Melville Douglas

SA Bond Fund

Fund Review

During the quarter we used the bonds sell off to opportunistically increase the duration position of the fund. At bond yields above 9.0% on the benchmark R186 we were buyers of bonds and we also used the sell off to restructure the sector exposures in the fund. We reduced our long duration exposure to the ultra-long end of the bond yield curve slightly and increased exposure to the belly of the curve. The fund however remains long the ultra-long end of the yield curve and overall its modified duration is slightly longer relative to the ALBI benchmark's modified duration. As a strategy to enhance the fund's performance through yield pickup we participated in new credit issuance auctions and were allocated our full allocation we had bid for. We bought the high-quality Woolworths 3 year floating rate paper when it came to market.

Market Overview

The effects of an escalating trade war between the USA and China was felt by emerging markets with risk assets remaining under pressure throughout the quarter. Coupling this with poor local economic data i.e. poor GDP growth data, the disappointing high frequency economic data and the weak rand collectively dampened risk appetite and we saw foreigners selling local assets in droves during the quarter. In August emerging markets were on the back foot with fears that the developments out of Turkey would have an adverse effect on the EM basket. Turkish President Tayyip Erdogan's appointed his son in law as the governor of the central bank thus further compromising the independence of the central bank and political relations between Turkey and the United States deteriorated to an extent where the US imposed targeted sanction on certain individuals. In the midst of this rout Argentina turned to the International Monetary Fund asking for an early release of funds from a USD50 billion deal to ease concerns that the country will not be able to meet its debt obligations for 2019. The rand swings during the quarter where wide, with the difference between the high and lows at -18%. This on the back of a strengthening dollar and massive risk-off sentiment in response to Turkey and Venezuela's persistent economic problems. It didn't help that Moody's issued a warning about risks to SA's fiscal consolidation plans and President Trump's comment via twitter on South Africa's land reform policy debate.

Despite the concerns about oscillating trade tensions between USA and China, September was a better month for EMs compared to August's indiscriminate sell-off. The central banks in key EMs raised interest rates, whilst the SARB opted to leave rates unchanged. The decision was a close call though, with three members of the seven-member committee voting for a rate hike. In its meeting the SARB revised its inflation forecast upward and sees inflation moving away from the target midpoint but remaining within the 3.0% – 6.0% target band until 4Q.

Looking Ahead

Our interest rate view has now changed and we now see the SARB keeping rates on hold at 6.50% for the remainder of the year but raising rates by 50 basis points in the next 12 months and as such we will reduce the duration of our bond fund as bond yields rise. We believe the below factors will weigh heavy on our capital markets and the rand in the near term: -

- Tightening global financial conditions
- Tariff standoff
- Credit rating agents decisions
- Domestic politics ahead of general elections