GRANATE
ASSET MANAGEMENT

Part of RMI
Investment Managers

QUARTERLY COMMENTARY – Q2 2018

Granate *SCI Multi Income Fund

Fund Profile

The Granate SCI Multi Income Fund is a domestic income portfolio which seeks to provide investors with consistent positive returns and minimal volatility. The objective of the portfolio is to deliver real returns in excess of money market and traditional income portfolios over the medium to longer term. Investors are primarily exposed to the fixed income and credit markets.

The portfolio aims to optimize risk-adjusted returns by strategically allocating within the various sources of the fixed interest and credit universe according to current valuations. The portfolio will optimize the yield of the portfolio whilst compensating as far as possible for the underlying risk. This is done by focusing mainly on credit and yield enhancing strategies, whilst very moderate duration strategies are employed. The portfolio is managed in accordance with regulations governing pension funds and CISCA.

1. Economic overview

Economic activity in major economies maintained its positive momentum during the 2nd quarter of 2018 despite growing concerns around a slowdown in global trade due to higher trade barriers.

Domestic economic data for the 1st quarter of 2018 (released during Q2 2018) showed that the economy is in worse shape than previously thought. GDP contracted at a seasonally adjusted quarter-on-quarter annualised rate of 2.2% (0.8% y/y), after recording a 3.1% growth rate in the 4th quarter of 2017.

The manufacturing and mining sectors (making up 7.7% and 12.5% of GDP) contracted by 9.9% and 6.4%, respectively, together contributing 1.6% to the GDP contraction. The agriculture sector, after growing by an average annualised rate of 35% in 2017 contracted by 24.2%, to cut a further 0.7% off GDP growth. Positive contributions came from the finance sector (1.8%) which contributed 0.3% towards growth followed by general government services which makes up 14.9% of GDP and grew by 1.8%.

Q2 2018 data has been, on balance, disappointing. PMI's, retail sales, mining and manufacturing production have all disappointed, posing further downward risk to GDP growth for 2018.

The Monetary Policy Committee (MPC) of the Reserve Bank met once during the 2nd quarter and decided (unanimously) to keep the repo rate unchanged at 6.5%. The MPC's hawkish statement was consistent with its growing focus of an inflation target of 4.5% (rather than 3%-6%). In its assessment, while the inflation forecast has remained broadly unchanged, the risks have moved to the upside due to the higher oil price, a weaker rand, higher electricity prices, and a reversal of capital flows to emerging markets. Importantly, however, the Governor reiterated that "...MPC attempts to 'look through' the first-round effects of such (supply side) shocks and to react to second-around effects". Inflation expectations and wage settlements are key in this regard.

Market expectations of the path of policy rates continues to trend higher. After pricing in no rate hikes for the year in May, the market has moved to price in a 70% probability of a rate hike by the end of the year and at least two 25 basis points (bps) rate hikes by the end of 2019.

The weaker rand certainly poses a risk that the SARB will move on rates sooner than previously expected. However, a surprisingly weak economy and the absence of demand pull inflation suggests rates on hold for the year.

2. Market overview

After a spectacular 1st quarter of 2018 for domestic bonds where the All Bond Index (ALBI) returned 8.1%, bonds sold off in the 2nd quarter – the yield on the benchmark R186 rising by 85 basis points (bps) and the ALBI losing 3.8% as global investors turned negative on emerging markets, finding some comfort in the safety of developed market bonds.

The quarter was characterised by large foreign selling of local bonds. After increasing their holdings to a record 43% at the end of March, foreign investors sold a total of R64bn of domestic bonds in the subsequent quarter, the largest 3 month selling on record.

While the yield on the 10 year US Treasury ended the quarter only 10 basis points (bps) higher than where it started, the yield movements during the quarter were particularly volatile. The yield on the 10 year Treasury traded above 3% for the first time in over 5 years during May as a result of investors becoming concerned that the US Federal Reserve will hike its lending rate by more than previously expected. In June, however, the focus moved to the risk that "trade wars" will negatively impact global growth, causing investors to flock to the safety of US Treasuries that then rallied by 37bps in a matter of days.

The listed property sector continued its poor run as it faces both disappointing growth and a risk of rising interest rates. In contrast to the 1st quarter, the 2nd quarter saw domestically focused counters suffer as management teams continue to guide for flat-to-low growth in distributions in the near term.

Inflation-linked bonds remain under pressure, performing worse than any other domestic asset class in the 2nd quarter, even though inflation has bottomed. This suggests that the market is confident that the SARB will do what it takes to ensure that inflation remains well within the target band of 3% to 6%.

3. Portfolio activity

Over the quarter as the bond market underperformed, our fair value model was indicating positive risk compensation for fixed rate government bonds. As such, we increased our duration in the fund to 1.1 from a level of 0.75, and increased our exposure to the R186. The fixed rate exposure in the fund has increased from 13% to 21% over the quarter. It is very clear that government bonds have become cheaper versus credit as bonds have underperformed swaps, and there has been a continuation of credit spread narrowing. Bank funding spreads have become expensive and the fund has benefited from positive performance in bank subordinated and hybrid debt. We reduced exposure to inflation linkers over the quarter as we found better relative value in nominal bonds, because the inflation risk premium that is priced into the nominal bond market was very attractive. Our exposure to listed property has remained low at 2.3% as we believe that on a risk-adjusted basis the property market needs to become cheaper before an increased exposure to this sector is justified. With most fixed income asset classes underperforming, the fund's large weighting to floating rate credit bonds enabled a positive return for the month. This is consistent with the fund's mandate to achieve consistent positive returns even in times of significant underperformance in fixed income asset classes.

4. Portfolio positioning

With credit spreads having narrowed, combined with a low supply of corporates coming to the debt capital markets to raise debt, means that credit is looking expensive, but could continue to perform positively and become more expensive. If our bond valuation model continues to offer value, we will favour government bonds over corporates, but will keep investing in high quality corporates to keep the yield in the fund high. We are favouring the insurance and securitization sectors in the credit space as bank spreads have become more expensive. We will look to increase duration in the fund if the bond market sells off further and our valuation model indicates positive risk compensation. Our property valuation model is indicating that some stocks are cheap and we will be slightly upweighting these exposures but will keep our property exposure lower than 5%, until we see meaningful recovery prospects for the sector. With real yields generally at low levels in the inflation linker market, we will not be increasing exposure unless there are attractive opportunities in the inflation linked bond corporate space.

With the recent emerging market sell off, offshore credit spreads are starting to offer value and we are looking for credit opportunities in the offshore market, but will always hedge this exposure back into Rands. We will continue to keep the yield in the fund high while diversifying across different sectors and risk categories and being mindful of interest rate risk.

Granate SCI Multi Income Fund – Portfolio Manager Profile

Bronwyn Blood (B.Com (Hons))

Prior to joining Granate Asset Management in December 2015, she was the Portfolio Manager of the Flexible Fixed Interest Funds and the flagship Absolute Yield Fund at Cadiz Asset Management. When Cadiz bought African Harvest in 2006 Bronwyn took over the management of the Flexible Fixed Interest funds.

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

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.