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

The fund returned 1.41% in December, bringing its total return for the 12-month period to 9.31%. This is well ahead of the returns delivered by both cash (7.09%) and its benchmark (7.82%) over the same one-year period.

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 we have been highlighting for some time, these higher levels better reflect the 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 down 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 7.1% and 2.9% respectively. The bulk of the ALBI's performance came from the 3 to 7 year and 7 to 12 year buckets, which both returned just over 11%, driven primarily by the falling repo rate over the course of the year.

Calendar 2018 will be a very important year for South Africa and the performance of the local bond market will anchor off three key outcomes. Firstly, 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 the direction of policy. Secondly, the trajectory of inflation over the course of the next two years and its implication for path of the SA repo rates. Finally, the evolution of the global monetary policy environment and its implication for emerging markets will have a large bearing on the direction of global and hence local bond yields.

The issue of policy inaction has led to a steady deterioration in SA 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 sub investment 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. In order for SA to avert a downgrade to below investment grade and consequently an exit from the Citi World Government Bond Index (Citi WGBI), we would need 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 need to see a more fruitful partnership between government and the private sector in order 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. Firstly, 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, at worst, to keep the repo rate stable over the next two years and probably bias the next move to the downside.

At the end of December, shorter-dated negotiable certificates of deposit (NCDs) traded at 8.135% (three-year) and 9.715% (five-year) respectively, down approximately 50 to 70bps in the last week of the month, reflecting the change in interest rate expectations (from 75bps of hikes to no change). NCD spreads relative to cash remain at quite tight levels due to a compression in credit spreads. NCDs continue to hold appeal due to the inherent protection offered by their yields, however the hunt for yield in the local market has started to push bank credit spreads into expensive territory (less than 100bps in the three-year area and 130bps in the five-year area). The fund continues to hold decent exposure to these instruments (both floating and fixed), but we will remain cautious and selective when increasing exposure. NCDs have the added benefit of being liquid, thus aligning the liquidity of the fund with the needs of its investors.

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 federal funds rate will move up to 2% by the end of 2019, slightly below the Federal Reserve's own projection of 2.25%. Even if the current term premium (the difference between the US 10-year bond and the fed funds target rate) of 100bps 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 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 global bond yields 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 EU, with both aggressively removing monetary policy accommodation, would have a more disruptive impact on emerging markets.

The rand had a massive month in December, recovering to R12.38 to the dollar (up 10.62% up for the month and 10.96% for the year). This performance was primarily driven by the appointment of Cyril Ramaphosa as the president of the ANC and expectations that he would swiftly adopt measures to put the economy back on the path to recovery. The fund benefited from holding put options on the dollar against the rand, which had the effect of synthetically reducing the fund's offshore exposure as the rand rallied following Mr Ramaphosa's election. The fund maintains a healthy exposure to offshore assets, and when valuations are stretched, it will hedge/unhedge portions of its exposure back into rands/dollars by selling/buying JSE-traded currency futures (US dollar, UK pound and euro). These instruments are used to adjust the fund's exposure synthetically, allowing it to maintain its core holdings in offshore assets. (It has the added benefit of enhancing the fund's yield when bringing back offshore exposure into rand.)

The fund has continuously used any spike in yields as an opportunity to add selective exposure to the longer area of the bond curve (12y+) at levels of around 10.25% to 10.50%, given its attractive return prospects relative to cash over the longer term. 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 Corporate SA starts to spend again after a yearlong hiatus. Inflation will remain well behaved with a chance 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 Citi WGBI still a possibility, we choose to be neutral on SA government bonds, looking instead for more attractive levels to extend duration further.

The SA listed-property sector gained 4.21% in December, bringing its return for the year to 17.86%. From our recent interactions with many of the listed property companies, it is clear that poor economic conditions have started to affect the local property market. Still, we remain confident that the sector offers selective value. The changes in the property sector over the last decade (including the increased ability to hedge borrowings and large offshore exposures) have rendered the yield gap between the property index and the current 10-year government bond a poor measure of value. On the surface, it appears quite stretched. However, if one excludes the offshore exposure, the property sector's yield rises to approximately 8.3%, which compares very favourably to the benchmark bond. The fund maintains holdings in counters that offer strong distribution and income growth, with upside to their net asset value valuations. In the event of a moderation in listed property valuations (which may be triggered by further risk asset or bond market weakness), we will look to increase the fund's exposure to this sector at more attractive levels.

The preference share index was down 2.58% in December, bringing its 12-month return to -3.36%. Preference shares offer a steady dividend yield, linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 8.5% and 11% (subject to a 20% dividends tax, depending on the investor entity). The change in capital structure requirements mandated by Basel III will discourage banks from issuing preference shares. This will limit availability (and boost possible buybacks). In addition, most of the bank-related preference shares trade at a discount, which enhances their attractiveness for holders from a total return perspective and increases the likelihood of bank buybacks. Despite attractive valuations, this asset class will continue to dissipate given the lack of new issuance. It stands at risk of being classified as eligible loss absorbing capital. The fund maintains select exposure to certain high-quality corporate preference shares, but will not actively look to increase its holdings.

We remain vigilant of risks emanating from the dislocations between stretched valuations and the underlying fundamentals of the SA economy. However, we believe that the fund's current positioning correctly reflects appropriate levels of caution. The fund's yield of 8.98% remains attractive relative to its duration risk. We continue to believe that this yield is an adequate proxy for expected fund performance over the next 12 months.

As is evident, we remain cautious in our management of the fund. We continue to invest only in assets and instruments that we believe have the correct risk and term premium, to limit investor downside and enhance yield.

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