CORONATION GLOBAL STRATEGIC USD INCOME FUND

Quarterly Portfolio Manager Commentary

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

The first quarter of 2019 (Q1-19) saw a sharp reversal in asset class returns. A combination of falling bond yields and rising equity prices led to a broad-based rally in asset prices, which was in stark contrast to the experiences of 2018. Once again, the actions of central banks were instrumental in generating positive returns for investors as they shifted towards more dovish stances. The fund returned 2.0% for the quarter and 2.1% over the last year, against a benchmark return of 0.7% and 2.8% over the same periods.

Lower expectations for future interest rates were at the heart of the rally in asset prices during the quarter. The US Federal Reserve's (Fed) December increase in the Fed fund's rate prompted plenty of public criticism. Alongside the trade dispute and fears of China cooling down, this led to weaker asset prices and a sharp tightening of financial conditions. The Fed's subsequent communications at the January and March meetings marked a significant softening of language and the market interpreted the median dot plot forecast of no more rate hikes in 2019 as surprisingly dovish. It also announced the end of its balance sheet runoff by October 2019, slightly ahead of expectations, but will continue to run down its mortgage-backed security holdings by replacing them with Treasuries.

The Fed's U-turn reflects a sharper-than-expected slowdown in global growth during Q1-19 (exacerbated by some one-off events such as weather, trade tensions and lower automotive volumes). With the risk tilted towards the downside, a more cautious stance made sense. While Fed officials maintain that they are relying on economic data as a guide, an extension in the timeline for US-China trade talks and the re-emergence of the debt ceiling debate in the third quarter of 2019 mean any new hikes are unlikely until late 2019 at the earliest. Ultimately, we expect the soft patch in Q1-19 global economic data to be mitigated aided by easier global financial conditions and policy stimulus in China. In the US, the sectors (consumer and housing) in which downturns usually precede recessions remain sound, while low levels of unemployment and higher-than-average savings rates, alongside the wealth effect of rising asset prices, suggest resilience.

The Fed's dovishness contributed to a significant rally in bond yields (with 10-year yields falling as low as 2.35%) and led to an inversion of the yield curve between the short end (three months) and 10-year rates. From a market perspective, this was a highly significant market event as inverted yield curves have been one of the most reliable indicators of previous recessions. Not surprisingly, this has prompted reams of debate and fuelled further safe-haven flows. Without dismissing the yield curve signal, there are reasons why it may be less powerful this time around, among these is the fact that quantitative easing has supressed the term premium and anchored longer-term rates.

Central bank actions have also supressed volatility, something that seems at odds with the levels of economic and political uncertainty that currently exist. The fund reacted to lower yields by reducing duration to around 0.5 years from 0.75 years at the end of December 2018. The move lower in yields during Q1-19 has been predominately through lower real yields as oil prices have moved higher and the Fed's actions suggest a tolerance for modestly higher inflation. The fund had increased its exposure to Treasury Inflation-Protected Securities in late 2018 and reduced its exposure during Q1-19 from 35 basis points (bps) of duration contribution to 13bps as break-evens rose.

European bonds kept pace with returns in the US as the weak external environment weighed on European growth, with manufacturing in Germany being particularly hard hit. European Central Bank (ECB) members believe the weakness will prove to be temporary, but the softer outlook required the ECB to send an expansionary signal via an extension of unchanged interest rate guidance to the end of 2019. The resumption of the long-term refinancing operations commencing in September 2019 will also be particularly helpful to Italy where 2019 growth expectations have fallen to just 0.1%. Since the ECB's announcement, it has been noticeable that the credit market now perceives an ECB 'put' to be in place - a marked change from the quantitative easing roll-off fears that dominated in late 2018.

In the UK, Prime Minister Theresa May's EU-negotiated Brexit deal failed to muster enough votes to get through Parliament. With a myriad of alternative approaches all failing to break the deadlock and the clock now exhausted, the UK is reliant on the EU granting an extension to find a compromise or risk falling out of the EU without a deal. While Parliament has clearly pivoted towards a softer Brexit, the potential for a no-deal Brexit remains "alarmingly high" according to the Governor of the Bank of England.

Corporate bonds recouped their losses from the fourth quarter of 2018, posting their strongest quarterly returns since 2009. US investment-grade bonds were up by 5% (outperforming government bonds by 2.6% - the greatest outperformance since 2012) and US high-yield bonds were up 7% (an outperformance of 5.7% — the largest since 2009). From the fund's viewpoint, the largest spread movement occurred in shorter-dated instruments (where a three-year single A-rated instrument rallied from 80bps to 50bps). This has steepened credit curves, prompting the fund to extend the maturity of some of its holdings while maintaining the overall credit duration at around 1.5 years. The other notable movement in the fund's positioning has been in floating-rate notes where the fund's allocation has increased from around 20% to 30%. This has been driven by the fall in swap spreads, such that spreads on floating-rate notes (FRNs) are broadly comparable to the spreads on fixed-rate bonds. We view the optionality embedded in FRNs at this entry point as attractive. With spreads now approaching their tightest levels since Q1-18, we are once again increasingly cautious on valuations and see them vulnerable to a rise in volatility or equity weakness. It seems odd that at the same time the market is fretting about an inverted yield curve, spreads are performing as if no downturn is on the horizon. If the reason for credit's strong returns is the reach for yield by investors, then the historically wide spread between the dividend yield on equity indices and corporate bond yields should be worthy of more debate.

The FTSE EPRA Nareit Developed Market Property Index returned 14.9% in Q1-19, with a broad-based rally across developed markets. Higher equity markets and lower bond yields alongside tighter credit spreads were all supportive of the sector, and, in turn, represent a risk should they reverse. Globally, logistics-orientated stocks continue to perform, as do some office portfolios, whereas retail stocks continue to struggle. The fund's exposure to property remains low at around 2.6%.

Within foreign exchange markets, the principal debate is whether the US dollar's appreciation is a thing of the past as interest rate expectations recede. Having appreciated throughout 2018, the US Fed's Trade-weighted Dollar Index was broadly unchanged in Q1-19. From an investor's perspective, while US rate expectations may have fallen, they remain well above the yields available in other developed markets, and growth expectations in regions such as Europe have fallen even more than those in the US. Meanwhile, China and the US have signalled that trade negotiations have made substantive progress and an agreement may come soon. This should support risk sentiment and boost a resumption of trade and investment that may arrest the recent economic slowdown. While we expect the effects of the recent stimulus in China to be lower than in the past, it should lend further support to global trade and commodity producers. With the US being a relatively insular economy, a pickup in global activity would normally see a weaker US dollar.

After a very-strong quarterly performance, the fund has reduced its interest-rate duration as well as some higher beta credit. Our credit holdings also benefit from the added hedge provided by the credit protection we have in place. Overall, though, valuations reflect quite a bit of good news and caution is once again warranted. High levels of political and economic uncertainty seem at odds with the low levels of volatility in many asset classes. We see this central bank-induced volatility as unlikely to persist as markets face up to the prospect of rising bond yields or a slower economy. For now, investors maybe having their cake and eating it, but indigestion may well be the result.

Portfolio managers
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