Cadiz Absolute Yield Fund

REGULATION 28 COMPLIANT

Quarterly Fund Manager Commentary – Second Quarter 2018

ECONOMIC AND MARKET COMMENT

2018 has been a tale of two quarters in the fixed income markets. The Ramaphoria-led rally on the back of Cyril Ramaphosa becoming President of South Africa in Q1 2018 was abruptly reversed. The local factors that had driven yields almost 100bp firmer in Q1 were sidelined by global developments. Where foreign inflows into the South African bond market were at record highs year to date in Rands, at close to R25bn by the end of March, we experienced record outflows from foreigners in Q2 2018 as almost R60bn left the bond market.

A raft of positive developments on the South African local front seemed aligned in Q1, from a strong Rand, the low point in inflation of 3.8%, a rate cut, a much improved outlook from National Treasury regarding SA's fiscal deficit and the stabilisation of the deficit, and crucially the decision by Moody's to retain SA's local currency credit rating at investment grade Baa3, with a stable outlook. However, local fundamentals lost importance in Q2, as foreign emerging market bond investors took flight. Large reductions in foreign emerging market local currency bond holdings reached a crescendo as Italy entered a political crisis, unable to form a government at the end of May. Coupled with jitters around Argentina and Turkey, the familiar theme of selling the most liquid emerging market namely, South Africa, took hold.

Global bond yields were mixed over the quarter – US 10yr treasury yields reached a peak of 3.12% mid quarter, but global risk aversion and flight to quality meant treasuries closed the quarter at 2.85%, in spite of the 2nd rate hike by the Fed for 2018 in mid June. The 10yr German Bund plunged from a mid May yield of 0.65% to a crisis low of 0.19%, and closed at 0.30%. The ECB decision to maintain QE until the end of December 2018 restored some calm to peripheral European bond markets and most finished the quarter at or near the low yields they had started the quarter at.

South African bond yields cracked under the relentless foreign selling pressure, and the R186 sold off from 7.96%, to close at 8.82%, having peaked at 9.24% in June – more than 140bp higher than the March 2018 low, and in line with bond yields just before Cyril Ramaphosa won the ANC Elective Conference in December 2017. The one positive development towards the end of the quarter was the dramatic flattening of the South African yield curve, as local institutions took advantage of long bond yields at or near 10% to buy bonds from panicking foreign sellers.

The poor Q1 SA GDP release definitely contributed to weakness in bonds and the currency – where the Rand Dollar exchange rate had been comfortably trading in the 11.50 to 12.00 Rand range in March, this blew out to 14.00 briefly in June, and the Rand also weakened against all the major crosses. Annualised QoQ GDP for Q1 2018 disappointed at -2.2%, versus a prior release for Q4 2017 of 3.1%, and our YoY GDP fell from 1.5% in Q1 2017 to 0.8% in Q1 2018. However, GDP is expected to improve from here on out, as the effects of the rate cut and the reforms & strategic appointments (in Cabinet and at key parastatal boards) made by President Ramaphosa kick in. However, many analysts have revised down 2018 estimates with 2% handles to more moderate figures in the 1.5% to 1.7% range, and the risk is that the much needed bounce in growth fails to materialise.

The bond market (All Bond Index) returned -3.78% for Q2 2018, reducing the 2018 year to date return to 3.99%. Equity markets (the JSE ALSI) were up +4.54% over the quarter and Inflation Linked Bonds (ILBs) suffered, falling by -4.46% for the quarter, with a -0.54% return year to date. Cash returned 1.78% for the quarter – clearly the place to be. Rolling 12 month returns for bonds fell to +10.16%, equities have returned +15.02%, and ILBs only +1.86% with cash returning 7.33% over the last 12 months.

PORTFOLIO REVIEW AND OUTLOOK

The longer modified duration positioning of the Fund reduced our return slightly in June, but we used the higher level of short dated yields to increase duration. The diversified holdings of Floating Rate Notes (FRNs) protected the fund in the rising short rate environment, and as yields continue to fall, we intend to increase holdings of FRNs. Our current House View of no further rate cuts in the current cycle has been reinforced by the much weaker currency and the higher oil price – and thus we will reduce modified duration into strength as and when bond yields rally. As mentioned, we will increase our exposure to Floating Rate Notes (FRNs) if attractive opportunities present themselves, in terms of credit spreads, although investors have been over-paying for credit of late. We continue to take advantage of credit opportunities, but only if fundamentals of specific companies and pricing justify doing so. The Fund will continue to exercise caution with our credit assessments before investing in credit assets. The liquidity position of the Fund is healthy at present, our property exposure remains low and we continue to focus on the fund objective of achieving an enhanced yield for our investors over the long term, with low volatility.

CONTACT DETAILS

A PO Box 44547, Claremont, 7735 | Alphen Estate, Alphen Drive, Constantia, 7806 | **T** 08000 CADIZ (22349) | **F** 0861 022 349 | **E** investorservices@cadiz.co.za | www.cadiz.co.za