QUARTERLY REVIEW

NEDGROUP INVESTMENTS CORE BOND FUND

as at 31 December 2019

See money differently

Bond portfolio continues to outperform cash

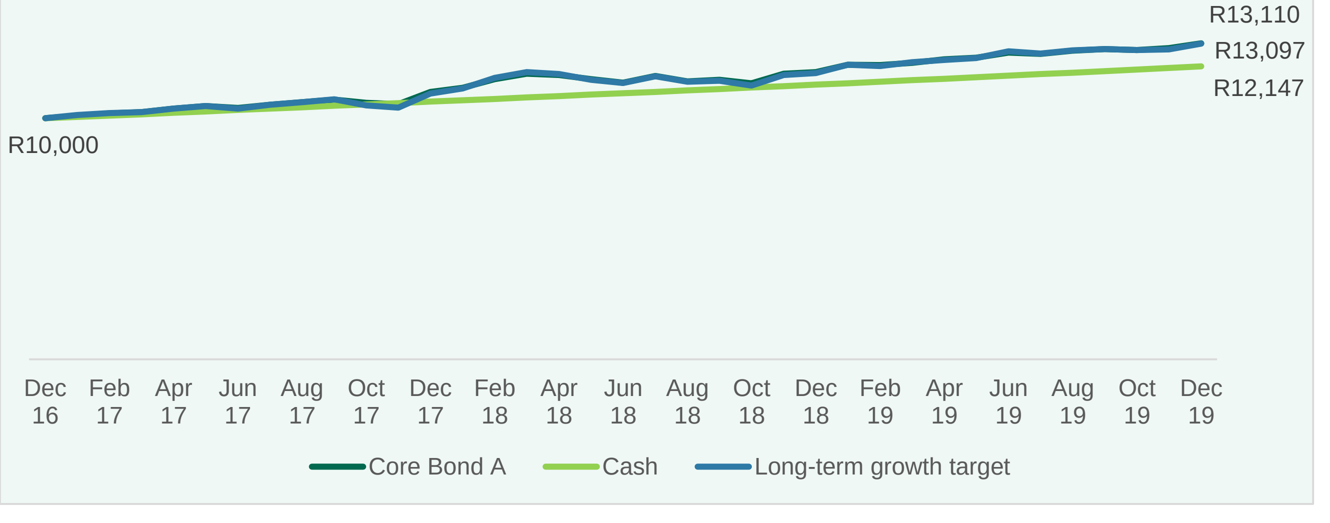
Local bonds were a relatively consistent feature of markets in the 2019. With the BEASSA ALBI up approximately 10.3% for the year, government bonds reacted as one would expect in the backdrop of weaker economic data. On a quarterly basis, for every R10 000 invested, the fund value was up by R186 (1.9%). The Fund return this quarter was slightly greater compared to the 1.4% observed in the third quarter. Over longer periods investors have been rewarded for taking on credit risk, as you can see in the table below. Notably, the fund has been on-track with its long-term target.

The table below compares an investment in the Nedgroup Investment Core Bond Fund to bank deposits (cash) over various time periods. This illustrates that over longer periods, investors have been rewarded for taking on interest rate risk. For every R10 000 invested in the Nedgroup Investments Core Bond Fund three years ago, you would have R13 110 at the 31st of December 2019. This is marginally better than the R12 147 you would have achieved had you invested your money in bank deposits (cash) over the same period.

Value of R10,000 investment in Nedgroup Investment Core Bond Fund versus Cash[1] and the Growth target

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years
Growth of fund (after fees) ***(Growth in %)***	R10 186 *1.9%*	R11 007 *10.1%*	R13 110 *9.5% p.a.*	R14 604 *7.9% p.a.*	R16 383 *7.3% p.a.*	R23 072 *8.7% p.a.*
Growth of cash ***(Growth in %)***	R10 160 *1.6%*	R10 664 *6.6%*	R12 147 *6.7% p.a.*	R13 730 *6.5% p.a.*	R15 167 *6.1% p.a.*	R17 835 *6.0% p.a.*
Growth target (Beassa ALBI) ***(Growth in %)***	R10 173 *1.7%*	R11 032 *10.3%*	R13 097 *9.4% p.a.*	R14 523 *7.7% p.a.*	R16 098 *7.0% p.a.*	R23 360 *8.9% p.a.*

Fund Return versus Cash[1] for 3 years ending 31 December 2019



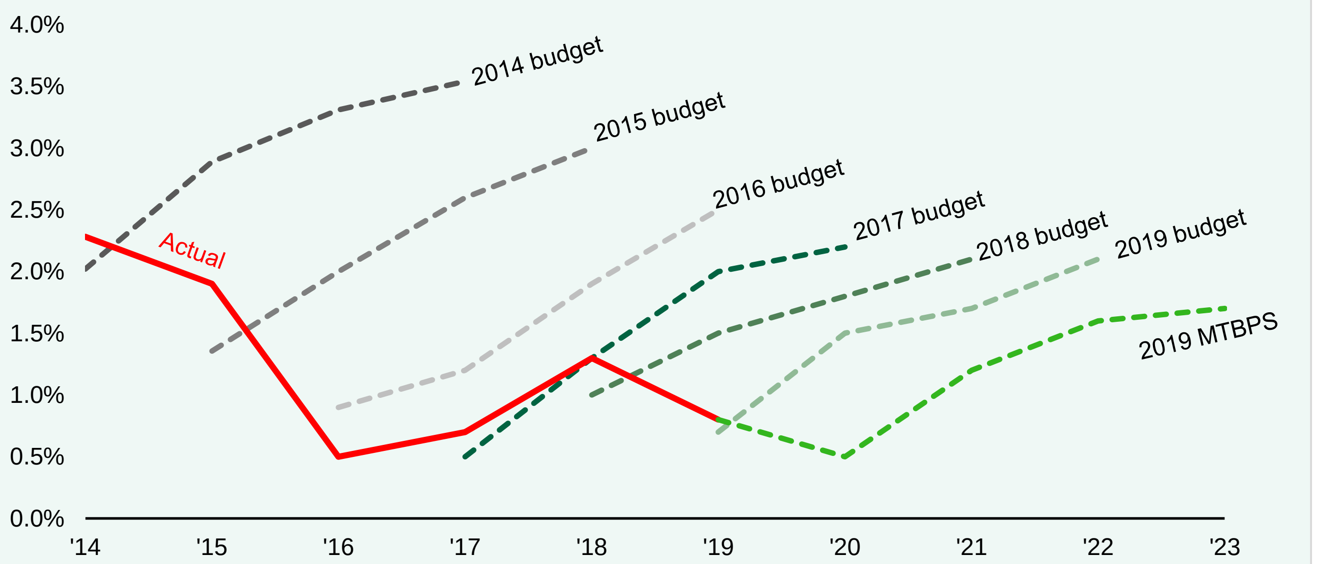
Over most periods, the Nedgroup Investments Core Bond Fund has done significantly better than bank deposits (cash) as the Fund benefited from the yield enhancement from investing in longer dated bond instruments. Over the past ten years it has delivered more than 2.7% of additional return per annum, or R5 237 for every R10 000 invested.

1. We used the STeFI call deposit rate for cash returns

South African markets: The year in review

The South African economy had a tough 2019 with economic growth forecast downgrades. The troubled power utility, Eskom, added to the economic woes, with rolling blackouts at various times during the year. In fact, Gross Domestic Product (GDP) to the end of quarter three was only 0.2% year-on-year. National Treasury has a track record of being overly optimistic with their GDP growth forecasts. The chart below shows the forecasts made in the annual budgets from 2014 to the mid-term budget of 2019. This is compared to the actual growth (in red).

National Treasury GDP Growth Forecasts vs. Actual GDP Growth



Source: Avior

Despite the weak economic climate, South African equities provided a return of 9.3% in 2019 (Capped SWIX Index). The majority of this growth arose from the strong recovery in quarter four, with South African equities delivering 5.3% over the final quarter of 2019.

The SA Nominal Bond market benefited from the improved sentiment towards emerging markets gaining 1.7% over the quarter and 10.3% over the year. However, SA inflation-linked bonds were not so fortunate, earning a return of only 2.6% over the year. This trend of nominal bonds outperforming inflation-linkers has been continuing for a number of years. Similarly, SA property limped along in tough trade conditions, returning 1.9% for the year. SA cash earned a decent return of 6.6% for the year.

Against the backdrop of low inflation (3.6% year on year to the end of November 2019), returns were decent. In fact, the SA Nominal Bond and SA Cash real returns far exceed their expected long term average.

The World Bank forecasts that GDP in South Africa in 2020 will be below 1% due to the ongoing struggles with electricity supply. Similarly, the International Monetary Fund is forecasting low growth for South Africa for 2020 and in general a synchronised global slow down.

Given the uncertainty in the SA economy there are likely to be surprises in 2020 which will have an impact on financial markets. However, the Fund is well diversified across asset classes and within asset classes, which should make it robust to a range of different scenarios.

Trouble brewing in the fixed income market

There has been a record inflow into money market and income funds recently as nervous investors tread water ahead of a potential downgrade and further bad news on the domestic and global front. These inflows need to be invested into a limited pool of mainly domestic fixed income assets, at a time when very few borrowers are looking to raise financing. This supply/demand imbalance benefits the few borrowers that are looking to raise finance, in that their cost of borrowing has been declining as a result of the excess demand for income generating assets.

In response to this excess liquidity in the market, banks have been able to reduce deposit rates at a faster pace than the SA Reserve bank has reduced the repo rate. As the majority of the larger money market and income funds in South Africa are heavily weighted towards negotiable deposits from the big 4 banks, yields on their funds have been declining in excess of the last MPC rate cut of 25 basis points. This has been further exacerbated by the fact that credit risk premia (i.e. the excess interest rate compensating investors for credit risk) on corporate debt has been discounted or ignored, in the feeding frenzy for yield.

Despite South African interest rates being amongst the highest of the emerging market countries, some of which have already been downgraded, such as Brazil; and domestic inflation is under control, we do not believe that the SA Reserve Bank is in a comfortable enough position to reduce rates dramatically while there is a Sword of Damocles hanging over the country's head in the form a Moody's downgrade and the likely sell-off of bond positions by index fund managers worldwide that will ensue. Considering the debacle at Eskom and the effect this will have on domestic economic growth, there now seems little doubt that Moody's will downgrade South Africa shortly. Perhaps, however, this will be the catalyst that shocks us back to reality and sound economic policy. We can only hope.

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