both in US\$. For the year, the Hang Seng produced -10.6% and the MSCI China posted -11.0%.

Emerging markets

With the exceptions of China and Turkey, larger emerging equity markets performed very strongly over the quarter. Brazil's Bovespa soared with a return of 18.6%, followed by South Korea's KOSPI with 13.9%, the MSCI South Africa at 12.7% and the MSCI India at 12.0% (all in US\$). The MSCI Turkey fell 12.1% (in US\$).

South Africa

In South Africa, at its 23 November policy meeting the SA Reserve Bank voted unanimously to keep the repo rate steady at 8.25%, as expected. Governor Lesetja Kanyago still sounded relatively hawkish regarding inflation, but noted that growth was likely to remain muted due to ongoing energy and logistical constraints (at ports and railways) weighing on economic activity and adding to the costs of doing business. Q3 2023 GDP contracted more than expected at -0.7% y/y (versus -0.2% forecast), with output declining in agriculture, mining and construction, while services output expanded. Looking ahead, the SARB projected GDP growth at 0.8% for 2023, 1.2% in 2024 and 1.3% in 2025. Besides local headwinds to growth, China's ongoing slower growth presents challenges for SA's commodity exports.

Headline November CPI declined to 5.5% y/y from 5.9% y/y in October, largely on the back of energy price decreases. However, after falling in Q3, surveyed inflation expectations for 2024 rose to 5.7% from 5.5% in Q4, according to the BER. Consumer confidence remained in the doldrums, as the FNB/BER Consumer Confidence Index registered -17 points in Q4 from -16 points in Q3.

South African assets were weighed down in 2023 by ongoing general pessimism over the country's weak growth prospects, loadshedding and uncertain government finances, exacerbated by the higher risks associated with the grey-listing of SA in global financial transactions and incidents like the "Lady R" and hosting of the BRICS Summit. This manifested in rand weakness, equity underperformance against the MSCI EM

Index and continuing low valuations on SA stocks and bonds. The FTSE/JSE ALSI returned 9.3% and the more domestically-focused FTSE/JSE Capped SWIX Index posted 7.9% for the year. However, SA bonds notably outperformed their global counterparts for the year, helped by their cheap valuations at the start of 2023, delivering a 9.7% annual return.

Performance

The fund returned 7.1% (after fees) for the fourth quarter of 2023 and 9.9% for the 12-month period ending 31 December 2023. The fund has delivered a return of 10.8% per annum since its inception in 1999 (after fees), compared to its after-fee objective of 9.3% per annum over the same period.

Looking at the fund's asset allocation, SA bonds added the most value to absolute performance for the quarter, while SA equities also added some value, followed by SA listed property, which had a strong quarter. Global equities and bonds added positively to absolute performance over the quarter.

Within SA equities, our holdings in many different stocks added to absolute fund performance in Q4 given the strong rally. The largest included Standard Bank, Textainer, Investec, Richemont, FirstRand, Goldfields and Exxaro. The few detractors from performance included Sasol (given the decline in the oil price over the period), and British American Tobacco and Absa to a lesser extent.

Strategy and positioning

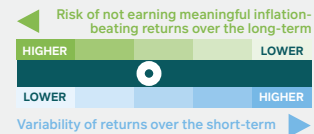
Starting with our view on offshore vs local asset allocation, during the quarter we increased our offshore exposure and reduced our total SA exposure: we trimmed our SA assets across equity, listed property and bonds and used the proceeds to buy global equities and increase our cash holdings. However, we continued to prefer more attractively valued SA assets compared to their global counterparts.

Within our **global holdings**, during Q4 we bought more global equity out of our SA holdings, so that our position moved from slightly underweight to slightly overweight at quarter-end as the global growth outlook improved. Following the strong November rally in global bonds, we also took profits on a portion of our 30-year global bond exposure so that our portfolios moved from slightly overweight to slightly underweight, and duration also fell from modestly over- to underweight at quarter-end.

In **global equities**, the MSCI ACWI 12-month forward P/E rose to 16.8X at quarter-end from 15.9X at the beginning of the quarter as stock prices gained ground. We increased our weighting on the back of the modest improvement in the interest rate outlook; however, we remain concerned that US equities remained priced for a perfect "soft landing" outcome in 2024. As such we have moved only modestly overweight from our previously slightly underweight exposure, and remained tilted away from the relatively more expensive US market. Equity markets that we prefer for their cheaper valuations include the UK, Japan, China and other emerging markets.

Within **global bonds**, November's sharp rally offered an opportunity for us to take profits on our holdings of 30-year US Treasuries, UK gilts and German bunds, thus reducing our overweight position in global bonds. Portfolio duration also fell. We used the proceeds to buy global equity and increase our global cash position. We continue holding moderate levels of local currency sovereign EM bonds where the real yields are high and the currency is trading at fair-to-cheap levels.

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The fund was underweight **global corporate credit** at quarter-end, based on our view of credit spreads as unattractive for the risk involved versus their government counterparts.

The fund still favoured **SA equities** at the end of Q4 2023, although we did take some risk off the table by selling into the quarter's rally and using the proceeds to buy global equities and increase our SA cash holdings. SA equity valuations (as measured by the 12-month forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) rose to 10.0X from 9.5X at the beginning of the quarter. Local equity market conditions during the year favoured stock picking, given the wide dispersion in valuations across the market, and even within sectors. Some of the top stock holdings that made the most meaningful contributions to performance over the past 12 months included Textainer, Standard Bank, Investec and Richemont.

Global shipping container lessor **Textainer** has been a preferred holding for several years, having benefited significantly from the recovery in global trade following the Covid pandemic. It possessed a sufficiently strong balance sheet that enabled the company to participate in the trade recovery post covid and increase its container fleet substantially. As an early mover, the company took advantage of the extended container shortages due to the dislocations in global trade to lease out the acquired containers at favourable lease rates for longer lease durations. This was financed with fixed rate debt that helped it withstand the higher interest rate environment. In the slowdown, the management team demonstrated discipline, not pursuing market share at all costs and rather focusing on share buybacks and shareholder returns. In October this year, the group announced an all cash buyout offer by US alternative investment firm Stonepeak at a 46% premium to its share price, sparking equivalent share price gains in Textainer and adding excellent value to our client portfolios.

Standard Bank and Investec: The fund has been overweight SA banks for some time, recognising that they are among the only businesses to benefit from rising interest rates as they receive more income from debtors and government bond holdings. There is a risk that debtors may default as interest rates rise, but at M&G we recognised that SA banks had been conservative in their lending practices in the run-up to, and during, the Covid pandemic, and had over-provided for bad debt in the economic downturn resulting from Covid, as well as in the conversion to a new accounting standard (IFRS 9). They had also had to comply with stricter lending regulations post the introduction of the National Credit Act in the late 2000s, giving them very healthy balance sheets at the beginning of 2023. Yet their valuations reflected the prevailing high uncertainty around inflation, interest rates and growth in SA and globally. Sentiment deteriorated further during the second quarter of the year after the emergence of the US regional banking crisis and rescue of Swiss banking giant Credit Suisse. Yet the banks consistently reported stronger-than-expected earnings and profits, successfully weathering the poor local conditions and helping lift their share prices. Among our bank holdings, Standard Bank and Investec were the standouts for the year.

Richemont, the global luxury goods group, has been another large contributor to the portfolio's performance in 2023 due to our active overweight in the stock. Despite its cyclicity, Richemont is a high-quality company with a regionally diversified business and a strong balance sheet reflecting a net cash position. The group also has strong free cash flows and a very strong balance sheet, being in a large net cash position. Richemont's jewellery businesses experienced surprisingly strong sales growth throughout 2023 across all its brands like Cartier, Van Cleef & Arpels and Piaget, reporting record operating profit for its 2023 financial year ending 30 March. And this despite headwinds that were supposed to materialise because of economic slowdowns in China and the West. The company's geographical diversification helped meaningfully as the robustness of the US economy (and Europe to a lesser extent) compensated for the slower-than-expected Chinese economic recovery post their COVID lock-down.

In Q4 we further lowered our already-underweight exposure in **SA listed property** by selling into that sector's good performance, while buying global equity and lifting our cash exposure. Property sector risks remained high relative to other sectors, while cash yields have become more attractive. 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 and growth prospects relatively weak, and many property companies are reliant on finance to expand their portfolios, among other fundamental factors.

We also sold some of our overweight holdings in **SA nominal bonds**, taking profit into the rally over the period. Still, we maintained our significant preference for these assets in the fund. From a yield of over 12% at the start of the quarter, the 10-year SA government bond rallied by over 100bps to close the quarter at a yield of around 11%. 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 over time.

We did not make any adjustments to our **SA inflation-linked bonds (ILBs)** positioning during Q4, continuing to marginally favour 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, we added to our **SA cash** holdings during the quarter after trimming some of our other SA exposure, but given our very underweight positioning prior to this, the fund remained tilted away from SA cash at quarter-end. Yields on cash-type instruments have become more attractive for investors following the SARB's steep interest rate hikes in 2023. □

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