CORONATION GLOBAL STRATEGIC USD [ZAR] FEEDER INCOME FUND

CORONATION
TRUST IS EARNED™

Quarterly Portfolio Manager Commentary

Please note that the commentary is for the US dollar retail class of the fund. The feeder fund is 100% invested in the underlying US dollar fund. However, given small valuation, trading and translation differences for the two funds, investors should expect differences in returns in the short term. Over the long term, we aim to achieve the same outcome in US dollar terms for both funds.

The second quarter of 2019 (Q2-19) witnessed a continuation of the broad-based rise in asset prices despite a rise in trade tensions. Globally bond yields declined and equity, alongside credit markets, performed well as lower inflation expectations lent support to the dovish lilt from central banks. Investors now expect significantly easier monetary policy across most markets, placing increased dependence on the authorities to validate the markets' moves. The fund returned 0.8% over Q2-19 and 2.7% over the last year, against a benchmark return of 0.7% and 2.8% over the same periods.

During Q2-19, the current US expansion may have become the longest on record, but investors' minds were firmly focused on the brinkmanship of President Donald Trump and his Chinese counterpart President Xi Jinping. Trade talks stalled in May after President Trump accused China of reneging on a deal and raised tariffs on an additional US$200 billion (to US$250 billion in total) of Chinese products at 25%, Beijing retaliated, raising levies on US$60 billion of US products. Prior to the recent G20 summit the US had threatened tariffs on a further US$300 billion of Chinese goods but, with an agreement to recommence trade talks these have been deferred. Many investors had believed that both parties had a reason to settle their differences; President Trump because he needed to spin a positive scenario ahead of the 2020 elections and President Jinping because the Chinese economy was already slowing. The longer the dispute persists, the less optimistic the investor community and business is becoming, with tariffs increasingly appearing to be used as a broader US foreign policy, with restrictions on China's telecommunications company Huawei, being a case in point. Huawei was placed on the US Entity List in May, a document that bans US firms from supplying the company.

However, China hasn't been the US's only target. In 2018, the US imposed steel and aluminium tariffs on many of their allies. More recently the US has threatened a 25% tariff on cars and auto parts, which has been delayed for now. The US is also proposing tariffs on up to US$25 billion of European goods in response to EU subsidies to Airbus (a pertinent issue given Boeings recent problems). Mexico has also been on the receiving end of the US grievances, alongside India, Japan and many others.

Recent increases (75% from the US) take global tariff levels back to those that prevailed in 2003. It also threatens supply chains and complicates capex decisions. Global trade volumes have fallen by the most in 10 years, with global Purchasing Manager Indices bordering on contracting. Global GDP looks set to slow to around 2.5% during the second half of 2019, a little below trend and the slowest since 2012, but the risk continues to be to the downside. While consumer and services sectors have remained more resilient to date, softer data is likely as conditions in labour markets soften.

Inflation data in recent months have given central banks little room for concern with the recent growth slowdown increasingly highlighting downside risks and allowing for a dovish tilt in policy as an insurance policy. Federal Reserve Chairman Jerome Powell's tone at the June Federal Open Market Committee (FOMC) meeting was much more dovish than suggested by the revised dot plot (where the average dot was lower by 0.32% in 2019 by 0.46% in 2020 and by 0.43% in 2021). It also added further impetus to the rally in US Treasuries. Three-month US Libor fell from 2.6% at the end of March to 2.32% at the end of June. Markets have now repriced to reflect an 80% chance of a 0.25% cut by the FOMC in July, with a 20% chance of a larger 0.5% cut. The market now sees 0.75% of cuts during 2019, 1% during the next 12 months and up to 1.25% during the next 18 months. The US Treasury curve is now inverted at the shorter end, with the three-year being the low point of the curve at 1.7%. Ten-year yields fell from 2.4% at the end of March to 2% by end June. Real yields lagged the move in nominal rates (down 20 basis points [bps] in 10 years) as break-even rates also fell by 20 bps to 1.7% in 10-year maturities. Tighter swap spreads have been another noticeable feature of recent months with longer maturities increasingly negative, suggesting strong receiving interest.

Our expectation at the end of the last quarter was that the soft patch in Q1-19 data would ultimately mitigate and initial signs suggested that was the case, as easier financial conditions globally and stimulus in China began to filter through. We remain of the view that the US economy isn't that weak outside of the manufacturing sector. This could naturally change if the trade disputes continue and the political resolve is strong enough to live with the consequences. US Treasury yields are now consistent with GDP growth closer to 1% in 2020 than the FOMC's 2% projection. Low levels of volatility allowed us to express a cautious view on rates but protect the fund against alternative outcomes via interest rate options. This optionality proved to be valuable as the shift lower in rates was more aggressive than our initial expectations. The duration of the fund has fallen from 0.5 years at the end of Q1-19 to only 0.15 years, which is extremely defensive.

While President Trump's actions having captured the headlines, the impact felt in Europe has arguably been more significant. The German car industry was already reeling from the auto emission scandal but the fallout from lower trade volumes and threats of US tariffs have seen a slump in activity and expectations. Higher nominal growth in Europe would help alleviate some of its debt issues but currently Europe is experiencing a renewed slowdown in nominal growth and more concerning from the European Central Bank's (ECB) perspective, record lows in inflation expectations, which is leading to talk of 'Japanification'.

In July 2012, Mario Draghi made an off-the-cuff remark that the ECB would do "whatever it takes" to solve the European Debt Crisis and in doing so averted a crisis. Seven years later in a speech in Sintra, Portugal, he said the ECB would "use all the flexibility within our mandate to fulfil our mandate", opening the door to possible rate cuts and renewed quantitative easing. Markets now expect the ECB to cut rates in September, just before Draghi leaves office in October (having never raised rates during his tenure of eight years) to be replaced by Christine Lagarde. One of Draghi's key messages throughout his tenure was that the ECB needed fiscal help from governments. Lagarde's political experience and connections should help facilitate co-operation between the ECB and governmental policy. Negative yields in German government bonds now extend out to 20 years with the 10-year (down 30bps during Q2-19) close to the ECB's deposit rate at -0.4% for the first time.

In the UK, Theresa May announced her resignation as Prime Minister in May, triggering a leadership contest that will result in a new leader of the Conservative Party and Prime Minister being elected on 22 July. Current polling places Boris Johnson as the favourite, which significantly increases the chances of a 'no deal' Brexit. While there is much debate around whether a 'no deal' outcome can be thwarted by Parliament, this ignores the fact that without the EU's consent to an extension, a 'no deal' is the legal default of not reaching an approved deal or revoking Article 50. The other issue that attracts little attention is that any deal with the EU is only the beginning of a much longer negotiating phase. Meanwhile the UK's vision of lucrative trade deals with other global players is running into problems in a world marked by heightened geopolitical tensions. We see little room for optimism at this juncture.

Despite the slowdown in global trade, emerging markets performed well as the recent dovish tilt from major central banks led developed market yields lower and kept the US dollar's strength in check. Low volatility has further enhanced the appeal of carry trades which remain front and central in the current 'bad news is good news' regime.

Corporate bonds widened during May alongside weaker equity markets, but this quickly reversed during June and spreads tightened over the quarter. The broad US investment grade market returned 4.3% during Q2-19, 0.9% in excess of government bonds. US high-yield bonds lagged returning 2.6% (only 0.3% more than government bonds). This was partly due to the lower duration of high yield bonds but also due to CCC-rated entities lagging (CCCs returned only 0.7% versus 3.2% for BB-rated bonds) as defaults increased. The hunt for yield has provided a powerful underpin to the market and the anticipated reopening of quantitative easing by the ECB has led to talk of a central bank 'put'. In a world where central banks seek to quell volatility, credit will continue to look attractive on a risk-adjusted basis, how long the 'genie' can be contained remains debatable. With excesses within the credit market increasingly appearing prevalent, we have become more cautious. The credit duration of the fund has shortened marginally during the quarter to around 1.4 years currently. Our new senior bank holdings were concentrated within 4- and 5-year maturities where we believe the credit term structure is most attractive. The fund continued to have a bias for floating-rate notes over fixed-rate notes but more recently falling government yields have created a demand for US Libor-linked instruments and tightening spreads have improved the relative attractiveness of fixed-rate debt especially in 2- to 4-year maturities. Stronger equity markets and tighter credit spreads have improved the backdrop for convertibles, and we continue to see value in a sector that often falls outside pure bond or equity investors. Within the higher quality end of the market, US spreads remain more attractive for the fund when foreign exchange hedges are incorporated and the exposure to the US has been rising as a result.

The FTSE EPRA NAREIT developed market property index returned 0.2% during the quarter - a far cry from the 14.9% in the first quarter and at odds with the move in other risk-based assets. Europe (down 1.8% in US dollar terms) and the UK (down 4.1% in US dollars) were the main detractors although the US market only returned 0.7%. The long-term trend of logistics outperforming retail-orientated stocks continues, and the valuation gaps continue to grow. German residential stocks came under significant pressure throughout June after the Berlin Senate approved a five-year rent freeze. Deutsche Wohnen, a large landlord in Berlin, fell 25% despite widespread legal opinion that the regional decision is unconstitutional. The fund had previously sold its German exposure and has begun to review the position, considering the large fall in share prices.

Within foreign exchange markets the broad trade-weighted US dollar was broadly unchanged. It was marginally weaker against the euro (-1.4%) and the yen (-2.8%) but slightly stronger against those currencies most dependant on global trade such as the Korean won (+1.7%) or Australian dollar (+1.1%). Sterling proved to be the laggard, down 2.6% against the US dollar over the quarter. Emerging market currencies were the biggest beneficiaries of a more stable US dollar and lower global rates as investors sought out higher yielding markets.

In anticipation of an unwind in excess rate expectations, the fund duration is now very short. The extremely low levels of bond yields and the elevated price of riskier assets feel like a disconnect, based on market dynamics (such as liquidity and yield targets) and not fundamentals, which is always concerning. In this regard the low levels of volatility also remain a concern. The fund continues to own credit protection to mitigate adverse movements in credit spreads. If global trade disputes cause a large growth slowdown, we believe risk premiums need to rise. Moreover, if globalisation has helped drive down inflation in recent years, what does a reversal mean? If companies are not able to pass on tariff increases, then profit margins must surely suffer and, with-it, risk-based valuations.

Portfolio managers
Stephen Peirce, Nishan Maharaj and Seamus Vasey
as at 30 June 2019