

PORTFOLIO MANAGER COMMENTARY

I've got chills. They're multiplying. And I'm losing control. – Danny Zuko, from the song 'You're the one that I want' featured in the 1978 movie Grease.

The happenings in Greece have become the main driver of "risk on - risk off" investor behaviour throughout global financial markets. Will they default/restructure or won't they? If they do, will the contagion spread to those countries that are 'too big to fail and too big to bail' like Spain, for instance? While political leaders in the EU appear to have the will to bail Greece out, the Greek population seem vehemently opposed to the austerity measures that need to be introduced.

Under the now gloomy shadow of the Acropolis, the US 10-year bond yield rallied by around 50 basis points to below 3% during the quarter on some softer economic indicator data released in the US as well as safe haven demand as contagion from the Greek crisis continues to pose a threat to Euroland. Despite the fiscal woes of a number of European countries, the ECB has begun its rate hiking cycle. In April, ECB chief Jean-Claude Trichet hiked short rates by 25 basis points, followed by another 25 basis points in July after signalling 'strong vigilance' with regards to inflationary pressures in the last week of June.

Local bonds have taken their cue from US Treasuries. During the quarter, we have seen the yield on the R186 government bond (maturing in 2026) rally by around 30 basis points to close to 8.50%. Foreign investors have once again returned to the SA bond market and were the main drivers behind the rally. For the month of June alone, foreign investors bought approximately R13 billion worth of SA government bonds. With the rand being relatively stable during the quarter at around R6.80 to the US dollar, and still no sign of rate hikes in the US on the horizon, the carry trade is still alive and well from the foreign side.

Local inflation data continued on its upward trend, passing the midpoint of the SARB's inflation target range in June at 4.6%. Food and energy prices remain the key drivers of inflation and our expectation is that CPI will approach the upper end of the target range of 6% in the fourth quarter of this year. So far, the MPC appears reluctant to act on this rising trend in inflation and the rhetoric coming from the members appears to be that they are waiting for second-round effects to manifest themselves in underlying inflation before responding. With the repo rate currently at 5.50% and inflation heading for 6%, negative real short rates towards the latter part of this year appear to be on the cards. Against this backdrop, we still regard inflation-linked bonds (ILBs) - yielding between 2.50% and 3% real - as attractive alternatives in the SA fixed income space.

For the quarter, the All Bond Index produced a solid return of 3.9%, pretty much in line with ILBs (where one has seen some recent real yield compression) and well ahead of cash which only managed a 1.4% return. The fund was ahead of the benchmark for the period with a return of 4.01%.

Figure 3 : Bond and Money Market (local currency returns)

Code	Name	June 2011	3 months	6 months	12 months	Year-to-date
JAPI05	All Bond	0.16%	3.9%	2.3%	11.3%	2.3%
GOVI	GOVI	0.18%	3.8%	2.3%	11.2%	2.3%
OTHI	OTHI	0.06%	4.5%	2.0%	12.2%	2.0%
JAPI01	Bonds 1-3 Years	0.54%	2.2%	3.5%	7.8%	3.5%
JAPI02	Bonds 3-7 Years	0.57%	3.2%	3.2%	9.9%	3.2%
JAPI03	Bonds 7-12 Years	0.09%	4.0%	2.5%	11.7%	2.5%
JAPI04	Bonds 12+ Years	-0.30%	4.9%	0.8%	12.1%	0.8%
GMC1	Cash	0.47%	1.4%	2.8%	6.1%	2.8%
BSAGI	Barclays/ABSA Govt Inflation-Linked Bonds	0.90%	3.8%	5.0%	10.9%	5.0%
J251	Preference Share Index	2.17%	1.0%	-0.3%	5.1%	-0.3%

Source: Deutsche Bank

On the domestic fiscal front, a substantial deficit still needs to be funded. Large weekly government auctions of R2.1 billion fixed-rate bonds and R600 million ILBs continue to take place and this is unlikely to change in the near future. Given the relatively large supply of bonds, coupled with rising inflation and our view that the next move in short rates is likely to be up, it is hard to envisage a further meaningful rally in long bond yields in the near future from current levels.

We continue to favour running shorter duration positions in our fixed interest portfolios and remain invested in ILBs.

Portfolio manager

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