CORONATION GLOBAL STRATEGIC USD INCOME [ZAR] FEEDER FUND

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Quarterly Portfolio Manager Commentary

Please note that the commentary is for the US dollar retail class of the fund. The feeder fund is 100% invested in the underlying US dollar fund. However, given small valuation, trading and translation differences for the two funds, investors should expect differences in returns in the short term. Over the long term, we aim to achieve the same outcome in US dollar terms for both funds.

Short-dated government bond returns within developed markets were modest at best as short dated yields drifted higher. The upswing in global growth continues and inflationary pressures remained absent, which has lent support to riskier asset classes. Corporate bonds rallied alongside equities, producing another solid quarter of gains. Despite rising short-dated bond yields, the US dollar continued to languish. The fund enjoyed a strong quarter, rising by 1.3% versus the benchmark return of 0.41%. During 2017, the fund delivered 2.37%, outperforming its benchmark by 0.95%.

Volatility within the US Treasury market remains very low, with 10-year yields having trading around 2.35% for most of the quarter and one-year realised volatility having fallen to its lowest level since the early 1980s. The US yield curve has continued to flatten aggressively, with two-year yields rising 40 basis points (bps) during the quarter while 30-year yields fell 10 bps. The vast majority of the movement in rates has come through changes in real rates as breakeven rates were very stable during the quarter. The Federal Reserve (Fed) raised the Fed funds rate by another 25 bps in December (the rate's upper band is now 1.5%), and its projections suggest a further three rate hikes in 2018. This is in contrast to the market, which currently prices in just two rate hikes. Jay Powell, a Fed Governor since 2012, is set to replace Janet Yellen as the chairperson in February. While markets do not anticipate material policy changes, Powell's apparent willingness to embrace the nitty-gritty of financial markets may prove valuable as the Fed continues to wind down its balance sheet.

When the Fed updated its Summary of Economic Projections in December, its GDP projection for 2018 rose from 2.1% to 2.5%. The subsequent minutes revealed that this amendment captures some of the anticipated effect (seen at around 0.5% in 2018 and probably slightly less for 2019) from the tax reform package that was passed in December. Longer-term expectations for GDP growth were left unchanged, and most economists are sceptical of the administration's claims that the reform will lead to a sustainable boost to growth. Given the already tight conditions in areas such as the labour market, it is more likely the reform (which comes with a front-loaded bias) will merely lead to magnify the cyclicality of the current economic cycle.

It may seem odd that the debt ceiling issue remains unresolved at the very time the US has passed $1.5 trillion worth of tax cuts (over a 10-year period), 30% of which will be front-loaded over 2018 and 2019, boosting the fiscal deficit by just under 1% in these two calendar years. A divided Congress needs to agree on a long-term spending bill by the 19th of January to avoid another government shutdown, with the new tax bill potentially bringing forward the date (to mid-March) by which the US Treasury will exhaust its cash reserves. To add to the fiscal mix, the Trump administration, now emboldened by the passage of the tax bill, has said it will make infrastructure the next big legislative priority. However, delivering tax cuts to the already healthy consumers and the private sectors of the economy will make it more difficult to fund any upgrades to the country's aging public infrastructure that may have improved the economy's competiveness and potential growth rate.

Our view has been that the Fed would surprise the market with its determination to normalise policy, and hence the fund has maintained a very short duration position. This allowed the fund to protect itself against the recent rises in short-dated US yields. With the short end of the yield curve now having steepened, there is more protection inherent in yields, and we are slowly increasing the funds duration. However, in maturities beyond five years, we believe the curve remains too flat and the minimal term premium offers little return.

Sentiment towards Europe has improved markedly and economic activity looks balanced and sustainable, with euro area GDP likely to be around the mid-2% level in 2018. Core inflation measures signal some upward pressure is underway, and pressures on wage growth are also likely to become more prominent in 2018. For now though, the European Central Bank's (ECB) commitment to ultra-low rates and continued quantitative easing remain extremely powerful drivers of yields. Markets expect the ECB's deposit rate to remain negative until early 2019, guided by ECB president Mario Draghi's comments that rates will not change until "well past" the end of the asset purchase programme (current purchases to fall from €60bn to €30bn a month from Jan 2018), which is expected around the third quarter of 2018.

In the UK, Gilts performed well despite the Bank of England (BOE) reversing the 25 bps emergency rate cut in November that has been put in place following the Brexit referendum decision. The UK was deemed to have made "sufficient progress" to begin phase 2 of Brexit negotiations. While that may seem encouraging, it merely brings one closer to the make or break decisions that need to ultimately take place. With inflation above target, it seems likely the BOE will hike again during 2018. With real yields in deeply negative territory, there seems little value given the uncertain backdrop.

The outlook for corporate credit meanwhile looks more challenging after another very strong performance in the past quarter. Credit spreads are now largely back to pre-financial crisis levels as corporate bonds with a maturity of between one and five years outperformed government bonds by 0.3% during the last three months, taking their annual outperformance to around 2% for 2017. Stronger economic growth and slightly more debt-friendly corporate behaviour does lend support to credit markets, but arguably valuations already reflect this and in the absence of significant drawdowns the market may be complacent. Despite large volumes of new issuance, inflows into the asset class has meant credit availability has often been scarce, dissuading selling and dampening volatility. The challenge for credit markets in 2018 will be how they wean themselves off the support that has emanated from central bank's quantitative easing (QE) programmes. While national QE programmes are important, the cross-border effects are also material. In this regard, the reduction in the ECB's programme is especially interesting as low rates in Europe have seen investors selling European bonds to the ECB and buying assets overseas. These volumes are not immaterial, with net foreign buying of US spread products equal to half the net issuance of US investment grade issuance in 2017. Global buying from central banks during 2018 will be approximately $1 trillion less than in 2017.

The fund has been adopting a conservative stance within credit for some time now, investing in high-quality shorter-dated instruments. Where possible we have sought to enhance the asset quality of our holdings, with compressed spreads. The ability to switch unsecured senior bank paper into covered bonds for minimal spread differences has been the type of trade we have looked to execute. Very short dated paper (> one year) has become expensive and with government yields steepening, the fund also favoured instruments in the 12-18 month region of the yield curve. Tighter swap spreads have also seen the fund reduce its exposure to instruments such as supranationals that typically trade relative to swaps. Within higher-yielding instruments, we believe some of the best opportunities lies within convertible bonds and the fund has increased its exposure to the asset class.

Within foreign exchange markets, the continued weakness of the US dollar is noteworthy as it is at odds with the rising interest rate differentials, relative upside surprises in economic data and more recently the likely support that should flow from the US tax reforms. For now it seems the politics of a Trump administration are outweighing the fractious politics within Europe. Cross-currency opportunities (driven by dislocations in the foreign currency swaps markets) have been scarce in the last six months, with short-dated Canadian instruments offering the best opportunities. We see a number of reasons why opportunities may re-emerge (such as tax reform driving US dollar repatriation), and remain alert to the opportunities. In the final days of 2017, there were very sizable dislocations caused by a shortage of US dollars in the interbank markets, and this allowed us to put on very attractive hedged positions in euros and yen. Since the year end, these disruptions have alleviated, allowing us to book attractive profits on the trades.

The fund's exposure to property was increased slightly to around 4% of fund, and shares subsequently enjoyed a better quarter (with the global property index up 3.8%) having struggled mid-year against the backdrop of rising bond yields and adverse sentiment towards the retail sector. Premium US malls where we had increased our exposure received a much needed boost from corporate activity. GGP received a bid from its principal shareholder Brookfield Property Partners at a 20% premium. The fund exited its position slightly above the bid level. Taubman and Macerich also disclosed stakes obtained by high-profile activist hedge funds. Australian-listed Westfield, which operates 17 flagship malls in the UK, US and Europe, also received a bid from Unibail, which the fund owns. Within the UK, Hammerson launched an all share offer for rival Intu. The fund has exposure to both companies. Within Australia, our holdings of Growthpoint Australia and Cromwell both recovered strongly and the fund sold its exposure. The fund also sold its holding of Redefine International as better value was seen in other stocks. German residential stocks were up between 10-15% during the quarter as strong fundamentals continue to underpin the sector. Regulatory price controls are probably the biggest constraint to further upside in these stocks.

While the sentiment within equity markets remains buoyant, we believe the valuations of many asset classes are far from cheap and the fund's exposure to duration remains low and its sensitivity to credit spreads modest. Property exposure is around average at 4%, and the sector still offers a decent yield pickup versus corporate bonds. If central banks follow through and sizably reduce asset purchases, then we suspect volatility is likely to rise and with it opportunities for the attentive investor.

Portfolio managers
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