PRESENTER: For the latest update from the Prudential Portfolio Management Group, I'm joined by Barry Widdows, Head of Multi-Asset Portfolio Management. So Barry it's great to have you with us again.

BARRY WIDDOWS: Thanks.

PRESENTER: So 2018, how has that been so far?

BARRY WIDDOWS: If we look back at 2017, we had a really great year for multi-asset investors and particularly low volatility. Coming into 2018, we've had a bit of a change of picture certainly. I think this was really sparked at the end of January/start of February when we had some really strong earnings data out of the US. And there was some fears that this would provoke inflation to accelerate and then a monetary policy response on top of that. So we saw yields rise in response and that had a bit of an impact on equities too. Also, if we look at the equity market in particular, we had some stock specific news, a lot of noise going on there. We had the concerns over digital tax impacting the tech sector. We also had the Facebook scandal, of course, and a number of geopolitical issues. We had the Russian issue and the sanctions of the tit for tat, and an escalation in Syria.

So a huge amount of stuff going on in Q1 for the markets to digest and deal with, equities in Q1 were down mid-single digits, and we also saw some falls in fixed income assets down some modest amounts. So really a period of higher volatility, it's worth saying our product, the Pru Fund, is a smooth product. So while all this volatility is going on under the surface, actually our investors have been getting a stable known return through the period and not being impacted by the volatility.

PRESENTER: So which asset classes then have most rebounded since the end of Q1?

BARRY WIDDOWS: Sure, so most of the, I guess all the asset classes that sold off have really rebounded to some extent. Equities certainly, credit markets, and sovereign bonds, although it varies a little by region. In the UK and Europe, we've seen a reasonable rebound in sovereign rates there. Less so in the US treasury market, where yields are still round about 3%, so trading at the widest point. Also, when we think about the UK market, I think it's worth mentioning UK

equities, which have done particularly well over the last couple of months. We've had a period of weak sterling and a strengthening oil price, and both those factors are particularly beneficial for the UK market. When we look at the FTSE 100 index, it's made up of large oil stocks and large multinational companies which generate a lot of earnings overseas. So those factors are real tailwinds for that market. And we've seen it up the last seven weeks in a row actually and up about 12% over that period, so some great returns there.

PRESENTER: And at the May meeting of the Bank of England, Carney decided not to hike rates, what do you think were the factors behind this?

BARRY WIDDOWS: That's right. So the Bank of England kept rates on hold at 0.5%, and that was expected at the time of the meeting. Although if you look back only about a month before that, the market was really expecting, pretty much certainty a guaranteed rate rise. So we had quite a change in view over that period. I think there were a couple of factors that caused that. First was really some dovish comments coming out Governor Carney at the Bank of England, and secondly we had a raft of weak economic data coming through from the UK economy. So we had weaker inflation data, we had a quarter one GDP number which again was very weak, and then we also had some industrial production data, and more recently even survey data. So if you look at the purchasing manager index, again that's softening, so indicating forward looking indications that are weaker too. And I think you put all that together, and we're not really seeing inflation pick up as a result of the weaker sterling, that all takes the pressure of the Bank of England from raising rates in the short term, and I think they'll take that opportunity to hold off given the overhang of Brexit as well.

PRESENTER: And moving across the pond and earnings season in the US so far has been quite positive, so why have markets not responded more positively would you say?

BARRY WIDDOWS: Yes, so we're coming to the end of the earnings season. We've had about 450 of the 500 largest companies report. Earnings there have been really good as you say, so sales growth has been about 8% on those companies, and earnings growth close to 25%, so some really great numbers coming through. And when we look at the detail there, the sectors, oil and gas has been driving a lot of it, as you'd expect with the oil price and the recovery

from a beaten down sector. But we've seen strong earnings coming through from a breadth of sectors. In fact every sector in the US has beaten expectations on earnings this season.

So why? I mean markets have done well, but certainly you could argue they could have done better, given the incredible strength of earnings, and I think part of that is because when you buy an equity, it's very a forward-looking animal: you're buying a stream of a share of profits, the stream going forward. So what really matters is the outlook and not the reported earnings in the past, and so investors in the market are really focusing on what companies are saying during earnings season about the outlook. A good example was Caterpillar, so the company that makes those large construction vehicles and sells them globally, had absolutely knock out earnings. Earnings growth was up 120%, way ahead of expectations.

The stock was trading up initially when it announced those earnings, but the management made a small comment during the earnings call that the outlook was perhaps a little bit weaker, that maybe the high watermark had been reached, and perhaps we're at the top of the cycle. And all of a sudden the stock reverses direction. End of the day down 6% despite those incredible earnings. So it's really the forward looking picture that the market's focusing on. And I think that's particularly so given valuations are somewhat high, so there's less tolerance for the market to put up with any revised downward outlook.

PRESENTER: And bond yields in the US are hitting 3%, any cause for concern there?

BARRY WIDDOWS: Well I think 3% has certainly been a figure that a lot of people have banded around, but it's worth remembering there's nothing magical about 3%, and in fact you go back a few months people were talking about 2.6-2.8% as a potential triggering of a bear market in bonds. I'd say our view is that we shouldn't think about a particular figure. Although some participants in the market do set thresholds and could anchor around certain figures, so we're cognisant of those levels. But in our view it's more we should be looking at the relative attractiveness of US equities versus US bonds, and how that's changed over time. When we look in other regions, say Europe, we look at expected real yields on equities, and they look way superior to expected real yields on bonds.

That used to be the case in the US too, but the gap has certainly narrowed there, given the rally in equity markets and also the rise in interest rates.

PRESENTER: So considering all of this, how are your portfolios positioned at the moment, and talk me through the rationale behind this?

BARRY WIDDOWS: Sure, so we remain constructive equities, and I think really we're focusing on those markets which have the best prospective earnings yield. Examples at the moment would be in Europe and Korea where we see some value. In fixed income, we remain negative on UK and European fixed income in particular. You look at returns from those assets after inflation and they're negative, and that doesn't look like an appealing return to us over the medium term. In the US, it's a little more nuanced. We remain pretty neutral fixed income there, having been negative previously. But with the bias towards expecting a steepening the US curve, and actually positioned towards financial stocks which might benefit from that steepening also. And then I suppose valuations generally remain stretched in some areas, although we're seeing pockets of value still in emerging markets, and actually appear in some developed markets so like Japan as well.

PRESENTER: And finally any other interesting opportunities you're seeing?

BARRY WIDDOWS: Yes, I think one area that's really getting us a little excited now is actually US infrastructure. And everyone's probably heard of Trump's plan to build the wall and his infrastructure plan, but it's a much bigger opportunity than that. There's been a huge underspend over recent decades in US infrastructure. Some estimates put it at $2trn that need to be spent over the next 10 years just to plug the gap, so huge opportunity there to get involved. And in fact there's some interesting statistics. So if you look at bridges in US, 25% of all bridges in the US need to be replaced over the next eight years. It's a phenomenal number and a huge amount of expenditure needed. And then if you look at water supply systems. In the UK, we have about 30 water supply systems for the country, and each of those supplies about two million people. In the US, there are 65,000 separate water supply systems, and each only supplying about 5,000 people. So there's a huge opportunity for consolidation and efficiency, but it takes a lot of money to do that.

So I think the opportunity is huge, but it needs public private partnership, the P3 programme in the US, to take advantage of that. So we're looking to get more exposure to US infrastructure in our portfolios. And I think one of the advantages of the Pru Fund is that you need a large fund that can take on long-term illiquid assets to take advantage of this type of investment and get those uncorrelated returns, and we're lucky that we're in a position to do that.

PRESENTER: Barry, thank you.

BARRY WIDDOWS: Thanks.

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