

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

#### Performance and fund positioning

The Fund returned 1.48% in September. Since inception almost a year ago, the Fund has returned 11.19%, which is ahead of cash 6.85% and its benchmark (7.07%) over the period. We believe that the current positioning offers the best probability of achieving at least cash + 2% over the medium to longer term.

Risky assets rejoiced in chorus at the near synchronous start to the global rate cutting cycle. The US Federal Reserve Board (the Fed) provided more reason for exuberance, with a jumbo reduction in lending rates of half a percentage point to mark the start of the rate cutting cycle. This was the first time in over 20 years that a US cutting cycle outside of hot wartimes or a crisis has started with such fervour. Global bond markets embraced the chords of jubilation from policymakers, as they rallied into the event, with almost every bond market in the world lower from a yield perspective over the quarter. South African (SA) assets, which have been enjoying renewed investor enthusiasm since the formation of the coalition government, topped the performance tables.

SA bonds returned 10.54% over the quarter, bringing their year-to-date (ytd) and one-year returns to 16.68% and 26.14%, respectively. As can be expected, cash has significantly lagged bond returns, by more than 10% ytd and over the one year. Falling inflation has been dreadful for inflation-linked bonds (ILBs). The instruments have managed to outperform cash over all periods; however, they have returned half of their nominal equivalents (4.75% quarter-to-date [qtd]; 6.89% ytd; 13.38% over 12 months). The rand has gained c.6% against the dollar since the start of the year, outperforming its emerging market peer group. This has meant that, despite the strong rally in global bond markets, local bonds have outperformed global bonds significantly (FTSE World Government Bond Index returned 6.95% qtd, 2.72% ytd and 11.02% over 12 months in US dollars). The primary reason for the strong performance of the local bond market has been a reduction in the risk premium post elections, which spurred a c.250 basis point (bps) rally (compression) in bond yields.

The Fed surprised the market by cutting the fed funds target range by 50bps to a range of 4.75% – 5% at the Federal Open Market Committee meeting in September. The Fed cautioned markets that the 50bps cut would not be the norm going forward. This quantum was put through on the back of moderating inflationary pressures and to help stabilise the labour markets.

US headline inflation slowed to 2.5% year/year (y/y) in August from 2.9% y/y in July, while core inflation remained unchanged at 3.2% y/y. The main driver of the moderation was another fall in energy costs, used as well as new car prices, and consumer discretionary goods. This was offset by shelter costs which increased, coupled with stubborn core goods and services prices that kept core inflation elevated.

In emerging markets (EM), the People's Bank of China announced a range of support measures for the sluggish Chinese economy, including rate cuts and fiscal stimulus, to help boost economic growth and get the domestic demand out of deflationary territory. The one-year medium-term lending rate was cut by 30bps to 2.0% and the reserve requirement for banks was reduced by 50bps to 9.5%, freeing up lending capacity. Some relief was aimed at the property market with relaxed lending credit policies being announced. While early financial market reaction was positive following the announcements, sustained momentum depends on the prompt implementation of announced measures and ability to deliver a rebound in domestic demand and a turnaround in the struggling property sector.

The rand ended the month at R17.27/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.

In a widely anticipated move, the South African Reserve Bank (SARB) cut the repo rate by 25bps, taking it to 8% from 8.25% at the September MPC meeting. The tone of the after-meeting statement was dovish, acknowledging an improved inflation outlook, moderating inflation expectations, although still too high, and included some meaningful near-term downward revisions to the SARB inflation forecasts. Inflation in 2024 is expected to average around 4.6% from the previous estimate of 4.9%.

Headline inflation eased to 4.4% y/y in August from 4.6% y/y in July, while core slowed to 4.1% y/y from 4.3% y/y. The main contributor to the easing was also another fall in fuel prices, coupled with a moderation in goods inflation including water, household furnishings, communication equipment and broader services prices.

At the end of September, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.03% (three-year) and 8.53% (five-year), significantly lower than 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 global monetary policy easing cycle has boosted the wind in the sails of risky assets' performance. Global and emerging market bond yields are all significantly lower than at the start of the year. However, current market pricing of interest rate expectations seems ambitious, which suggests global bond yields are well priced at current valuations. SA bonds have enjoyed renewed investor optimism following the formation of the Government of National Unity and on the heels of the global bond rally. SA inflation expectations have reduced significantly but are now fairly priced in through repo rate expectations. The country's fiscal accounts remain at risk over the longer term and current bond valuations fully discount a more optimistic outcome. ILBs still offer value relative to nominal bonds, if inflation materialises higher than forecast or if real yields follow nominal bond yields lower. Bond portfolios should be positioned neutral duration at current levels with a healthy dose of ILBs for good measure.

The local listed property sector was up 5.16% over the month of September, bringing its 12-month return to 50.97%. 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.

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 through not marking them to market<sup>1</sup> 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 9.45% (gross of fees) remains attractive relative to its duration risk (which measures the Fund's sensitivity to changes in interest rates). 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 30 September 2024

<sup>1</sup> Valuations are not regularly adjusted to mirror their current value