Portfolio Manager Quarterly Comment

Market review

The SIM Enhanced Yield Fund ended the year on a very strong note and delivered a healthy return for the final quarter, taking the return for the full calendar to one of the highest on record for the fund. The fund served as a valuable building block to clients amid the volatile investment and economic environment. The performance of the fund over shorter, medium as well as longer-term time periods stacks up very well compared to the various alternatives, including the benchmark as well as the broader peer group and even other asset classes more broadly. The overall performance figures of the fund continue to look very pleasing and remain well intact with the fund having delivered perhaps even more than was intended; the fund has not only delivered on the investment objectives of enhancing yield and delivering superior risk-adjusted fixed-income returns, it has also protected capital in absolute and real terms while delivering highly competitive returns compared to other popular asset classes such as more traditional bonds and even equities as well as listed property. Looking at the performance of the fund over the past year as well as the longer term, it has delivered quite superior returns and in particular risk-adjusted returns. With valuations still looking quite attractive at current levels it also further supports the forward-looking return prospects for the fund, albeit with financial market volatility still to be expected given the outlook for the year ahead. In all, the fund has shown it is well positioned to benefit from higher-yielding assets and opportunities available in the local space while we seek to limit the potential for undue shorter-term volatility.

The year ended on a positive note with decent returns delivered by financial markets during the final quarter of the year after what was another volatile year in the markets. Initially the fourth quarter started on the back foot but things finally turned a corner towards the end of October as asset classes pretty much across the board started trading stronger, driven in large part by inflation worries subsiding and growth concerns around a hard landing also abating. In conjunction with this we also saw central bank policy rhetoric shifting more dovish, all of which resulted in a positive reinforcement on the stronger market sentiment. The reason for the fourth quarter kicking off on the back foot was mainly a continuation of the challenging conditions which set the tone for most of the year so far, both locally as well as internationally, with negative investor and market sentiment driven predominantly by inflation uncertainty and the impact of higher interest rates, while geopolitical conflict also added further fuel to the fire. The outbreak of conflict in the Middle East early in October put upward pressure on oil prices, which also resulted in further worries around global inflationary concerns, although ultimately this abated in the subsequent months as oil prices have been trading weaker ever since. The anticipation of an end to the US policy rate hiking cycle subsequently resulted in November being a stellar month for financial markets with both equities and bonds delivering healthy gains. The gold price broke through new records in early December as markets priced in that the dollar could weaken should the US Federal Reserve (Fed) start cutting interest rates. Inflation in US personal consumption expenditure fell to 3.5% in October from 3.7% in November while inflation in the European Union region fell to 2.4% in November from 2.9% in October. Global financial markets enjoyed another final boost during December, in particular after the Fed signalled that they anticipate 75 basis points (bps) of policy rate cuts during 2024.

The positive sentiment carried through with most asset classes ending the year on the front foot.

Taking a closer look at asset class returns, the S&P 500 Index in the US posted a return of 11.2% for the final quarter, which took the return for the full year up to a stellar gain of 24.2%, albeit being driven largely by the returns of the larger tech stocks. European equities were up 6.4% for the final quarter, taking the full-year return to 12.7% and the Nikkei in Japan finished the final quarter up 4.8%, taking the full-year return to 29.4%. Developed markets continued to outperform emerging markets with the MSCI World Index returning 11.6% for the final quarter while the MSCI Emerging Markets Index was up 7.7% by comparison. As for the full year, developed market equities delivered 21.6%, as such delivering a substantial outperformance as compared to the 7.2% delivered by emerging markets. Global bonds finished the year with yields trading stronger in the final quarter, in the US we had the 10-year Treasury note yield trading 82 bps stronger, while in the UK their 10-year gilt was 103 bps stronger, European 10-year yields 86 bps stronger and in Japan the 10-year yield ended the quarter 16 bps lower. Local markets followed suit and also ended the year on a strong note with local equities as measured by the FTSE/JSE All Share Index ending the final quarter up 6.9%, while local listed property bounced back sharply and the J253 total return index was up 16.4%. The exchange rate also stabilised somewhat, albeit at higher levels. The rand ended the year at 18.26 against the US dollar compared to 18.89 at the end of the third quarter and 17.04 at the beginning of the year. Local nominal bonds as measured by the All Bond Index ended the fourth quarter up 8.1% while local inflation-linked bonds (ILBs) were up 6.2%. Longer-dated nominal bonds and ILBs were the better performers for the final quarter as we witnessed yields trace sharply lower. The 7-12 year area of the nominal bond curve delivered 9.4% for the final quarter while 12+ year maturity bonds delivered 9.2%, as compared to the 1-3 year and 3-7 year areas, which delivered 4.1% and 5.7% respectively. As for ILBs, the 12+ year linkers delivered 7.6% for the final quarter outperforming the shorter maturity sectors with the 3-7 year and 7-12 year areas delivering 4.2% and 5% respectively. By comparison, cash as measured by the Alexander Forbes Short-Term Fixed-Interest Index delivered 2.1% for the fourth quarter. For the full year, we had the local equities ending the year up 9.3%, local nominal bonds up 9.7%, local ILBs at 7%, while local listed property was up 10.1% and cash up 8.1% by comparison. It was the ‘belly’ of the nominal bond curve which delivered the best performance last year, with the 3-7 year and 7-12 year areas of the curve delivering 10.3% and 11.9% respectively, while on the short end the 1-3 year area of the nominal curve delivered 4.1% and at the long end 12+ year bonds underperformed with a return of 7.5% for the year. On the real curve, we had shorter-dated ILBs being the better performers with the 3-7 year area of the linker curve returning 9.3%, while 7-12 year and 12+ year ILBs returned 7.8% and 4.3% respectively for the full year.

Zooming in a bit further on the local interest rate environment, we had the South African Reserve Bank (SARB)’s Monetary Policy Committee (MPC) again keeping the repo unchanged at 8.25% during their scheduled meeting in November. It was a unanimous decision by the committee and in fact the first time all of the members were actually aligned on their vote since the May meeting when the unanimous decision was made to hike by 50 bps to the current level. This time around their statement noted that the MPC is ‘ready to act should the risks begin to materialise' and they emphasised their willingness to act in response to upside risks to inter alia the inflation trajectory, but in all likelihood the local policy rate has indeed peaked and the path is expected to be sideways or generally unchanged for the time being. As a reminder, the more recent pause during the last three MPC meetings of the year comes after the policy rate had increased at a remarkably fast pace, in fact 10 consecutive times since the hiking cycle started and with the total increase at 475 bps since policy tightening began in November 2021. The local policy rate is currently at the highest level since 2009 and more than double the lows reached during the pandemic. The future policy rate path will very much depend on developments in the inflation trajectory as well as international developments in terms of the growth outlook, inflation and central bank actions. The trade-off will likely increasingly shift at least partially from the inflationary considerations towards the growth outlook during the course of the year, as is generally expected to also be the case for global central banks more generally in the coming year. Historically, the interest rate hiking cycle has typically only ended once it is clear inflation has peaked and is heading decisively towards the intended target. Based on current information, we believe SA is indeed approaching that point. The South African headline consumer price index (CPI) continued to moderate towards the end of the year in line with expectations. For the 12 months ended November local inflation printed at 5.5% year-on-year (y/y) after printing 5.9% in October and reaching a two-year low during July at 4.7% y/y. Headline inflation was pulled lower as a result of a drop in fuel prices on the back of base effects as well as outright decline, while food and core inflation ticked up higher and surprised on the upside. Core inflation has still remained largely subdued printing at 4.5% y/y for November. Local inflation is expected to have continued to trend lower during December, also on the back of fuel prices, and local CPI is also expected to continue to tick lower in the coming months. The inflation trajectory, both locally as well as internationally, will continue to be a key factor to watch in the coming year. Central banks around the world face a conundrum of balancing their mandate of inflation and price stability with that of a number of other challenges being thrown their way, including economic growth conditions as well as financial stability. It will continue to be an important theme driving financial markets and we are due to still face a financial market environment which takes its cue from the inflation trajectory and central bank actions.

The outlook for the fund looks very favourable taking into consideration the attractive valuations on local assets as well as the attractive balance we have been able to strike between taking advantage of higher than average yields available without introducing additional risks. In particular, the strong performance of the fund more recently again highlights the benefits investors stand to accrue from the higher-yielding environment while at the same time we are currently running very low risks in the portfolio – in fact, we have a substantial amount of unutilised risk budget which we are in a position to deploy should opportunities arise. More generally, financial market volatility should be expected for the foreseeable future or at least the year ahead and the fund is well positioned to mitigate for this while still benefiting from attractive valuations. In all, our funds are currently well positioned with valuations playing to the favour of the performance outlook reflecting the less positive fundamental picture, while we are in a good position to take advantage and allocate capital to new investment opportunities should they arise.