M&G Investments

M&G Insights

Be aware of cycles

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The strategy of the M&G Enhanced Income Fund is based on three pillars: being drawdown focused, cyclically aware, and tactically alert. In a previous article, Mind the drawdown, the drawdown focus pillar of the strategy was highlighted. In this article, the cyclically aware pillar will be explained. Fixed income assets are highly cyclical in nature as their performance is inextricably linked to both inflation and interest rate cycles, both locally and globally.

While market participants and the public predominantly focus on the nominal level of interest rates, central bankers are more interested in the real interest rate level (policy rate less realised targeted inflation), as it reflects the true measure of policy. Currently, central bank policy rates in both the United States and South Africa are in restrictive territory, with real interest rates at multi-decade highs in both countries.

The US Federal Reserve belatedly started hiking interest rates in 2022, after inflation had already peaked, shifting real interest rates from highly accommodative to very restrictive levels. It has been said that central bank policy rates take the "escalator up but the elevator down". While this is usually the case, policymakers have been more cautious in this easing cycle, following the recent inflation surge.

Four phases of South Africa's monetary policy

There have been four distinct phases of monetary policy in South Africa following the Global Financial Crisis (GFC).

- Phase one was the period from mid-2011 to late 2014, which can be called the "6% target", where the real repo rate was either very low or negative under Governor Gill Marcus.
- Phase two we deem the "4.5% target" period from late 2014 to mid-2020 under Governor Lesetja Kganyago where there were positive and sometimes high real policy rates.
- Phase three was the period from mid-2020 to end-2022, which can be called "un-anchoring", where monetary policy was highly accommodative.
- Finally, the current phase since the start of 2023 we deem as "re-anchoring" with restrictive policy.

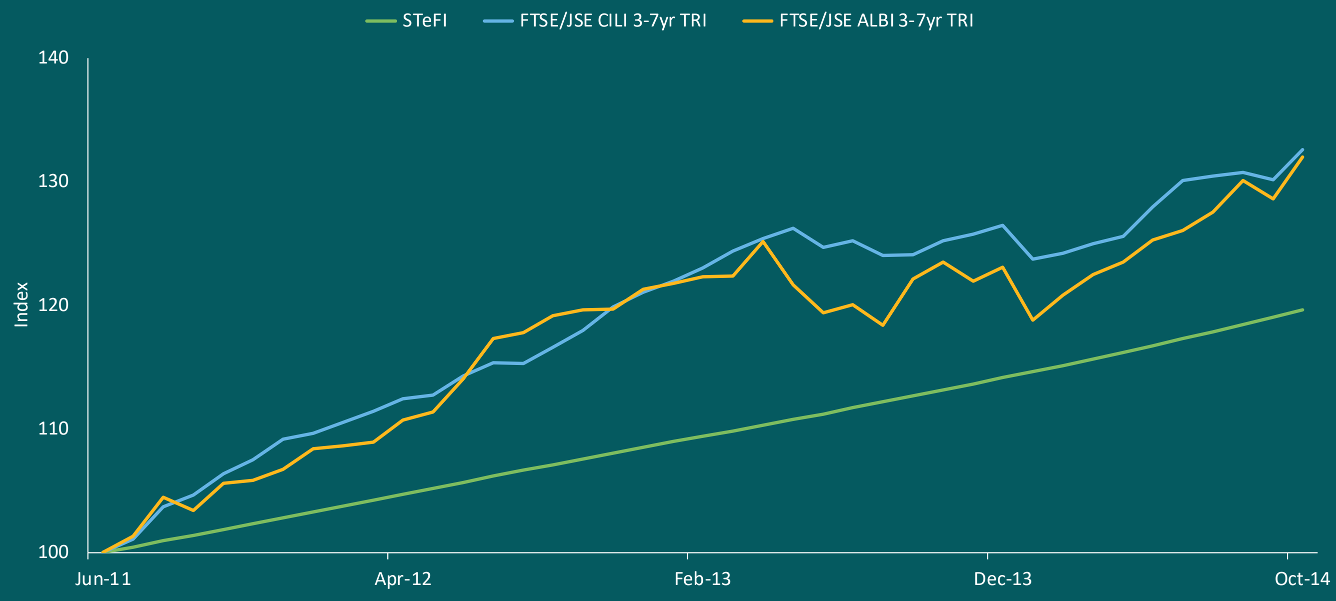
Surveyed inflation expectations indicate that economic agents have followed the phases outlined above. The current high real repo rate signals the SARB MPC's intent to re-anchor inflation expectations. The bond market's breakeven inflation expectation is derived from the difference between nominal and inflation-linked bonds (ILBs). Breakeven inflation at the five-year tenor is the most sensitive and practical from a duration perspective, and it has also followed the phases described above.

Case studies of the four phases

We analysed the four phases of monetary policy by comparing the returns of cash, five-year nominal bonds and five-year inflation linked bonds.

Case study 1 – "6% target"

ILBs outperformed slightly, but more so on a risk adjusted basis

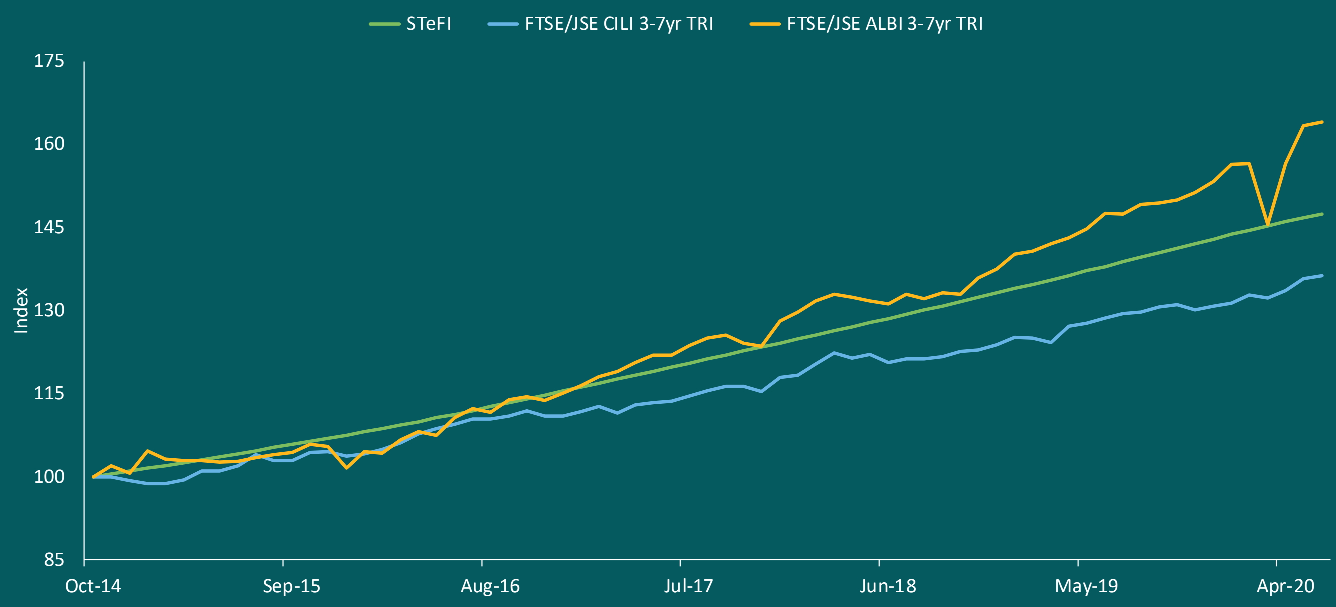


Source: M&G Investments, Bloomberg 31.01.2025

During the "6% target" phase ILBs slightly outperformed nominal bonds, but more so on a risk-adjusted basis and both beat cash returns by a wide margin.

Case study 2 – "4.5% target"

SAGBs outperformed strongly, even despite the Covid shock

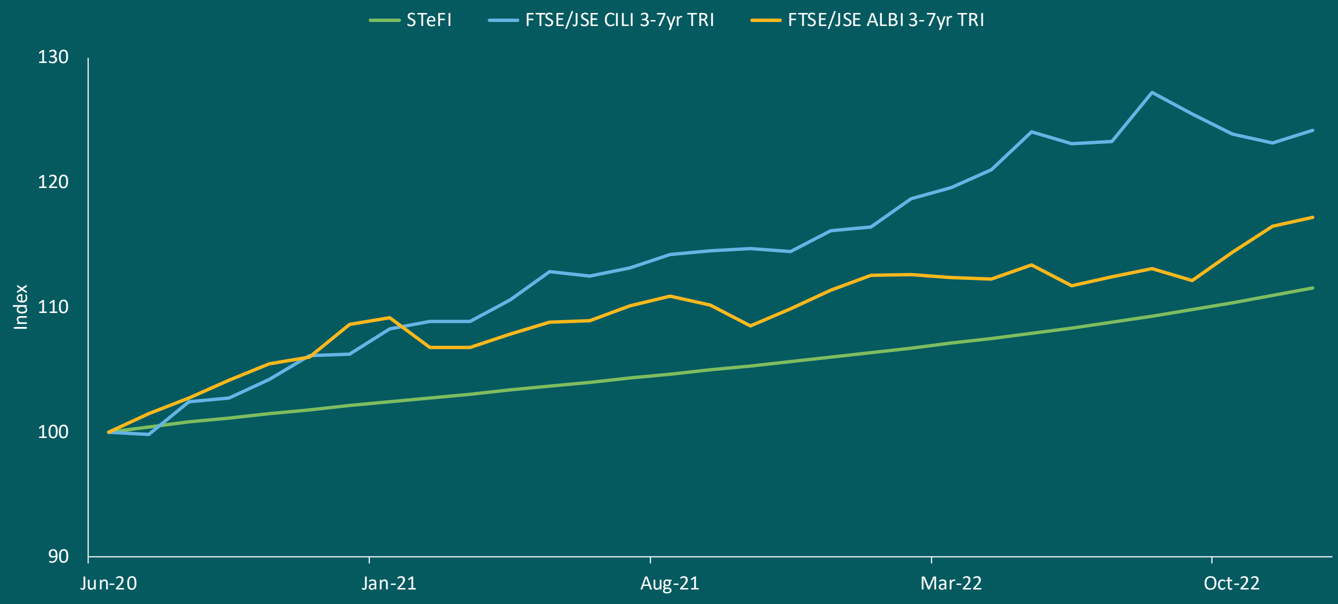


Source: M&G Investments, Bloomberg 31.01.2025

Over the "4.5% target" period, nominal bonds performed best, handsomely beating cash returns, which in turn outpaced ILBs comfortably.

Case study 3 – "Un-anchoring"

ILBs outperformed strongly, with stable yields and high inflation carry

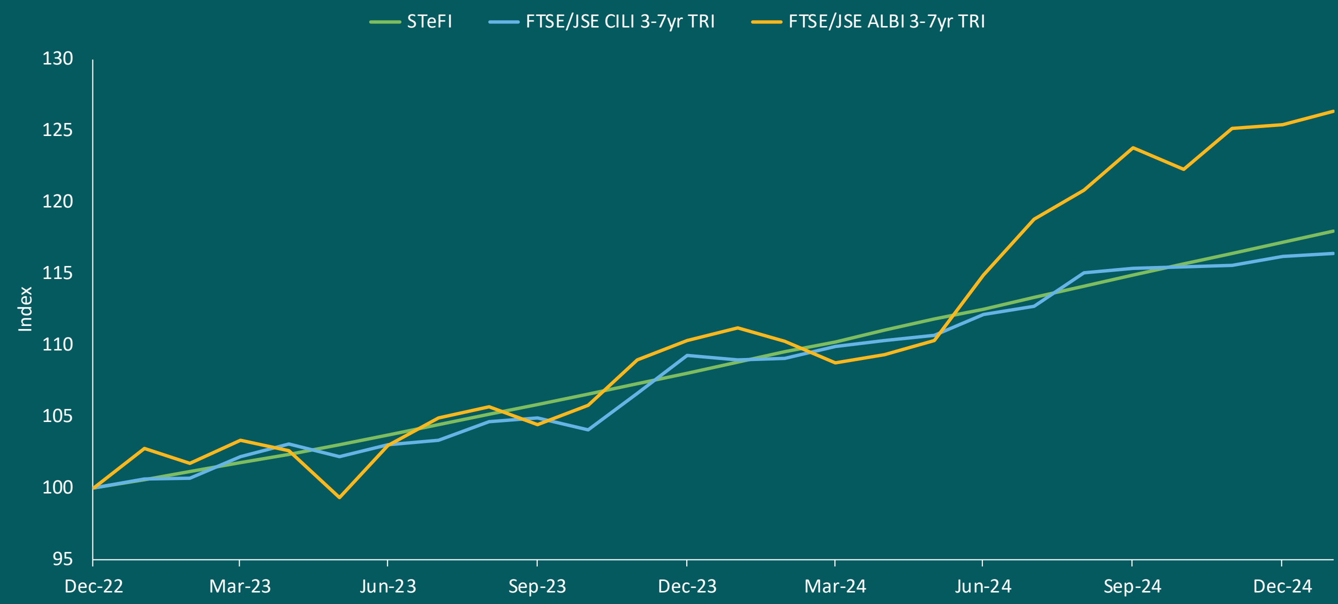


Source: M&G Investments, Bloomberg 31.01.2025

The "un-anchoring" phase saw ILBs strongly outperform with stable yields and high inflation carry, followed by nominal bonds and then cash.

Case study 4 – "Re-anchoring"

SAGBs have outperformed, especially post the election and global turnaround



Source: M&G Investments, Bloomberg 31.01.2025

In the current "re-anchoring" phase, nominal bonds have outperformed, especially after last year's local election and the recovery in global yields. Cash returns have lagged by a significant margin but still managed to pip ILB returns.

Over the past decade of broad-based US dollar strength, the rand has weakened against the greenback. Even if one were to adjust the value of the rand for the interest rate carry earned in SA rands versus US dollars over this period, the rand has still lost value. Although not a focus of domestic monetary policy, the interest rate differential over this period was not sufficient to protect domestic capital, and this has market implications.

The shape of the yield curve is another market factor influenced by the stance of policy and the inflation as well as interest rate cycles. The two-year point is mainly affected by monetary policy, while the ten-year point is more affected by fiscal policy. Looking at the history of the 2s10s ZAR interest rate swap spread, one observes how in the aftermath of the GFC the curve has not inverted (gone negative). This is largely due to the very loose fiscal policy experienced since then, as well as policy rates not reaching the high levels seen in previous periods.

In managing the M&G Enhanced Income Fund, we are cognisant of where assets should be priced based on the point in the inflation and interest rate cycle. This approach has proven beneficial for our investors, as the fund ranked 28th out of 109 peer funds for the three years ending 31 January 2025. In fixed income, it's important to be aware of cycles rather than look through them, as they could present opportunities.