NEDGROUP INVESTMENTS

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# NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter Two, 2020

## Nedgroup Investments Flexible Income Fund

| Performance to 30 June 2020 | Fund Performance[1] | Stefi*110% |
|---|---|---|
| 3 months | 3.9% | 1.2% |
| 12 months | 5.8% | 6.61% |

The fund had a strong quarter, as global and local markets largely regained their losses experienced in Q1 of this year. All asset classes in the fund contributed to this gain, but our position in the 10-year government bond and inflation-linked bonds contributed most of the fund's return. Our floating rate notes continue to generate consistent yield and smaller allocations to property, preference shares and convertible bonds also attributed positively. The only detractor would be our US dollar exposure, as the rand recovered some of the losses experienced in Q1 but is still nowhere near pre-COVID-19 crisis levels.

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.

**Market Commentary**

The second quarter of 2020 saw global markets experience an exceptional rebound from the March lows brought on by the COVID-19 pandemic. Equities soared with the FTSE/JSE All Share index returning 23.2% and the MSCI World returning 19.5%. Incredibly, the NASDAQ is now up 13% year to date having returned 30.9% for the quarter. Local bonds similarly experienced this recovery with the ALBI generating 9.9%, and linkers 17.7%. Offshore bonds yields remain at ultra-low levels, and real yields have now reached multi-year lows.

The bullish trajectory of global markets has however felt disconnected from the harsh economic realities so many corporates and sovereigns are still experiencing because of this crisis. Some signs of economic activity and recovery are present, but this rally is attributed to the unprecedented actions of policy makers. Governments have massively increased spending while global central banks have provided unprecedented levels of monetary policy support. The Fed has taken the lead in terms by cutting rates aggressively close to 0% and engaging in QE (creating new money to purchase debt). They have purchased $1.7trn of federal debt and promised to buy up to $750bn in corporate debt and $500bn in state and local government debt. They are offering support to commercial paper markets, money-market funds, foreign central banks (through swap lines) and to small-to-medium-sized businesses (through loan purchases). The Fed's balance sheet is now just shy of $7.2trn (see chart below). QE has historically only been an acceptable policy tool for developed market central banks, but in this crisis, we have for the first time seen emerging markets broadly make use of it.

These central bank interventions have allowed markets and businesses to function under a time of severe stress, but the long-term implications are still largely unknown. The propping up of financial markets can destroy the market's ability to allocate capital efficiently. Given the massive expansion of central bank balance sheets, we question whether people will still view currencies, even dominant ones like as the US dollar, as a safe place to store wealth. The effects of this round of QE on inflation is one of the largest debates in the market at present. Intuitively new currency created should lead to higher prices. However, the money created by QE after the great financial crisis (GFC) in 2008 largely found its way into asset prices. This round of QE has again provided an immediate boost to asset prices, but this time we have also seen much larger proportion of QE finding its way to the man on the street. The massive cash injection to households will help offset the deflationary effect of the economic contraction brought on by COVID-19. Themes such as deglobalisation and domesticating supply chains can also be inflationary if they play out and must be monitored. Despite the uncertainty, we know that the possibility for broad inflation is certainly back on the table and we need to manage our portfolios accordingly.

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

**SARB Intervention**

The SARB has been one of the emerging markets undertaking QE, albeit on a very conservative scale to date. They have been purchasing government bonds in the secondary market, to ensure market liquidity and functioning, and through this mechanism have increased their balance sheet by R35bn since the crisis started. The market has so far been very comfortable with the level of purchases and considered approach taken by the SARB. Governor Kganyago has spoken prudently about the playoffs between cost and inflation when performing QE. If investors begin to question the willingness of the SARB to be responsible and stick to its inflation mandate, one will see capital outflows and a weakening of the currency This will be negative for investment and the long-term growth prospects of the economy.

**SA Budget update**

South Africa's debt trajectory was already problematic before the crisis, and the supplementary budget delivered by Minister Mboweni on 24 June highlighted just how dire the fiscal situation has become. The supplementary budget was necessitated to reprioritise public spending as a result of the COVID-19 pandemic. The 2020/21 fiscal year is expected to now print a 14.6% main budget deficit, compared to the 6.8% projected in the February budget. Our debt to GDP ratio is currently 82%, more than 15% above what it was projected to be, and frustratingly almost 22% of revenue is now going purely to servicing debt. Treasury believes there will be a tax revenue shortfall of R304bn, but details on expenditure cuts were still vague. They are looking to introduce zero-based budgeting in an effort to curb expenditure, and the document notes that R230bn of expenditure cuts are needed in the next two years, on top of the R160bn of savings on public sector wages pencilled into the February Budget to stabilise our debt to GDP ratio (the active scenario in the image below). The lack of implementation of such cuts and proper reforms means the debt to GDP continues to drift higher (the passive scenario in the image below), and we find ourselves in a debt trap.

The implementation risk around expenditure cuts of this size is significant, and the political willingness to make difficult decisions on reform have yet to be seen by government. Even at this important juncture they are willing to fund non-essential public entities such as SAA. Should we see measures start to be taken to stabilise this debt trajectory, we would feel more positive on SA government bonds and be willing to take on higher nominal duration at these yields, but the current fiscal path signals large insolvency risk that will eventually need to be addressed either through restructuring or through running higher inflation.

**A Fragile Global Economy**

We must note that the COVID-19 crisis is not alone responsible for the financial crisis we have found ourselves in, but rather the fragility of the system caused by elevated levels of global debt prior to the onset of the virus. It's the reason why so many consumers and businesses became insolvent in an economic shutdown that lasted only a few weeks, and why trillions of dollars of stimulus were necessary so quickly, exacerbating these debt levels further. Traditional debt cycles allow recessions to be addressed by interest rate drops, and fiscal stimulus. However, this time it's different, as arguably the worst recession of our generation has hit at a time when those tools have been exhausted. History has shown us similar occurrences in the past and are usually followed by large deleveraging events that typically involves yield curve control/QE to generate a currency devaluation, allowing smoothing of such a big, systemic adjustment.

**Portfolio Commentary**

Current positioning and outlook:

*Low Duration*
As of end of Q2 2020, SA duration is 0.41 years in nominal bonds and 0.44 years in inflation-linked bonds. This is due to our 6.6% weighing in the SA 10-year bond. While SA bonds still offer value at these levels and have 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. 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. Overall corporate credit spreads have widened from expensive levels since the onset of the COVID-19 crisis, but we believe further weakness can be seen should economic activity continue to lag. We retain our preference for senior bank debt.

*Convertible Bonds*

Our convertible bond exposure to Royal Bafokeng offers a very attractive payoff profile, with a good yield and upside participation should the asset move through the strike. 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, although the local convertible market remains small.

*Property*

The fund currently has 1.62% exposure to a diversified pool of domestic property assets. We have maintained a conservative exposure and chosen not to add significantly despite the weakness. The levels of debt and reduced economic activity make the yield outlook highly uncertain, and for the time being would rather selectively allocate to names who are not highly leveraged.

*Preference Shares*

Preference Shares exposure is conservative at 2.44%, 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 8.7% is very attractive in this environment.

**Offshore Bonds & Money Market**

The fund maintains an exposure to offshore bonds and money market instruments at 17% where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality. We have built a position in US tips, given our view that US inflation may result from substantial QE. Our FX exposure is around 5%, allowing us to participate in rand weakness, should further weakness occur.

| Portfolio Positioning | |
|---|---|
| w.a. Gross Yield* | 6.8 |
| Modified Duration | 1.24 years (0.85 local/0.39 offshore) |
| Effective Currency Exposure | 5.02% |

*Not converted to Rand based yield. 12-month projected yield on property based on current distributions which may go up or down. Assumes inflation of 4.5% for inflation linked bonds.

**Summary and Conclusion**

Global markets have largely recovered their losses experienced in Q1 of this year, but economies and corporates are still experiencing the harsh effects brought on by this crisis. Central bank stimulus has propped up financial assets despite the fundamentals, and we need to guard the portfolio against this disconnect. For this reason, we remain focused on our diversified alpha process, which is built upon the principles of risk diversification, and ensure our bets are calculated and moderate. We remain confident in the credit quality of the portfolio and have done a full review of all credit subsequent to the crisis to ensure our views remain relevant in this time of stress. We continue to hold a moderate allocation to nominal government bonds, as the yield and risk premium offered is attractive; but given the increase in risk of these assets due to the sovereign's deteriorating fiscus, this holding will remain moderate at these levels. We will continue to build our position in inflation linkers, as we are currently able to buy these at very attractive real yields and should inflation return to reasonable levels, provide a very attractive yield to the portfolio. Should SA run a higher level of inflation to reduce real debt levels, these linkers will be particularly attractive and act as a form of protection in this scenario.

# 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)..

OUR TRUSTEE
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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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