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

The fund returned 0.4% in November, bringing its total return to 6.3% for the year and 7.8% for the 12-month period. This is ahead of the returns delivered by both cash (6.9%) and in line with its benchmark (7.6%) over the same one-year period.

After a brutal October, November was a good month for South African bond markets, and performance was positive. The All Bond Index surged 3.9%, with the rebound concentrated in longer-dated bonds (12+ years), which gained 4.5%. This was followed by the belly of the curve, (7-12 years), which was up 3.3%. Short-dated bonds performed worse, up 1.8%, while inflation linkers returned -1.1%. Cash returned 0.6% in November.

Markets grappled with increasingly mixed global activity data, with a wider base of indicators showing slowing growth momentum – some cyclical, some idiosyncratic. The Federal Reserve hiked the Fed funds target rate as expected, but weaker data in Japan and Europe have dampened expectations of normalisation in these regions. In emerging markets (EMs), weak activity data in China was not offset by news of policy interventions to support growth, while selective rate tightening in a number of EMs suggest growing concern about currency vulnerability to higher US funding costs. Oil prices fell sharply towards month end, allaying some concerns about rising inflation.
A closer look at the economic data shows US growth momentum slowed in Q3-18 off a robust Q2, but, in aggregate, remains strong. GDP was confirmed at 3.5% q/q saa, from 4.2% q/q saa in Q2-18. October headline consumer prices increased from 2.3% y/y to 2.5% y/y, while core inflation eased to 2.1% y/y from 2.2%. Core PCE inflation also surprised to the downside, rising just 0.1% m/m and 1.8% y/y.

The FOMC raised the Fed Funds rate by 25 basis points (bps) to 2.0% - 2.3% in September and maintained its guidance for a further 25bps hike at the December FOMC. However, concerns about the possible impact of escalating trade tension on US output, with growing signs of slower growth momentum, have raised market concerns about a possible pause in the Fed's 2019 anticipated hiking cycle.

Inflation accelerated modestly to 5.1% y/y in October from 4.9% y/y in September. Food inflation moderated and remains low in absolute terms with all the increase related to retail fuel prices. Both general goods and services price pressure remains subdued. Core inflation was unchanged at 4.2% y/y. A large retail fuel price reduction in December should see headline inflation moderate back towards 4.5% y/y and will lower the 2019 trajectory by about 20bps. Despite this, the South African Reserve Bank (SARB) MPC raised the repo rate by 25bps to 6.8% in November, in a 3:3 vote, with the Governor having the casting 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, 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 8.6% (three-year) and 9.1 % (five-year), close to 30bps 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.

In South Africa, Q3-18 GDP data confirmed a modest recovery from recession, with q/q saa growth up 2.2% - at the upper range of forecasts and ahead of consensus at 1.6% q/q) and annual growth of 1.1% y/y (consensus 0.5%). StatsSA detailed data showed a small upward revision to Q2-18 GDP growth, and the Q3-18 detail suggest a modest recovery in consumer spending provided the welcome reprieve.

The rand was up 6.6% over the month, ending at 13.87 to the dollar. Sentiment towards South Africa improved in line with an uptick in emerging market sentiment. 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.)

Policy pronouncements have made a small, but welcome, step in the right direction. Local bonds 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 1.3% in November, bringing its return for the rolling 12-month period to -21.3%. 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 11.1%, 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 1.5% in November, bringing its 12-month return to 10.2%. 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 9.18% 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 30 November 2018