M&G Insights

Navigating fluid global markets for solid returns

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With the first quarter of the year behind us, and an important local election ahead of us, South African investors are thinking about global investments and pressing advisers for solutions. To get it right, global investing requires a long-term view, careful research and diversification, and patience in the face of the continuous, unpredictable fluidity of financial markets. Yes, "fluid" is probably the best way to describe the state of global assets, and investors should embrace it. So what does this fluidity look like at the moment? How are we at M&G Investments viewing it and investing for the best outcomes in our global balanced portfolios?

US again leads the way

Given its size and influence in the global financial system, any discussion about global markets inevitably starts with the USA. And once again, the American economy has proved to be the engine of growth pulling much of the rest of the world along in the post-Covid period, defying most pundits along the way.

Far from being a drain on the US economy, immigration has played a crucial role in sustaining strong job growth. Since 2022 there has been a significant wave of immigration, with immigrants being drawn to the booming US economy, which recovered more quickly from the pandemic shock than many other countries.

Immigrants have filled labour gaps and positively impacted job creation, contributing to steady economic growth without pushing up inflation due to their relatively low wages. If you look at the composition of the immigration data, it is concentrated in the lower-skilled sectors, which is positive for overall economic performance, and accounts for the fact that the US is really the only economy that has experienced upwards revisions in growth forecasts this year.

But if the US Federal Reserve can't get inflation under control, then those real gains will be a thing of the past, especially if there is another shock that leads to energy prices or global food prices accelerating again. Think of the recent escalation in the Middle East conflict, with Iran entering the fray. That has already caused oil prices to rise meaningfully.

In addition, financial conditions have loosened. In other words, with inflation falling, real interest rates have also been falling even though nominal interest rates remain at relatively elevated levels. This has had the effect of putting some health back into household budgets and onto corporate balance sheets, and least over the shorter term, and has reinforced expectations of a "soft landing" for the US economy in 2024.

The US Fed has also been surprised by how durable the equity market rally has been. While initially it was quite a narrow rally, in the last quarter of 2023 it broadened out and so far this year, the S&P Equally Weighted Index has kept pace with the "Magnificent Seven".

With so many 2023-24 forecasts proven wrong (as we see year in, year out), we are reminded why at M&G we don't rely on forecasts in making our investment decisions. Global conditions can – and do -- change in an instant. They're fluid. Instead we use consistent, valuation-based analysis to build robust, well-diversified portfolios that can deliver strong returns no matter what scenario plays out in the global markets. Then we take advantage of short-term market mispricing to add extra value. Here's how our global balanced portfolios are currently positioned.

Leaning into the East

Looking at China, not too long ago it was considered that it would lead the global economy out of the Covid recession. But now, many investors consider it irrelevant due to its relatively slow recovery. Of course, we like narratives such as these because that's often when we find tactical investment opportunities. Indeed, believing in the country's stronger long-term growth prospects and following the large and indiscriminate sell-off in Chinese stocks in late 2023 and early 2024, we found some excellent opportunities to buy high-quality global companies at cheap valuations. We are maintaining a tactical overweight Chinese equity position in many of our global funds,

There are also some interesting aspects to Japan at the moment.

The impressive performance of Japanese equities in 2023, which also continued into the first quarter of 2024, proved quite beneficial for our global balanced portfolios, where we were tactically overweight these assets.

The Bank of Japan's historic interest rate hike to implement a positive real interest rate for the first time in 17 years, and its easing of its yield curve control policy, have presented more opportunities for investors, especially in the bond market. However, these changes also merit some caution.

One of the pernicious things about financial repression is that it exerts downward pressure on what you can earn from a safe asset, which pushes investors in search of higher yields further up the risk spectrum – into longer-dated assets and equities. In turn, this tends to reduce the risk premium because there are more buyers. So, the moment government starts easing limits on the term premia on Japanese bonds, allowing them to rise to reach more appropriate yields for the risk involved, you should start seeing the cascading effect on the pricing of riskier assets like equities.

An eclectic mix of equities

Beyond Asia, we are overweight European stocks on valuation grounds, but try to avoid the UK for the same reason. We are also overweight Latin America, where we're invested in a diverse range of companies. We have had opportunities to buy companies trading on attractive P/E ratios of anywhere from 9X earnings and even up to 16.5Xearnings, provided the country's macro backdrop is positive for growth, inflation is under control, and the currency is quite cheap.

We're tilted away from sectors with high valuations, such as financials in Europe and banks in the US. During Q1 2024 we moved to be slightly more defensive in our overall portfolio positioning, not because we aren't backing valuations, but given the phenomenal rally in equities in the fourth quarter of last year, without fundamentals really improving as well, we became more cautious. As a consequence, we took some profits in global equities and used the proceeds to buy more global bonds and increase our cash holdings.

30-year US Treasuries offer rare real return

Currently about 25% of our portfolio is invested in global bonds, of which around 60-65% are US securities, even though the US Treasury has been issuing bonds quite aggressively and investors have raised concerns about the country's high debt levels. However, we have found that the relationship between supply and demand has very little to do with where actual spot rates or yields are trading in the world's largest and most liquid market. Currently, 30-year US Treasuries are paying a real yield for the first time in a very long time; they may be the cheapest developed market bonds you can find, and they tend to do quite well in a world where risk appetite is quite poor.

With a real yield of 1.5%- 2%, investors can get a very attractive risk-adjusted return by buying 30-year US Treasuries, which perform well when interest rates are falling and the world is worried about risk.

In conclusion, what can be seen from the above is that yesterday's expectations of global asset moves can quickly be proven wrong tomorrow. Even the US Fed can be wrong. The key to coping with this fluidity, we believe, is to invest for the long term in well-diversified, risk-aware portfolios grounded in fundamental asset valuations, where active managers can also add value through shorter-term tactical opportunities.

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