Portfolio Manager Quarterly Comment

Market overview

The Fund reached its seven-year track record during the second quarter of 2018 with the performance achieved continuing to stack up very well compared to the investment objectives of the Fund. The results show that the strategies employed for the Fund can deliver sustainable outperformance, but we have nevertheless continued to seek ways in which to further enhance on the performance profile of the Fund over the last few years. 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 during favourable and even unfavourable credit market environments.

The first half of the year was a tale of two quarters. The first quarter was dominated by positive newsflow and 'Ramaphoria' on the local front, which further supported South African fixed-interest assets and the currency, short on the heels of the very good performance delivered during December. 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 unscathed. The international developments overshadowed positive developments on the local front and weighed on the local interest rate market performance.

Local interest rates ended the third quarter higher as international factors again weighed on our local market, in particular during August and September. The third quarter started on a positive footing with emerging markets having had a better month during July and the South African bond market also posting a strong return for the month. August saw emerging markets underperforming with the Argentinian Peso and the Turkish Lira both weakening significantly during the month, and the Rand also weakening more than 10% against the US Dollar in August. Emerging market bond and equity indices also ended the month in negative territory with SA bonds following suit – South African nominal bonds and inflation-linked bonds both ended the month in negative territory, with nominal bonds underperforming the inflation-linked bond indices. The month also drew some local attention from US President Trump who tweeted about South African land issues, which had little impact on local financial markets' performance and mainly resulted in a flurry of newsflow around the comments. Developed markets delivered mixed performance in August with US equities posting positive returns driven by the strong returns of technology stocks such as Amazon and Apple, while European equities lagged behind and delivered negative returns. Developed market bonds benefited from the risk-off sentiment with yields trading marginally firmer over the month of August. September kicked off with a bout of volatility in global bond markets. This was at first set off by emerging market-specific factors but then spread further into broader international bond markets. US treasuries ended the month weaker with the 10-year treasury yield closing above 3% at the end of the quarter. South African bonds were not left unscathed with yields on South African government bonds ending the third quarter still hovering at elevated levels.

The Monetary Policy Committee (MPC) at the South African Reserve Bank (SARB) kept the repo rate unchanged at their scheduled meetings in July and September, with the last change to the policy rate being a 25-basis point decrease to 6.5% at the meeting in March. The vote at the meeting in September was split with four in favour of unchanged and three voting for a 25-basis point hike, indicating that there are some diverging views. Nevertheless, the resulting unchanged outcome was in line with consensus expectations. The bar for rate cuts remains higher than it has been historically and the statement had a hawkish tone, although a bit less hawkish than was to be expected. Monetary policy should still be seen as being on the accommodative side at current levels. The MPC reiterated their intention to contain inflation well within the inflation target range and closer to the mid-point 4.5% target. SARB Governor Lesetja Kganyago highlighted that the medium-term inflation outlook has deteriorated and the SARB's inflation forecast is for an annual average of 5.7% in 2019 and 5.4% in 2020, with CPI set to peak at 5.9% in the second quarter of 2019. The growth outlook for 2018 has been lowered to 0.7% while the forecast for 2019 is 1.9% and 2% for 2020. The SARB's Quarterly Projection Model (QPM) shows five interest rate hikes of 25 basis points each towards the end of 2020, which is unchanged from the previous MPC meeting.

South African economic growth figures for the second quarter were reported and indicated that the local economy had slipped into a technical recession with two consecutive quarters of negative growth. This marks the first local recession since the global financial crisis a decade ago. South African GDP growth for the second quarter was shown to have contracted by -0.7% following a downward revised -2.6% in the first quarter. The market consensus expectation was for a positive number in the second quarter. The primary and tertiary sector declined by -4.6% and -0.6% respectively in the second quarter, from -17.0% and 0.3% respectively in the first quarter. The secondary sector recovered somewhat to 0.5% compared to -5.0% in the first quarter. A detailed split reveals that five sectors declined and six sectors delivered positive growth. Agriculture shrank by -29.2%, transport by -4.9%, wholesale and retail trade was down -1.9%, general government -0.5% and manufacturing -0.3%. The expenditure side of GDP shows that household consumption and gross fixed-capital formation fell by -1.3% and -0.5% respectively while gross domestic expenditure shrank to -3.6%. Future growth expectations should also be revised lower. The bounce in GDP in the second half of 2017 partly reflected South Africa's improved terms of trade, which along with lower inflation boosted consumer purchasing power and spending. However, the deterioration in the terms of trade during the first half of 2018 and an increasing tax burden (including the 1% VAT hike in April 2018) has weakened disposable income and households' spending power. At the same time real private sector credit extension has remained weak partly due to tightening global financial conditions. Against this backdrop and given constrained profits growth, fixed investment spending and associated job creation has disappointed.

The dynamics in the global corporate credit environment is at an interesting juncture. The past number of years have been a generally favourable global credit environment with corporate profits strong, in particular in the US, while interest rates have been at their lowest level in history. The global low interest rate environment furthermore resulted in a global search for yield, resulting in an added benefit of a large pool of liquidity available from investors looking to allocate capital to higher-yielding credit. Although interest rates have started increasing more recently in the US and there have been some moves higher on spreads, corporate funding rates nevertheless remain around their lowest levels in history. There are some noteworthy dynamics in the markets and on the balance sheets of corporates, with some disparity between countries. Corporate leverage has increased significantly in developed markets as well as most emerging markets, however, there are disparities between the US with significant increases in leverage and, for instance, Japan where this has not been the case. In emerging markets corporate debt levels are at their highest level in history when measured as a percentage of GDP, however, the increase has been fuelled predominantly by China. The favourable global credit market environment can reasonably be expected to continue for some time, however, global investors should remember that cycles inevitably turn and they should not be caught off guard when they do.

Overall the investment proposition for the SIM Enhanced Yield Fund remains a good one. The Fund is supported by well-established fixed-interest processes as well as an extensive credit process. In addition, the valuations of assets which form part of the investable universe of the Fund are more than fair. All of this suggest that going forward we should be able to deliver similarly good results that we have been able to achieve thus far.