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

Performance

The Fund returned 1% in January, bringing its 12-month total return to 9.88%, ahead of cash (7.95%) and its benchmark (8.75%) 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 had a lacklustre start to the year. The FTSE/JSE All Bond Index (ALBI) delivered 0.71% in January, with the long end of the curve (12+ years) returning 0.65%. The belly of the curve (7-12 years) was up 0.69%, while medium-term bonds (3-7 years) rose 0.83%. Short-term bonds (1-3 years) returned 0.78%, cash was up 0.68%, and inflation-linked bonds (ILBs) were flat at 0.06%.

January comprised a heavy calendar of developed market (DM) central bank meetings, all voting to keep policy rates unchanged. Post-meeting statements retained hawkish tones with a reluctance to give guidance on the path for rate cuts. Inflation readings remained steady, relatively unchanged from the previous month, although some underlying dynamics have become moderately less benign in the last month, and growth dynamics remain solid. Markets are having to reprice rate-cutting expectations to later in the year.

In the US, the Federal Reserve Board (Fed) left the Fed funds rate unchanged at a 5.25%-5.5% target range at its Federal Open Market Committee (FOMC) meeting in January. The FOMC stated it had no plans to start cutting rates given that inflation is still running above the Fed's target. The US economy has experienced decelerating inflation, but a strong labour market and resilient economic activity, make the call for policy easing more complicated. The futures market is pricing 100 basis points rate cuts in 2024.

US headline inflation accelerated to 3.4% year on year (y/y) in December from 3.1% y/y in November, while core inflation eased to 3.9% y/y from 4.0% y/y. Headline inflation averaged 3.4% and core inflation came in at 3.9% for 2023. The December increase in headline inflation was driven by a rise in prices for energy, shelter, used cars, and apparel. Services inflation remained unchanged. Reaching 2% target inflation is going to be a bumpy ride given the strong labour market, its impact on services prices, and upward pressure emerging in core goods.

The Bank of England (BOE) left policy rates unchanged at 5.25% at the Monetary Policy Committee (MPC) meeting in January. The MPC noted that the restrictive stance of monetary policy is weighing on economic activity and gradually leading to a looser labour market. The BOE expects inflation to ease in the second quarter of 2024 and then pick up in the second half of the year owing to a combination of base contributions that are related to energy prices, other domestic price pressures, and geopolitical tension.

In emerging markets, China's economy grew by 1.0% quarter on quarter (q/q) in the fourth quarter of 2023, from a growth of 1.5% q/q in the third quarter of 2023. For 2023, the economy grew by 5.2% from 3.0% in 2022. Growth was supported by industrial production, retail sales, and fixed asset investment.

The rand ended the month at R18.69/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.

The South African Reserve Bank (SARB) voted unanimously to keep the repo rate unchanged at 8.25% at the January MPC meeting. The SARB's post meeting statement retained a somewhat hawkish tone, highlighting persistent upside risks to inflation. While headline inflation has decelerated, core inflation remains sticky, and expectations remain elevated. The SARB highlighted that domestic electricity and logistical challenges are seen as both a constraint on growth and inflationary, adding to domestic policy challenges in the year ahead.

SA's headline inflation slowed to 5.1% y/y in December from 5.5% y/y in November, while core inflation remained unchanged at 4.5% y/y. Overall, headline inflation averaged at 5.9% and core inflation came in at 4.8% in 2023. The decline in inflation was due to fuel price cuts, flat food prices, and subdued rental inflation. Elsewhere, price increases remain a bit of a mixed bag. There were solid gains in apparel, household services, restaurants and hotels, and personal care, while household goods and durables were soft for the month. Looking ahead, we expect headline inflation to ease to 5.3% in 2024, but for core inflation to accelerate to 5.1%, leaving limited scope for policy easing this year.

Fund positioning

At the end of January, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.79% (three-year) and 9.29% (five-year), unchanged 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 last 18 months has seen aggressive rate hiking campaigns across most developed and emerging markets. Inflation is easing, which should allow central banks to begin easing monetary policy. 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 capital to fund its burgeoning deficits, as growth falters and inflation remains towards the upper end of targets. This reprieve will only 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, albeit some of this premium has reduced with the rally last quarter. We would advocate, slightly overweight positions in bond portfolios, focused on maturities of less than 12 years, together with decent allocation to sub eight-year maturity ILBs.

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 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 up 4.4% over the month, bringing its 12-month return to 16.5%. 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 net yield of 9.98% (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 31 January 2024