CORONATION STRATEGIC INCOME FUND

Quarterly Portfolio Manager Commentary

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

The fund returned 0.5 % in October, bringing its total return to 8.9% 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 poor performance in October. The All Bond Index returned -0.35% for the month, with the 12+ year part of the curve taking most of the hit and returning -0.51%. The one- to three-year part of the curve held steady and generated 0.55%. Inflation-linked bonds also delivered disappointing performance and returned -0.50%. Cash returns remained positive and generated 0.55% for the month.

The month of October was plagued by weak GDP prints from developed economies for the third quarter of 2019 (Q3-19). This points to a synchronised slowdown in global economic activity, on the back of Brexit uncertainty, renewed central bank activity and ongoing trade talks between the US and China, among other macroeconomic and geopolitical anxieties. South Africa delivered a sombre Medium-Term Budget Policy Statement (MTBPS), and ratings agency Moody's changed the country's credit rating outlook from stable to negative but affirmed the sovereign credit rating at Baa3.

The Federal Reserve Board (the Fed) cut interest rates by 25 basis points (bps) to the 1.5% - 1.75% target range at its October meeting. Fed Chairman Jerome Powell indicated that future policy actions will be data dependent, and that the Fed will continue to assess the impact of the previous interest rate cuts on the economy. He also noted that US inflation has been well contained below the 2% target and consumer spending been strong over the last few months.

In the UK, Prime Minister Boris Johnson struck a deal with the EU that was later rejected by Parliament. This resulted in an application for a Brexit deadline extension to January 2020, and, subsequently, the announcement of a fresh election, scheduled for 12 December this year. The pound weakened slightly on the back of the failed Brexit deal, and economic data remains lacklustre.

The rand was up 1.3% over the month, ending at $1/R15.10. The rand's performance has lagged many of its emerging market peer group currencies, which is justified given the poor local fundamentals, and, more specifically the fiscal deterioration signaled at the MTBPS. 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 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 enhancing the fund's yield when bringing offshore exposure back into rand.

At the end of September, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 7.85% (three year) and 8.33% (five year); slightly higher 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.

In South Africa, September headline inflation slowed to 4.1% year on year (y/y) vs August's 4.3% y/y. Core inflation moderated to 4.0% y/y from 4.1% y/y. The biggest contributor to the low number was a moderation in rental growth, while food inflation was largely unchanged at 3.7% y/y vs August's 3.8% y/y. Overall inflation pressures remain benign and inflation is well contained around the South African Reserve Bank (SARB)'s target midpoint.

Finance Minister Tito Mboweni's MTBPS disappointed markets, showcasing a budget deficit average of 6.2% of GDP over the next three years, increasing debt and debt service costs, and escalating the debt-to-GDP ratio to 71.3% in 2022/23. The country's finances have deteriorated significantly since the February budget, with state-owned-entity (SOE) bailouts and the large wage bill putting pressure on expenditure as revenue continues to disappoint. The revenue shortfall is expected to reach R50 billion this year and to increase further in the medium term. Overall, the statement painted a dire picture of the country's fiscal position and issued a strong warning to policymakers that any improvement needs to be contingent on tough political decisions about public sector wages, SOE bailout policies and improving nominal GDP growth.

Rating agency Moody's affirmed South Africa's Baa3 long-term foreign currency and local currency issuer rating but changed the sovereign credit rating outlook from stable to negative. Moody's decision to change the outlook from stable to negative reflects a loss of confidence in government's ability to address the deterioration in its finances and implement structural reforms to help revive economic growth. However, the rating agency cited the country's stable financial sector, resilience to a prolonged period of low growth and a robust macroeconomic policy framework as the main contributors in affirming the rating at Baa3.

South African inflation will remain benign and growth subdued, which would, at worse, allow policy rates to remain on hold. 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, as highlighted in the MTBPS. The outlook change to negative by Moody's, poses risk of a future subinvestment downgrade in the near term and a possible exit of South African government bonds (SAGBs) from the Citi World Government Bond Index. SAGBs trade at fair value at best and 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 moderate allocation to SAGBs at current levels.

The local listed property sector was up 2.8% over the month, bringing its return for the rolling 12-month period to -4.7%. 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 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. 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 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 Preference Share Index was up 1.1% over the last month and quarter, bringing its 12-month return to 20.1%. 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 8.8% 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 October 2019