QUARTERLY COMMENTARY – Q1 2018

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

Economic activity in major economies maintained its strong momentum during the 1st quarter of 2018. Furthermore, consensus forecast for economic growth for both developed and developing economies for 2018 and 2019 have been revised upwards. These upward revisions to economic growth have come despite the increasing risk of "trade wars" as countries are retaliating to the US's imposition of trade barriers and rising policy rates in the US.

Domestic economic data for the 4th quarter of 2017 (released during Q1 2018) showed that the economy is in better shape than previously thought. The domestic economy grew by a quarter-on-quarter annualised rate of 3.1% (1.9% y/y) in the 4th quarter of last year, after recording an upwardly revised 2.3% growth rate in the 3rd quarter. The primary sector (mainly agriculture) remained strong, but encouragingly, both the secondary (manufacturing) and tertiary (trade) sectors rebounded.

Q1 2018 data has been, on balance, encouraging. PMI's, business and consumer sentiment, and mining production have improved while manufacturing production and retail sales have softened, albeit from a strong performance in Q4 2017.

The Monetary Policy Committee (MPC) of the Reserve Bank met twice during the 1st quarter. While both MPC meetings took place after the change in the country's leadership, the situation was very different amongst the two meetings. In the January meeting the economy was still facing significant fiscal and thus rating downgrade risks. Therefore, while inflation was falling and the economy weak, the SARB kept the repo rate unchanged as five members of the MPC voted for no change and one member voted for a 25bp cut. When the MPC met in March, two of the key risks that the economy was facing in January were gone, namely further fiscal deterioration and the rating downgrade. Furthermore, consumer and business confidence showed a marked improvement. This, together with the fact that the committee's inflation forecast was lowered, led to a 25bp repo rate cut. Surprisingly, however, the March MPC statement was relatively hawkish and the decision was a close call as three of the seven (a new member was appointed to the MPC) voted for an unchanged repo rate.

The March MPC statement suggests that a further rate cut this year is in the balance. Inflation has continued to decline, but the 1% VAT increase, higher oil prices and base effects suggests that inflation has probably bottomed in the 1st quarter. This, together with the MPC's increased focus on the middle of the inflation target band (4.5%) as where it wants inflation expectations to settle, suggests that a further 25bp cut is not a given. A favorable outcome in the public-sector wage negotiations, if obtained, could be the deciding factor.

2. Market overview

The South African bond yields continued their downward trend in 1st quarter of 2018, with the yield on the benchmark R186 declining by 60 basis points (bp) and the All Bond Index (ALBI) recording its best 1st quarter return on record. The rally in the bond market started at the end of November last year, but picked up significant momentum during the ANC elective conference once it became evident that the "Zuma camp" has lost its grip on power. The downward trend in yields was mainly a result of the market "pricing out" the political risk (with all its implications on the economy) that was being discounted in the bond market.

The chain of events triggered by the favourable outcome of the ANC elective conference culminated in Moody's decision not to downgrade South Africa's credit rating – a move that would have probably resulted in large spike in yields as foreign investors would have sold their local bond holdings. Importantly, the credible budget presented (which still needs to be delivered on) by National Treasury, which articulated a path towards fiscal consolidation, has meant that government will borrow less and reduce the size of its weekly bond auctions. The improved fiscal outlook and the resultant decline in borrowing has resulted in a flattening of the yield curve during the quarter with the aggregate yield on the 12+ sector of the yield curve declining by 77bp points compared with that of the 3-7 sector of the yield curve which fell by only 34bp.

Inflation-linked bonds, which have been out of favour for the best part of the last two years, also ended up having a strong quarter (4.15%) courtesy of a March rally which saw yields fall by between 15bp and 39bp on short and long dated bonds, respectively.

After being the best performing domestic asset class in the 4^{th} quarter of 2017 (+8.3%), the property sector was the worst performer (-19.6%), registering its worst quarterly return since the middle of 2006. The selloff was concentrated in four shares that are part of the Resilient group, which make up 27% of the JSE property index, and accounted for 15.2% of the 19.6% loss of value in the sector.

3. Portfolio activity

We increased the interest rate risk exposure in the fund during the first two and a half months of the quarter as risk events passed and it was becoming clearer that the market is moving into "normal" valuation mode where the political risk and the damage that was inflicted to the economy during the Zuma era ended. The increase in interest rate risk in the fund was done through purchases of government bonds with the longest maturities, a reflection of our view that yields were too high, and that the long end of the nominal yield curve offered the best value across the curve. Furthermore, we significantly reduced the fund's (payed) swap position as a strategy of increasing interest rate risk and taking profit on the bond-swap spread.

The portfolio's asset class exposure was kept defensive during the quarter, with holdings in the more volatile asset classes (namely listed property and long-dated nominal and inflation-linked bonds) kept well below the fund's long-term strategic asset allocation. We did, however, increase the fund's exposure to property (+0.9%) to 5.6% by buying domestically focused counters that should benefit from the low interest rate environment and improved business sentiment.

In line with our view that the shorter end of the inflation-linked curve was offering better value than nominal bonds we increased the funds exposure to this asset class.

4. Portfolio positioning

Towards the end of the 1st quarter we reduced the interest rate risk of the fund significantly as our valuation models showed that the bond market rally pushed yields to levels below fair value. The Unconstrained fund maintains high levels of liquidity at all times either by holding large exposures to government bonds or shorter dated bank assets (NCD's or call money). Our preference remains for shorter dated inflation-linked bonds as they should continue to benefit from declining issuance, falling real policy (repo) rates, and attractive inflation carry over the next few months due to the VAT hike, increase in sin tax and the higher fuel levy. Furthermore, we believe that near-term inflation forecasts (priced in by the market) could be biased to the downside – a regular occurrence when the cyclical inflation rate bottoms.

In line with Granate's house view, the fund is relatively underweight the corporate bond market and overweight banks (due to the low exposure to government bonds). Whilst we are of the view that the rand is overvalued, we do not consider current levels on the rand to justify an outright purchase of foreign currency in the fund. Since the fund is cognizant of limiting drawdowns, our preference is, at this stage, to use certain listed property holdings (namely Hammerson and Intu) for foreign currency exposure. The portfolio's asset class exposure remains underweight property, long-dated nominal and inflation-linked bonds relative to its long-term strategic asset allocation. We will look to move closer to the fund's long-term strategic asset allocation as valuations become more attractive.

Granate SCI Unconstrained Fixed Interest Fund – Portfolio Manager Profile

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

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.

Granate Contact Details

Tel: +27 (21) 446 9303
Email: info@granate.co.za
Website: www.granate.co.za
Granate Asset Management (Pty) Ltd
(FSP) License No. 46189
Cape Town: 23rd Floor, Portside Building, 5 Buitengracht Street, Cape Town 8001
Johannesburg: 2 Merchant Place, Cnr Rivonia and Fredman Drive, Sandton, 2196

GRANATE
ASSET MANAGEMENT

Part of RMI
Investment Managers

Disclosures

The portfolios were managed by Momentum Collective Investments (RF)(Pty) Ltd prior to 28 November 2017. Sanlam Collective Investments (RF) (Pty) Ltd, a registered and approved Manager in Collective Investment Schemes in Securities and the Manager retains full legal responsibility for the co-brand portfolios. Collective investment schemes are generally medium- to long-term investments. Past performance is not necessarily a guide to future performance, and that the value of investments / units / unit trusts may go down as well as up. A schedule of fees and charges and maximum commissions is available from the Manager on request. Collective investments are traded at ruling prices and can engage in borrowing and scrip lending.

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.