Please note that the commentary is for the retail class of the fund.

The fund returned 2.23% over the last quarter, bringing its return over past 12 months to 11.31%, well above its benchmark (0.01% and 1.09% respectively).

The last quarter of 2017 was particularly eventful in the local bond market. Following the poor Medium Term Budget Policy Statement in October, when SA's fiscal deterioration became a reality, the local 10-year bond sold off aggressively from 8.6% to a high of just above 9.5%. As previously highlighted, these higher levels were a better reflection of underlying risks in the local economy given the policy and political backdrop. Up to the ANC elective conference in December, SA bonds spent most of the quarter at levels of around 9.25% to 9.5%. As Cyril Ramaphosa emerged as the new president of the ANC (and possibly the country), the local bond market rallied to close the year at levels of 8.59%. Before December, there were expectations that bonds would underperform cash for the year, but the All Bond Index (ALBI) ended 2017 up 10.2% (gaining 5.66% in December alone). This is significantly above the performance of cash and inflation-linked bonds, which returned 7.5% and 2.8% respectively. The bulk of the ALBI's performance came from the three- to seven-year and the seven- to twelve-year buckets, which both returned just over 11%, driven primarily by the falling repo rate over the course of the year.

2018 will be a very important year for SA, and the performance of the local bond market will anchor three key outcomes. The first outcome is the ability of government to push through reforms that support a recovery in growth, which is directly tied to Mr Ramaphosa being able to exert his influence as the new leader of the ruling party on policy direction. The second outcome is the trajectory of inflation over the course of the next two years and its implication for the path of the SA repo rates. Finally, the evolution of the global monetary policy environment and its impact on emerging markets will have a large bearing on the direction of international and hence local bond yields.

The issue of policy inaction has led to a steady deterioration in SA's credit fundamentals, as illustrated by the constant downgrades of SA's credit rating over the last two years. SA is now rated below investment grade by all but one of the rating agencies, Moody's (which has SA one notch above subinvestment grade, but intends to pronounce judgement before the end of February). Moody's will be looking for some evidence that government is trying to halt the current path and trajectory of fiscal deterioration, as well as for indications of pro-growth reforms. For SA to avert a downgrade to below investment grade and consequently an exit from the Citigroup World Government Bond Index (WGBI), we would have to see corrective actions implemented at many of the large state-owned enterprises to alleviate concerns around financial stability and more importantly, governance. This would imply the need for new or revamped boards and management teams that could restore confidence in these institutions. In addition, one would have to see a more fruitful partnership between government and the private sector to kick-start growth. Whether Mr Ramaphosa can implement such changes, despite an already divided ruling party, is a question that is unfortunately beyond the scope of this report. However, given that Mr Ramaphosa is seen by the market as a reformist and corporate SA has not spent any money over the last year, we could see a boost to economic growth from 'relief spend' over the first two quarters of 2018, taking growth to above 1.5% for the year. Whether this growth would be sustainable would rely on how quickly reforms are implemented. Moody's will more likely than not be willing to give SA a stay of execution if there is evidence that the country is turning a corner. Even if the downgrade does come, the global backdrop and trajectory of SA economy will play a much more vital role in determining where the local bond market settles.

Two key developments should support a lower (or at least a more stable) inflation profile over the next year. First, the rand has rallied 11% this year, which will continue to subdue the rand price of oil and overall import inflation. Second, the recent decision to only award Eskom a 5% tariff increase, while a problem for Eskom's liquidity, is good news for inflation. The combined effect is that at the bare minimum we should see inflation average 5% to 5.5% over the next two years, implying the real policy rate will average 1.75% to 1.25%. This should allow the SA Reserve Bank (SARB), at worst, to keep the repo rate stable over the next two years and probably bias the next move to the downside.

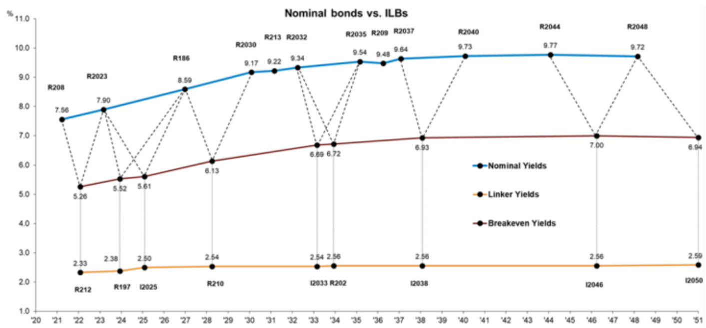
Globally, the path and pace of the increase in US interest rates will remain a key driver for global bond yields. Current market pricing suggests that the federal funds rate will move up to 2% by the end of 2019, slightly below the Federal Reserve's (Fed) own projection of 2.25%. Even if the current term premium (the difference between the US 10-year bond and the federal funds target rate) of 100 basis points (bps) is maintained and the Fed does moves its target rate to 2% to 2.25%, this implies that the US 10-year bond should be in the 3% to 3.25% range as opposed to the current level of 2.4%. Given the current US administration's embrace of pro-growth policies, risks to US inflation will remain tilted to the upside, suggesting the US 10-year bond might overshoot the 3% to 3.25% target. More importantly, however, as history has shown us, is the pace at which global bond yields move higher. If they continue to move higher at a gradual and measured pace, this would maintain a supportive environment for emerging markets. An abrupt change in the direction of monetary policy in the US or the EU, with both aggressively removing monetary policy accommodation, would have a more disruptive impact on emerging markets.

In the table below, we bring together the various elements of our fair value model and then incorporate some of the main points from our discussion in this article. The key takeaway is that at current levels, the SA 10-year bond is fairly valued. Under an adverse outcome (scenario B), we could see a 50 bps move higher in yields, while under a favourable outcome (scenario A), we could see a 58 bps compression in yields. Under scenario A, we assume that the market is correct and the Fed only hikes interest rates twice this year, that SA inflation averages 5% over the next year and that SA adopts a reform agenda as is currently expected. With scenario B, we assume that the Fed hikes four times, SA inflation averages at the top end of expectations (5.5%), US inflation averages 2.25% (resulting in the aforementioned four hikes) and that SA's reform agenda takes longer to implement, resulting in a wider credit spread. Although the risks to the implementation of policy adjustments by Mr Ramaphosa remain high, the fact that he has been appointed the leader of the ruling party and has acknowledged the need for government to clean up its act does leave the risks biased towards further compression in bond yields towards the levels suggested by scenario A.

	Market Level (29/12/2017)	Scenario A	Scenario B
US 10-year bond	2.40%	3.0%	3.5%
Market-implied 10y average inflation expectation for SA	6.09%	5.0%	5.5%
Market implied 10y average inflation expectation for US	-1.98%	-2.00%	-2.25%
South Africa sovereign risk spread	2.2%	2.2%	2.5%
Implied fair value of SA 10-year bond	8.71%	8.2%	9.25%
Current SA 10-year bond	8.78%	8.78%	8.78%
Cheap/(Expensive)	7bps	58bps	(47bps)

An event that could prove problematic is if Moody's chooses to downgrade SA to subinvestment grade, resulting in an exit from the Citigroup WGBI. The magnitude of the associated outflow could be anywhere between $5 billion to $9 billion, which is quite sizeable. However, much depends on the global environment and the trajectory of the local economy. If we are still loosely following the conditions suggested in scenario A, the outflows could be easily digested. This will have very little sustained impact on bond levels, as market participants will use the flow to allocate more to SA government bonds. However, if fiscal consolidation and the reform agenda continue to be pushed out, it is likely that the SA 10-year bond will settle at levels of 9.25% to 9.5%. Despite our expectation for a recovery in the SA economy over 2018, given the symmetric nature of the yield moves, we choose to maintain a neutral outlook on SA government bonds. To build an overweight position, we require better levels to provide a more adequate margin of safety.

Inflation-linked bonds (ILBs) had a tumultuous year, underperforming bonds and cash considerably. Given the current implied market breakeven inflation levels, we still see little value in ILBs with a maturity of greater than seven years. The market expects inflation to average above 6% (close to 7% in the longer-dated bonds), which, given our inflation expectations (5.5%), remains too rich (see the graph below). Our preference is to hold longer-end nominal bonds instead of ILBs. The shorter end of the ILB curve remains an area of interest. Average inflation breakeven levels sit between 5.25% and 5.5%, which is more in line with our forecast and provides one with protection against inflation moving above 5.25% to 5.5%. In addition, with the SARB's real policy rate target being closer to 1.5%, these shorter-end real yields will remain well anchored, increasing their attractiveness.



The SA economy could be at a key turning point if the newly elected ruling party leadership is able to push through much-needed growth reforms, stabilise ailing parastatals and restore confidence in the SA economy. SA's growth could receive a short-term boost from inventory renewal as SA corporates start to spend again after a year-long hiatus. Inflation will remain well behaved, with chances of further downside surprises adding to the case for a lower repo rate. SA government bonds should benefit from this renewed optimism and contained inflation. However, at current levels they are only at fair value, and with exclusion from the Citigroup WGBI Index still a possibility, we are neutral on SA government bonds. We require more attractive levels to enter overweight positions.

Portfolio managers
Mark le Roux and Nishan Maharaj
as at 31 December 2017