Strategy commentary

Ninety One Global Managed Income

Quarter ending 30 June 2024

The following commentary gives the views of the investment manager at the time of publication.

Key points

- Financial markets delivered a mixed performance over the quarter, as equity markets diverged and fixed income investors became more focused on risk, including that of stubborn inflation
- The Strategy delivered a broadly flat return over the quarter, with emerging and developed market bonds and equities just positive
- Net equity ended the review period at 15%
- The Strategy remains cautiously managed, with the managers looking for the pockets of opportunity

Growth assets
- React positively to economic strength
- Positive correlation with equities over time

Defensive assets
- React positively to economic weakness
- Safe havens in market crises

Uncorrelated assets
- Variable relationship with economic growth
- Independent returns to equities

Market background

Financial markets delivered a mixed performance in Q2. Investors focused on several key risks, including growing concerns regarding inflation. The core CPI print in the US heightened fears of persistent inflation, leading the market to price in fewer rate cuts for the rest of the year. This was even as the European Central Bank (ECB) delivered its first rate cut since the pandemic. Four of the central banks with G10 currencies have now cut rates this year. Finally, politics and geopolitics returned to the fore, notably in the Middle East and later in France, where a notable selloff followed the snap election.

Global equities advanced in the quarter, delivering low mid-single digit returns with emerging markets (EM) outperforming developed markets (DM). US equities hit fresh record highs, driven by the 'Magnificent 7' with Nvidia advancing for the seventh consecutive quarter. However, once again gains were narrowly led, with the equal-weighted S&P 500 Index losing ground during the quarter. President Macron's snap election announcement led to a selloff in French equities, affecting broader European equities. Conversely, UK equities performed well due to an improving economy, a revival of M&A activity and falling inflation. Chinese equities were mixed, with supportive economic data offset by the prospect of more US trade tariffs, particularly targeting EVs. Global high-yield corporate debt delivered positive returns, while EM debt was mixed, with local currency negatively impacted by US dollar strength. EM debt hard currency bonds saw a small positive return. The oil price rose due to renewed concerns over Middle East conflict and OPEC+ clarifying potential changes to production cuts. While metals were generally strong, the prices of several agricultural commodities continued to decline in Q2.

Within defensive assets, DM sovereign bonds faced challenges as investors priced in slower rate cuts, despite the ECB's first cut since the pandemic. The notable selloff among French assets widened the Franco-German 10 year spread by +29bps in the week after the election announcement – the biggest weekly widening since the 2011 sovereign debt crisis. UK gilts also declined. Global investment-grade corporate debt, affected by rate movements, delivered a negative return. The Japanese yen was the worst performing G10 currency in Q2 for the second consecutive quarter.

The price of gold moved higher by +4%, delivering its third consecutive quarterly gain.

Past performance does not predict future returns; losses may be made.

Performance review

The Strategy was largely flat over the quarter, gross and net of fees[1].

Higher yielding stocks were generally down with our selections outperforming but not adding much, while lagging the broader market. Equity options added somewhat to returns but futures hedges were a modest drag. Yield increases across most government bond markets limited their contribution over the quarter. Currency exposure had a small negative impact on returns.

Activity and positioning

Based on evolving evidence over the past six months, we believe there is an increased likelihood of a soft landing for the US economy, rather than the emergence of recessionary conditions. However, we remain aware that policy impacts are still unfolding and will closely monitor data developments and related downside risk.

Within fixed income, our exposure to developed market sovereign bonds was increased at the margin. We also increased our exposure to emerging market debt local currency bonds given we are seeing rate cuts in several countries with the expectation of more to come; the risk premium is reasonable with valuations expected to improve. Elsewhere the allocation to corporate debt (both high-yield and investment grade) was consistent with the previous quarter. Our duration was increased, ending the review period at 3.7 years. In terms of the underlying composition, early in the quarter we reduced US duration in favour of the likes of the UK and New Zealand; however, in the latter half of the quarter we added US duration back, taking advantage of the repricing. The portfolio's credit quality continued to be A rated on average, in line with the previous month. Within currency, our small net long in the US dollar was broadly in line with the previous quarter.

Net equity was increased at the margin but continues to be managed within a cautious range, ending the quarter at c.15%. As at the end of the review period, equity options represented about a third of our hedged equity exposure. While we have seen some improvement in data, we remain cautious about the potential for further downside and are positioned accordingly. Options enable us to navigate volatile and uncertain markets, providing us with exposure to rising markets, and enabling us to cut risk quickly in falling markets.

Outlook and strategy

As discussed above, we have revised the probability of a US recession lower and the probability of a soft landing higher due to emerging evidence. We are mindful that policy needs to feed through and therefore continue to closely monitor the evolution of data and related downside risk. In Europe, where policy is tight and growth indicators remain weak, we see an elevated risk of a disinflationary period in the eurozone and think that rates will continue to fall with increased confidence on the outlook for inflation. In emerging markets, several central banks have already begun to cut interest rates. China has its own challenges in the near term; however, policy appears loose with easing measures becoming more forceful. We believe that the Chinese economy will experience a more benign outcome than the bearish consensus suggests.

Overall, we believe this backdrop means we may see greater differentiation in asset class performance. While uncertainty is likely to continue for a while, particularly around the timing and magnitude of rate cuts, there are pockets of opportunity. There are assets that are attractively valued, offer good income sources, with less uncertainty, and are potentially more defensive in an economic downturn.

While we have marginally increased the probability associated with a soft landing in the US economy versus the emergence of recessionary conditions, we are mindful of the risks, and the portfolio is positioned relatively cautiously. Net equity for example continues to be managed within a cautious range. Volatility may pick up from recently depressed levels, reinforcing the need to manage downside risks while looking for resilient yielding opportunities to generate a defensive total return. Options continue to play an important role here, providing an attractive and flexible way to hedge some of these risks while retaining potential to capture market upside.

We favour certain government bond markets, such as the UK, New Zealand and Australia. In terms of emerging market bonds, many central banks appear to be closer to a peak in interest rates than major developed banks. Our exposure in these markets remains in short-to-medium dated maturities, with most of the currency risk hedged back to USD. Within the corporate bond market, we see few compelling opportunities beyond high quality short-dated paper. We have no allocation to high-yield corporate bonds as credit spreads have tightened, providing little compensation for downside risk. Overall, our fixed income

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[1] Where performance is gross of fees, returns will be reduced by management fees and other expenses incurred. Net performance is net of highest institutional segregated portfolio management fee.

Not all securities held have been discussed. Attribution is shown gross of fees. Fees are deducted at the portfolio level which is where their impact is shown. For further information on how the overall strategy performed during the period covered, please reference the relative performance noted in the Performance review section.

exposure is high quality on average (A), and our duration 3.7 years, with a small portion held via options.

Within equities, we seek businesses that are growing their earnings and passing on higher prices relatively successfully, particularly within the consumer staples sector. Overall, our current exposures are relatively defensive, and our continued focus on resilient income leaves us well placed to navigate the high inflation environment given our equities typically exhibit characteristics such as low leverage, high profitability, and strong pricing power. We have conviction in the persistence and growth potential of the income underpinning the dividends of our holdings. In addition, many resilient higher dividend equities are relatively attractively valued, which should support medium-term return potential.

Overall, the backdrop is continually evolving, and this necessitates a nimble approach to investing. We continue to be cautiously positioned in terms of equity and credit risk, while looking for opportunities to pick up attractively valued, resilient income-generating securities which offer compelling cash flows and potential returns.

Specific risks

Charges from capital: Expenses are charged to the capital account rather than to income, so capital will be reduced. This could constrain future capital and income growth. Income may be taxable. Commodity-related investment: Commodity prices can be extremely volatile and losses may be made. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. Derivatives: The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging and Frontier market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Interest rate: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise.

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