Amplify SCI* Absolute Fund

Fund Commentary | June 2024

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"At the shorter end of the curve, rate cuts are expected this year, and will be a function of the currency and domestic inflation."

Overview

SA's sovereign risk premium narrowed to below 300 bps

The positive national election outcome saw the term and sovereign risk premia priced by SA assets compressed in the second quarter of 2024, such that the generic 10-year bond yield fell 80 bps to end the quarter at 11.23% – almost on par with our estimate of fair value. The 10-year yield has since fallen further to 10.94% in July.

Analysing the components of yield compression we note that US real yields fell 24 bps, ending June at 2%, and that SA's sovereign risk premium (as measured by the difference in SA dollar-denominated debt and US debt) narrowed 65 bps to 260 bps. The sovereign premium has not averaged below 300 bps since the first half of 2021.

At the shorter end of the curve, rate cuts are expected this year, and will be a function of the currency and domestic inflation. In this respect, the Bureau for Economic Research (BER)'s latest inflation expectations survey for the second quarter of 2024 weighs in favour of lower rates. Expectations of CPI in two years' time slowed to 4.9% from 5.2% in the first quarter of 2024. Actual inflation is trending in the right direction. While we don't have a full second quarter worth of data, headline inflation has slowed from 5.4% in the first quarter of 2024 to 5.2%, on average, in April and May. The net move was largely due to a fall in food inflation from 6% to 4.4% countered by a rise in fuel from 5% to 9.1%. Core inflation slowed from 5.3% to 5% and excluding administrative prices CPI is at target (4.5%), on average, in April and May.

US dollar weakens against the rand for the quarter

Over the quarter, the US dollar weakened by 3.7% against the rand (from USDZAR 18.90 to 18.20), even while the dollar strengthened by 0.8% against global currencies in general. This was largely due to the post-election rally which saw the currency move from around 19.00 to 18.00. Macroeconomic fundamentals (inflation differentials and commodity prices) have also improved, resulting in our unadjusted USDZAR fair value estimate of 15.60, an improvement from 16.00 in the first quarter of 2024. After accounting for SA's structural growth and political risks, the adjusted fair value of USDZAR rose to 19.30 (at better rand levels than 19.50 in the first quarter of 2024).

Local overview

Growth expectations should start to recover

Looking ahead, we expect that with loadshedding having dissipated, growth expectations should start to recover, providing scope for the rand to remain around 18.00. Much also depends on the success of the Government of National Unity. Strength in the rand is dependent on the dollar, which is likely to remain strong over the coming months, as well as potential global investor flows returning to emerging markets as yields in developed countries fall.

The reduction in SA's sovereign risk premia priced by bonds and the currency, reduces upside risks to inflation and provides space for the SA Reserve Bank (SARB) to cut rates. We expect rates to fall as much as 50 bps in 2024 with the first cut likely in September. Importantly, the SARB repeated their intention to lower the inflation target, sticking to their guns despite apparent reluctance from the government. This policy priority, alongside CPI which will remain above the new target, should keep the cutting cycle relatively shallow.

Market performance

A strong quarter for South African equities

Global equity markets were up by 1.8% over the second quarter of 2024 in US dollar terms. Emerging market equities were up 4.1% over the quarter. South African equities had a very strong quarter, returning 8.2% in rand terms, with an equivalent US dollar return of 12.3% as the rand strengthened almost 4% against the dollar.

Domestically, over the last quarter, the SA money market returned 2% in rand terms. The SA bond market strengthened by 7.5% over the quarter

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after a substantial 5.2% bounce in June. The World Government Bond Index was down 1.6% in US dollar over the second quarter. The FTSE/JSE SA Listed Property Index rallied 6% in June, resulting in a return of 5.5% over the quarter.

Portfolio performance and positioning

Performance

The fund delivered a performance of 4.9% after fees over the quarter, resulting in a 12-month net return of 10.3%, ahead of its inflation plus 4% return target. Contributions to return for the quarter were from domestic equity (+2.9%), domestic bonds (+2%), domestic money market (+0.5%) and domestic property (+0.5%). Foreign equity (-0.2%) and foreign money market (-0.6%) detracted from the quarterly return.

Positioning

We continue to favour a well-diversified portfolio with money market and floating rate note (FRN) holdings comprising 19% of the portfolio, local equity exposure at 33%, property exposure at 5%, foreign equity at 10% and foreign money market at 7%. The fund's exposure to domestic bonds is 26% (including a 5% allocation to inflation-linked bonds), resulting in a duration of 1.8 years at the fund level.

Although we expect a shallow SARB cutting cycle (75-100 bps over the next 18 months), we continue to see significant value in SA Government FRNs at 140 bps above the 3-month Jibar. We do not expect real policy rates in SA to decline below 2.5%, which should continue to render a real return of approximately 4% from 5-year FRNs. The fund also extended its money market investment to 12 months in anticipation of the shallow cutting cycle that we expect to commence in September this year.

Total equity exposure of 43% remains well within the 60% mandate limit. Global equity exposure at 10% remains at cautious levels. The fund holds active equity sector overweight positions in Media and Tech, General Industrials and Healthcare, while maintaining active underweight positions in Food Retailers, Gold, Mining and General Financials.

INTELLIGENT IMPACT THAT MATTERS