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 6.8 % for the 12-month period. This return is ahead of cash (3.5%) and its benchmark (3.9%). Celebrating its 20-year anniversary in July, the Fund's annualised and cumulative return ahead of its benchmark since inception is 1.6% and 163.1% respectively.

South Africa's (SA) recovery has been elevated by the current global environment, translating into strong asset price performance. The rand is up c.3% against the US dollar this year, with most of that performance coming through in the second quarter of the year (Q2-21). This is pretty much in line with its emerging market peer group (except Brazil, which has enjoyed a more significant recovery in its currency following the commencement of its pre-emptive rate hiking cycle), but what has set SA apart is the performance of its local bonds. Despite the yield on the 10-year bond being 30 to-40 basis points (bps) higher since the beginning of the year, the FTSE/JSE All Bond Index (ALBI) has returned 5.0% this year (6.9% over the 2Q-2021). This has been led by the strong performance of bonds with a maturity of >12 years, as the yield curve has continued to flatten. Inflation-linked bonds (ILBs) had a poorer quarter returning c.3% but remain ahead of ALBI returns, year to date (7.7%). Both ALBI and ILB returns remain well ahead of cash for the quarter (0.9%) and the year (1.7 %).

June saw developed market central banks maintaining monetary policy rates and revising growth expectations upwards following increased economic activity and success in rolling out the vaccine programme. In emerging markets, a few central banks surprised the market with rate hikes as inflation pressure continues to rise.

In the US, the Federal Reserve Board (the Fed) left policy rates unchanged at 0.00% to 0.25% and maintained the size of the asset purchasing programme, as expected by the market. The post-meeting communication highlighted growth risks to the upside as economic data has positively surprised expectations. Importantly, though, the Fed turned more cautious on inflation, revising its 2020 forecast up to 3.4% from 2.4% at the previous meeting – although the gains are still deemed likely to be temporary. Headline inflation accelerated to 5% year on year (y/y) in May from 4.2% y/y in April. The uptick was the result of a combination of factors, including low base effects, increased energy prices and an extension of high used vehicle prices. Core inflation rose to 3.8% y/y in May from 3% y/y in April.

In emerging markets, China's headline inflation increased to 1.3% y/y in May from 0.9% y/y in April. The upward pressure came from a mix of factors, namely, increases in the cost of non-food goods, transportation, communication, clothing, and education. Core inflation increased to 0.9% y/y in May vs 0.7% y/y in April. Elsewhere in emerging markets, central banks in Brazil, Mexico, Russia and Hungary hiked policy rates as inflation concerns mount. Inflation pressures are seen to be on the upside, owing to base effects, increasing demand and rising commodity prices.

The rand was stronger over the quarter but weaker over June, in line with the performance of high yielding emerging market assets. This was further buoyed by positive developments on the growth and political front in SA, which helped the rand end the quarter at US$1/R14.28. 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 (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 the first quarter of 2021 (Q1-21), SA's GDP was stronger than expected at 4.6% quarter on quarter (q/q) seasonally adjusted annualised (saa), compared to a revised growth of 5.8% q/q saa in the fourth quarter of 2020. Positive contributions came from financial and business services, mining, manufacturing, transport and trade sectors. From the demand side, household and government spending slowed down but remained positive contributors to GDP, while inventories provided a strong boost as these were drawn down at a slower pace than before. The new restrictions could dampen third-quarter GDP this year, despite efforts made to limit the impact on the broader economy.

Headline inflation accelerated to 5.2% y/y in May from 4.4% y/y in April. Core inflation was stable at 3.1% y/y in May vs 3.0% y/y in April. The inflation uptick largely reflects base effects related to fuel and somewhat higher food and apparel prices. The South African Reserve Bank left rates unchanged in May, but more recent comments from Monetary Policy Committee members suggest some growing caution about the outlook for inflation.

At the end of June, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 6.07% (three-year) and 7.14% (five-year), significantly higher than the close at the end of the previous month. This was largely driven by expectations for higher inflation, reduced stimulus, and quicker rate normalisation speeds across global emerging and developed markets. However, SA's more moderate inflation expectations suggest that the 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.

Global monetary policy normalisation will take the form of the tapering of bond asset purchase programmes, followed by a rise in policy rates. This will result in global bond yields moving higher over the next few years. Historically, the pace and magnitude of the rise in global bond yields have had significant repercussions for the local bond market. More specifically, the more sudden and sizable the sell-off in global bond yields, the larger the rise in local bond yields. Currently, the US 10-year Treasury Bill (a proxy for global bond yields) is at 1.50%, and pricing in the forward market puts expectations for this rate to be at 2% to 2.25% over the next two to three years.

The magnitude of the move is not large by historical standards, although the pace of the repricing will remain unpredictable. Local bonds have generally had a high beta (a relative measure of volatility between two assets) with US 10-year bonds. However, the spread between SA bonds and US bonds are at historically wide levels, primarily due to the deterioration in SA's fiscal metrics. It is plausible that with SA's fiscal metrics recovering, this spread is too wide and should narrow, implying that even if US bonds were to sell-off, the equivalent sell-off in SA bonds should not be severe. As the spread has widened, the beta between the two assets has decreased; that is, the influence of US rates on SA rates has diminished. This suggests that the risk premium embedded in SA bonds should absorb a significant amount of the widening in global bond yields.

The prospects for the local economy have improved as reform progress has gathered momentum, and global developments have provided tailwinds to the local recovery. Inflation is moving higher but should remain under control despite uneasiness around global inflation. The recovery in growth should gain more traction and spill into next year, which will provide more breathing room for the fiscus. SA government bonds (SAGBs), despite their recovery in Q1-21, still embed a significant risk premium relative to cash. The steepness of the yield curve makes the 12- to 15-year area attractive, even if the local rate hiking cycle starts sooner than expected. We continue to favour positions to SAGBs focused in the 12- to 15-year area of the curve and allocations to ILBs with a maturity of less than eight years.

The local listed property sector was down 3% over June, bringing its 12-month return to 25.6%, and has been the largest drag on the Fund's performance. The balance sheet concerns coming out of the Covid-19 crisis have subsided somewhat as companies have managed to introduce dividend pay-out ratios (with some withholding dividends entirely) and sell 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 down 4.2% over the month, bringing its 12-month return to 14.8%. Preference shares offer a steady dividend yield linked to the prime rate and, depending on the risk profile of the issuer, and 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, limiting 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 its associated risks are 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 local economy's underlying fundamentals. However, we believe that the Fund's current positioning correctly reflects appropriate levels of caution. The Fund's yield of 6.35% 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 2021