AMPLIFY

Amplify SCI* Strategic Income Fund

Fund Commentary

January 2021

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*Sanlam Collective Investments
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financial services provider (FSP no: 47909)

Global

Poor balance sheet stocks rally might have broader implications

Is it possible to start a commentary without mentioning WSB? Reddit day-traders were all the rage ('against the machine') last month. It seemed some funds were taught an expensive lesson: avoid shorting just the worst stocks, as the reversal risk and volatility is simply too hard to manage. French multinational financial services group Société Générale (SocGen) argues the consequences of these poor balance sheet stocks rallying so strongly might have broader implications. For one, they now represent 11% of the Russell 2000 Index versus just 6% at the end of 2019, making the Russell 2000 even more sensitive to credit risk. And if this focus on short-sellers has a spill-over and limits the ability to short-sell, this could have ramifications for those who short to hedge other less liquid assets, such as credit…

Global markets trapped in sideways action

Most global markets were trapped in sideways action with slower than anticipated vaccination rollout blamed for the lack of post-Biden follow-through. Ongoing delays of a new US stimulus package appears to be a further dampener. Public health officials have confirmed that the South African strain, which was worrying both for its infectiousness and its evasive prowess, has been detected in the US. While just a few cases have been documented so far, there are reasons to believe that it might be more widespread, echoing the dynamics of the spread of Covid-19 in Washington last year. Meanwhile the efficacy of vaccines continues to be explored, with recent results from the Johnson & Johnson one-dose option providing fuel for both optimists and pessimists. The latest data on the Novavax vaccine are similarly mixed, with a trial involving British volunteers showing it was highly effective, but it was less than 50% effective in a smaller trial in South Africa. At the time of writing global vaccine administration crossed the 100 million mark, equalling around 1.3 doses for every 100 people. There, however, remains a stark gap between vaccination programmes in different countries, with some yet to give a single dose (here's looking at you, South Africa…).

US Fed don't see inflationary effects as lasting

The first Federal Open Market Committee (FOMC) meeting of the year seemed a non-event, with Fed chair Powell keen to emphasise it is way too early to talk about tapering or inflation. However, the Kansas City Fed's Manufacturing Survey reported prices paid for raw materials continued to rise rapidly – to the highest reading since 2011 – and though consumer spending is slipping, inflation crept higher in December, as did inflation expectations. When asked during the post-FOMC press conference about the potential for inflation, Powell considered a couple of different factors and said that 'in both cases [considered], we don't see those [inflationary effects] as either lasting or particularly large'. We have a favourite saying in the office. Trust, but verify.

Equity markets have been roiled retail investor activity

For risk assets (and by derivation the dollar) the key question at present revolves around the potential for lower vaccine efficacy, which, if confirmed, could reduce the medium-term growth outlook, possibly weighing on risky assets and supporting the safe-haven dollar. Also, European Central Bank (ECB) officials appear to be talking up the prospect of deposit rate cuts – and thus its currency down. In general, there seems to be a renewed theme of currency wars surfacing, with the US also commenting on a few countries manipulating its currencies, and China in particular. Finally, equity markets have been roiled by unusual retail investor activity in several heavily shorted stocks, which has driven up equity market volatility, and if not addressed at a regulatory level stands the risk of dragging down broad indexes. Finally, it is worth keeping an eye on commodity prices. Not only have we seen huge demand for grains (China, as they restock their strategic pork reserves after another swine flu episode), but also in the metals space, especially iron ore, which seems to be trading well above fundamental fair value. The impact of a change in metal prices of course also means South Africa's terms of trade might be influenced as oil prices remain close to the US$60 mark.

Local

South Africa is moving into a three-dimensional chess period in February as markets become more conditioned to the idea of a global economic recovery, the arrival of vaccines, more evidence of potential positive revenue surprises for the Budget, and therefore, maybe, lower issuance of bonds. All weighed up against a return of foreign inflows and the seasonal impact of large coupon flows.

Low for longer does not imply lower for longer

None of the above should be new news, which explains why the R2048 is down an impressive 120 basis points since the US elections, almost matched by meaningful curve flattening also after the South African Reserve Bank (SARB) not only left interest rates unchanged again in January, but highlighted that low for longer does not necessarily imply lower for longer.

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Inflation-linked bonds appear to be a consensus trade

Even with the positive news of beaches reopening (still trying to understand why they were still closed into February?) and hopefully our children going back to school (!), limited vaccine availability, questions around vaccine efficacy against the so-called SA strain, and (hopefully) fiscal consolidation mean conditions remain tough for the average SA consumer. If we couple this with SARB comments, Eskom news, oil and food prices, and current positioning, it is understandable that the long inflation-linked bond now appears to be a consensus trade.

We do not see the State of the Nation address being able to move the needle sustainably on the rand, and look to foreign flow dynamics for direction as we move towards the tabling of the National Budget on 24 February. National Treasury probably has a final shot at redeeming itself with regard to improving its funding strategy. Yield curve flattening appears to have momentum (and much further room to move), but it will need confirmation from the funding side for the trade to have legs.

Portfolio positioning

Our approach remains highly tactical

We have started taking profit in some of our overweight holdings, with an emphasis on maintaining duration as we see the monetary trade run out of runway. We are happy to build cash buffers into risk events after a significant rally in rates over recent weeks and consensus views rising fast. We are also reminded of some important International Monetary Fund comments:

‘To reignite growth and job creation, there is a need to advance reforms that address Eskom and other SOEs’ difficulties, strengthen competition and governance, and increase labour market flexibility.

‘The resurgence of infections and the protracted vaccination procurement and distribution processes, as elsewhere, will likely weigh on the economic recovery this year, notwithstanding improved external conditions.

‘Special attention should be given to improving the efficiency of SOEs and the quality of their services by hardening their budget constraints and undertaking well-defined strategic equity partnerships, particularly in the energy sector.’