Portfolio Manager Quarterly Comment

Market overview

The year kicked off with a US government shutdown and Brexit uncertainty in the headlines, highlighting the paralysis these major global economies are caught up in – partly due to the lack of good leadership in place. The major driver of global market moves and noise for most of the quarter continued to be a combination of US–China trade talks, the ongoing Brexit debacle, as well as global growth concerns and central bank policy shifts. Towards the end of the quarter, global central banks turned unexpectedly dovish and bleak economic data with associated negative outlooks for the global economy drove global bond yields sharply lower. Global developed market bond yields are back at all-time lows and into negative territory in countries like Germany and Japan, with the moves pushing the total value of negative-yielding debt outstanding worldwide to above US$10 trillion.

Locally, yields were slow to react to the global debt rally towards the end of the quarter, with South African government bond yields at first remaining sticky at the levels they had grown comfortable with before finally taking cue from global markets. After the conclusion of the local policy rate announcement and perceived risk of a credit rating downgrade a little out of the way, our local interest rates re-aligned with global rates and traded stronger. The other more noteworthy move during the quarter was seen during February as local interest rates traded significantly weaker around the time the National Budget was tabled. The local 10-year government bond yield touched 9.3% during February before rallying back to close the end of the calendar quarter at 8.9%.

The SIM Active Income Fund had a good start to the year after posting solid returns in 2018. The returns were particularly noteworthy when considering the especially challenging investment environment locally as well as globally. By a number of measures, last year was one of the toughest on record with the vast majority of global asset classes ending the year in negative territory. These drawdowns were also associated with a fair share of volatility as global markets traded erratically all the way through to the last few trading days of 2018, and again starting the first trading days of 2019 in a particularly erratic fashion. Global markets traded with wild swings on a daily basis with sell-offs being followed by sharp reversal rallies on a daily basis during the last few trading days at the end of last year. The new year again kicked off in a similar fashion with conflicting economic and company news flow pulling markets in all directions. Although markets traded with a fair share of shorter-term volatility, some rationality at least prevailed with the first quarter of the year being particularly strong across most major asset classes, and so delivering healthy returns after the previous calendar year’s drawdowns. The vast majority of global asset class returns ended the first quarter in positive territory when measured in local currency as well as in Dollar terms.

The South African government’s National Budget was tabled during February and our view is that South Africa is now moving beyond the crossroads. The core message from the Budget is that non-performing state-owned companies have become such a drag on the fiscus that it is difficult to place South Africa’s government finances on a sustainable path. This situation is compounded by an underperforming economy, which necessitates continued tax increases. New revenue-raising measures amount to R15 billion in 2019/20, mainly by not compensating for bracket creep, which effectively raises personal income tax. Worryingly, the Main Budget primary deficit (revenue less non-interest spending) increases to -1% of GDP in 2019/20 from -0.8% in 2018/19 and remains in deficit over the medium term. As such, the gross loan debt continues to increase and only stabilises in 2023/24 at a projected level of close to 60% of GDP. The debt level in itself is not especially high relative to GDP. However, given persistent sovereign debt rating downgrades the real interest rate government pays on new debt is high relative to GDP. Hence, in the absence of a substantial
improvement in the primary budget balance, the debt level can only be stabilised over time should the real interest rate on debt decline relative to the real GDP growth rate. The clearest path to this outcome would be to improve South Africa’s sovereign debt ratings or to lift real GDP growth. The former is hardly likely under current conditions, while the latter is difficult given high real interest rates and a situation in which the government is absorbing a large share of available savings to fund itself. It should be noted there is a lot that is also good in the Budget, including the determined effort to boost capital expenditure relative to consumption expenditure and the firm stand on the need to improve the operational and financial performance of state-owned companies. Finance Minister Tito Mboweni indicated the time is approaching when hard decisions need to be taken, including whether or not the central government should issue guarantees for the operational expenditure of state-owned companies, as well as consideration of equity partners where necessary. Overall, the Treasury’s intent is to stabilise the debt ratio and return South Africa’s government finances to a sustainable path, but the track record of recent years is not good and raises questions over South Africa’s fiscal consolidation path. The decisions taken in 2019, starting with the Budget, will provide important clues as to which path we have picked. At the very least, government support for state-owned companies must be accompanied by a credible plan for the turnaround of these entities. A fiscal adjustment needs to not only lead to an improving trend in government budget deficits, but it must also address the deteriorating trend in the public sector’s net worth.

The credit rating of South Africa continues to be a key potential risk factor to monitor. Moody’s is currently the only rating agency which still has an investment-grade rating for South Africa, although only one notch above investment grade. Both S&P and Fitch have a sub-investment-grade rating on South Africa. In November S&P announced they are keeping their rating unchanged at BB+ for the local currency and BB for the foreign currency, with a stable outlook. In December Fitch also affirmed their rating of South Africa at BB+ on both the local and foreign currency debt, also with a stable outlook. It appears both rating agencies have given South Africa the benefit of the doubt, citing the usual key risk factors and challenges relating to economic growth, structural reform, fiscal consolidation and the ongoing concerns of SOEs. Moody’s is key at this stage being the only rating agency which still has an investment-grade rating for South Africa, with the exclusion from global bond indices and potential foreign outflows thus hanging in the balance. Should Moody’s downgrade South Africa to sub-investment grade, it could lead to portfolio outflows and weakness in local fixed-interest markets. Moody’s was due to give a review of their rating of South Africa during October last year, but then postponed their review into the new year. After anticipation from some, Moody’s subsequently did not issue a formal statement about their credit rating of South Africa on their scheduled rating at the end of March. Market participants were relatively equally split in their expectations of no change to the outlook versus a change to negative outlook but with the rating unchanged. Initially it was not entirely clear whether they would wait until after the national elections in May to issue a credit opinion, but they subsequently did so in the following week by giving further details of their framework and thinking behind the rating, and keeping the local as well as foreign currency debt unchanged at Baa3 with a stable outlook. The attention now shifts to the local political outlook and national elections, while fiscal dynamics remain a key driver and the potential for event risks also weighing in.

Headline consumer price inflation (CPI) in South Africa increased marginally to 4.1% year-on-year in February from 4% in January and marked a cyclical low point. Core inflation measures – which exclude food and non-alcoholic beverages, petrol and energy – remained unchanged at 4.4% year on year. Looking ahead, we expect headline CPI to remain comfortably within the 3-6% range, owing to technical factors such as the fading impact of VAT and sugar tax and a relatively low oil price compared to last year’s peak. Non-technical disinflationary drivers include improved inflation expectations and subdued compensation of employees. Overall, inflation is expected to remain relatively well anchored within the target range and our forecasts are underpinned by the assumption that the Rand gains slightly while at the same time oil prices remain relatively stable.
Local inflation-linked bond yields kicked off the year at elevated levels and seemed to turn a corner towards the end of January as real yields started to trade stronger. The rally was short-lived as there was little further support to drive real yields lower and we again ended the quarter with real yields trading up. Inflation-linked bond yields seem to offer better value at the short to medium area of the curve when compared to nominal yields, while the steepness of the nominal curve and implied breakeven levels suggest better value is to be found in nominal yields as one goes further out on the term structure.

The asset allocation in the SIM Active Income Fund worked well during the last two years where financial markets were characterised by volatility, uncertainty and it was generally a challenging investment environment. Overall, we are pleased with the performance outcome and positioning of the fund, especially given the circumstances and sharply negative returns seen on most asset classes worldwide during the past year. The Fund managed to deliver performance in a volatile market environment driven by a number of local as well as international factors. The Fund was able to participate in market strength but was also more insulated from market volatility than could otherwise have been the case, especially considering the events and market movements we witnessed. The Fund’s investment objectives are always a key consideration when evaluating the overall positioning and underlying investments. This has continued to prove to work for the Fund as the performance has managed to keep pace with the local market during periods of strength, while in addition we have had scope available to take advantage of investment opportunities during market weakness and when interest rates traded higher.

The mandate of the SIM Active Income Fund is orientated towards higher-quality assets and it is also important to remember that the SIM Active Income Fund does not utilise any offshore exposure. Offshore asset allocation brings with it the potential for associated currency diversification benefits and an expanded investable universe. This expanded opportunity set would have been beneficial, in particular during the last two years as we witnessed big moves in the local currency as well as reversals over shorter periods than is otherwise more generally the case. The Fund has performed well when considering the risk-adjusted returns delivered, as compared to inflation as well as other assets classes. When looking at the return of the SIM Active Income Fund compared to inflation, the Fund has performed as good as it can be expected to while on the other hand the conservative nature of the Fund has resulted in strong positive returns compared to returns in listed equity and property, which have been muted and even firmly in negative territory at times. Going forward it should reasonably be expected that the performance will again normalise closer to historic norms.