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

Performance

The Fund returned 0.74% in October, bringing its 12-month total return to 9.17%, ahead of cash (7.51%) and its benchmark (8.29%) over the same year. 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

Local bonds slightly recovered in October after a poor performance in September. The FTSE/JSE All Bond Index (ALBI) delivered 1.71%, with the long end of the curve (12+ years) posting the best performance of 1.99%. The belly of the curve (7-12 years) was up 1.79%, while medium-term bonds (3-7 years) delivered 1.32%. Short-term bonds (1-3 years) returned 1.07%, cash was up 0.68%, but inflation-linked bonds (ILBs) were down 0.98%.

October saw favourable third quarter of 2023 (Q3-23) real GDP reports for China and the US, while growth in the euro area contracted. China and US growth was mainly supported by consumer spending, while the European consumer remains under pressure. The developed market central banks kept policy rates on hold at the end of October and early November meetings, assessing the lagged impact of policy tightening measures, moderating inflation, and an easing in near-term inflation expectations.

In the US, real GDP was up 4.9% quarter on quarter (q/q) in Q3-23 from revised growth of 2.1% q/q in Q2-23. Contributors to the growth included increases in consumer spending, private inventory investment, local government spending, residential fixed investment, and exports. These were partly offset by weaker non-residential fixed investment and increases in imports. Consumers spent more on services like housing, utilities and health care, food services, and entertainment. Amid strong growth numbers, the market pricing of a near-term recession has receded.

The Federal Reserve Open Market Committee (the FOMC) kept rates on hold, leaving the target range unchanged at 5.25% - 5.5% at the meeting in early November. The decision to pause was taken despite strong economic growth in Q3-23 and tight labour markets. Federal Reserve Board Chair Jerome Powell indicated the FOMC would not rule out another rate hike at the December meeting as rising inflation, as well as intensifying global economic and political uncertainty, increase the case for greater precaution.

US headline inflation remained unchanged at 3.7% year on year (y/y) in September, while core inflation eased to 4.1% y/y in September from 4.3% y/y in August. Energy and housing costs kept headline inflation up while food prices continued to moderate. Nonetheless, core services inflation is still showing solid price increases largely driven by rent inflation, which is being offset by moderating core goods prices.

In emerging markets, China's economy grew by 1.3% q/q in Q3-23 from revised real growth of 0.5% q/q in Q2-23. Growth was positive in the retail sector, and industrial production growth remained unchanged from the prior quarter. Unfortunately, the property sector remains weak. There is little anticipation that recent stimulus will have a meaningful positive impact on growth in the near term.

The rand ended the month at R18.65/US$1. SA's idiosyncratic problems and the turn in global risk sentiment continued to weigh on the ZAR. Offshore credit assets and certain developed market bonds have seen an improvement in valuation, making them look very attractive. The Fund has utilised a significant part of its offshore allowance to invest in these 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.

In South Africa (SA), the Minister of Finance presented the Medium-Term Budget Speech Policy (MTBPS) in early November. The MTBPS detailed a renewed and concerted effort to consolidate expenditure with details showing attempts to protect spending on social grants, healthcare, and education while cutting costs, underperforming grants, and forcing departments and public entities to absorb some of the unbudgeted increases in wages. Revenue collections were revised down due to weaker growth and lower commodity prices, while tax buoyancy was revised down over the medium term. Along with higher spending, primarily related to wages and the rise in debt service, National Treasury now sees the deficit widening to 4.7% of GDP from 4.6% in the previous year. The public sector borrowing requirement was revised up to accommodate the larger deficit, higher interest costs, and planned redemptions. The debt-to-GDP ratio is expected to rise to 74.7% in FY23, up from 70.9% in FY22.

Headline inflation accelerated to 5.4% y/y in September from 4.8% y/y in August, while core inflation slowed to 4.5% y/y from 4.8% y/y. Rising fuel prices and an increase in food inflation after four months of deceleration pushed up headline inflation. The bigger story was the easing in core pressures as the quarterly survey of housing prices saw an easing in both rental and owners' equivalent rent. We are expecting headline inflation to rise again in October, but it should slow again in November as fuel prices adjust before rising again in January. The South African Reserve Bank is meeting at the end of November, and we expect the repo rate to be left unchanged.

At the end of October, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 9.14% (three-year) and 9.75% (five-year), lower than the close at the end of the previous month. 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.

SA's fundamental outlook continues to be plagued by inflation that will remain above the midpoint of the target band, a deteriorating fiscal outlook and very little confidence in the current administration's ability to correct the trajectory. Local assets have continued to trade poorly, with the risk premium embedded in local bonds remaining elevated. The recent turmoil in global bond markets has added a further spanner to the works as the prospect of higher rates for longer and deteriorating debt outlook weigh on bond yields. However, the current valuation of global bond yields suggests an increased margin of safety, which could provide some comfort to global bond investors. This, combined with the healthy risk premium on offer in local bond yields, should offer some support to our local bond market.

ILBs are securities designed to help protect investors from inflation. They are indexed to inflation so that the principal amount invested and, hence, the interest payments rise and fall with the inflation rate. ILBs have offered protection to investors over the last quarter. However, current breakeven inflation across the ILB curve averages between 5.5% and 6%, which is well above even our own expectations for inflation over the medium term. It is only the shorter-dated ILBs (I2025, 1.3 years to maturity and I2029, six years to maturity) that flag as cheap from a valuation perspective. Risks on the inflation front still remain elevated, and these shorter-dated ILBs, due to their inherent inflation protection, warrant a decent allocation within portfolios.

Credit markets have remained relatively subdued. Net issuance this year has been paltry, with most of the issuance on the back of refinancing maturing bank-senior and subordinated debt. Despite the poor fundamental backdrop in SA, credit spreads have continued to tighten this year as net supply has dwindled. Senior bank credit has compressed significantly, with the gap between five- and seven-year terms almost non-existent. The compression of term premium in credit spreads indicates a market that is hungry for yield at any cost and not what one would expect in the poor economic environment. Subordinated bank credit (AT1 and AT2) has seen a similar compression, with AT2 spreads now just 30-40 basis points (bps) above senior spreads. This compression is quite dramatic, and although banks remain well-capitalised and very far from a failure, given the nature of the instruments, we feel current pricing to be too optimistic. Given their tight valuations, we consider current credit spreads unattractive and see better alternatives elsewhere. Current pricing of global interest rates and credit markets offers an attractive, risk-adjusted opportunity for investors.

The local listed property sector was down 3.3% over the month, bringing its 12-month return to -1.2%. Operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. The current poor growth outlook, combined with an increase in cost base due to higher administered prices and second-round effects on loadshedding, will weigh on the sector's earnings in the coming year. We believe that one must remain cautious due to the high levels of uncertainty around the strength and durability of the local recovery.

Outlook

We remain vigilant of the risks 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 10.41% (before fees) 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 October 2023