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NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter Four, 2021

Nedgroup Investments Flexible Income Fund

Performance to 30 September 2020	Fund Performance[1]	Stefi*110%
3 months	2.2%	1.0%
12 months	8.2%	3.9%

The fund had a strong Q4 performance, outperforming its benchmark. All asset classes contributed positively to performance over the quarter, with the offshore component doing particularly well given the weakening of the ZAR.

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

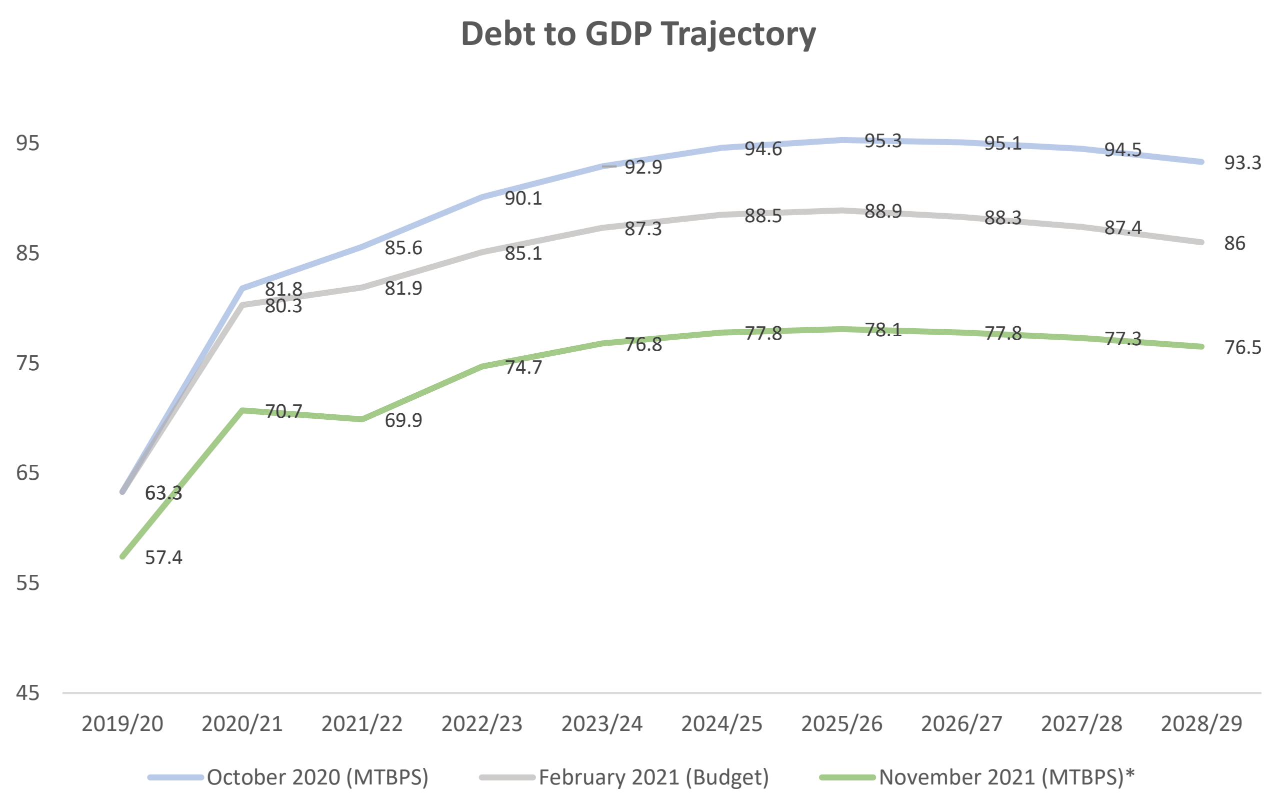
The global economy rebounded from the COVID19 recession in 2021 stronger than many anticipated, with most global stock indices now at, or close to, all time highs. This asset price inflation is easily attributed to the unprecedented monetary and fiscal stimulus applied globally since the onset of the crisis, with new highs reached despite COVID19's continuous mutations and lockdown curveballs. Even as the Omicron variant dominated headlines over the last few weeks of 2021, we saw the markets rally into year end, with the S&P 500 returning 11.0% for the quarter and 28.7% for the year. Local equity markets performed similarly well, with the ALSI returning 15.1% for the quarter and 29.2% for the year, while listed property returned 8.3% for the quarter and an impressive 36.9% return for the year. Despite tighter monetary policy, local bonds also returned a positive 2.9% for the quarter and 8.4% for the year. Higher inflation concerns however allowed local inflation linked bonds to outperform nominal bonds, generating 5.0% for the quarter and 14.9% for the year.

Easy monetary policy officially started coming to end in the fourth quarter of 2021. The Fed began winding down its $120bn-a-month bond-buying program in November, saying it would reduce the stimulus by $15bn a month. However, inflation printing 6.8% YoY in November, an inflationary pace not seen since 1982, increased pressure on the central bank policy-makers to take further action and the stimulus will now be reduced by $30bn a month starting in January 2022. Broad money supply growth, coupled with a period of constrained resources have certainly proven that inflation is not transitory, and even the Fed themselves have admitted as much. While the contributing factors to inflation have been fairly broad-based, energy prices (oil) were a big factor. With faster tapering, and rate hikes now expected by mid-2022, the Fed were clearly behind the curve, but likely preferred higher inflation to significant asset price deflation, something they certainly cannot afford.

On the local front, the quarter was characterized by our first rate hike of 25bps in November from the multi-decade lows of 3.5%. The MPC communicated the start of what will likely be a gradual hiking cycle, with their models projecting a 25bp hike at every MPC in 2022. While local inflation has been largely subdued, the November CPI release of 5.5% along with somewhat higher expected prints in the short-term, sparked the need for the hiking cycle to begin. Inflation is however expected to again moderate with the early 2022 prints, moving back down toward the midpoint of the target band. There is no indication that South Africa is experiencing persistently high inflation; a clear exception to what other economies are experiencing. Sadly, this is largely attributed to the lack of local economic growth and risks to this are skewed to the downside going forward, with COVID19 and related lockdown effects having further delayed the growth recovery. Given this, the gradual nature of the hiking cycle is necessary, and may even turn out to be slower than the SARB's projections.

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

Despite a poor growth outlook, positive news could be found in the November MTBPS. Notable tax revenue overruns (due to strong commodity prices) and reasonably contained spending means the MTBPS saw the South African fiscus look in much better shape than anticipated in the February budget, and significantly better than what was forecast in the 2020 MTBPS. These differences can be seen in the debt to GDP trajectories, where the 2021 MTBPS debt trajectory looked significantly lower than that set in the February 2021 budget and 2020 MTBPS:



**A GDP rebasement took place prior to the November 2021 MTBPS, which also contributed to a lower debt to GDP ratio*

While it is difficult to see the fiscus continue this consolidation in the absence of high commodity prices, due to expenditure pressures, continued SOE support and lower growth all hampering tax revenues, we can concede that relative to many other emerging markets we are no longer on the precipice of a fiscal cliff and have managed to buy ourselves time. This better fiscal picture does not coincide with the large risk premium priced into local government bonds, and we remain bullish on this asset class.

SA's current account is expected to moderate to around 2.9% in the last quarter of 2021, given the deterioration in SA's terms of trade on the back of lower coal and iron prices and higher oil prices. This dynamic largely explains the weakening in the currency and further weakening is plausible as SA's current account surplus gradually moves lower, likely dropping back into deficit territory by the end of year. We are less bearish on the ZAR than previously, given its weakness over the year, and currently view it around fair value.

Current positioning and outlook

- Moderate Duration

As at the end of Q4 2021, SA duration is 0.86 years in nominal bonds and 0.30 years in inflation linked bonds. We continue to predominantly hold the SA 10 Year nominal bond (R2030) and 5 Year SA inflation linked bond (I2025), but also have exposure to longer term government nominal bonds, as the yield curve remains steep. Yields on nominal bonds remain at attractive levels and are pricing in a SA risk premium that we believe more than compensates for any fiscal risk; we therefore further increased our duration over the quarter. Inflation linked bonds generally appear more fairly priced than nominal bonds but provide a nice hedge should these fears escalate over the coming months, and we maintain exposure in the short end.

- High Credit Quality

The portfolio has a high degree of credit quality. Our credit process has historically shielded the fund from capital loss due to credit events in SA and we are confident in our ability to protect investor's capital in the fixed income space. We retain our preference for a diversified portfolio of senior bank debt and low risk / high grade corporates.

- Convertible Bonds

Locally, we maintain a 30bp position in the Sappi convertible bond. Additionally, we maintain a 1.7% exposure to some offshore convertible bonds. We continue to look for opportunities in this space, but given the strength of equity markets, it remains on the expensive side.

Property

The fund currently has 2.7% exposure to domestic property. We have maintained a conservative exposure, as the levels of debt and reduced economic activity maintain an uncertain outlook for the sector. We continue to selectively allocate to names who are not highly leveraged and where liquidity is sufficient.

- Preference Shares

Preference Shares exposure is conservative at 2.9%, with the majority in the Big 4 banks. The pre- and post-tax yield remains attractive in this environment. Institutions buying back their preference shares has allowed this asset class to rally dramatically over the past few months, as this trend is expected to continue.

- Offshore Bonds & Money Market

The fund maintains an exposure to Offshore Bonds & Money Market instruments at 19.1% where a very attractive yield pickup over domestic assets is available when hedged back to ZAR while maintaining a high degree of credit quality and diversification. Our effective offshore exposure is at 6.7%; this was reduced over the quarter as the ZAR continued to weaken against the USD to fairer levels. Our offshore exposure is however still higher than our neutral position, as it provides a nice hedge to the healthy duration in the portfolio. Should the currency continue to weaken, however, we will endeavour to protect the portfolio against rand strength and continue lightening our exposure.

Summary and Conclusion

Ultra-loose monetary and fiscal policy stimulus enabled a strong year for asset markets in 2021. Over the course of the year we've spoken about reflation, stagflation and stimulus, but what's clear is that by the end of 2021 we've just ended up with just good old inflation. The non-transitory kind. Global central banks have taken note, but markets so far have largely ignored the introduction of tighter monetary policy toward the end of the year. What is for certain, however, is that 2022 will experience significantly more tightening, both in terms of asset purchases and potential rate hikes. A cautious approach is warranted, as foreseeably a more challenging year may play out given this stimulus withdrawal and the high overall starting market valuations.

We do, however, see a lot more opportunity in the local fixed income market. Local government bonds (nominal in particular) are offering exceptional yield in a muted local inflation environment and where fiscal risk is reduced given the significant tax revenue overruns. The global backdrop may make a rally in any EM bonds difficult, but with an exceptional running yield and the view that over time the search for yield in an otherwise expensive global environment may generate demand, we are happy to be patient.

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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DATE OF ISSUE
16 October 2019