Please note that the commentary is for the retail class of the Fund

The Fund returned 0.7% in June, bringing its total return to 4.8% for quarter ended June 2020 and 4.5% over the 12-month period.

The local economic backdrop is concerning, but valuations were considerably cheaper by the end of first quarter. South Africa's (SA's) asset price recovery was buoyed by better risk sentiment in global markets. The All Bond Index (ALBI) was up 9.9% in the second quarter of 2020 (Q2-20), but its returns remain flat year to date (YTD) and a paltry 2.8% over the last 12 months. ALBI performance continues to be the driven by bonds in the zero- to seven-year area of the curve, as cash rates have pulled down aggressively on the 275 basis points (bps) of repo rate cuts carried out by the South African Reserve Bank (SARB). The 12-year-plus area of the curve has continued to underperform due to the deterioration in government finances and increased public-sector borrowing requirements. Inflation-linked bond (ILB) performance has been dismal, with the Composite Inflation Linked Index down 3% over the last 12 months, led again by ILBs in the seven-year-plus area. Despite poor index performance, ILBs out to seven years have still generated a return more than cash (2.9%) YTD.

We are already six months into 2020, a year that truly defies description, with a landscape that still presents as volatile and treacherous. At the beginning of the year, before Covid-19 turned into a fully-fledged pandemic, it was hard to find a pessimist in financial markets. The subsequent global lockdown sent both global and local economies into severe recession. Global monetary and fiscal policy then unleashed a flood of money into the economy, the likes of which has never been seen before, spurring expectations for a quick recovery. Asset prices started to recover in Q2-20, as economies across the globe started to open up from 'hard lockdowns.' However, concerns about a second wave of infections in developed markets and escalating infection rates in emerging markets (EMs) threaten to derail the recovery.

The rand was stronger, as it gained 2.9% inQ2-20 against the US dollar, ending June at US$1/R17.40. The easing of lockdown measures globally and initial indications that the expected contraction would not be as severe as initially thought, served to buoy risk sentiment and EM currencies. However, the local fundamental backdrop remains quite poor. 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.

EM debt crises have traditionally occurred in countries that predominantly have foreign- denominated debt; face an accelerated decline in their currency, resulting in an increased debt burden that they are unable to service; and an inflationary problem that re-enforces the downward spiral in their currency. South Africa (SA) is slightly different in that inflation will remain modest over the next two to three years. However, due to an incapacitated State, the poor condition of State-owned enterprises, a lack of targeted structural reform, and a dearth of political direction, government finances have deteriorated to such an extent that debt service costs are the fastest rising government expenditure item. In the fiscal year 2020/21, the fiscal deficit will register a whopping -15%, the debt-to-GDP ratio will exceed 80%, tax revenue will be down R300 billion, and nominal growth will be down 3.5%. Many countries around the world, both developed and EMs, will face a similar reality as the fiscal taps open to soften the fallout from the Covid-19 pandemic.

Unfortunately, due to its poor starting position, glacial pace of reform implementation and reliance on foreign portfolio flows, SA is teetering on the edge of debt trap.

Local public sector borrowing requirements will push up to almost R800 billion this year, due to the drop off in tax revenue. Over the longer term, more steps are needed to ensure that the underlying growth engine is restarted through targeted, efficient and transparent investment into the local economy by government and the private sector. In the interim, SA will have to rely on funding from international finance institutions (IFIs), such as the International Monetary Fund and the World Bank, as well as capital markets to keep the ship afloat. IFI funding is relatively cheap and has little conditionality, but will still need to be repaid in foreign currency, while local capital market funding will have to be accompanied by a strong commitment to reel in wasteful expenditure, refocus current expenditure, and implement key sector reforms (e.g. energy, labour, transport), to increase investor confidence and trust. SA has a long history of not delivering on key policies and reforms, which has resulted in the current debt nexus and erosion of investor confidence in the country.

Consumer price inflation will average 2.7% over the next year and 3.5% over the next two years. Following the cumulative 275 basis points (bps) rate cuts since the beginning of this year, the SARB has room to reduce rates by another 50bps over the next three to six months and is likely to keep them at similar levels over the next 12 to 18 months to support the economic recovery.

At the end of June, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 5.1% (three-year) and 6.3% (five-year), much lower than the previous month. Shorter-dated NCDs have pulled lower due to the significant interest rate cuts, recovery in bond yields and tightening of credit spreads. Short-dated fixed-rate NCDs continue to hold appeal due to the inherent protection offered by their yields and relative to our expectations for a lower repo rate. In addition, NCDs have the added benefit of being liquid, thus aligning the liquidity of the Fund with the needs of its investors. The Fund continues to hold decent exposure to these instruments (less floating than fixed), but we will remain cautious and selective when increasing exposure.

The fallout from the Covid-19 pandemic will linger for some time to come. In SA, the impact will be mostly felt in a much dimmer growth outlook, which will have a severe impact on government finances. The effects of the very hard lockdown and poor policy choices will weigh heavily on the economy going forward. As the economy was not well positioned going into the crisis, strong reforms are needed to return the country to a structurally better growth path, although lower interest rates will lend support to the economy through this difficult phase. South African Government Bonds (SAGBs) do embed a decent risk premium, although this premium has reduced slightly post the recovery in Q2-20. As mentioned, SA is on the brink of a debt trap and, although promises have been made to restore the country to a more sustainable debt trajectory, the implementation risks remain elevated. The valuation of SAGBs does provide some offset to this, implying that local bonds do warrant at least a neutral allocation in portfolios.

The local listed property sector was up 12.9% over June, bringing its return for the quarter to 18.7% and -40% over the rolling 12-month period. Listed property has been the largest drag on the Fund's performance. This has resulted in a general rise in balance sheet risk across the sector. The current crisis will reduce rental income, put pressure on asset values, increase the cost of borrowing for lower-quality businesses, and test inexperienced management teams. It is entirely possible that most of the companies will require additional capital and that dividends are suspended to preserve capital. One must be cautious not to take these at face value and understand how the key issues mentioned above affect that yield. We believe there are a few select large-cap counters that satisfy our stringent conditionality.

The FTSE/JSE Preference Share Index was up 2.8% over June, bringing its return over the quarter to 17.6% and -13.4% over the 12-month period. Preference shares offer a steady dividend yield linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 8% and 10% (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 the 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 6.5% (gross of fees) 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 30 June 2020