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.

Riskier assets continued to struggle during the second quarter with many sectors of the market posting negative returns. Credit spreads continued to widen and corporates once again underperformed government bonds. The US dollar rebounded in the second quarter against all other currencies benefiting from safe haven flows and the US Federal Reserve (Fed) once again raised interest rates. The fund returned 0.18% in what proved to be another challenging quarter and 1.11% over the last year, against a benchmark return of 0.65% and 1.98% over the same period (gross returns for fund).
The economic narrative has become more complex in recent months. Central banks led by the US have begun to scale back the size of asset purchases and rising policy rates and tighter financial conditions are beginning to have an impact. China too is feeling the effect of less credit growth adding to the headwinds for emerging markets. Meanwhile the US administration's recent trade tariff hikes have added to investors' concerns that a broader trade war may develop. In the near term, US growth will be supported by the fiscal expansion and the Fed will continue to tighten monetary policy as the output gap closes and wealth effects buoy consumers. A more meaningful slowdown remains a risk in late 2019 or early in 2020.

US 10-year bond yields rose as high as 3.1% in mid-May, prompting talk of a break out to the upside before falling back below 3% and ending the quarter at 2.85%. The Fed raised the Fed funds rate by a further 25 basis points (bps) as expected in mid-June (upper bound now 2%), the latest 'dot plot' was deemed to be slightly hawkish as it suggests two more moves are likely in 2018. With short rates rising and markets acknowledging the potential for a slowdown in late 2019, the yield curve continued to flatten. While Europe and Japan resist higher short rates, the rise in US short rates and a flatter curve has meant higher hedging costs for overseas buyers. With US issuance set to rise substantially in the wake of US tax cuts and the runoff of the Fed's balance sheet set to accelerate, bond hedging costs look set to rise further. US Libor funding spreads peaked at the end of March and have since fallen from 0.6% to 0.4% currently. While we see the levels in March as extreme, there remains a chance that funding spreads will once again widen when the US Treasury begins to issue large amounts of Treasury bills again later in the year. Ultimately, the higher supply raises the prospect of higher US yields as hedged foreign demand wanes. Despite being wary of longer-dated valuations, the US Treasury's current bias towards shorter-dated issuance is likely to contribute to a bearish flattening of the yield curve. With US breakeven rates of inflation relatively stable (despite higher oil prices), movements in the yield curve have manifested themselves in higher real yields - real yields on a five-year, inflation-linked instrument at 0.7% are at the highest level since 2009. The fund added duration as US 10-year yields rose above 3% but once again reduced some exposure after bonds retreated 30 bps from the highs. At the quarter end, the fund's interest rate duration was around one year, about 0.25 years higher than at the end of the first quarter.

European investors have had much to deal with over the last three months with politics finally spilling over into markets. The Eurozone now has to contend not only with Brexit but a new Italian populist government which looks set to use domestic issues as a bargaining chip in the wider Eurozone reform debate. Migration has become a hot topic (especially for the coalition government in Germany) and individual states attitudes to the subject are a reminder of just how divided Europe remains on many issues. Europe's relationship with the US is also under strain as evident at a recent G7 summit. The imposition of tariffs (and subsequent retaliations), alongside the funding of NATO, remain live issues. Italian bonds performed poorly (down 5.2% in the last three months) in the wake of the Italian government's formation with yields experiencing unprecedented moves (two-year yields rose from 0% to 2.75% before ending the quarter at 0.67%). In core Europe, yields fell as the ECB remained dovish on rates, predicting rates would remain at current lows at least through the summer of 2019. The central bank also announced its intention to reduce new asset purchases from the current €30bn a month to €15bn in the fourth quarter of 2018 and complete purchases at the end of the year. Existing maturities will continue to be reinvested for an extended period with the market speculating that the ECB will skew those purchases into longer maturities thereby maximising the duration impact of its actions. Within the UK, Brexit wrangling dominates the headlines with definitive progress scant much to the annoyance of the business community. The Bank of England is inching closer to raising rates once again, resulting in current bond yields looking unappealing.

Emerging markets struggled throughout the quarter with local currency debt particularly weak as investors unwound carry trades. Turkish bonds lost 10% in value, Indonesia 6% and Brazil 5%. Emerging market currencies endured a particularly harsh selloff, the JP Morgan (JPM) Emerging Market Currency Index was down 10% during the quarter, with Argentina down over 30% and the South African rand, Turkish lira and Brazilian real down around 14%. Hard currency emerging market debt fared better but also succumbed to the wider sell off in credit markets. The spread on the JPM Emerging Market Bond Index widened from 3.2% to 3.9% during the quarter.

Credit spreads continued to widen in the second quarter with the weakness spreading from short, high quality instruments that bore the brunt of the widening in Libor during the first quarter to longer-dated and lower rated names in the last three months. European corporate bonds were particularly weak in June on the back of developments in Italy and the prospect of less asset purchases from the ECB. Financials suffered more than corporate credit, especially within Europe despite fears over rising trade tensions.

The US high yield markets proved to be an exception with the high oil price lending support to the shale producers. This has meant the ratio between US high-yield spreads and investment grade is at its tightest since the financial crisis. Much of the selloff was flow related as selling emerged on the back of ETF outflows or managers reducing exposures which helps explain why cash markets widened more than hedging instruments such as credit default swaps. Having built up sizable US Treasury bill positions in the first quarter, the fund switched much of this exposure out into AAA-rated covered bonds at the end of April as covered bonds spreads rose and Treasury bills became very expensive compared to swaps. The fund also invested in financial paper around the two year part of the curve, targeting a yield of around 3%. After the recent softening of spreads in the intermediate maturity (five-year), the fund has increased some of its longer-dated holdings. The fund has also added to some of its convertible holdings where we believe some of the best value is to be had. The fund also took part in new issues form FirstRand, Barclays Africa and Growthpoint. Due to movements in the cross currency basis we have increasingly found US corporate bonds to be more attractive for the fund than non-US denominated bonds hedged back into dollars. Overall, the credit risk within the fund rose from 1.15 years of credit duration to 1.57 years at the end of June. The fund also continues to employ a put option strategy to guard against a significant widening in credit spreads.

Property enjoyed a better quarter in local currency terms during the quarter although the strength of the US dollar meant only a few markets produced positive returns when expressed in US dollars. The funds exposure to property remained around 4% of fund throughout the quarter. Having bought back into Growthpoint Australia in the first quarter, the fund once again exited its position after a strong recovery in the shares. The fund also reduced some of its positons in German residential names such as Vonovia, Deutsche Wohnen and LEG after s strong run from the sector. After a raft of corporate announcements last quarter only Unibail's takeover of Westfield has proved successful. Klepierre withdrew its bid for Hammerson and Hammerson in turn walked away from its plans to merge with INTU. In the US, there are tentative signs that the retail backdrop for mall operators may be improving and management teams are expressing confidence in their ability to reposition malls for changing consumer trends - Simon Property Group reacted best among our holdings. UK names remain unloved with Brexit concerns or the weakness among high street retailers a headache for many property companies.

Within foreign exchange markets, the US dollar outperformed all other currencies with the Fed's broad dollar index up 5.6% over the quarter. There has been much debate as to the drivers of the dollar's move, - are we seeing some realignment due to interest rate differentials, is this flow driven as investors flee riskier asset classes such as emerging markets or is this reflective on some form of liquidity squeeze brought about by a shortage of dollars? The reality is it is most likely a bit of all these factors and US dollar speculative positioning is now a little extended, arguing for some let up in the dollar's recent strength. With recent significant outflows from equities and emerging market bond funds and investors' appetite for risk having swung into deeply bearish territory, there is a strong likelihood that recent trends will abate in the short term. The caveat may be a continued escalation in trade tensions that contributes to a further weakness in riskier asset classes and drives investors into perceived safe havens. The recent weakness in the Chinese currency has led some to speculate that China could utilise its currency to partly offset tariff increases. A more plausible explanation is that China has allowed its currency to readjust lower to realign it more closely with its trading partners which have in recent time weakened against the US dollar. China is also battling to offset the tightening in one part of the economy brought about by its clamping down on excessive leverage by supporting other sectors of the economy via reductions in banks' reserve requirements and enhanced liquidity operations.

The fund duration of around one year remains modest but we feel short-dated issues now offer good levels of breakeven protection. We remain more sceptical of longer-dated government bonds in the US and view developed market yields outside the US as expensive. Within credit markets, we believe value is emerging but this is a relative observation as a large deterioration in sentiment that motivated sizable sector outflows would soon reset spreads wider, one of the reasons we continue to employ an option protection strategy. We believe there are pockets of value and our convertible positions fall into this camp. Given that the withdrawal of central bank liquidity is in its early stages, investors should not be surprised if the recent rise in market volatility persists.

Portfolio managers
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