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

The fund returned 0.4% in July, bringing its total return to 8.4% 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 had a weak month, with the All Bond Total Return Index returning -0.7% in July amid global pressure and a deteriorating domestic fiscal position. The long end of the bond curve showed the worst performance and returned -1.1%. Inflation-linked bonds (ILBs) delivered a muted performance and only returned 0.1%. Cash returns were stable and returned 0.6%.

On the global front, the International Monetary Fund (IMF) reduced its 2019 global growth forecasts in July to 3.2% from a previous forecast of 3.3%. It cited ongoing trade wars between China and the US, a poor growth outlook in emerging markets and a decrease in consumer confidence as the main drivers behind the cut in the growth rate. There was much central bank activity in July; with the US Federal Reserve (Fed) cutting its funds rate range by 25 basis points (bps), the South African Reserve Bank (SARB) cutting the repo rate by 25bps and the European Central Bank (ECB) leaving rates unchanged, among others.

The Fed cut its fund rate range by 25bps to between 2% and 2.25% in July, cautioning that this was a mid-cycle adjustment and not the start of a cutting cycle. The cut was a response to negative global growth and persistent trade tensions between China and the US and persistently lower than targeted CPI. Overall comment was received as hawkish relative the dovish expectations. However, the market is still pricing in an additional 25bps cut for September. The US also threatened to apply 10% tariffs on $300bn of imported Chinese goods after trade talks failed to progress sufficiently between the two countries.

The ECB left rates on hold in July and reiterated a dovish stance, signaling that rates could remain at current levels until mid-2020. The market is expecting a 10bps cut to the deposit rate and additional asset purchases in September. The Bank of England (BoE) kept rates on hold and is unlikely to move short-term, given the uncertainty surrounding Brexit, but also signaled its willingness to respond to deteriorating conditions. The UK overnight indexed swap (OIS) forward rate curve is pricing in one 25bps rate cut by year end, adopting the easing stance of other global central banks. The rand was down 1.8% over the month, ending at 14.34 to the US dollar. Increasing concerns of lower growth due to the intensification of the US-China trade war, combined with benign inflation expectations, led to more dovishness from the Fed and ECB, which fuelled the global bond market rally. By the end of June, the US 10-year bond had rallied to 2% (down from 2.7% at the beginning of 2019), while approximately US$13 trillion worth of global government bonds slipped into negative yielding territory. This spurred a rally in nearly all emerging markets' currencies and bonds, as the carry trade came back into vogue. 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 into rand).

In South Africa, the South African Reserve Bank's (SARB) monetary policy committee (MPC) voted unanimously to cut the repo rate by 25bps to 6.25%, as expected by the market. The MPC noted inflation has remained balanced at the mid-range of the target band, providing some room to ease monetary policy. The statement however reiterated that South Africa's problems remain structural in nature and rate cuts will do little to address these issues. SARB Governor Lesetja Kganyago also mentioned that a 50bps cut was not discussed in the meeting and cautioned that further easing would be data dependent. The forward rate agreement (FRA) curve has since flattened and is only pricing in 50% of a 25bps rate cut in the next 12 months.

June headline CPI printed at 4.5%; unchanged from May's numbers. Core inflation ticked up to 4.3% year-on-year (y/y) from 4.1% y/y in May. Food and alcoholic beverages inflation rose, but transportation inflation and petrol prices decreased. Inflation has consistently printed at 4.5% and below in the last seven months. The SARB now sees inflation risks balanced and inflation averaging 4.4% y/y in 2019.

At the end of July, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 7.9% (three year) and 8.4% (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 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 activity data remain mixed - manufacturing production increased by a meagre 1.1% y/y in May vs April's 4.3%. May's numbers were supported by an increase in food and beverages and growth in the textile sector but offset by weaker petroleum and chemical production. Mining production in May contracted by 1.5% y/y, dragged down by gold and diamond production, which decreased by 24.4% y/y and 30.7% y/y respectively. Retail sales accelerated by 2.2% y/y in May vs April's 2.7% y/y increase. Taken together, sequential GDP activity in Q2-19 is expected to have picked up to 2.4% q/q saa after contracting -3.2% q/q saa in Q1-19.

The Minister of Finance tabled a Special Appropriation Bill to release additional funding for failing power utility Eskom. Under the bill, Eskom will receive R59bn more over the next two financial years; R26bn for the 2019/20 financial year and R33bn in 2020/21, in addition to the R23bn a year already allocated. State-owned entities (SoEs) remain a key risk to the fiscus. National Treasury has increased nominal and ILB issuance to accommodate the additional expenditure. Moody's issued a statement saying Eskom's financial developments are credit negative, but made no ratings action, while Fitch lowered South Africa's outlook from stable to negative and affirmed the BB+ rating level.

Cyclical economic factors are supportive of bond yields. Inflation will remain benign and growth subdued, which would allow an easing in policy rates. However, persistently low growth and the need for further support of SOEs will weigh heavily on government finances, resulting in wider budget deficits and a significant increase in the debt burden. South African government bonds (SAGBs) are most likely to exit the Citi World Government Bond Index in the next 12 months, as pressure mounts on Moody's to move South Africa into sub-investment territory. The global environment has turned more supportive for emerging markets and South Africa; however, SAGBs have a very limited margin of safety against a turn in global sentiment or a worsening in local economic conditions. Therefore, it is prudent to maintain a neutral to slightly underweight allocation to SAGBs at current levels. Any exposure to local bonds should be taken in longer-dated SAGBs and shorter-dated ILBs.

The local listed property sector was down 2.6% over the month, bringing its return for the rolling 12-month period to -6.3%. 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 up 0.7% over the month, bringing its 12-month return to 19.9%. 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 8.45% 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 July 2019