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

Performance

South Africa (SA) fared relatively better than its counterparts during much of the year, despite the worst bout of loadshedding on record. December, however, brought fresh political concerns as the "Farmgate" scandal threatened to derail President Cyril Ramaphosa's presidency and his campaign for a second term as ANC president. Fixed income recorded a torrid year as all the instruments within the asset class underperformed cash (+4.82%) over the period. SA 10-year bonds closed the year at 10.86%, almost 100 basis points (bps) higher than the close at the end of 2021, and at a level not seen since the onset of the Covid crisis in March 2020. Despite a high starting yield, the FTSE/JSE All Bond Index (ALBI) generated a total return of 4.26% for the year, which was not only below cash but also marginally behind inflation-linked bonds (ILBs) that delivered a total return of 4.54%. In US dollars, the ALBI was down -2.38% in 2022, which is significantly better than global bonds that were down -18.26% (as measured by the FTSE World Government Bond Index).

The Fund returned 0.69% in December, bringing its 12-month total return to 4.91%, which is ahead of cash (4.82%) but lagging its benchmark (5.3%) over the same period. This monthly return must be seen in the context of returns from the investable asset classes, all of which underperformed cash except for offshore (USD) cash. For the quarter, the Fund returned 3.46%, well above cash (1.5%) and its benchmark (1.65%). We continue to believe that current positioning offers the best probability of achieving the Fund's cash + 2% objective over the medium to longer term.

Fund positioning

December saw a moderation in the pace of rate hikes from major central banks. However, while inflation is seen to have peaked in most developed economies, the risk of persistence remains high as the war in Ukraine will continue to threaten energy prices and keep food prices elevated. Additionally, the broader base of price pressures, which have emerged in many developed countries, are likely to take time to subside.

In the US, the Federal Reserve Board (the Fed) increased the policy rate by 50bps at its December Monetary Policy Committee (MPC) meeting, taking the target rate range to 4.25%-4.5%. This brought cumulative rate hikes since the hiking cycle began to 425bps. The move to a smaller hike was not a market surprise, but Fed Chairman Jerome Powell warned that the Central Bank's job is not yet complete. Future rate decisions will consider the cumulative tightening that has already been implemented, the lag with which monetary policy affects economic activity, general inflation, and developments in the economic and financial markets. The market now expects the Fed rate to peak at 5.0% in 2023, as expectations are for inflation to ease from here. US headline inflation slowed to 7.1% year on year (y/y) in November from 7.7% y/y in October, while core inflation decreased to 6.0% y/y in November from 6.3% y/y in October. Energy costs and food inflation slowed down while vehicle prices and costs for shelter had a slight increase, implying faster moderation in headline inflation than that of core prices.

In emerging markets, China's headline inflation slowed to 1.6% y/y in November from 2.1% y/y in October, while core inflation remained unchanged at 0.6% y/y. The sharp decline was due to a decrease in food prices – more specifically, pork prices. Non-food inflation, as well as prices for transport, apparel and health services remained unchanged. More broadly, subdued price pressures reflect weak economic activity.

The rand ended the month at R17.03/US$1. Expectations around aggressive global monetary policy normalisation weighed on risk appetite as global liquidity reduces in the face of elevated inflation. Offshore sovereign bonds have seen a significant repricing and are now closer to what we consider to be long-term fair value. Credit assets have seen a substantial drop in valuations which has made them look very attractive. The Fund has utilised a significant part of its offshore allowance to invest in these types of assets. When valuations are stretched, the Fund 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.

Locally, the economy grew at a much-stronger-than-expected 1.6% quarter on quarter (q/q) in the third quarter of 2022 (Q3-22) following a contraction of 0.7% q/q in the second quarter of 2022. On the supply side, growth came mostly from agriculture and transport, as well as financial and business services, while utilities (mostly electricity) detracted. On the expenditure side, net trade was the biggest contributor, despite challenges in network industries and strikes in Q3-22. Inventory accumulation, possibly owing to aggravated loadshedding, was also a major positive contributor to growth. Looking ahead, Q4-22 activity will be dogged by high levels of loadshedding, which may be partly offset by a decent tourist season. Nonetheless, we expect activity to be weaker than in Q3-22.

Headline inflation moderated to 7.4% y/y in November from 7.6% y/y in October, but core inflation remained unchanged at 5.0% y/y. Lower fuel and transport costs accounted for much of the moderation, while food and broader goods and services prices remain sticky. We expect CPI to average 6.9% in 2022. An early and substantial fuel price cut in January 2023 should see a faster slowing in headline inflation than we had expected and will lower the average headline CPI for 2023. Despite this, we expect the South African Reserve Bank to raise the repo rate by 50bps in January, to a peak rate of 7.5%.

ILBs, like nominal bonds, continue to trade at elevated levels. One can attain returns of 3%-4.5% after inflation when investing in the SA ILB market. In a world of cheap valuations, the limiting factor is cash and one must be careful, like with credit, in assessing the relative attractiveness of the various asset classes. Although the real yields on offer are quite attractive, the required inflation for ILBs to outperform nominal bonds remains high as one goes for longer ILB maturities of six to seven years (I2029). Within a fixed income portfolio, we therefore continue to favour allocating to ILBs with a maturity of less than seven years.

The global environment will remain in a state of flux for at least the first half of 2023. This as the battle between monetary policy normalisation, slowing global growth, and sticky inflation continues to wage on. Risk sentiment has recovered slightly since the severe bout of risk aversion in the second half of 2022, but SA faces its own challenges both politically and economically. Loadshedding, crumbling local infrastructure, and souring local sentiment precipitate the need for swifter reforms, together with more private sector involvement. The valuation of SA bonds should provide a reasonable buffer, as they have already since they trade at a significant discount to fair value.

Corporate credit is an incredibly effective tool that can be used to enhance the yield and longer-term performance of fixed income portfolios. However, it is important to understand that yield is earned over a multi-year investment horizon, and a long-term focus is essential when analysing and investing in the asset class.

The local credit market is more nuanced than international credit markets, with significantly lower issuance and, hence, much lower liquidity, making it predominantly 'buy and hold' in nature. This accentuates the need for rigorous interrogation of credit quality and appropriate compensation in valuation for holding these instruments. In the years following the Global Financial Crisis, credit has been employed as a significant driver of fixed income portfolio returns, but the types of instruments utilised have become more complex and less transparent with regards to the actual risk they carry. This requires investors to spend more time scrutinising not only the credit quality of their investments, but also the instruments through which they lend to these entities.

We believe that the corporate credit spreads currently on offer are not attractive, and do not reflect their inherent risks. As such, we have been allocating away from credit and allowing our investment in credit to become less material in our portfolios for quite some time. However, with the recent repricing in global rates and credit markets, we believe these offer an attractive opportunity for investors. The local credit market has been influenced by a shortage in supply and an increase in liquidity. Issuance this year has been net negative, and according to ASISA data, savings continue to accumulate. A supply/demand imbalance of this magnitude continues to distort fundamental credit pricing.

At the end of December, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.925% (three-year) and 9.39% (five-year), higher than the close at the end of the previous month. The recent move is due to a repricing in bond yields in the local market. Our 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.

The local listed property sector was up 1.1% over the month, bringing its 12-month return to -1.9%. The balance sheet concerns in the sector have subsided, as companies have managed to introduce dividend payout ratios (with some withholding dividends entirely) and selling off assets in order to recapitalise themselves. 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 due to 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.

Outlook

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 9.64% 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 2022