Quarterly Review

M&G Corporate Bond Fund

First quarter 2019

Fund manager – Richard Woolnough

FOR INVESTMENT PROFESSIONALS ONLY

Overview

- The tone of global bond markets changed markedly at the start of 2019, and risk appetite returned, as investors were encouraged by signs that the US Federal Reserve would pause its rate raising cycle. These conditions proved conducive to the fund's short duration, slightly long credit spread duration positioning; the fund delivered a positive return over the quarter, although its short duration detracted in relative terms in March when government bond yields fell sharply.
- We held fund duration close to its maximum permitted short, ending the quarter at 6.5 years.
- We have been active in both the primary and secondary markets over the quarter, with a particular focus on longer-dated paper, and relative value cross currency opportunities.

Main risks associated with this fund:

For any past performance shown, please note that past performance is not a guide to future performance.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund may lose as much as or more than the amount invested.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

Further risk factors that apply to the fund can be found in the fund's Key Investor Information Document (KIID).

Things you should know:

The fund allows for the extensive use of derivatives.

Quarterly, YTD and long-term performance

	3 months %	YTD %	1 year %	3 years % pa	5 years % pa	Since tenure[1] % pa
M&G Corporate Bond Fund	4.1	4.1	2.9	4.2	4.5	5.7
IA £ Corporate Bond sector average	3.9	3.9	3.0	4.5	4.7	4.5
Fund quartile ranking in sector	2	2	3	3	3	1

Single year performance (5 years)

	2018 %	2017 %	2016 %	2015 %	2014 %
Sterling I	-2.5	5.3	8.6	0.0	10.8
Sector	-2.1	5.0	9.1	-0.1	10.4

Source: Morningstar, Inc., UK database as at 31 March 2019. Sterling I class shares, income reinvested, price-to-price basis. The fund's sterling I class shares launched on 02 July 2007. Performance data shown prior to this date is that of the fund's sterling A share class.

[1] Richard Woolnough took over management of the fund on 27 February 2004.

Past performance is not a guide to future performance.

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Market performance and portfolio positioning

2019 began in a very different vein to how 2018 had ended: global bond markets rallied in January as the US Federal Reserve (Fed) signalled a new dovish approach towards the end of December, and then confirmed this in its late January meeting. The US central bank also indicated its balance sheet may not shrink as much as expected. The Fed needs "an ample supply of reserves" in the markets to control the policy rate, chair Jerome Powell said.

This dovish message reminded investors of 2016, when previous chair Janet Yellen was on course to start normalising rates eight years after the financial crisis, but refrained from doing so, providing a favourable backdrop for risk assets.

The strong start to the year continued throughout February. The market appeared to think this pause in the hiking cycle will last forever, with implied expectations pricing in a significantly greater chance of rate cuts than hikes over the coming years.

Citing "muted" inflation pressures and the fact that "growth has slowed in some major foreign economies, particularly China and Europe", Fed Chair Powell repeated that "our policy decisions will be data dependent [and that] we're in no rush to make a judgement about changes in policy".

The rally in risk assets continued into March, meaning that many investors will look back more fondly on the first quarter of 2019 than the previous three-month period.

March saw a decent repricing across bond markets in response to the dovish Fed meeting and nervous sentiment from the European Central Bank (ECB). The market now anticipates help from the Fed in the form of rate cuts. Meanwhile, firm US consumer data has provided a solid bedrock for performance.

The picture in Europe has been less rosy, with the ECB lowering its growth forecast and an ongoing repricing in inflation expectations. In the UK, there is still no clear path forward following Prime Minister Theresa May's failure to get her Withdrawal Bill through parliament at the third attempt, and the original date set for the UK's departure already passed.

Duration

Duration remains close to the fund's maximum permitted short versus the iBoxx £ Corporates Index at 6.5 years versus the index's 7.9 years. We remain of the view that yields should be higher, despite shorter-term noise around Brexit and the Fed currently.

	Asset allocation (%)			
	Physical	CDS short	CDS long	Net
Government bonds	**3.0**	**0.0**	**0.0**	**3.0**
Investment grade corporate bonds	**72.3**	**0.0**	**0.0**	**72.3**
Fixed rate	71.1	0.0	0.0	71.1
Floating rate	0.9	0.0	0.0	0.9
Index linked	0.3	0.0	0.0	0.3
Credit default swap indices	0.0	0.0	0.0	0.0
High yield corporate bonds	**3.7**	**0.0**	**0.0**	**3.7**
Fixed rate	3.7	0.0	0.0	3.7
Floating rate	0.0	0.0	0.0	0.0
Index linked	0.0	0.0	0.0	0.0
Credit default swap indices	0.0	0.0	0.0	0.0
Securitised	**16.5**	**0.0**	**0.0**	**16.5**
Cash	**4.5**	**0.0**	**0.0**	**4.5**

Source: M&G, as at 31 March 2019.

CDS short: bought protection (short credit exposure); CDS long: sold protection (long credit exposure).

The columns may not always add up when reading across as physical bond holdings and/or cash are sometimes used as collateral for CDS exposure.

Credit risk

In January, portfolio activity was mainly focused on longer-dated new issues from Inbev, denominated in US dollars, which came with an attractive new issue premium. We also added to Deutsche Telecom and Altria in sterling, and some sterling financials. We took profits in several credits that have performed particularly strongly.

In February, we decreased our exposure to AAA and AA rated credit, with the aim of moving risk into the BBB rated space as opportunities arise. We added long-dated US dollar bonds from Altria during the month, which we funded through the sale of some Vodafone paper that had performed very well. We also sold down some strongly performing issues from Microsoft, JPMorgan and Royal Bank of Scotland. We also looked for relative value opportunities – selling some sterling-denominated paper from British American Tobacco (BAT) and InBev in favour of their respective US dollar bonds.

We were active in the new issue market in March, adding sterling-denominated bonds from Skipton, HSBC and Anglo American. From a relative value cross currency trading perspective, we mainly sold out of sterling issues in favour of some US dollar bonds in names including Time Warner, Vodafone, British Telecom and BAT. We took profits in some good performers, such as TFL, Tesco, JPMorgan, Altria and the European Investment Bank.

We are looking for opportunities within asset-backed securities, as there are several new deals in the pipeline and the asset class has repriced in recent months.

Spread duration is at 8.3 years, marginally (0.3 years) longer than the index.

Outlook

The biggest story in financial markets in recent months continues to be the likelihood of the US economy entering recession. The market is pricing in imminent recession, while a range of leading economic indicators point to the next recession being several years away. The labour market remains very strong, which will push wages higher in time. The US is a service-based economy, and its reliance on people rather than goods means that it is unlikely to turn deflationary in the short to medium term. The market now expects the US Federal Reserve's next move will be to cut rather than increase interest rates; however, in our view, the Fed risks falling further behind the curve.

While the UK is at a different stage in the cycle to the US from a monetary policy perspective due to Brexit, the two are in a similar place from an economic standpoint.

Against this backdrop, corporate bond valuations remain attractive and we are being paid to take risk. We prefer corporate bonds to government bonds for a variety of reasons. One is supply – there will be significant shift in supply dynamics going forward. Treasury issuance is set to rise considerably as the US budget deficit swells under President Trump, while the recent era of merger & acquisition activity that has been funded by companies issuing substantial amounts of debt is coming to an end.

Regardless of how these situations develop, what we do as fund managers does not change. We look at where we are in the interest rate cycle and the economic cycle, and we look at where we can find the most attractive opportunities for the fund from different sectors and individual issuers at any given stage.

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