Granate ASSET MANAGEMENT

Market Update
JUNE 2023

"But Dad, I thought it was *good news* if things went up?"

My 9-year-old daughter wanted to know why I was "huffing", so I explained to her that bond yields just keep going up. Her response was the title of this note. I had the task of explaining to her that fixed income is a bit different to equities. If yields are going up, it means the value of the bonds are going down. She shrugged and went off to practice handstands.

Where are we with Government Bonds?

Market sentiment is in the doldrums. The electricity crises, cholera, dry water taps, diplomatic missteps, the collapsing rand, and the increased cost of living dominate conversations of our fellow South Africans. Bonds have been annihilated during the month of May, down nearly 5%. They have sold off to levels last seen in the depths of the Covid crisis. Remember Nenegate when we all experienced a weekend of high levels of anxiety? The bond market is saying that this time it's as bad.

At the time of writing, we can buy a SA Government Bond that matures in 2030 at a yield of 11.3%. I am of a positive disposition but allow me to paint a negative scenario. Let's say the South African Reserve Bank is unsuccessful in bringing inflation under control and it stays at its current 6.8% for the next 6 years. Buying this bond and holding it to maturity would give you a return of inflation + 4.5% for each of those years. This is an extraordinary real return for what we think is a low-risk investment. This will be a bad investment if one of two things happen. 1) The Government defaults on its payments. 2) Inflation rockets to levels far higher than current levels. The first scenario is highly unlikely, the second scenario is not impossible, but improbable.

We are not blind to the specific South African issues we face but we think prices are currently being set by panicked sellers.

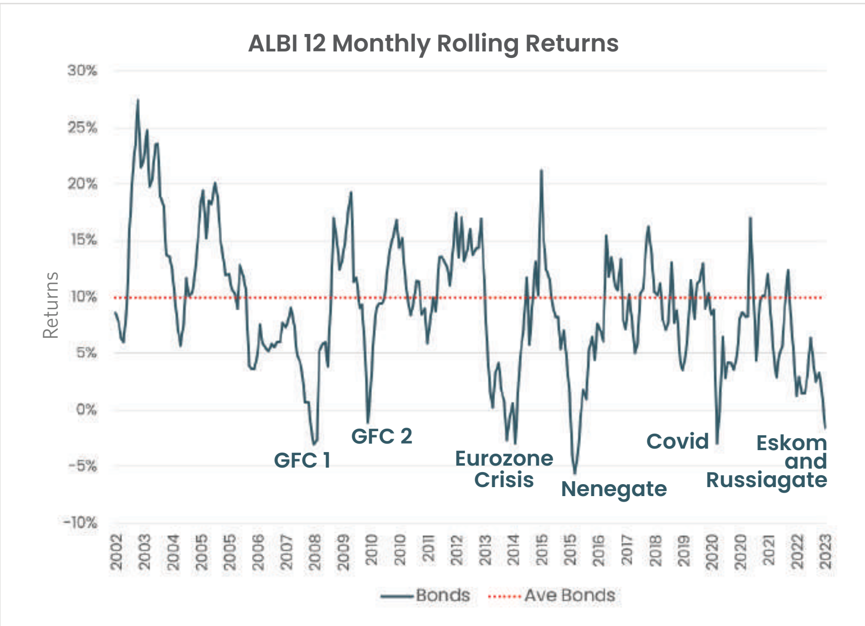
What kind of impact has this had on the Granate BCI Multi Income Fund?

We invest across a broad range of fixed income instruments and asset classes in this fund. We aim to deliver returns more than cash with an eye on delivering returns which are 2-3% ahead of inflation. We will allocate capital to areas that are offering compelling risk compensation. Carefully considered risk is the currency one pays for returns. This is why we will always focus on what kind of return we will get for taking certain risks. We do this while also aiming to minimise volatility in the fund. It is a delicate balancing act, but our process is designed to do exactly that.

Over the course of this year we have been reducing our exposure to SA Government bonds. Although they have still been attractively valued, other investment opportunities have emerged offering us the opportunity to further balance the portfolio for different scenarios. These new opportunities have largely been driven by the increase in interest rates both locally and abroad while a global aversion to emerging markets has driven prices down (and yields up) as people sell. This has allowed us to diversify the fund further into offshore credit and floating rate shorter dated bank paper, thus reducing the fund duration (interest rate risk). Despite this, there are few places to hide in a month like May of 2023, and our clients felt this.

This is not our first zombie apocalypse

We have stared down big bond selloffs many times before. Bonds don't travel in straight lines as you can tell from the chart below which shows the one year rolling return of the FTSE/JSE All Bond Index. Although the peaks and troughs are not as extreme as in equity markets, these sell offs can be painful at times. Very often they are fuelled by emotions rather than fundamentals, and this in turn provides opportunity. It's worth remembering that nominal bonds are mean reverting instruments, moving back to their issue price unless they default. There is some certainty in that direction of travel which is why at extremes like we are seeing now, it is worth adding a bit more to the fund. This is what we did in the difficult period when Covid reached our shores, and our funds were handsomely rewarded for this.



It's important to stress that this time is different. When Covid struck South Africa, the bond market yields shot up and interest rates were aggressively cut. This meant that the returns being offered by floating rate instruments (whose yield is linked to the interest rates) were not attractive. It made sense to take a large position in nominal bonds. As discussed above, today there are many more opportunities across a wide range of fixed income asset classes, so we are not buying bonds to the same extent as we did then.

Negative months are unusual but not unprecedented

Despite our flexible approach, we have not completely immunised our clients from the market forces this month. We wish we could do that month-on-month and still give you the returns we have been able to deliver. For the 86 months we have been managing the Granate BCI Multi Income Fund, we have had 4 months in which we posted a negative return. In previous selloffs there were strong positive market reversals soon after. It was hard to see what the "catalyst" for this positive reversal would be at the time. In the case of the Covid crisis it was widely expected that the arrival of a vaccine would be the catalyst. However, many months before there was any sign of a vaccine being discovered, the markets had recovered. The catalyst is almost always simply the dissipation of panic if the fundamentals hold true.

Negativity is neither a life nor an investment philosophy worth pursuing

We know we are entering a darker winter than we would have hoped for or have ever experienced. Furthermore, our government is, at best, indecisive regarding its diplomatic stance towards Russia. The markets have sent a clear message to our government to choose their friends wisely. We hope they are listening, and we feel the frustration as much as any other South African but when markets are very emotional, we need to be very rational. Negative minds don't solve problems and will struggle to find opportunity. My "huffing" moment was not constructive. A rational mindset requires us to be vigilant to the challenges, while having our eyes wide open to find the flowers in the unkept garden. We will keep doing that for our clients and are very grateful for having the opportunity to do so.

Granate is a people business.

We are committed to creating a rich and rewarding culture through our shared values. Granate is configured thoughtfully and intentionally so that our team can thrive for the benefit of our clients. We care about the same things you do and are *relentlessly* **committed to protect and grow your savings**.