Please note that the commentary is for the retail class of the Fund.

Performance and fund positioning

The Fund returned 1.15% in August, bringing its 12-month total return to 11.80%, which is ahead of cash (8.30%) and its benchmark (9.15%) over the same period. We continue to believe that the Fund's current positioning offers the best probability of achieving its cash +2% objective over the medium to longer term.

Local bonds had a solid performance in August. The FTSE/JSE All Bond Index (ALBI) delivered 2.38%, with the long end of the curve (12+ years) producing the best performance, up 3.14%. The belly of the curve (7-12 years) closed 2.47% higher, while medium-term bonds (3-7 years) returned 1.72%. Short-term bonds (1-3 years) were up 0.99%, while cash returns were muted at 0.67%. Inflation-linked bonds (ILBs) were up 2.24% for the month.

The UK and South Africa (SA) released soft economic growth readings for the second quarter of 2024 (Q2-24). July inflation data were a mixed bag, with the UK, China and euro area slightly edging up, while the US and SA continued to show price moderation.

US headline inflation edged lower to 2.9% year on year (y/y) in July from 3.0% y/y in June, while core inflation eased to 3.2% y/y from 3.3% y/y. The main driver of the decline was a fall in used car prices and continued moderation in food inflation. Energy costs remained flat, and inflation in certain core services categories, such as housing rentals and car insurance, remained elevated.

In emerging markets, China's headline inflation was up just 0.5% y/y in July from 0.2% y/y in June. The increase was due to higher food prices as a result of adverse weather conditions. Core items such as vehicles, electronics, and household utilities experienced price declines. Deflation in the Producer Price Index continued, falling another 0.8% y/y in July from a decline of 0.8% y/y in June.

SA's economy grew by 0.4% q/q in Q2-24 from 0% q/q (upwardly revised) in Q1-24. From the production side, seven out of 11 subsectors saw growth recover, while agriculture was weak following a period of drought, and mining also contracted. From the expenditure side, there was a decent recovery in household and government spending. This was offset by weak net trade and another contraction in gross fixed capital formation. Growth in Q2-24 points to a nascent recovery in economic activity off a weak base, but with poor momentum. The outlook for the rest of the year remains positive on the back of moderating inflation, which will provide support for real incomes, the possible uplift from two-pot system income, and the prospect of lower interest costs. Incremental easing of logistics constraints should help both transport sectors and exports at the margin, but a more meaningful contribution from capital expenditure is needed to build stronger, more enduring momentum. Disappointingly, the sustained support from suspended loadshedding has not yet been felt in the activity data.

The rand ended the month at R17.80/US$1, putting the currency's performance ahead of its EM peer group since the beginning of the year. Offshore credit assets and certain developed market bonds continue to flag as relatively attractive. The Fund has utilised a significant part of its offshore allowance to invest in these assets. When valuations are stretched, the Fund will hedge/unhedge portions of its exposure back into rands/dollars by selling/buying JSE-traded currency futures (US dollars, UK pounds, and euros). These instruments are used to adjust its exposure synthetically, allowing it to maintain its core holdings in offshore assets.

SA headline inflation eased to 4.6% y/y in July from 5.1% y/y in June, while core inflation reduced to 4.3% y/y from 4.5% y/y. The main reason for the headline moderation was lower food inflation, a fall in alcoholic beverages and tobacco prices, and a decline in transport costs. The outlook for headline inflation in the near term continues to improve, with the stronger currency supporting ongoing easing in retail fuel prices, aided by low food inflation. We expect the South African Reserve Bank to cut the repo rate by 25 basis points to 8.0% in September.

At the end of August, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.24% (three-year) and 8.73% (five-year), significantly lower compared to the end of the previous month. Our inflation expectations suggest that the current pricing of these instruments remains attractive due to their lower modified duration and, hence, high breakeven relative to cash. In addition, NCDs have the added benefit of being liquid, thus aligning the Fund's liquidity with the needs of its investors. The Fund continues to hold decent exposure to these instruments (fewer floating than fixed), but we will remain cautious and selective when increasing exposure.

Global monetary policy remains conducive for risk assets, which should remain supportive of flows into emerging markets. SA has seen a significant reduction in risk premium following the formation of the Government of National Unity and the inclusion of the pro-reformist opposition into cabinet. SA inflation has benefited from both local and global factors and should support a shallow rate-cutting cycle starting towards the tail end of 2024. However, low growth, upside risks to inflation, and burgeoning deficits will continue to weigh on the longer-term outlook for SA, unless reform implementation is accelerated. SA's bond yields have seen significant compression, with the margin of safety narrowing significantly, both on an absolute basis and relative to the emerging market peer group. There might be slightly more juice left in the SA bond rally. But we believe that SA bonds now trade at or very close to fair value. A more positive shift in underlying fundamentals is needed to justify tighter valuations and outperformance. Thus, we would advocate positions closer to neutral in bond portfolios.

The local listed property sector was up 8.4% over the month, bringing its 12-month return to 36.7%. Operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. The current subdued growth outlook, combined with an increase in the cost base due to higher administered prices and second-round effects on loadshedding, will weigh on the sector's earnings in the coming year. We believe that one must remain cautious given the high levels of uncertainty around the strength and durability of the local recovery.

We believe that allocating significant amounts of capital to the local credit market is unwise and would represent a substantial opportunity cost in the face of attractive valuations in other, more liquid asset classes. The current level of credit spreads on offer are at historically compressed levels despite SA being close to the weakest economic position in its history. Corporate profitability and creditworthiness are inevitably tied to economic outcomes, with significant polarisation in performance.

The use of structured products, such as credit-linked notes (CLNs), has become ubiquitous within the local market. This sector of the market has grown exponentially over the last five years and has reached a market size of over R100 billion. However, only a third of this market reprices, creating an inaccurate representation of asset volatility and pricing. CLNs mask the underlying/see-through credit risk as the issuing entity (predominantly local banks) is seen as the primary credit risk. The increased usage of CLNs has not expanded the pool of borrowers, rather it has only served to concentrate it. This is due to the ability to limit the volatility of these instruments by not marking them to market[1] based on the underlying asset price movements. This is why CLN repacks of SA government bonds have become so popular over the last five years. The combination of attractive yields and no volatility is an opportunity that not many would pass up, unless, of course, transparency of pricing is important to the underlying investor. As a result, there can be significant unseen risks within fixed-income funds. Investors need to remain prudently focused on finding assets of which the valuations are correctly aligned to fundamentals and efficient market pricing.

Outlook

We remain vigilant of the risks from the dislocations between stretched valuations and the local economy's underlying fundamentals. However, we believe that the Fund's current positioning correctly reflects appropriate levels of caution, while its yield of 9.58% (gross of fees) remains attractive relative to its duration risk. We continue to believe that this yield is an adequate proxy for expected portfolio performance over the next 12 months. As is evident, we remain cautious in our management of the Fund. We continue to invest only in assets and instruments that we believe have the correct risk and term premium to limit investor downside and enhance yield.

Portfolio managers
Nishan Maharaj and Mauro Longano
as at 31 August 2024

[1] Valuations are not regularly adjusted to mirror their current value