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

Performance and fund positioning

The Fund returned 0.95% in May, bringing its 12-month total return to 12.09%, ahead of cash (8.27%) and its benchmark (9.13%) over the same year. We continue to believe that current positioning offers the best probability of achieving the Fund's cash + 2% objective over the medium to longer term.

Local bonds' performance in May was poor. The FTSE/JSE All Bond Index (ALBI) delivered 0.75%, with the long end of the curve (12+ years) delivering a mediocre return of 0.58%. The belly of the curve (7-12 years) closed 0.74% higher, while medium-term bonds (3-7 years) returned 0.88%. Short-term bonds (1-3 years) were up 1.03%, while cash was up 0.68%. Inflation-linked bonds (ILBs) were down 0.75% for the month.

May headline inflation readings eased marginally from the previous month, with food prices declining, but core inflation remained broadly sticky. Central banks kept policy rates unchanged and remain reluctant to guide rate cut expectations, while inflation remains stubbornly above target.

US headline inflation slowed only slightly to 3.4% year on year (y/y) in April from 3.5% y/y in March, while core inflation eased to 3.6% y/y from 3.8% y/y. The headline progress is owed to continued moderation in food prices, a drop in used vehicle prices, airfares and household items. Housing, motor vehicle insurance and energy prices increased.

In emerging markets, China's headline inflation picked up to 0.3% y/y in April from 0.1% y/y in March. Rising services prices were the main contributor to the uptick, while food prices remain the main drag, along with car prices and household equipment which remain in deflation. The Producer Price Index continued its deceleration, falling by 2.5%y/y in April from a decline of 2.8% y/y in March – signalling that weak price pressures are likely to continue contributing to the CPI in coming months.

The rand ended the month at R18.79/US$1. 'SA's idiosyncratic problems and the turn in global risk sentiment continued to weigh on the ZAR. 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 the 'Fund's exposure synthetically, allowing it to maintain its core holdings in offshore assets.

In South Africa, the economy contracted by 0.1% q/q in Q1-24 from a revised growth of 0.3% q/q in Q4-23. From the production side, seven out of eleven subsectors saw growth contrac,t and contributed negatively to overall GDP. This was only partly offset by the agricultural sector, which posted significant gains after contracting in Q4-23. When measured from the expenditure side, household consumption, government spending, gross fixed capital formation and exports all contracted. A reduction in imports provided a positive offset to the drag from all other components. Looking ahead, the easing in loadshedding should help support the figure for Q2-24, but a revival in confidence will be critical to sustaining higher rates of consumption and investment needed to boost overall growth.

The South African Reserve Bank (SARB) left the repo rate unchanged at 8.25% at the May MPC meeting. The post-meeting statement's tone was less cautious than before, with the SARB acknowledging the easing in near-term inflation forecasts and improvement in energy and logistics constraints being supportive of economic growth. Headline inflation is expected to reach 4.5% in the second quarter of 2025 and to remain within range until the end of 2026. Among the concerns of the MPC were the ongoing geopolitical tensions, a volatile exchange rate, domestic policy uncertainty, unusually elevated financial markets uncertainty, and elevated inflation expectations.

Headline inflation eased to 5.2% y/y in April from 5.3% y/y in March, while core inflation slowed to 4.6% y/y from 4.9% y/y. The main trends remain intact – food inflation continues to moderate in annual terms, fuel prices have picked up and there was a smattering of other components, including insurance and public transport costs, which helped core prices ease.

At the end of May, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 9.37% (three-year) and 9.96% (five-year), 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.

The significant reduction in rate cut expectations over the last quarter has tainted the enthusiasm for risk assets. However, the monetary policy pivot still remains in play, and, as such, emerging markets should continue to see supportive flows into their markets. Idiosyncratic SA factors have led to further underperformance of SA assets relative to the peer group. Low growth, sticky inflation and burgeoning deficits will continue to weigh on the longer-term outlook for SA unless reform implementation is accelerated through increased private sector participation. 'SA's bond yields remain elevated but still provide an attractive alternative to cash, given their high embedded risk premium.

ILBs are securities designed to help protect investors against inflation. They are indexed to inflation so that the principal amount invested and, hence, the interest payments rise and fall with the inflation rate. ILBs have offered protection to investors since the start of the year. However, current breakeven inflation across the ILB curve averages between 5.5% and 6%, which is well above even our own expectations for inflation over the medium term. Only the shorter-dated ILBs (I2029, six years to maturity and I2033, nine years to maturity) flag as fairly valued from a valuation perspective. Risks on the inflation front still remain elevated, and these shorter-dated ILBs, due to their inherent inflation protection, warrant a decent allocation within portfolios.

The local listed property sector was down -0.01% over the month, bringing its 12-month return to 19.71%. Operational performance will remain in the spotlight as an indicator of the pace and depth of the 'sector's recovery. The current poor growth outlook, combined with an increase in 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 due to 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 offerare at historically compressed levels despite SA being close its 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, but only a third of this market reprices, creating an inaccurate representation of asset volatility and pricing. 'CLN's 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, pricing transparency is important to the underlying investor. As a result, there can be significant unseen risks within fixed income funds. Investors must remain prudently focused on finding assets of which the valuations align correctly 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. The 'Fund's yield of 10.3% (gross of fees) remains attractive relative to its duration risk. We continue to believe that this yield is an adequate proxy for expected Fund 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 May 2024

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