GRANATE
ASSET MANAGEMENT

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QUARTERLY COMMENTARY – Q4 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 has slowed down marginally in the 4th quarter but remains on track to match last year's robust performance. While consensus forecast is for a continuation of the economic upcycle there are signs that the risks of a US recession (with boarder global implications) is growing. Similar (low) rates of unemployment and yield curve shape have historically been followed by recessions.

Domestic economic growth in the 3rd quarter of 2018 (released during Q4 2018) rebounded to a seasonally adjusted quarter-on-quarter annualised (q/q) rate of 2.2% from an upward revised -0.4% 2nd quarter growth rate. The positive outcome means that the economy has emerged from its brief recession. The strong rebound was predominantly due to a strong performance of the manufacturing sector (making up 13.5% of GDP) which recorded its strongest 3rd quarter (7.5%) in over a decade and despite a poor performance of the mining sector (-8.8%) (that makes up only 8.1% of GDP). Concerningly, gross fixed capital formation declined by a q/q rate of 5.1%, its 10th negative quarter in the last 12. High frequency economic data releases for the 4th quarter have surprised on the upside and suggest that the economy continued to grow in 4Q although, judging from the still weak confidence and PMI surveys, momentum remains subdued.

The Monetary Policy Committee (MPC) of the Reserve Bank met once in the 4th quarter and increased the repo rate by 25bps to 6.75% - the first hike since Feb 2016, in a close decision (3:3 vote). While the rate hike was broadly in line with the SARB's Quarterly Projection Model, communicating the decision was made difficult by a much stronger rand and lower oil price since the previous meeting. Furthermore, the MPC's inflation and GDP growth forecasts were lowered, implying less justification for a hike. Therefore, we think that the decision by the SARB should be seen as a further sign that the MPC is focused on the midpoint (4.5%) as the inflation target rather than the 3%-6% range.

We maintain our view that barring a sell-off in the rand or a rally in oil, the SARB is likely to keep the repo rate unchanged in January 2019 before hiking again in March 2019, but global developments could mean a delay in the next hike.

2. Market overview

Financial markets ended the year on shaky ground. Locally, money market outperformed all other domestic asset classes both for the quarter and the year. Adjusted for inflation, only bonds and money market recorded positive returns over the last 1, 3, and 5 years. Given the make-up of domestic pension funds (with their heavy weighting towards equities), real value of retirement saving has, at best, remained unchanged over the last 5 years and in many cases would have declined.

The bond market returned a respectable 2.7% in the 4th quarter as bond yields (R186) traded in a 50 basis point (bp) range and ended the quarter practically where is started. The long end of the yield curve (R2048), however, was only 2bp lower implying a slight decline in value. The reasonable performance of bonds came with a significant bout of volatility. November (+3.9%) was a stand-out month where the bond market was supported by a strong rand (+6.6%) which benefited from improving terms of trade and a generally supportive global environment, as evident from the strong performance of both EM bonds and equities, that saw foreign investors returning as net buyers (+R2.6bn) to the local market for the first time since July. Taking global markets performance in the 4th quarter into account, South African bonds have held up well – a function of the attractive prospective real yields that they are trading at.

Global economic uncertainty impacted financial markets in the 4th quarter more than it did in the 3rd as evident from the worst quarterly performance in 10 years of key equity indices such as the S&P500 and a spike in the VIX index. This sent investors to the safe haven of developed market bonds driving all key market rates lower with the yield on the 10yr US Treasury declining by 36bp, this despite the US Fed raising its key lending rate by 25bp. Despite the increase in risk aversion emerging markets fared well outperforming all major asset classes.

Inflation-linked bonds continue to perform poorly as inflation, while likely to remain around current levels for the next few months, is not expected to rise rapidly and does not appear to pose a major, hence investors are not seeking inflation protection which this asset class offers.

The listed property sector remains a significant underperformer having recorded its 4th consecutive negative quarter and its 10th negative month of the year in December. The sector has come under growing scrutiny due to allegations of inaccurate financial reporting by some of the larger companies. Furthermore, results and trading update point to very tough trading conditions as also evident by the risk that Edcon (a substantial tenant in most retail shopping centres) may not meet its rental obligations.

3. Portfolio activity

We maintained the portfolio's high exposure to fixed rate bonds early in the 4th quarter before selling down some of the shorter dated fixed rate bonds. We reduced the fund's fixed rate bond exposure by 14% during the quarter, cutting interest rate risk as our models suggested that the market has moved into expensive territory during November. While we reduced the portfolio's interest rate risk, we increased the exposure to the ultra-long end of the yield curve as we consider the curve to be too steep.

Market volatility during the quarter meant that the rand also strengthened to levels which our models suggested are overvalued. This, together with a narrowing gap between South Africa's short dated yields and those in the US, gave us an opportunity to take on some US$ exposure at attractive yields.

We increased the portfolio's exposure to the listed property sector by 1% during the quarter to 6% (significantly underweight its strategic asset allocation). The volatility of the sector remained extremely elevated and we continued to focus on counters that we believe are less volatile and now offering attractive yield such as Growthpoint and Equites. After reducing the fund's exposure to Hammerson and Intu in the 3rd quarter, we now sold out of these counters. This despite, in the case of Hammerson, the share trading at a significant discount – we do not believe that the risk associated with Brexit justifies holding the stock.

4. Portfolio positioning

South Africa's economic growth is expected to pick up in 2019, however, low consumer and business confidence are likely to remain low before the outcome of the general elections is known and there are clear signs that the president is able to implement his economic policies. Given the uncertainty around the further burden that state-owned enterprises will put on the fiscus, the risk of a credit rating downgrade by Moody's remains elevated and is likely to remain a source of volatility during the year. Nonetheless, real yields of South African bonds remain very attractive, offering good returns for investors that are willing to take on a fair amount of volatility.

By the end of the quarter our bond valuation guide, after indicating that South African bonds are offering positive *risk compensation*, were back to fair *risk compensation.* Therefore, we have lowered the fund's exposure to fixed rate bonds but increased the relative exposure to the long end of the curve. In this way we have been able to keep the funds overall yield to maturity the same as it was at the beginning of the quarter at around 9.5%.

We maintain a relatively low (vs the funds strategic asset allocation) exposure to listed property despite a material improvement in value due to the large sell-off of the sector. This is because the economy remains weak and investors are sceptical about the sector's ability to maintain its earnings. Furthermore, property funds with exposure to the retail sector are facing uncertainty around the structural shift in consumer preference and the growth of online shopping. While local market dynamics are clearly different to those in developed markets, it is very likely that online shopping will put pressure on established shopping centres.

Granate SCI Unconstrained Fixed Interest Fund – Portfolio Manager Profile

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

Prior to joining Granate Asset Management in December 2015, 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 holds an M.Soc.Sci. (Economics) from the University of Cape Town.

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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.