CORONATION GLOBAL STRATEGIC USD INCOME FUND

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Quarterly Portfolio Manager Commentary

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

After an extended period of above average returns form riskier assets, the past quarter provided the first insight into the challenges markets may face as central banks begin to scale back their asset purchase programmes. Corporate bonds performed well during January but credit spreads widened during February and March as equity markets softened and volatility rose. Corporate bonds underperformed government bonds for the first quarter since the end of 2015. Property prices once again struggled and were a drag on performance. The fund returned -0.6% in what proved to be a challenging quarter and 1.4% over the last 12 months, against a benchmark return (which was boosted by the rising level of US Libor) of 0.5% and 1.7% over the same period.

Global growth is currently in a sweet spot, benefiting from a cyclical upturn in all major regions and is running at its fastest rate since 2011. The question is where the risks of a slowdown may emanate from. Will it be the return of inflation that prompts a more rapid tightening of monetary policy or will it be geopolitical (such as the risk of a looming trade war)?

After the passage of the US tax bill, the country's trade deficit has now become the focus of the Trump administration. Renegotiating NAFTA may have been a first salvo but more recently the proposed imposition of tariffs on a range of imported products has riled allies, adversaries and investors. In addition there are signs in many regions of more protectionist attitudes to national industry champions. Taken together, these actions in an economy growing above potential are more likely to see price pressure increase. While tensions on the Korean peninsula appear to be easing, risks in several other geopolitical hotspots threaten market sentiment most likely via rising energy costs.

The upward movement in US Treasury yields during the first quarter reflected the impact of the passage of the US tax changes, with market participants upgrading economic forecasts for 2018 and 2019 and investors expressing concerns about the increasing size of fiscal deficits. US 10-year yields peaked close to 3.0% in February before retracing slightly to 2.7% at quarter-end having closed 2017 at 2.4%. The yield curve continued to flatten as shorter dated yields rose most, with breakevens only marginally wider. Two thirds of the sell-off has come via rising real rates, with five-year real yields rising from 0.27% to 0.46% over the quarter. The fund switched its US inflation-linked exposure into underlying fixed exposure during February as breakeven rates of inflation reached 2%.

The Federal Open Market Committee (FOMC), led by the new chair Jerome Powell, raised rates in March by a further 0.25% (the upper bound of the Fed Funds target range is now 1.75%) and amended its growth projections upwards to 2.7% in 2018 (from 2.5% in December and 2.1% pre-tax cuts) and 2.4% in 2019 (up from 2.1%). Its forecast for the unemployment rate fell slightly in 2018 and was lowered to 3.6% in 2019 and 2020. This would be consistent with the lowest unemployment rate since the late 1960s. Some investors have begun to draw parallels with policies of the Nixon administration and worry that the twin deficits will lead to a loss of confidence and a weaker dollar as was the case in the early 1970s. The FOMC also adopted a slightly more hawkish stance in its projection of interest rates with the dot plot rising form 2.688% in December to 2.875% in March and 2020 projections increasing from 3.062% to 3.375%

While official rates may have only increased by 0.25%, rates in the interbank market have been rising much faster. The three-month Libor spread has risen to 0.6% from 0.26% at the end of December. This is the result of several factors coming together. Part of it is driven by much higher Treasury bill issuance following the resolution of the debt ceiling (further exacerbated by the Fed shrinking its balance sheet). The other element has been more supply from banks and less demand from corporates as a result of changes in the US tax system. The result is that three-month Libor has risen 1% in the last six months and at 2.3% is now a credible alternative for investors who may not want exposure to longer dated Treasuries, which are more volatile and doesn't carry a much higher yield.

Credit spreads remain relatively tight but have begun to soften slightly under the weight of supply, a less supportive equity backdrop, and the rise in bank funding costs. The weakness was not limited to the US market and euro and sterling spreads also widened. It is noteworthy that since central banks asset purchases have begun to be reduced, markets have struggled to extend their gains. We continue to see the immediate risk to valuations as more dependent on changes in the flow of funds into the asset class (ETF and passive significant) rather than solvency related at this stage. The more fundamental credit challenge will come as central banks adjust policy rates higher, the world economy begins to slow and large amounts of refinancing come due (in 2019 and 2020). For this reason, we remain wary of valuations in longer maturities which are increasingly unappealing to offshore buyers due to rising US dollar hedging costs.

We believe the Fed's current expectation for the Feds Funds rate in 2020 is likely to prove overly aggressive and the fund has begun to increase its interest rate duration from very modest levels. This it did by lengthening from shorter dated Treasury bills (which have moved from very cheap to very expensive) into corporate bonds with maturities between one and two years, particularly financials where we believe there is now adequate breakeven protection. Despite a rise in US bank funding costs, there has been a narrowing of cross currency basis swaps for technical reasons which we would expect to begin to unwind over few months. In the meantime, this has meant non-US assets have become less compelling for the fund and very few new positons have been initiated. The fund has also continued to add to its exposure within convertible bonds (Redefine & Impala), some of which we believe are very appealing. The fund lengthened the maturity of a few of its small emerging market government positions as the credit curve steepened in late January.

In Europe, government bond markets performed well despite an inconclusive election result in Italy. On the economic front, momentum has slowed to its weakest level in more than a year as the composite Purchasing Managers' Index has fell abruptly in February and March. Indications still suggest annual growth in the region of 2.5% and some of the weakness may be in part be explained away by weather, supply chain bottlenecks and unusually high levels of absenteeism due to flu. The slowdown comes at a delicate moment for the European Central Bank as policymakers debate further tapering of their bond buying programme. Meanwhile inflationary pressures remain modest despite some evidence of a firming of some underlying elements such as within services.

In March, the UK reached an agreement that a 21-month transitional period would begin in March 2019, giving the impression that headway is being made in discussions with the European Union. However, some of this progress is viewed by Eurosceptic Members of Parliament as merely the result of a compromise of previous 'red lines'. While markets have become more optimistic that a manageable muddle-through result will ultimately be achieved, the chances of a 'no deal' (because of future unsurmountable hurdles) or the failure of a final deal to be ratified by MPs remains significant. In the meantime, inflation remains above target at a time when slack in the economy has reduced and wage pressures are picking up. A further rate increase is widely expected by the market in May with tightening thereafter likely to be heavily dependent on whether global growth (and in particular the EU) remains above trend.

Emerging markets hard currency debt performed well during the quarter despite a backdrop of weaker corporate bonds. The US dollar-denominated debt spreads ended the quarter only 10 basis points (bps) wider at 320 bps. Local currency denominated debt performed well, up 4.7% in US dollar terms for the quarter. The star performers were South Africa (up 8.6% in local currency terms and up 13.5 in US dollar terms) and Mexico (up 3.6% in local currency and up 11% in US dollar terms).

The fund's exposure to property increased marginally during the quarter to 4.2%. However, the rally of late 2017 fizzled out and property shares struggled particularly during February with the global index down 4% for the quarter. The retail sector remains depressed with bankruptcies such as Toys-R-Us, Claire's and Bon-Ton adding further pressure, although better consumer sentiment in the US offers a glimmer of hope. In the UK, Hammerson's bid for Intu was thrown into doubt by a counter bid for Hammerson from Klepierre, the European operator of shopping centers. Hammerson has rejected Klepierre's initial bid of 615p which was 40% above its previous closing price. Klepierre has subsequent to quarter-end upped its offer to 635p per share. After this too was rejected, it withdrew its offer and will no longer be pursuing a deal to acquire Hammerson. Hammerson produced an estimated Net Asset Value (NAV) of 790p for the first quarter, up 1.8% from the end of 2017 as part of the reasoning behind its rejection of Klepierre's initial bid. With its share now priced at a 40% discount to its valuations, investors are clearly increasingly sceptical of the sustainability of such valuations. German residential companies continued to report solid operational results and after a weak performance in January have recovered most of the ground they lost. The fund bought back into Growthpoint Australia at a yield above 7% and added Nepi Rockcastle to the portfolio after it fell very sharply during January and February. The share price is now more aligned with its NAV and growth prospects. With gearing in many property companies lower than in previous cycles and yields at a healthy margin above corporate bonds, there appears to be value in the sector, however, as recent times have demonstrated, hopes of capital growth may require a little more patience.

Within foreign exchange markets, the US dollar continued to struggle despite a continued widening in interest rate differentials. Within the G10, the yen was the best performer (up 6%) despite the Bank of Japan dismissing speculation it may be beginning to consider tapering its stimulus programme. The Norwegian krone also performed well after the central bank lowered its inflation target form 2.5% to 2%. With inflation now above the new target, the central bank suggested a rate hike was now likely as soon as September. Sterling also rallied against the US dollar (up 3.7%) just ahead of the euro (up 2.5%). The Canadian dollar was amongst the weakest currencies as expectations for rate rises moderated and concerns surrounding NAFTA weighed on the currency, despite Mexico been the best performing currency. The fund continues to hedge its non-US exposure back into US dollars.

The weakness of the first quarter is a useful reminder to market participants that valuations can move in more than one direction. With US government yields now materially higher in shorter maturities and credit spreads wider, the prospect for absolute returns has increased. As discussed, we remain cautious of some sectors but continue to employ an option protection strategy to mitigate any excessive downside that could result from a sizeable market sell-off.

Portfolio managers
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