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QUARTERLY COMMENTARY – Q4 December 2017

Granate *SCI Unconstrained Fixed Interest Fund

Fund Profile

The Granate SCI Unconstrained Fixed Interest Fund is a domestic fixed interest portfolio which seeks to provide investors with exposure to the fixed interest market and aims to offer maximum returns by actively extracting value from various sources within the fixed interest universe. The portfolio uses strategic asset allocation, aggressive duration (ranging between the duration typical of a money market fund and the longest maturity South African government bond), yield curve positioning, switches, stock selection as well as derivative and other yield enhancement strategies, including exposure to foreign currency to maximize returns. The objective of the portfolio is to maximize both income and capital over a long-term investment horizon. Given that the portfolio aims to maximize total return (which includes capital) it is expected to be more volatile than a traditional income fund with the possibility of negative monthly returns. The portfolio is managed in accordance with regulations governing pension funds and CISCA.

1. Economic overview

Global economic activity in the 4th quarter of 2017 continued to improve and the business cycle upswing is now in its 9th year as interest rates remain low and inflation is, in most countries, below target despite tightening labour markets. 2018 is promising to build on last year's momentum as financial conditions and improved sentiment combine to provide another year of synchronized global growth.

Domestic economic data activity remained relatively weak in the 4th quarter, although the economy is expected to have maintained positive growth after expanding by a quarter-on-quarter annualized rate of 2% (0.8% year-on-year) in the 3rd quarter. The SARB composite of leading indicators continues to improve as does the ABSA PMI which recorded its 4th consecutive increase, albeit remaining below the all-important level of 50 for a 6th month. While a significant confidence boost will support economic growth over the next quarter or two, South Africa's growth is likely to remain below trend for the foreseeable future.

Major central banks continued to communicate to the market a more hawkish outlook for interest rates, although it is only the US (FOMC) and the UK (BOE) that raised policy rates among the main central banks during the quarter. The FOMC remains by far the most hawkish major central bank and after raising its lending rate 3 times in 2017 (from 0.75% to 1.5%) and embarking on shrinking its balance sheet is expected to continue its tightening policy in 2018.

In South Africa, the Monetary Policy Committee (MPC) of the Reserve Bank met once in the 4th quarter (November) and left the repo rate unchanged at 6.75%, a unanimous decision by the six MPC members. The November statement set a more hawkish tone than in September (although with the same decision despite a split MPC vote) as the committee considered risks to the inflation outlook to have increased, mainly due to higher international oil prices and a weaker rand exchange rate. Risks to growth, on the other hand, were deemed to be on the downside. The decision was also affected by the "rapidly deteriorating fiscal position" which the statement said "...could potentially reduce the scope for further monetary policy accommodation".

While two of the three main upside risks to domestic inflation raised by the MPC (weaker currency, Eskom price increases, and higher international oil prices) have subsided, currency weakness is likely to return as fiscal consolidation remains a challenge that will not vanish anytime soon. This means that Moody's will likely downgrade South Africa's credit rating to below investment grade and tax hikes will keep inflation from remaining at or below the middle of the target range. Therefore, we think that the MPC will change its view on the risks to inflation to be balanced, but keep the repo rate unchanged for the foreseeable future.

2. Market overview

South African financial markets had a nervous and volatile quarter as investors faced the difficult task of weighing up the probabilities of different ANC elective conference outcomes.

The Property sector was the best performing domestic asset class (+8.3%) followed by Equities (+7.4%), Bonds (+2.2%), Money Market (+1.8%), and Inflation-linked bonds (+1.0%). For the 12 months to the end of December all domestic asset classes offered positive inflation adjusted returns other than inflation-linked bonds which lagged inflation by approximately 1.8% and is now the only asset class to return negative real returns over the last 5 years.

The quarter started poorly for bonds having returned -2.3% and -1.0% in October and November, respectively, but a very strong rally in December (+5.7%) resulted in the asset class returning a respectable 2.2% for the quarter. Unsurprisingly, given the stellar performance of bonds, the property sector had a strong 4th quarter outperforming all other asset classes as some of the heavyweights in the SAPY index had a strong December while those with a greater exposure to foreign markets performed better in October and November.

The strong performance in income generating assets was supported by a strong rally in the rand which gained 10.62% against the USD in December, its 2nd best monthly performance since 2000. The rand was obviously driven by improved sentiment towards South Africa and strong commodity prices, although we think at current levels it has overshot and unlikely to strengthen much further.

3. Portfolio activity

As in the previous quarter we kept a relatively low interest rate risk exposure in the portfolio during the quarter as we maintained the view that the risk to bond yields was asymmetric in an environment of deteriorating policy certainty. This despite the fact that from a cyclical perspective bond yields remain at levels above "fair value". The strategy did bare fruits in October and November, where bonds sold off, but also meant that the fund missed out on a significant part of the December rally.

The portfolio's asset class exposure remained defensive. We increased our exposure to the property sector by 1.4% by buying foreign counters as we see this as a good way to pick up some foreign currency exposure where we believe valuations are attractive. The portfolio maintains some exposure to inflation-linked bonds in the short end of the yield curve. While we do remain generally negative on this asset class, we do consider this to be defensive, particularly in the event of a further rating downgrade.

We have also reduced the portfolio's exposure to corporate bonds during the quarter as we believe that the low credit spreads do not, in many cases, offer sufficient liquidity risk compensation and therefore have opted to increase the exposure to bank bonds and NCD's instead.

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4. Portfolio positioning

The ANC elective conference went ahead as scheduled and resulted in a market favorable outcome. The bond and currency markets rallied strongly, with the yield on the R186 retracing to well below their levels prior to the October 25th Medium Term Budget.

The strong rally implies that the market is now pricing in rapid fiscal consolidation and avoiding a Moody's downgrade (and possibly getting a S&P upgrade). We doubt very much that pricing local bonds at pre-MTBPS levels is justified. The post MTBPS selloff was trigged by the significant deterioration of South Africa's debt to GDP and the lack of policy response to the deteriorating fiscal outlook. While we think that the policy implementation post the Zuma era is likely to be better, there are still question marks about government's ability to turn the fiscal trajectory. On the other hand, we know that South Africa's debt burden is already higher than what was tabled in the MTBPS both due to Eskom's failure to secure a 19.9% increase in the electricity tariff and Government's announcement of free higher education for poor and working class students.

A strong confidence rebound post the change in leadership is likely to generate faster economic growth, which should help boost government revenues. However, if the tax buoyancy rate does not improve, revenue could miss the even lower (R50.8bn shortfall) MTBPS projection.

Granate SCI Unconstrained Fixed Interest Fund – Portfolio Manager Profile

Jonathan Myerson (M.Soc.Sci. - Econ)

Jonathan served as the Head of the Fixed Interest team at Cadiz Asset Management from 2006 to 2015 where he managed the Unconstrained, House View and Inflation-Linked Bond funds. Jonathan has 11 years of sell-side experience having worked as a Fixed Interest Strategist at HSBC from 1995 to 2003 and then at RMB from 2003 to 2006. Jonathan joined Granate at its inception as Head of Fixed Income in November 2015.

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Disclosures

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The Manager does not provide any guarantee either with respect to the capital or the return of a portfolio. Performance is based on NAV to NAV calculations with income reinvestments done on the ex-div date. Performance is calculated for the portfolio and the individual investor performance may differ as a result of initial fees, actual investment date, date of reinvestment and dividend withholding tax. The manager has the right to close the portfolio to new investors in order to manager it more efficiently in accordance with its mandate. A money market portfolio is not a bank deposit account. The price is targeted at a constant value. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument and in most cases the return will merely have the effect of increasing or decreasing the daily yield, but that in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio.

Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures and in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. Seven day rolling yield is calculated by taking into account the interest earned by the fund during a 7 day period minus any management fees incurred during those seven days. Income funds derive their income primarily from interest-bearing instruments. The yield is a current and is calculated on a daily basis. Annualised return is the weighted average compound growth rate over the period measured. The portfolio management of the funds is outsourced to Granate Asset Management (Pty) Ltd (FSP no. 46189), an authorised financial services provider in terms of the FAIS Act.