Portfolio Manager Quarterly Comment

Market review

The uncertainty as to where global yields will or should settle increased again during the past quarter. The world is adjusting to higher average policy rates and long-term yields have not yet found a new equilibrium, with developed market bond yields rising by almost half a percent during the quarter. Global bond markets are either pricing in higher long-term inflation, or (more likely) higher long-term policy rates in order to be able to keep on managing inflation within target bands. With the US being a long-yield economy, due to much of consumers' and companies' interest expenses being determined by yields on long-term debt, increases in bond yields effectively suggest tightening economic conditions. This causes discomfort in equity markets due to increased earnings risk, while at the same time it also presents an increase in the discount rate being used for valuation purposes. In 2022, the yield on the US 10-year bond rose by some 2.5% and during the same time the S&P 500 Index declined by 25%. In the past quarter the US long-bond yield increased by another 0.8% and again coincided with downward pressure on equity markets. Recent rises in energy prices also contributed to tighter financial conditions. Offsetting these headwinds, the large Covid-distorted spending rotation between goods and services is still impacting actual economic activity as well as distorting traditional indicators thereof. Due to it, the goods and housing sectors have already bottomed and are likely to see some improvement off low bases despite slowing overall economic activity – contributing to a consensus economic outlook that seems to have migrated towards a soft landing for the US economy.

Recent revisions to earnings expectations suggest the same and have been marginally positive. Furthermore, the much higher level of the federal funds rate than what was expected in recent years, implies much improved scope for the US Federal Reserve (Fed) to battle potential economic downturns, than what they had available in the last two decades, providing some comfort to investors that there is 'dry powder' available for stimulus should the economic downturn surprise on the downside. Consequently, equity markets did not perform as poorly during the recent renewed rise in bond yields as one would otherwise have expected it to do and for the quarter, global equities even outperformed global bonds, although only by a very small margin. The MSCI World Index delivered a negative return of 3.5% compared to the Bloomberg Global Aggregate Bond Index, which was down 3.6%. Global property continued to be impacted more than equities by the rising long-dated yields and declined by 6.6% for the quarter. Fortunately we had reduced our foreign property exposure and hence the drag on performance due to foreign property exposure, was limited.

Our foreign equity construct remained defensive, with sizeable exposures to Emerging Markets (EM), which we hoped would be less prone to sharp contractions given that they are absolutely and relatively cheap, as well as Real Assets (RA), which we hoped would be less prone to sharp contractions given high yields and superior earnings visibility and a contractual inflation-linked element to earnings. In addition to this, we hold a component of exposure via a portable alpha note, which delivers consistent alpha in excess of the MSCI World Index.

The RA exposure continued to struggle in the face of rising bond yields, which has been the dominant valuation factor for real assets and property in recent times. However, this was more than offset from value added by both the EM and portable alpha exposures. The Sanlam Global Emerging Market Fund outperformed the MSCI World Index by 0.6% and with our portable alpha notes delivering excess returns in the range of 2-3% p.a., their quarterly performance contributions also continue to be sizeable and consistent.

In the local market, bonds performed better relative to equities, with a very small negative return of 0.3% from the All Bond Index, compared to a negative 4% from the FTSE/JSE SWIX Index. Local equities pretty much performed in line with global equities when measured in the same currency. Local bonds, however, outperformed global bonds, despite very similar increases in bond yields over the period. Local bonds benefited from both a higher nominal yield as well as a lower modified duration, hence outperforming global bonds on both the income and capital components of returns. At a 12% yield the All Bond Index can accommodate a further rise of 2% in yield over the course of a year and will still deliver a positive return, whereas a similar rise in global yields would result in a loss of about 10%. It was fortuitous that we previously reduced the size of our local equity exposure and used it to increase the exposure to local bonds. However, it would have been even better if we invested in local cash, since both bonds and equities underperformed local cash, which delivered a positive return of 2.1% for the quarter. Our local asset allocation hence did not contribute as much to performance as it potentially could have.

The current valuation levels of local assets remain attractive, with especially the high prospective real returns from local bonds that stand out relative to the long-term trend returns we expect the asset class to deliver. We therefore continue to hold a relatively high level of exposure to the asset class. With the global economic conditions tightening and global equity valuations just fair, we are not at maximum allowed exposure levels to equities and we are supplementing both our local and foreign equity exposure with protective structures that will reduce some of the downside in case of a severe equity contraction. The protection on the local equity portion is especially attractively priced, since the protective band is very close to the current market price and hence any further contraction in local equities over the course of the next two quarters would see the portfolio behave as if we held a much lower exposure.