CORONATION STRATEGIC INCOME FUND

Quarterly Portfolio Manager Commentary

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

The fund returned 0.5% in December, bringing its total return to 8.4% for the 12-month period. This is ahead of the returns delivered by cash (6.9%) and its benchmark (7.6%) over the same one-year period.

Despite the amount of turbulence that was injected into financial markets with Brexit, the US/China trade war and Hong Kong protests, global equity markets closed calendar 2019 up more than 25% in US dollars (as measured by the MSCI World and All Country World indices). Global bond markets were not excluded, as most bond markets saw their yields compress over the course of the year, driven by a slowdown in global growth and a dovish twist by global central banks. Emerging market bonds provided a total return of 13.5% in US dollars as the hunt for yield intensified in a world where $11.2 trillion worth of debt now trades at a negative yield.

Despite the rally in global equity and bond markets, South African (SA) bond and equity markets underperformed their global peers. The local economy continued to slow due to concerns about deteriorating government finances and State-owned enterprises (SOEs), specifically Eskom, as bouts of load shedding continued to intensify. The All Bond Index (ALBI) produced a total return of 10.3% in rands (13.1% in US dollars), which was driven by a rally in the three- to 12-year area of the curve as expectations of further interest rate cuts continued given the low-growth and contained inflation environment. The slow pace of policy change and implementation, as well as tough decision making, will continue to weigh on the country into 2020. That said, the flower that blooms in adversity is the most rare and beautiful of all, so let's hope SA can learn and heal from its damaged past, rather than run from it.

In SA, the rand was up 2.5% over the year, ending calendar 2019 at US$1/R14.00. The rand's recovery in the final month of the year has put its performance in line with its emerging market peer group currencies. Poor local fundamentals, in the form of lower growth and continued signs of fiscal deterioration, imply that the rand will remain under pressure during the first quarter of the year as we head towards the February 2020 budget. The fund maintains its healthy exposure to offshore assets and, when valuations are stretched, will hedge/unhedge portions of its exposure back into rands/dollars by selling/buying JSE-traded currency futures (US dollars, UK pounds and euros). 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 rand weakness, enhancing the fund's yield when repatriating exposure. Offshore exposure remains the best protection for rand investors in the event of a risk-driven sell-off.

Inflation is expected to average close 4.5% over the next two years, which is at the midpoint of the inflation targeting band, while growth is not expected to reach 1.5% until 2021 (SA's growth has averaged sub-1% since 2015), while global growth is expected to average just above 3%. The monetary policy committee (MPC) has reiterated that they want inflation closer to the midpoint, so that it can use monetary policy more effectively during times of crisis. SA's economy is struggling to grow and, although monetary policy is a blunt tool, it can be used to boost confidence and relieve some consumer pressure. Currently, real policy rates are above 2%, and if the repo rate does not move, the real policy rate will average 1.7% over the next two years. In previous cycles, when growth was this low, the real policy rate averaged close to zero. This suggests that there is room for the MPC to move policy rates at least 50 basis points (bps) lower over the next year.

At the end of December, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 7.67% (three year) and 8.09% (five year); quite a bit lower than the previous month and close to 80-90bps lower over the year. 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.

Fiscal policy in SA has been on a slippery slope since the global financial crisis, as the administration has struggled to narrow the fiscal deficit while government debt has ballooned. The reasons for this are well known, but, in recent years the slowdown in growth has decreased tax revenue, while expenditure has continued to increase to rescue ailing SOEs (Eskom, South African Airways, Denel). Eskom has been and remains the biggest risk to the local economy. Turnaround plans have been tabled and key personnel have been replaced, but due to the extent of a decade plus of maladministration and corruption, the operational turnaround has been slow. It is inevitable that financial support will be ongoing, and government will need to cut expenditure in other areas to keep the nation's ailing power supplier online. The February 2020 budget will be another watershed moment, as investors will again look to policymakers to make the hard, shorter-term decisions, such as freezing or cutting the government wage bill despite union objections.

Most rating agencies have given up hope when it comes to SA and moved us into sub-investment territory. Moody's is the only rating agency that has SA as investment grade, which keeps us in the World Government Bond Index (WGBI). However, given the deterioration seen over the last year, it is very likely that they will downgrade SA in 2020, which should see outflows from the local bond market of between R70bn and R120bn. This seems like the end of the world, but we should not forget that SA has a very deep and liquid bond market and a very large and sophisticated savings industry. Moreover, this deterioration and the risks around it have been well flagged over the last two to three years, so investor positioning has adjusted accordingly. SA also comprises less than 1% of the WGBI, so, at current valuations, investors might choose not to exit. In the worst case, government fails to demonstrate a better picture in the budget in February 2020 and SA exits the WGBI, but that does not mean the end of the world for SAGBs. It is more likely that we see some fiscal effort at the budget and with regards to SOEs. While this does not rule out an exit from the WGBI, it at least keeps policy trajectory headed in the right direction.

Inflation-linked bonds (ILBs), once again, underperformed nominal bonds in 2019, with a return of 2.6% for the year. Only shorter dated ILBs provided a positive return, albeit below cash. A five-year ILB trades at a real yield of 3.6%. Using expected inflation of 4.5%, if one holds this bond for the next three years the nominal return would be in excess of 8%, which compares very favourably to equivalent maturity nominal bonds. In addition, with expectations for the real policy rate to move closer to 1%, it makes the carry-on shorter dated ILBs even more attractive. At current levels, shorter dated ILBs do warrant a position in the portfolio.

The SA economy has been plagued with low growth, ballooning government finances and a volatile global geopolitical environment. Low growth and well contained inflation suggest the trajectory for SA policy rates to be lower over the next 12 months. In addition, SA bonds have continued to underperform relative to their global and emerging market counterparts, suggesting an increased risk premium given SA's precarious economic backdrop. At current levels, South African government bonds (SAGBs) seem adequately priced relative to underlying risks, which suggests a neutral allocation in portfolios.

The local listed property sector was down 1.6% over December 2019, bringing its return for the rolling 12-month period to -0.4%. Listed property has been the largest drag on the fund's performance, primarily due to idiosyncratic domestic issues relating to the pressure on tenant profitability as a result of lower GDP growth, which has had an unfavorable impact on the broader property sector. Despite the underperformance, from a valuation perspective, the sector remains very attractive. If one excludes offshore exposure, the property sector's yield is greater than 10%, 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 SA Preference Share Index was down 0.5% over December, bringing its 12-month return to 18.6%. 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 8.48% 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
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as at 31 December 2019