Portfolio Manager Quarterly Comment

Market review

The SIM Enhanced Yield Fund delivered very good results for 2018, building further on the track record and previous years' good performance. The performance is in stark contrast to the global environment where, by a number of measures, 2018 was one of the toughest years on record for broader asset class returns worldwide. The vast majority of asset classes delivered negative returns for 2018 – measured in Dollar terms as well as in local currency terms. When looking at the broader set of major global asset classes, positive returns were almost exclusively earned from holding either cash or a handful of other assets. Locally it was no exception: safer-haven asset classes such as cash, credit and bonds delivered positive returns while on the other hand most listed equity as well as property returns ended the year firmly in negative territory. The SIM Enhanced Yield Fund is positioned squarely at the lower end of the risk spectrum and during the last year served a valuable purpose by delivering strong positive returns in a tough environment. The continued good results show that the strategies employed for the Fund can deliver sustainable outperformance, but we nevertheless continue to seek ways in which to further enhance the performance profile of the Fund. Yield enhancement is pursued by using a combination of both interest rate and credit strategies. The Fund's track record so far demonstrates that it is possible to outperform during various interest rate cycles, as well as in favourable and even unfavourable credit and financial market environments.

The year ended off with a volatile December in financial markets, which was a fitting conclusion seeing that it was quite characteristic of most of the rest of the year. There were wild swings on a daily basis in global markets with sell-offs followed by sharp reversal rallies and this erratic behaviour extended all the way to the last few trading days of the year. The moves were driven largely by concerns around the US Federal Reserve (Fed)'s actions and their pace of monetary policy normalisation. Local asset classes were not left unscathed, however, local interest rates managed to edge stronger towards the end of the month after trending higher at the beginning of December. It was characteristic of most of the rest of the year during which interest rates were pulled in all different directions. The first quarter was dominated by positive news flow and Ramaphoria on the local front, which supported South African fixed-interest assets, even though it was short on the heels of the strong performance delivered during December 2017. By contrast, the second quarter was dominated by negative developments on the international front, which weighed on emerging market assets in general with South African fixed-interest assets and the currency not escaping the pressure. The international developments during the second quarter overshadowed positive developments on the local front and weighed on the local interest rate market performance. Local interest rates subsequently also ended the third quarter higher as international factors again weighed on our local market, in particular during August and September. During the fourth quarter South African nominal bond yields continued to trade at elevated levels although remaining within a narrower range. Foreigners sold a record amount of their holdings of our local bonds during the course of last year with foreign ownership decreasing to the lowest level in almost two years. This weighed on valuations and foreign sales continued during the fourth quarter, which opened additional headroom for our local yields to trade at more elevated levels.

The Monetary Policy Committee (MPC) at the South African Reserve Bank (SARB) hiked the repo rate by 25 basis points (bps) to 6.75% at their scheduled meeting in November. The hike was despite the fact that the SARB could have justified keeping the rate unchanged given their underlying expectations, inflation and other forecasts. The bank commented that the hike followed 'robust debate' and was on the back of risks posed to the long-term inflation outlook, including tighter global financial conditions, a weaker rand, higher wage growth, higher oil prices as well as rising electricity and water tariffs. At the previous MPC meeting in September, the vote was split with four in favour of an unchanged policy rate and three voting for a 25-bps hike, indicating that there were diverging views. Going into the November meeting, there was not much justification for major changes to the SARB's inflation forecasts, indicating the MPC members had little reason to change their views from the previous meeting. With one of the more dovish MPC members having retired since the previous MPC meeting; this resulted in three MPC members voting for a hike and three which preferred to keep rates unchanged. This left the MPC split and the hike then due to the Governor, Lesetja Kganyago, casting the deciding vote. The local market took the news well with local bond yields trading stronger and the Rand strengthening. The MPC's comments were again on the hawkish side and so aligned with their continued endeavour to guide local inflation expectations closer to 4.5%.

South African economic growth figures for the third quarter showed that the local economy had recovered from the technical recession. Real gross domestic product (GDP) recovered to +2.2%, beating consensus expectations of around 1.9%. The second-quarter figure was also revised upwards to -0.4%. Both the secondary and tertiary sectors picked up to +4.5% and +2.6% in the third quarter from +1.1% and -0.4% respectively in the second quarter. By contrast, the primary sector decreased to -5.4% from -3.3% in the second quarter. The more detailed breakdown of GDP shows an improvement in manufacturing and agriculture, which printed at +7.5% and +6.5%. Similarly, transport, wholesale and retail trade, and general government improved to +5.7%, +3.2% and +1.5% respectively. Personal services slowed marginally to +0.7%. Meanwhile, mining, construction, and electricity, gas and water declined to -8.8%, -2.7% and -0.9% respectively. From the demand-side, figures reveal that gross domestic expenditure (GDE) contributed +2.8% in the third quarter following a contraction in the second quarter. The improvement can be attributed to households and government expenditure, which added +1% and +0.4% respectively. Inventories made a significant contribution of +2.4% and offset the drag from gross fixed-capital formation. The external sector remained a net drag as imports detracted more than a positive contribution from exports.

Local confidence levels are continuing to move in the wrong direction following the previous recovery led by Ramaphoria earlier in the year. The RMB/BER business confidence index (BCI) declined for the third straight quarter during the fourth quarter of the year. The index declined to 31 points in the fourth quarter from an already depressed 34 points in the previous quarter, with none of the sectors measured scoring above 50. We are all aware of the fact that the country and the economy is not in the position where South Africans want to see it, and are equally aware of the number of reasons for it. Confidence levels need to recover for investments to come through and long-term potential growth to improve from the current depressed state.

The SIM Enhanced Yield Fund is positioned with a relatively cautious orientation going into 2019. The Fund's positioning is balanced by taking advantage of interest rate opportunities as well as credit opportunities. We are currently seeing more opportunities in local interest rates, which are trading at elevated levels, while on the other hand credit spreads have been trending downward as the supply of new paper in the market has not been nearly enough to meet total demand. The local economic environment and global financial conditions remain relatively unfavourable at present with a number of identifiable risk factors to consider. However, the valuation of South African fixed-interest assets remains attractive with local yields starting the year at still relatively elevated levels, which provides a better starting point and supports the forward-looking return prospects of the Fund.