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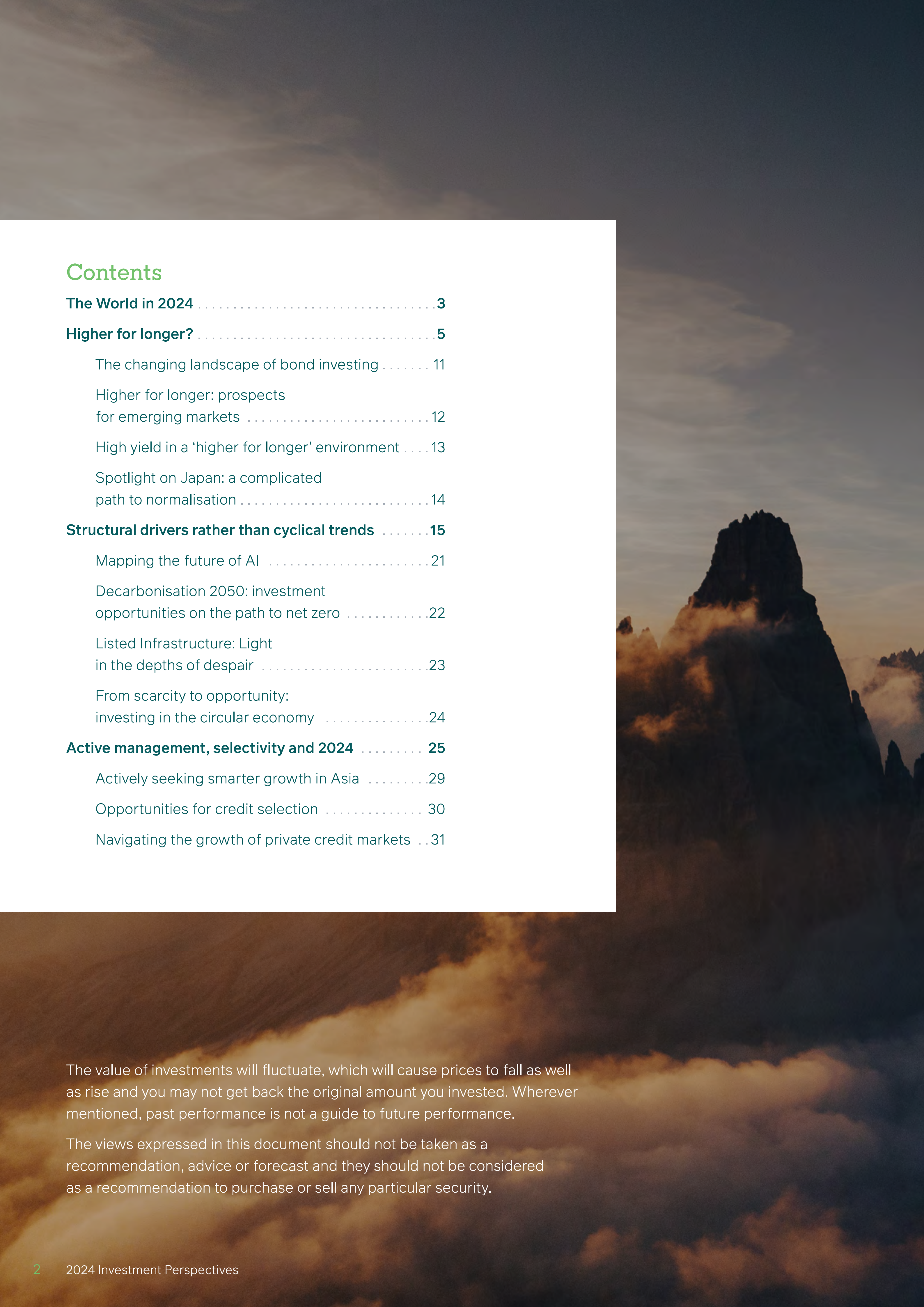
M&G Investments

Investment Perspectives

Peak views: what lies ahead in 2024?



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The World in 2024

Welcome to the latest edition of Investment Perspectives, Peak views: what lies ahead in 2024? At the end of another year of (mainly positive) surprises in financial markets, investment experts from across M&G's equities, fixed income, multi asset and private assets teams provide their views on the main topics and trends influencing markets.

As we approach the end of 2023, financial markets are at an important junction. Major developed market central banks have paused their rate rises and there is considerable uncertainty about what happens next.

As inflation has come down meaningfully in the past 12 months, there is a growing view among investors that the cycle of interest rates hikes is at an end, even though inflation remains above central banks' target level. Markets are currently forecasting that we may see rate cuts next year. However, policymakers have indicated that rates may remain at these elevated levels for some time.

The divergence between the expectations of investors and central banks' apparent commitment to tighter monetary policy is one of the main sources of uncertainty in markets at present.

At the time of writing, the prevailing market view appears to be that policymakers, primarily in the US, are on track to deliver a 'soft landing', bringing inflation down without causing a major recession. This view reflects the fact that, despite one of the most aggressive and rapid rate hiking cycles in history, the global economy has held up well so far.

But there are signs that demand is softening and economic activity is weakening. This sets up one of the biggest debates for 2024: will policymakers keep rates 'higher for longer' if we see growth slow significantly or unemployment rise?

Indeed, in these pages Jim Leaviss, CIO Fixed Income, suggests that the more likely scenario for next year is not a soft landing, but a slowdown followed by central banks cutting interest rates. In his view, the current environment offers opportunities in government bonds and duration (interest rate risk).

Meanwhile, despite a high degree of market volatility, and contrary to popular opinion coming into 2023, most equity markets look to be ending the year firmly in positive territory, with sentiment buoyed by the prospect of 'peak interest rates'.

As we head into 2024, from a valuation standpoint, the UK and Europe are looking more compelling than US equities in aggregate following the strong index returns in 2023. But as Fabiana Fedeli, CIO Equities, Multi Asset and Sustainability, points out, outsized returns in the US market have been highly concentrated, which means that there could still be very good opportunities there for active investors who are willing to dig a little deeper.

In addition, after a few months of return convergence, we are starting to see a return to greater dispersion across stocks globally, even within the same sectors, providing support to an active investment approach as we head into 2024.

Importantly, a potential economic downturn could see equity markets come under pressure next year, so selection will remain key. By focusing on companies that are able to benefit from longer-term structural drivers rather than those with more cyclical exposure, Fabiana suggests that investors can continue to find attractive investment opportunities.

Dave Fishwick, Head of Macro Investment, agrees that, should we see a structural shift to a higher rate environment, active investing could have an increasing role to play going forward. In Dave's view, active managers could benefit from elevated dispersion in both equities and fixed income, while in-depth analysis will once again come to the fore as investors look to distinguish between the winners and losers of tomorrow, in an increasingly competitive environment with a potentially tougher economic backdrop.

Paths beyond the peak

As we approach ‘peak rates’, we are arguably nearing the end of the beginning of this economic cycle. What happens next is not clear. Besides the economic uncertainty, next year multiple countries are due to hold elections, most notably the US but also India, Mexico and South Africa. According to Bloomberg Economics, voters representing 41% of the world’s population will go to the polls in 2024. Politics and geopolitical issues such as the Israel-Gaza crisis and US-China tensions could potentially add to the complex macroeconomic backdrop and cause further disruption to volatile financial markets.

The investment landscape is challenging. However, we hope these perspectives provide some clarity on what might lie beyond the peak and highlight potential paths to help you prepare for the year ahead.

Themes for 2024:

We have highlighted three core themes – ‘higher for longer’, ‘structural trends’ and ‘active management’ – that we believe could provide a path through the current uncertainty and offer opportunities in 2024 and beyond.

Higher for longer?

Major central banks have raised interest rates dramatically in the past two years to bring inflation under control. As 2023 draws to a close, inflation has come down and there is a growing belief that we could be at the end of the tightening cycle. The big issue is how long policymakers will keep rates at elevated levels. Even if there are rate cuts next year, as the market currently anticipates, interest rates are unlikely to return to the exceptionally low levels of recent years. We consider the potential impact of this shift to a new regime and tighter monetary policy.

Structural not cyclical

Against a backdrop of heightened near-term macroeconomic uncertainty, we believe that there is value in taking the long view and concentrating on investment themes that have a future focus. Across public and private markets, we think long-term structural trends can offer compelling opportunities for patient investors. In our view, themes such as innovation including AI, infrastructure, and sustainability and decarbonisation should endure, regardless of the current complex macroeconomic outlook.

A new era for active management?

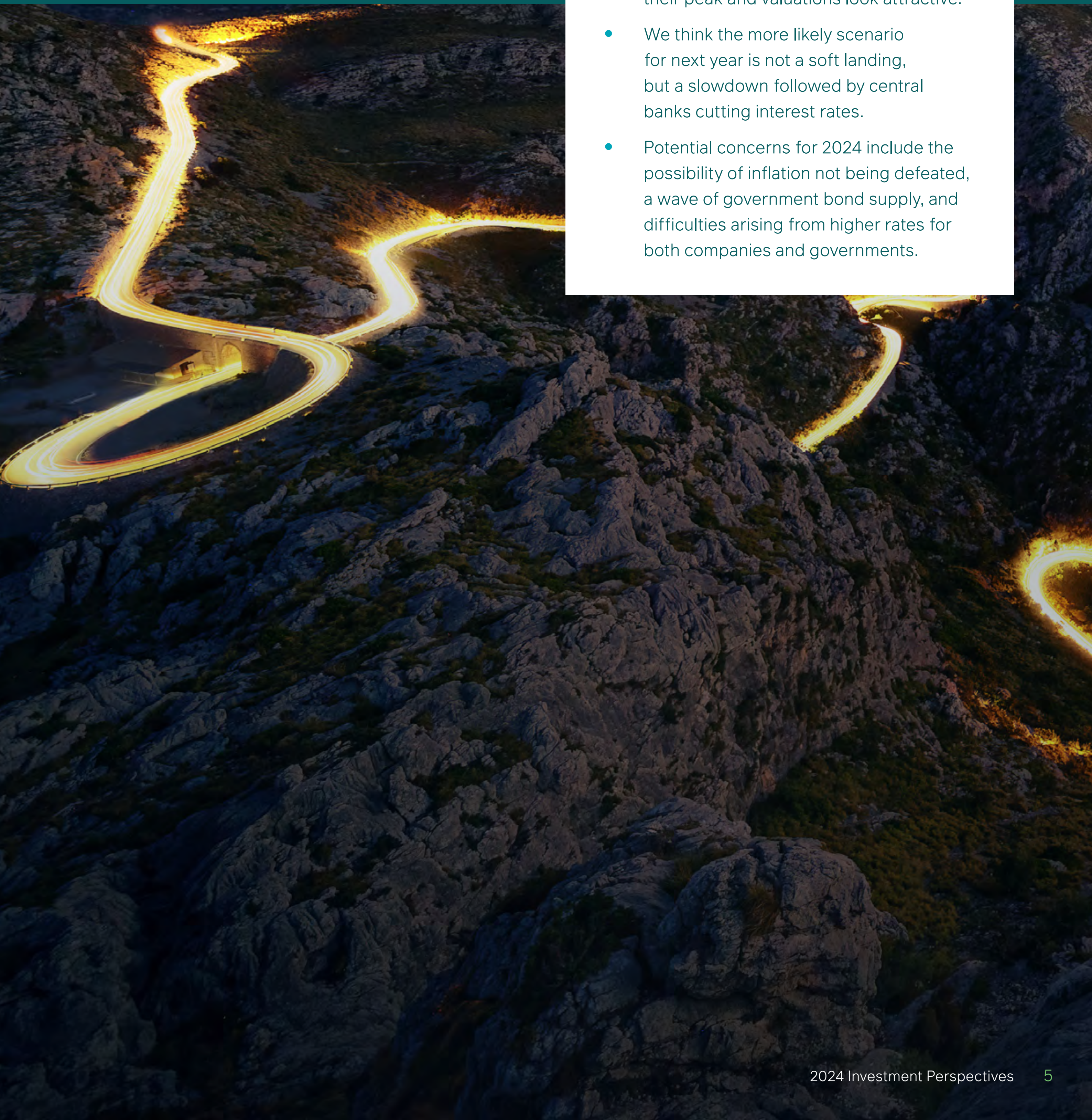
Active management has faced numerous challenges in recent years, from the rise of passive strategies to positively correlated returns across asset classes. In our view, the COVID pandemic and the end of the low interest rate environment could create more favourable conditions for active managers. Increased dispersions in valuations and the importance of identifying winners in a tougher environment could potentially benefit disciplined, selective investors.

Higher for longer?

Jim Leaviss
CIO Fixed Income

Key observations:

- We believe there is an opportunity in 2024 for investors in government bonds and duration, as interest rates may be at their peak and valuations look attractive.
- We think the more likely scenario for next year is not a soft landing, but a slowdown followed by central banks cutting interest rates.
- Potential concerns for 2024 include the possibility of inflation not being defeated, a wave of government bond supply, and difficulties arising from higher rates for both companies and governments.



After two years of declines, 2023 has proved to be another tough year for bond investors. A high degree of volatility has seen bonds veer from positive to negative territory; as it stands, after a recent rebound, the global bond index is on course to end the year slightly up for the first time in three years.

The backdrop to this turbulent performance has been ongoing monetary policy tightening by major central banks in an attempt to bring persistent inflation under control. Interest rates have subsequently reached levels last seen before the Global Financial Crisis of 2008/2009.

The rate hikes have brought the era of 'cheap money' to an abrupt end – except in Japan which has persisted with its negative rate policy. In response, sovereign bond yields have continued to climb: at one point the US 10-year Treasury yield reached a 16-year high of 5% before retreating to a level broadly in line with its long-term average. (Bond yields and prices move in opposite directions).

While there is indeed a plethora of worries that has fuelled the negative sentiment towards bond markets, we believe that the major change in valuations that has taken place has created an opportunity for investors in government bonds.

In particular, we think that, for the first time in many years, duration is now attractive, and this year we have been increasing duration (sensitivity to interest rates) in a number of our portfolios.

Peak rates?

The rationale for adding duration now is underpinned by our belief that both the timing and valuations are favourable for investing in government bond markets.

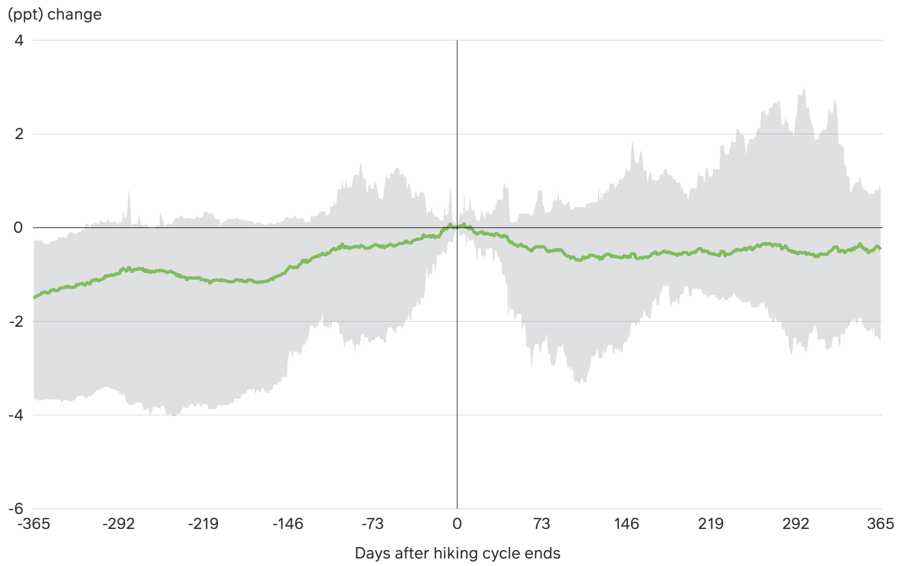
Historically, the 10-year US Treasury yield has tended to rally after the Federal Reserve (the Fed) ends its hiking cycles. Research from Deutsche Bank shows that the biggest fall is typically seen within three months of the last hike – this has even been as much as 3 percentage points, equivalent to a capital gain of around 7% (Figure 1).

Investing in US Treasuries at the peak of the cycle therefore has the potential to deliver a healthy capital gain from a credit risk-free asset. However, timing this decision is extremely difficult as it is hard to establish when peak rates have been reached. You never really know the last hike has taken place until it has passed by.

The challenge is that policymakers rarely announce when they have reached peak rates. In their recent meetings, the Fed, the European Central Bank (ECB) and the Bank of England (BoE) all kept their rates on hold. The big question for investors is whether this is a pause to assess the impact of previous hikes or the end of the road.

Figure 1: Average move in the 10-year US Treasury yield before and after last Fed hike

Past performance is not a guide to future performance



Source: Bloomberg Finance LP, Deutsche Bank: Jim Reid. Range – all since 1969

We think the ECB and the BoE could well have hiked for the last time. The Fed has previously indicated that it will likely raise rates once more this year; if that happens in December, we believe this may be the final hike, although there is a growing belief that the Fed's rate hiking has already ended, particularly following comments from policymakers during November which the market perceived as more dovish.

A 'higher for longer' scenario

While there is a widespread belief that we are at or approaching the peak in interest rates, there is considerable uncertainty about the path they may take in the coming months. One narrative in markets is that we are in a 'Table Mountain' scenario – referring to the distinctive flat top of South Africa's iconic landmark. This suggests that after 500 basis points of rate rises, we stay on a plateau for the foreseeable future before any rate cuts.

This view has been encouraged by policymakers who have repeatedly stressed that rates are likely to remain restrictive for an extended period to bring inflation down further. Federal Reserve Chair Jerome Powell has even suggested that the Fed would "not hesitate" to raise rates again if necessary to defeat inflation. As we enter 2024, one of the biggest debates in financial markets is whether interest rates will remain elevated. Are we really in a 'higher for longer' environment or are we close to a turning point?

Although the US economy has been extremely resilient this year – GDP growth in the third quarter was 5.2% annualised – it is worth remembering that monetary policy works with a lag. This hiking cycle began at a historical low of near zero, which is one reason why the impacts may be taking longer than the usually cited 12-18 months.

How long higher rates take to feed through to the real economy can vary. For example, within the mortgage market, which has further knock-on impacts in the real economy, there are big dispersions. The US has 30-year fixed mortgages, whereas Sweden has 18-month long mortgages and in the UK 5-year fixed mortgages have become increasingly common.

As a result, the impact of higher borrowing costs on consumers and companies feeds through at different speeds. Several factors have helped US consumers this year, such as the excess savings built up during the pandemic, a healthy jobs market and higher wages. However, there are signs that the real economy may feel pain in due course, particularly after such a long period of very low rates.

The Table Mountain scenario would be welcome as it suggests that we are heading for a soft landing in the global economy. However, we believe that this is unlikely. History shows that this type of extended rate-plateau rarely happens and generally we do not get soft landings in economic cycles.

Figure 2: Two views of the future: the bond market versus policymakers

Past performance is not a guide to future performance

Source: Bloomberg, Federal Reserve, 31 August 2023

If we look back at previous rate cycles, on average, the Fed hikes and then a few months later it starts cutting rates aggressively because it hasn't managed to achieve a soft landing and the economy starts to weaken. There are a few outliers in history but that tends to be the pattern.

It could be different this time. However, we think that it is much more likely that central banks will be cutting rates aggressively at some point in 2024 rather than keeping them elevated at current levels. This view is dependent on whether we have reached peak rates yet. We don't know for certain, but it looks like we are nearly there.

Valuation opportunities in government bonds

In addition to a potentially supportive path for interest rates, we believe that US Treasuries currently offer value. Comparing the market's expectations for 10-year Treasury yields in 10 years' time with the Fed's forecast for long-run interest rates, we can see that there is a significant dislocation (Figure 2). In our view, this is usually a signal of good value in US Treasuries.

There are some arguments that the Fed's expectations are too low, and it might upgrade longer term interest rate expectations. We think this could happen as demand for money increases with big stimulus measures such as the Inflation Reduction Act. Nevertheless, we believe there is likely to be some convergence between the two and this indicates to us that there are valuation opportunities in long-dated US government bonds at present.

Reasons to be nervous

While we believe the valuation and timing arguments are valid, there are some reasons to be nervous about buying government bonds. One concern is the possibility that inflation might not be defeated. While inflation has come down significantly from the peaks of 12 months ago, it still remains above central banks' 2% targets, even in Japan.

Moreover, inflation usually comes in waves. Base effects have been favourable this year, as falling food and energy prices have made the year-on-year comparisons lower. However, if Europe were to experience a cold winter, for example, and natural gas prices rise with demand, the base effects could lead to inflation climbing again next year. This could also feed through to wage negotiations, which in turn might result in increased inflationary pressures. A further inflation spike would likely mean interest rates rising again, which would hurt fixed income markets.

Supply wave

Another concern relates to the wave of supply of government bonds to come in 2024. According to research from Apollo Global Management and Haver Analytics, 31% of outstanding government debt in the US (US$7.6 trillion) needs to be refinanced within the next 12 months. Around the world, there will be a huge amount of issuance in 2024, while central banks continue with quantitative tightening (reversing their post-GFC bond buying programmes). Rising supply will likely test investors' demand for bonds.

In the past, governments have tended to issue larger amounts of debt at times of economic weakness, and there has been generally healthy demand as rates are likely to be cut. However, will the same pattern be repeated in the year ahead? If inflation picks up and central banks are not cutting rates, will there still be demand for these bonds? We think this could potentially be a more challenging situation and lead to higher bond yields.

Governments around the world have borrowed heavily recently, partly due to the response to the GFC and pandemic-era stimulus programmes: in the US, the debt-to-GDP ratio is now around 120%. These debt levels might have been manageable in a low interest rate environment, but with the cost of borrowing climbing they could become problematic. Ratings agencies have certainly taken notice with Moody's recently lowering its outlook on the US credit rating to "negative" from "stable".

Indeed, one explanation that has been suggested for the government bond selloff that happened in September and October was concern among investors about fiscal deficits and the creditworthiness of governments.

The amount of interest the US government has to pay on its debt has been rising fast. Annual interest payments look like they will soon hit US$1 trillion, and likely increase even further as maturing debt will need to be refinanced at higher rates. To put this in perspective, total interest payments for the US have now reached the same level as their total debt in 1980.

With supply expected to increase, we could well see the high credit rating of developed market economies be downgraded in the coming years.

Quality matters in credit

It is not just governments that face a potential challenge from higher rates: companies could struggle too. When investing in corporate bonds, our main consideration is whether we are being compensated for the risk of default, or the non-payment of the debt.

Using the additional spread offered on corporate bonds above equivalent government bonds (the latter sometimes referred to as the risk-free rate), we are able to see the level of defaults that the market is pricing in. At present, the spread and implied default rate for higher quality investment grade corporate debt (represented by the green bars for AA, A and BBB bonds) is above the average historical level and even the worst ever default rate (Figure 3).

In our view, this suggests that there is value available among investment grade bonds currently, particularly for active investors who are able to be selective and identify the most attractive opportunities.

However, the picture varies lower down the quality scale towards the riskier high-yield and 'junk' bonds. Here, the market anticipates defaults to be above average and close to the worst ever. This level of expected defaults makes us rather nervous about the lower quality high yield market, and so we have been reducing credit risk in this area in some of our flexible strategies.

Conclusion

In conclusion, we think the opportunity for investors in 2024 is in government bonds and duration (interest rate risk). With bonds having suffered over the past couple of years as investors have repriced their inflation expectations and as central banks have increased interest rates, valuations now look attractive.

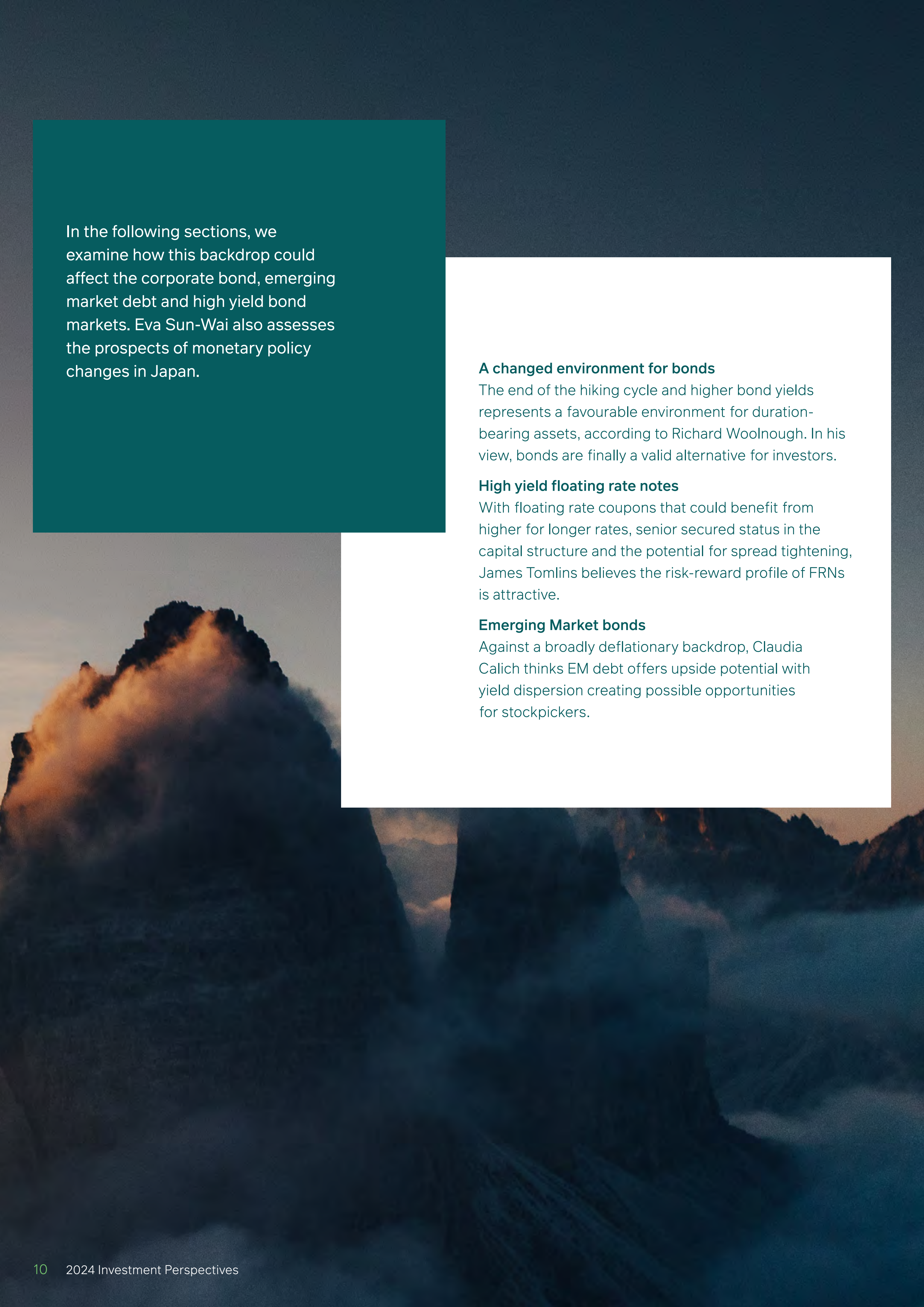
We think the more likely scenario for next year is not a soft landing, but a slowdown followed by central banks cutting interest rates. In this environment, we want to be exposed to perceived 'safe haven' government bonds and longer in interest rate duration, which we would expect to perform well in such a scenario.

Conversely, we are looking to be more selective in corporate bond markets, where thorough research is always important: here, we are well supported by our strong team of fundamental credit research analysts in aiming to take risk only where we are being compensated for it.

Figure 3: Corporate bond default rates: the market's expectations versus history

Past performance is not a guide to future performance

*Assuming 40% recovery rate for IG and 30% recovery rate for HY. Information is subject to change and is not a guarantee of future results.
Source: Bloomberg, Deutsche Bank, ICE indices, S&P, 31 October 2023

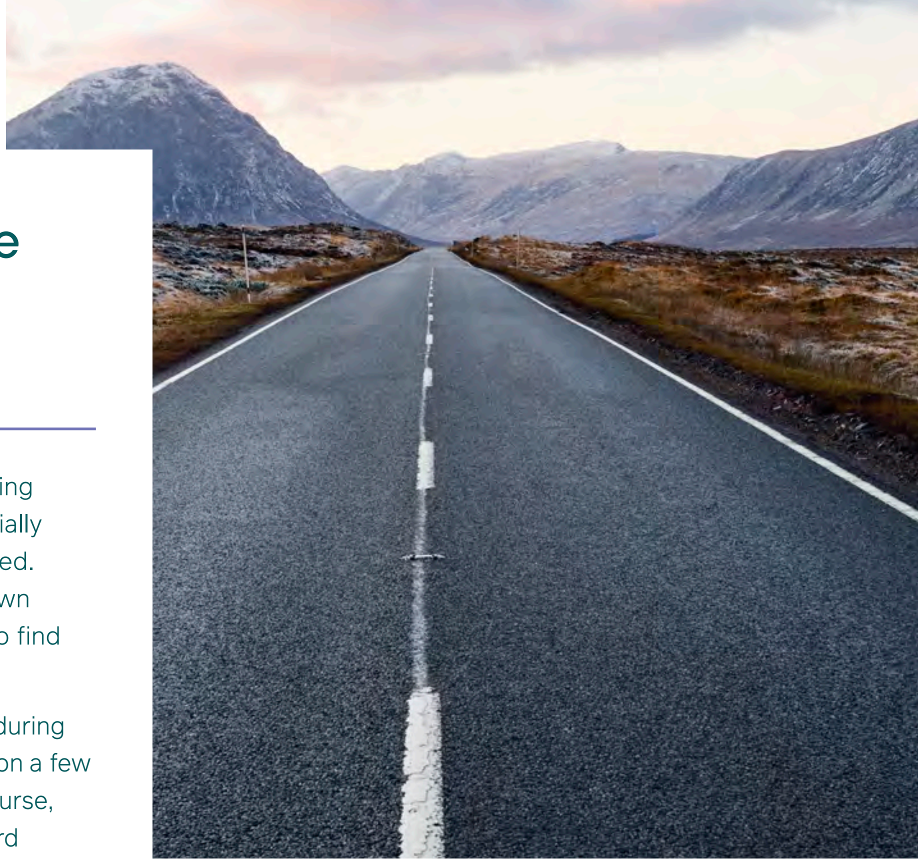


In the following sections, we examine how this backdrop could affect the corporate bond, emerging market debt and high yield bond markets. Eva Sun-Wai also assesses the prospects of monetary policy changes in Japan.

A changed environment for bonds
The end of the hiking cycle and higher bond yields represents a favourable environment for duration-bearing assets, according to Richard Woolnough. In his view, bonds are finally a valid alternative for investors.

High yield floating rate notes
With floating rate coupons that could benefit from higher for longer rates, senior secured status in the capital structure and the potential for spread tightening, James Tomlins believes the risk-reward profile of FRNs is attractive.

Emerging Market bonds
Against a broadly deflationary backdrop, Claudia Calich thinks EM debt offers upside potential with yield dispersion creating possible opportunities for stockpickers.



The changing landscape of bond investing

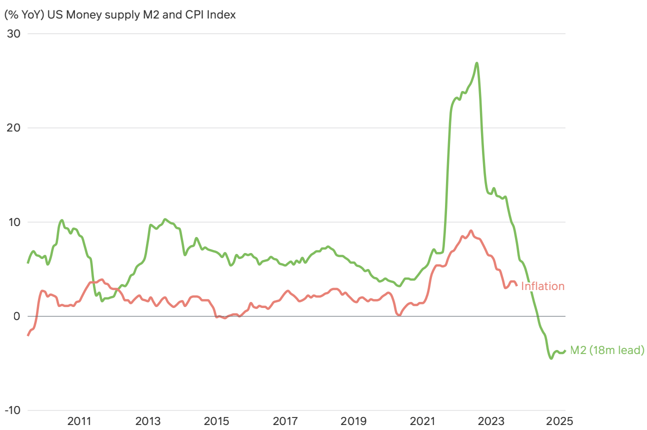
Richard Woolnough
Corporate Bond Fund Manager

Years of ultra-low interest rates made it challenging for investors to be constructive on bonds, especially government bonds. However, things have changed. While in the past it was hard to find reasons to own bonds, now we think it is starting to be difficult to find reasons not to own them.

The massive increase in liquidity we experienced during the COVID pandemic led to a resurgence of inflation a few months later. Central banks have now reversed course, causing money supply to fall and putting downward pressure on inflation as a result (Figure 4). Falling inflation could mean central banks are at the end of their hiking cycle, which would effectively put a ceiling on how far rates can go. This, together with historically elevated bond yields, has created an attractive risk-reward opportunity for duration-bearing assets, in our view.

Credit, on the other hand, which we believed to be relatively good value for the majority of the last twelve months, is now moving back towards what we consider 'fair value'. Pockets of opportunities remain, however, particularly for active flexible funds. As usual, we will draw on our experienced in-house fixed income team to try and identify dislocations in credit markets and generate alpha for our clients.

Figure 4: Inflation is on a downward trajectory

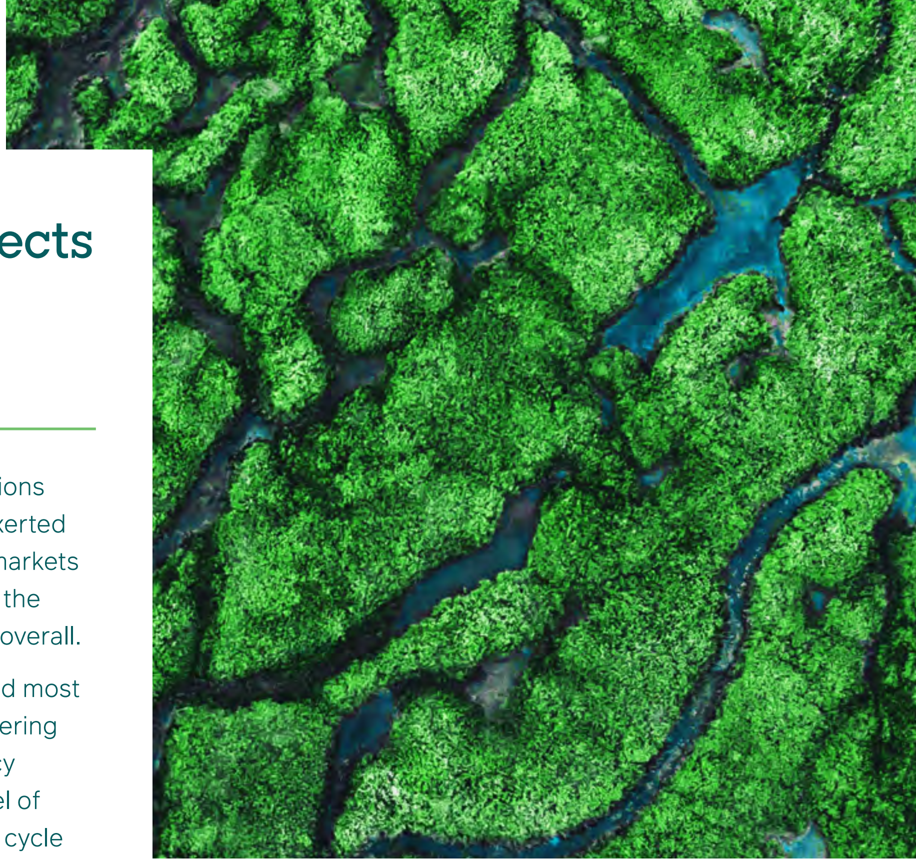


Source: M&G, Bloomberg, 31 October 2023 (latest data available)

There is also now a notable valuation gap between bonds and stocks, which we think means bonds are not only attractive in absolute terms, but also in relative terms, and finally can represent a valid alternative for investors.

This is also reflected in our portfolio positioning. The flexible bond strategy can also take a certain degree of equity exposure when we believe the income stream offered by stocks is greater than the one offered by bonds. This has happened in the past, but it is not the case today. As a result, the strategy currently holds no stocks in the portfolio.

In summary, the macro environment altered considerably after COVID as did valuations. After more than 10 years of being short duration and predominantly long credit, we have now changed, underlining our active and flexible approach to bond investing. As we enter 2024, the strategy is now long duration and broadly neutral on credit.



Higher for longer: prospects for emerging markets

Claudia Calich
Emerging Markets Debt Fund Manager

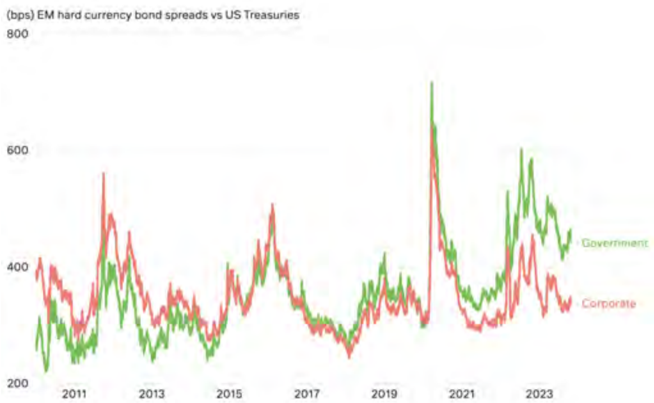
While central bank rhetoric and market expectations around interest rates staying higher for longer exerted a partial brake on sentiment towards emerging markets (EM) in the latter stages of 2023, we believe that the global macroeconomic outlook remains resilient overall.

The EM universe remains one of the broadest and most diversified asset classes within fixed income, offering diversification by region, country, sector, currency and commodity. Today, it also exhibits a high level of disparity from an economic and monetary policy cycle perspective too.

EM central banks were very quick in increasing base rates in the face of high inflation and have also been able to start their cutting cycles first, with Latin America leading the way in 2023. Conversely, Asia saw comparatively less inflation and therefore had more moderate monetary policies. In the EM space we are now at a point where, while we shouldn't overlook short-term inflationary factors, the broader picture is deflationary in nature which we expect to continue in 2024.

While this dispersion drove our preference for Latin America versus Asia, alongside more attractive valuations, we see an opportunity in selling strong performing names and rotating into other countries and regions where we have had underweight positions.

Figure 5: Potential for EM spreads to narrow



Information is subject to change and is not a guarantee of future results.
Sources: JPMorgan indices: JPM EMBI Global Diversified Blended Spread Index, JPM CEMBI Diversified Broad Composite Blended Spread Index, as at 31 October 2023.

Yields in emerging markets remain elevated relative to their highs during the 2020 COVID sell-off; however, spread levels are not as historically high due to the movement in US Treasuries. But with room for further spread compression, we believe that EM debt offers upside potential in the near term (Figure 5).

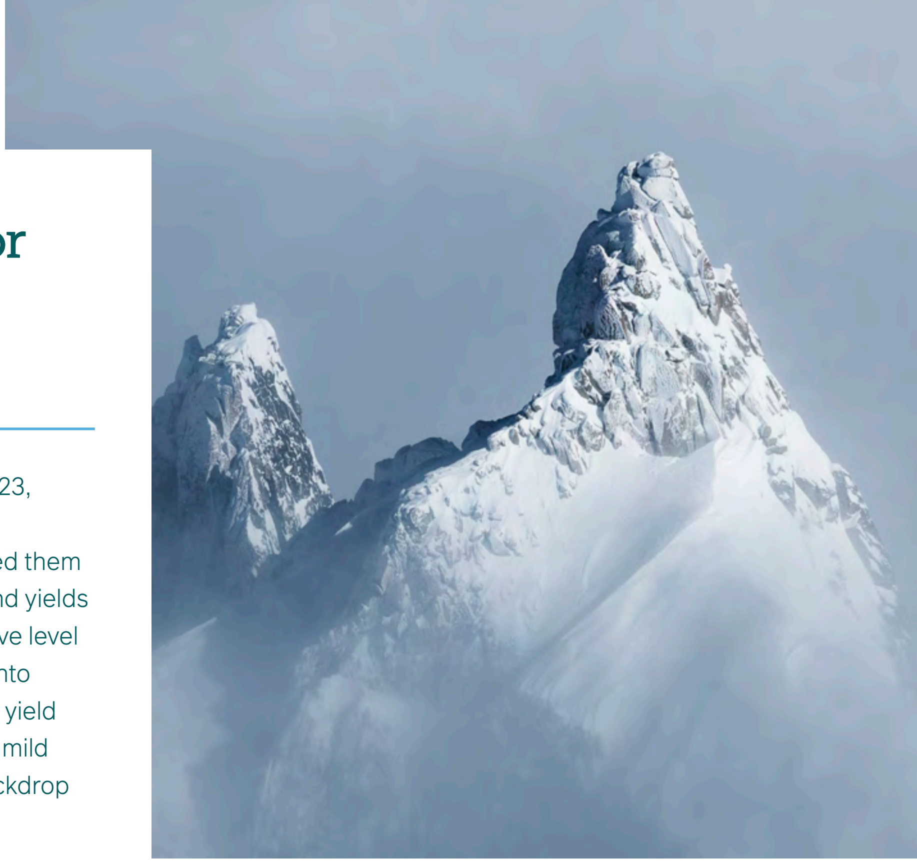
Within EM itself, there is also significant yield dispersion between investment grade and high yield (HY) names, particularly in the sovereign hard currency space, which creates potential opportunities for bottom-up investors. While tail risks can't be eliminated within an EM portfolio, diversification is important in managing potential drawdowns.

Although EM countries have remained broadly robust in the higher-for-longer environment, a number of frontier countries face pressure points. EM corporates have also stayed strong, although expected defaults are ticking up, particularly for the most indebted issuers, which is what we would expect at this stage of the cycle. Notwithstanding this, corporate HY defaults are expected to end 2023 at around 3%, excluding those in Russia, Ukraine and China's real estate sector.

Despite some uncertainty, we think the broader picture is still conducive to emerging markets performing well in 2024. Economies have been surprisingly resilient and have been largely able to adapt to the inflationary story and then the higher-for-longer environment. Additionally, with a Fed pivot far more likely than further hikes in 2024, in our view, we have cause for optimism for emerging markets. This will especially be the case if the US dollar does not strengthen further should the Fed be done raising rates and risk aversion remains subdued.

High yield in a 'higher for longer' environment

James Tomlins
High Yield Fund Manager



High yield bonds have delivered solid returns in 2023, with HY Floating Rate Notes (FRNs) the standout performer. Their floating rate coupons have enabled them to withstand the sharp increase in government bond yields of recent months, while benefiting from an attractive level of carry and a benign default environment. Going into 2024, the continued inversion of most government yield curves, spread valuations and the expectation of a mild default cycle could provide a supportive macro backdrop for the asset class, in our view.

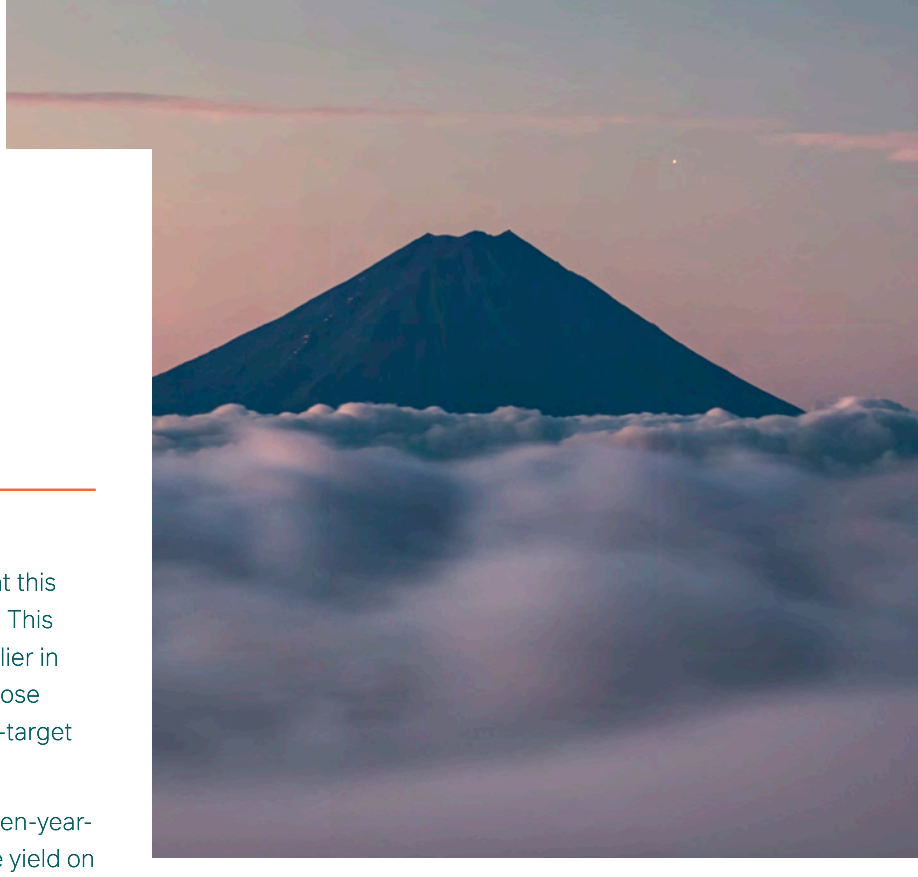
In 2023 most government yield curves inverted as a result of the steep rate hikes and increasing focus on the 'higher for longer' narrative. We believe instruments such as FRNs, which are pegged to the front of the curve, remain a good way to exploit the carry pick-up available at the front-end of the sovereign curves. (A carry trade involves borrowing at a lower interest rate in order to invest in instruments that pay a higher interest rate). By late 2023, FRNs were delivering a yield advantage of more than 100 basis points versus longer-dated bonds, and with much lower duration risk (exposure to changes in interest rates) than their longer-dated counterparts.

On the valuation front, we believe FRN spreads can benefit from further tightening in coming months. While spread levels for traditional high yield bonds currently look fairly priced those on HY FRNs remain relatively wider, hovering around 600bps in recent months. This divergence is down to technical market factors. While FRN supply has been stable, demand from collateralised loan obligation (CLO) structures and loan funds (typically important buyers of FRNs) has been lower, which weighed on spreads. However, CLO issuance started to gain traction in late 2023, which we expect to re-stimulate demand for HY FRNs. If this continues, then we would expect to see further spread compression.

High yield company fundamentals have held up reasonably well so far, thanks mainly to buoyant consumption and pre-emptive corporate refinancings enabling issuers to lengthen their maturity profile at attractive rates. Nevertheless, as developed economies slow and the impact of higher rates starts biting into corporate balance sheets, an uptick in default rates is likely. Our base case scenario remains that of a mild default cycle (resulting in a global default rate of c.3%) which would not be too damaging for the corporate sector. However, should default rates increase more aggressively, HY FRNs can play an important role towards capital protection thanks to their senior-secured status in a company's capital structure.

Spotlight on Japan: a complicated path to normalisation

Eva Sun-Wai
Global Macro Bond Fund Manager



There has been plenty of discussion about the normalisation of monetary policy in Japan and what this might mean for global bond and currency markets. This year, the Bank of Japan (BOJ) has remained an outlier in the global tightening cycle, sticking with its ultra-loose monetary policy, despite inflation remaining above-target for more than a year.

There have been some modest changes to the seven-year-old yield curve control (YCC) policy, which caps the yield on 10-year Japanese government bonds (JGBs). The BOJ has tweaked the policy to allow yields to rise to a soft limit of 1% and yields have been creeping up. Rather surprisingly, the relaxation of the yield cap has been accompanied by significant weakening of the yen versus the US dollar this year, but this is arguably driven by the wide differential between interest rates in the US and Japan.

Broadly, YCC is slowly being dismantled, but the market is expecting a larger shift from the current framework. However, the situation is complicated. The BOJ wants to see sustainable inflation in Japan and appears relatively relaxed about keeping policy loose to achieve this. At the same time, it is in a regime where, in an economic downturn, they have nowhere to go as they can't cut rates.

YCC is also very beneficial for the government because it means it can borrow money at low rates. With a very large debt-to-GDP ratio of c.250%, significantly higher borrowing costs would be challenging for the government.

These are difficult dynamics and there is no great incentive for the BOJ to raise rates. Policymakers certainly don't want to hike too soon and cull any potential inflation. They don't yet believe that inflation is sustainable enough domestically to warrant large tightening of monetary policy. They are also concerned about the potential consequences of higher interest rates on the country and Japanese banks after such a long period of ultra-loose policies.

In our view, the best case for Japan is for other central banks to move first. For example, if the Federal Reserve were to cut rates, it would narrow the rate differentials between the dollar and the yen and mean the BOJ has less pressure to raise rates themselves. The yen has been badly affected by the rate differentials and on a real effective exchange rate basis it is the cheapest it has been this century.

In a way, a weak currency has been helpful for Japan as it has boosted their exports. On the other hand, as the country is a big oil importer, it has also hurt them. There is plenty of discussion about what could happen to the yen if the BOJ ended negative rates. Japanese investors hold a lot of overseas assets, and are collectively the largest foreign owner of US Treasuries.

One potential consequence of higher yields in Japan could be the repatriation of Japanese money back to the domestic market, although we are yet to see the start of this movement. If the negative interest rate policy and YCC are lifted and we begin to see repatriation flows, this could potentially have significant consequences for the Treasury market as well as the yen.

Given that the yen tends to act as a 'safe haven' currency, it could benefit from any global slowdown in the months ahead. Therefore, we think the potential for an inflection point in the yen means that it will be important to pay close attention to developments in Japan in 2024.

Structural drivers rather than cyclical trends

Fabiana Fedeli
CIO Equities, Multi Asset and Sustainability

Key observations:

- With the rapid rise in interest rates and the depletion of COVID-era household savings, we believe it is logical to expect a further slowdown in demand ahead.
- After a few months of return convergence, we are starting to see a return to greater dispersion across stocks globally, even within the same sectors, providing support to an active investment approach as we head into 2024.
- Amid the macroeconomic uncertainty, we favour long-term structural themes, such as Innovation (including AI), Infrastructure, and a low-carbon economy, that we believe will continue to prevail supported by long-term capital, independent of near-term volatility.

2023 was a year in which markets were news flow-driven and reactive to short-term data, in an attempt to second guess the pace and trajectory of interest rate moves by central banks.

As we enter 2024, it is likely that eyes will remain firmly fixed on how policymakers respond to macroeconomic developments from here. The rebound in risk assets in November was arguably driven by weaker-than-expected US inflation data, which fuelled optimism that the Federal Reserve's hiking cycle is over. But, despite headline inflation coming down, it remains above target, while core inflation also remains stubbornly high.

In addition, the economic backdrop, although not stellar, has been fairly resilient in 2023.

In the absence of core inflation returning to, or close to, target levels, the only other reason central banks would start cutting is if the macroeconomic backdrop started to materially deteriorate.

Over the course of 2023, investors' expectations of the path of interest rates altered considerably. Policymakers have raised rates higher and faster than many market participants had anticipated, and expectations in the second half of year were more closely aligned with the 'higher for longer' narrative. As we enter the final straight, the prevailing narrative is that we've reached 'peak interest rates'. As for the trajectory from here, markets seem to be see-sawing between expectations of 'still higher for longer' and anticipation of rate cuts.

The 'elusive recession'

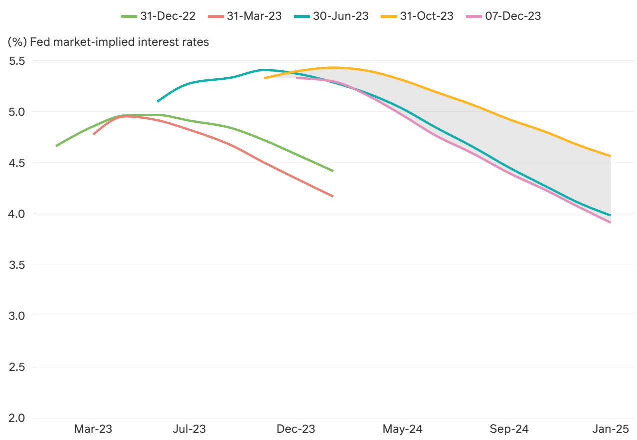
One of the most widely debated issues in 2023 was the likelihood of the economy buckling under the pressure of rapid monetary policy tightening. This expected downturn has proved to be something of an 'elusive recession' with the macroeconomic backdrop proving more resilient than many had expected.

There are valid reasons for this, not least the lag effect of monetary policy. The higher rates have not affected all consumers or corporates yet as many have been protected by fixed low-cost financing or mortgages. The excess savings built up during COVID have also provided some consumers with a buffer against higher prices.

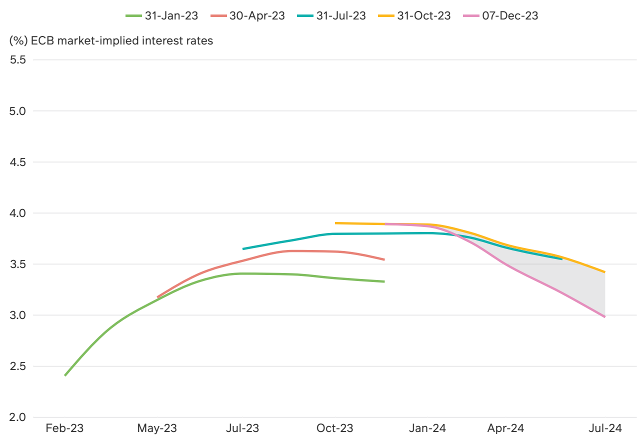
Current macroeconomic data isn't showing signs of a deep recession or a widespread credit crisis looming in the near term, but expectations of further demand contraction appear logical. As we move through 2024, more households and businesses will start to feel the impact of inflation and face higher financing costs, which is likely to affect their spending power.

There is increasing evidence that economic activity is weakening, particularly in Europe where the eurozone GDP contracted in the third quarter following modest-to-no growth earlier in the year. The UK failed to grow at all in the third quarter. And while US GDP growth until now has been particularly resilient, cracks are appearing in some areas of demand, particularly at the lower-income end of households. It is likely that global growth will slow further next year.

Figure 6: Markets see-sawing between 'higher for longer' and rate cuts



Source: Bloomberg, 7 December 2023 • Note: Shaded area represents the recent change in rate cut expectations



Source: Bloomberg, 7 December 2023 • Note: Shaded area represents the recent change in rate cut expectations

Should we see a slowdown ahead, and if it is deeper and more entrenched than what we expect, longer-term government bonds could reprise their 'insurance' role, and, in our view, provide better risk-reward than equities in aggregate.

This is not to say, however, that there are not compelling opportunities in equities. Two areas of the market that have suffered recently amid the intra-sector return convergence we witnessed between August and October were infrastructure and renewables. These are two long-term structural themes that we favour, and for a number of these companies it has been a case of the 'baby being thrown out with the bathwater' in the panic around so-called 'bond proxies'.

A number of these companies have solid balance sheets, with fixed-rate debt, long-term maturities, cost pass-through in their pricing agreements, and many pay attractive dividends. The impact from higher rates is relatively limited and downward pressure on their share prices has been unwarranted, in our opinion. We've been taking advantage of this and adding to stocks in these areas that we believe have strong competitive positions and good long-term growth prospects.

It's also important to remember that, even if a recession were to come, there are different degrees of severity, and risk markets could remain resilient in a mild recession. Let's not forget the German Dax Index (the Dax) was up in the first half of 2023 despite the country having entered a technical recession, given a quarter-on-quarter GDP decline of 0.5% in the fourth quarter of 2022 and a 0.3% decline in the first quarter of 2023. So, the difference between a mild recession and deep recession can be very large in terms of impact on risk assets.

The case for selection

As we note above, most equity markets materially outperformed bonds this year, despite the challenging macroeconomic backdrop, confounding many investors' expectations coming into 2023. US indices, particularly the tech-heavy NASDAQ, have been among the strongest performers, but looking only at headline index level returns obscures the full picture.

We believe that investors need to differentiate between investing in broad market indices and active stock picking. Many investors appear to believe that a small group of US stocks have outperformed global indices year-to-date. Actually, this is not the case. It is true that the size of a few stocks, coupled with good performance, has led to sizeable moves in the NASDAQ and the S&P 500 indices, allowing them to outperform other global equity indices.

However, of the best performing stocks in the MSCI AC World Index (ACWI) year-to-date, only three of the Top 10 are US-listed stocks, while 65% of the Top 40 stock performers year-to-date are non-US stocks (see figure 7 below). As witnessed in 2023, we believe that in 2024, too, active investors will be able to find attractive pockets of opportunity across the globe.

Taking the long view

Navigating a path through unpredictable markets, when there is a lack of visibility about what lies ahead, can be challenging. Clearer signs of a deeper economic slowdown could put pressure on equity markets. We are starting to see signs of weakening, but we don't think it's time to run for the exits right now. We do, however, think it's a great time to take advantage of structural opportunities, particularly as some of these have been caught in the recent market volatility and present attractive entry points, in our view. As ever, selectivity remains key.

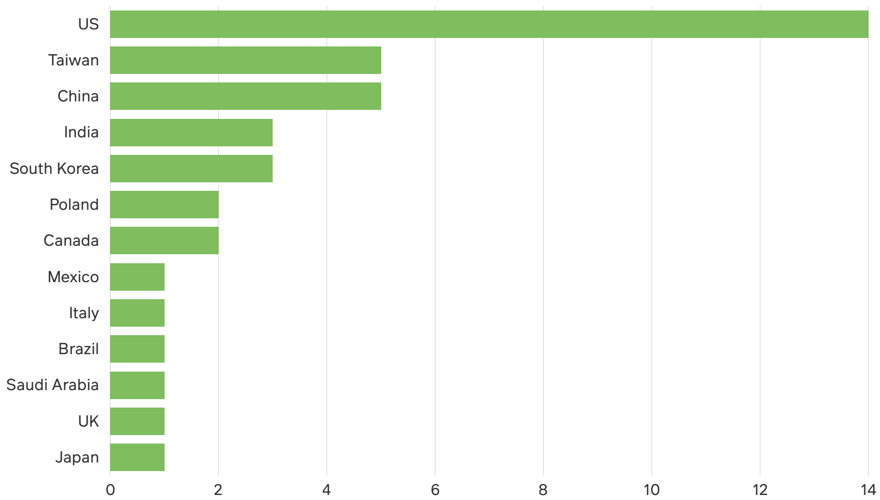
Amid the current uncertain macroeconomic backdrop, we favour investments that are underpinned by structural drivers rather than those exposed to cyclical or economically-sensitive factors.

For example, we favour long-term themes such as Innovation (including AI), Infrastructure, and a low-carbon economy, to which we believe capital will flow, independent of the near-term vagaries of the macroeconomic backdrop.

Figure 7: The case for selection: looking beyond US equities

Past performance is not a guide to future performance

(No. of companies) MSCI AC World Index: 65% of the top 40 best performers are listed outside the US (YTD)



Source: M&G Investments, Bloomberg, 5 December 2023, in USD terms

MSCI AC World Index: 7 of the top 10 best performers are listed outside the US (YTD)

No.	Security	Return (%)	Country	Sector	Market Cap. (USD Billion)
1	Coinbase Global Inc	296.2	US	Financials	33.5
2	Zhongji Innolight Co Ltd	260.7	China	Information Technology	11.3
3	Ecopro BM Co Ltd	221.6	South Korea	Industrials	22.4
4	NVIDIA Corp	218.8	US	Information Technology	1150.2
5	Rolls-Royce Holdings PLC	218.0	UK	Industrials	30.5
6	Wistron Corp	203.6	Taiwan	Information Technology	8.4
7	CosmoAM&T Co Ltd	190.2	South Korea	Information Technology	3.8
8	Palantir Technologies Inc	185.0	US	Information Technology	39.8
9	Quanta Computer Inc	182.5	Taiwan	Information Technology	24.5
10	Cambricon Technologies	170.7	China	Information Technology	9.2

Source: M&G Investments, Bloomberg, 5 December 2023. *Data in USD terms, but 7 of 10 performers also applies in local currency terms

Innovation

Artificial Intelligence (AI) is not a new phenomenon but it has been one of the biggest topics this year as the world has discovered the potential scale and capability of generative AI applications. We believe these technological advances represent the start of a multi-decade growth theme that has the potential to generate pervasive change in the broader economy and reshape the competitive landscape across all industries.

Over the coming years, we anticipate that businesses across a broad range of industries will adopt AI into their operations, driving a significant improvement in efficiency and productivity. From our discussions with investee companies, demand for AI is broad-based across a diverse set of industries, from finance, to industrial applications, to healthcare.

Importantly, not all companies that invest in AI will be able to reap the full benefit of their investment. For example, companies that have collected relevant proprietary data over time will likely have an advantage over their competitors as they can utilise generative AI to analyse, learn from, and create new applications for such data.

Investing in solutions

The increased focus on sustainable and impact investing, whether that involves the shift to a low-carbon economy to address climate change, efforts to create a more equal and inclusive society, seeking better health outcomes or creating a circular economy to protect the environment, is another important structural trend that is not necessarily correlated with the macroeconomic cycle.

Across both public and private markets, there is enormous scope for forward-thinking companies to solve some of the world's biggest challenges. In our view, these longer term tailwinds can often be overlooked by investors preoccupied with the near-term uncertainty in markets.

Renewables stocks, for example, have seen downward pressure on share prices more recently amid higher interest rates and supply-chain disruption, but the longer-term outlook for some of these companies is still very strong, in our opinion.

There is a perception in the market that governments have taken a step back on renewables, but the data would argue otherwise. For example, in the UK, the government has just increased the guaranteed price offer for offshore wind projects by 66%, and the US is now allowing projects for renewables to be retendered, taking into account increased costs. So, governments are not wavering, they're actually upsizing their support and, at the same time, many of these stocks are now trading on undemanding valuations.

It remains important to be extremely selective. Not all companies in this space will prevail, but those with experience, expertise and discipline are well-positioned to take market share from weaker rivals.

The infrastructure of the future

Infrastructure, by its very nature, is a long-term asset class as it generally involves physical assets that take a long time to build and operate for many years. It is also integral to future progress by facilitating the development of areas such as new technology, digital communications and clean energy.

Many infrastructure businesses arguably have a significant role to play in various areas – from the development of smart grids to optimising water resource management to improving waste collection, sorting, and recycling services, and providing physical and digital connectivity. As a result, we believe these businesses have attractive growth prospects, driven by powerful long-term tailwinds, with AI adoption providing the potential to further enhance long-run growth potential in the sector.

In the following pages, we highlight in more detail the potential opportunities and outlook for investments in AI, sustainability themes and infrastructure.

The future of AI

Jeffrey Lin believes the integration of AI into products to make them more powerful and the widespread adoption of AI by companies beyond the technology sector are important long-term trends.

Decarbonisation 2025

Investing in companies with strong business model that are supporting efforts to decarbonise the global economy can be a rewarding long-term strategy, suggests John William Olsen.

Listed Infrastructure

The combination of very attractive valuations and long-term structural tailwinds is creating a compelling opportunity in listed infrastructure, according to Alex Araujo.

Circular Economy

Amid growing demand for limited natural resources, we believe the transition to a circular economy offers attractive opportunities in a wide range of sectors for investors in private markets.

Mapping the future of AI

Jeffrey Lin
Head of Thematic Technology Equities

AI is a technology that has been developed over many decades. However, 2023 could be considered the year when the world recognised AI's potential to transform the future. ChatGPT arguably sparked the excitement: it enabled anyone with an internet connection to access a plethora of knowledge and information at low cost and with no training. The emergence of generative AI tools that can create diverse forms of content, including images, words and music, with simple prompts revealed the technology's remarkable capabilities.

With the potential to improve efficiency and productivity across a range of industries, we believe AI is set to be a powerful multi-decade trend. Over the next few years, we anticipate that there will be plenty of opportunities not only for companies instrumental in enabling the development of AI and the growth of its applications, but also for those set to benefit from adopting it into their own business operations.

So far, the main focus of this wave of AI has been the technology companies who offer the equipment or services to perform the computing processes involved; what we refer to as 'AI enablers'. Chipmaker Nvidia is the most prominent example – the company has seen its revenues and share price rocket on the back of strong demand for its processors to build out the technology for mass deployment.

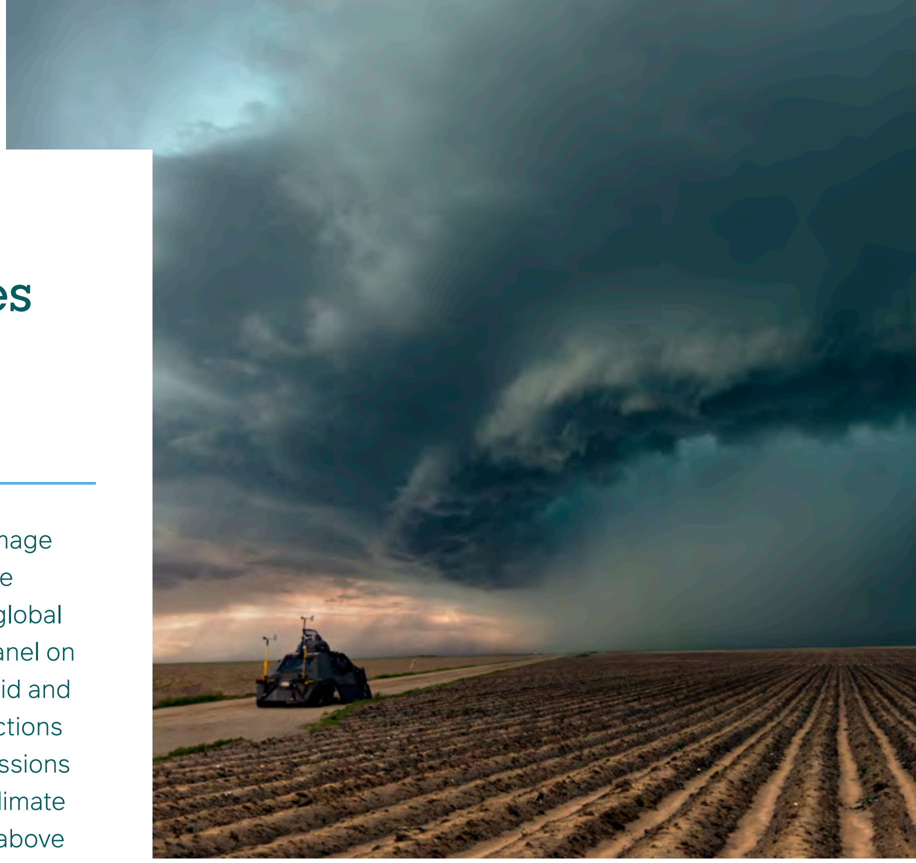
We are starting to see more companies offering AI-enhanced services to customers. These 'AI providers' tend to be software companies that, through AI, can make their software more powerful, easier to use or deliver more functionalities, to enhance the offering to their customers. They can also provide the architecture for their customers to build their own models.

Companies such as Microsoft, Adobe and ServiceNow are already incorporating generative AI into their products. Over the medium to long term, we believe the new technologies and features being developed by enterprise software companies will increase user engagement and provide the opportunity to extract additional revenue from customers because of the productivity gains.

And further down the line, we see AI being widely employed by companies beyond the technology sector. These 'AI beneficiaries' will use AI to improve their products, services or internal processes.

The positive adoption trends are encouraging, and we believe that as AI becomes increasingly pervasive in the real economy, there will be increasingly attractive opportunities for long-term investors.

Decarbonisation 2050: investment opportunities on the path to net zero



John William Olsen
Head of Impact Equities

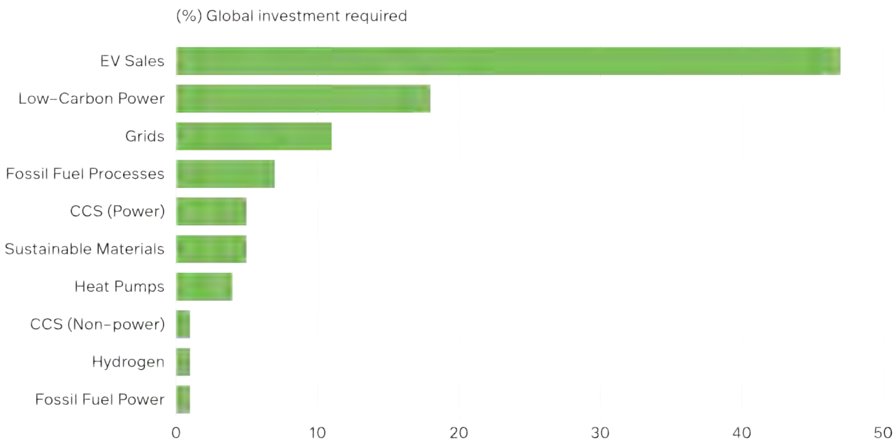
Recent extreme weather has highlighted the damage that climate change is inflicting on people and the planet, and the urgent need to decarbonise the global economy. According to the Intergovernmental Panel on Climate Change (IPCC), we will require deep, rapid and sustained greenhouse gas (GHG) emission reductions over the coming decades, reaching net-zero emissions by 2050, if we are to avoid the worst effects of climate change and limit global warming to below 1.5°C above pre-industrial levels.

Reaching net zero will require large amounts of capital investment over the coming decades. BloombergNEF forecasts that a successful net zero transition could require up to US$200 trillion of total investment by 2050, or US$7 trillion annually. Encouragingly, governments around the world are backing their ambitious climate targets with policies and regulations, as we have seen with the US Inflation Reduction Act and the European Union's REPowerEU programme.

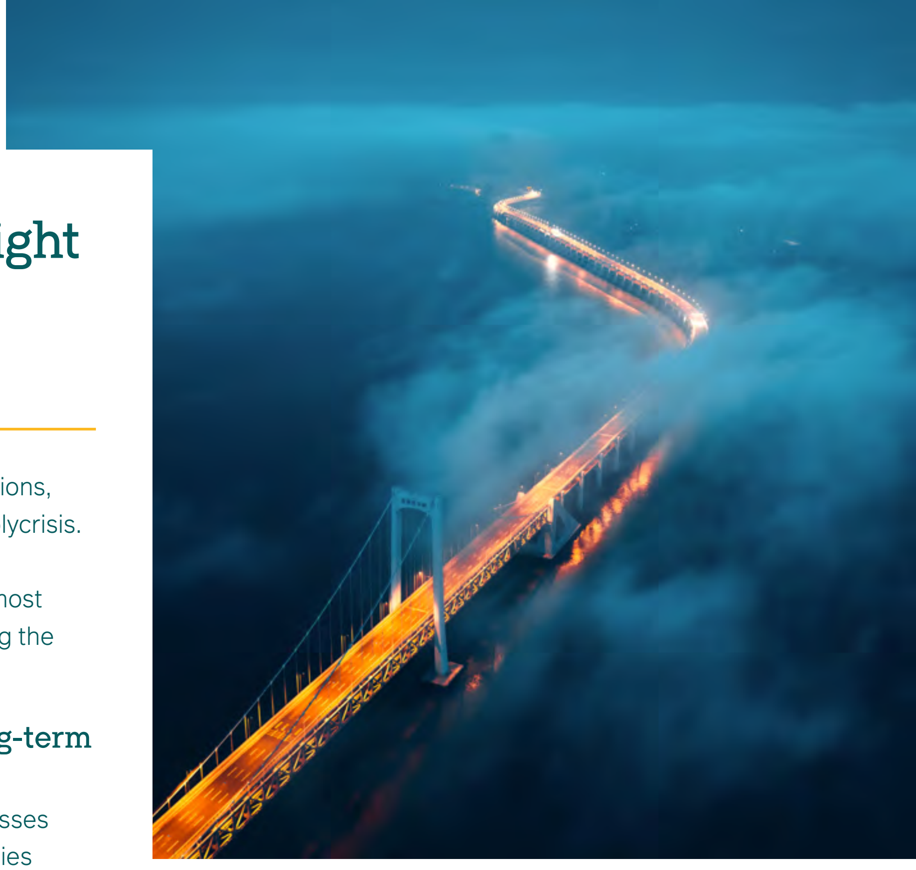
With this in mind, we believe decarbonisation is a structural trend offering significant opportunities for long-term investors. When investing, we seek companies that are making tangible contributions towards the Paris Agreement on climate change, either by reducing their own emissions and/or providing the solutions for others to do so. For example, a company may have set science-based targets (SBTs) – these are GHG emission reduction targets aligned with the reductions needed to limit the worst effects of climate change, according to the latest climate science. Alternatively, a company may provide solutions that help to save or avoid GHG emissions in areas such as clean energy, improved efficiency or promoting a circular economy.

However, structural themes alone are not enough for successful long-term investments. We look to combine this tailwind with companies that exhibit strong business models that are defensible from competition and possess the ability to compound returns over a long time period. This can provide a greater chance of generating attractive long-term financial returns for our clients, while also supporting the decarbonisation efforts required to tackle climate change.

Figure 8: The $194.2 trillion path to net zero



Source: BloombergNEF 2022 • Note: CCS refers to carbon capture and storage.



Listed Infrastructure: Light in the depths of despair

Alex Araujo
Global Equities Fund Manager

In the aftermath of the pandemic, geopolitical tensions, and climate incidents have marked a new era of polycrisis. From this view, infrastructure has come into sharp focus as a means to address some of the world's most pressing challenges from energy security to closing the digital divide.

Compelling opportunity to harness long-term growth trends

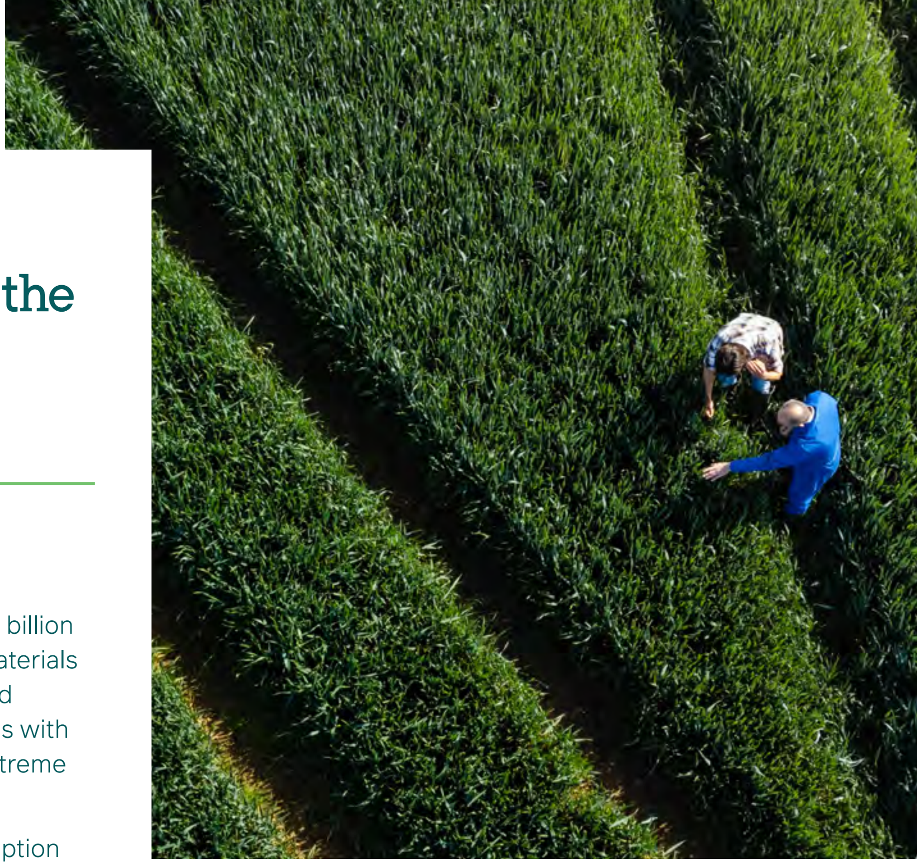
Higher interest rates have hit infrastructure businesses particularly hard this year. Utility firms and companies structured as real estate investment trusts (REITs), which are seen to have relatively high levels of debt, have borne the brunt of the negative sentiment due to perceived sensitivity to higher rates.

However, we believe the current negative sentiment towards the asset class is creating a once-in-a-lifetime opportunity for long-term investors. In our view, while concerns over 'higher for longer' interest rates have spurred market volatility, they have also unlocked attractive valuations for owners and operators of critical infrastructure assets, particularly in the listed sphere.

Infrastructure serves as the fundamental driver of the global economy, underpinning our everyday activities. Although the sector has fallen out of favour this year, we continue to believe that it still holds very attractive growth prospects. In our opinion, the long-term structural tailwinds behind listed infrastructure — which encompass demographic change, universal connectivity and urbanisation, to name a few — remain very much intact. Listed infrastructure is an asset class driven by multi-decade trends; with low valuations, we believe there is now a compelling opportunity for long-term investors to invest in strategic physical assets that could harness these positive trends.

From scarcity to opportunity: investing in the circular economy

Vishal Purohit and Amy Coleman
Impact and Private Equity



The growing demand-supply gap for natural resources

With the global population expected to reach 9.7 billion by 2050, demand for food, water, energy, and materials is rapidly rising. We are facing increasingly limited access to natural resources as the world grapples with the interrelated challenges of climate change, extreme weather events, and biodiversity loss.

Given the pressing need for responsible consumption and production, transforming our economies to adapt to these challenges remains a key priority. As outlined by the UN Sustainable Development Goal (SDG) 12, the shift from a linear to a circular economy entails the efficient use of resources, reduction of waste, and repurposing of materials. In this way, circularity reconceptualises the entire product cycle from inception to end-of-life, as opposed to instilling recycling practices alone.

This transition creates potential opportunities for investors in private markets, as businesses looking to advance more circular supply chains will need the supporting infrastructure to do so. From food systems to textiles, circular practices and opportunities can be found across a broad range of sectors and themes.

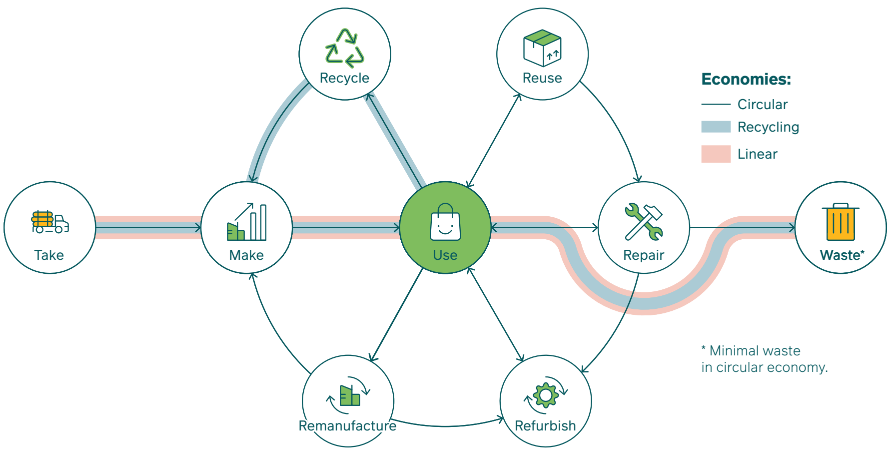
The case for investing in the circular economy

One area that has presented significant challenge in recent years is the growing issue of electronic waste ('e-waste'). In Europe alone, 4.7 tonnes of e-waste are generated every year, of which only 40% is recycled.2 In response to the need for circular solutions, companies are progressively looking to refurbish and resell electronic equipment; effectively reducing the requirement for raw materials, as well as energy and water consumption in the manufacturing process.

In slowing the flow of resources, scaling reprocessing technologies and reimagining business models, companies may reduce costs, build more agile supply chains, and potentially capture financial value.3 A recent study estimated that circular business models have the potential to generate €265 billion in revenue and result in 15% of the physical consumer goods market by 2030.

Considering the uptick in legislation and innovation, we believe the transition to a circular economy represents a structural shift that has the potential to offer attractive returns for long-term investors.

Figure 9: Circular Economy: the blueprint for a sustainable future



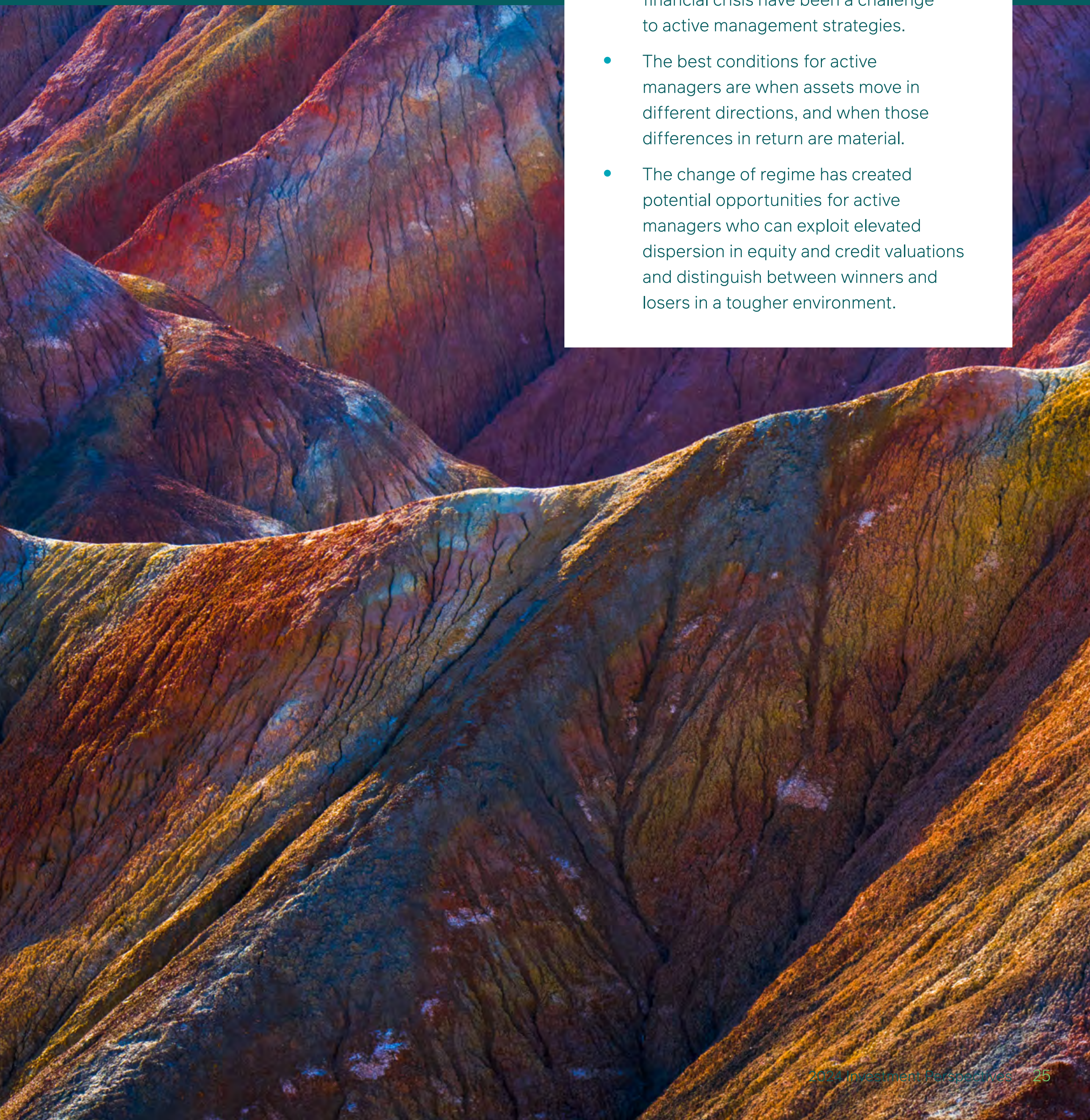
Source: Adapted from DXC Technology

Active management, selectivity and 2024

Dave Fishwick
Head of Macro Investing

Key observations:

- The rise of low-cost passive investment vehicles as well as the macroeconomic and market environment since the global financial crisis have been a challenge to active management strategies.
- The best conditions for active managers are when assets move in different directions, and when those differences in return are material.
- The change of regime has created potential opportunities for active managers who can exploit elevated dispersion in equity and credit valuations and distinguish between winners and losers in a tougher environment.



The decade after the 2008 financial crisis was characterised by low and stable inflation, relatively synchronised economic policy across major nations, and an existential challenge to the concept of active management.

That challenge was a primarily structural one, driven by technological advances allowing the rise of low-cost passive vehicles, which seek to track an index. These advances are a positive: just as M&G's launch of the UK's first unit trust and the 'thrift plan' for small regular savings (in 1931 and 1954, respectively) made diversified baskets of investments available to ordinary households, recent financial innovation has helped lower costs for investors.

However, active investment strategies have also come under fire over this period for failing to meaningfully outperform these passive strategies, causing some to question whether active management is even worth pursuing*.

M&G are clearly firm believers in the role to be played by active investors. It is not only a key part of the very process which makes markets more efficient, but also an activity that can provide investors with superior returns and protection from loss, even after fees.

Viewing the last decade through a macroeconomic lens can explain why active management has generally been less valuable for investors. It can also suggest reasons why it may have a role to play in 2024 and beyond.

Market and Macro conditions

While the rise of passive vehicles is a structural force, the relative strength of passive product performance versus active alternatives is in part a reflection of the prevailing conditions since the GFC.

In stock markets, the last ten years have seen the largest country in global indices (the US) outperform the rest of the world, and the largest stocks within that country (in the tech sector) outperform a more diversified basket:

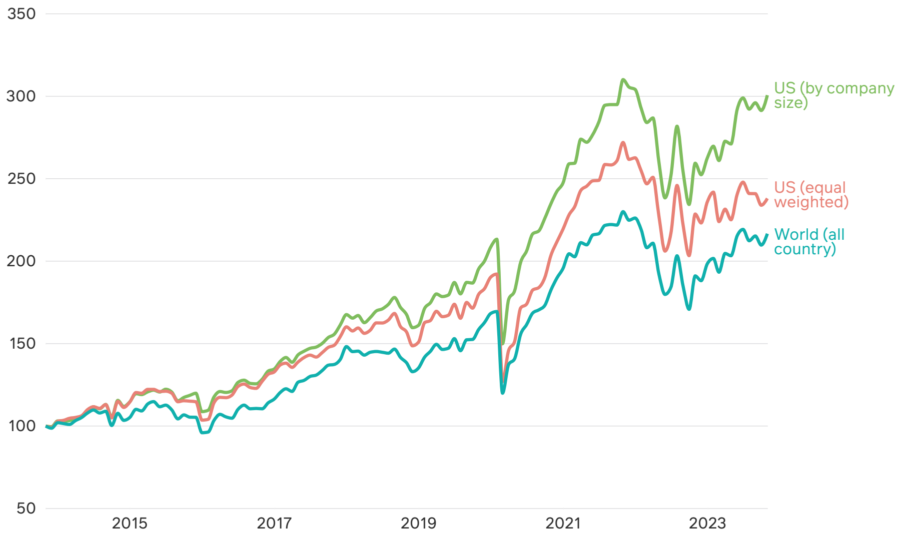
Earnings growth has been a key element of this, but so have the low costs of funding that have allowed these companies to embark on new projects and take over competitors. Such an environment makes it extremely difficult for active global equity managers to add value, unless they are prepared to adopt even more concentrated risk than what is already a concentrated passive benchmark.

At the same time, credit markets have seen a step down in average default rates since the early 2000s, arguably engendered by very low interest rates and the impacts of direct policy support. This has made active managers less able to demonstrate value by identifying the most vulnerable companies.

Figure 10: A decade of dominance for US stocks

Past performance is not a guide to future performance

(Total returns) MSCI US & Global indices



Source: LSEG Datastream, November 2023. Rebased to 100 at 16 November 2013.

*It is true that investors in aggregate should not be able to outperform the passive index, but professional active managers like M&G make up only a subset of the total range of participants trading the market at any one time. Not only are there private investors, but also a whole range of investor types that won't be captured in 'active' peer groups: staff who own stock in their own companies (which can be sizable in the tech space), investors with different benchmarks, and institutions like sovereign wealth and pension funds to name a few.

In multi-asset and macro, it has been an environment in which both fixed income and 'growth' assets have been supported by low and anchored interest rates, which has prompted positive returns across almost all assets. As a result, the return impact of preferring one asset class over another has been relatively muted for much the period, particularly since these conditions have also resulted in more correlation between bonds and equities in bouts of stress.

Lastly, convergence in policy approaches in much of the developed world has meant that there hasn't been the extent of currency volatility that existed from the 1970s to the 1990s, meaning potentially less volatility and opportunity for investors looking overseas as well.

Looking forward. A new regime?

It remains to be seen how far the pandemic and its aftermath prompt a break with the regime that has coincided with active management's biggest challenges. In the first section of this outlook, Jim Leaviss has discussed some of the arguments around the future path of interest rates.

Whatever one's own view, it seems that the best conditions for active managers are when assets move in different directions, and when those differences in return are material. Periods of transition in markets can bring these conditions, as can 'uncertainty'.

So, while the world of declining and then low interest rates and inflation were a correlating force for the most part, the change of regime that has occurred during the last couple of years has created potential opportunities for active managers:

- Divergence in views about which companies will be the winners and losers in the world to come has resulted in elevated dispersion in equity and credit valuations, potentially increasing the rewards to those who get these calls right.
- Cash and secure income sources are and may continue to be a potentially viable option for many more investors going forward, and become a new tool for active managers when valuations look rich in other assets.
- A potentially tougher environment for companies, with higher costs of capital and the growth of labour power making it more important to be able to select winners and avoid defaults in corporate bond and lending markets.
- Passive indices which may be highly concentrated in a small number of stocks or bonds such as technology, or a particular region like the United States could offer less diversification.

These are long-lasting themes which are likely to have an impact over a far greater timeframe than simply the next twelve months. However, as the pandemic and its aftermath have demonstrated, major changes in the environment can also be created by shorter term shocks.

The following notes highlight some of the views of active managers at M&G, reflecting themes of identifying opportunities in volatile markets (Asian equities), markets where dispersion in valuations and the rewards to avoiding ‘losers’ could be high (corporate credit), and the necessarily ‘hands on’ management of private assets.

Asian equities
Dave Perrett believes that negative sentiment and market volatility can provide attractive opportunities for active investors to identify undervalued companies in Asia.

Credit Selection
For Richard Ryan, active credit analysis offers the opportunity to exploit valuation dispersions and identify mispricing opportunities across the market.

Private Credit
A prudent and rigorous approach is crucial for investors to capitalise on the potential opportunities in the growing private credit market, suggests Aramide Ogunlana.

Actively seeking smarter growth in Asia

Dave Perrett
Co-Head of Asia Pacific Equities

2023 has been tough for Asian equities. Investor sentiment has been kept in check by the Fed's ongoing interest rate rises and the strength of the dollar. As the region's largest economy, worries about weak economic growth in China and the problems in its giant property sector have arguably dented confidence as well.

While there are risks associated with China, in particular, we believe that volatile markets driven by macroeconomic concerns can create interesting opportunities for disciplined, bottom-up stock pickers.

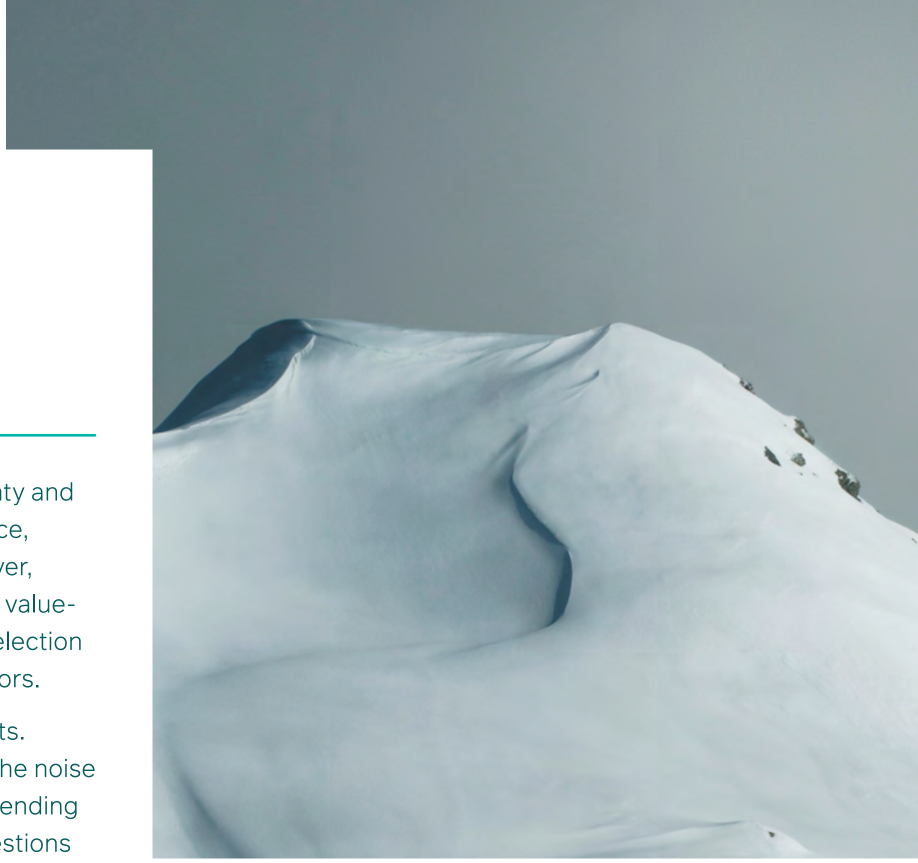
In times of uncertainty and negative sentiment, stocks often get sold indiscriminately across the board, which can create a fertile environment for selective investors to identify undervalued companies. At present, we believe that pessimism about China's fortunes and the wider economic outlook is presenting opportunities for active investors to find great companies, both in China and across the region, at very attractive valuations.

By focusing on near-term uncertainties and recessionary fears of weaker profits, we believe many investors are overlooking the longer-term prospects for companies that have powerful structural tailwinds behind them and an improving approach to delivering returns to shareholders. In China, for example, we are seeing the pace of share buybacks increase rapidly and dividend yields hit multi-year highs.

Across the region, we see opportunities ranging from shipbuilders, who could benefit from the replacement of the existing global shipping fleet to meet tighter environmental standards, to innovative businesses involved in environmentally friendly technologies such as renewable energy and electric vehicles that could be winners as Asian economies shift towards clean energy sources.

Moreover, active investors like M&G who engage respectfully with companies – through what we call "value-added shareholdership" – can potentially add greater value to the companies they invest in, whether it be through better corporate governance, shareholder returns and improved sustainability actions.

"Value-added shareholdership" is an additional and important way in which M&G can seek to add value for its clients in Asia. In summary, amid all the present uncertainty, we feel that Asia today offers a wide spectrum of exciting long-term opportunities for engaged bottom-up stockpickers like M&G.



Opportunities for credit selection

Richard Ryan
Senior Credit Portfolio Manager

Against a backdrop of macroeconomic uncertainty and potential market volatility, we believe that vigilance, patience and diversification are essential. However, as active bond investors, we firmly believe that a value-based and research-driven approach to credit selection can deliver long-term outperformance for investors.

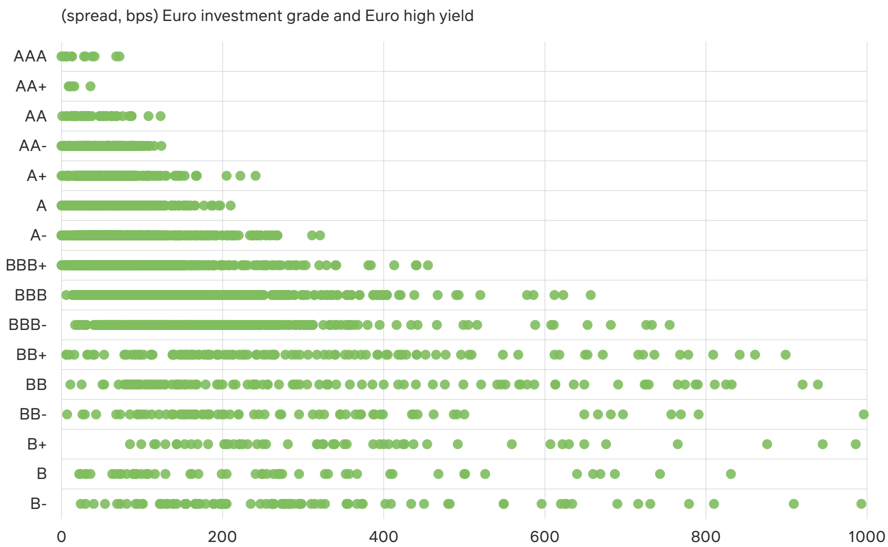
Dispersion is a structural feature of credit markets. Active credit investing involves looking through the noise to undertake rigorous assessment of the risk of lending to companies, in order to answer two simple questions – if we lend to this company do we believe we will be repaid, and secondly, are we being paid enough to take this risk? This assessment of risk requires significant research capabilities, which can provide insight that is often missed in today's markets.

In our view, there are two ways to add value: relative value opportunities and fundamental opportunities. The relative value opportunities arise where our analysts' view of the credit fundamentals (expressed through our own internal rating) broadly agrees with the rating agencies, but where we disagree with the market pricing – the relative valuation – of those risks. The wide dispersion of pricing within rating bands is structural and persists through the investment cycle, giving us plenty of opportunities to buy or sell securities where we disagree with the market pricing.

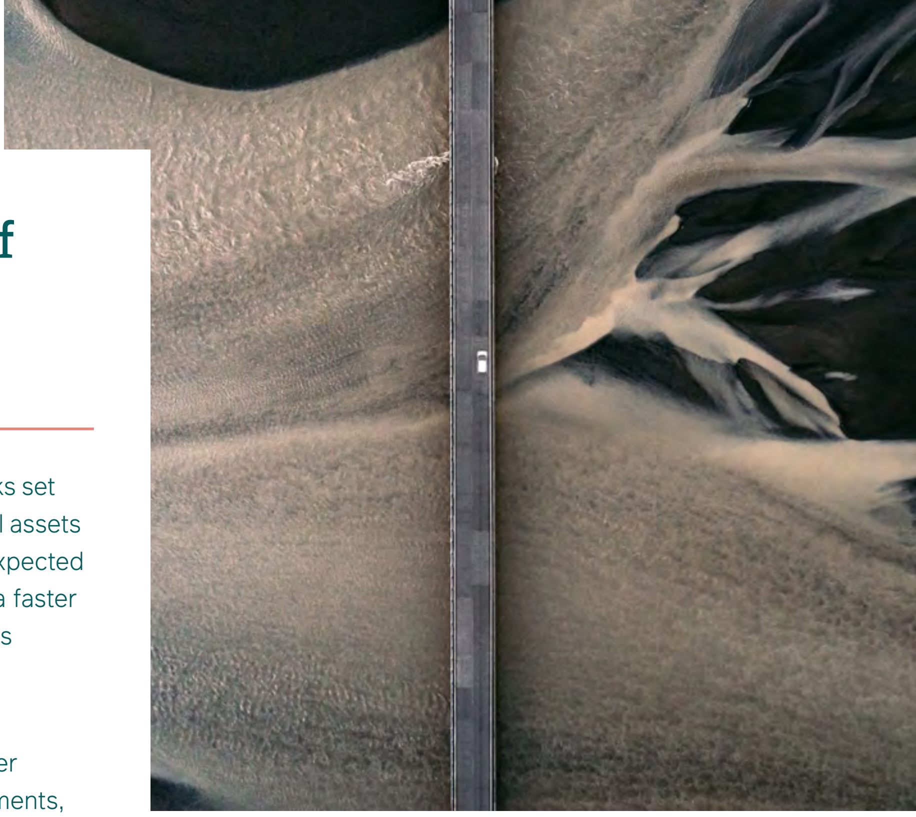
The fundamental opportunities are where our analysts' internal rating disagrees more meaningfully with the rating agencies. These differences are less frequent but can be important – for example, a source of capital preservation, where we identify declining credits before they are downgraded, or significant opportunities for outperformance where we identify early-on credits that may be improving in quality.

Exploiting these mispricing opportunities requires careful analysis and our selective approach relies on the expertise of a large and experienced credit research team. By digging deeper and doing the in-depth research we believe we can identify attractive opportunities across the market.

Figure 11: Spread dispersion presents opportunities through the cycle



Source: M&G, ICE BofA Euro Corporate Index (Ref .ER00) and Non-Financial High Yield Constrained Index (Ref HEAD), composite credit rating derived from average of S&P/Moody's/Fitch as at 30 November 2023.



Navigating the growth of private credit markets

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The recent growth of the private credit market looks set to continue at pace. From $875 billion in 2020, total assets under management allocated to private debt are expected to hit $2.3 trillion by the end of 2027, increasing at a faster rate than alternatives overall, according to forecasts by Preqin.

The main driver of this trend is banks' retreat from the commercial lending market. As a result of tighter regulation and more stringent capital ratio requirements, European banks, in particular, have scaled back their financing activities. This has created an opportunity for non-bank institutions to step into the gap and provide capital to companies that are unable to access traditional lending channels.

Investors have been attracted to private credit by the prospect of relatively high levels of income, compared to public assets, as well as the security afforded by senior corporate lending that sits at the top of the capital structure. The potential for diversification benefits from an uncorrelated and relatively less volatile asset class has also fuelled interest in the asset class.

Figure 12: Leading factors supporting private credit investing

As we look ahead to 2024, higher for longer interest rates or a weakening economic backdrop will certainly be challenging and will likely lead to a rise in defaults among weaker companies. We believe this highlights the importance of a prudent and rigorous approach to lending and credit selection.

One of the benefits of private credit investing is that lenders often have close relationships with company owners and a deep understanding of the businesses, which can help them assess the risks associated with loans to smaller companies with more nuanced funding needs. It also enables better monitoring, transparency and even influence, notably in relation to Environment, Social and Governance (ESG) issues.

As experienced, fundamental active investors with a team of experts dedicated to private credit origination, analysis and fund management across the globe, we believe we are well placed to capture the opportunities in this exciting and growing asset class.

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