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

The themes of late 2017 continued into the first quarter of 2018. Emerging markets continued to move stronger, driven by expectations of strong, synchronous global growth with no significant upward pressure on inflation. Strong upward growth revisions in the US and many of the emerging markets drove global growth expectations higher to between 3.5 and 4% for 2018. Undoubtedly, 2017 was a year of very low or no realised volatility, with the VIX (Chicago Board Options Exchange SPX Volatility Index – a proxy for global market volatility) registering three consecutive all-time lows. However, even a massive spike in that index to levels of 30% from below 10% was not enough to derail the valuations of emerging market currencies and local bond markets in the first quarter of 2018. For the first three months of the year, emerging markets bonds returned 4.3% in dollars as suggested by the J.P. Morgan GBI-EM Diversified Index, compared to 1.4% for emerging market equities and -0.8% for the S&P 500 Index.

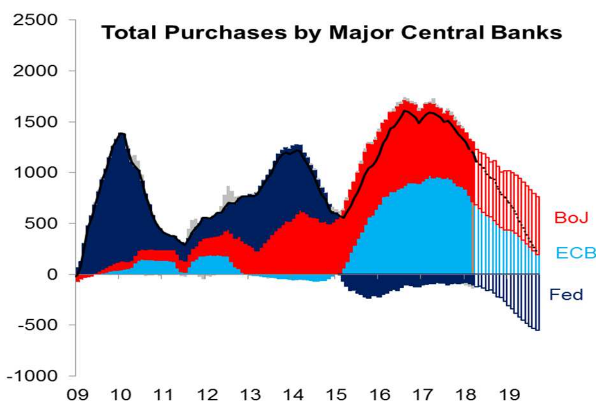
In South Africa, 'Ramaphoria' continued to inspire a further rally in local assets. The election of Cyril Ramaphosa as leader of the ANC was a much-needed step in the right direction; what has proven surprising is the pace and impact of consequent changes. His replacement of Jacob Zuma as president of the country led to a cabinet reshuffle to focus on policy stability and implementation. Emphasis has been on getting SOEs back on track with the appointment of credible individuals at Eskom and the department of public enterprises. Most importantly, Cyril Ramaphosa has inspired a nation to hope again. The announcement of an adequate budget added further credibility, as it sought to put South Africa back on the path to fiscal consolidation by making tough decisions on VAT increases and expenditure. SA bonds, despite rallying 50bps since the ANC elective conference, continued to revel in the 'new dawn', with the benchmark bond rallying another 50bps to end the quarter at 7.98%. The All Bond Index (ALBI) returned 8.1%, driven primarily by the bonds with maturity of greater than 12 years (constituting 60% of ALBI) which returned 10%. The R900bn reduction in bond issuance by National Treasury at their weekly auction drove the outperformance of the longer end of the bond curve.

The local economy is now fundamentally on a much stronger footing, with local inflation forecasts and expectations having been revised lower. Inflation, as measured by the CPI headline index, is set to average 5% over the next two years and should, at the bare minimum, start to alleviate pressure on an economy that has struggled to grow meaningfully above 1% over the last three years. Furthermore, the risks to inflation are tilted to the downside, stemming primarily from food (15% of the basket) and services (50% of the basket) inflation. Service prices are set based on historical CPI measurements and based on the lower expected inflation going forward, it's very likely that this becomes self-reinforcing, resulting in stable to lower services' prices. In addition, regulatory scrutiny in the insurance and medical aid industries should help keep prices in check. The consumer should benefit from lower inflation as real disposable income increases, underpinning the growth recovery. As 'Ramaphoria' filters through South Africa, we should also see a renewed uptick in both business and consumer confidence. This increased confidence should enable corporate SA to start spending on inventory renewal and investing into longer-term projects. The combination of increased consumer spending and fixed investment could help South Africa achieve 2-2.5% growth over the next 2-3 years. While this is a marked improvement, it is still some way off what is necessary to achieve sustainable job creation and reduce poverty levels.

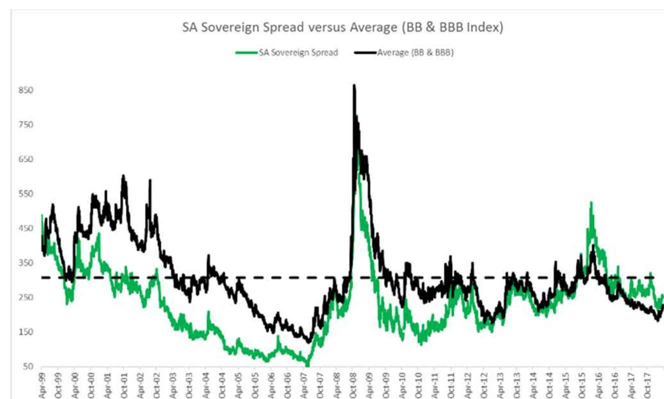
The recent price moves in SA assets have been remarkable, but it is vital for South Africa and financial assets that prices do not move too far ahead of reality, especially given the long road ahead and risks around implementation.

Our fair value for SA government bonds depends on the global risk free rate (US 10y), inflation differential between South Africa and the rest of the world (US CPI) and a credit spread for South Africa as an issuer. At the time of writing, the level for the US 10y is 2.8%, 3% inflation differential (5% in SA and 2% in the US) and a 2.47% SA sovereign spread. This implies a fair value for the SA 10y bond at 8.27%, compared to a market trading level of 8.18%, putting it close to fair value. However, the sustainability of global risk free rate (US 10y) and SA sovereign spread levels must be questioned.

The sheer magnitude of quantitative easing (QE) by the US (FED), Europe (ECB) and Japan (BoJ) since the global financial crisis has driven global bonds yields tighter, particularly in developed markets. Since the FED stopped its QE program in 2014, both the BoJ and ECB have taken up the slack; with purchases far in excess of those made by the FED (see figure below). However, in the next 18 months, global central banks are expected to purchase 80% less than they currently do. This, together with the fact that globally developed market policy rates are on aggregate expected to rise, suggests one should anticipate a further move higher in developed market bonds yields, especially the US 10y. The FED's current forecasts put the FED Funds rate (US policy rate) at 2.875% by the end of 2019, while the market is expecting closer to 2.475%. At the bare minimum, based purely on policy rates, if the FED's forecast is realised it suggests that the US 10y should be trading at 3.2%. Coupled with the removal of the largest buyer of Developed Market bonds from the market (ECB and BoJ), it is easy to justify 3.2% as a minimum expectation rather than a cap on US 10y yields.



The purchase of bonds by global central banks has forced investors to go further up the risk curve in search of yield. This has led to a compression in credit spreads, especially in emerging markets, making it cheaper for many EM countries to borrow money. South Africa has also been a beneficiary of this hunt for yield. The country effectively has a split rating i.e. Fitch and S&P rate it as sub-investment grade while Moody's rates it investment grade. This makes the comparison of South Africa's credit spread quite difficult. Thus, in the graph below, we use an average (black line) of the BBB (IG Credit Index) and BB (first rung of sub-IG Credit Index) to compare SA's credit spread. There are two key observations: Firstly, SA trades slightly cheap relative to this average index given its split rating (~25bps). Secondly, the absolute level of these credit spreads are quite low. If a normalisation were to take place, i.e. if global central banks continue to reduce QE as expected and remove policy accommodation, it is very likely that we would see credit spreads moving closer to their historical average (dashed black line below). This implies that although the SA credit spread might move tighter relative to the average index, the absolute level of credit spreads will have to move wider. The longer-term average of the index is approximately 80bps higher than current levels. To be conservative, if normalisation does occur, we could see credit spreads moving at least half way back to their longer-term average, which is a move of 40bps higher. In such an environment, even if South Africa does everything right and moves back to investment grade, we would still need to see the SA credit spreads 15bps wider. The point is that the current level of the SA credit spread should be seen as a floor/minimum rather than having scope for further compression.



Adjusting our estimates of fair value for the above, we have a global risk free rate of 3.2%, SA credit spread of 2.62% and an inflation differential of 3%. This suggests a fair value on the SA 10y of 8.82%, making the current level of 8.18% expensive.

The outlook for the local economy is much better. Inflation should allow the SARB room to ease rates a little more. In addition, lower inflation and positive sentiment should help increase consumer spending and provide a decent underpin for growth. This could lead to new investment by corporate SA into inventory renewal and long-term projects, which could also add more upside to the growth outlook. The pace of changes made by the new leadership has been impressive, but most of the easy wins have already been realised. What lies ahead is a much tougher battle. SA bonds have ridden the wave of optimism on the back of the new dawn. However, at current levels, most of the good news (if not more) has already been priced in. The risks from global monetary policy tightening (higher policy rates and a reduction in QE) could have negative consequences for SA bonds (which have a very limited buffer to withstand these shocks). We therefore choose to be cautious of SA bonds at current levels, looking instead for more attractive levels before moving to neutral or overweight positions.

Portfolio managers
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as at 31 March 2018