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NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter Two, 2022

Nedgroup Investments Flexible Income Fund

Performance to 31 March 2022	Fund Performance[1]	Stefi*110%
3 months	0.8%	1.2%
12 months	5.2%	4.2%

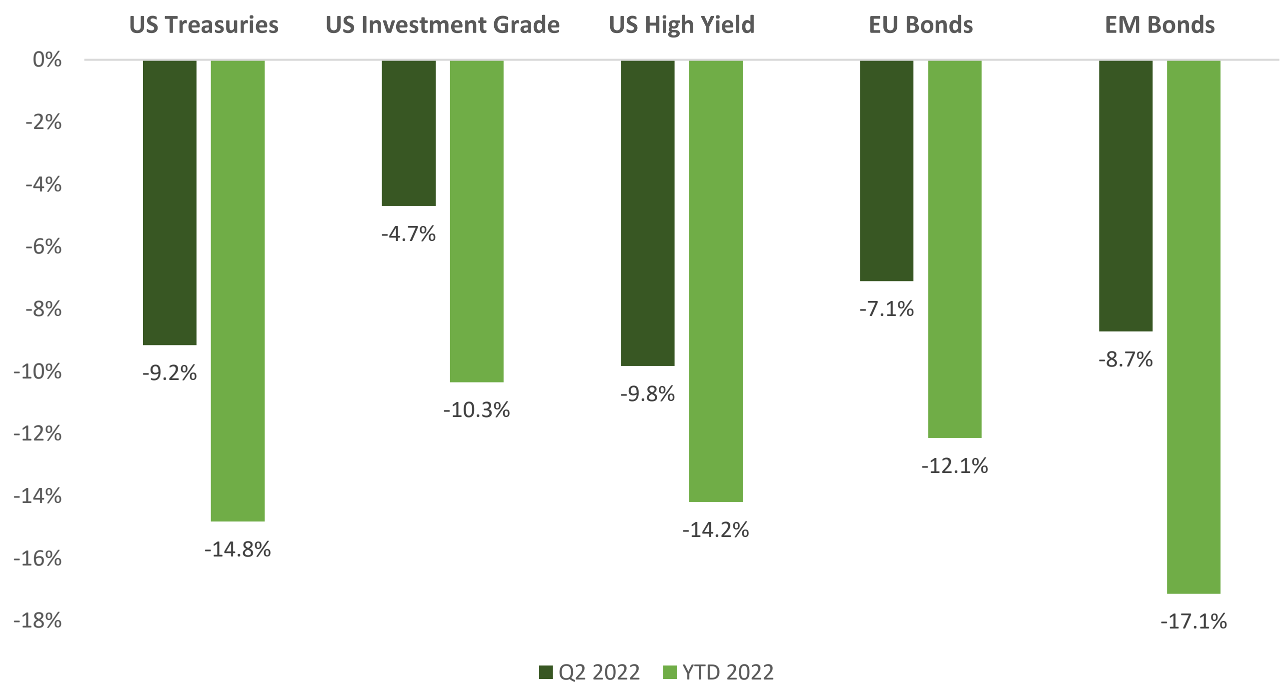
The fund performed adequately, over what was another difficult quarter for fixed income markets, despite slightly lagging the benchmark. Poor performance in both local and offshore bonds, as well as a significant pullback in property detracted from returns, while a weakening ZAR and higher resetting floating rate instruments contributed positively, successfully shielding the portfolio from a lot of the market volatility felt over the quarter.

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 signature. 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 2022 was characterized by further extreme global market volatility, as global inflation continues to escalate, and recessionary fears took hold across markets in anticipation of further central bank action.

The S&P 500 returned an awful -16.1% for the quarter, with broader global developed market stocks experiencing similar pain (the MSCI World index returned -16.1% in USD). Global bonds, after a poor Q1, experienced another dreadful quarter, with negative returns not seen in decades. The extent of the drawdowns in bonds across the world can be seen below[2]:



[1] Net return for the Nedgroup Investments Flexible Income Fund, A class. Source: Morningstar (monthly data series).
[2] Indices used include LGTRTRUU Index, LBUSTRUU Index, LF98TRUU Index, LBEATREU Index, EMUSTRUU Index (from Left to right)

In the US, another higher-than-expected CPI print of 8.6% pushed fed funds expectations higher. The FOMC responded promptly the following week, raising the federal funds target range by 75bps to 1.5%-1.75%, with the Fed's dot plot showing a median projection for 3.25%-3.5% for year-end rates. Upward pressure is coming from a variety of areas within the CPI basket, not only food and energy. May's CPI number saw strong readings on tenant's and owner's equivalent rent, higher airfares as well as additional new and used vehicle price increases. The US 10Y reached a high of almost 3.5% in June. The last week of the quarter, however, proved interesting as yields across the curve rallied in response to increased recessionary concerns, taking the 10Y down to 3%. The market is starting to believe that the fed might not be able to hike as aggressively into a weak economy. The Atlanta Fed, through their GDPNow estimate, revised their Q2 2022 real GDP figure down strongly to -1%, indicating a recession is possibly closer than what was previously anticipated. This would be the second quarter of negative real GDP prints, a technical recession if true.

With inflation and higher interest rate expectations being felt around the world, central banks everywhere are having to respond, and this poses a particular problem for exceptionally geared nations. The ECB is one, now preparing to hike rates for the first time in over a decade in the July meeting, after calling an emergency meeting in June. This meeting highlighted just how precarious a position they find themselves in, as many economies within the EU will struggle to afford the effects of higher interest rates. They announced their "anti-fragmentation" policy, a new label for what is essentially quantitative easing (which was previously announced would be ending), that will keep bond yields of certain regions artificially low through bond purchases. Continued "QE" and concerns around potential gas supply problems are haunting Europe, and this could significantly affect the ECBs monetary policy trajectory and their ability to be hawkish. These concerns are being seen clearly in the currency (EUR), which is trading at almost parity to the USD. Different, but equally large, problems are haunting Japan where despite dovish policy (and ignoring inflationary pressures as transitory), the central bank has had to implement a massive increase in its bond purchasing program as pressure from rising global rates threatened the yield cap currently in place. This in turn has resulted in the yen reaching a 24-year low, a real problem for Japanese policy makers, as it flames inflation and hurts the consumer.

Emerging markets were no exception to the selloff, with the MSCI EM index returning -11.4% in USD for the quarter. Locally, our equity indices fared slightly worse than the EM index, with the FSTE/JSE All Share Index returning -11.7% - the pullback in resource stocks contributing largely to that figure. Local bonds returned -3.7% for the quarter, struggling off the back of higher developed market rates and depressed local growth expectations. Listed property also struggled, with a -11.5% return. Inflation linked bonds, on the other hand, performed better (+3.0%) as short-term inflationary pressures build locally.

Over the last few days of the quarter, and first days into July, South Africa started to experience one of the worst loading shedding periods since 2019, with national stage 6 schedules announced on the back of Eskom employee strikes. Local bonds moved significantly off the back of this, with the SA 10Y moving from 10.5% on the 23rd June to just under 11% by quarter end, this at a time where US rates were actually rallying. Similarly, the ZAR came under significant pressure, losing 11.4%, to end at R16.28/$ for the quarter. The Nedbank economist estimates that every 1000MW of electricity not available for an entire year, impacts GDP by 40bps. This means that Stage 6 loadshedding shaves 0.6bps of growth everyday it is in place.

Local May CPI also saw a large upside surprise with inflation printing 6.5%, inflation is breaching the upper limit of the target band for the first time since 2017. Food inflation was the biggest contributor to the upside surprise and increases the risk around inflation expectations and wage demands going forward. This upward surprise alone adds around 0.4% to the year ahead inflation forecast, so it is no wonder that this move, along with increased price expectations in certain CPI buckets, has seen local CPI forecasts move considerably higher, with many expecting a peak in October at around 8%. This probably means the tightening path currently followed by the SARB will continue at an increased pace. We expect 75bps and 50bps hikes in July and September to now follow. These measures will add stress to an already growth depressed economy, now further exacerbated by unprecedented loadshedding. This does not paint a strong picture for the SA economy in the next few months.

Current positioning and outlook

- Moderate Duration

As at the end of Q2 2022, SA duration is 0.9 years in nominal bonds and 0.3 years in inflation linked bonds. We continue to predominantly hold the SA 8 Year nominal bond (R2030) and 3 Year inflation linked bond (I2025), but also have exposure to longer term government nominal bonds, we still believe the yield curve can flatten in this current rising interest rate environment. Despite weakened growth expectations, there are no short-term fiscal concerns around SA, and the large risk premium priced into SA government bonds remains unjustified. We are therefore still bullish on these bonds, particularly nominal bonds. Inflation linked bonds look largely fairly valued but short-term inflation pressures and their excellent diversification properties mean the current exposure is still warranted.

- 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 20bp position in the Sappi convertible bond. Additionally, we maintain a 0.7% exposure to some offshore convertible bonds. We continue to look for opportunities in this space, but currently yields are low compared to nominal bonds, with increased uncertainty from a share performance and balance sheet point of view for many counters in this environment.

- Property

The fund currently has a 2.5% exposure to domestic property. We have maintained a conservative exposure, as the levels of debt and reduced economic activity remain a concern for the sector. We continue to selectively allocate to names who are not highly leveraged and where liquidity is sufficient.

- Preference Shares

Preference share exposure remains at 3.1%, with the majority in the large banks. The pre- and post-tax yield remains attractive and with institutions buying back their preference shares, this asset class has rallied appreciably over previous quarters. We expect the buy-back trend to continue, and although a lot of this expectation is already in the price, we believe there to be additional upside.

- Offshore Bonds & Money Market

The fund maintains an exposure to Offshore Bonds & Money Market instruments at 10.1% 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 net effective offshore exposure is at 5.2%; slightly lower from last quarter as we sold USD into ZAR weakness. Our offshore currency exposure acts as a hedge to portfolio duration and protected the portfolio well over the quarter as bonds and ZAR weakened together. We view the local currency (ZAR) as being slightly undervalued as at quarter end, and will continue to reduce exposure into further weakness, all the while remaining cognisant that this asset class is a valuable diversifier in volatile times.

Summary and Conclusion

After a turbulent Q1, rife with geopolitical risk and inflation fears, Q2 provided another period of extreme global market volatility. Inflationary concerns continue to take centre stage, with markets continuing to experience higher than expected CPI prints. As central banks are having to intensify their efforts in combating inflation, recessionary fears are coming to the forefront. As a result, we have seen significant drawdowns in practically all asset classes. Local news, particularly around stage 6 loadshedding, has also added some idiosyncratic risk to local asset pricing. The flexible income portfolio has performed resiliently to the extreme market moves experienced over Q2, protecting capital and allowing us to deploy cash into undervalued asset classes and enhance the yield of the portfolio going forward. The global macro environment remains highly uncertain, but for the first time in decades there is value being presented in developed market bonds and local fixed income assets are pricing in unjustifiably high-risk premia. We will continue to deploy cash into opportunities that suits an income fund from a risk/return perspective, and as market nerves settle, this should bode very well for futures returns in the portfolio.

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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Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital. Our funds are traded at ruling prices and can engage in borrowing and scrip lending.

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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