FUND UPDATE

Coronation Strategic Income Fund

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THE FUND RETURNED -0.94% in June, bringing its 12-month total return to 3.76%. The latter return is in line with cash (3.82%), but below its benchmark (4.21%).

South African (SA) markets stood out over the first quarter of this year (Q1-22) for their resilience among the global turmoil, but succumbed to the pressure from global markets in the second quarter (Q2-22). Inflation-linked bonds (ILBs) were the only safe place within local fixed income markets as they registered a return of 2.95% for the quarter. This brought their year-to-date (YTD) and one-year returns to 3.26% and 10.72%, respectively. ILBs were buoyed by an increase in inflation expectations (following an upside surprise in May's inflation number) and an upcoming period where inflation will remain above implied breakeven inflation levels. Nominal bonds followed global bond trends as yields kicked up almost 100 basis points (bps) since the previous quarter as risk sentiment soured. Despite losing almost 2% in 2022, SA bond performance remains significantly better than global markets that are down almost 15% in US dollars so far this year (as measured by the FTSE World Government Bond Index).

June saw some developed market central banks tightening monetary policy settings to curb rising inflation. Inflation remains an ongoing challenge, with upside surprises to data across all regions. While US data is expected to have peaked, inflation in the euro area and the UK is expected to accelerate further as price pressures associated with the impact of the war in Ukraine continue to be felt.

In the US, the Federal Reserve Board raised the target range of the federal funds rate by 75bps, moving the range to 1.50% to 1.75%. The decision to hike was largely driven by spiking inflation and increasing near-term inflation expectations. Headline inflation increased to 8.6% year on year (y/y) in May from 8.3% y/y in April. Core inflation slightly decreased to 6.0% y/y in May from 6.2% y/y in April. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures.

In emerging markets, China's headline and core inflation remained unchanged at 2.1% y/y and 0.9% y/y, respectively, in May. Food prices rose the most as consumption strengthened following an easing of lockdown restrictions in some of the country's major cities. Following months of rolling lockdowns, growth is expected to contract in China during Q2-22, prompting further stimulus from both monetary and fiscal authorities.

The rand ended the quarter at R16.29/US$1. Recent geopolitical tensions and expectations around aggressive global monetary policy normalisation weighed on risk appetite as global liquidity reduces in the face of elevated inflation. When valuations are stretched, the Fund will hedge/unhedge portions of its exposure back into rands/dollars by selling/buying JSE-traded currency futures (US dollars, UK pounds and euros). These instruments are used to adjust the Fund's exposure synthetically, allowing it to maintain its core holdings in offshore assets.

In SA, the economy grew by 1.9% quarter on quarter (q/q) in Q1-22 from a growth of 1.4% q/q in the final quarter of 2021. The manufacturing, trade and financial sectors were the biggest contributors to GDP. The mining and construction industries detracted from growth. On the expenditure side, household and fixed capital spending contributed positively to growth. Looking ahead, we expect GDP to contract in Q2-22 owing to a combination of ongoing strike activity (which already contributed to a contraction in mining output), the KZN flooding and persistent loadshedding.

Headline inflation increased to 6.5% y/y in May from 5.9% y/y in April. Core inflation ticked up to 4.1% y/y in May from 3.9% y/y in April. This uptick came from increases in transport costs and food prices. The South African Reserve Bank (SARB) is due to meet in July and we are expecting a 50bps rate hike, taking the repo rate to 5.25%.

At the end of June, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.79% (three-year) and 9.29% (five-year), higher than the close at the end of the prior quarter. The recent move higher was in sympathy with bond yields, expectations for higher inflation, given the move higher in global commodity prices and more aggressive SARB interest rate tightening. Our inflation expectations suggest that current pricing of these instruments remains attractive due to their lower modified duration and, hence, high breakeven relative to cash. In addition, NCDs have the added benefit of being liquid, thus aligning the Fund's liquidity with the needs of its investors. The Fund continues to hold decent exposure to these instruments (fewer floating than fixed), but we will remain cautious and selective when increasing exposure.

ILBs have had a great run over the last two quarters. Despite good outperformance, we still value in the shorter-dated ILBs given that their real yields are more than 2% and the implied breakeven inflation for these instruments still sits at 5% versus our expectations for inflation of above 6% for the next year. This implies a minimum expected total return of 8.6% (2.6% + 6%) for an instrument with a maturity in 2025, which is 2% above expected cash rates and close to what can only be achieved by investing in a nominal bond of longer maturity (2026). We still believe that longer-dated ILBs, given their higher modified duration and significantly higher implied breakeven inflation, do not offer as much value as their equivalent nominal bonds and we would thus avoid these.

Central banks globally have started down a path of rapid monetary policy normalisation in the wake of much higher and persistent inflation. In many cases, policy rates are expected to move into restrictive territory and risk sending the global economy into recession. There has been a profound impact on global risk sentiment and expectations for emerging market central banks to adopt a similar stance. In SA, the market has priced a much more aggressive monetary policy normalisation cycle despite a more gradual rise in local inflation. Bond yields have widened in line with the deterioration in global risk sentiment and repricing in global bond yields, but still encapsulate a significant risk premium. We continue to believe that bond yields in the 10-year area of the curve still offer significant value for bond portfolios and allocations to ILBs should still be maintained, but focused in the shorter end of the yield curve.

The local listed property sector was down 10.47% over the month, bringing its 12-month return to -0.11%. The balance sheet concerns in the sector have subsided, as companies have managed to introduce dividend payout ratios (with some withholding dividends entirely) and selling off assets in order to recapitalise themselves. Going forward, operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. We believe that one must remain cautious, given the high levels of uncertainty around the strength and durability of the local recovery. However, certain counters are showing value, given their unique capital structures and earnings potential. These counters remain a core holding within the Fund.

The FTSE/JSE Preference Share Index was down 0.01% over the month, bringing its 12-month return to 46.43%. The performance over the last year has been bolstered by an announcement by the banks of their intent to repurchase a significant portion of their outstanding preference shares. Preference shares offer a steady dividend yield linked to the prime rate and, depending on the risk profile of the issuer, currently yield between 8% and 10% (subject to a 20% Dividends Tax, depending on the investor entity). The change

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in capital structure requirements mandated by Basel III will discourage banks from issuing preference shares, which will limit availability. Due to the reduced liquidity in this asset class and other instruments, at the same point in the capital structure, trading at more attractive valuations, the Fund will not look to increase its holdings and will maintain its current small exposure to specific corporate preference shares.

We remain vigilant of the risks emanating from the dislocations between stretched valuations and the local economy's underlying fundamentals. However, we believe that the Fund's current positioning correctly reflects appropriate levels of caution. The Fund's yield of 8.5% remains attractive relative to its duration risk. We continue to believe that this yield is an adequate proxy for expected Fund performance over the next 12 months.

As is evident, we remain cautious in our management of the Fund. We continue to invest only in assets and instruments that we believe have the correct risk and term premium to limit investor downside and enhance yield. +

Please note that the commentary is for the retail class of the Fund.