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

The Fund returned 0.75% in the first quarter (Q1-21), bringing its total return to 9.12% for the 12-month period. This return is ahead of cash (4%) and its benchmark (4.4%).

Progress is rarely made in a straight line, and there are always bumps in the road, but ultimately what matters is the direction you are heading in. It is just over a year since the World Health Organisation declared Covid-19 to be a global pandemic, and the world went into lockdown. The difference now, however, is that we have several viable vaccines that will help stave off serious infection, lessen the pressure on healthcare systems and, hopefully, return our lives to some version of normality. There are concerns that new variants might reduce the efficacy of vaccines; the vaccines might not be rolled out expeditiously; and that second, third and fourth waves will delay the global recovery. Ultimately, there is light at the end of the tunnel, and it doesn't look like another train!

South Africa (SA) remains precariously placed in the global recovery due to its stretched public finances, a glacial pace of reform implementation and the leisurely rollout of its vaccination programme. Following a strong start to the year, SA government bonds (SAGBs) gave back a portion of their initial gains due to concerns that the large amount of global fiscal and monetary stimulus would stoke inflation, hence forcing a quicker normalisation in policy rates. The benchmark 10-year SAGB rallied to 8.75% by the beginning of February but sold off by over 100 basis points (bps) by the end of Q1-21, ending at 9.89%. This resulted in the All Bond Index (ALBI) returning -1.7% over the quarter, anchored by the underperformance of the 7- to 12-year area of the curve. SAGB yield movements were not dissimilar to the experience in many emerging markets around the world as a reaction to a circa 80bps selloff in US 10-year yields. Conversely, South African inflation-linked bonds (ILBs) produced a return of 4.6% in Q1-21 as real yields held onto their gains since the beginning of the year. Due to March 2020 being the peak of the Covid-19 crisis in financial markets, the one-year performance of SAGBs and ILBs look spectacular at 17% and 16.7%, respectively.

In the US, the Federal Reserve Board (the Fed) left the funding rate range unchanged at 0.00%-0.25% and maintained the current asset purchasing programme pace and size. The Fed reiterated its stance of improvement in employment and inflation, reaching their target ranges being necessary precursors of interest rate hikes. US headline inflation accelerated to 1.7% year on year (y/y) in February from 1.4% y/y in January. Upward inflation pressure came from increases in energy costs and medical care service prices. Prices for food, vehicles and apparel were slightly lower than January's reading. Core inflation moderated slightly to 1.3% y/y in February from 1.4% y/y in January.

In emerging markets (EM), China's headline inflation contracted by 0.2% y/y in February from a contraction of 0.3% y/y in January. This deflation is on the back of falling meat prices, along with a drop in transport, apparel and utility costs. Elsewhere in emerging markets, the rollout of the vaccine in 2021 has been slow but is expected to contribute to further recovery in economic activity in the latter part of the year. Monetary policy settings have become more mixed, with some emerging market central banks signalling broad accommodation, while Russia, Turkey and Brazil's central banks all raised interest rates in March.

The rand was relatively unchanged over Q1-21 despite broader EM currency weakness, ending at US$1/R14.78. The onset of the second wave in many parts of the world and increased developed market bond yields weighed on sentiment. However, underlying economic data continued to suggest better than previously expected global growth outcomes. In SA, specifically, this has led to slightly improved expectations, supporting the currency outperformance over February. 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 SA, headline inflation slowed to 2.9% y/y in February from 3.2% y/y in January. The decline came from a moderation in food prices and a decrease in medical insurance costs. Core inflation fell more sharply, from January's 3.3% y/y to 2.6% y/y in February. Inflation pressure in the economy remains benign, and both core and headline inflation are anticipated to remain close to the 4.5% mid-point of the inflation target range.

At the end of March, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 5.83% (three-year) and 7.08% (five-year), much higher than the close at the end of the previous quarter. This was in large part driven by a repricing in global rate expectations following the selloff in developed market bonds. Shorter-dated NCDs have been pulled lower due to the significant interest rate cuts, a recovery in bond yields and a tightening of credit spreads. Short-dated fixed-rate NCDs continue to hold appeal due to the inherent protection offered by their yields and our expectations of a lower repo rate. 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.

SA's Budget speech in February was an important road marker on South Africa's recovery path. Following better-than-expected tax revenue receipts, the National Treasury presented a picture of public finances that was much better than the October 2020 Medium-Term Budget Policy Statement but still not indicative of debt stabilisation. It was very encouraging that the tax windfall was not used to increase expenditure in other areas but instead used to reduce the borrowing requirement over the forecast period. This resulted in a reduction in weekly nominal fixed-rate issuance by circa 30%, which was welcomed by markets and resulted in the relative outperformance of the 12-year+ area of the curve. However, implementation risk remains high as all the expenditure consolidation is focused on a three-year public sector wage freeze, and public sector unions have already expressed their disapproval.

In addition, State-owned enterprises (SOEs) and other local municipalities are a further risk to expenditure, given their poor health going into the Covid-19 crisis. Long-term austerity is not palatable in SA, given the size of the expenditure adjustment needed to right the ship. To keep from sinking, SA needs to increase its potential growth rate by accelerating its reform process and involving the private sector in this process.

There are early signs that the private sector is starting to contribute to investment but, for this to be sustained, policy needs to be transparent and stable. It is also essential that previous perpetrators of corruption are brought to justice to show that there are real consequences for malfeasance. Unfortunately, given the country's poor track record, investor confidence remains depressed, which is abundantly reflected in the elevated level of bond yields and the steepness of the yield curve.

The positive showing in the February Budget should have resulted in an extensive rally and flattening in the SA bond curve. However, due to the selloff in global rates, this was cut short and reversed. In January 2021, short-term inflation expectations in the US, as reflected by market-implied breakeven inflation expectations (the difference between US nominal and ILB yields), moved materially above 2%, peaking at 4% for one-year forward inflation and 2.5% for five-year forward inflation. This now sits at around 2.3% to 2.5% across all maturities, which means that the market expects inflation in the US to exceed the 2% average inflation target set by the Federal Reserve Board (the Fed). This change in inflation expectations was driven by the Fed's revision to average inflation targeting (i.e., targeting average inflation rather than aiming to keep it at a target point); the unprecedented level of monetary policy stimulus (zero base rates and the bond-buying programme); and increased fiscal stimulus (approval of President Joe Biden's $1.9 trillion support package and the proposal of a further $2.2 trillion infrastructure spending package).

In SA, during the last taper tantrum, yields were materially lower (6.8% in the 10-year area as of March 2013), the yield curve was relatively flat (5y5y rates were trading 100bps above the 10-year area), and local inflation was already at 6%. This time around, yields are close to 10%, and the curve is materially steeper (5y5y rates are 400bps above the 10-year), and inflation is at 3%. In addition to this, SA's current account is in surplus (vs a 6% deficit in 2013), and foreign ownership of the local bond market is sub-30% (vs above 40% in 2013). This suggests that not only are valuations materially more attractive, providing a larger buffer, but the need for external funding of the deficits is also much lower.

SA remains in a delicate balancing act. In the short term, inflation will remain under control, and growth will pick up, supporting a cyclically better economic outcome. However, the fiscal accounts are problematic, given the high levels of debt. While the cyclically better economic outcomes have provided some breathing room, there needs to be an acceleration in growth-enhancing reforms, more emphasis on reviving private sector confidence to encourage investment, and no deviation from current expenditure plans. The recent move higher in developed market bond yields has sparked concerns of a replay of the 2013 taper tantrum. However, SA bond valuations are much more generous now with a much-reduced external funding requirement. We view SAGBs as an attractive investment opportunity and would still advocate an overweight position relative to the benchmark for a bond fund. In addition, we would also allocate to four-year ILBs and steer clear of corporate credit spreads at current levels.

The local listed property sector was up 6.4% over the quarter, bringing its 12-month return to 34.4%. Listed property has been the largest drag on the Fund's performance. The balance sheet concerns coming out of the crisis have subsided somewhat as companies have managed to introduce dividend payout ratios, withhold dividends in some cases 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 up 2.1% over the quarter, bringing its 12-month return to 30.1%. 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 of its associated 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 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 5.8% 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 March 2021