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

The fund returned 0.5% in October, bringing its total return to 5.9% for the year and 7.6% 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 September reprieve, October was another tough month for South African bond markets, and performance was negative. The All Bond Index fell 1.7% and weakness was concentrated in longer-dated bonds (12+ years), which lost 2.3%. This was followed by the belly of the curve, (7-12 years), which was down 1.47%. Short-dated bonds performed better, up 1.3%, while inflation linkers returned 0.8%. Cash returned 0.6% in October.

Markets grappled with a combination of data that showed more uneven growth dynamics across developed economies as well as rising inflation risk, as tight labour markets and emerging pipeline price pressures started to emerge. In emerging markets, weak activity data in China was not offset by news of policy interventions to support growth, and ongoing rhetoric about a likely escalation in trade tensions remains a lingering uncertainty.

A closer look at the economic data shows US growth momentum slowed in Q3-18 off a robust Q2, but, in aggregate, remains strong. Preliminary data show GDP slowed to 3.5% q/q saa, from 4.2% q/q saa in Q2-18. While much attention is being given to the imminent mid-term elections, September headline consumer prices moderated from 2.7% y/y to 2.3%, while core inflation was steady at 2.2%. Core PCE inflation was also unchanged at 2.0% y/y.

Having raised the Fed Funds rate by 25 basis points (bps) to a 2.0% - 2.3% range in September, some uncertainty about a December hike has emerged with slightly more mixed data and considerably weaker equity and bond markets. The publication of strong October payroll data – notably the increase in average hourly earnings to 3.1% y/y - the strongest since June 2009 – seems likely to keep the Federal Open Market Committee on track to hike another 25 bps at the December 19 meeting.

Inflation was unchanged at 4.9% y/y in September. Food inflation accelerated modestly, but remains low in absolute terms, and despite isolated pressure on retail fuel prices, both general goods and services price pressure in a weak economic context remains subdued. Core inflation was unchanged at 4.2% y/y. The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) left the repo rate unchanged at 6.5% in September but voted 4:3 for a 25 bps hike. The hawkish stance represented by this vote, especially in the face of weak growth and acknowledged absence of demand pressures, suggests the SARB may be willing to sacrifice growth in the short-term for tighter policy and a longer-term moderation in expectations. This increases the risk of a 25 bps hike in November.

At the end of July, shorter-dated fixed rate negotiable certificates of deposit (NCDs) traded at 8.8% (three-year) and 9.4% (five-year), up slightly 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, the Medium-Term Budget Policy Statement (MTBPS) detailed a weak economy and deterioration in fiscal outlook, which now sees gross government debt at 58.5% of GDP by the end of 2021/22. However, the newly-appointed Finance Minister Tito Mboweni delivered a strong commitment to consolidation with little tolerance for waste, and has since spoken of his desire to see loss-making state-owned enterprises sold off or shut down. Activity data seems to have stabilised. Manufacturing, retail and wholesale trade sales have recovered modestly off Q2-18 lows, while retail credit accelerated slightly in September to show growth of 5.1% y/y. Negatively, mining production contracted sharply in August, and the unemployment rate ticked up to 27.5% in Q3-18 from 27.2% in Q2-18.

The rand was down 4.2% over the month, ending at 14.77 to the dollar. Sentiment towards South Africa soured post the MTPBS, which was exacerbated by poor emerging market sentiment. This, combined with continued uncertainty on key long-term South African policies, ensured the rand remained at weakened levels. 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.)

Recent policy pronouncements have made a small, but welcome, step in the right direction. Local bonds have 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 1.7% in October, bringing its return for the rolling 12-month period to -18.7%. 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 0.9% in October, bringing its 12-month return to 6.7%. 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 9.1% 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 31 October 2018