Quarterly Review

# M&G Global Macro Bond Fund

## First quarter 2019

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FOR INVESTMENT PROFESSIONALS ONLY

M&G INVESTMENTS

## Overview

- The US Federal Reserve adopted a more dovish stance in the first quarter of 2019.
- The central bank's rhetoric helped most areas of the global bond markets to deliver positive returns.
- We maintained a globally diversified fund of government and corporate bonds in developed and emerging markets.

**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.

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.

High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

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 will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

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 may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the fund's exposure to such securities may exceed 35% in the governments of Germany, Japan, UK, USA although these may vary subject only to those listed in the prospectus.

The fund allows for the extensive use of derivatives.

## Quarterly, YTD and calendar year performance (5 years)

| | 3 months % | YTD % | 2018 % | 2017 % | 2016 % | 2015 % | 2014 % |
|---|---|---|---|---|---|---|---|
| **Fund** | 0.6 | 0.6 | 3.7 | -3.8 | 25.3 | 0.9 | 6.0 |
| **Sector** | 1.7 | 1.7 | 0.1 | 1.6 | 17.2 | -0.7 | 4.6 |

**Past performance is not a guide to future performance.**

*Source: Morningstar, Inc., UK database as at 31 March 2019. Sterling I class shares, income reinvested, price-to-price basis. Sector: IA Global Bond.*

## Performance review

Several key themes continued to influence investors' sentiment in global bond markets during the first quarter of 2019. These included dovishness from the Federal Reserve (Fed), which resonated among other central banks amid slower economic growth. Importantly, the Fed dampened expectations of further rises in interest rates this year. In addition, financial markets remained encouraged by reduced trade tensions between the US and China.

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Risk assets performed well in this environment, with areas of corporate credit and emerging market debt delivering the best returns in the global fixed income markets. Yields also declined among core government bonds. The 10-year US Treasury yield fell to 2.4% from 2.7%, while the 10-year German bund yield edged into negative territory, decreasing to -0.1% from 0.2%.

In the UK, much uncertainty remained about the terms and timing of the country's departure from the European Union. The way forward on Brexit was still unclear when the UK government requested an extension to the country's exit deadline date of 29 March. UK government bonds, helped by their perceived 'safe-haven' status among investors in times of uncertainty, found support in this environment. The 10-year gilt yield fell from 1.3% to 1.0% during the quarter.

Across core government bond markets, longer-dated bonds outperformed their shorter-dated counterparts. This hampered the fund's relative performance to an extent as we maintained a short duration bias in its positioning. However, the fund's allocation to US Treasuries contributed positively to its absolute return as yields fell.

The fund's relative performance was also held back by our underweight allocation to credit, as both the investment grade and high yield segments performed well. The fund's performance was helped by its allocation to emerging markets, as its exposure was mostly held in hard currency bonds. These assets delivered solid results and markedly outperformed their local currency counterparts. Within the fund's overall currency positioning, while we increased its exposure to sterling, the depreciation of the US dollar against the British pound was a performance headwind.

## Duration

Active management of the portfolio's duration is a key performance driver for the fund, together with its credit risk and currency positioning. During January, our main portfolio changes included reducing the fund's allocation to developed market government bonds after yields fell. The fund's duration shortened to around 4.3 years from 6.1 years, mainly as a result of this activity.

In February, our transactions within the government bond markets included taking some profits from the fund's holdings of US Treasury Inflation-Protected Securities (TIPS). However, we remained committed to holding conventional US Treasuries, and bought additional 10-year US government bonds from the proceeds of these sales. The fund's overall duration ticked down to 4.2 years in the month.

We slightly increased the fund's weighting in US Treasuries in March. This resulted from additional purchases of two- and 10-year US government bonds, which were partly funded by selected sales from the fund's corporate bond allocation.

At the end of the first quarter, the fund's duration stood at 4.2 years. By currency, the US dollar remained the largest contributor to the fund's interest rate risk throughout the period. This contribution was 3.9 years at the end of the quarter.

## Asset allocation

Among corporate bonds, we maintained the fund's investment grade weighting at a near-neutral level. In the high yield asset class, having increased the fund's exposure towards the end of 2018, we took some profits in January on tighter spreads by closing a high yield index position in the credit default swap (CDS) market. As a result, the fund remained underweight in high yield bonds as we felt that narrower spreads lacked value.

Our overall approach to credit also included a bias towards US exposure over European segments of the market, while we continued to assess new issues for potential buying opportunities.

Elsewhere, we added to the fund's overweight stance in emerging market bonds in the opening month of the quarter. Our buying activity focused on emerging market hard currency government bonds on a selective basis, including euro-denominated sovereigns from Romania, Turkey, Ivory Coast and Egypt.

After emerging markets rallied in January, we reduced the fund's hard currency position in Argentina, as well as local currency sovereign debt in Turkey. We also reduced some local currency exposures to short positions in early February, including the South Africa rand, Brazilian real, Mexican peso, and Russian ruble. In March, we took some profits from holdings of real estate bonds in China and switched the proceeds into US Treasuries. We also lowered exposure to the Indian rupee by selling rupee-denominated supranational bonds from the International Bank for Reconstruction and Development (IBRD).

From a long-term perspective, however, we continue to favour holding an allocation to emerging markets based on factors such as an attractive pick-up in yields and low default rates.

### Currency exposure

We maintain the view that active management of the fund's currency positioning can provide a useful additional performance lever to its duration and credit risk. During the quarter, we maintained a sizeable exposure to the US dollar. In February, this allocation rose from 44% to 48.2%, mainly as we reduced positions in emerging market currencies.

Among the latter, the portfolio's largest exposures continued to include the Indonesian rupiah and Malaysian ringgit. In developed markets, we added to the fund's Japanese yen and sterling positions in February, while exposure to the euro was reduced.

We have favoured exposure to the Japanese yen in recent quarters, believing the currency was undervalued and 'under-owned' among investors. In addition, we think the yen provides a good risk diversifier to the portfolio. In terms of the fund's sterling allocation, our recent approach towards the currency was to add exposure as a tactical play since the prospect of softer Brexit appeared more likely.

At the end of March, the fund's largest currency exposures were to the US dollar (47.9%), euro (16.3%), yen (15.3%), and sterling (14.5%). Among emerging currencies, the portfolio's largest long exposures at the end of the period were the Indonesian rupiah (2.2%) and Malaysian ringgit (1.3%).

## Outlook

The possibility of recession driven by a slowing global economy was an increasing theme in the global outlook going into the second quarter. In the bond markets, investors even began to price in the prospect of a cut in interest rates, rather than a rise, as the next policy move by the Fed.

In the fund, while we maintain a globally diversified portfolio, our main positioning themes continue to include a cautious approach towards high yield bonds in the credit market. This largely expresses our view that valuations in the area look less attractive after a period of solid performance, although we continue to assess the market for better buying opportunities.

Elsewhere, despite emerging bond markets experiencing increased volatility during 2018, we believe that with careful stock selection, this asset class offers diversification opportunities and risk/reward appeal. Our preference remains to hold a higher exposure to hard currency emerging market bonds over local currency debt.

In terms of the fund's overall currency positioning, this remains diversely exposed across both developed and emerging market currencies, although our total exposure to the latter area is modest and very selective.

Looking ahead, our investment strategy is still to seek what we believe is the best relative value among global bonds and currencies amid the prevailing economic conditions, while avoiding areas where we view the outlook as less favourable.

## Long-term performance

| Sterling I | 1 year % | 3 years % pa | 5 years % pa | Since launch (15 Oct 1999) % pa |
|---|---|---|---|---|
| **M&G Global Macro Bond Fund** | 7.3 | 5.5 | 6.0 | 5.5 |
| **Morningstar Global Bond sector** | 3.8 | 4.5 | 4.3 | 5.1 |
| **Fund quartile ranking in sector** | 1 | 2 | 1 | 1 |

*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 16 December 2011. Performance data shown prior to this date is that of the fund's sterling X share class.*

**Past performance is not a guide to future performance.**

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