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

The fund returned 0.6% in July, bringing its total return to 4.1% for the year, 1.6% for the quarter and 7.8% for the 12-month period. This is well ahead of the returns delivered by both cash (6.9%) and its benchmark (7.7%) over the same one-year period.

July brought some reprieve to three consecutive months of bond market weakness. The aggregate index rose 2.4% during the month. The recovery was also relatively broad-based, with longer-dated bonds (12+ years) up 2.8%, followed by the belly of the curve (7 to 12 years), which was up 2.3%. Short-dated bonds (1 to 3 years) were up 0.9%. Inflation-linkers fared worst, with returns of just 0.3%, while cash yielded 0.6%.

July's news flow was dominated by escalating global trade tension, with US president Donald Trump upping the ante on China by stating his intent to continue raising tariffs on Chinese imports to the US. The only good news was that after a meeting with EU President Jean-Claude Junker, President Trump's threats of raising tariffs on European vehicle exports seem to have dissipated. In aggregate, US data remain positive, with activity data a little more muted from Europe and some emerging markets. Concerns about both the primary and secondary impact of the tariff increases have risen and prompted some downward revisions to growth forecasts for late 2018 and 2019.

In the US, GDP growth was confirmed at 4.1% q/q saa for Q2-18. The detail showed a sharp acceleration in consumer spending, and confirmed a rebound in private sector fixed investment. Also, some of the planned fiscal expansion is becoming evident in government spending, further supporting expectations that growth should remain robust through end-2018 and into 2019. Inflation data showed a modest acceleration in June, with headline inflation at 2.9% y/y, while core inflation ticked up to 2.3% y/y from 2.1%. The stronger dollar remains a headwind to inflation, but rising tariffs are a mounting risk.

The FOMC left the Fed Funds rate unchanged at 1.8% in July, with few changes to the statement, or outlook. At this time, two additional 25bps rate hikes are expected in 2018 for the September and December meetings respectively, and the central tendency on the 'dot plot' implied four more hikes in 2019.

At the end of July, shorter-dated fixed rate negotiable certificates of deposit (NCDs) traded at 8.4% (three-year) and 8.9% (five-year) down slightly over the month. The spreads of floating rate NCD's 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 SA, 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 the repo rate (flat with a bias for a 25bps reduction). However, credit spreads remain in expensive territory (less than 100 bps in the three-year area and 130 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.

China remains hostage to the acceleration in trade tension, with the US announcing the likelihood of a further $200bn in tariff increases in July, possibly to be implemented by September. President Trump has since suggested more is to come. Activity data have weakened with tighter financial conditions as policymakers have consistently reigned in credit growth. Despite headline growth of 6.8% y/y in Q2-18, underlying activity indicators have weakened, including construction, property sales, various metals production, and vehicle sales. Policymakers have matched President Trump's tariff increases in a tit-for-tat manner and have seemed to try to cushion the impact on the domestic growth through a number of policy initiatives, including tax cuts. However, there is not yet a great deal of data evidence of policy support and China's GDP is expected to slow in H2-18.

The rand was up 3.4% in July, ending at 13.28 to the dollar. Concerns around a possible trade war between the major global economies and the impact of higher developed market inflation on the current state of global monetary policy accommodation have continued to sour risk sentiment and the appeal for emerging markets in general and SA. 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 remains mired in a low-growth environment, with quarterly activity indicators only modestly up on the very weak Q1-18. Mining and manufacturing rebounded in May after a weak April, and retail sales have picked up a little in line with improved consumer confidence. This is unlikely to see a materially positive impact on Q2-18 GDP growth, although growth should be positive in sequential terms after the -2.2% q/q saa contraction in Q1. The data also still bode well for better growth in H2-18. Encouragingly, the July PMI index rebounded to 51.5 from a lacklustre 47.9 in June.

Inflation surprised expectations to the downside again in June, with headline CPI at 4.6% y/y from 4.4%, and core inflation moderating to 4.2% y/y from 4.4%. Despite recent pressure on retail fuel prices and the weaker currency, the outlook for inflation remains relatively benign. The SARB MPC voted unanimously to leave the repo rate unchanged at 6.5% in July (in line with consensus) and issued a more hawkish statement in light of recent currency volatility and a potentially more hostile global environment for risk assets.

South Africa's underlying economy still remains in a better place relative to history and its peer group. Inflation is expected to remain stable and well contained, while growth will continue to move higher. Local bonds have now 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 0.5% in July, bringing its return for the rolling 12-month period to -13.6%. 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 0.5% in July, bringing its 12-month return to 2.4%. 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 9.3% 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 and Mark le Roux
as at 31 July 2018