CORONATION STRATEGIC INCOME FUND

Quarterly Portfolio Manager Commentary

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

The Fund returned 1.05% in July, bringing its 12-month total return to 4.22%. This latter return is above cash (3.88%) and that of its benchmark (4.28%) over the same period.

Local bonds recovered strongly in July from the lows of June. The FTSE/JSE All Bond Index delivered 2.44%, with the long end of the curve (12+ years duration) delivering the best returns (+ 3.33%). Long-term bonds (7-12 years) posted a recovery of 2.23%, while medium-term bonds (3-7 years) returned 0.62%, and short-term bonds (1-3 years) delivered 0.26%. Cash returns came in at 0.36% and inflation-linked bonds (ILBs) fell -1.23%.

July saw the US and China reporting economic contractions for the second quarter of 2022 (Q2-22). The reasons for the contractions were mixed, with China affected by lockdowns and the US experiencing weaker government spending and a drag from inventories drawdowns. Central banks continue to tighten monetary policy settings to curb rising inflation.

In the US, the economy contracted by 0.9% quarter on quarter (q/q) in Q2-22, following a contraction of 1.6% q/q in the first quarter of 2022 (Q1-22), placing the economy in a technical recession. The contraction was led by a decline in fixed capital investment, government spending and a sharp decline in inventory accumulation. Personal consumption was positive, although weaker than expected. The economy remains in a vulnerable position as it continues to be plagued by high inflation and tight monetary settings.

The Federal Reserve Board (the Fed) raised the target range of the Federal Funds rate by 75 basis points (bps), moving the target range to between 2.25% and 2.50%. The Fed's statement highlighted that further rate hikes are deemed appropriate in the coming months to curb inflation. Headline inflation increased to 9.4% year on year (y/y) in June from 8.6% y/y in May. Core inflation was unchanged at 6.0% y/y. Elevated inflation is not just a reflection of non-core prices related to demand and supply shocks, but also a broader base of domestic price pressures, including rising wage costs and deteriorating expectations.

In emerging markets, China's economy contracted by 2.6% q/q in Q2-22 from revised growth of 1.4% q/q in Q1-22. The contraction was a result of the lockdowns that were imposed in China's major cities from March to May of this year to control the spread of Covid-19. Production across many sectors was halted and consumer spending was limited due to restricted mobility. Weak growth has prompted expectations of additional stimulus and the People's Bank of China has signalled its willingness to ease, if needed.

The rand ended the month at R16.60/US$1. Recent geopolitical tensions and expectations around aggressive global monetary policy normalisation weighed on risk appetite as global liquidity reduces in the face of elevated inflation. 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.

In South Africa (SA), the South African Reserve Bank (SARB) raised the repo rate by 75bps to 5.5% at the MPC meeting in July. The vote split was more of a surprise than the large hike, with one member voting for a 50bps hike, three members opting for 75bps and one member voting for 100bps. The SARB also materially revised 2022's average headline inflation to 6% – significantly up from 5.1%, premised on near-term price pressures associated with rising fuel prices, food inflation and global price pressures filtering through to SA's main trading partners.

Headline inflation printed at 7.4% y/y in June from 6.5% y/y in May, while core inflation accelerated to 4.4% y/y from 4.1% y/y. Food and energy prices continue to be the key drivers of the acceleration in headline inflation. Administered and regulated prices are also under pressure; currency volatility and uncertain global capital flows are additional potential risks.

At the end of July, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.47% (three-year) and 9.07% (five-year), much lower than the close at the end of the previous month. The recent move due to a repricing in both bond yields and repo rate expectations in the local market. Our 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.

Central banks globally have started down a path of rapid monetary policy normalisation in the wake of much higher and persistent inflation. In many cases, policy rates are expected to move into restrictive territory, which carries the risk of sending the global economy into recession. There has been a profound impact on global risk sentiment and expectations are for emerging market central banks to adopt a similar stance. In SA, the market has priced a much more aggressive monetary policy normalisation cycle, despite a more gradual rise in local inflation. Bond yields have widened in line with the deterioration in global risk sentiment and a repricing of global bond yields, but still encapsulate a significant risk premium. We continue to believe that bond yields in the 10-year area of the curve offer significant value for bond portfolios and allocations to ILBs should still be maintained but focused in the shorter end of the yield curve.

The local listed property sector was down 8.81% over the month, bringing its 12-month return to 9.75%. The balance sheet concerns in the sector have subsided, as companies have managed to introduce dividend pay-out ratios (with some withholding dividends entirely) and selling off assets in order to recapitalize 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, 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 6.9% over the month, bringing its 12-month return to 55.4%. 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 of 8.84% 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
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as at 31 July 2022