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NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Performance to 30 June 2019	Nedgroup Investments Flexible Income[1]	STeFI*110%
3 months	2.1%	1.8%
1-year	9.6%	7.3%

The fund had a positive quarter with investors benefitting from yield pickup on our floating rate assets, as well as a strong rally in inflation linked bonds and preference shares. Convertible bonds in the fund also experienced another strong quarter. The fund is tactical with duration but remained conservative and out of government bonds. Bond yields did not move to sufficiently attractive levels to add duration, especially given concerns around the fiscus and Eskom's increasing burden on the sovereign coming to light. The fund performed well over the quarter, and the longer-term performance of the fund continues to demonstrate 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 second quarter of 2019 saw an overall appreciation of risk assets. In May, renewed trade tensions and weaker US manufacturing data led investors to take a more cautious stance, leading risk assets to experience a decline. These losses however rebounded in June, as trade tensions eased post the G20 summit and central banks indicated more accommodative policy. The S&P appreciated a further 4.3% for the quarter, recording a new historic high. Despite emerging markets lagging the performance of developed market equities for the year and quarter, South African equities still generated a strong positive return for investors, well ahead of major EM peers.

With global central banks signaling looser monetary policy, bond yields fell markedly over the quarter. The US 10-year is now at its lowest levels since November 2016, and even briefly fell below 2%. German 10-year yields moved c.30 bps more negative. On the local front bonds similarly experienced appreciation, with the 10-year yield strengthening from just over 9% to 8.7%.

The rand touched 15 to the US dollar during the quarter, but strengthened back to 14.08, on the back of the move into risk assets in June.

In SA Q2 saw Preference Shares (+5,5%) generate the best return, outperforming Listed Property (SAPY +4.5%), Bonds (+3.7%), Equities (SWIX +2.9%), Inflation-Linked Bonds (+2.8%) and Cash (1.8%).

Global Monetary Policy

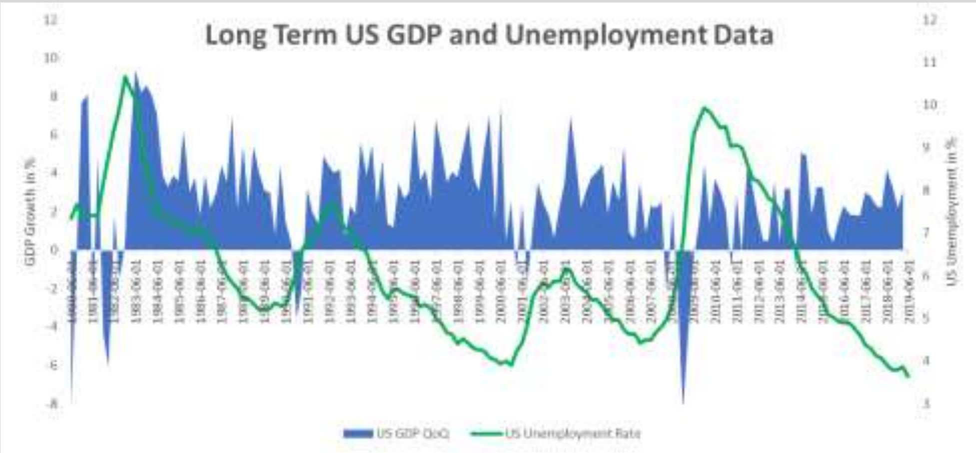
The world's central banks continue to adopt an increasingly dovish outlook, to address inflation shortfalls and stimulate growth. The European Central bank and Federal Reserve are likely to start easing soon, while the Bank of Japan has indicated extra stimulus as an option if inflation continues to fall short of its target. Some central banks such as India, Russia, Australia, New Zealand etc. have already started cutting rates.

The markets expectations around easing by the ECB appear reasonable, but the level of easing expected by the Fed, we believe, is overdone.

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

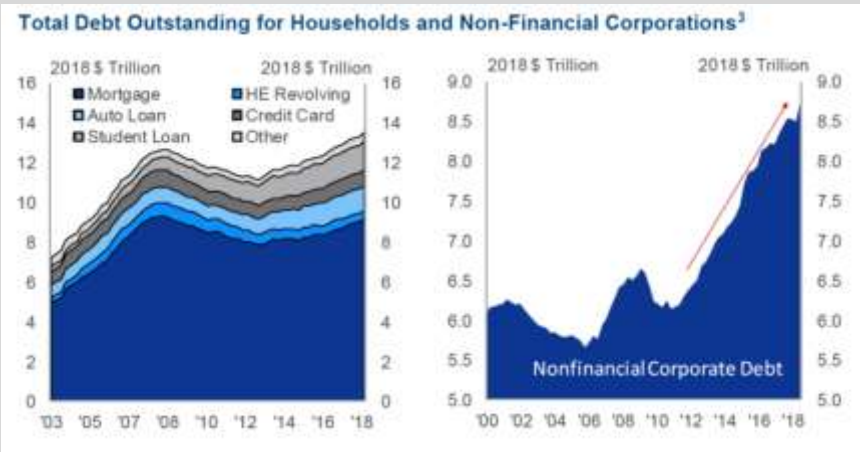
The Fed made a monumental shift in policy toward the end of 2018. The market moved from pricing multiple hikes for 2019, to now pricing a 100% chance of a cut in a July, and two to three more cuts priced till the end of the year. Their increasing dovish rhetoric they attribute to slowing global growth, lack of inflation pass-through and increased uncertainty around trade wars.

However, recent economic data out the US, with perhaps the exception of manufacturing data, is still signaling good growth. The latest GDP number came out at 3.1%, unemployment is still sitting around all-time lows of 3.7%, annual wage growth still strong at 3.1% and payrolls (after a weak May) making a large rebound in June, well above consensus expectations. The G20 meeting in Japan also provided some clarity and relief around the ongoing trade war between the US and China, with an announcement that the US will not implement any new tariffs on Chinese goods, and more productive talks between the US and China resuming. The S&P is sitting at all-time highs. Weak inflation remains a consideration, but in the Feds own words is still being attributed to “transitory influences” rather than a lagging economy. In fact, policymakers usually see job gains with low unemployment as posing inflation risks.



Source: Bloomberg

Given this, alongside the record level of US corporate debt in the system (see graph below), it is believable that the Fed won’t want to cut rates as aggressively as the market is pricing this year – as a matter of fact, it would be historically unprecedented. The Fed does not usually mislead the market and having built their case for “insurance cuts” recently, a cut in July is a likely option. But given continued data strength and more clarity on trade, we believe the Fed will lead the market away from the aggressively priced easing.



Source: FPA

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On the South African front, the next MPC is scheduled for the 18th July and the market is fully discounting a rate cut of 25bps at the next two meetings, as well as partially another cut at the third. South Africa has experienced consistently below consensus GDP growth over the last few quarters, with our last GDP print (Q1 2019) at a surprising -3.2%. Additionally, inflation has also surprised to the downside, with the latest number around 4.5%. Given this low growth, low-inflation environment, alongside a more dovish global backdrop, we agree there is scope for an interest rate cut at the next meeting. Whether this will be the start of more cuts, will likely be determined from what results at the Fed and other central bank meetings thereafter.

South African Fiscus Update

The planned break-up of Eskom into three distinct entities, namely generation, transmission and distribution will take many years to implement and come at additional cost at first. If the plan is successfully executed it will result in increased efficiencies and better accountability. However, it does nothing to address Eskom's immediate challenges.

The Energy Availability Factor (power generated as a proportion of total installed capacity) has been tracking well below 70%, the worst it has been in recent years and is partially responsible for the load shedding experienced earlier in the year. This is indicative of severe operational challenges as a backlog of power plant maintenance appears to be piling up resulting in unplanned outages.

In addition to deep operational challenges, Eskom is also financially unsustainable. Eskom's excessive operating costs, consisting mainly of primary energy costs (especially coal) and staff costs as well as excessive interest costs can't easily be reduced. At the same time, rising electricity tariffs and a weak economy dampen demand meaning that the revenue line likely won't grow fast enough to achieve profitability and so further financial relief for Eskom is inevitable one way or the other.

A support package for Eskom of R23bn per year was set out in Mboweni's February 2019 budget. However, per Eskom and the Energy Regulator's projections they actually require about double that amount once capital expenditure and crippling interest costs are taken into account. In his SONA, Ramaphosa pledged unwavering commitment to Eskom saying they would front-load the support package, meaning that the annual contribution from the state will be in excess of R23bn and presumably closer to the forecasted cash requirement unless a debt swap takes place.

The state of government finances is looking increasingly bleak. Ballooning budget deficits combined with weak economic growth means that stabilising the public debt burden is looking increasingly unlikely in the medium term. Most economists are expecting fiscal deficits of nearly 6% for 2019 with little improvement in the subsequent years, while growth is not expected to reach 2% until 2021. Under this scenario debt stabilisation is simply unattainable.

Unfortunately, the bail out of Eskom will add significantly to the government debt burden. A number of proposals have been made to restructure Eskom debt. A special purpose vehicle to house the debt with a government guarantee would make it possible for Eskom to return to financial sustainability. However, if government were to take over Eskom's roughly R440bn of debt, it would add about 10% points to government debt as a percent of GDP, accelerating us down the path of fiscal unsustainability. Higher cost of debt funding for government is likely due to the deterioration of creditworthiness of the sovereign, but it appears there is little alternative.

Portfolio Commentary

Current positioning and outlook

- Low Duration

The fund remained conservative over the quarter, with SA duration at 0.1. SA yields have been fluctuating around fair value, perhaps on the slightly cheap side, but have not moved to sufficiently attractive levels for the fund to increase duration. We anticipate that worse local fundamentals and greater pressure on emerging markets as the Fed does not provide as much monetary support as anticipated will present an opportunity to invest at higher yields.

- High Credit Quality

The portfolio has a high degree of credit quality. Our credit process has historically shielded from credit events in SA and we are confident in our ability to protect investor's capital in the fixed income space.

Corporate credit spreads remain compressed for another quarter. This is largely a function of the global liquidity dynamic and lack of corporate bond issuance in SA. 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 about 4.6% exposure to convertible bonds issued by Royal Bafokeng Platinum, Remgro, Intu Properties and introduced Redefine 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 1.6% exposure to a diversified pool of domestic property assets. We slightly reduced this exposure during the quarter, selling out opportunistically after strong share price moves. Given the diminished growth prospect of this sector, we require attractive yields in order to increase our property position.

- Preference Shares

Our exposure to preference shares is slightly reduced to 4.2% (Q1 2019: 4.7%) over the quarter.

- Offshore Cash & Money Market

The fund maintains an exposure to offshore cash and money market instruments at 6.6% where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality.

Summary and Conclusion

The second quarter saw the continued rally of risk assets as the market continues to price easing by major global central banks. This has pushed asset prices higher, many beyond fair value. Reasons for the Fed in particular to provide the level of easing the market is pricing, is becoming unlikely and this threatens to upset the continuance of this rally. Not only does this threaten the performance of emerging market assets, but deteriorating local fundamentals are adding additional pressure. The South African fiscus is no closer to seeing consolidation and growth remains the biggest impediment.

For these reasons, and at current valuations on the expensive side for many asset classes, we are happy to remain conservatively positioned. 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	0.08
Domestic Inflation Linked Duration	0.19
Total Domestic Duration	0.27
Offshore Duration	0.15
Total Fund Duration	***0.42***

Effective Offshore Exposure	4.8%
Fund Yield	8.0%

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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).

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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.

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