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

Emerging markets and South African fixed income markets managed to keep their heads above water this quarter, but the water wasn't calm. Local bonds produced a negative return in US dollar terms, in large part due to the poor performance of the rand. The local currency fell victim to a broader sell-off in emerging market currencies, which was driven in large part by the sell-off in the Turkish lira and Argentinian peso.

South Africa didn't differentiate itself during the quarter. Economic conditions worsened, with growth materialising below both our and market expectations (-0.7% versus 0.9% expected), which pushed the economy into technical recession. In the context of the weaker emerging markets backdrop, South Africa did not fare well, as is evident by the poor performance of the currency over the quarter. But South Africa's problems are by no means as severe as those of Turkey and Argentina. Once the panic eased, both the rand and local bonds recouped some of their losses. The All bond index (ALBI) was up 0.8% in the quarter, which was slightly behind cash (1.7%) as the longer end of the curve (maturity longer than 12 years) underperformed the rest of the bond curve. Concerns about growth, the implications for tax revenue and further bailout for SOEs weighed on the fiscal outcomes, which led to this underperformance. Inflation-linked bonds have continued to fare poorly, with returns of 0.5% for the quarter and 0.9% over the last year, well behind cash (6.9%) and the ALBI (7.1%).

The euphoria of the first quarter has quickly faded as policy uncertainty remains a key obstacle to South Africa's recovery. Policy trajectory and the intentions of policymakers have moved in the right direction, however, uncertainty around land expropriation without compensation (EWC) and mining regulations have impeded the translation of confidence into actual spending. Towards, the end of the quarter, a new, more acceptable version of the Mining Charter was released, which should ease concerns from the local mining sector. However, in order to see an increase in consumption spending, currently contracting quarter on quarter, more clarity on EWC is required. Given the current rhetoric from policymakers, this should be resolved over the next couple of quarters, which will then help with a faster recovery in growth in 2019.

Despite the depreciation in the currency and rise in the oil price, forecasts for inflation still remain contained. Inflation is expected to stay in the target band over the next 2-3 years and only near the top end of the band in the first half of 2019. The recent SARB rhetoric has indicated an eagerness to raise interest rates, which seems puzzling given the subdued growth and inflation outlook. Our expectations are for rates to remain flat until the second half of 2019. In addition, concerns around a blowout in South Africa's fiscal deficit and implications for a further credit downgrade (which would trigger an exit from the Citi World Government Bond Index), are overdone. The economic assumptions behind the February budget still hold and while revenue has underperformed this year, this has been matched (if not exceeded) by expenditure underruns, which place less pressure on the fiscus and allow Moody's to keep us in investment grade at least until the second half of 2019. Thus the local environment for South African government bonds remains quite supportive.

The change in risk sentiment and the global monetary policy will continue to pose a risk to emerging market sentiment and asset performance. This by implication suggests that there might be further downside to holding local government bonds. As long-term investors, we focus on the valuation of underlying assets relative to fundamentals and whether current valuation provides our client portfolios with a sufficient margin of safety in the event of short-term volatility or adverse price movements. The major choice facing local bond investors is whether to be invested in cash or bonds.

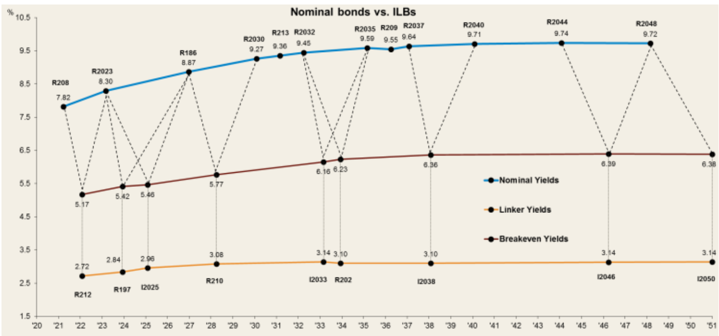
A three-year breakeven analysis of the 12-year and 26-year government bonds, i.e. how much yields could sell off before the return on the government bonds equate to cash (assuming a flat rate of 6.5%), does provide comfort for holders of local government bonds relative to cash. It shows the longer end of the government bond curve offers better value at current levels. It requires a similar magnitude of basis-point movement for both the 12-year and 26-year bond to breakeven relative to cash. In addition, if one is more positive on bond yields (as we will show below), then holding a 26-year fixed rate bond will provide a greater total return than a 12-year government bond, since it trades at a higher yield and has a higher modified duration (capital at risk measure).

In addition to the above analysis, one must ensure that current levels of valuation provide an attractive entry point and a decent margin of safety against an adverse movement in the event the fundamental backdrop deteriorates due to any "black swan" type events. In the table below, we use our fair value stack up (with an adjustment for 12-year government bonds) in order to firstly check whether current levels are attractive and whether, under an adverse scenario, bonds still provide an attractive return over the long term.

	Base	Bear
US 10y	3.25	3.75
SA Inflation	5.00	6.00
US Inflation	2.00	2.50
SA Credit Spread	2.640	2.64
SA 10y FV	**8.89**	**9.89**
SA 12y FV	**9.14**	**10.14**

The main takeaways are firstly that given our base case assumptions of a 3.25% US 10-year rate, 5% South African inflation, 2% US inflation and a steady South African credit spread, bonds are currently cheap. Secondly, even if our worst-case scenario were to play out over the next two years, local government bonds would at worst provide a cash-type return (12y bond yields can move to 10.13% before it underperforms cash+1%).

The next thing one has to decide is whether one should be allocating any bond investments towards inflation-linked bonds (ILBs) in order to provide some diversification and inflation protection to the portfolio. One would only hold inflation-linked bonds which have a breakeven inflation of less than 6%, given the SARB is an inflation-targeting central bank that has never allowed inflation to average more than 6% over any extended period. Therefore, any longer ILB (maturity >= 12y) does not offer value relative to its nominal bond counterpart. However, a case can be made for shorter-date ILB's, where implied breakeven inflation is around 5.5% with real yields of close > 2.5%. In this case, the shorter date ILB offers an attractive pickup relative to the real policy rate (currently at 1-1.5%) and provides one with a "free protection" in the event inflation moves closer to the top end of the band over the next 2-3y.



Recent economic releases have suggested that the local economy is taking much longer than initially anticipated to move onto a sustainable growth path. South Africa's longer-term growth prospects are being dimmed by shorter-term uncertainty on key policies. Policy pronouncements more recently have signaled policymakers' intention for a more market-friendly outcome, which should put growth back on an upward trajectory. Local inflation should remain within the target band, even after the recent selloff in the ZAR and rally in the oil price. Local government bonds provide an attractive return relative to cash, compare favourably relative to their EM peer group and offer decent margin of safety against a shorter-term deterioration in fundamentals. 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.

Portfolio managers
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as at 30 September 2018