NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Quarter One, 2019

For the period ended 31 March 2019

NEDGROUP INVESTMENTS FLEXIBLE INCOME

Performance to 31 December 2018	Nedgroup Investments Flexible Income[1]	STeFI*110%
3 months	2.4%	1.8%
12 months	9.8%	7.3%

The fund had a positive quarter as investors benefitted from a strong performance of its allocation to preference shares and convertible bonds. Yield pickup on our domestic and offshore floating rate assets and offshore property also drove performance. The fund has been tactical with duration, selling its remaining holding in government bonds, and is currently conservatively positioned from an interest rate perspective. The fund performed well over the quarter and the longer-term performance demonstrates significant outperformance of the benchmark.

The Nedgroup Investments Flexible Income Fund has delivered on its mandate to outperform cash with a predictable and low risk return profile. Its performance is attributable to its philosophy of investing in a diversified range of fixed income asset classes, avoiding expensive asset classes and focusing on high credit quality.

Market commentary

The first quarter of 2019 saw a sharp rebound in risk assets virtually across the board. The S&P 500 gained 13.6% over the quarter after a sharp sell-off in the fourth quarter of 2018 (-13.5%) erasing all of the losses and leaving the index within striking distance of all-time highs. This sharp reversal of fortunes can be attributed in part to a 180 degree turn in the Fed's monetary policy stance. Having hiked rates gradually but consistently between December 2017 and December 2018 a sudden fear of soft global growth and even the potential of recession caused the Fed to turn extremely dovish. The result was a swift reflation of risk assets.

Peculiarly, safe-haven global bonds rallied strongly in the first quarter of 2019 (US-Treasuries rallied 30bps) at the same time risk assets rallied. In fact, US long dated rates temporarily fell below short rates. Historically, yield curve inversion has been a reliable indicator of an impending recession. These moves may indicate that the market is expecting an economic slowdown, but that global central banks will ease monetary conditions sufficiently to prop up corporate earnings and support equity markets (the so called "Fed put" is as relevant as ever).

In South Africa the first quarter saw preference shares (+6.2%) with the best return outperforming equities (SWIX +6.0%), bonds (+3.8%), cash (+1.6%), listed property (SAPY +1.4%) and inflation-linked bonds (+0.3%).

South Africa credit rating update

On 29 March local investors breathed a sigh of relief when Moody's failed to issue an assessment on the South Africa sovereign credit rating, keeping us Baa3 Stable. Moody's did issue an update, which they explained does not constitute a formal rating action publication, as the credit committee did not meet at this review date (or interestingly the last review date in October 2018 either) to reassess the sovereign's credit rating.

The update published by Moody's was a lot more sanguine than many expected, especially given the significant deterioration seen in the fiscus over the past few months due to poor tax buoyancy, waning growth, uncontrolled expenditure and increasing obligations to support failing SOEs. The report indicated that despite more conservative growth expectations, and a deteriorating fiscal outlook, the Baa3 rating is still appropriate as other sovereigns at this rating are experiencing similar deterioration. The levels of real GDP growth they are forecasting in their assessment is 1.3% and 1.5% over the next two years, with the debt to GDP ratio escalating to 65% over the next five years. They believe that it is only at deterioration significantly beyond these stated forecasts that they will reconsider the Baa3 rating assigned. Additionally, Moody's seems to be comfortable that the debt mix between local and hard currency is appropriate, and the long tenure of the debt is positive. They are positive, but not unrealistic, about the Ramaphosa administration and reforms slowly happening over the next few years.

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[1] Net return for the Nedgroup Investments Flexible Income Fund, A class. Source: Morningstar (monthly data series).

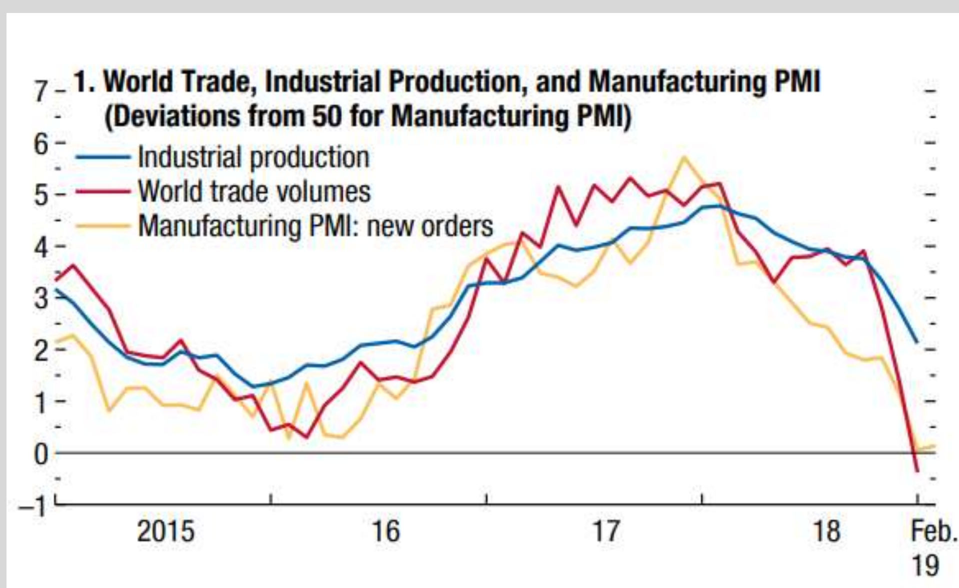
It has been our view that the fiscus has deteriorated so significantly since the last formal review, that a change to negative outlook was likely this year. Despite their communication to the market signaling the contrary so far, it is important to note that a formal credit review has not taken place and the committee has yet to vote over the matter. Additionally, economists continue to forecast growth and fiscal metrics that are deteriorating at a significant rate. It appears that South Africa has reached the top of the Laffer curve, where increased tax rates are not generating the expecting amount of income anymore (signaling that tax revenue has topped out). On the expenditure side there appears to be very little consolidation and this is especially difficult to do in an election year. Concerningly, we now have several economists start to forecast the fiscal deficit this year at 5% and if growth remains as low as it has been over the past few years, this debt burden will just continue to escalate unsustainably.

The decision by Moody's not to formally assess South Africa's sovereign rating in March leaves the country quite vulnerable, in that they have merely delayed making a decision on whether our investment grade rating is still appropriate. Given the deterioration since their last formal review, as well as the believed deterioration still to be seen over the year, the risk of a rating outlook change (or even a rating change) is still present in 2019.

Global economic slowdown

Expectations of global GDP growth have been reduced on the back of a slowdown in several key economies. The IMF has trimmed its 2019 global growth forecast four times to 3.3% for the year.

In the United States the tailwinds of fiscal easing (particularly tax cuts for corporates) are now behind us. Global cross-border trade and Industrial Production have slowed, due in part to prior front loading of purchases in anticipation of new tariffs pledged by President Trump.



Source: IMF

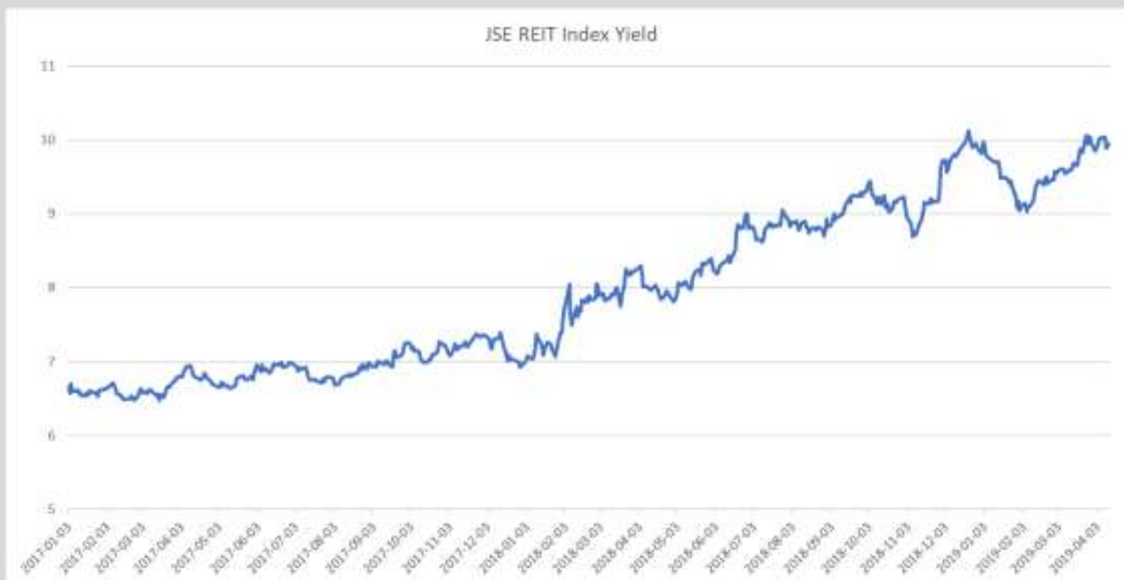
While we are a long way from outright recession, lawmakers and central bankers are clearly concerned. The US Fed has taken a dovish turn in their forward guidance with the market now pricing in cuts to the Federal Funds Rate. China for its part has aggressively eased credit conditions, with Total Social Financing (a broad measure of credit extension in China) increasing by RMB 8.2tn (approx. R17.1tn) in the first quarter of 2019, representing a 40% increase over the first quarter of 2018. This appears to have stabilised the Chinese economy for now, but at the cost of an ever-increasing debt burden which could lead to a painful adjustment at some point in the future. Germany is experiencing a sharp slowdown with 2019 growth expectations revised downwards from 1.8% to 0.9% on the back of a struggling auto sector which is a key component of the Eurozone's largest economy. Material downgrades for growth in other key European markets such as the United Kingdom, Italy and France are also being penciled in.

While ebbs and flows in economic growth are to be expected, it is notable that a decade after the Global Financial Crisis, monetary and fiscal policy in most major economies remain highly accommodative. If the slowdown intensifies it is entirely possible that we see a redoubling of extraordinary monetary stimulus. If this does in fact materialise, the question then becomes how much additional debt can the system bare and how effective will additional easing be given we are already

in an accommodative environment? Although answers to these questions are uncertain, one should be cognizant that fragility in the system remains.

South African listed property – Reflecting South Africa's economic reality

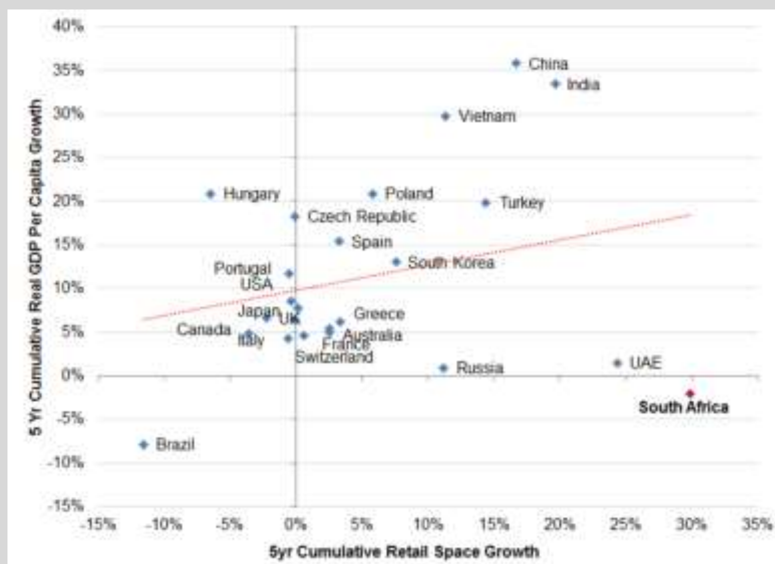
From a yield perspective, South African property looks cheap with a starting yield of around 10%. This is an indication that the decline in the growth prospects for the sector is finally being reflected in valuations. While the increase in yield from the 6.5% level is partially attributed to the derating of the Resilient stable, the yield on all stocks has shifted higher to compensate for the diminished growth prospects.



Source: Bloomberg

Fundamentals are poor

While South Africa's GDP growth averaged just 1% for the last five years, property development has continued to increase the amount of space available in all sectors. In the retail sector, space has grown by 30% in the last five years even as real GDP per capita has gone backwards.



Source: RMB Morgan Stanley, Euromonitor, Statssa

South African retailers have consistently taken up space as they competed aggressively for market share. However, in real terms (after inflation), trading densities have been negative for over a decade. This means that the increased sales have not

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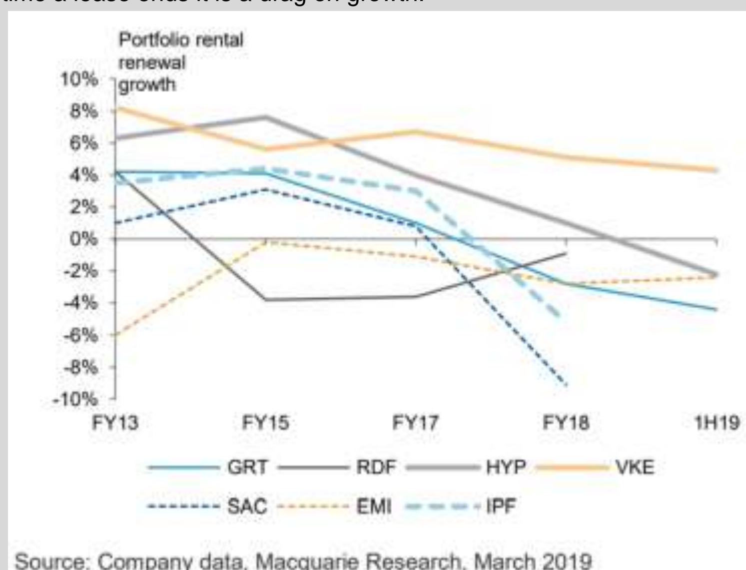
matched the increase in space. With retailers now under pressure and looking to close underperforming stores, space growth is likely to be negative.

Source: RMB Morgan Stanley, SAPOA, Statssa

The impact of more space into a weak economy means that, aside from Vukile, all the major local property companies now have negative rental growth upon renewal. The extent of rental reversions is understated due to higher contributions to tenant installation costs and rent-free periods. The companies still benefit from the positive escalations on the majority of their portfolios, but every time a lease ends it is a drag on growth.



Source: Company data, Macquarie Research, March 2019

Adjusting to a low growth environment

Companies in the sector have been struggling to grow earnings for a number of years due poor economic growth and business confidence. Rather than accepting a lower distribution growth, they have engaged in financial engineering in order to report a higher growth number to investors. Highly leveraged offshore exposure, swap restructurings and distributing capital have become the norm. We have been cautious on the sector for the last two years given the deteriorated growth prospects in a poorly performing economy. The market has finally realised that much of the growth in recent years has been an illusion.

While the sector looks very cheap on a yield basis, it faces significant headwinds from the poor economy, the increase in available space and the higher levels of gearing. South African investors have been spoilt with very attractive returns for a long time, and the adjustment to a lower growth environment will take time. We will continue to maintain a conservative and diversified exposure to local property in the current environment.

Current positioning and outlook

- Low duration

  We sold out of our remaining government bonds during the quarter. As a result, the South African duration is 0.1 which remains conservative. We believe that rates (at 6.75%) are around 75 basis points below fair value. The supportive global liquidity backdrop has aided Emerging Market bond flows and yields, but we will not chase the asset class beyond levels deemed fair value.

- High credit quality

  The portfolio has a high degree of credit quality, with no unlisted issuers. Our credit process has historically shielded from credit events in South Africa and we are confident in our ability to protect investor's capital in the fixed income space.

  Corporate credit spreads remain very compressed. This is largely a function of the global liquidity dynamic and lack of corporate bond issuance in South Africa. We have focused our asset purchases on senior bank debt and will wait for value to emerge before taking corporate bond exposure.

- Convertible bonds

  We have 4.9% exposure to convertible bonds issued by Royal Bafokeng Platinum and Remgro and introduced Intu Convertible during the quarter. We have historically added value through this asset class as it provides a mix of yield and capital appreciation. We will look to increase the exposure if we see value.

- Property

  The fund currently has 2.1% exposure to a diversified pool of domestic property assets. We have been gradually accumulating these, focusing on the better-quality counters, adding 0.4% during the quarter. These offer attractive yields in an environment of diminished growth prospects.

- Preference shares

  We trimmed our exposure to preference shares to 4.7% (Q4 2018: 5.1%) over the quarter.

- Offshore cash & money market

  The fund increased its exposure to offshore cash and money market instruments to 7.2% (Q4 2018: 5.7%) where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality.

Summary and conclusion

Global markets are pricing in a Goldilocks scenario where growth is good enough to support asset prices, but insufficient to tilt central banks away from their dovish bias. This has pushed assets to fair value and in some cases beyond fair value. However, a range of global risks threaten to upset the apple cart. We will continue to be cautious in this environment and focus on capital protection. Our aim is to generate a reasonable return with a low level of downside risk and take advantage of opportunities provided by any shocks to add risk exposure when the market offers value.

Portfolio summary

Domestic Duration	0.12
Domestic Inflation Linked Duration	0.22
Total Domestic Duration	**0.34**
Offshore Duration	0.10
Total Fund Duration	**0.44**

Effective Offshore Exposure	4.9%
Fund Yield	8.3%

DISCLAIMER

WHO WE ARE

Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE

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PERFORMANCE

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Certain unit trust funds may be subject to currency fluctuations due to its international exposure. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital.

PRICING

Funds are valued daily at 15:00. Instructions must reach us before 14:00 (12:00 for Nedgroup Money Market Fund) to ensure same day value. Prices are published daily on our website and in selected major newspapers.

FEES

Certain Nedgroup Investments unit trust funds apply a performance fee. For the Nedgroup Investments Flexible Income Fund and Nedgroup Investments Stable Fund, it is calculated daily as a percentage (the sharing rate) of total positive performance, with the high watermark principle applying.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

DISCLAIMER

Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Nedgroup Investments has the right to close unit trust funds to new investors in order to manage it more efficiently. For further additional information on the fund, including but not limited to, brochures, application forms and the annual report please contact Nedgroup Investments.

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