PRUDENTIAL INCOME FUND
30 SEPTEMBER 2018

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY COMMENTARY

INCOME FUND

MARKET OVERVIEW

The third quarter of 2018 was another difficult quarter for investors, as the rand, bonds and equities all came under selling pressure from the risk-averse global sentiment, as well as a further broad deterioration in the economy. The land expropriation debate also continued to exacerbate uncertainty. The rand was exceptionally volatile during the quarter, hitting its worst level of R15.69 to the US dollar on 5 September amid the strong sell-off in emerging market currencies and assets, and exacerbated by President Trump's exaggerated tweet about land seizures and white farmer killings. The local currency did recover somewhat to end the quarter at around R14.14 per US$, some 3.2% weaker over the three months. It deteriorated 2.7% against the euro and ended 1.9% weaker versus the UK pound sterling over the quarter.

Headlining the disappointing data, South Africa's Q2 GDP data shocked the market with a contraction of -0.7% (q/q annualised), coming on the heels of a revised -2.6% in Q1 and putting the economy into a technical recession. This was well below the consensus forecast of 0.5% growth and was due primarily to a sharp fall in agricultural production, although household spending also suffered, particularly that on durable goods as consumer budgets came under pressure. The GDP contraction, in turn, sparked concerns over the government's longer-term fiscal policy and raised the spectre of further credit rating downgrades. Moody's, however, said the prospects of it changing its investment-grade sovereign rating in the next eight months were low, although it did halve its 2018 growth estimate to only 0.7%.

In a close vote at its September Monetary Policy Committee meeting, the SA Reserve Bank (SARB) kept interest rates on hold, as expected. While mindful of the poor state of the economy, it was more hawkish in tone, noting that inflation risks had risen due to rand depreciation and the higher oil price, as well as ongoing negative sentiment toward emerging markets. Governor Lesetja Kganyago said the Bank's current projections implied that five interest rate hikes of 25bps each would be necessary through 2020 to keep inflation within the 3-6% inflation target band. Although August CPI slowed to 4.9% y/y from 5.1% in July, economists expect it to rise closer to 6% towards year-end as second-round inflation effects take hold.

Among positive developments for the quarter, in an effort to help restore business and consumer confidence President Ramaphosa unveiled plans to re-prioritise government spending to help boost the ailing economy. These were largely greeted favourably, although with some scepticism around implementation. The President also made headway with attracting foreign investment totalling some US$35.5 billion from China and other countries, including US$2.5 billion for struggling Eskom. Some progress toward a constructive policy in the mining sector also came in the form of the retraction of the controversial Minerals and Petroleum Resources and Development Act (MPRD), which had alarmed investors. In addition, the government took steps in uncovering more details on corruption across several government departments with the start of the State Capture Inquiry on 20 August.

For the quarter, the BEASSA All Bond Index returned 0.8% - the yield on the benchmark R186 SA government bond barely moved, ending the quarter at around 9.0% from 9.1% at the beginning of the quarter. However, this masked substantial volatility as the benchmark yield traded as low as 8.57% and as high as 9.25% over the three months. Meanwhile, inflation-linked bonds delivered 0.5%, and cash as measured by the STeFI Composite Index produced 1.7%

PERFORMANCE

The fund generated a return of 2.1% (net of fees) for the quarter, outperforming its benchmark, the STeFI Composite Index, by 0.4%. For the 12 months ended 30 September 2018, the fund returned 8.8% (net of fees) while the benchmark returned 7.3% over the same period.

The fund was launched in December 2016 with the aim of delivering returns in excess of money market yields by investing in longer dated liquid paper - without compromising capital stability. Although capital protection is not guaranteed as the fund is exposed to spread risk, we highlight the low sensitivity to interest rate changes on the back of a low duration position.

The maximum term of instruments is not limited compared to money market funds at 13 months. The fund has a maximum weighted average duration of 2 years as opposed to a typical money market fund targeting a maximum 90 days' weighted average maturity.

The quarter end weighted average duration of the fund came in at 47 days.

STRATEGY AND POSITIONING

The fund has generally sought to take advantage of banks' requirements to secure longer dated funding which better matches the profile of their loan books. This has led to a steep credit curve whereby they are prepared to pay significantly more for funding beyond the 12-month point. We prefer these longer-dated securities and have exposure to securities issued by banks such as ABSA, Standard Bank, FirstRand, Nedbank and Investec both in floating and fixed rate securities.

While credit issuance has been scarce since 2016, mixed with a tightening of credit spreads, 2018 so far has seen a number of banks and corporates coming to market, after some hesitance following the downgrade of the sovereign credit rating last year. Issuances were generally well supported and largely cleared around the lower-end of guidance.

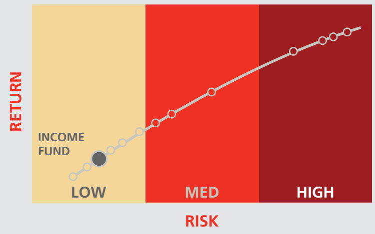
We continue to look for opportunities that will enhance the return to investors without compromising the stability of their capital. ■

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	D CLASS
1 year	8.8%	7.3%	8.8%
Since inception	8.5%	7.4%	8.6%

[1] Inception dates: D Class: 6 December 2016

1-YEAR INCOME RETURN	A CLASS	D CLASS
Fund yield (net of fees)	8.3%	8.4%

RISK/RETURN PROFILE:



FUND MANAGERS:
Roshen Harry and Sandile Malinga

ASISA CATEGORY:
South African - Interest Bearing - Short Term

BENCHMARK:
STeFI Composite Index measured over a rolling 12-month period

INCEPTION DATE:
6 December 2016

FUND SIZE:
R1 253 811 191

Sources: Prudential, Morningstar & Deutsche Securities