CORONATION GLOBAL STRATEGIC USD INCOME FUND

Quarterly Portfolio Manager Commentary

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

At the end of 2019, we expressed a view that the low levels of volatility felt at odds with the current levels of uncertainty surrounding trade, geopolitics and asset prices. What we didn't foresee was that the unusual cases of pneumonia in Wuhan, reported by China to the World Health Organisation (WHO) on 31 December, would utterly transform our daily lives and the outlook for economies and financial markets. Indeed, despite the WHO declaring the Covid-19 outbreak a global emergency at the end of January, financial markets only started to react in the latter half of February, when Italy, a democratically-elected government, began to impose lockdowns. In the intervening six weeks, vast swathes of the global population has experienced confinement, the knock-on effects of which will be hugely disruptive to individuals, companies and economies. Not surprisingly, in this environment, riskier asset classes experienced some of their sharpest negative price movements on record. The Fund returned -4.5 during the first quarter and -2.0% over the previous 12 months, against a benchmark return of 0.4% and 2.3%.

By way of some context, the Dow Jones took just 20 trading days versus a previous median of 156 days to enter a bear market (defined as a greater than 20% fall). The second-fastest decline was in 1929. Peak-to-trough, the Dow fell 37% and the S&P 500 34% between mid-February and mid-March. If those lows hold, the subsequent 20%-plus recovery will mark a new bull market and one of the shortest bear markets in history. Over the same period, the spread on the US corporate bond index widened from 101 basis points (bps) to 401bps before recovering to end the quarter at 304bps. Meanwhile, the spread on high-yield bonds rose from a low of 338bps in mid-January to 1087bps in mid-March before recovering to 875bps at the end of March. US investment-grade bonds returned -4% during the quarter (March was the weakest month on record, down 7.5%) but the move in US treasuries cushioned the blow, with returns relative to US Treasuries for medium-dated A-rated credits lagging by around 10%. US high-yield bonds lost 13% (down 11.8% in March second only to October 2008), but closer to 18% relative to treasuries. While one should be wary of making direct comparisons due to the changing weightings of indices over time, credit spreads have only been wider during the Global Financial Crisis (GFC), and in 2002, in the case of high yields. One notable feature of the selloff was the weakness in shorter-dated bonds as investors took advantage of their greater liquidity to fund withdrawals. The result was a disproportional widening in shorter spreads that has left the credit curve very flat, and this detracted from the Fund performance.

When viral contagion became financial contagion, the US Federal Reserve (Fed) felt it necessary to act and in size with the first emergency rate cut since 2008 of 0.5% on 3 March. This was followed by a further 1% on 15 March, returning the Fed Funds rate to the 0% lower bound, the rate that persisted in the wake of the GFC between 2009 and 2015. Fed minutes, which were released subsequently, described the outlook as "profoundly uncertain", with financial markets exhibiting "extraordinary turbulence and stresses". The Fed noted the disorderly nature of the Treasury market, agency Mortgage Backed Securities, as well as problems in issuing commercial paper, noting firms were tapping backup facilities (corporates have drawn down $200 billion of revolving credit facilities). The US Treasury curve bull flattened with shorter-dated bonds falling 140bps in yield (2-year now 0.25%) and ten-year bonds falling from 1.92% at the end of 2019 to a record intraday low of 0.32% on 9 March before ending the quarter at 0.66%. The Fund increased its duration marginally prior to the move lower in yields, but it was largely inconsequential, with government rates now so low. With high-quality spreads having widened, the Fund has reduced its exposure to short-dated instruments, such as Treasury bills, in favour of high-quality short-dated corporate bonds.

At this juncture, one can only speculate how large the contraction in growth will be and the trajectory of the growth rebound thereafter. Estimates suggest the contraction in US growth during the first quarter could be as high as 10% on an annualised basis and in excess of 20%, and possibly even 30%, in the second quarter of 2020 (by far the weakest ever quarterly growth on record, with similar estimates in other G7 countries) before recovering in the second half of the year. Overall contraction of US GDP could be in the order of 4-6% in 2020 (and lower still in the eurozone), depending on the magnitude of the recovery. With the service sector making up large parts of developed market economies, the loss of output globally could be in excess of $5 trillion, on a par with 2008-2009, with a good portion lost for good. Estimates for global growth in 2020 are now closer to minus 2% versus a forecast of 3.3% in January from the International Monetary Fund (IMF), with every month that economies remain shut potentially detracting a further 2%.

While the GFC was a financial crisis that went on to affect the economy, this is an economic crisis that may, in turn, become a financial one. At the end of March, the cumulative number of central bank rate cuts stood at 65 for the quarter. However, in what has become a cashflow crisis, this is more about access to money than the price of money. This is perhaps most obviously demonstrated when one looks at levels of unemployment. In flexible economies such as the US, the change has been dramatic, with the most recent jobless claims reaching 6.6m (ten times the figure during the GFC), bringing the total to almost 16.8 million in the last three weeks and an unemployment rate that will head towards 15%, and possibly higher in April. No wonder then that governments are pursuing wage subsidies in order to encourage firms to retain workers. At the end of March, policymakers had pledged roughly $12 trillion to alleviate the problems, far greater than during the GFC, with $7 billion in monetary stimulus (asset purchases, liquidity facilities) and $5 trillion of fiscal stimulus (payments to individuals and businesses). This assistance is set to grow, and some of more pertinent schemes are touched upon later. The upshot of all of this support is a significant deterioration in governments' fiscal positions and a huge expansion in the balance sheets of central banks. The US fiscal deficit is set to be the largest since the Second World War, with deficit estimates of up to 18% of debt-to-GDP in 2020 and 11% in 2021. This would amount to an increase of around $4 trillion, or close to a cumulative 20% above already high levels, taking US debt-to-GDP to over 100% in 2021.

With continental Europe deeply affected by Covid-19, the subsequent fallout presents an existential threat to the eurozone. Italy, the EU's third-largest economy, which has been the worst affected nation, is still seething at the refusal of other EU nations to offer medical help in the early days of the pandemic. The current refusal to endorse 'coronabonds' (jointly-issued debt) risks elevating tensions further for a populist government already at odds with the European Commission (EC) over their spending plans. Italy's debt projections (150%+ of debt-to-GDP) are looking increasingly challenging as growth across the eurozone collapses. The EU finance ministers agreed upon a €540 billion package of measures which allows for member states to borrow up to 2% of their GDP (€240 billion) from the European Stability Mechanism without conditions. Secondly, the EC plans to give cheap loans

(€100 billion) to support labour markets and, thirdly, the European Investment Bank will receive more support (€25 billion, leveraged to €200 billion) to help ailing companies. A future recovery fund was also discussed, but the issue of mutualisation remains a sticking point for now, with eurozone members still needing to accumulate debt in their own name. Britain, meanwhile, left the EU on 31 January and is now in the transition period that lasts until the end of 2020 under the withdrawal agreement. Serious negotiations against the backdrop of Covid-19 seem implausible, although the government hasn't acknowledged any delays yet. The UK's response to the pandemic has focused on protecting the UK's economic capacity, with employment support measures a top priority.

Emerging markets (EMs) have been hard hit by the pandemic. Their economies are particularly susceptible to the collapse in world trade, falling commodity prices and capital outflows as investors unwind carry trades. To compound their problems, the levels of debt in developing nations is far higher than during previous crises and the markets do not afford them the same leeway to conduct unorthodox monetary policies. The International Monetary Fund (IMF) is looking to deploy its full financial capacity of $1 trillion, but is also advocating for a standstill of debt servicing. Unlike the period following the GFC, China's ability to provide support to EMs via strong growth dynamics will be lacking. Prior to the pandemic, China was already struggling to boost its economy, and, despite an aggressive credit response from the People's Bank of China, there will be material headwinds from the global slowdown and increased wariness of the China complex.

Certainty is currently a precious resource and there is very little when it comes to the outlook for inflation. The slowdown in economic activity and lower nominal bond yields is consistent with lower breakeven rates of inflation, but inflation-linked markets are also less liquid than fixed-rate markets and this led breakevens to overshoot to the downside, as nominal yields hit record lows in mid-March and real yields spiked higher. US five-year breakeven rates of inflation, which began the year at 1.7%, fell to an intra-day low of 0.1% in mid-March (briefly pushing the real yield up to 0.85%) before closing the quarter at 0.5% as real yields fell to 0.06%. The collapse in US breakevens has been most keenly felt in shorter maturities where breakeven rates of inflation are negative for the next three years. While the weakness in the oil price will detract from headline consumer price inflation, implied inflation now appears very low. While the recent deal to cut oil production by 10 million barrels per day (roughly 10%) ends the price war and seeks to stabilise the oil market, supply is still likely to exceeds demand in the near-term. The Fund added to its holdings of US Treasury Inflation-Protected Securities (TIPS), the majority of which are in 3- to 7-year maturities.

US financial assistance to the underlying economy takes the form of $2 trillion (equivalent to 10% of GDP), seeded by the Coronavirus Aid, Relief and Economic Security (CARES) Act passed by Congress on 25 March. Three-quarters has been set aside for the Treasury to make payments ($1200) direct to qualifying individuals and to support small business via payroll support and tax credits. Of the remaining $500 billion, $46 billion has been set aside for airlines and businesses critical to national security. The CARES Act allows the Fed to use the remaining $454 billion to establish programmes and facilities for the purpose of providing liquidity to the financial system and eligible businesses, states and municipalities. In practice, the Fed can leverage this to provide over $4 trillion of lending capacity. The Fed has so far announced ten emergency programmes utilising approximately $200 billion of equity, targeting primary dealers, money markets, commercial paper , primary and secondary corporate bond programmes, asset-backed securities, global swap and repo facilities, medium-sized business lending, small-business payment protection and a municipal lending facility. In addition, the Fed has also relaxed certain banking requirements. The leverage ratio for the next year will no longer include Treasuries, which will reduce banks' capital needs by around 2%, freeing up lending capacity and providing support to the Treasury market. Of particular interest are the Primary Corporate Credit Facility (PMCCF), which allows for bridging loans ($500 billion capacity) of up to four years and the Secondary Market Corporate Credit Facility (SMCCF), which allows for the purchase (maximum $250 billion leverage dependent) of existing corporate bonds with a maturity of under five years. Initially intended for investment-grade issues, the Fed broke new ground and will stoke controversy by recently relaxing its guideline to include 'fallen angels' (supportive of autos) and qualifying high-yield exchange-traded funds (ETFs). While these actions will aid prices, where 30% of the market trades are distressed (spreads above 1000bps or prices below 80c), it's not obvious that it will avert widespread defaults, which analysts expect to be around 10%. Against a market that has become increasingly covenant-light, it also raises issues of moral hazard and begs the question of whether or not the Fed will continue to relax its criteria if the crisis escalates further.

We are wary of the view that economies will merely bounce back and believe disruption to supply chains and demand will be significant. Government assistance will be very supportive, but it is unlikely to be without its challenges and will not benefit all. Against the current backdrop, we continue to favour high-quality investment-grade issuers, with strong balance sheets and ample cash as well as continued access to finance. Given the attractive spreads in shorter maturities and relatively flat credit curve, we retain a bias towards shorter maturities. The Fund, which had previously considered corporate spreads to be expensive (and held more financials as a result), used the weakness in spreads to buy several high-quality investment-grade names (IBM, Qualcomm, Sanofi, Verizon, Berkshire, McDonalds, Apple, BAT, Glaxo) in maturities out to five years. The Fund also sought to boost its exposure through several ETFs, which offer broad-based exposure to the US corporate bond market. Overall credit duration has increased from around one year to around 1.6 years, with single A-rated issuers seeing the most uplift. The Fund's exposure to high yield has also increased as the Fund used the large selloff to take advantage of specific instruments (MTN, First Rand, Absa) where the risk/reward is considered highly attractive. Within hard-currency EM debt, the Fund added short-dated US dollar bonds issued by Indonesia, Morocco, Hungary and Colombia.

Property performed abysmally (EPRA index down 28% during the first quarter of 2020) across all sectors and jurisdictions, as companies face multiple challenges going forward. The nature of property companies' asset means they are very susceptible to rapid change. While the challenges differ across sectors, there is some communality. The first, most obvious one is potential oversupply in a slowing economy, which may be compounded within the office sector as businesses have since become accustomed to working remotely. Furthermore, many tenants (particularly retail) will be unable to pay their rent (or simply refuse to) due to cashflow problems or, worse, due to insolvency. Sectors exposed to hospitality will clearly be impacted by travel bans, with volumes unlikely to bounce back quickly. Asset prices will also be undermined by forced sellers into a market with few buyers. For those with high levels of debt, funding costs have also risen substantially, and capital raises may be necessary to meet covenants. If this wasn't bad enough, there remains a risk that property companies attract higher taxes from municipalities seeking to balance their books. The Fund began the year with a relatively low exposure to property (2.4%), but reduced this to below 2% when it sold Deutsche Wohnen. This wasn't enough to prevent property detracting meaningfully from the Fund's performance during the quarter as our retail-orientated names performed poorly.

US dollar strength was the dominate feature of foreign exchange markets. The Fed's broad trade-weighted index rose 10% between the start of the year and the mid-March lows in equity markets, before ending the quarter 7% higher. Only the Japanese yen and Swiss franc, both perceived as safe havens, posted marginal gains. Worst affected were commodity producers and EMs. While the crisis persists and global trade withers, the demand for US dollars will continue to underpin its strength, but valuations look increasingly stretched. The Fund holds two currency options that mature in June, bought when volatility was low at the end of last year. The Fund's yen options are now marginally in the money, while the euro ones remain around 4% out of the money.

The medium-term outlook for asset prices will be dependent on the direction of government policy in the aftermath of this crisis. The US relationship with China was already under huge strain - the trade war being just one aspect of a wider geopolitical tussle. In an ideal world, the global nature of this crisis would lay the framework for greater co-operation, especially between the developed and less developed world, but we have also witnessed examples of self-serving behavior, most prominently from the US. It is not inconceivable that peak globalisation has passed for the foreseeable future. This crisis differs from the GFC in the fact that its epicenter isn't a few overleveraged financial organisations, but millions of workers (principally in lower-income brackets) whose jobs and incomes have ceased to exist. Critics of the bailouts of the last crisis pointed to the lack of accountability on the part of bankers while the wider populous endured years of austerity. While we are still in the early stages of this crisis, policies aimed to support incomes are to be welcomed, but actions to support companies that shoulder workers with escalating fiscal deficit risks fueling populism further. Deficits will need to be addressed in time and redistributive policies must be more likely. Higher corporate taxes may be on the horizon. It also seems likely that corporates will seek to de-risk balance sheets, as was the case in the early years following the GFC. This would argue more in favour of creditors than equity holders.

We would be surprised if the recent strong recovery in asset prices, post the enormous amounts of stimulus, marks the end to the high level of volatility in the market. In the absence of a vaccine, Covid-19 will continued to be hugely disruptive. Despite the upheaval of the last six weeks, we are still in the early stages of dealing with its impact. While governments and central banks responses may allay some of the immediate concerns, they bring with them a new set of challenges. While several asset classes now offer higher potential returns than in the recent past, we must be mindful that the current challenges are unprecedented. We believe the Fund occupies one of the primary areas where we consider risk-reward to be much improved (Fund yield has risen from 2.6% at the end of 2019 to 4.2% at the end of March), namely that of short-dated credit. We expect much healthier returns for the rest for 2020 after a disappointing first quarter.

Portfolio managers
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