M&G Emerging Markets Bond Fund

Update on key themes and fund positioning

December 2017

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FOR INVESTMENT PROFESSIONALS ONLY

- *Emerging market bonds proved to be a resilient asset class in 2017, performing well against their developed market counterparts. Investors are reminded that past performance is not a guide to future performance.*
- *We believe the relative value case for emerging debt markets remains attractive based on a variety of factors.*
- *An increased allocation to local currency-denominated bonds continues to be one of the fund's key themes.*

The value of bonds and the income from them will rise and fall and an investor may not get back the amount originally invested. The value of an investment may fall if the issuer of a fixed income security held is unable to pay income payments or repay its debt (known as a default). Currency exchange rates will also affect the value of investments.

Moreover, emerging markets are generally more sensitive to economic and political factors, and investments may be less easily bought and sold. In exceptional circumstances, the fund may encounter difficulties when selling or collecting income from emerging market investments, which could cause the fund to incur a loss. In such circumstances, it could lead to the temporary suspension of dealing in shares in the fund.

While the performance of emerging market (EM) bonds has moderated since the third quarter relative to their stronger returns in the first half of 2017, we believe a number of factors continue to underline the relative attraction of the asset class. These include the higher yields available from EM bonds relative to their developed market counterparts, as well as the diversity of both the EM government and corporate bond universes.

In addition, Figure 1 (overleaf) shows the elevated real yields of many EM countries. Some of the fund's largest country allocations are to Latin American markets that offer solid real yields and where inflation has fallen, such as Brazil. We also still expect the credit quality of EM bond issuers to stabilise as economic growth forecasts edge upwards across most developed and developing countries. With improving fundamentals, this synchronised global economic outlook is encouraging for emerging bond markets, as EM credit ratings actions tend to correlate with growth rates.

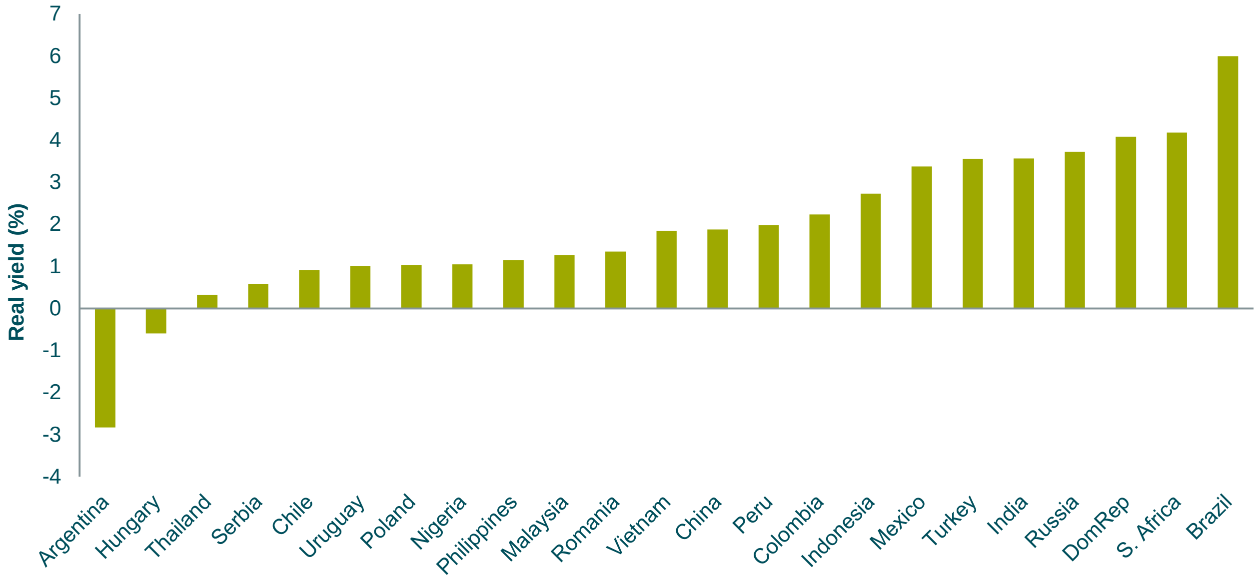
At the same time, the relevant risks need to be monitored closely. These include higher US interest rates, although so far the Federal Reserve (Fed) has tightened at a relatively slow and gradual pace that was widely anticipated. In turn, reactions among EM bond markets to the Fed's hikes have been fairly muted. Also relevantly, the higher US interest rate environment is less challenging for many EM economies than in previous cycles, largely due to factors such as the improvements they have made to their current accounts, as well as adjustments towards having lower overall levels of US dollar-denominated debt. However, US rate increases may cause a headwind for other emerging economies, particularly those more dependent on US dollar funding.

Looking ahead, and provided the Fed does not fall behind the curve and needs to tighten more aggressively, we believe the asset class should continue to withstand a gradual path of US tightening. Helpfully, for example, the real yields in many EM bond markets look high enough to sustain their appeal against such an outlook.

Other risks appeared to start being 'priced out' of emerging debt markets as 2017 progressed. These included the more pessimistic scenarios regarding the outlook for US/China relations under President Trump's administration. The US has not, for example, named China as a currency manipulator nor has it engaged in a trade war.

However, the current renegotiation of the North American Free Trade Association (NAFTA) has yet to be finalised, with EM investors watching for any moves by the US to introduce tariffs. Elsewhere, while EM bond markets have proved resilient to tension over North Korea's armaments testing activity, the possible elevation of this risk remained an area to watch as 2017 drew to a close.

Figure 1. Most EM countries still have an elevated real yield



Source: M&G, Bloomberg, 30 November 2017. Please note, past performance is not a guide to future performance.

Flexibility is key

Overall, we continue to believe that flexibility remains key for successfully investing in the emerging bond markets, as this provides the freedom to hold those bonds and currencies that offer the best relative value and avoid countries or industries where the outlook is unfavourable. Below is a selection of our current most and least favoured areas:

Favoured:

Latin America: Encouragingly, economic signals have shown improvement in several of Latin America's larger markets, including Brazil and Mexico, despite the uncertainty for the latter surrounding NAFTA's renegotiation. In Brazil, economic growth picked up in 2017, despite renewed political turmoil, while declining local inflation has helped the country's central bank to lower interest rates. In the fund, we have maintained exposures to both these markets and they currently rank among its largest country allocations. In our assessment, these markets' high real yields support their appeal.

In Mexico, we remain aware of NAFTA-related uncertainty in the near term, as well as the risks from general elections in 2018. The political candidates cover all levels of market favourability. While Mexican assets could react to the politics as well as the economic story, a winning government would probably need a large majority to undo the reforms that have so far taken place. We think this outcome is unlikely and, in turn, remain constructive on the country. In the fund, our sovereign selections include long-dated government bonds, such as positions in the country's 'century' bonds and securities maturing in 2047. In the corporate bond space, meanwhile, the fund's holdings in Mexico consist of idiosyncratic credit stories on a selective basis.

India: We have held a favourable view on India for some time, and have both local and hard currency exposure. As at the end of November, for example, the fund was 2.6% invested in rupee-denominated 7.3% 2022 bonds from the National Highways Authority of India, making this one of the largest holdings from an individual issuer in the portfolio. The fund held a 0.7% position in US dollar-denominated bonds from Indian telecoms group Bharti AirTel. We have long viewed India's macroeconomic backdrop as supportive and, while its debt level is quite high, it is sustainable as the majority is in local currency. In general, we have considered India to be a good example of an emerging nation whose positive reform momentum has helped to make it an improving story. However, the market has been well aware of this backdrop, which has been reflected in the country's bond market valuations.

Africa: We also favour various allocations in the Africa region, on a selective basis. These include Nigeria, which has a comparatively low level of debt versus other African nations. We like some financials in Nigeria as banks benefit from decent profitability and can now focus on loan book quality recovery, having restructured a number of bad assets, particularly in the oil sector. As foreign exchange liquidity has improved, the naira currently offers good liquidity. The country is out of recession, although its recovery remains fragile. From a cautionary perspective, we are also mindful that Nigeria is among the lowest collectors of taxes in Africa. Elsewhere, Egypt is another one of our preferred exposures, with holdings that include local currency-denominated T-bills that we regard as offering attractive yields. While there could be a risk of 'hot money' flowing into the market, we think the securities compensate for the risk and believe the government can cover its interest payments as its reserves have strengthened.

Cautious:

China: The fund holds a significant underweight position in China, which for much of 2017 has stood at zero. This conviction view reflects our assessment that credit spreads in this mainly investment grade market are tight and better relative value may be found elsewhere. While the economy has performed better than expected in the past year, making the possibility of a 'hard landing' not such a concern, we remain wary about debt levels in the country. Given the tight spread levels, we consider that Chinese bonds generally do not offer proper compensation for the risks.

Turkey: We have also maintained an underweight allocation in Turkey, due to political troubles, disagreements with the US administration, and poor inflation readings. We also note that the country has a relatively high dependency on US dollar funding, making higher US interest rates an additional headwind in the country's outlook. However, given the extent of Turkey's underperformance in the past few months, we added some sovereign exposure in November by buying lira-denominated government bonds.

Gulf Cooperation Council (GCC): We are avoiding most GCC countries given their incomplete adjustment to lower oil prices and tight valuations. In addition, higher dependencies on US dollar funding again make rising US interest rates a potential headwind.

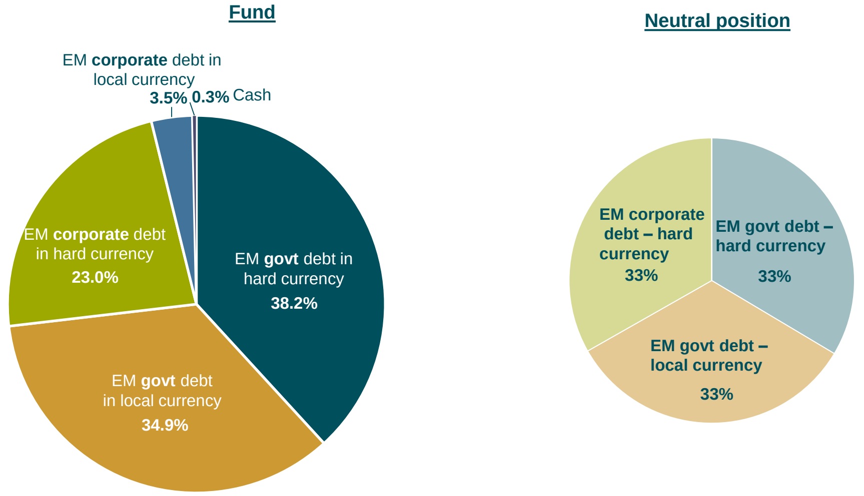
Boosted local currency debt

Overall, we maintain a globally diversified portfolio of emerging market local and hard currency (mainly US dollar-denominated) government bonds, as well as emerging market corporate credit that is mostly denominated in hard currency (see Figure 2).

During 2017, one of our key fund positioning themes has been increasing the overall allocation to local currency sovereign debt. In our view, the relative attraction of these assets has improved after their underperformance in 2016, based on factors such the strengthening of many EM currencies against the US dollar and the higher yields that can be found in this segment of the market. Helpfully for the fund's performance, the sub-asset class has been the best-performing segment of the emerging markets year to date.

The fund's overall allocation to local currency bonds edged up again in November to around 38.5%, the highest level in the fund's history. At the end of the month, the fund's largest local currency exposures were to the Singapore dollar, Russian ruble, Indonesian rupiah, Indian rupee Brazilian real, and Peruvian nuevo sol.

Figure 2. Asset allocation across all available EM opportunities



Source: M&G, 30 November 2017. 'Neutral position' defined as composite index comprising 33% JP Morgan EMBI Global Diversified, 33% JP Morgan CEMBI Broad Diversified, and 33% JP Morgan GBI EM Global Diversified indices.

We are unrestricted in allocating the fund's assets between local currency-denominated EM sovereign debt, hard currency EM sovereign debt, and hard currency EM corporate debt. In turn, this gives us the freedom to actively manage three levers that drive the fund's performance, namely credit risk, duration sensitivity, and currency positioning.

We believe the scope to invest in global EM corporate bonds significantly increases the opportunity set for investors in the asset class, as this has been a fast-growing segment of the fixed income universe over the past decade. As a result, this area now offers widely diversified choices across geographies and industry sectors, as well as credit quality and maturity. Currently, with EM spreads pricing in the improved fundamental outlook, we continue to believe that stock selection based on careful and thorough credit research remains key to investing successfully in the sub-asset class.

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The fund allows for the extensive use of derivatives.

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