

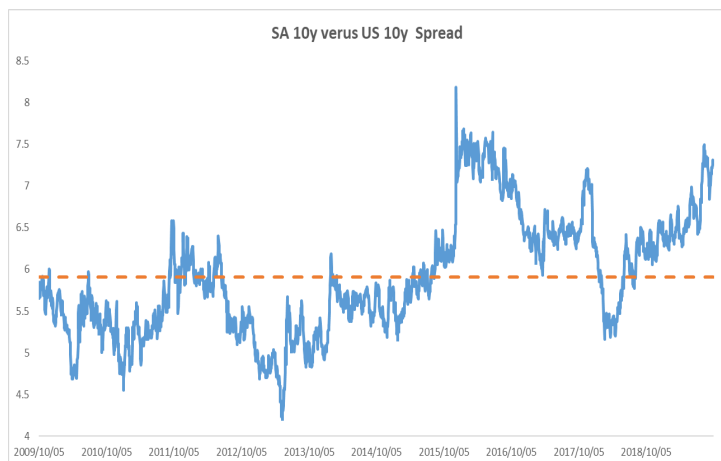
Please note that the commentary is for the retail class of the fund.

The US 10-year bond has rallied from levels of just above 2% to 1.7% over the course of the quarter, for several reasons. The escalation of tension in the US/China trade relationship has dented global confidence, which has led to a material slowdown in the global capex cycle. This has coincided with a slowing in US and global growth. Central banks have been quick to step in and engineer a softer growth landing, with the US reducing interest rates 0.5% this year and the European Central Bank (ECB) moving deposit rates further into negative territory, accompanied with a restart of their bond purchase programme. Current data emerging from Europe points to growth slowing to 1% with inflation of 1.5%, which suggests, at a bare minimum, a continuation of accommodative monetary policy in the EU. US data, more specifically the US labor market, has proved more resilient despite recent cracks starting to appear. The US Federal Reserve Board (the Fed) has adopted a wait-and-see approach to further rate easing, which is much more restrained than the market's current pricing of interest rate cuts. We are still quite far away from seeing a restart of the US quantitative easing (QE) programme, given the room to move lower on policy rates. The hope is that recent measures implemented by global central banks are enough to mitigate an aggressive growth slowdown in the months to come.

On the local front, we remain in limbo as we await the Medium-Term Budget Policy Statement at the end of October and further details on the turnaround for Eskom. Inflation continues to be well behaved and expectations are for it to average 5% over the next two to three years. Growth expectations have been continually revised down, with current expectations for a marginal pick up to 1.5% over the next two to three years. Structural reforms have been much talked about, especially in the new National Treasury economic strategy plan released by Finance Minister Tito Mboweni towards the end of the third quarter. Unfortunately, time is running out, and what's needed now is an accelerated implementation of these initiatives in order to bring back confidence and investment into the local economy.

Government finances continue to weigh heavily on the local outlook, with the fiscal deficit expected to breach -6% this year and debt/GDP to push above 60%. The major culprit of this deterioration has been the continued support needed by ailing state-owned entities (SOE's), most specifically Eskom. Without a credible plan to turn around the entity, more money will need to be poured in to allow it to meet its obligations. Herein lies the major risk for the local economy, and, while there has been an acknowledgement of the problems by government, there has been a lack of urgency in putting a credible plan in place to halt Eskom's deterioration, let alone turn the entity around. Moody's is still the only rating agency that rates SA as an investment-grade country and has provided the country with a tremendous amount of leeway over the last 12 months. Their recent statements suggest that they will continue to do so, given the reform intent of government. However, given what is currently known about the trajectory of further deterioration, if there are no substantial efforts to fix the problems the country faces, it is very likely that SA is assigned a negative outlook on our investment-grade rating by November 2019 and that SA is downgraded to sub-investment grade territory by the third quarter of 2020.

The deterioration in SA's fundamentals have been well flagged, which has allowed a risk premium to be built into SA government bonds (SAGBs), both in terms of absolute yields and the steepness of the yield curve. SA's credit spread (represented alongside by SA credit default spread) already trades at levels that are consistent with a sub-investment peer group. In addition, 10-year SAGBs trades at a spread of 7.3% over US 10-year yields, which is well above the long-term average and close to the widest levels it has been in ten years. These measures suggest a decent amount of the bad news is already being priced in by markets.



Furthermore, SAGBs look quite cheap when compared to the EM universe. In the below table, we show the nominal yields of various EM bond markets and their implied real yields (the return one would get if we strip out the effects of inflation over the next year). SA not only sits well above the EM average but also at the top of the ranking table when it comes to the relative cheapness of nominal and real yields. In a world of very-low to zero yields, SA bonds look fantastically attractive and relatively cheap to dollar-based investors.

	Nominal Yield	Implied Real Yield
South Africa	8.92	4.13
Indonesia	7.26	3.79
Brazil	7.05	3.23
Mexico	6.88	3.16
India	6.70	3.04
Russia	6.90	2.62
Malaysia	3.33	1.85
Average	5.15	1.30
China	3.14	0.73
Chile	2.53	-0.07
Israel	0.89	-0.36
Poland	1.99	-0.55
Czech Republic	1.33	-1.09
Turkey	13.15	-1.16
Hungary	1.97	-1.19

As a dollar-based investor, when one invests into a local currency bond market, there are two major risks that one takes. Firstly, you take the risk that the yield at which you are investing does not offer a sufficient margin of safety in the event of further local fundamental deterioration, and secondly you are taking the risk that the currency depreciates to such an extent that it wipes all the yield from the bonds. The first risk is something that we have discussed at length in the past. We construct a fair value for 10-year SAGBs, using the expected global risk-free rate (US 10-year), expected US/SA inflation differentials and SA credit spread. We use values of 2% (Normal US 10-year rate), 3.8% (5.3%-1.5%) [SA 10-year breakeven - US 10-year breakeven] and 3.2% (SA EMBI Plus Sovereign Spread) to arrive at a fair value of 9.03%, which is not far from current levels of 8.9%. This suggests that SAGBs trade pretty much at fair value, implying not much room in the case of further fundamental deterioration.

Dollar-based investors have the option of buying 10-year SA bonds issued in dollars, currently trading at 4.9% with no currency risk or buying a 10-year SAGB issued in rand trading at 8.9%. If you do not expect the currency to move, then it's a no-brainer to buy the bond issued in rand due to the higher yield on offer. Over the last 20 years, the rand has depreciated by an annualised rate of 4.5%. The annual depreciation would comprise inflation differentials and risk premium. Since SA runs a higher inflation rate than the US, the rand has to deteriorate by a minimum of the inflation differential in order for purchasing power between the two countries to remain unchanged. The more unpredictable part is the risk premium that needs to be priced due to the risk of deterioration in other local factors. Over the last 20 years, inflation differentials between SA and the US have been 3.4% (5.6%-2.2%: actual inflation outcomes), suggesting the risk premium should be 1% (4.4%-3.4%). Current inflation differentials sit at 3.8%, which makes the 20-year annualised depreciation of 4.4% look reasonable, as we assume a reduced risk premium going forward. This implies that a dollar-based investor can expect a return in dollars of 4.5% (8.9%-4.4%). Compared to the actual SA 10-year dollar bond, this is not that attractive, unless one has a materially positive view on the currency. It would also explain why the local SA bond market has experienced outflows this last year of approximately R8 billion. This is a big turnaround from the R20 billion of inflows we were sitting with at the end of the first quarter of 2019.

SA 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. The global environment remains supportive for EM and SA, especially given the renewed monetary policy easing embarked on by global central banks. However, 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 neutral to slightly underweight allocation to SAGBs at current levels.

Portfolio managers
Nishan Maharaj, Steve Janson and Seamus Vasey
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