QUARTERLY COMMENTARY – Q2 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 positive momentum during the 2nd quarter of 2018 despite growing concerns around a slowdown in global trade due to rising 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 1^{st} quarter of 2018 for domestic bonds where the All Bond Index (ALBI) returned 8.1%, bonds sold off in the 2^{nd} quarter – the yield on the benchmark R186 rising by 85bps 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 1^{st} quarter, the 2^{nd} 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 remained under pressure, performing worse than any other domestic asset class in the 2^{nd} 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

We started the 2^{nd} quarter with a low interest rate risk exposure as valuation became stretched post the change in government leadership rally. The April sell-off started offering better buying opportunities and we gradually increased our interest rate risk exposure to take advantage of higher yields. We continued to increase our interest rate risk exposure by buying long dated nominal bonds in the weekly auctions that offer a two day "free" option increasing exposure of the amount bought in the auction. Maturing Negotiable Certificates of Deposit, corporate bonds and call money were used to increase the portfolio's exposure to fixed rate bonds from 23% at the end of March to 50% at the end of June.

The exposure to inflation-linked bonds fluctuated during the quarter. The bottom of the inflation cycle did provide some opportunities in the shorter end of the inflation-linked bond curve as the inflation carry (the portion of returns that is attributed to inflation) was attractive. However, we have subsequently reduced the exposure to the longer dated holdings in the portfolio as the market appears to have become too negative on the inflation outlook.

We have increased the exposure to the listed property sector marginally (+0.7%) during the quarter as certain counters appear to be offering better value post the recent sell-off. We did, however, reduce our exposure to the currency hedge counters (namely Hammerson and INTU) as we believe that the benefits of the hedge have now declined.

4. Portfolio positioning

The global economic environment is uncertain and the last quarter showed the vulnerability of emerging markets to higher US interest rates and a "trade war" induced slowdown. However, it appears that the market has broadly adjusted to this environment and our bond valuation models suggest that nominal bonds are offering a positive risk compensation. At a current yield of above 9% on the All-bond index and good prospects for inflation remaining contained, inflation adjusted yields (real yields) seem attractive at around 4%. Therefore, we remain long interest rate risk on the portfolio and will look for opportunities to increase this further.

While the property sector remains under pressure due to higher interest rates and a weak growth environment, post the selloff in the sector, some SA centric companies are trading at a positive yield spread to the SA 10-year bond. Over all we maintain a significant underweight exposure to the property sector versus our strategic asset allocation as we are very cognisant of the changing nature of the domestic listed property sector. We maintain an exposure to the more liquid, less volatile counters which are focused to "specialised" sectors that we believe have long-term prospects.

Inflation-linked bonds at the long end of the yield curve remain expensive. Shorter dated inflation-linked bonds continue to offer some defensive properties, but we will look to sell out of these and increase our exposure to long-dated bonds.

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

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.