NAMIBIA ASSET MANAGEMENT

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NAM CORONATIONSTRATEGIC INCOME FUND

QUARTERLY COMMENTARY Q2-2023

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

Performance

The Fund returned 2.12% in June, bringing its 12-month total return to 8.85%, which is ahead of cash (7..03%) over the same period. We continue to believe that current positioning offers the best probability of achieving the Fund's cash + 2% objective over the medium to longer term.

Fund positioning

The last quarter diverged from recent trends in global fixed income, as emerging markets outperformed developed markets. Despite the dollar remaining relatively strong over the quarter, there were select emerging market currencies that outperformed (Brazil and Mexico). The story of the second quarter of 2023 (Q2-23) is, however, one of emerging market yield compression versus developed markets. Many emerging markets are at, or very close to, the peak in their rate hiking cycles and, with inflation expected to turn quite quickly, these markets have started to price in rate cuts, which has supported their bond markets. Developed markets are definitively on the other end of the spectrum, with inflation still remaining sticky in many economies, interest rates still set to go higher, and bond yields languishing at decade highs. UK bond yields were hit the hardest over the last quarter, selling off close to 100 basis points (bps) versus 20bps-50bps in other developed markets, including the US.

South Africa (SA) has found itself swimming against the stream; but headed in the wrong direction. The rand was down c.6% versus the US dollar and the FTSE/JSE All Bond Index (ALBI) was down c.1.5%, over the quarter. The key driver of the poor currency performance was the decline in SA's terms of trade (-18%) due to the fall in commodity prices and persistent high levels of loadshedding. This had the knock-on effect of dampening the demand for bonds, resulting in bond yields rising c.100bps across the curve. Longer end bonds were significantly weaker, as bonds with a maturity of greater than 12 years significantly underperformed those with a shorter maturity than seven years (a 2%-3% relative performance differential), due to the expected further fiscal deterioration. Inflation-linked bonds (ILBs) proved the only safe place to hide over the quarter, as they were only down 0.7%, but still lagged the ALBI year to date (0.2% versus 1.8%) and over the 12 months (1.2% versus 8.2%). Cash returns are slowly catching up with ALBI returns, outperforming the index over the last quarter at 1.9%, but still lagging bonds at 3.6% year to date and at 6.5% over the last 12 months.

SA's problems are well known and documented. Slowing growth due to the slothful pace of reform implementation, significant policy uncertainty and a growing debt load that darkens economic prospects over the medium term. Economic growth is expected to barely make it above 0% this year, with an acceleration to 1.5% next year expected as the energy constraints start to loosen, but this is still well below the needed 2.5%-3%. Inflation is decelerating but at a much slower pace than previously hoped, which will keep policy rates higher for longer, at or around 8.5%. The fiscal deficit will widen significantly this year to c.6% (including treating Eskom as an expenditure item as opposed to a debt transfer) and will remain there

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for the next three to four years, with elevated financing costs eating up more than a quarter of collected revenue. This renders the fundamental economic backdrop for SA particularly gloomy.

The US economy grew by 1.1% quarter on quarter (q/q) in Q1-23, following an expansion of 2.6% q/q in the fourth quarter of 2022 (Q4-22). Most of the growth came from consumer spending, although subsequent data suggests this momentum faded in the later part of the quarter. Government spending was also positive, but business investment was muted, and inventories subtracted from economic growth. Growth is expected to slow over the coming months as the effects of monetary tightening, muted business investment, a slowdown in consumer spending and tightening credit conditions accumulate.
The Fed raised policy rates by 25 bps, moving the target rate range to 5% - 5.25% at the May Federal Open Market Committee (FOMC) meeting. The vote was unanimous and widely expected by the market. The Fed's statement acknowledged a more resilient underlying economic performance than was expected in Q1-23, but highlighted that the cumulative effects of higher interest rates have yet to be felt. Combined with tighter credit conditions, the statement emphasised that future decisions will be even more data dependent, which may signal a willingness to pause.

US headline inflation slowed to 5.0% year on year (y/y) in March from 6.0% y/y in February, while core inflation increased slightly to 5.6% y/y from 5.5% y/y. Falling transport costs account for the easing in headline inflation, while food prices were flat, and an uptick in housing explained the rise in core inflation. Risks to inflation remain on the upside as the labour market conditions continue to be tight and wage pressures persist.

The rand ended the month at R18.85/US$1. SA's idiosyncratic problems (loadshedding and poor longer-term growth prospects, continued to weigh on the ZAR. Offshore credit assets have seen a substantial drop in valuations that has made them look very attractive. The Fund has utilised a significant part of its offshore allowance to invest in these types of assets. 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.

At the end of June, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 9.47% (three-year) and 9.79% (five-year), significantly lower than the close at the end of the previous month. Our inflation expectations suggest that the 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.

Despite the better environment for emerging market fixed income over the last quarter, SA has bucked the trend, with an economic outlook that remains plagued by low growth, sticky inflation and an increasing debt burden. In addition, intense levels of loadshedding have shattered consumer and investor confidence in the country's growth potential and the government's ability to enact reforms timeously. SA assets have seen a further significant reprice, with bond yields trading close to their Covid-wide levels relative to

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developed and emerging market bond yields. The embedded risk premium remains significant. The move in local bond yields will, in large part, be dictated by global factors. The US dollar and US bond yields are at, or near, their peak and should provide some support for emerging markets going forward. This should also provide some support for local bonds.

ILBs are securities designed to help protect investors from inflation. They are indexed to inflation so that the principal and, hence, the interest payments, rise and fall with the rate of inflation. ILBs have enjoyed a strong quarter, as they outperformed nominal bonds significantly, but with inflation expectations now closer to 5% for the next 12 months and nominal yields still elevated, it seems like the tide has turned against ILBs. At a 5% inflation level, there appears to be little benefit in holding them. However, as we move towards expectations of 5.5%-6% inflation, value appears in the shorter-dated ILBs (out to 2029 maturity).

As a reminder, our expectations are for inflation to decelerate over the next year to an average of 5.5%, but we believe that risks are skewed to the upside due to the longer-term effects of loadshedding on input prices, larger passthrough due to higher prices in source markets, and a weaker rand. As such, we still believe there is merit in holding ILBs with a maturity of 2029 (or shorter) due to the inherent protection they offer against the potential of sticky or higher-than-expected inflation.

Credit markets have remained relatively subdued. Net issuance this year has been a paltry R1.8 billion, with most of the issuance on the back of refinancing maturing bank-senior and subordinated debt. Despite the poor fundamental backdrop in SA, credit spreads have continued to tighten this year as net supply has dwindled. Senior bank credit has compressed close to 20bps,with five-year paper trading at three-month Jibar+130bps and seven-year paper trading at three-month Jibar+138bps. The compression of term premium in credit spreads is indicative of a market that is hungry for yield at any cost, and not what one would expect in the poor economic environment. Subordinated bank credit (AT1 and AT2) has seen similar compression, with AT2 spreads now just 50bps above senior spreads. This compression is quite dramatic and, although banks remain well capitalised and very far from failure, given the nature of the instruments, we feel current pricing to be too optimistic. We view current credit spreads as unattractive, given their current tight valuations and see better alternatives elsewhere. Current pricing of global interest rates and global credit markets offer an attractive, risk-adjusted opportunity for investors.

SA listed property sector was up 0.9% over the month, bringing its 12-month return to 8.9%. Operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. The current poor growth outlook, combined with an increase in cost base due to higher administered prices and second-round effects on loadshedding, will weigh on the sector's earnings in the coming year. We believe that one must remain cautious due to the high levels of uncertainty around the strength and durability of the local recovery.

Outlook

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 10.58% (before fees) 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.

Portfolio managers
Nishan Maharaj and Mauro Longano
as at 30 June 2023