Quarterly Commentary as at 30 September 2017

MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

Bond Fund

Quarterly Commentary

The Fund finished slightly ahead of its benchmark in September, delivering a return of -1.05% versus -1.08% for the ALBI, as bond yields traded sideways during the month. Investment markets domestically lost some ground in September. There were both global and local factors. It became evident that the path for US policy interest rates was going to be more restrictive than previously thought. The immediate result was a sell-off in global bonds as well as a strengthening in the USD. The geopolitical tension between North Korea and the United States also added to the uncertainty and resulted in emerging market currency weakness.

Domestically, risk to fiscal consolidation continued to dominate with two foreign banks declining to continue lending money to South African Airways (SAA) and National Treasury being compelled to step in to provide the funds to enable SAA to repay Citibank. Failure by SAA to meet this debt obligation would have triggered triggered a call on the guarantee exposure totaling ZAR 16.4 billion, leading to an outflow from the national revenue fund and possibly resulting in elevated perceptions of risk related to the rest of SAA's guaranteed debt. Unfortunately, these events escalate concerns over the governance of state-owned enterprises and the potential threat they pose to fiscal stability, a factor that credit rating agencies have long cited as a major concern. Despite weaker growth the South African Reserve Bank, in its September meeting, decided to keep interest rates on hold at 6.75%, citing an elevated risk to sovereign credit downgrade and heightened levels of political risk ahead of the ruling parties elective conference schedule for later in 2017.

For SA investors, the economic news is likely to remain poor, with an economy which is struggling under the burden of high interest rates as a result of politics and the resulting credit rating downgrades. At present, we are left with a recession, soft domestic demand and a confidence crisis that is undermining investment in productive capacity. The recession was not inevitable and there's a considerable weight of politics having an impact on consumer and business decision-making. And yet the economy could easily produce a strong recovery. The credit cycle has been very weak and bank balance sheets are very healthy – it would not take much to spark improved growth, especially given the strong and still improving external conditions. It's hard to know if a simple change of political leadership would be a sufficient condition. The recession is a reality that has already been priced in – the debate now is mainly to do with where the trough occurs. Because of that, there is a risk that investors continue to be too defensive in their positioning instead of looking through. Given that we continue to take the view that the political balance is changing, however slowly, we think it important to ensure that the Fund has adequate duration exposure.

Risks remain, with heightened political noise ahead of the ruling parties elective conference at the end of the year, prospects of further downgrades, deterioration in fiscal matrices and recession all priced in. However, what has not been priced in is the likely hood of domestic recovery. As a result, we'll continue to assess the outlook for inflation coupled with local interest rate moves that will drive potential returns in the bond market, and balance these risks in the Fund accordingly.