M&G **Insights**

M&G Investments

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Global considerations: Are we going back to a 2% inflation regime?

A recurring theme that emerged at M&G Investments' recent Global Management Forum (GMF) in London was the question of whether the world would go back to the pre-Covid macroeconomic environment of low inflation, low real (or even negative) interest rates relatively soon, or whether we would remain in the current higher-inflation, higher-interest rate regime (with positive rates) for a much longer period. Are conditions evolving more towards the former or latter? This is one of the considerations that has been driving our investment debate in the early months of 2023. Why is this such an important factor for investing? Because simplistically, levels of real interest rates form the base for determining risk premia across all asset classes, from the least to the most risky. In building our portfolios, we assess whether those risk premia offer sufficient reward for investors to hold those assets over time, compared to both their own history and relative to other assets' prevailing risk premia.

Markets anchored in the past

In our discussions at the GMF, what was apparent was that financial markets are currently still anchored to pre-Covid levels of inflation and interest rates, even though it is not clear that this regime will return. Even though bonds have adjusted to higher short-dated interest rates, this anchoring is reflected in the inverted US bond yield curve (with short-term interest rates

meaningfully higher than longer-term rates) and steeply inverted forward rate and US dollar swap curves indicating only temporarily higher inflation and interest rates. The bond market is assuming that the US Federal Reserve will achieve its inflation target of 2% soon, with nominal short-dated interest rates back at 2%-2.5% in fairly short order, and therefore real interest rates at zero.

For us, this is one of the bigger risks now present in global markets – that is, overoptimism – especially in the shorter-term with the most recent US data pointing towards a stronger-than-expected economy. And taking a longer-term view, the positive macroeconomic trends helping keep global inflation low and corporate earnings share high for many years, including globalisation, offshoring, lower corporate taxes and low borrowing costs are no longer as influential. Instead, security of supply, local sourcing, ESG considerations, decarbonisation and green energy, de-globalisation and higher capital costs are gathering steam, all factors that would tend to drive up producer costs and consumer prices around the world, presenting growing headwinds to corporate profits.

Based on the above, we are taking a cautious approach on our global positioning in the current environment until we have greater clarity on the direction of inflation and how embedded it has become in economies around the world, and interest rates. Our approach, as is well-known, is to take advantage of opportunities to buy assets at attractive valuations, especially where there's evidence of irrational price action in the market.

Global bond and forex positioning

As such, and based on current valuations, our global bond positioning in our multi-asset funds is still slightly underweight, although we have been holding 30-year US Treasury bonds at what we deem to be attractive real yields. This is also a useful way to offset equity risk in risk wobbles. We have also preferred exposure to a basket of higher-yielding emerging market (EM) bonds in undervalued local currencies that offer some buffer against further market weakness. We have also been seeing opportunities in specific credit sectors, such as High Yield, to get exposure to companies that aren't in distress but whose spreads are trading at distressed levels – although we haven't added to this asset class yet.

Along with our EM bond trades, we have also been looking to currency markets to capitalise on higher risk premia. The team currently prefers to hold a diversified basket of currencies to smooth out any individual currency or country risks, and aims to be long currencies that have high carry (a high implied interest rate and weak spot rate) and short those currencies with negative carry (a lower implied interest rate).

Global equities and earnings

Turning to global equities, and looking at corporate earnings expectations, we noted that one-year forward US earnings were only suggesting 4%-5% growth, not particularly high. Therefore, it was hard to conclude that the equity market was overconfident, or that it wasn't pricing in a downturn, only that that the scale of the downturn might be underestimated. Equally, investors didn't appear to be notably extrapolating recent share price gains into rising earnings expectations, which has sometimes been the case in the past.

These relatively neutral equity market expectations, added to the largely neutral global equity market valuations prevailing, led us to maintain our neutral to slightly underweight global equity positions in our multi-asset portfolios. It was also noted that there were still good opportunities for investing across various regional or country-specific equity markets, as evidenced for example by the still-elevated valuation spreads between different the regions or countries. With US equities more expensive than other countries, we opted to stay underweight that market, while still holding US financial stocks that benefit from higher interest rates and preferring attractive emerging market equities. Some relative-value trades looked attractive as well, participants agreed. The same was true at single-stock level within countries as well, making it an ongoing stock-pickers' market.

So with slightly underweight positions in both global bonds and equities, we continue to hold more global cash than usual, reflecting our cautious view. We can then quicky deploy it as necessary to take advantage of opportunities that arise, as noted above.

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