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

Performance and fund positioning

The Fund returned 0.24% in February, bringing its 12-month total return to 10.08%, ahead of cash (8.07%) and its benchmark (8.90%) 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.

Local bonds performed poorly in February. The FTSE/JSE All Bond Index (ALBI) delivered -0.58%, with the long end of the curve (12+ years) returning -0.53%. The belly of the curve (7-12 years) was down 0.78%, while medium-term bonds (3-7 years) fell 0.88%. Short-term bonds (1-3 years) were 0.04% lower, while cash was up 0.63%, and inflation-linked bonds (ILBs) were down 0.70%.

February was filled with GDP readings from the leading developed markets for the fourth quarter of 2023 (Q4-23), with the US economy showing some resilience while the Euro area and UK are battling subdued economic activity. Inflation readings for January were, on balance, firmer. This suggests that headline and core prices are sticking closer to 3%, with much of the past disinflation momentum stalled. As a result, markets have repriced rate-cutting expectations to later in the year.

In the US, the economy grew by 3.3% quarter/quarter (q/q) in Q4-23 from growth of 4.9% q/q in the third quarter of 2023 (Q3-23). In annual terms, real GDP accelerated 2.5% in 2023 from 1.9% growth in 2022. The economy remains supported by strong consumer spending and tight labour markets, defying recession predictions in early 2023.

US headline inflation slowed to 3.1% year on year (y/y) in January from 3.4% y/y in December, while core inflation was unchanged at 3.9% y/y. The easing in headline inflation was driven by a drop in energy costs, while prices increased at a softer pace for food, shelter, new vehicles, apparel, and medical care. The market moved to pricing the first cut in June of this year following this January inflation print from previously expecting a rate move in May, as expectations for an easy return to target have adjusted outwards.

In emerging markets, China's headline deflation continued, contracting by 0.8% y/y in January from -0.3% y/y in December, while core inflation slowed to 0.4% y/y from 0.6% y/y. Food prices were weak and services inflation also slowed in January. Producer price inflation fell by 2.5% y/y in January after falling 2.7% y/y in December, signalling more weakness in consumer prices to come.

The rand ended the month at R19.16/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 continue to flag as relatively 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 Enoch Godongwana, delivered the National Budget Speech for 2024 at the end of February. The highlight was the utilisation of the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) balance to help reduce SA's near-term borrowing requirements; largely through a R100 billion withdrawal in 2024/2025, followed by R25 billion per annum over the next two years. On the expenditure side, the Budget reallocated funds to accommodate the 2023/2024 wage agreement and higher allocation to 'goods and services' than envisaged. Increases in social grants are expected to be below inflation and no allocations were made to State-owned entities and National Health Insurance. On the revenue side, a rebound in tax collections is supported by personal income tax brackets which have not been adjusted to accommodate inflation, higher wage assumptions, and some windfall from the introduction of the two-pot retirement system.

SA's headline inflation increased to 5.3% y/y in January from 5.1% y/y in December, while core inflation was marginally higher at 4.6% y/y from 4.5% y/y. The main contributor to the increase in inflation came from the rising price of fuel, while the prices of food and non-alcoholic beverages eased, and apparel and household utilities prices remained unchanged.

At the end of February, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 9.07% (three-year) and 9.56% (five-year), higher compared to 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.

The aggressive rate-hiking campaigns across most developed and emerging nations have helped inflation moderate. This should allow central banks to begin easing monetary policy in the second half of 2024. This monetary policy pivot should help support emerging markets as capital flows towards the higher yields on offer. SA, specifically, is in dire need of funding for its burgeoning deficits as growth falters and inflation remains towards the upper end of targets. This reprieve will prove temporary unless reform implementation is accelerated through increased private sector participation. For now, SA's bond yields still provide an attractive alternative to cash given their high embedded risk premium, despite the reduction in this buffer. We would advocate for slightly overweight positions in bond portfolios, focused on maturities of less than 12 years, together with a decent allocation to sub-8-year maturity ILBs.

ILBs are securities designed to help protect investors against 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 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 0.3% over the month, bringing its 12-month return to 16.3%. 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 10.1% (gross of 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 29 February 2024