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 0.52% in May, bringing its total return to 8.38% 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.

Local bonds put in a muted performance during the month of May with the All Bond Total Return Index returning 0.64% and bringing its year-to-date return to 5.26%. The yield curve, however, did steepen quite aggressively over the course of the month, with the long-end (12+ years) consequently underperforming further and returning just 0.41%. After a strong performance in March, inflation-linked bonds (ILBs) retraced some of their gains with a negative return of 0.9%. Cash returns were stable and returned 0.61% for the month.

After a tentative improvement in April, incoming data in May predominantly pointed towards a softening of the global growth environment in the second quarter of 2019 (Q2-19), with manufacturing and financial conditions deteriorating across most major economies. Contributing to this downturn was a notable resurgence in trade and geopolitical tensions with the US not only ratcheting the pressure considerably up on China, by raising tariffs to 25% on $200 billion of Chinese imports, but also opening new fronts against Mexico and India. Beyond this, headlines were dominated by fresh political turmoil in the UK, culminating in the resignation of Prime Minister Theresa May and the outcome of EU parliamentary elections.

The rand was down 1.9% over the month, ending at 14.58 to the US dollar. Sentiment towards South Africa (SA) continues to swing with emerging market sentiment. In the months following the SA election, the performance of the rand has been led by SA's idiosyncratic issues, specifically lower growth and further fiscal deterioration. 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 to rand).

In the US, the second reading for the first quarter of 2019 (Q1-19) GDP was revised down to 3.1% quarter-on-quarter (q/q) from the preliminary reading of 3.2% q/q. While this wasn't a major revision, it was notable that corporate profits were down -2.8% q/q, which was the second consecutive quarterly decline. Other high-frequency data showed a turn for the worse in April. Retail sales numbers disappointed with a meagre 0.1% year-on-year (y/y) print, while industrial production contracted by 0.5% month-on-month (m/m). And, though the unemployment rate improved, down to 3.6% from 3.8%, underlying wage pressures remained muted with average hourly earnings coming in softer-than-expected at 0.2% m/m.

US headline CPI for April increased to 2% y/y from 1.9% y/y in March, while core inflation also rose to 2.1% y/y. Beyond firmer housing costs, however, the underlying data pointed to broad-based weakness with apparel prices remaining in deflation. This lack of inflationary impulse in the economy was further confirmed by core personal consumption expenditure inflation again printing at a meagre 1.6% y/y. Though the latest Federal Open Market Committee (FOMC) meeting indicated that Fed officials believe most of this recent weakness in core inflation is transitory, the narrative from the Fed continues to shift to the prospect of rate cuts, which the market has quickly priced in.

The ANC maintained its majority rule it the national elections but support slightly declined to 57.5% vs 62% in the last elections held in 2014. The DA came in second with 20.77% of the votes and the EFF's support increased to 10.65%. This result was largely priced in by the market. President Ramaphosa's newly appointed cabinet by needs to act fast to implement the policy reforms that will help stimulate the economy.

In the local economy, Q1-19 seasonally adjusted annualised (saa) GDP growth contracted by a shocking 3.2% q/q. The big contributor to the decline was mining production, which was down 10.8% q/q, while manufacturing production was down 8.8% q/q. The only positive momentum came from business and the financial services sector, which were up 1.1%, government services grew 1.2% assisted by additional hiring and spending ahead of the election, while personal services grew 1.1% q/q (saa rate). The breadth of the weakness in Q1-19 GDP data is considerably worse than expected. The data represents less of the impact of load shedding, and rather serves as a testament to a very-constrained domestic demand, particularly visible in the expenditure side data. Forward-looking data has since also been mixed, with the Purchasing Manager Index (PMI) up in April and down in May, and a similar picture for vehicle sales. The Q1-19 contraction number poses downside risk to the South African Reserve Bank (SARB)'s 1% annual growth forecast, with the economy now more likely to grow by 0.5%-0.7% in 2019.

The SARB's Monetary Policy Committee left rates on hold at the May meeting, with a split of three members voting for a hold and two voting for a rate cut of 25 basis points (bps). April headline inflation remained anchored at 4.4%, while core inflation came in at 4.1%. The forward rate agreement (FRA) curve has priced in two full 25bps cuts over the next 12 months, with the first cut at the July meeting and the next cut at the beginning of 2020.

At the end of April, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.09% (three year) and 8.57% (five year); down significantly 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.

Chronic load shedding and poor local sentiment will continue to weigh on SA's growth outcomes. Inflation should remain under control allowing policy rates in South Africa to, at worst, remain stable. Global monetary policy has once again turned more supportive for risk sentiment, which should help buoy emerging market valuations over the shorter term. At current levels, local government bonds trade at cheap to fair value estimates. However, given the longer-term risks posed to the economy from a further state-owned enterprise deterioration, allocations should be kept at a neutral level. While nominal bonds continue to compare favourably to ILBs, the balance in the front end of the curve has shifted towards ILBs.

The local listed property sector was down 2% over the month, bringing its return for the rolling 12-month period to -9.1%. Listed property has been the largest drag on the fund, primarily due to generalised equity weakness and idiosyncratic domestic issues relating to the possible closure of Edcon, its impact on the broader property sector and 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 is still 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 0.9% over the month, bringing its 12-month return to 19.2%. 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 8.70% 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 May 2019