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

The Fund produced decent returns for the quarter, remaining ahead of cash and the benchmark over the period, and well ahead over 12 months.

South African assets have had a roller coaster of a year. South African government bonds (SAGBs) traded in a 130 basis points (bps) range and, despite ending the year just above the midpoint of the trading range, still managed to outperform most emerging and developed bond markets. The FTSE JSE All Bond Index (ALBI) was up 8.4% in local currency, but the depreciation of the rand over the year eroded most of the return. This still put its return at -0.18% in US dollars, which is better than the FTSE World Government Bond Index at -6.97% and J.P. Morgan Emerging Market Bond Index at -1.51%.

The ALBI return far exceeded cash at 3.6% and was driven by the outperformance of bonds with a maturity of greater than 12 years that produced a return of 12.6%. This flattening of the yield curve was in large part due to the front end of the yield curve (less than seven years' maturity) widening relative to longer maturities. Inflation-linked bonds (ILBs), which carry a significantly higher duration than nominal bonds, saw real yields compress almost 100bps which helped them produce a bumper return of 15.5%. However, over three years their return (7.3%) remains below that of nominal bonds (9.1%).

December news flow was dominated by developed market central bank meetings, including a surprise rate hike by the Bank of England. Upside inflation risks have brought forward the need for central banks to tighten monetary policy settings, as sticky bottlenecks prevail, exacerbated by constrained supply chains, high primary commodity prices, labour shortages in the US and parts of Europe, and a new Covid-19 variant. While the full impact of the new variant is still unclear, the impact is likely to exacerbate some of the inflation pressures and pose a headwind to the ongoing recovery.

In the US, the Federal Reserve Board (the Fed) left interest rates unchanged at the target range of 0.00% - 0.25% but brought forward the taper of its bond purchases at the December Monetary Policy Committee (MPC) meeting. Furthermore, the Fed now expects three 25bps rate hikes to be implemented in 2022 to counter upward price pressure, while still considering the necessary progress made towards target employment. Headline inflation increased to 6.8% year on year (y/y) in November from 6.2% y/y in October. Core inflation increased to 4.9% y/y in November from 4.6% y/y in October. Commodity prices continue to account for much of the upside, but broader core goods and service prices are a widening source of pressure.

In emerging markets, China's headline inflation accelerated to 2.3% y/y in November from 1.5% in October, as food inflation reaccelerated. Core inflation slightly decreased to 1.2% y/y in November from 1.3% y/y in October. Inflation remains something of a mixed bag in emerging markets, but increasingly upside surprises to baseline forecasts are likely to prompt further rate hikes in 2022.

The rand ended the quarter at R15.94 to the dollar. The cyclical tailwinds from strong commodity prices are starting to fade and the rand is at the mercy of global risk appetite. Omicron, and its impact on global growth came under the spotlight throughout December, which was a drag on the rand's performance. The Fund maintains its healthy exposure to offshore assets. When valuations are stretched, it will hedge/unhedge portions of its exposure back into rands/dollars by selling/buying JSE-traded currency futures (in 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.

In South Africa, the economy contracted by 1.5% quarter on quarter (q/q) in the third quarter of 2021 (Q3-21) from a revised growth of 1.1% q/q in the second quarter of 2021. The trade, agriculture and manufacturing sectors were the biggest contributors to the decline. On the expenditure side, household consumption and exports decreased. Aspects of the weakness in the Q3-21 GDP are very specific and related to the July 2021 riots and their immediate aftermath. However, the impact on longer-term growth from other economic sectors is unclear, given persistently high unemployment and weak consumption across a range of goods and services, despite decent income growth. The gross operating surplus has recovered well, but confidence and investment remain weak. The building blocks for resilient growth are in place, but consumers and businesses remain reticent.

Headline inflation accelerated to 5.5% y/y in November from 5.0% y/y in October. Core inflation slightly increased to 3.3% y/y in November from 3.2% y/y in October. The large fuel hike in November contributed the most to the inflation uptick, while food and other goods and services prices remained relatively stable. Looking ahead, we expect price pressures from food and energy to persist, and some price increases in goods affected by supply constraints is also increasingly likely. The outlook for interest rates, despite some evidence of weak activity in the fourth quarter of 2021 and the emergence of Omicron, remains for a steady normalisation of the repo rate.

At the end of December, shorter-dated fixed-rate Negotiable Certificates of Deposit (NCDs) traded at 6.74% (three-year) and 7.50% (five-year), lower than the close at the end of the previous month. SA's more moderate inflation expectations suggest that current pricing of these instruments remains attractive due to their lower modified duration and, hence, high breakeven relative to cash. In addition, NCDs have the added benefit of being liquid, thus aligning the Fund's liquidity with the needs of its investors. The Fund continues to hold decent exposure to these instruments (fewer floating than fixed), but we will remain cautious and selective when increasing exposure.

The local economy remains on track to recovery; however, the repercussions of the pandemic continue to reverberate in the form of high unemployment, increased levels of poverty and reduced business confidence. Government finances remain fragile and increased demands on the fiscus threaten to increase the debt load further, pushing the country into a debt trap. Inflation is moving higher but should remain under control despite uneasiness around global inflation. Despite the precarious local backdrop amid the turbulence caused by local and global monetary policy normalisation, SAGBs still encapsulate a significant risk premium and large margin of safety. We continue to view overweight positions to bonds in the 10- to 15-year area of the curve as attractive. In addition, we believe ILBs in the four- to nine-year area offer good value due to high real yields and embedded inflation protection.

The local listed property sector was up 7.88% over December, bringing its 12-month return to 36.9%. The balance sheet concerns coming out of the Covid-19 crisis have subsided somewhat as companies have managed to introduce dividend payout ratios (with some withholding dividends entirely) and to sell off assets. Going forward, operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. We believe that one must remain cautious, given the high levels of uncertainty around the strength and durability of the local recovery. However, certain counters are showing value, given their unique capital structures and earnings potential. These counters remain a core holding within the Fund.

The FTSE/JSE Preference Share Index was up 6.55% over the month, bringing its 12-month return to 44.97%. The most recent performance has been bolstered by an announcement by the banks of their intent to repurchase a significant portion of their outstanding preference shares. 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, which will limit availability. Due to the reduced liquidity in this asset class and other instruments, at the same point in the capital structure, trading at more attractive valuations, the Fund will not look to increase its holdings and will maintain its current small exposure to specific corporate preference shares.

We remain vigilant of the risks emanating from the dislocations between stretched valuations and the local economy's underlying fundamentals. However, we believe that the Fund's current positioning correctly reflects appropriate levels of caution. The Fund's yield 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 31 December 2021