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M&G Investments

2023 Mid-Year Investment Perspectives

INVESTMENT PERSPECTIVES | SECOND EDITION | BROUGHT TO YOU BY M&G INVESTMENTS

In this issue

The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

Past performance is not a guide to future performance.

The views expressed in this document should not be taken as a recommendation, advice or forecast.

Navigating uncertain markets

Welcome to the Mid-Year edition of Investment Perspectives. 2023 has been an eventful year so far, but, despite periods of volatility, financial markets have largely stabilised after last year's turmoil.

In this edition, we reflect on recent developments and assess the factors that could influence markets in the months ahead.

We highlight the key drivers and opportunities in the fixed income and equity markets, with contributions from Fabiana Fedeli, CIO Equities, Multi Asset and Sustainability, and Jim Leaviss, CIO Public Fixed Income.

We also examine the current investment landscape in private markets, with articles discussing the flexibility of private credit and the impact of higher interest rates on the real estate market. Our real assets team highlights the potential opportunities created by long-term 'megatrends' such as the energy transition and digitisation.

We are also delighted to have a contribution from Parit Jakhria, Director of Long-Term Investment Strategy in the M&G Treasury & Investment Office, discussing the topic of asset class interactions and diversification. The Treasury & Investment Office oversees approximately £152bn* across a range of multi-asset investment solutions, unit-linked funds and annuities on behalf of Prudential Assurance Company, a subsidiary of M&G plc.

In his article, Parit explains how inflation has driven a change in the economic regime, leading to a change in focus for central banks and financial markets. In this new environment, he suggests markets may not be able to rely on central bank support as much as they have in recent years; economic cycles may also be shorter with more day-to-day uncertainty.

Against this backdrop, Parit sees value in a diversified portfolio across different asset classes and risk factors, as well as suggesting that evolving markets require a dynamic allocation strategy.

Investment Perspectives is designed to showcase M&G's extensive investment capabilities and expertise, spanning a wide range of asset classes, regions, and both public and private markets.

We hope you find this collection of articles interesting and helpful in navigating the current market environment. ■

*as at 31 December 2022.

An eventful start to the year

If policymakers' aggressive response to high inflation was one of the principal drivers of financial markets last year, uncertainty about the consequences of higher interest rates has dominated so far in 2023.

There has been plenty of debate about how central banks' rapid monetary tightening might affect the path of economic growth – will we have a 'soft' or 'hard' landing, for instance – and how markets might react.

Despite fairly widespread expectations that we were heading for a recession, economies have, by and large, remained resilient. A robust employment market and wage growth have supported consumer spending, even in an environment of rising prices.

The demise of several US banks in quick succession and the emergency rescue of Credit Suisse was arguably the first sign that recent policy tightening was causing some pain but, despite fears of contagion through the global financial system à la 2008, the crisis appears to have been contained.

Inflation has remained in focus. Recent developments suggest an easing of price pressures in headline components, such as wholesale energy prices, producer prices and measures of supply chain disruptions. However, there are signs that core inflation remains 'sticky', particularly given tight labour market conditions. The slow pace of inflation's fall – it could be described as 'stubborn' – has caused interest rate expectations to fluctuate.

Despite this challenging backdrop, and other concerns such as the US debt ceiling, markets, particularly equities, have been surprising resilient. Apart from US banks and energy stocks, which have been hit by the banking crisis and weaker oil prices, respectively, many stockmarkets have been steadily recovering some of last year's declines. US mega-cap technology stocks, in particular, have soared this year, driven by excitement about the potential of Artificial Intelligence (AI).

Fixed income markets have generally registered positive returns too, albeit with periods of volatility and weakness in specific parts of the market, notably longer-dated gilts. However, commodity markets have faced a more difficult backdrop with the uncertain economic outlook and concerns over slowing Chinese demand weighing on energy and copper prices. In contrast, gold has benefited from its traditional 'safe haven' attributes and registered solid returns in the first half of 2023.

The importance of diversification and dynamic allocation

Parit Jakhria,
Director, Long-Term Investment Strategy, M&G Treasury & Investment Office

The Long-Term Investment Strategy team is part of the M&G Treasury and Investment Office, a team of in-house investment strategists and 'managers of managers' for the Prudential Assurance Company (PAC), a subsidiary of M&G plc. The Long-Term Investment Strategy team sets the Strategic Asset Allocation for investment funds, as well as providing various economic scenarios and modelling for M&G plc. As part of this, we regularly review our asset class views and their sensitivity to economic and capital-market developments.

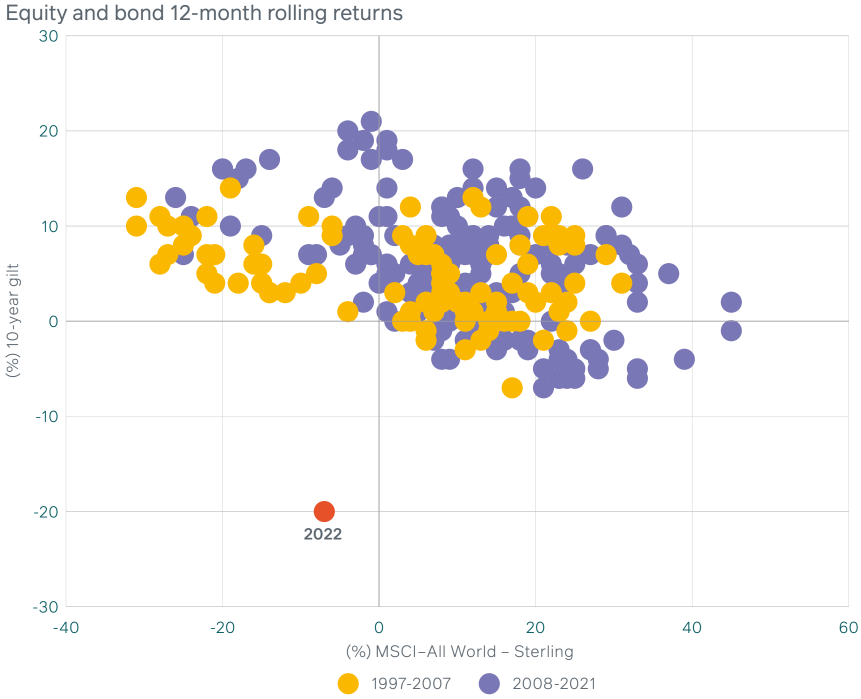
The 'axiomatic' equity-bond correlation

For every rolling 12-month period this century, and in fact since the Bank of England's independence in 1997, bond and equity returns for multi-asset investors have exhibited a certain pattern, which is neatly illustrated in Figure 1 below. It was almost axiomatic that any downswing in equity markets would have been at least partially offset by positive returns from fixed income and vice versa.

This, in turn, spawned a large number of multi-asset houses who sought to invest cheaply and in scale in developed market fixed income and equity mandates, with the view that equities and bonds were suitably diversifying. This led to a large number of similar funds, with the only market differentiator being fund fees, which in turn were being driven increasingly lower as a result of the competition. Certainly, these funds performed fine in the recent decade of quantitative easing and low rates (the 'lower for longer' environment), as increasingly lower yields boosted fixed income returns and the equity-bond relationship remained well-behaved, until 2022...

Figure 1: Suitably diversifying

Equity and bond 12-month rolling returns



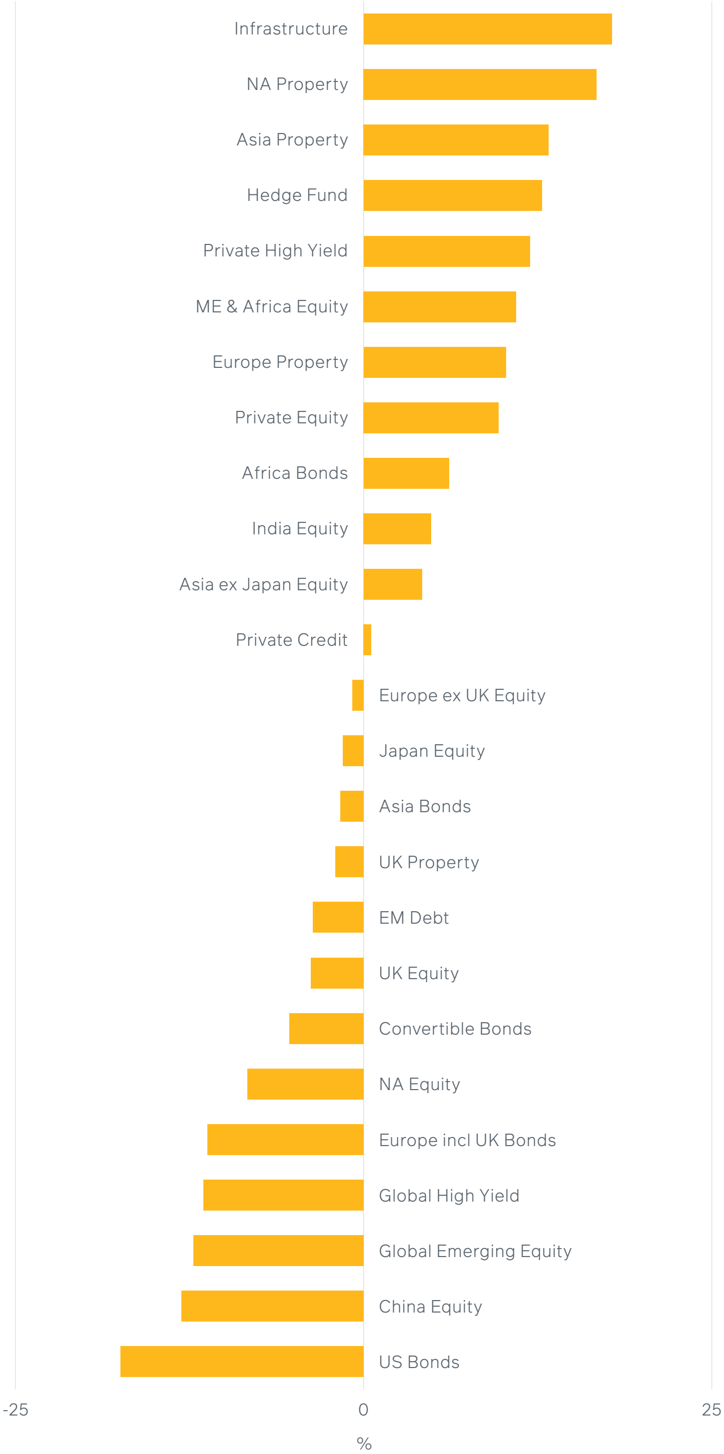
Source: M&G, Refinitiv Datastream, 31 December 2022. Returns in sterling.

Past performance is not a guide to future performance.

It was almost axiomatic that any downswing in equity markets would have been at least partially offset by positive returns from fixed income, and vice versa.

Figure 2: There are several alternatives to equities and bonds

Asset class returns in 2022



Source: M&G, 31 December 2022. Returns in sterling.
Past performance is not a guide to future performance.

Where to hide?

A major headache for multi-asset investors globally has been where to invest in years like 2022 when developed market bonds and equities both disappoint. This has led to a commonly used phrase by asset managers of 'nowhere to hide'.

Fortunately, there is a wide array of other asset classes and geographies available to investors willing to invest the time and effort to look further afield. And last year, when equities and bonds struggled, several other asset classes, such as infrastructure and property, delivered positive returns, as the returns chart of our main multi-asset fund building blocks shows (Figure 2).

Inflation and regime change?

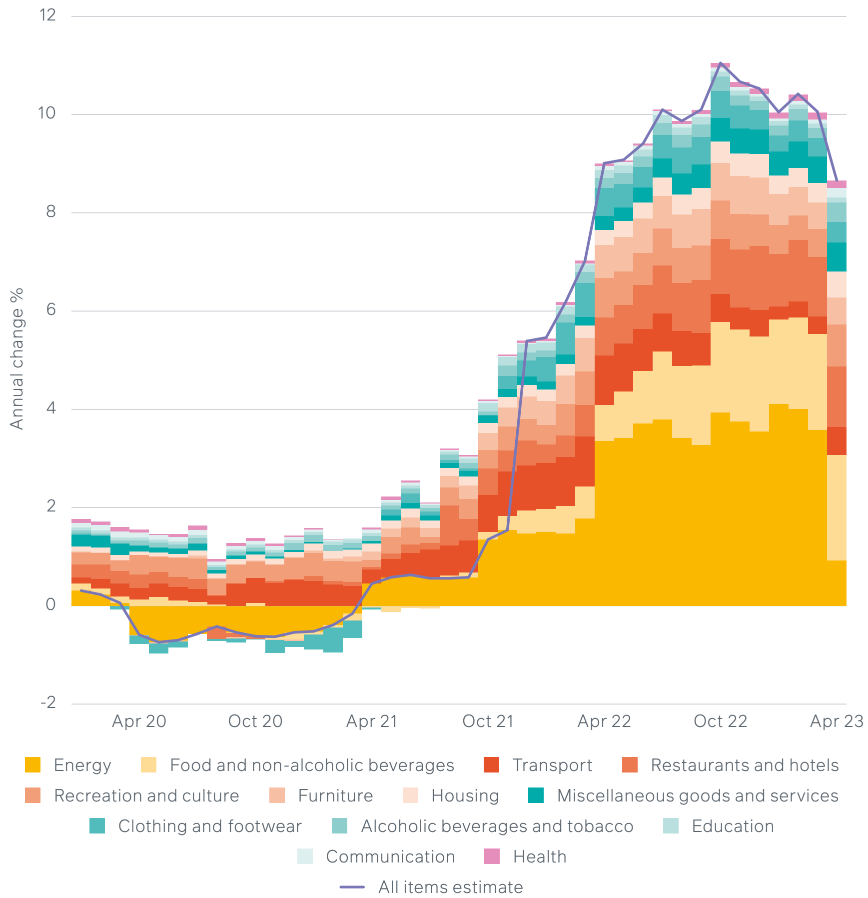
Regime change denotes the replacement of one structure with another. It can indicate a shift in the interactions of various parts of the economy. However, unlike a political regime change, a shift in economic regime is often difficult to identify at the onset. While a market anomaly does not necessarily mean a regime shift, it prompts us to revisit the structural forces of an economy that are aligned to a regime to establish what may be changing and why.

On reflection, it is increasingly clear that we are now in a regime where central banks and markets worry about inflation shocks at least as much as growth shocks, which is in direct contrast to the investment environment over the last two decades.

We are in a regime where central banks and markets worry about inflation shocks at least as much as growth shocks

Figure 3: Energy and food have fuelled high inflation

UK CPI and inflation components



Source: M&G, Refinitiv Datastream, May 2023.

Looking through the sub-components of Consumer Prices Index (CPI) baskets, energy and food price spikes have played an important role in taking inflation prints significantly higher, especially in the UK and Europe (Figure 3).

As we look ahead, the boost to headline inflation from factors such as food, energy and supply chain disruptions looks set to fade over coming months, with base effects from last year's price spikes beginning to drop out from April onwards. However, whilst the most recent print indeed saw a reduction of circa 1.4% from energy prices, the food price element has remained stubbornly high, as have the core components. This naturally leads to the question of where inflation will ultimately settle over the next 12-18 months. Our main fear is the risk that higher inflation expectations will become entrenched.

Shorter economic cycles?

Another feature of recent events suggests the policy landscape is shifting away from the era of the 'central bank put': an environment of central bank policy where markets could rely on central banks to act gradually to tighten policy as economic expansions progressed but ease aggressively at the first sign of weakness. That environment provided a useful backstop to equity markets, whilst also establishing the role of government bonds as a source of portfolio 'insurance'.

If softening activity trends turn into a more pronounced downturn, markets may not be able to rely on central bank support to the same degree as previously, if and when inflation readings remain stubbornly high.

This 'symmetry' where central banks are worried about policy errors in both directions will be a material change to the period post central-bank independence. In our view, it will result in much shorter economic cycles compared to what the markets were getting accustomed to in the 21st century (eg, the 12 years between the Global Financial Crisis (GFC) and the COVID-19 shock), and hence more day-to-day uncertainty.

There is a small silver lining though: shorter economic cycles should, in theory, result in a much smaller build-up of excesses. On the flipside, multi-asset allocation may need to evolve more dynamically to keep up with the economic cycles.

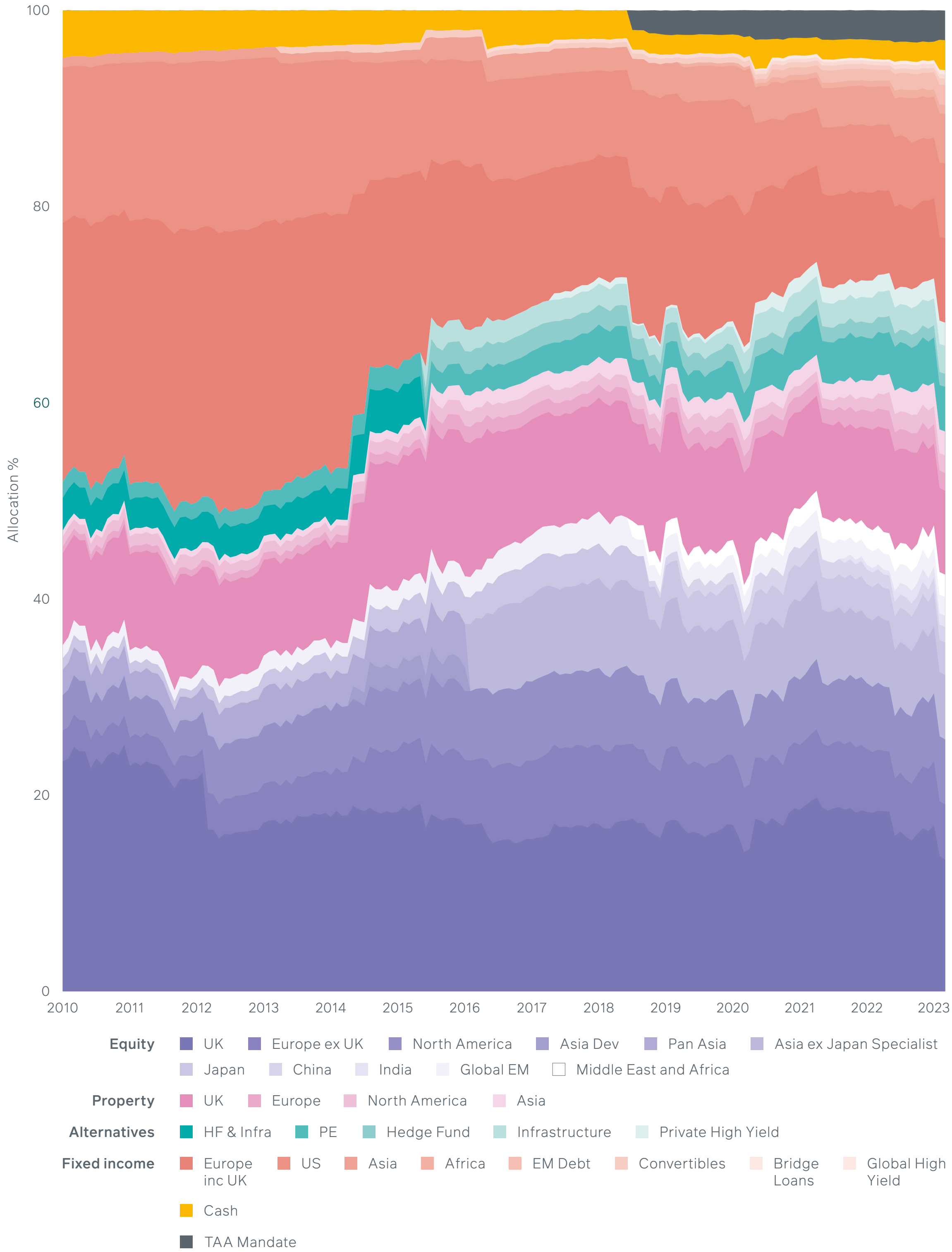
Concluding thoughts: merits of a diversified and dynamic allocation

Investors now need to contend with an interest-rate environment in which mainstream investments offer less diversification. Against this backdrop, we continue to see value in pursuing a portfolio that is well-diversified across different asset classes, with positive exposure to risk factors such as inflation risk, and tilted toward the solutions to the problems of the coming decade, such as shifting patterns in global trade and the necessary climate transition.

We also maintain our long-held belief of seeking to harvest risk premia (the expected return above that of risk-free assets such as government bonds) across asset classes, where the compensation is especially attractive relative to the inherent risks. While a shift higher in the interest rate regime affects all asset classes to some degree, those with high starting risk premia potentially offer some buffer against valuation losses imposed by rising rates.

Finally, with shorter economic cycles, we believe a dynamic allocation strategy to match the evolving capital markets will be essential.

Figure 4: Evolution of the PruFund Strategic Asset Allocation over time



Source: M&G, Refinitiv Datastream, May 2023. For illustration purposes only. PruFund is one of the multi-asset funds that follows the Strategic Asset Allocation set by the Long-Term Investment Strategy team. The chart has been chosen to illustrate the wide range of asset classes, across multiple geographies, that the team invests in, and how the team has dynamically changed the asset allocation over time. This version of PruFund is only available to UK investors.

Take nothing for granted

Fabiana Fedeli,
CIO, Equities, Multi Asset and Sustainability

Two key market drivers

As we head into the second half of 2023, markets will likely be preoccupied with the same two key drivers that influenced sentiment in the first half of the year: ongoing central bank decisions and the likelihood, timing and depth of a recession.

Central bank rate divergence

In the US, we've had varying opinions from Federal Open Market Committee (FOMC) members on the direction of travel for interest rates from here. Despite diverging views, ultimately, the committee will be data driven. Given the current data, we expect a pause at the June meeting, as the Federal Reserve (Fed) tries to assess how far tightening credit conditions stemming from the US regional banking events are impacting market liquidity. In our view, the Fed is unlikely to cut rates this year, unless we have a deep recession or see inflation drop to 2% – both of which are not in our base case scenario for 2023.

In the UK and Europe, we expect further tightening ahead from the Bank of England (BoE) and the European Central Bank (ECB) given the stickier inflation compared to the US.

Ongoing uncertainty around the shape and timing of a recession

We have seen a number of weak or weakening activity-related data points, recently. However, there has been no clear sign of a major and pervasive deterioration. It feels logical to expect further deterioration in demand as the 'higher for longer' rate environment weighs on spending. However, the likelihood, timing and extent of a recession remains uncertain at this point.

Let's not forget, that recessions can come with a lag. As a barometer, if we look at historic US recessions that appear to have been triggered by a rate hike cycle from 1965 to today, these occurred to varying degrees and appeared with a wide range of lags of between five and 15 months from the last rate hike. Of course, while history may rhyme, it doesn't necessarily repeat itself. We still believe that market performance, and particularly the relative performance of equities versus fixed income markets, will hinge on the length and depth of a slowdown versus current expectations.

In this environment, the market will likely remain data-driven with investors examining each data point closely for clues about the macroeconomic outlook and, by extension, policy decisions.

Near-term outlook for Equities

Commentators are becoming increasingly negative on Equities, basing their arguments on the prospects of a recession ahead. We prefer to take a more balanced view, recognising that while a downward trend of macroeconomic data ahead may be highly likely, the extent of the deterioration versus current expectations will be the real determinant of equity markets performance.

The likelihood, timing and extent of a recession remains uncertain at this point.

Figure 5: Equity market valuations

Japan is getting closer to its 10-year average but we expect further earnings improvements

Source: Bloomberg, 5 June 2023.

On the surface, global equity markets appear fairly priced for the risks ahead assuming a moderate recession, although not for a deeper demand decline. However, below the surface, there are notable differences not only between regional markets but also between stocks in the same market. In particular, the S&P 500 Index appears significantly overvalued versus other markets, given fundamentals.

The US market is still trading at close to half the equity yield of other major markets, meaning that it is almost twice as expensive. In past years, a perception of higher quality and relatively higher earnings growth has been supporting such a premium.

Given the recent US regional banking events, and relatively muted earnings growth, the justification for such a valuation premium is looking less plausible in our view, particularly versus Europe. As we wrap up the first quarter earnings season, EAFE (Europe, Australasia and Far East) companies have delivered more robust earnings and sales growth numbers than those in the US, where we've seen the S&P Index deliver year-on-year declines in EPS growth.

The breadth in performance has also been different across equity markets. In the US, the recent rally has been concentrated in a handful of stocks, primarily mega-cap technology stocks. In Europe, by contrast, the strongest market rallies (in Germany's DAX and the CAC in France) have been much broader in nature, extending beyond just the luxury goods names for example.

In the US, the recent rally has been concentrated in a handful of stocks, primarily mega-cap technology stocks

What has helped Europe, in our view, has been the very pessimistic starting assumptions which have not been realised, particularly on energy supply and prices. Also, we have a number of European companies performing well on the global stage. This has allowed a broad range of corporates to participate in the rally – pharmaceuticals, industrials and consumer-related businesses, as well as those related to the energy transition, which are benefiting from the billions of dollars of green subsidies contained in the US Inflation Reduction Act and expectations of Europe's attempt to match this.

The market remains one where selection is the main driver of alpha, diversification is key and volatility has to necessarily become our friend

When talking about broader markets, we stand by our position that this is not a market for 'broad strokes investing' (taking directional macroeconomic calls and swinging entire portfolios one way or the other). The market remains one where selection is the main driver of alpha, diversification is key and volatility has to necessarily become our friend. The recent earnings season continues to show that companies are performing very differently, even when in the same sectors, due to tilts in exposure, product mix, pricing strength, balance sheet strength and, ultimately, better management.

Higher-than-average return dispersion both between and within sectors reinforces our belief that selection is the way to deliver alpha in the current environment. In our view, the market offers attractive opportunities for bottom up, fundamental investors who are willing to dig a little deeper.

Attractive value in Japan

Within developed economies, Japan remains one of our favourite markets. We have found a number of companies that are improving operational leverage with a positive impact on earnings growth, alongside increasing shareholder returns via raising dividends and share buybacks, even without the support of the macroeconomic backdrop. However, less well recognised in our view, alongside this culture of self-help and corporate reform, is the prospect of wage growth boosting consumption, providing a further potential tailwind for growth in the years ahead.

After years of short-lived excitement and false starts, and having eventually fallen off the radar for many, there are signs that investors are starting to recognise the potential growth opportunity among Japanese corporates: in May, the broad TOPIX Index reached its highest level since Japan's stock market bubble burst in 1990. Despite the growing attention from foreign investors, we still believe that the upside prospects for Japanese companies are not fully appreciated and there are compelling opportunities, particularly for active, engaged investors.

Investors are starting to recognise the potential growth opportunity among Japanese corporates

One factor to keep in mind for investors wanting to invest in Japan is the impact of currency. The recent announcement of a monetary policy revision from the Bank of Japan (BOJ) could mean a change in monetary policy sometime ahead, but as always when it comes to Japan, in a cautious way. The BOJ is most likely buying time to make sure that the current inflationary pressure is non-transitory and also to combat market speculation of policy change.

A change in policy, whether in the form of a further widening of the Yield Curve Control (YCC) band or a rate hike, would support the Japanese yen (JPY). Therefore, when picking stocks in Japan, it is important to consider that for some the currency tailwinds may be a thing of the past. The difficulty will be in determining the timing of a BOJ move as the market has got it wrong many times before. Luckily, there are many stocks where the fundamental tailwinds appear stronger than any potential currency impact.

Selective opportunities in China

In emerging markets, we believe that interesting opportunities can be found in China. As always, selection remains important. China's reopening sparked a great deal of excitement about a rebound of economic activity and markets, arguably, got ahead of themselves. The reality is that after a period of rolling COVID lockdowns, a very weak real estate market and challenged local finances, any recovery was always going to be gradual and uneven – there is scar tissue that will take time to heal.

However, there is room for fiscal and monetary policy to be eased, as has been done with selective support for the real estate and infrastructure sectors – especially in terms of the energy transition. Importantly, there are no inflationary constraints on Chinese policy makers.

Ongoing US-China tensions remain an overhang, and this has manifested itself in a higher risk premium and lower valuations. The tensions are unlikely to go away completely and their impact has to be considered when selecting stocks. The silver lining is that the world's two largest economies are very closely intertwined through trade – both directly and indirectly through Asian trading partners. Neither side wants, or can afford, major disruption in the current economic climate. Hence, the recent more conciliatory comments from President Biden and low-level meetings taking place again.

Aside from all the macroeconomic noise, we are encouraged by what is happening from a microeconomic or bottom-up perspective: a number of large Chinese companies are doing a good job in terms of margins and profits, despite softer-than-desired headline growth, and we are seeing many companies returning cash to shareholders in the form of buybacks.

Short-term market dislocations and long-term opportunities

In a market where news-driven short-term reactions have become the order of the day, volatility can become our friend, offering attractive opportunities. One of these presented itself among non-US banks, in Europe and even more so in Asia, where many fundamentally sound, and tightly regulated, banks experienced what we believed to be unwarranted share price falls, following the US regional banking turmoil. This sell-off was a good example of the pockets of mispricing that are occurring in an increasingly news-driven market. And there will likely be more ahead as the market reacts to central bank decisions and datapoints that appear to support fears of a deep recession.

While we wait patiently for market dislocations, we continue to like companies exposed to long-term themes that we believe will continue to attract capital even in a global demand slowdown: infrastructure, innovation (such as AI, but also in other intellectual property-heavy areas such as healthcare) and the low carbon ecosystem. As mentioned, the recent earnings season has reminded us that companies in the same sectors can fare very differently due to differences in exposure, product and pricing strength, and – ultimately – management. Therefore, across all of these themes we remain selective.

Our multi-asset portfolios currently hover around a neutral stance between equities and fixed income, and trade tactically around those positions, putting more focus on the underlying composition of the portfolios. We maintain a relative preference for non-US equities, where we find more compelling opportunities from a valuations vis-à-vis earnings profile standpoint.

Our strategies also have a small overweight in duration expressed via the long end of the US curve and some selected emerging market sovereigns and currencies, such as Brazil and Mexico, given the high real yields and the improving inflationary environment.

As we move through 2023, we remain diversified, continue to focus on bottom up, differentiated research to drive alpha, and stand ready to take advantage of tactical opportunities presented by market volatility.

Fixed income valuations have been reset

Jim Leaviss,
CIO, Public Fixed Income

The past year has undoubtedly been one of the most interesting times in my 30-year career in bond markets. It's also been one of the most dangerous for bond investors, with inflation rates surging above 10% and with one of the fastest rate hiking cycles in economic history.

As we know, 2022 was a terrible year for nearly all asset classes, and fixed income was no exception – double-digit losses were not uncommon, while many longer-dated government and inflation-linked bonds saw losses in excess of 20%.

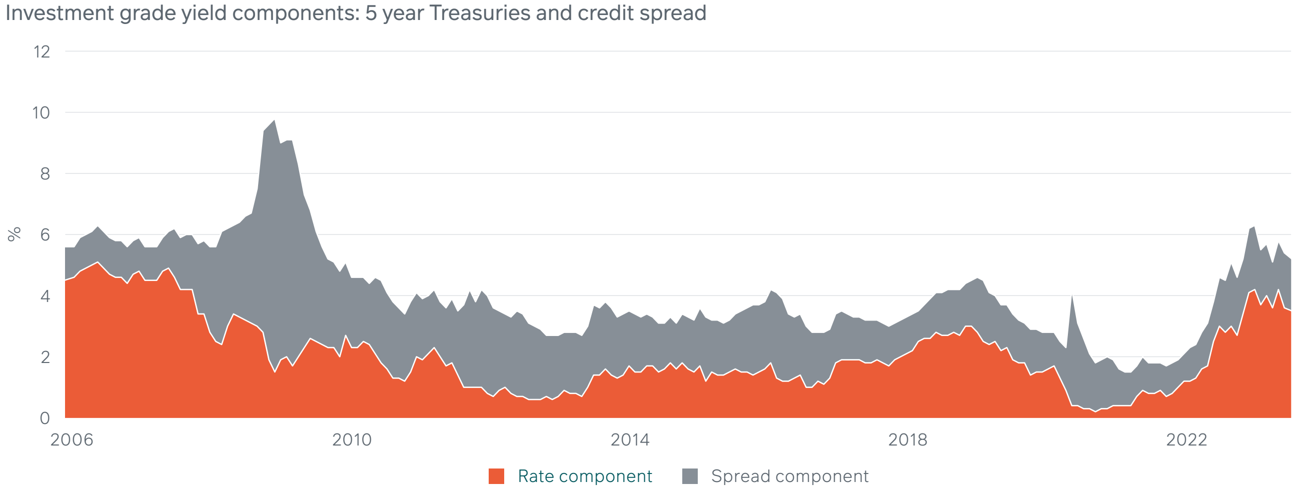
What this has meant, however, is that fixed income valuations have been reset and this has brought a lot of value back into bond markets, in our view. This is the case almost everywhere you look – from emerging market bonds to European short-dated credit – we are now seeing value across the board.

For perhaps the first time in a decade, we believe bond investors are being well paid to take both interest rate and credit risk. Investment grade corporate bonds, in particular, should be well placed to navigate the more uncertain economic environment – through its separate interest rate and credit spread components, we believe the asset class offers an attractive combination of yield, diversification and resilience to perform in a variety of market conditions.

Inflation on a downward trajectory

Higher valuations are clearly very good news for bond investors, although inflation is likely to remain the key driver of returns. While we do appear to be slowly winning the battle against inflation, it is probably too soon to be declaring victory just yet.

Figure 6: Investment grade corporate bonds provide natural diversification



Source: Bloomberg, 30 April 2023.

We think the recent inflationary period can be broken down into three distinct phases, each with its own narrative. The first stage was all about supply chain disruptions following the re-opening of the global economy after COVID. This was perhaps best symbolised by the container ship stuck in the Suez canal for six days in 2021.

In the second stage, the blame for inflation moved on to workers and the shortage of labour as many chose to leave the workforce. We now appear to be entering a third phase, where inflation is being explained by companies keeping their prices high, even though input costs have fallen back – so called 'greedflation'.

While we do appear to be slowly winning the battle against inflation, it is probably too soon to be declaring victory just yet.

We'll need to see how things unfold from here, although the good news is that – with the possible exception of the UK – inflation has started to come down, and the sharp deceleration in money supply could continue to push inflation lower. We're by no means out of the woods – core inflation rates remain elevated – but we do seem to be past the worst, and we think this will allow central banks to bring the current rate hiking cycle to an end.

Approaching the end of the rate hiking cycle?

After one of the fastest series of rate hikes in history, the market is now predicting rates to come down gradually over the next 12 months. However, it's important to note that the market's forecast is based on an average of two very different outcomes – on the one hand, where the US economy keeps growing and rates rise to perhaps 6% or beyond; and, on the other hand, where we see further banking problems and a steep recession causing the Federal Reserve (Fed) to slash rates back towards 2%.

My view is that we could be due a big slowdown, because when central banks raise rates as quickly as they have, things tend to break. We've seen this time and time again – from the Long-Term Capital Management (LTCM)/Russian debt crisis in 1998 to the global financial and eurozone crises a decade later. All these things occurred after a sudden rate rise, and we're seeing the early signs of stress now following the recent string of bank failures.

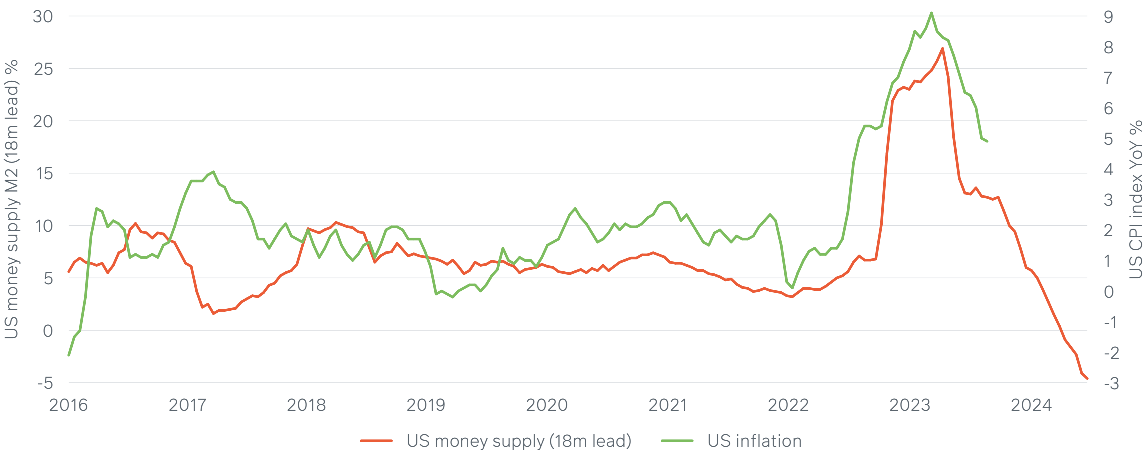
We believe this has fundamentally changed the narrative – having previously been in the 'higher for longer' camp, we are now of the view that the Fed will need to start applying the brakes as they assess the implications of the recent turmoil. Provided we don't get another inflation shock, then it feels like we could be near the top of the current rate hiking cycle.

Identifying opportunities in government bonds

Looking at government bond markets today, the first thing we do is to assess whether a government's debt burden is sustainable based on its nominal Gross Domestic Product (GDP) growing at a faster pace than its cost of borrowing (as reflected by its government bond yield). For many governments, inflation has been extremely beneficial in reducing debt/GDP ratios, and these are the countries we want to focus on.

We also look to identify countries where we think interest rates and inflation will come down the quickest. In developed economies, it feels like the US is furthest down the road in this process. Indeed, we're now seeing a collapse in US money supply, and this normally leads to falling inflation.

Figure 7: Inflation is on a downward trajectory



Source: M&G, Bloomberg, 30 April 2023.

We've also seen a sharp inversion in the US yield curve – where long-term yields are lower than short-term yields – and this has historically been a very reliable predictor of a US recession.

This is before we even consider the implications of the recent banking collapses in the US – it's worth emphasising that the second, third and fourth largest bank failures have all occurred in the past couple of months – it feels astonishing that markets seem so relaxed about this. The recent turmoil is likely to lead to a significant contraction in credit to parts of the US economy, which could be the equivalent of a 50-100bps rate hike.

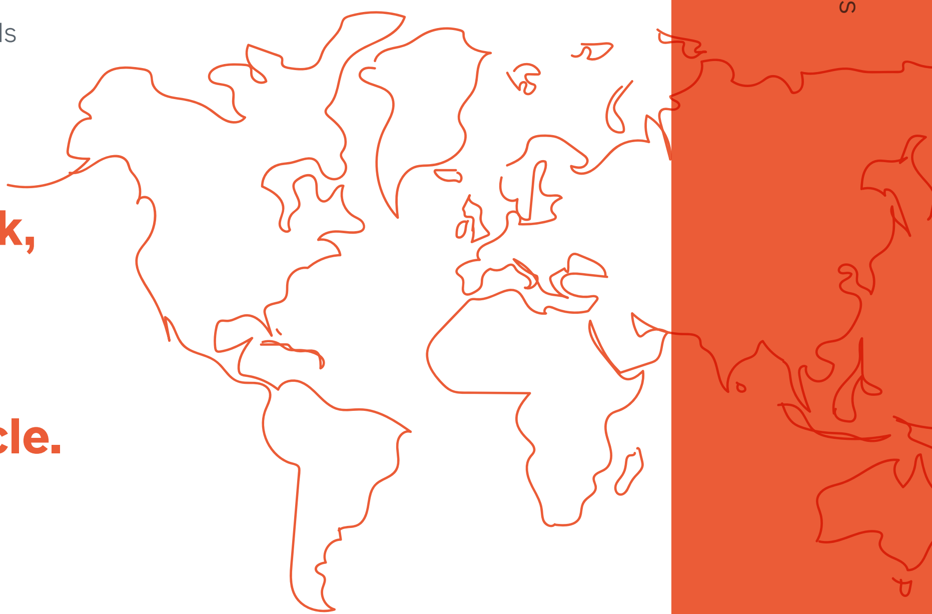
For these reasons, we think the Fed is likely to pause its rate hiking agenda as it takes stock of the latest economic data. Given the likely direction of travel, US Treasuries remain our preferred area in core government bond markets. In contrast, the European Central Bank will probably need to hike for a little longer yet given that core inflation remains elevated. We therefore remain somewhat more cautious on European government bonds, which could face further headwinds in the short-term.

Provided we don't get another inflation shock, it feels like we could be near the top of the current rate hiking cycle.

Selective value in emerging markets

Looking further afield, we continue to see value in emerging market (EM) bonds. While it is important to be very selective in the space, EM countries generally offer the strongest long-term growth potential, and benefit from young populations and low debt/GDP ratios. Valuations also look attractive, in our view, with EM bonds offering yields well in excess of inflation.

EM central banks generally acted ahead of the curve in this cycle and took the opportunity to hike rates early – this means inflation should also start to come down quite rapidly and provide a further tailwind to the asset class. While not without risks, we think this is more than reflected in EM bond valuations and we are currently finding attractive opportunities in a number of areas, especially in Latin America and South East Asia.



Positive trends remain in place for private assets

Private markets, just like public markets, face challenges from the new investment landscape. Investors will clearly need to consider the impact of higher funding costs on deals and investment returns. However, we remain confident that the outlook for private market investing is positive. We believe demand for the asset class remains strong, with investors attracted by a combination of high yielding (often floating rate or inflation-linked) assets and growth opportunities. Data provider Preqin is forecasting private markets AUM to continue to grow and reach US$18tn by 2027, double the amount in 2021[1].

In the near term, there are signs that private debt firms may be able to benefit from the recent wave of further funding retrenchment by banks. This arguably provides another impetus for the trend of non-bank funding that has been well underway since the global financial crisis.

Looking further ahead, we think that long-term trends such as the broadening and democratisation of the investor base and growing interest in sustainability and impact investing represent exciting opportunities for private assets.

In the following sections, we examine in more detail the trends and opportunities in the private credit, real assets and real estate markets.

[1] The Future of Alternatives in 2027 | Preqin.

Private credit: Finding a versatile toolset for a complex situation

For over a decade, both corporate and consumer borrowers benefited from low-interest rates and a very low cost of capital – but this is changing as global economies continue to adjust to central bank interest rate hikes and an uncertain geopolitical backdrop. Private credit proved its resilience and adaptability through the current cyclical downturn, and demand for the asset class continues. Given the current macroeconomic backdrop, private credit may be well-placed to help investors steer through the myriad challenges ahead.

Some three years on from the onset of the COVID-19 pandemic, market participants have found themselves contending with higher interest rates than they've seen in over a decade and a challenged economic environment. Although inflation has eased since its recent double-digit peaks, the risk of elevated inflation in Europe remains for this year. Indeed, despite troubles in the banking sector, the European Central Bank has continued to hike rates to the highest level since 2008, signalling that inflation remains a high priority on its agenda.

Many corporate and consumer borrowers entered this inflationary period in fairly decent shape at a fundamental level, although we remain mindful that with a return to more normal base rates away from zero levels, the higher interest obligations could trigger a wave of defaults in weaker companies. Indeed, these shifting macroeconomic and market conditions highlight the importance of remaining forward looking, continually reassessing the evolving nature of risk factors, and most importantly taking a prudent approach to credit selection.

As markets continue to adapt to this new complex phase, the demand for duration and real income hedges through floating-rate instruments like private credit has increased. This in combination with the current dislocation offers significant opportunities for private lenders to capitalise on this demand, providing a credible solution as deal pipelines build and investment opportunities proliferate across the spectrum.

Figure 8: Asset allocation can be specifically tailored for macro backdrop for 'an all-weather portfolio'

Potential allocation

- Senior debt
- Mezzanine strategies
- Securitised
- Real assets debt eg Real Estate, Infrastructure

Rising growth

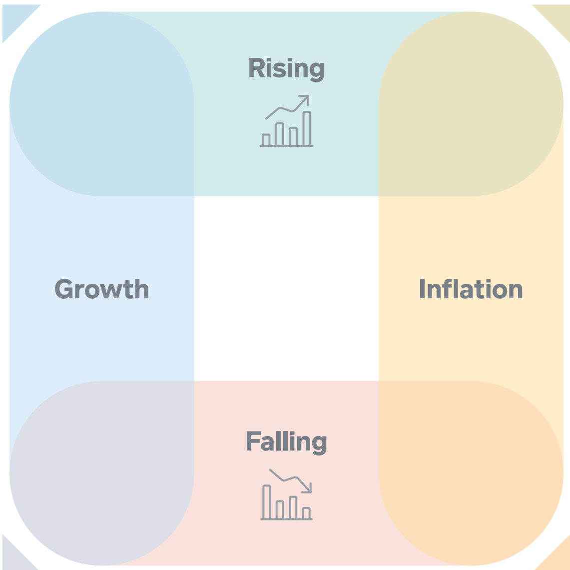
Rising economic activity leads to improving earnings and wage growth. Asset valuations rise. Fewer corporate and consumer defaults. Spreads decrease.

Potential allocation

- Senior debt
- Mezzanine strategies
- Securitised
- Real assets debt
- Inflation linked debt

Rising inflation

Floating rate coupon structure enables income to adjust with changes in interest rates and not fall as interest rates rise. Present value of future cost of default rates.



Falling growth

Declining economic activity leads to lower earnings. Asset valuations fall.

Rising default rates. Spreads increase.

Potential allocation

- Senior debt
- Distressed/opportunistic
- Senior securitised
- Senior real assets debt

Falling inflation

Reference rate floors can provide yield protection.

Present value of future cost of default rates.

Potential allocation

- Senior debt
- Securitised
- Senior real assets debt
- Income strips

Source: M&G, for illustrative purpose only. The views expressed in the above flowchart should not be taken as a recommendation, advice or forecast.

A differentiated and diverse toolset

Although historically seen as a niche asset class, the global search for yield has seen investors consistently increasing their allocations to private credit and alternatives. According to data from Preqin, assets under management in private debt has grown from just under $500bn in 2013 to $1.2 trillion by 2021 and expected to double once more to $2.3 trillion by 2027[2].

The complexity return premium is not the only driver of this, increasingly investors are also allocating on the basis of diversification and yield stability. We believe private credit is a versatile toolset for investors in various environments, whether challenging or a bull run, offering exposure to differentiated groups of income-bearing assets which can help investors in their quest to achieve their efficient frontier portfolio.

Multiple access points

Private and alternative credit markets are not a single marketplace but rather a series of different asset classes with different types of risks and different access points. These range from relatively small to large – including leveraged loans which are on a par in size with the developed high yield market – and indeed value between them can wax and wane over time. The companies which encompass this universe are similarly diverse, ranging from mega-cap household names to more esoteric offerings.

This means private credit can act as a tactical tool to gain exposure to different assets but also allocation can be specifically tailored for a changing macro backdrop in a 'all-weather portfolio' in areas such as Senior Debt, Mezzanine, Inflation-linked Debt, Securitised Debt and Real Assets Lending. These are asset classes that could be better positioned to weather volatile and inflationary periods given their historic close positive correlation to inflation. In contrast to traditional fixed income, private credit assets typically carry limited duration risk. During a period of higher inflation, private credit's floating rate coupon structure enables income to adjust with changes in interest rates and not fall in real terms as rates climb.

It is worth noting that like most asset classes, a combination of high economic growth and low inflation is fundamentally more favourable. In the growth stage of the cycle where economic activity leads to improving earnings and wage growth – and therefore fewer corporate and consumer defaults, all else being equal – asset valuations should rise. Overall, we believe private credit can be blended in a simple structure with no need for complex derivatives to offer a secure income for investors through the different stages of an economic cycle.

Flexibility is key

Although inflationary and recessionary concerns may continue to drive investor sentiment, the ultimate path to recovery is uncertain. In our opinion, the dislocation and dispersion across credit markets provides an attractive entry point for investors looking for experienced deployers of flexible, patient, and long-term private capital. However, balancing this with the flexibility to go where the best relative value lies within private credit and adjust exposures can be hugely helpful during times of higher uncertainty.

A new, interesting trend we are seeing is greater blurring of the boundaries of lending. The funding tap where issuers seek finance is evolving and becoming more fluid: high yield names are obtaining funds anywhere from the loan universe to direct lending and even distressed funds. Investors, such as M&G, which have the breadth of capabilities to see across all these markets should be in a good position to find attractive opportunities. Whichever market it is, we believe being as selective and diverse as possible can help to build these robust 'all weather' portfolios.

[2] Preqin, 'Global report 2023: Private debt', (preqin.com), January 2023.

Real asset megatrends: Global trends shaping investment opportunities

Megatrends are long-term, global themes forecast to shape and transform society, the economy, and the environment over the next few decades. Investors are able to participate in the propagation of these trends through allocations to Real Assets, which are tangible physical assets with intrinsic value due to their substance and properties. The ability to identify and understand these trends helps to shape our opportunity landscape. We focus on four key megatrends which are highly interconnected: Energy Transition, Digitisation, Food System and the Natural World.

Energy transition

To limit global warming to 1.5°C above pre-industrial levels, in line with the Paris Agreement, greenhouse gas (GHG) emissions must be reduced by 45% by 2030 and reach net zero by 2050[3]. Increased global renewable energy capacity continues to play a major role in this path to net zero, with rapid growth forecast. By 2027, the global renewables capacity is expected to grow by 2400GW, equal to the entire power capacity of China[4].

Beyond traditional renewables, opportunities exist in numerous high growth areas, including electric vehicle infrastructure, biofuels, decarbonisation of heat, and hydrogen.

Government support also provides attractive tailwinds: Across the European Union's REPowerEU plan, the Inflation Reduction Act in the US, and the UK's Ten Point Plan, an estimated US$680bn[5,6,7] in clean energy policy funding aims to mobilise significant private investment[3]. The REPowerEU policy was notably a reaction to Russia's invasion of Ukraine, highlighting energy security as a key international priority.

Digitisation

As the global population grows and technology progresses, data has become an essential part of daily life across all sectors. Increased digitisation has the potential to speed up technological development,

[3] Net Zero Coalition | United Nations
[4] Executive summary – Renewables 2022 – Analysis – IEA
[5] REPowerEU: affordable, secure and sustainable energy for Europe, 2022 | European Commission (https://ec.europa.eu)
[6] Inflation Reduction Act: One page summary, 2022 | The Senate Democratic Caucus (www.democrats.senate.gov)
[7] The 10 Point Plan for a Green Revolution, 2020 : UK Gov (www.gov.uk)

promote economic growth, and enable more efficient use of resources.

Despite rapid progression, a digital divide persists across developed regions such as Europe and North America. In the US, 24 million individuals currently lack access to high-speed internet, with many unable to connect due to gaps in digital equity and literacy[8].

Given the significant funding gap, recent policy responses have played an essential role in generating investment tailwinds: the US Infrastructure Investment and Jobs Act provides $65bn to upgrade broadband coverage, with a focus on unserved rural locations[9].

Newer areas of the digital landscape, 5G and generative artificial intelligence, are creating never-seen before opportunities leading to significant demand for digital infrastructure such as fibre and data centre capacity.

Food system

With the global population expected to reach 10 billion by 2050[10], the world faces a growing demand for food amidst limited natural resources and increasingly frequent extreme weather events.

Food systems are responsible for one-third of global GHG emissions[10] and generate hidden costs of US$12 trillion[11] related to health, environment and poverty. These rising costs, alongside the increasing threat from climate events, are forcing food producers and retailers to invest in sustainable solutions. Areas of focus include precision agriculture and technologies able to operate entirely independently of the external environment.

Institutional capital is still in the early stages of entering the market, with opportunities spanning large-scale agriculture, controlled-environment farming, and new food creation methods.

Natural world

There is a growing global understanding that preserving and restoring natural ecosystems is essential to combat climate change, protect biodiversity, and safeguard economic activity.

$44 trillion of economic value generation, over half the world's GDP, is moderately or highly dependent on nature and its services and is therefore exposed to risks from nature loss[12].

While still in its early stages, policymakers are exploring ways to attract private sector investment through subsidies and carbon and biodiversity markets. Current opportunities include regenerative agriculture, improved forest management and habitat restoration, such as mangrove replanting.

Limited capital has been allocated, but expectations are for the investment opportunity set to grow as the journey towards protecting and restoring natural ecosystems progresses.

Selection is crucial to unlocking value

Investing in Real Asset megatrends provides the opportunity to address one of the greatest global challenges: building a sustainable future. Despite the rapid growth in each of the markets, prudent deal selection remains crucial to unlocking value. Key challenges include navigating the complex and volatile macroenvironment while avoiding areas of the market trading at inflated valuations. Equipped with a robust investment process, increasingly deep expertise and a flexible approach to capture the most promising opportunities, we believe we have the potential to manage these challenges and deliver attractive returns within each of these themes.

[8] https://www.mckinsey.com/industries/public-and-social-sector/our-insights/are-states-ready-to-close-the-us-digital-divide
[9] Fact Sheet: The Bipartisan Infrastructure Deal | The White House (www.whitehouse.gov)
[10] World population projected to reach 9.8 billion in 2050, and 11.2 billion in 2100 | United Nations (www.un.org)
[11] Stop Food Loss and waste, for the people, for the planet | United Nations (www.un.org)
[12] Nature Risk Rising | World Economic Forum (www.weforum.org)

Global real estate: Have the storm clouds passed?

After a decade of 'free' money, it is unlikely that interest rates can rise as quickly as they have from such low levels without consequences for the financial system. We assess the potential impact of higher rates on the real estate sector and consider the opportunities that might arise.

We believe the 'green premium' is set to remain a feature of the market

Reduction in investor demand for riskier property

The uncertainty wrought by the banking sector turmoil means lenders and investors are likely to operate with a greater degree of risk aversion, by being cautious in what they decide to proceed with, and by demanding higher compensation when they do take on risk.

Given the reduction in availability of financing and the more expensive cost of debt, particularly for riskier lending, with reduced demand from debt-backed property investors at any given level of asset pricing, higher-risk, poorer-quality real estate assets are likely to bear the brunt of any further softening of yields/prices.

Polarisation exacerbated by less capital to improve assets

A 'flight to quality' is likely to result in relative resilience for core, prime property with secure cashflows (particularly where repricing of the asset has already occurred).

Poorer quality assets, on the other hand, are more vulnerable to occupational market risks like vacancy, particularly amidst a relatively fragile economic environment.

The ability of such assets to improve their performance is likely to be hindered through less capital being available for the required expenditure on refurbishment or redevelopment.

It's possible that this trend could delay the investment in upgrading Environmental, Social and Governance (ESG) credentials for 'brown' assets – not a great outcome for making progress on the path to net zero carbon. We believe the 'green premium' is set to remain a feature of the market, whereby more sustainable buildings have higher rents.

Asia Pacific real estate is likely to remain more resilient, in part reflecting less severe inflation and policy rate increases

Opportunities for alternative lenders

With the banks having significantly less appetite to lend, their retreat provides a potential opportunity for non-bank lenders, such as real estate debt funds, to step in and provide loans for borrowers who require financing for their real estate investments.

We believe new entrants with fresh capital or without legacy portfolios will be able to take advantage of what could be the most attractive lenders' market since before the global financial crisis (GFC) drove borrowing rates down to record lows.

Regional variations

While work-from-home habits are a potential headwind for the US office sector, opportunities may be found in a range of other US real estate segments, such as the multifamily sector, logistics markets and data centres. In the UK, multi-let industrials, retail warehouses and the Living sector remain interesting, in our view.

Meanwhile, in Europe, we think structural elements in the logistics, residential and office sectors, in particular, remain supportive for strong rental growth moving forward. However, location remains key and there are risks to the downside from sluggish economic growth, elevated inflation and higher interest rates.

In our view, Asia Pacific real estate is likely to remain more resilient, in part reflecting less severe inflation and policy rate increases. There are regional variations, however. In Japan, structurally-favoured sectors like multi-family housing and logistics are also likely to offer prospects for moderate rental growth, which may surprise on the upside given the inflationary backdrop. Some property sectors in Australia and Korea on the other hand may give greater cause for concern.

From crisis comes both challenge and opportunity

As the challenges are worked through in the coming quarters, both winners and losers will likely emerge. Some investors may suffer – notably those who have been overleveraged and now face refinancing risks, or those who have been overly exposed to weaker/riskier property - but others should be able to take advantage of great opportunities, such as acquiring mispriced assets.

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