

PORTFOLIO MANAGER COMMENTARY

The ALBI returned 2.4% for the quarter, most of which was made in January, while the fund returned 2.6%. Longer-dated bonds outperformed shorter-dated ones over the period, and the inflation-linked index outperformed vanilla bonds as CPI remained above the target range. Cash lagged bonds quite significantly, and has lagged even more when looking at a 12-month return. Inflation-linkers remain the best-performing fixed interest class over all time periods within the past 12 months. Note that the real return on cash has barely been positive over the last year, and on a forward-looking basis, current cash rates out to one year are expected to show negative real returns.

Bond and money market returns

Name	March 2012	3 months	6 months	12 months	Year-to-date
All Bond	0.12%	2.4%	6.0%	13.2%	2.4%
GOVI	0.13%	2.3%	5.9%	13.0%	2.3%
OTHI	0.04%	2.6%	6.2%	13.8%	2.6%
Bonds 1-3 Years	0.50%	2.0%	4.2%	9.7%	2.0%
Bonds 3-7 Years	0.23%	2.0%	5.4%	12.4%	2.0%
Bonds 7-12 Years	0.38%	2.5%	6.9%	14.6%	2.5%
Bonds 12+ Years	-0.37%	2.7%	6.1%	13.4%	2.7%

Cash	0.47%	1.41%	2.84%	5.76%	1.41%
Barclays/ABSA Govt Inflation-Linked Bonds	1.15%	2.7%	7.3%	14.8%	2.71%

Source: Deutsche Bank

Despite a plethora of global and local market news, bond yields were largely unchanged at the end of the quarter compared to end-2011, as the rally in January was largely reversed during February and March. A more convincing downward move was generally seen in inflation-linkers, particularly in the shorter-dated R189 where its real yield moved deeper into negative territory. It closed the quarter at -0.5% on a combination of higher inflation and potential buy-backs of the bond ahead of its maturity in March 2013.

On the global side, concerns about the Euro area ebbed somewhat as a restructuring agreement was reached on Greek debt, resulting in a 'voluntary' haircut of 75%. However, and despite the markets clearly showing relief, Greece is still not out of the woods: investors whose bonds fall under international (rather than Greek) law have still not reached agreement, and the Greek government continues to extend the deadline for these. The new 10-year bonds are already trading over 20%, indicating continued scepticism, and a third bail-out package is already being talked about. Meanwhile, concerns about Portugal remain, worries over Spain are increasing, and Ireland is to hold a referendum on the fiscal treaty on 31 May. Thus, while concerns about Euroland have receded for now, the potential for further upset from this angle is clear.

There was some divergence in core global bond yields over the quarter. German bunds barely moved, with the 10-year yielding 1.82% at end-March from 1.83% at end-2011. However, US bonds sold off somewhat on the reduction in risk aversion combined with some stronger-than-expected economic data. The US 10-year finished March at 2.21% from 1.88% at the previous quarter-end. SA bonds broadly tracked trends in the US, albeit finishing the quarter on a slightly stronger note.

The annual budget speech in February surprised markets on the positive side, with the Minister reining in the deficit projections. It has since been announced that the expected deficit for the fiscal year just ended (2011/12) is 4.5%, slightly better than expected at the time of the budget. Despite the better-than-expected data, bonds could not sustain much of a rally post the budget. This is partly because funding still remains high, and partly because there is some scepticism over the extent to which public sector wage increases can be contained – this being an important contribution to the expected lower deficit numbers. Moreover, soon after the budget and despite the improved numbers, Standard & Poor's joined Moody's and Fitch in attaching a negative outlook to its credit rating on South Africa, citing structural problems and the potential for politics to pressure the budget sometime in the future.

On the monetary policy side, although there is clearly no desire to raise interest rates anytime soon, the SARB has started expressing concern about more broad-based inflation pressures (albeit still in the context of a relatively sanguine inflation outlook). We agree that there is already evidence of these in the data, but are concerned that they may have more of an effect than is currently factored in by most analysts. We continue to see inflation above target through the first half of next year. The rand could be a game-changer, but continued passthrough from oil and food price hikes as well as the increasing likelihood of further second-round effects from petrol prices (with the Gauteng pump price nudging R12/l) keeps us cautious. We continue to believe that with inflation above target and growth around 3%, a negative real repo rate is too accommodative and we expect interest rates to start being normalised later this year.

Portfolio manager

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