M&G Investments

M&G Bond Fund

Income

Q4 2024

Market overview

In the fourth quarter, global markets and sentiment were shaped by political shifts and central bank actions. November was dominated by the US election, starting with the lead up to the election date and results announcement to the subsequent nominations for key office position appointments. The Trump victory led to a further increase in the US dollar accompanied by a strong rally in US equity markets.

Central banks globally continued to adjust their policies well into the latter part of December. Several rate cuts were announced in December, including the US Federal Reserve (Fed), European Central Bank (ECB), Canada, Switzerland, Mexico, and Turkey. The Bank of England (BOE) and Bank of Japan (BOJ) held rates steady. The Fed's rate cut, accompanied by a hawkish tone, suggested that it could be the last cut for a while, and the market reacted by selling off as expected. Meanwhile, China's stimulus package announcement in September resulted in volatility in equity markets continuing into the quarter.

Global equities experienced a slight decline of 1% in the fourth quarter, but showed a strong annual gain of 17.5%, as measured by the All Country World Index (ACWI). Both developed and emerging market equities saw negative returns in the fourth quarter, with developed markets down by 0.2% and emerging markets down by 8.0%.

Global bonds were one of the weakest asset classes, with the Bloomberg Global Aggregate Index showing a 5.1% decline for the quarter and a 1.7% decline for the year. This was unexpected, considering the start of a rate-cutting cycle. However, market expectations for a shallow cutting cycle, coupled with concerns over persistent US inflation above the 2% target, dampened bond market performance. Volatility in the bond market was driven by rising inflation expectations and central bank actions, leading to selloffs in key government bond markets, particularly US Treasuries and UK Gilts.

The FTSE All Bond Index (ALBI) returned 0.4% for the quarter, while inflation-linked bonds (ILBs) returned 0.8%. Notably, South African bonds finished the year with a robust 17% gain, while ILBs returned 7.8% (both in rand). Throughout the year, the nominal bond market experienced significant volatility, with the 10-year bond yield peaking at 12.50% in April before strengthening to around 10.30% by year-end. The yield curve also bull-flattened in 2024, with long-term bond yields falling more sharply than shorter-term ones. The ILB curve flattened slightly, coming off an already flat basis at the start of the year.

Performance

The M&G Bond Fund delivered a return of 17.3% for the year (A class, net of fees) outperforming its benchmark (ALBI) by 0.1%. For the three-year period, the fund delivered 11% versus the benchmark return of 10.3%.

On a relative basis the fund continues to perform well, ranking 2nd out of 38 funds over the past three years and 9th out of 31 funds over the past five years (Morningstar).

Positioning

In the fourth quarter the All Bond Index (ALBI) delivered a modest 0.4% with the impressive rally the bond market experienced since the SA elections in May losing steam. The SA yield curve bear steepened over the fourth quarter resulting in longer dated bonds underperforming their shorter dated counterparts. Despite this sell off in bonds, the ALBI delivered a stellar one-year return of 17.2% with longer dated bonds delivering almost 21%.

During November 2024, S&P revised South Africa's outlook to positive from stable and subsequently revised the outlook on six South African financial institutions to positive from stable and raised the national scale ratings on four South African banks (ABSA Bank Limited, FirstRand Bank Limited, Investec Bank Limited and Nedbank Limited) upward by one notch, from zaAA to zaAA+.

Relative to other liquid emerging markets and developed markets we follow, the South African bond market delivered impressive returns for investors. A large driver of these returns could be attributed to the improvement in investor confidence following the local election outcome held in May and progress made on reforms in key sectors. Despite this foreign investor holdings of SA, local currency bonds were still low at just under 25%, a large contrast from around 40% achieved during the 2018 period. In the fourth quarter the SA bond yield rally was halted which could in part be attributed to global factors, for example the US election outcome and the impact of Trump's domestic and trade policies on growth and inflation. Also, growth in the US has been resilient gauging from the recent economic activity data releases and a number of Fed governors having expressed their concerns about the stickiness of inflation.

Long dated SA bonds we believe still offer value at current levels and long-term investors have the opportunity to earn attractive real returns. Long dated SA bonds yields were a nudge above 11% at year end offering investors a real yield of about 6%. The South African Reserve Bank (SARB) in consultation with National Treasury are in discussions about a reduction of the inflation target from the current 3 to 6% range. Should a decision be taken that the SARB target a lower inflation range this could be a catalyst to meaningful bond performance. The timeline is however very uncertain.

Headline CPI inflation rose 0.1pp to 2.9% y/y in November due to slower fuel price deflation. This print was however

Annualised performance	A class	Benchmark	B class
1 year	17.3%	17.2%	17.5%
3 years	11.0%	10.3%	11.2%
5 years	9.5%	9.6%	9.7%
7 years	9.1%	9.4%	9.3%
10 years	8.3%	8.7%	8.5%
20 years	8.4%	8.6%	8.6%
Since inception	9.9%	10.1%	-

Risk profile

Risk of not earning meaningful inflation-beating returns over the long-term

HIGHER — LOWER

LOWER — HIGHER

Variability of returns over the short-term

Fund facts

Fund objective
To maximise income while securing steady capital growth. This is achieved by investing in a diversified portfolio of bonds in the South African market.

Investor profile
Individuals that require a high level of income from their capital investment with relatively low risk. The recommended investment horizon is 1-3 years, or longer when used as strategic exposure to the asset class.

Investment mandate
The Fund invests in a combination of government, semi-government and corporate bonds, and other interest-bearing securities. No duration constraints apply. The Fund is managed to comply with regulations governing retirement fund investments (Regulation 28).

Fund managers
Roshen Harry
René Prinsloo

ASISA category
South African - Interest Bearing - Variable Term

Benchmark
FTSE/JSE All Bond Index

Inception date
27 October 2000

Fund size
R1 028 530 812

Sources: M&G Investments, Morningstar & Deutsche Securities lower than the 3.1% median Bloomberg survey of economists. Nevertheless, the market still expects the SARB to continue its rate cutting path.

In November the Monetary policy committee (MPC) at the SARB reduced the repo rate by 25bp to 7.75% which was broadly in line with analyst expectations. The MPC unanimously voted in favour of the 25bp cut and there was no discussion of a 50bp cut as was the case in September meeting. The overall tone of the MPC statement was cautious, and the committee noted that the outlook was uncertain given the challenging global environment.

As at the end of the year the Forward-Rate Agreements (FRA) market signalled that the SARB would be lowering the policy rate over the following 12 months by about 50bps to 7.25%. This is a notable change to the depth of rate cuts relative to the beginning of the quarter where the FRA market expected the SARB to reduce the repo rate to about 6.8% within 12 months.

The BER inflation expectations survey for the fourth quarter of 2024 indicated further moderation in inflation expectations across all the time horizons. Inflation expectations are backward looking and the moderation in headline inflation experienced over the last couple of months would be reflected in the inflation expectations of the participants being surveyed. The same goes with higher past inflation prints of 2022 which were at the time projected well into the future. For example, the December 2023 survey showed that average inflation expectations for 2024 then increased to 5.7%.

Average inflation expectations for participants being the Analysts, Business and trade unions for 2025 fell from 4.8% to 4.5% and for 2026 fell from 4.8% to 4.6%. It is interesting to note that the inflation expectations of trade unions for 2025 was at the midpoint of the SARB inflation target of 4.5% and for 2026 it was at 4.3% which is encouraging. Businesses surveyed were slightly higher than the SARB mid-point coming in at 4.8% for both 2025 and 2026. Five-year inflation expectations over all groups averaged 4.6% compared to 4.8% in the third quarter survey. This trajectory is welcomed by the SARB and they anticipate inflation expectations to moderate further given their policy stance coupled with experience of lower inflation will serve to anchor inflation expectations more firmly at lower levels.

Interestingly, the IMF published a statement in November that SA's outlook is improving supported by recovering domestic demand and stable electricity supply and upwardly adjusted SA's real GDP growth to 1.5% in 2025 from 1.1% in 2024. However, the IMF warned that the risks to the outlook were to the downside highlighting protectionist policies and delays in the reform implementation. They also suggested a fiscal consolidation strategy to lower public debt-to-GDP and the implementation of a fiscal rule which would enhance credibility. This could lead to lower SA bond yields resulting in lower financing costs for the fiscus allowing funds to be used in other initiatives.

The fund had a meaningful exposure to the R2037 bond at the beginning of the fourth quarter despite reducing this exposure somewhat in the previous quarter. Given the good performance of the R2037 bond we decided to reduce exposure to this bond and deploy the capital in other instruments, for example the R2040s which is a longer dated bond maturing in January 2040 and is now the largest exposure in the fund.

The quarter was marked with higher bond volatility as we saw a reversal of the strong rally in bonds that ensued since May 2024 as the market gained some confidence in the South African economy post the SA election. The SA bond yield curve bear steepened with the short-dated bond yields i.e., the R186 increasing by about 33bps to 8.27% and the long dated newly issued bond instrument i.e., the R2053's yield increasing by approximately 46bps to 11.1%.

As mentioned previously, the neutral duration position of the fund against its benchmark means that it will naturally lag the most aggressively positioned funds over rallies such as what we saw over the past quarters (although it will also hopefully outperform the most conservatively positioned peers). However, we seek to generate attractive returns versus peers over the medium to long term by taking advantage of relative value opportunities on the SA bond curve. We expect this approach to over time lead to more consistent outperformance of the benchmark than would be achievable by taking significant duration and macro views in the fund.

Fixed rate credit spreads remain at historically low levels and are in fact negative for the better-quality issuers. There were two fixed rate issuances in the market during November 2024, however neither of these opportunities were viewed as favourable: Momentum Metropolitan Life Limited issued R500m via a 5.5-year fixed rate note in November at a spread of 25 bps and Industrial Development Corporation issued R393m via a 10-year fixed rate note at a spread of 99 bps. In the current environment of historically low fixed-rate credit spreads we expect the fund to remain uninvested in credit.

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Contact us

info@mandg.co.za

mandg.co.za

0860 105 775

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities