Portfolio Manager Quarterly Comment

Market overview

The New Year kicked off with a bang as the first week of January offered little relief to investors still reeling on the heels of a volatile December. At first an unexpected cut to revenue guidance from Apple as well as softer Chinese data and ISM numbers sent jitters throughout financial markets, but later in the week markets turned around as support came from a cut in Chinese monetary policy rates and strong US employment numbers. It was a bit of a roller coaster week to kick off 2019, and it felt like a continuation of December where there were wild swings in global markets on a daily basis: sell-offs were followed by sharp reversal rallies and the erratic behaviour extending all the way to the last few trading days of the year. For most of the first quarter a large part of global financial news headlines and market moves were dominated by a combination of central bank policy rhetoric, US–China trade talks, global economic growth concerns and the ongoing ‘Brexit’ debacle. US and global interest rates moved sharply lower towards the end of the quarter as central bank rhetoric turned increasingly dovish, which also left some questions unanswered regarding what exactly has central bankers so concerned about global economic growth prospects.

On the local front, the Ramaphoria of last year feels like a lifetime ago with our local bond yields also seeming to take a cue from the general malaise. Local interest rates spent most of the first quarter oscillating within a relatively narrow trading range, only really breaking out on the back around the tabling of the National Budget during February. For most part, local interest rates continued to trade at elevated levels and offer attractive real yields compared to the subdued inflation environment. It seems that local interest rates have settled at current intermediate levels as a trading range: on the one hand subject to an upward pull on the back of the deterioration in the local outlook and potential for credit rating downgrades going forward, while on the other hand the inflation outlook and monetary policy serve as an anchor to keeping rates lower. We finally saw local interest rates rally a bit towards the end of the quarter on the back of lower global interest rates, but the real yields on offer locally remain very attractive given the contained inflation outlook.

The Monetary Policy Committee (MPC) at the South African Reserve Bank (SARB) kept the policy rate unchanged at 6.75% at their scheduled meeting in January. The Bank lowered their inflation forecast for 2019 to 4.8% from 5.5% previously, and for 2020 to 5.3% from 5.4%, with the downward revisions attributed to lower international oil price assumptions and with the exchange rate stronger as compared to the previous meeting. Furthermore, inflation expectations surveyed by the Bureau of Economic Research (BER) continued to drift lower inside the SARB inflation target band of 3-6%. The quarterly projection model (QPM) showed one more 25-basis point increase throughout the forecast period ending in 2021, however, the Bank warned that data outcomes would guide future interest rate decisions. They reiterated the intention to guide inflation and expectations closer to the midpoint, being 4.5%. Subsequently, in March, the MPC again kept the policy rate unchanged in a unanimous decision by the members with an accompanied dovish tone. Gross domestic product (GDP) growth forecasts were revised lower, for 2019 from 1.7% to 1.3% and for 2020 to 1.8% from 2.0%, with power cuts as well as weaker business and consumer confidence levels being attributed for the downward revisions. Inflation forecasts remained unchanged for 2019 and 2020. The MPC was positive on a further downward trend in inflation expectations with the BER survey showing that five-year expectations were down to an all-time low of 5.1%. However, the MPC still noted that they will continue on their path to guide inflation expectations lower at 4.5%. Looking ahead, the policy rate will probably stay on hold this year on current intermediate levels as a trading range: on the one hand subject to an upward pull on the back of the deterioration in the local outlook and potential for credit rating downgrades going forward, while on the other hand the inflation outlook and monetary policy serve as an anchor to keeping rates lower. We finally saw local interest rates rally a bit towards the end of the quarter on the back of lower global interest rates, but the real yields on offer locally remain very attractive given the contained inflation outlook.

South African economic growth figures for the fourth quarter of 2018 showed that the local economy had grown by 1.4% annualised following an upward revised 2.6% in the third quarter. On a year-on-year basis, real economic activity eased to 1.1% in the fourth quarter from a revised 1.3% in the third quarter. The breakdown by sector shows that the secondary and tertiary sector momentum slowed to 3% and 1.7% respectively in the fourth quarter, from 4.9% and 2.9% previously. Primary sector growth declined by -1.1% in the fourth quarter from -4% in the third quarter. Subdued consumer inflation has provided some real income support and consumer balance sheets on aggregate appear to be in decent shape to support a pick-up in credit extension and consumer...
demand. We expect a moderate improvement in growth going forward, but still see South Africa underperforming the global economy. The implementation of structural reforms and a recovery in confidence levels could boost growth over time, but we assess risks to the economic outlook to be tilted on the downside. Local confidence levels are still at depressed levels and much lower compared to the first quarter of last year when the country was caught in a bout of optimism. The RMB/BER Business Confidence Index (BCI) declined for the fourth straight quarter during the first quarter of the year and reached a very depressed 28 points from 31 points in the previous quarter. This is on par with the lowest level the index has reached since the global financial recession, when the index level also measured 27 towards the middle of 2017. None of the sectors now measured scored positive and there was further deterioration in four of the five sectors surveyed. 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.

Foreigners sold a significant 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 towards the end of last year, which allowed for additional headroom for our local yields to trade at more elevated levels going into 2019. With our local yields starting the year at more elevated levels and thus off a higher base, it increases the likelihood for yields to thus trade stronger going forward or at least stabilise, but either way, the situation supports the return prospects of the Fund.

The SIM Enhanced Yield Fund fits squarely on the lower end of the risk spectrum compared to other investment products and during the last year served a valuable purpose by delivering strong positive returns in a very tough global as well as local investment 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 favourable and even unfavourable credit and financial market environments.

The SIM Enhanced Yield Fund is currently positioned with a relatively cautious orientation going into 2019. The Fund’s positioning is balanced by taking advantage of both interest rate opportunities and 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 enough to sufficiently meet the demand. The local economic environment and global financial conditions remain relatively unfavourable with a number of identifiable risk factors to consider. However, the valuation of South African fixed-interest assets remains attractive with local yields still at relatively elevated levels, which provides a better starting point and supports the forward-looking return prospects of the Fund.