Quarterly commentary

Kagiso Islamic High Yield Fund
June 2020

The fund was up 4.9% this quarter, outperforming the STeFI benchmark (up 1.5%). This quarter's performance resulted primarily from an allocation to domestic stocks. The fund has returned 5.0% pa since its inception in March 2019.

After falling further than the general market in the first quarter, mid-cap stocks have generally lagged larger, liquid stocks in the sharp subsequent recovery, leading to a very material underperformance for the year to date. Many of these stocks are trading in thin volumes and at very depressed prices, amidst high uncertainty regarding the lasting damage they are suffering from the current crisis. More realistic market prices are likely to emerge as these companies report results and reposition their prospects. Given that the fund holds a high weighting in mid-cap stocks, though up strongly this quarter, it has lagged its benchmark for the year to date.

Economic backdrop
Efforts to reopen global economies are cautiously underway and it appears that the most severe scenarios concerning global health and economic outcomes may have been averted. However, a considerable amount of uncertainty remains regarding countries where the pandemic is still accelerating and the extent of subsequent waves post the unlocking phase. The immense increase in global government debt balances due to aggressive fiscal stimulus will most likely hamper future, long-term growth. Uncertainty remains very high.

Positively, the global economy entered the crisis in a buoyant position, with healthy consumer dynamics in most developed markets and a moderating, but still robustly growing, Chinese economy. Developed market consumer health appears to have been preserved thus far through extensive fiscal and monetary support and increased savings rates (from less spend under lockdown). Early consumer indications (discretionary retail sales and vehicle purchases) have been better than initially feared. However, their sustainability will be put to the test once fiscal support tapers off and the extent of permanent job losses are evident.

The Chinese economy has had a remarkably smooth resumption of economic activity, with many key economic indicators now above pre-crisis levels, including automotive purchases and online retail sales. However, the path of a return to trend growth, which is vital for a return of global growth to higher levels, is unlikely to be smooth as:

- consumer confidence is still shaken;
- the capacity and appetite for debt-fuelled infrastructure stimulus appears diminished; and
- there are risks to manufacturing and export growth from extremely weak global trade and possible further deterioration in geopolitical relations.

Locally, growth weakened further in the first quarter prior to the COVID-19 lockdown, following the very weak 2019 economic performance. The sharp decrease in fixed capital formation, from an already low base, is particularly concerning. Our very weak economy has been severely (and potentially permanently) damaged due to the extended lockdown. Economic prospects for the near-term (household consumption in particular) have weakened substantially. It is now clear that our post-crisis economic recovery will take meaningfully longer than the rest of the world due to the inherent structural weaknesses of the South African economy.

The medium-term outlook for emerging economies is extremely varied at present, with differing exposures to low energy prices (importers vs exporters) and the decimated tourism industry and differing impacts from the pandemic.

Market review
Global markets were materially stronger this quarter (up 19.5% in US dollars), with Germany up 27.0% and the USA up 20.5%, but with the UK and Hong Kong lagging (up 9% and 4.7% respectively). Within emerging markets (up 18.2% in dollar terms), previous laggards South Africa and Brazil were stronger in the period.

In rand terms, the local equity market was up 23.8% this quarter, with mid-caps (up 15.4% for the quarter and down 25.5% year to date) again underperforming large caps (up 24.2% for the quarter and up 0.4% year to date). Resources outperformed (up 40.6%) with gold miners up 68.0% and PGM miners up 62.1%. Standout performers included Sasol (up 258%), African Rainbow Minerals (up 67.8%) and Northam Platinum (up 67.4%).

Industrials (up 17.1%) were strong, primarily due to Naspers (up 23.9%), with other large global companies also buoyant (British American Tobacco up 11.9% and Richemont up 14%). Standout performers included KAP (up 66%), Aspen (up 55.2%) and Telkom (up 44.3%). Retailers were mixed, with Truworths (up 36.1%) and Mr Price (25.4%) outperforming, while Massmart (down 16.5%), Pick and Pay (down 15.8%) and Shoprite (down 14.7%) underperformed.

Financials were up 13.0%, with listed property (up 20.5%) and life insurance (up 19.1%) outperforming banks (up 7.5%). Redefine (up 39.7%), Resilient (up 35.4%), Discovery (up 34.1%) and Coronation (up 32.6%) outperformed. Capco (down 13.8%), Capitec (down 2.4%) and FirstRand (down 1.9%) underperformed.

Governments in developed countries responded to the healthcare crisis and the resultant pausing of large parts of their economies with aggressive fiscal stimulus packages. Together with a dramatic easing of monetary policy (rate cuts, increased quantitative easing and other unconventional measures) this will likely temper the permanent economic damage from the crisis. The interventions are providing a powerful buffer to financial markets for the time being.

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Fund performance and positioning

Positive performance from our local equity holdings was the most meaningful contributor this quarter along with our holdings in sukuks, which also contributed positively. Material contributors this quarter included our holdings in African Rainbow Minerals, BHP and Resilient Properties.

We believe that there will be casualties among local companies, where: balance sheets are weaker, the pandemic permanently affects prospects and management teams do not adapt well to the new environment. Companies with stronger business models and management teams will outperform, especially in the weaker economy in the years ahead. We are attempting to maintain exposure to such stronger companies at the right price.