

PORTFOLIO MANAGER COMMENTARY

The All Bond Index (ALBI) returned 2.1% in March, with gains driven by the longer end. The return for the quarter was 4.4%. These returns outstripped those of cash and inflation-linked bonds, both in March and for the quarter as a whole.

Bond and money market returns					
Name	March 2010	3 months	6 months	12 months	Year-to-date
All Bond	2.11%	4.4%	5.6%	9.0%	4.4%
GOVI	2.09%	4.4%	5.5%	8.8%	4.4%
OTHI	2.17%	4.9%	6.0%	10.1%	4.9%
Bonds 1-3 Years	1.02%	2.6%	4.6%	8.1%	2.6%
Bonds 3-7 Years	1.62%	4.0%	5.7%	9.4%	4.0%
Bonds 7-12 Years	2.51%	5.6%	6.6%	9.8%	5.6%
Bonds 12+ Years	2.24%	3.6%	4.1%	7.5%	3.6%
Cash	0.60%	1.8%	3.7%	7.9%	1.8%
Barclays/ABSA Govt Inflation-Linked Bonds	0.39%	0.0%	0.2%	5.1%	0.0%

Source: Deutsche Bank

Bond yields have been in a general downward trend since mid-January, a trend that was maintained in March and which gained momentum following the SARB's decision to cut the repo rate by 50 basis points (to 6.5%) at the MPC meeting on 25 March. The SARB's move, which had not been fully discounted in the markets, was enabled by a combination of lower-than-expected inflation, and generally still soft economic data as well as continued rand strength which bode well for further disinflation. At this stage, we believe that most of the expected good news is factored in and our base case would be for rates to remain on hold for the remainder of this year.

Inflation re-entered the 3% - 6% target range in February at 5.7% (data released in March), which was sooner than many had expected. We think that underlying trends in consumer inflation look positive at the moment; there seems to be an absence of any significant demand-side pressure, while a broad number of categories continue to show beneficial influences from the currency. Indeed, most of the rand-sensitive categories are either within or below the inflation target range. The main factors holding inflation up continue to be administered prices, and even these appear to be less of a problem than had initially been expected (e.g. the Eskom price increase being approved at a lower level than requested). We think CPI could fall to around the mid-point of the target range during the course of this year. Movements in the rand will continue to be crucial and a reversal of rand strength remains a key risk.

Although growth has undoubtedly bottomed and is moving noticeably higher, this so far seems to be led principally by manufacturing (linked to exports and the global recovery) and domestic car sales (coming off an exceptionally battered base). In general, domestic growth indicators remain soft – for example, credit extension is still negative year on year. We do expect that growth will spread more widely over the remainder of the year, due to a combination of jobs recovery in manufacturing and the effects of low interest rates (and the strong rand) in general on domestic demand. While this will be positive – especially for tax revenues – it also brings a concern that, at some stage, the current account deficit will widen out again and start to be a negative for the currency (and in turn for inflation).

On 1 April, National Treasury announced preliminary revenue and expenditure data for the fiscal year ended March 2010, which showed revenue collections had picked up significantly towards the end of the fiscal year. Thus, just six weeks after the Budget Speech, Treasury has been able to revise the 2009/10 Budget deficit down by 0.5% of GDP to 6.8% of GDP. While no revisions have been made for the 2010/11 fiscal year, we feel it is quite likely that the number will be revised down from what we consider a conservative estimate of 6.2% of GDP. Even with these numbers, though, it should be noted that supply into the domestic bond market will remain at multi-year highs (especially if one takes parastatals into account).

The generally positive domestic news was underpinned by a move lower in emerging market spreads over March. However, another latent risk for both SA and emerging market bond yields in general arises from the US bond market, where yields have recently moved higher on a combination of stronger growth data and large supply, even despite expectations of interest rate rises being pushed out as core inflation surprises on the downside. As quantitative easing programmes start being wound down, we expect that supply issues will continue to dominate US and other developed bond markets. At some stage, though now it is looking more likely to be in 2011, major central banks will have to start reversing emergency low levels of interest rates as well. It is thus difficult to see an outcome where global bond yields do not continue rising into 2011, and this will almost certainly have an impact on SA yields.

We thus remain in a position of largely balanced risks, where shorter-term domestic outcomes have been positive for bonds (and may be so for some months yet), but where there are concerns about the longer term. As a result the fund has tended to remain largely neutrally positioned in terms of duration. Overseas investors seeking higher global yields have been more active during 2010 helping fuel the rally both in medium-dated bonds but also in the rand.

The fund reduced its exposure to long-dated maturities following the budget announcement of two new longer-dated issues and increased its holding of inflation-linked bonds to 8% as real yields weighed down by supply increased to attractive levels. Corporate bonds spreads also began to tighten as new deals were increasingly well supported.

Portfolio manager

Mark le Roux