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 -0.1% in February, bringing its total return to 7.1% for the 12-month period. This is ahead of the returns delivered by cash (6.9%) over the same one-year period.

Local bond performance was broadly flat in February. The All Bond Index was down for the month, while the 12+ years area of the curve took the biggest knock, delivering -0.3%. Short- dated bonds (1-3 years) maintained a positive return of 0.79%. Mid-term bonds (3-7 years) delivered 0.2%, while the longer part of the curve (7-12 years) returned 0.1%. Inflation-linked bonds delivered 0.6%, while cash remained stable at 0.5%. There was surprise end-of-month volatility caused by a sell-off of emerging market assets.

Global market volatility intensified as the economic impact of the outbreak of COVID-19 escalated. The Federal Reserve Board (the Fed) surprised the market with an emergency March rate cut of 50 basis points (bps), moving the federal funds rate range from 1.5-1.75% to 1-1.25%. The rate cut is meant to cushion consumers and business from the economic risk of the virus outbreak. This saw the 10-year Treasury Note's yield dipping below 1%. The Fed will meet again later in the month and the futures market is pricing in a further 25bps cut. US headline inflation increased to 2.5% year-on year (y/y) in January from December's 2.3% y/y. The Personal Consumption Expenditure deflator also rose to 1.7% y/y in January from 1.5% y/y in December. The inflation uptick was driven by a rise in trade services costs, and food and wholesale prices, but elsewhere remains relatively benign.

In emerging markets, China's manufacturing PMI plunged to 35.7 points in February from a previous print of 50 points in January, a move indicating unprecedented weakness. The shutdown of factories at the beginning of the year heavily impacted the manufacturing sector's performance. Other indices marking production, employment and exports all fell to record levels. In early indications, the IMF decreased China's 2020 GDP growth to 5.6%, stating that the increased spread of COVID-19 will affect China's production capacity.

The rand was weaker as it lost 4% against the US dollar, ending February at US$1/R15.65. The combination of the risk-off environment caused by the coronavirus and poor local fundamentals weighed heavily on the local unit. In addition, newsflow during January, which included more load shedding, soured sentiment towards SA even further. The fund maintains its healthy exposure to offshore assets and when valuations are stretched, 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 rand weakness, enhancing the fund's yield when repatriating exposure. Offshore exposure remains the best protection for rand investors in the event of a risk-driven sell-off.

The South African fourth-quarter GDP print was surprisingly weak at -1.4% quarter-on-quarter (q/q), seasonally adjusted average (saa) versus a revised third-quarter print of -0.8% q/q, saa. This was the second consecutive contraction, landing the economy into a technical recession. Overall GDP growth for 2019 was just 0.2% y/y versus 2018's 0.8% y/y. The biggest contributors to GDP in value added terms came from finance and business services and the mining sector. The detractors were trade, transport, storage, communication, manufacturing and agriculture. From the supply side, mining was up 1.8% q/q, saa with PGMs, iron ore and gold performing well. Agriculture disappointed with a contraction of 7.6% q/q, saa owing to a fall in production of field crops and horticultural products. On the expenditure side, government spending fell by 0.2% q/q, saa, reflecting lower employment. Household consumption produced a meagre growth of 0.4% q/q, saa. Gross fixed capital formation contracted by 10% q/q, saa, with machinery and equipment investment being the main detractors, reflecting the rollover of the last IPP projects. Net exports contributed positively to GDP, with exports benefiting from growth in precious metals and stones and a steep decline in imports. Headline inflation printed at 4.5% y/y in January versus 4% y/y in December, but core inflation came in at 3.7% y/y in January versus December's 3.8% y/y. January inflation numbers had a base line effect related to low fuel prices in January 2019, although housing and utility costs also increased. Food inflation remains benign, and low rental inflation should help keep CPI well within target in 2020. Transport costs are expected to increase in the first half of 2020, before stabilising by year end. Given the accommodative global environment and contained inflation, there is a room for further rate cuts, and we are expecting the South African Reserve Bank (SARB) to cut an additional 50bps in 2020.

At the end of February, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 7.30% (three year) and 7.77% (five year); slightly lower than the previous 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 February, Minister of Finance Tito Mboweni presented the budget for the 2020/21 fiscal year and it was not materially different from the October Medium-Term Budget Policy Statement (MTBPS). The budget showcased an average budget deficit of 6.2% of GDP over the next three years, increasing debt and debt service costs and escalating the debt-to-GDP ratio to 71.6% in 2022/23. No increases in the weekly issuance have been tabled, because National Treasury prefunded its 2020/21 obligations last year. An additional R17.2bn of funding was allocated to State-owned enterprises (SOEs), with South African Airways receiving R16.4bn of the allocation to repay guaranteed debt and to service debt. The Minister presented expenditure cuts through a R160bn reduction of the wage bill, reduced debt service costs by R31bn and a reduction of R101bn from other divisions. Gross tax revenue estimates were R138bn lower over the forecast period, in addition to the R251bn reduction announced in the MTBPS. The sharp decrease over the Medium-Term Expenditure Framework was driven by large reductions in personal income tax, company income tax and VAT receipts over three years. Overall, the budget painted a dire picture of the country's fiscal position and the implementation of the proposed expenditure cuts is key to shifting the country's challenging fiscal policy.

The SA economy has been plagued with low growth, ballooning government finances and a volatile global geopolitical environment. Low growth and well contained inflation suggest the trajectory for SA policy rates to be lower over the next 12 months. In addition, SA bonds have continued to underperform relative to their global and emerging market counterparts, suggesting an increased risk premium given SA's precarious economic backdrop. At current levels, South African government bonds (SAGBs) seem adequately priced relative to underlying risks, which suggest a neutral allocation in portfolios.

The local listed-property sector was down 15.7% over February, bringing its return for the rolling 12-month period to –21.3%. Listed property has been the largest drag on the fund's performance, primarily due to 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. If one excludes offshore exposure, the property sector's yield 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 FTSE/JSE Preference Share Index was down 3.9% over January, bringing its 12-month return to 10.6%. 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 8.15% 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
Nishan Maharaj and Mauro Longano
as at 29 February 2020