M&G Global Macro Bond Fund

# Dollar strength, performance tailwind

FUND MANAGER JIM LEAVISS

The US dollar has rallied in recent months as the relative strength of the US economy contrasts with the weaker outlook for key regions such as the eurozone and Japan. For Jim Leaviss, manager of the M&G Global Macro Bond Fund, the long-term case for the greenback to perform well remains intact, a view that is represented in the fund by the maintenance of a substantially overweight allocation to the US dollar. This positioning helped the fund to deliver first-quartile performance in the third quarter of 2014 and should continue to contribute positively to its returns in the event of further strength from the currency.

**Jim Leaviss**

"The long-term case for the dollar to perform well remains intact."

## Big calls from conviction views

As well as the active management of its duration and credit risk, the currency positioning of the M&G Global Macro Bond Fund is an important third lever for Jim to seek to maximise its returns. In his current outlook, Jim retains a conviction view on the US dollar, which is expressed in the fund via the maintenance of a significantly overweight exposure to the currency (see figure 1). This stance was a key positive contributor to the fund's performance in the third quarter of 2014, when its US dollar allocation ranged between 87% and 99% and helped to deliver a top-quartile return in its sector of 7.6%. The fund's longer-term performance record may be seen in the table below, which also shows that it delivered top-quartile returns in the six-month, three-year, five-year and since-launch periods to the end of September 2014.

This strategy continues to be based mainly on Jim's bullish outlook for the US economy. Following the downside surprise on first-quarter US gross domestic product growth caused by last winter's extreme weather conditions, the economy has returned to performing well. The factors driving its growth include lower austerity measures compared with last year, higher corporate investment and improving employment.

As a result of this outlook, Jim believes it is right to assess the prospect of tighter monetary policy in the US. While the Federal Reserve (Fed) is likely to remain cautious in the upcoming months and wait for stronger economic data, Jim anticipates rate rises being introduced at some point in 2015, with inflation data being an influence on the timing.

**Fund performance in EUR**

| | 3 months % | 6 months % | 1 year % | 3 years % pa | 5 years % pa | Since launch* % pa |
|---|---|---|---|---|---|---|
| M&G Global Macro Bond Fund | 7.6 | 9.6 | 9.8 | 7.6 | 8.5 | 4.7 |
| Morningstar Global Bond sector average | 5.2 | 8.3 | 8.9 | 3.9 | 5.7 | 3.9 |
| Fund quartile ranking in sector | 1 | 1 | 2 | 1 | 1 | 1 |

Source: Morningstar, Inc., Pan-European database as at 30 September 2014. Euro A class shares, gross income reinvested, price-to-price basis. *The fund was launched on 15 October 1999. For Italy, please note that the performance stats are quoted gross of Italian tax on capital gains. Past performance is not a guide to future performance.

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This backdrop of economic growth and prospective rate increases underlines Jim's expectation that the US dollar should perform well in the currency markets. Other favourable factors in its outlook include the US's improving current account deficit, the trend of 'onshoring' economic activity back to the country from centres such as China where labour costs are no longer so cheap, and America's progress towards increased energy independence.

Also, importantly, the imminent ending of quantitative easing (QE) by the Fed should benefit US dollar sentiment. Having scaled back on QE so far this year, the Fed is now nearing the end of this form of monetary stimulus, which is mainly designed to suppress bond yields and interest rates. In doing so, QE activity becomes a downward contributor to currency performance, and its elimination removes what has been a dampener on the US dollar's performance for some time.

### Euro, sterling downside

In contrast, Jim has an unfavourable outlook for the euro, believing that the European Central Bank's recent stimulus measures to tackle falling inflation are likely to further weaken demand for the single currency. In his view, therefore, downside risk remains for the euro and the fund's allocation to the currency is now significantly underweight, having been slightly above a neutral level at the end of the second quarter (see figure 2).

Elsewhere, Jim's fundamental outlook on sterling remains cautious and the fund's allocation to the currency is also underweight relative to a neutral position. While sterling recently fluctuated in the run-up to Scotland's independence referendum, he views the pound as expensive even without the risk of a UK break-up as voters eventually rejected separation. The UK's ongoing very large current account deficit remains a key concern. Jim also notes that the UK faces a general election in just over six months, and if the Conservative Party is elected, there will be an 'In/Out' referendum on Britain's EU membership, while if the Labour Party wins, it may not be investment friendly in some areas, as indicated by its proposals for new pricing regulations for utility companies. He expects such factors to contribute to some further uncertainty in sentiment towards sterling.

The flexibility of the fund's approach allows Jim to take short positions in currencies he does not like, and the largest of these at the moment continues to include short exposures to the Japanese yen, as well as the Australian and New Zealand dollars. Jim believes yen sentiment is likely to remain adverse against Japan's persistent economic growth problems and the country's need for ongoing stimulus, while China's economic slowdown has negative implications for the latter two commodity-related currencies.

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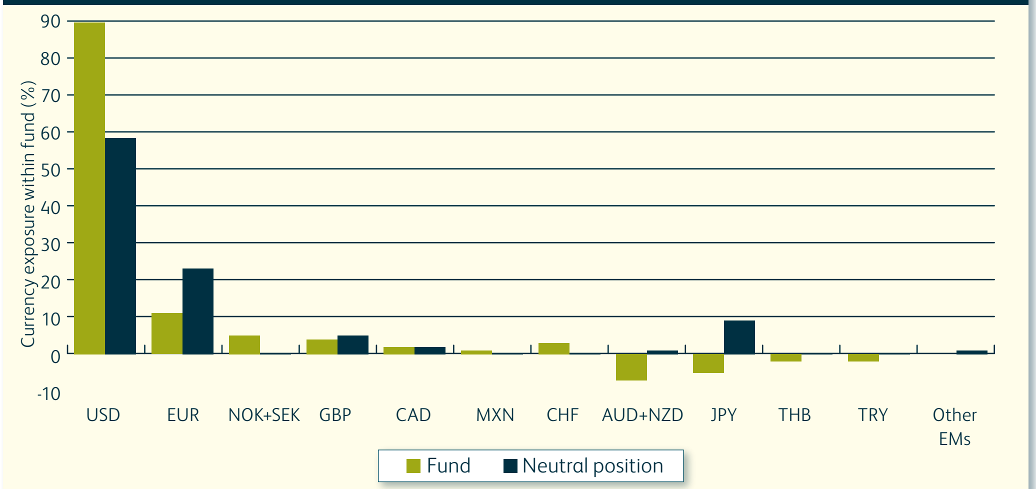
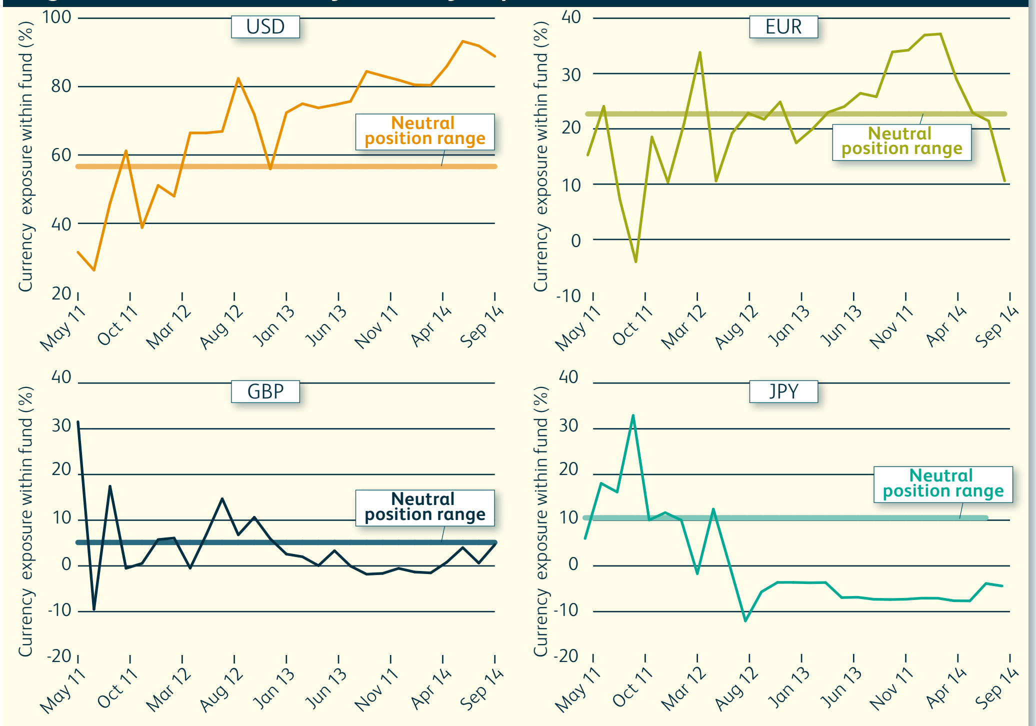
**Figure 1. The fund's currency exposure**




Source: M&G, 30 September 2014.

**Figure 2. Evolution of key currency exposures within the fund**




Source: M&G, 30 September 2014.

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## Short duration, selective credit risk

While the fund's large exposure to the US dollar dominates its currency positioning, its flexibility has also allowed Jim to make big calls on its duration and credit risk. Throughout the year to date, the main feature of his interest rate risk strategy has been to maintain short duration in expectation of tighter monetary conditions in the strengthening US and UK economies. Indeed, the fund's duration has been steadily reduced as yields have fallen; by the end of September its position was 1.9 years, significantly shorter than a neutral level for the portfolio of around 6 years.

In terms of credit risk, the fund maintains a large allocation to investment grade credit where Jim favours relative valuations, in contrast to underweighting high yield and emerging market bonds. Within its investment grade weighting, one of Jim's favoured themes has been to switch longer dated issues into shorter dated floating-rate notes (FRNs) in the banks sector. FRNs are an attractive play on expectations of rising yields as they offer floating-rate coupons that adjust in line with changes in interest rates. Buying these assets has also helped to reduce the fund's overall duration. Jim is not so constructive on high yield bonds at current valuations, and has concerns about the massive inflows into the asset class in recent quarters. He is also cautious about emerging market bonds, a stance he has held for some time due to factors such as China's economic slowdown and the ending of the Fed's QE programme.

As always through the fund's unconstrained approach, Jim aims to take advantage of global trends to position the portfolio to generate the best returns in the prevailing economic conditions.

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