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

The fund returned 0.7% in August, bringing its total return to 4.8% for the year and 7.8% for the 12-month period. This is well ahead of the returns delivered by both cash (6.9%) and its benchmark (7.6%) over the same one-year period.

After a brief reprieve in July, August was a brutal month for emerging bond markets, and South Africa was not unscathed. The aggregate index fell 1.9% on the month and weakness was broad based. Longer dated bonds (12+ years) lost 2.4%, while the belly of the curve (7-12years) was down 1.6%. Short dated bonds were up a little at 0.2%, while inflation linkers fell 0.2%. Cash returned 0.6% in August.

August's market news was dominated by an escalation in trade tensions and market weakness in emerging markets. Concerns about the impact of more normal developed market monetary policy settings have increased with the recovery in second-quarter growth, exposing vulnerable emerging markets to a reassessment of related risk. Turkey and Argentina were initially hardest hit, but a general decline in risk sentiment, combined with heavy losses to emerging market positions broadened the impact on other emerging markets and exacerbated the situation. In developed markets, central banks and the private sector alike noted concerns about the impact of rising trade tension.

A closer look at the economic data shows growth in the US continues at a healthy clip. Second-quarter real GDP was revised up to 4.2% quarter-on-quarter (q/q), and early data for the third quarter of this year suggest a healthy tracking at about 3% based on a combination of softer housing data, offset by strong durable goods orders. In July, consumer prices rose 0.2% month-on-month (m/m) both at the headline and core levels. The annual pace of headline inflation was unchanged at 2.9%, while that of core inflation edged higher to 2.4%. Compensation data show healthy wage growth – revised data for non-farm compensation per hour accelerated to 3.1% year-on-year (y/y) in the first quarter of the year from 2.7% in the previous data.

In Europe, political news flow quietened ahead of Italy's budget submission by mid-October, and the next European Council on Brexit on 18-19 October. Economic data has been mixed in August, but continue to suggest economic stabilisation with some downside risk. GDP accelerated to 0.5% quarter-on-quarter (q/q) in the second quarter of the year, and tracking data suggest GDP of 0.47% in the third quarter. PMI data released for August however, were moderately below expectations, albeit still in expansionary territory at 54.4. Expectations however continue to slide lower. Headline CPI decelerated to 2.0% y/y from 2.1% y/y in July. Core inflation was just 1.0% y/y.

The ECB Governing Council reiterated its view that the markets were pricing its guidance correctly and that uncertainties surrounding the inflation outlook are receding. While (largely external) growth risk is deemed to be to the downside, and prominent, no changes to current monetary guidance emerged.

In the UK, the risk of a 'no deal' remain high as the October European Council meetings approach with no internal agreement on proposals put forward by PM May. EU negotiator Michel Barnier publicly stated his strong opposition to the future trade relationship proposed by the Chequers plan and highlighted an agreement is needed 'well before the end of the year'. Economic data were mixed here too. Second-quarter GDP rebounded after a weak start to the year with growth at 0.4% q/q from 0.2% in the previous quarter, and July retail sales rebounded to 3.5% y/y from 2.9% in June on good weather, sports events and a general improvement in sentiment. But forward-looking PMI data weakened in August and consumer confidence has since fallen back. South Africa's weak growth was confirmed with a well below-consensus contraction of -0.7% q/q seasonally adjusted and annualised (saa), and 0.4% y/y in the second quarter, which put the economy back in recession. Supply-side data showed a big contraction in agriculture of -29.2% q/q saa, following -33.6 in the first quarter – larger than most expectations. However, the weakness was broad-based, with manufacturing, transport and worryingly, trade and government services all contracting in sequential terms. Demand side data showed a combination of weaker capex, inventories and also of concern, household spending was only partly offset by a rebound in net exports. Looking ahead, GDP is expected to firm, but unlikely to exceed 1% in 2018.

Inflation remains broadly contained, although rising retail fuel prices have pushed headline higher. CPI was 5.1% y/y in July from 4.6% in June, while core inflation was unchanged at 4.3% y/y. Recent currency weakness is likely to continue to place some pressure on fuel prices, but the degree of weakness in the underlying economy remains a constraint on more general pass through. The SARB MPC left the repo rate unchanged at 6.5% in July.

At the end of July, shorter-dated fixed rate negotiable certificates of deposit (NCDs) traded at 8.8% (three-year) and 9.4% (five-year) down slightly over the month. The spreads of floating rate NCDs have dulled in appeal over the last few quarters, due to a compression in credit spreads. There has been a reduced need for funding from banks in South Africa, given the low growth environment. Fixed rate NCDs continue to hold appeal due to the inherent protection offered by their yields and relative to our expectations for a stable repo rate. However, credit spreads remain in expensive territory (less than 100 basis points in the three-year area and 130 basis points in the five-year area). The fund continues to hold decent exposure to these instruments (less floating than 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.

The rand was down 9.6% in August, ending at 14.69 to the dollar. Emerging market sentiment soured continuously during the month, following aggressive selloffs in the Argentinian peso and Turkish lira. This combined with continued uncertainty on South Africa's land reform policy and poor growth numbers propelled the rand to its weakest levels in two years. The fund maintains its 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 offshore exposure back to rand.)

South Africa's long-term economic prosperity is being hampered by short-term uncertainty on direction of key policy initiatives with regards to land, SOE and mining reform. This has continued to hamper new investment and spending, which has dragged South Africa's growth prospects lower yet again. Inflation is expected to remain stable and well contained, despite the weaker currency and disappointing GDP growth print. Local bonds have adjusted to reflect realistic expectations for the local economy and the more unfriendly global environment. South African bonds compare favourably to their emerging market peers, relative to their own history and offer a decent cushion against further global policy normalisation. At current levels, the yields on offer in the local bond market are attractive relative to their underlying fundamentals and warrant a neutral to overweight allocation.

The local listed-property sector was down 2.5% in August, bringing its return for the rolling 12-month period to -10.5%. Despite the underperformance over the last few quarters, from a valuation perspective, the sector is still very attractive. 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. If one excludes the offshore exposure, the property sector's yield rises to approximately 10.3%, 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. 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 up 3.2% in August, bringing its 12-month return to 6.0%. Preference shares offer a steady dividend yield, linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 9% 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. 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 and because it stands at risk of being classified as eligible loss-absorbing capital (only senior to equity). 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 local economy. However, we believe that the fund's current positioning correctly reflects appropriate levels of caution. The fund's yield of 9.2% 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 , Mark le Roux and Mauro L ongano
as at 31 August 2018