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

The fund returned 0.9% in August, bringing its total return to 8.6% for the 12-month period. This is ahead of the returns delivered by cash (7.0%) and its benchmark (7.7%) over the same one-year period.

Local bonds rebounded in August after the weak performance in July. The All Bond Total Return Index generated 0.84% for the month and 7.87% year to date. The 3-7-year portion of the curve enjoyed the best performance, ending the period up 1.06%. Bonds with maturities of 7-12 years returned 1.01%, with the very long end (12+years) up 0.74%. Inflation-linked bonds performed poorly, falling -0.84%. Cash returns were stable at 0.60%.

On the global front, trade tensions between China and the US continue to impact on global markets. Brexit developments remain uncertain and at times chaotic, and another election in the UK seems increasingly likely. The risk of a 'no deal' Brexit persists.

Policymakers remain concerned about persistently low inflation and the deteriorating growth outlook, broadly signaling more accommodative monetary policy settings. The US Federal Reserve Bank (Fed) has reiterated that there is room for further rate cuts should economic data disappoint, and the market is pricing a 25bps rate cut with 95% probability at the Fed's September Monetary Policy Committee (MPC) meeting. In Europe, the European Central Bank's (ECB's) President Mario Draghi has cautioned against using quantitative easing as the only tool to combat the deteriorating weak economy. The ECB is open to exploring other tools to help stimulate economic growth. Nonetheless, the eurozone overnight index swap (OIS) curve is pricing in a 67% probability of a 20bps reduction in the ECB's deposit rate to -0.60% at the September meeting. The Bank of England (BOE) emerged with a dovish stance and indicated further monetary easing is likely should Brexit strategies deteriorate.

Broadly, July inflation data remained mixed, with several key releases surprising on the upside. US consumer price inflation (CPI) increased to 1.8% year on year (y/y) in July from 1.6% y/y in June. Higher services, energy, transportation and commodity prices were the main drivers in the US CPI number. UK CPI increased to 2% y/y in July vs June's 1.9% y/y and the producer price index (PPI) surged to 1.3% y/y vs June's 0.3% y/y. Inflationary pressures in the UK remain a concern and the weak UK pound has resulted in elevated import costs. Eurozone CPI fell to 0.9% y/y in July vs June's 1.1% y/y print. Low energy costs and low services inflation dragged down the CPI print. China's CPI rose to 2.8% y/y in July vs June's 2.7% y/y. Food, tobacco and medical care were the main contributors to the uptick in the number, while in most other emerging markets CPI remained contained and printed within target bands.

The rand was down 5.6% over the month, ending at 15.2 to the US dollar. This was in line with the poor performance of the emerging market (EM) peer group but spurred on by poor local fundamentals. 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. This has the added benefit of enhancing the fund's yield when bringing offshore exposure back into rand.

In South Africa, Q2-19 gross domestic product (GDP) print surprised the market and came in at 3.1% quarter on quarter (q/q) seasonally adjusted and annualise (saa), against a consensus forecast of 2.5% q/q saa. In annual terms, GDP grew 0.9% y/y after being flat in Q1-19 and compared to market expectations of 0.7% y/y. The biggest contributors to GDP in value-added terms came from mining production, financial and business services, manufacturing and utilities services. Contained load shedding and fewer strike disruptions in Q2-19 helped support growth. Agriculture was again a detractor as a result of weakness in field crop production and pressure on horticulture. Measured from the demand side, consumer expenditure ticked up slightly, and household consumption grew 2.8% q/q saa in Q2-19, following -0.8% q/q saa in the first quarter. Government expenditure grew by 2.8% q/q saa, broadly reflecting election-related employment growth. For the first time in six quarters, gross fixed capital formation expanded, mostly as a result of increased spending on machinery, equipment and residential property. Net exports, however, detracted from the GDP growth, as exports weakened in line with deteriorating terms of trade, and imports surged as machinery and equipment demand picked up.

At the end of August, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 7.58% (three year) and 8.05% (five year); down 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 100bps in the three-year area and 110bps 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.

Domestic data activity in June disappointed. Manufacturing production fell by 3.2% y/y from a revised 0.4% y/y contraction in May. Petroleum, iron and steel production declined the most. Mining output also contracted by 4.2% in June compared to May's -1.5% y/y, dragged lower by weak gold and diamond production.
The July CPI print surprised the market to the downside, coming in at 4% y/y vs 4.5% y/y in June. A weaker than expected electricity tariff increase, coupled with lower transport inflation, largely accounted for the surprise. Food inflation remained stable, with the increase in bread and cereal prices offset by low diary and processed food inflation. Producer price inflation (PPI) also fell sharply in July to 4.9 y/y vs June's 5.8% y/y, as fuel and energy prices fell. Given ongoing low growth and benign inflation prints, the market is pricing in a 40% chance of a rate cut when the South African Reserve Bank (SARB) MPC meets in September.

South African government bonds (SAGBs) are most likely to exit the FTSE World Government Bond Index (WGBI) in the next 12 months as pressure mounts on Moody's to move SA into sub-investment territory. The global environment has turned more supportive for emerging markets and SA; however, SAGBs have a very limited margin of safety against a turn in global sentiment or a worsening outlook in local economic conditions. Therefore, it is prudent to maintain a neutral to slightly underweight allocation to SAGBs at current levels. Any exposure to SA bonds should be taken in longer-dated SAGBs and shorter-dated inflation-linked bonds.

The local listed property sector was down 3.1% over the month, bringing its return for the rolling 12-month period to -10.4%. Listed property has been the largest drag on the fund's performance, primarily due to generalised equity weakness and idiosyncratic domestic issues relating to the possible closure of Edcon and its impact on the broader property sector, as well as lower real GDP growth. However, from an income perspective, distribution growth and expectations about future distribution growth remain sound. Despite the underperformance, from a valuation perspective, the sector remains very attractive. The changes in the property sector over the last decade (including the increased ability to hedge borrowings and large offshore exposures) should make listed property more resilient going forward. If one excludes the offshore exposure, the property sector's yield rises to approximately 10.7%, 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 down 0.6% over the month, bringing its 12-month return to 16.1%. 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 8.61% 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 and Mauro Longano

as at 31 August 2019