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

If you want to see the sunshine, you have to weather the storm, but in order to weather and navigate the storm, you have to adjust your sails. At Coronation, we are constantly questioning the assumptions that underlie our valuation-driven approach to investing so as provide our clients with portfolios that are anti-fragile and best positioned to withstand the shorter effects of adverse volatility.

The fund returned 0.9% in December, bringing its total return to 7.3% for the year. This is ahead of the returns delivered by cash (6.9%) and behind its benchmark (7.6%) over the same one-year period. Over two and three years, the fund still remains well ahead of both cash and its benchmark. 2018 was a difficult year, with almost all investable assets classes underperforming cash. The exceptions were bonds (7.7%), preference shares (15.0%) and offshore assets (rand depreciated 13.8% against the US dollar). Over the years, we have continuously flagged that in periods of high volatility and over shorter measurement periods, investors should expect returns that are in line with that of cash. 2018 was such a year; however, the fund remains well positioned to benefit from the attractively priced assets that it currently owns.

2018 was a difficult year for emerging markets and more especially for emerging market fixed-income investors. The year started with tremendous promise as emerging market bond yields and currencies appreciated markedly. Then the tide turned. The US/China trade war escalated, raising concerns about global growth expectations, which we now know to be too high. Around about the same time, the US Federal Reserve (Fed) started to lift its expectations for the US economy and consequently, its expectations around US interest rates. This combination of higher-than-expected US rates, lower global investor confidence and slower global growth, painted a very poor picture for emerging markets. This change occurred so suddenly that many authorities in these markets were left with very little time to react, so valuations of emerging market currencies and bonds had to adjust and act as the pressure valve. Emerging markets with large external deficits were the first to suffer, as was evidenced by Turkey and Argentina, which were both down between 30% to 50%. Emerging market bonds were down 7.9% in US dollars for 2018, while emerging market bonds in their local currencies only returned a paltry 2.9%.

South Africa didn't fare much better, as concerns on the key policies (land, mining charter and state-owned enterprise (SOE) reform) and much slower growth weighed heavily on local asset price performance. The All Bond Index (ALBI) was up 7.7% for 2018, however the rand was down 13.8% to the US dollar, bringing South African government bond returns in US dollars to -7%. Performance across the various parts of the yield curve was pretty balanced, with the very front end of the curve outperforming. We see the performance at the front end of the yield curve (one to three year) as unsustainable given that this performance was in large part driven by the buyback of bonds in that area of the curve as part of National Treasury's switch auction programme. South African government bonds had a rollercoaster of a year, with the benchmark bond starting the year at 8.59%, hitting a high of 7.88%, then a low of 9.36% and ending the year at 8.87%. Inflation-linked bonds (ILBs) continued to suffer as real yields moved almost as much as nominal bonds (I2025 – low: 3.15%, high: 2.08%) primarily due to the adjustment lower in both medium- and longer-dated inflation assumptions. Due to the higher duration that these bonds carry, ILBs only managed to eke out a return of 0.3% for the year.

Global markets were very volatile in December, as they grappled with the ongoing steady rise in US interest rates at a time when global activity data have continued to slow. Political rhetoric in the US added to the uncertainty, while rising political tension was observed in parts of Europe as well as in China and Russia. In the UK, Prime Minister Theresa May survived a vote of no confidence, but has to date failed to secure support for the Brexit withdrawal agreement, creating heightened uncertainty for both UK politics and the economy. In emerging markets, weak activity data in China continued, despite efforts to provide support. Overall, it was a torrid 12 months for financial markets, with most asset classes delivering negative full-year total returns when measured in US dollars.

A closer look at the economic data shows US growth momentum continued to moderate in December, although the labour market remains very strong. The US ISM Manufacturing Index fell to its lowest level since 2016 in the December print, at 54.1 (down from 59.3 the previous month – well below expectations). Durable goods orders, housing demand and price indicators have also weakened, and both tend to flag changes in underlying activity well. GDP for the fourth quarter of 2018 (Q418) is tracking 2.4% from 3.5% (on a quarter-on-quarter seasonally adjusted annualised (q/q saa) basis) in the third quarter. Most recently, a prolonged US government shutdown could add to softening sentiment as the political standoff in Washington persists.

The Federal Open Market Committee (FOMC) raised the Fed Funds rate by 25 basis points (bps) to a 2.25% - 2.5% range in December. Despite sharply weaker US markets and public criticism from President Donald Trump, Fed Chairman Jerome Powell maintained a relatively upbeat outlook for the US economy, but acknowledged growing downside risk to growth. Rates markets have since priced out further US policy rate tightening in 2019.

In South Africa, growth momentum remains subdued. GDP growth in Q3 was 2.2% q/q saa, and 1.1% y/y – marginally better than what was forecast, but still uninspiring. Activity data is also still a mixed bag: credit growth moderated in November to 5.6% y/y (from 5.8%); mining production surprised to the upside, but was only up 0.5% y/y, while manufacturing was up 1.1% y/y. The PMI was a little better at 49 (from 48.2) but remains in contractionary territory. Retail sales posted growth of 2.2% y/y in October. Taken together, GDP is likely to grow less than 1% in 2018.

Domestic inflation accelerated modestly to 5.2% y/y in November from 5.1% y/y in October. Food inflation moderated and remains low in absolute terms with all of the increase related to retail fuel prices. Both general goods and services price pressure is broadly contained, with core inflation at 4.4% y/y. A large retail fuel price reduction in December should see headline inflation slow towards 4.5% y/y and will lower the 2019 trajectory by about 20 bps.

Despite this, in a tied 3:3 vote, the South African Reserve Bank (SARB) MPC raised the repo rate 25bps to 6.75% in November, with the Governor casting the deciding vote. The MPC has reiterated its desire to see CPI and inflation expectations closer to the mid-point of the target band (4.5%), implying that despite prevailing low inflation and slow growth we can expect modest increases in interest rates in coming months.

At the end of November, shorter-dated fixed rate negotiable certificates of deposit (NCDs) traded at 8.45% (three-year) and 8.96% (five-year), slightly tighter 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 bps in the three-year area and 110 bps 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 3.4% over the month and 13.8% over the year, ending at 14.35 to the dollar. Sentiment towards South Africa continues to swing, with emerging market sentiment souring in sympathy with equity markets in general in December. 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 African government bonds mostly reflect realistic expectations for the local economy, although have benefitted from a turn in global sentiment recently. South African bonds compare favourably to their emerging market peers, relative to their own history, and still offer a respectable cushion against further global policy normalisation. At current levels, the yields on offer in the local bond market are fairly valued relative to their underlying fundamentals and warrant a neutral to modestly positive allocation. The relative underperformance of ILBs versus nominal bonds in past quarters has resulted in real yields moving to levels that have not been seen in at least the last eight years. While nominal bonds continue to compare favorably to ILBs, the balance in the front end of the curve has shifted towards ILBs.

The local listed-property sector was down 1.3% in December, bringing its return for the rolling 12-month period to -25.0%. Listed property has been the largest drag on performance over 2018, primarily due to generalised equity weakness and idiosyncratic South African issues relating to the possible closure of Edcon, its impact on the broader property sector and lower real GDP growth. However, from an income perspective, distribution growth and expectations around future distribution growth remain sound. Despite the underperformance, 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) should make listed property more resilient going forward. If one excludes the offshore exposure, the property sector's yield rises to approximately 10.7%, 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 1.7% in December, bringing its 12-month return to 15% (this is due to December 2017 - a very bad month for the index – now falling out of the period under review). 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 risks 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 9.3% 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 Longano
as at 31 December 2018