Analysis

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Global investing: Cash and diversified equities preferable

Key take-aways

- Today's much higher global market volatility in both equities and bonds, and the unpredictability of national policies and market moves, means that investor portfolios should be extra well-diversified.
- Currently M&G is holding more global cash than usual, to take advantage of alpha opportunities amid the volatility. They are neutral in global equities, which are generally trading around fair value (but selective opportunities are numerous) , and are avoiding expensive global bonds.

While there are still attractive investment opportunities in global markets these days, careful diversification and more active management and intervention are needed to get the best results in an offshore portfolio, due to the relatively expensive valuations and higher volatility now prevailing. For global portfolios, at M&G Investments we currently prefer cash and diversified global equities in our asset allocation, while developed market bonds remain expensive across most maturities and investors are paying up (or even losing money) for their diversification and duration benefits.

Is higher inflation here to stay?

To address where we stand in the current debate around "transitory" versus longer-lasting higher inflation around the world, we believe that investors can't conclude that higher inflation will necessarily become a more permanent feature of national economies, and result in much higher interest rates and future stagflation as some are forecasting. The Covid pandemic saw unprecedented and unplanned shutdowns across national services sectors and manufacturing. Producers postponed investment in expanding their capacity, and instead cut costs. Supply chains have consequently had difficulties gearing back up to meet consumer demand, which has accelerated amid the re-opening of economies, in turn causing supply bottlenecks and rising prices. The extremes of the economic downturn, and its following rapid rebound, mean that we can't predict when supply and demand will re-balance across different sectors. Pricing mechanisms still need to fully adjust. So in our view, it's premature to say whether or not we have an inflation problem.

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Equally, predictions of longer-lasting higher inflation ignore the fact that global growth is being driven by several structural engines, namely the recoveries in three main regions: the US, Europe and China. All of these are proceeding at different speeds, and it is impossible to determine how their combination will impact the overall rates of global growth and inflation over the nearer-term. The US recovery has been steady, with bouts of financial market instability, while the EU has registered permanently weak growth, combined with periodic financial stress coming from the peripheral economies (like Greece and Italy) in the absence of central bank support. Finally, China's economic cycle is much further advanced, having already fully recovered from the Covid downturn and now slowing in response to policy tightening.

We can't know how these dynamics will play out, so we believe it's best not to be wedded to an inflation view. After all, having a view on inflation in recent times, whether positioned long or short in developed market bonds, hasn't helped portfolio managers add to returns given the historically low bond yields.

However, it is true that the global rate hiking cycle has begun, with several developed countries having started raising interest rates – but notably some are in response to factors other than inflationary pressures. This includes Scandinavia, where central banks recognized that interest rate levels were abnormally low historically, and the Czech Republic, where rate hikes have been motivated by the economy's particularly rapid recovery. We are certainly not opposed to higher rates from a structural perspective, given the negative real rates that have prevailed.

Positioned for alpha with cash, equities

Using current asset valuations as the foundation for M&G Investments' global asset class positioning, current market conditions mean that we favour cash as well as equities (as the best source of returns), the latter well diversified and not concentrated in any particular sector or geography. Developed market bonds are expensive and generally to be avoided, only being useful for diversification purposes.

In bonds, shorter-dated developed market bonds are still very unattractive – among the most expensive assets to hold – while longer-dated bonds have become more expensive over the past year as government yield curves have flattened. Therefore, to get the benefits of portfolio diversification through bond holdings, investors have to pay up. However, at M&G we have identified more attractive opportunities elsewhere: in emerging market government bonds such as Chile, for example, that should add value to portfolios over the medium term. At the same time, episodes of bond market volatility and mis-pricing have increased significantly, especially since the onset of the Covid pandemic, making it advantageous to adopt a more active (or interventionist) tactical asset management approach to get added alpha from the asset class. This means we have been taking advantage of mis-pricing more frequently, buying and selling assets more quickly to add alpha to client portfolios. Having cash on hand for flexibility in TAA is important in executing this strategy.

As for global equities, M&G Investments considers the MSCI All Country World Index (ACWI) to be reasonably priced from a historical perspective. With valuations trading around fair value, our portfolios are positioned broadly neutrally from an asset allocation perspective. Within the asset class, however, investors need to be well diversified and selective in their equity exposure, holding more, but smaller, positions in order to limit downside risk. This is due largely to the wider divergence across company earnings, sectors, and national policies, and different growth prospects around the world. It is also as a result of increased equity market volatility.

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While certain global equities are offering excellent return potential compared to bonds and cash, others could represent value traps. For example, when the share prices of Tencent and other Chinese tech companies plunged in response to news of additional Chinese government regulation earlier this year, we believed it was a good opportunity to add to Tencent holdings because of the company's diversification and underlying resilience in its earnings. Yet one has to know when to avoid a stock despite its cheapness as well, and have a very clear idea of what you consider to be fair value for a company.

So in conclusion, we are currently at a very unusual juncture in global financial markets, with the impact of the Covid shutdowns, combined with more nationalist policies, leading to significant divergence across economic growth and asset prices around the world. Episodes of idiosyncratic volatility are also more frequent and severe. This has led us to be especially well diversified in our equity exposure, and to be holding more cash than usual to capitalise on sudden asset price swings. Finally, but just as importantly, global developed bonds are best avoided. M&G Investments believes that being more interventionist, and also taking on more and smaller bets in portfolios, are among the most effective ways to add alpha amid the global recovery from the Covid crisis. □

Eric joined M&G Investments in 2006 and is a member of the M&G Macro & Multi Asset Business based in London. He previously worked a Managing Director and Head of Macro Research at JP Morgan Cazenove. His qualifications include a BA in Philosophy, Politics and Economics from Pembroke College, Oxford, and an MSc in economics from the London School of Economics.