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NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter One, 2020

Nedgroup Investments Flexible Income Fund

Performance to 31 March 2020	Fund Performance[1]	Stefi*110%
3 months	-2.1%	1.7%
12 months	3.9%	7.2%

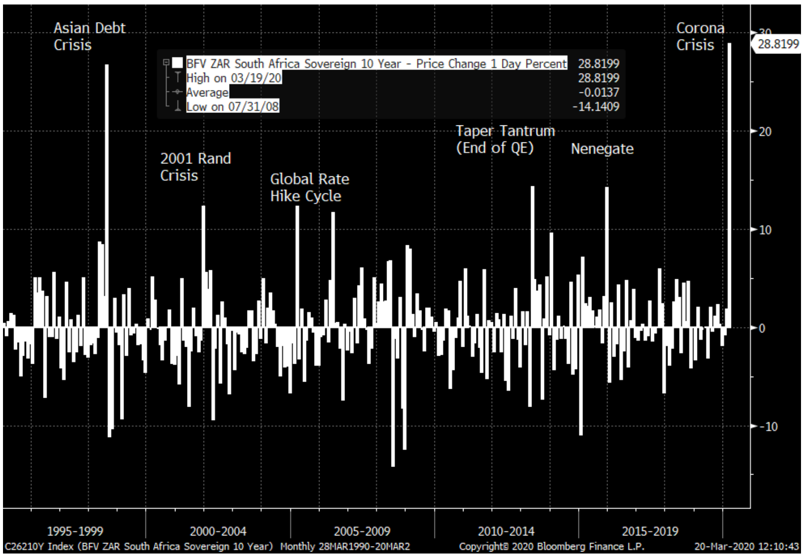
The fund had an unusual quarter as the COVID-19 crisis caused a sharp drawdown across local and global markets in March as assets were sold indiscriminately. Our 10% holding in SA government bonds was a significant detractor. International bonds also came under pressure due to the sell-off in emerging market (EM) assets. The broad-based nature of the risk off move meant that even the relatively small positions in convertible bonds, property and preference shares had a significant impact on the fund’s performance. The portfolio’s conservative position in floating rate notes, short term inflation-linked bonds and FX exposure did provide some help to the fund. While the performance has been very disappointing, the market moves were amongst the most extreme we have seen, rivalling that of the financial crisis of 2008.

Over the longer term the Nedgroup Investments Flexible Income Fund has delivered on its mandate to outperform cash with a predictable and low risk return profile. Its long-term 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. While we are very disappointed with the performance of the fund over the last month, we are comfortable with the large cash position and the overall credit quality of the portfolio. There is some evidence of market stabilisation and we expect a recovery in the local and offshore bond positions. With the yield on the fund moving up over the last month and asset prices recovering, we anticipate a recovery in performance in the coming quarter.

Market Commentary

The global markets experienced a financial crisis in March as the COVID-19 pandemic forced countries to implement lock downs. With economic activity constrained for the foreseeable future, a global recession is unavoidable. The depth and duration of the recession will be dependent on the ability to function while at the same time containing the spread of the virus, until either a vaccine or herd immunity is developed.

Cash and money markets were the only positive return asset classes in SA during March. The bond market experienced its worst sell off since the EM Financial Crisis of 1998. Yields rose around 300 basis points at their worst point, before ending the month around 200 basis points higher after the SARB stepped in with a bond purchase (QE) program.



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

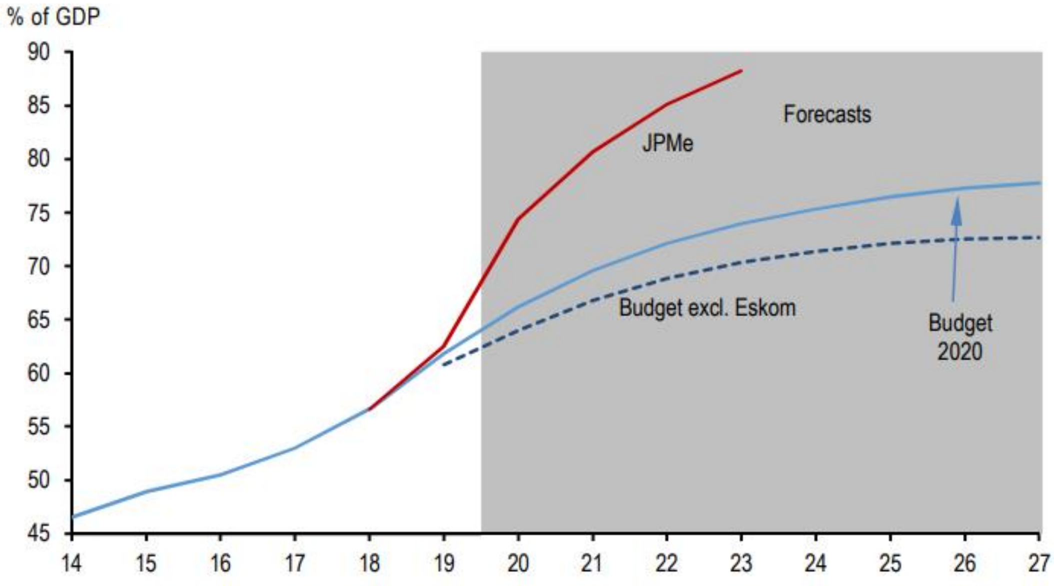
The ALBI delivered a return of -8,7% for the quarter, even as the SARB cut rates 100 basis points at a surprise meeting. The Inflation-Linked Bond Index fared even worse due to its high weighting to long duration bonds. The ILB Index returned -16,8% for the quarter as the lack of liquidity during the month caused a sharp repricing. The rand depreciated by 27,4% against the US dollar over the quarter, and 19% on a trade weighted basis The All Share Index started selling off on 20 February, experiencing a drawdown of 34% by mid-March, but then recovering to end the quarter down 21%. The nature of the lockdown has left listed property absorbing a large portion of the economic pain. The SAPY was down 36% for the month and 48% over the quarter.

Moody's Review

On Friday the 27th March Moody's implemented the long-anticipated downgrade of South Africa's local and foreign currency debt rating to Ba1, losing our investment grade status. Given the significant deterioration in the country's fundamentals, the move was inevitable and largely anticipated by the market. A more unexpected move by Moody's, was that they retained the negative outlook on the new rating.

The four factors Moody's (and other ratings agencies, at different weightings) look at when assessing the credit rating of a sovereign are growth, fiscal and institutional measures, and a country's vulnerability to shocks. South Africa's growth and fiscal metrics have deteriorated to a point where, despite stronger scores on other factors, our overall rating has moved down. While many countries will experience this deterioration as a result of COVID-19, our default risk as a country is significantly elevated given our poor starting point. Our poor growth and inflexible fiscus created an unsustainable debt position even prior to the pandemic, but now these projections are reaching critical levels.

Economists are forecasting double digit budget deficits for FY20/21, with growth for 2020 to conclude somewhere between -4% to -7%. That means our debt-to-GDP trajectory estimates over the medium term are approximately 10% higher than that projected in our already poor budget in Feb 2020, taking us from 65% projected for FY20/21, to around 75%. Now, there are serious questions being posed around South Africa's ability to finance this budget deficit at manageable costs.



Source: National Treasury, J.P. Morgan forecasts.

The negative outlook on the new rating means that over the coming months, we could move deeper into junk status. Moody's communicated that this outlook could change to stable if fiscal consolidation is broadly in line with their current expectations, which includes a "slow but durable" growth improvement and financing risks staying low. They expect a 2.5% GDP contraction in 2020, and a gradual compression in primary fiscal deficits over the medium term. Generally, their estimates appear slightly more optimistic than many economists are forecasting (see previous paragraph), so we may well disappoint on this front.

The biggest implication of the current downgrade away from investment grade classification, is that South Africa automatically gets excluded from the World Government Bond Index (WGBI), and the size of the outflow and the implications of this on bond prices have been largely speculated over the past few months. Estimates of the outflow size range between $1bn and $12bn, but our estimate is toward the bottom end of this range. We had previously indicated that the effect of the outflows would very much depend on the global environment. A downgrade last year, when global markets were rallying and risk premiums were low, would likely have had minimal impact on bonds prices (20-40 basis points). However, the timing of the downgrade means that the impact may be potentially bigger. The fact that the WGBI rebalance has been postponed to the end of April (as opposed to the end of March) due to the levels of global market turmoil, and the fact that the SARB is intervening in the local bond market, will however assist in spreading out the flows and mitigating some price effect.

This downgrade, and potential further downgrades later this year, may cause some reaction, but in the bigger scheme of what is happening in global markets, it is not what we are looking at in determining further significant moves in bonds. Rather, it is further effects and policy responses around the COVID-19 pandemic, as well as economic structural reforms that will form our view. In the absence of decisive growth and fiscal interventions, as we are currently experiencing, the local funding pressure will persist, and we will keep demanding this massive risk premium on bonds.

Emerging Market Currencies Hit by Public Health Crisis

For the rand and its peer currencies the Public Health Crisis has been the catalyst for a sudden-stop in liquidity. The Federal Reserve, now the lender of last resort to the world economy, has moved to shore up most US dollar-denominated assets around the world. EM however have unfortunately been left in the lurch. The incentive for global investors to invest in EM is as a result greatly diminished. Year-to-date the rand, along with the Mexican peso and Brazilian real, have given up 23% of their value. Indonesia, India and Turkey's currencies have fared somewhat better.

What is clear is that the health crisis we face requires strong government intervention to save lives and shield individuals and businesses from the inevitable loss of income that the crisis brings along. There is no question that the lockdown comes with large short-run economic costs. We would argue however that delaying a response comes with more protracted economic costs further down the line as a laxer approach now will lead to more uncertainty and stringent measures. This has certainly been reflected in the performance in Brazil and Mexico where both leaders Bolsonaro and AMLO have been very reluctant to act.

Country	GDP 2019 %	Budget Balance (% of GDP)	Vulnerability Rank (Higher = Worse)	FX YTD Perf. (%)	Covid-19 Policy Response
Indonesia	5.0	-2.0	1	-14.7	Aggressive
India	6.1	-3.8	2	-6.5	Aggressive
Mexico	-0.1	-1.6	3	-23.0	Limited
Turkey	0.2	-3.1	4	-12.3	Moderate
Brazil	1.1	-5.9	5	-23.0	Limited
South Africa	0.1	-6.3	6	-23.5	Aggressive

Source: Bloomberg, Abax

We have seen governments the world over, move rapidly to ramp up relief spending and loosen monetary policy to mitigate a deep global recession. Developed markets have certainly led the way in this regard, but emerging markets too have been attempting to intervene. Unfortunately, many emerging markets have very little room to spend, with growing debt levels a binding constraint. A simple vulnerability score based on 2019 GDP and Budget Balance shows that SA is in a particularly tight spot. The SARB for its part did a 100 basis-point reduction in the repo rate and moved to purchase government bonds to stabilise bond yields. These emergency measures make sense in the immediate, but if too much reliance is placed on these stop-gap measures, further devaluation in the rand is likely.

It's unclear how we will square the circle of tackling the humanitarian crisis while stabilising the economy. This is going to require some extraordinary measures, and most likely IMF help. Unfortunately, Minister Mboweni has been conspicuously silent in this time of crisis. Without a credible plan to fund our fiscal deficit there is little reason for global investors to warm to rand assets. Until that happens the rand will remain under pressure.

Current positioning and outlook

- Low Duration

As of end of Q1 2020, SA duration is 0.67 years in nominal bonds and 0.14 years in Inflation-Linked Bonds. This is due to our 10% weighing in the SA 10 Year bond. While SA bonds offer value at these levels and an attractive yield, the risk to the SA fiscus has shifted fundamentally higher due to the crisis. We will therefore look to maintain a relatively conservative position to bonds and increase our preference for Inflation Linked Bonds.

- High Credit Quality

The portfolio has a high degree of credit quality. The 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.

Overall corporate credit spreads have widened from expensive levels but given the deterioration in the economic outlook and the impact on corporates, we expect further weakness. We retain our preference for senior bank debt and government paper.

- Convertible Bonds

Our convertible bond exposure came under pressure due to the sell-off in the underlying shares. However, the yields are now attractive and upside participation has value. We have historically added value through this asset class as it provides a mix of yield and capital appreciation. We believe that convertible bonds can provide an inflation hedge, so in this new environment we will look for opportunities to add to this asset class.

- Property

The fund currently has 1.48% exposure to a diversified pool of domestic property assets. We have maintained a conservative exposure and chosen not to add despite the weakness. The levels of debt and reduced economic activity make the yield outlook highly uncertain. From an income perspective, we would only look to add once we see strong evidence that the economy is reopening.

- Preference Shares

Preference shares exposure is conservative at 2,24%, with the majority in the Big 4 banks. Given the systemic nature of the banks, we believe that the SARB will do everything possible to help them navigate the crisis. We are comfortable with the capital value and the post-tax yield of 12% is very attractive in this environment.

- Offshore Cash and Money Market

The fund maintains an exposure to offshore cash & money market instruments at 17% (effective currency exposure is 5.8%) where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality. We have been increasing our FX exposure as the rand remains vulnerable. The offshore exposure has weighted average term of 1.2 years and given the increasing risks we will continue to maintain a conservative positioning.

Summary and Conclusion

We must remember that while SA's fiscal position is dire, the entire world is dealing with the COVID-19 crisis, and deficits and debt are a global problem. Bonds had already de-rated significantly. Our spread to emerging market peers had moved up from 2% to around 3% as the market moved to price in the downgrade. The crisis has resulted in the sharpest bond move on record, the only comparable being the Asian crisis of 1998. We currently hold 10% of government bonds in our funds, with a yield of around 11%. This is a substantial risk premium given the SARB is likely to cut rates aggressively. We will maintain this position as we believe the risk premium is adequate, and we will look to add further bond exposure in the inflation linked space as we get the opportunity. If we continue to see the lack of follow-through from Treasury and the Cabinet, we will look to mitigate the risk of a debt crisis by reducing bond exposure or increasing FX exposure from its current levels.

Disclaimer

WHO WE ARE
Nedgroup Collective Investments (RF) Proprietary Limited is an authorised Collective Investment Scheme and the representative of Nedgroup Investments Funds PLC in terms of the Collective Investment Schemes Control Act. It is a member of the Association of Savings & Investment South Africa (ASISA)..

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HOW ARE OUR FUNDS PRICED
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
A schedule of fees and charges is available on request from Nedgroup Investments. One can also obtain additional information on Nedgroup Investments products on our website.

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Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

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