PRUDENTIAL ENHANCED INCOME FUND
30 JUNE 2021

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY COMMENTARY

MULTI-ASSET

MARKET OVERVIEW

During the second quarter (Q2) of 2021, more progress in vaccine rollouts worldwide, as well as positive corporate earnings reports and economic news, continued to lift equity returns, particularly in developed markets, even as concerns emerged over high valuations. Bonds – both government and corporate credit – also recorded solid performances, retracing some of their Q1 losses and buoyed by reassurances from central banks that easy monetary policies would not be halted any time soon. It was no coincidence that cheaper, out-of-favour equities like Listed Property were among the strongest performers, while more expensive sectors like Resources underperformed.

Meanwhile, the approval of even more US government spending helped support the global growth outlook, as did improving conditions in the UK and Europe. However, emerging market equities lagged those of developed markets, and South African equities broadly underperformed their EM peers due largely to the market's high Resources exposure, after outperforming in Q1.

In the US, the economy gathered speed as Q1 GDP growth was recorded at a final 6.4% (q/q annualised) and Q1 consumer spending jumped 11.1% y/y, amid a ramp-up in factory production and signs of labour shortages in some areas. Bullish sentiment was further stoked by the bipartisan approval of a five-year, US$1.2trn infrastructure spending plan. At its June policy meeting, the US Federal Reserve (Fed) left interest rates unchanged, easing investor concerns over rising inflation, while also signalling two 0.25% interest rate hikes by the end of 2023. Longer-dated US Treasuries rallied on the accommodative stance, helping flatten the UST yield curve after its steepening trend in previous quarters. This was despite headline consumer inflation of 5.0% y/y in May, its highest rate in nearly 13 years, which policymakers consider to be temporary.

Spurred by the improving growth outlook, US equity markets continued to rally for the quarter (although June gains were more subdued), with the S&P 500 delivering an 8.5% return, the Dow Jones Industrial 30 5.1%, and the technology-heavy Nasdaq 100 11.4% (all in US$).

In the UK, the rapid spread of the Covid-19 Delta variant, in the face of the country's successful implementation of its vaccination programme, proved to be a setback for the economy's anticipated full reopening in June, dampening market sentiment to some extent. The latest GDP figures proved equally bleak as the economy shrank by 6.1% y/y in Q1 2021. Despite this, the Bank of England upgraded its growth forecast for the year to 7.25% from 5% in February, and left its key interest rate unchanged as expected, while warning against any "premature tightening" until it reached its GDP growth and inflation goals.

In the EU, Q1 GDP contracted by 1.7% y/y, disappointing most analysts on the back of slower-than-expected vaccine programme rollouts and the emergence of more contagious virus variants which forced extended lockdown measures. On the other hand, later in the quarter, consumer and business sentiment recorded strong rebounds, albeit not yet reaching pre-Covid levels.

Meanwhile, the European Central Bank (ECB) left interest rates on hold at its June policy meeting, with President Christine Lagarde injecting some bullish sentiment by emphasizing that growth in the region should pick up amid stronger global growth and consumer spending, and that the central bank would continue its bond purchases and other supportive monetary measures. Unlike the US Fed, she refrained from signalling when the ECB might start to ease its accommodative policy. Consumer inflation in the EU rose to 2.3% y/y in May, due largely to a low annual base effect.

For the quarter, French equities far outperformed their regional counterparts as the CAC 40 delivered 10.1%, the UK's FTSE 100 5.8%, and the German DAX 4.4% (all in US$).

Japan's economic contraction for Q1 2021 was revised to -3.9% y/y from a previously estimated -5.1% y/y, above market expectations of -4.8% y/y. However, further restrictions to economic activity due to the worsening spread of the Coronavirus, particularly in the Tokyo region, have led many to expect Q2 growth to be weaker, and again in negative territory. The Bank of Japan left its key short-term interest rate unchanged at -0.1% in June, and also extended the deadline for its pandemic-relief programme from September 2021 to March 2022. In a further move to boost growth, policymakers unveiled a new scheme to provide funds to financial institutions that invest or extend loans related to climate change issues. Japan's CPI hovered around 0%, higher than previous deflation due to the rise in global oil prices, although inflation expectations were unchanged.

In China, GDP growth slowed to 0.6% q/q in Q1 2021 from 3.2% the previous quarter. The People's Bank of China again left its lending rates on hold in June, while noting in its Q1 monetary report that it was more worried about an uneven economic recovery, weak consumer spending and lack of private business investment than rising prices. The government continued its crackdown on the large local IT and fintech companies, introducing more regulations regarding financing and microlending in a bid to curb "monopolistic" practices online.

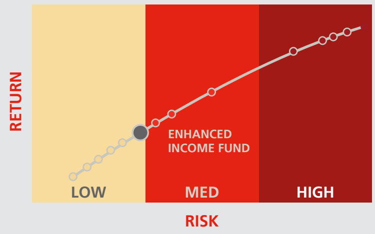
For the second quarter of 2021, Japan's Nikkei 225 returned -1.6%, the MSCI China produced 2.3% and Hong Kong's Hang Seng delivered 2.9% (all in US$).

Among other large emerging equity markets, in US$ terms Brazil's Bovespa was by far the best performer with a 22.3% return, rebounding from a disastrous Q1, while the MSCI Russia delivered 14.4%. The MSCI India posted a respectable 7.0% and South Korea's KOSPI 6.3%, but the MSCI South Africa and MSCI Turkey both ended in the red with -1.3% and -0.2%, respectively, all in US$.

After gaining over 22% in the first quarter of 2021, the spot price of Brent crude oil rose another 18.2% in Q2, for an increase of 45% so far in 2021, fuelling inflation around the globe. As for commodity prices, most were higher over the quarter with the exception of platinum, which lost 7.4%. The gold price gained 4.5% for the quarter, and palladium was up 3.5%, giving it a 40% gain over the past 12 months. Industrial metals were also stronger: nickel rose 14.6%, aluminium 11% and copper 6%.

Turning to South Africa, economic growth surprised to the upside as Q1 2021 GDP growth measured 4.6% q/q annualised, notably higher than the 2.5% market forecast. Despite the gradual recovery, Stats SA noted that the economy's absolute size was equivalent to that last seen in Q1 2016, five years earlier. Covid-19 vaccine supplies continued to make their way into the country and the government's vaccination programme made headway, but this progress was overshadowed in June as the third wave of Covid infections gathered pace, driven by the more transmissible Delta variant. This prompted President Cyril Ramaphosa to reintroduce Level 2, and subsequently Level 4, lockdown measures, again curtailing vital economic and social activity.

RISK/RETURN PROFILE:



FUND MANAGERS:
David Knee and Roshen Harry

ASISA CATEGORY:
South African - Multi-Asset - Income

BENCHMARK:
STeFI Composite Index measured over a rolling 36-month period

INCEPTION DATE:
1 July 2009

FUND SIZE:
R852 246 067

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	T CLASS	X CLASS	D CLASS
1 year	7.5%	4.0%	7.7%	7.4%	7.8%
3 years	5.4%	6.0%	5.7%	5.4%	5.8%
5 years	6.1%	6.6%	6.5%	6.3%	6.6%
7 years	6.4%	6.7%	n/a	6.6%	7.0%
10 years	7.1%	6.8%	n/a	7.3%	n/a
Since inception	7.6%	7.0%	6.6%	7.3%	7.6%

Inception dates: X Class: 1 April 2011, D Class: 1 July 2011, T Class: 2 January 2015

Sources: Prudential, Morningstar & Deutsche Securities

Meanwhile, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5% at its 20 May MPC meeting, warning that slow progress on vaccinations, limited energy supply and policy uncertainty continue to pose downside risks to the economic outlook. This was despite the jump in consumer inflation to 4.4% y/y in April and 5.2% y/y in May, attributed largely to the previous low base. The central bank raised its growth forecasts for 2021 from 3.8% to 4.2%, but lowered its projections for 2022 and 2023 to 2.3% and 2.4% respectively. It is also projecting two 25bps interest rate hikes in 2021.

During the quarter global credit rating agencies S&P and Fitch reaffirmed South Africa's long-term sovereign credit rating at BB-, citing an upturn in near-term economic performance and improved public finances as contributing factors. Moody's, however, postponed its review on South Africa's credit rating, which currently sits at Ba2 with a negative outlook.

The FTSE/JSE ALSI was roughly flat for the second quarter, returning 0.05%, while the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 0.6%.The standout sector was Listed Property (the All Property Index) with an 11.1% total return. Financials delivered 7.5% and Industrials eked out 0.8%, but the Resources Index returned -5.0%. This performance reflected the value still seen in "SA Inc" counters, which have lagged during the recovery, and the growing view that Resources shares may be reaching the end of their bull run.

Finally, the rand appreciated against the major global currencies over the quarter, rising strongly from its oversold position in April and May before retracing some gains in June. It gained 3.3% against the US dollar, 3.1% versus the pound sterling and 2.4% against the euro over the three months.

PERFORMANCE

The fund delivered a return of 2.8% (net of fees) for the second quarter of 2021, outperforming its benchmark (the STeFI Composite Index) by 1.9%. For the year ended 30 June 2021, the fund returned 7.5% (net of fees), outperforming its benchmark by 3.5%.

For the quarter, investments in floating-rate instruments, fixed-rate bonds, inflation-linked bonds, SA property and international assets (hedged back into rand), contributed positively to overall fund returns.

STRATEGY AND POSITIONING

In the second quarter of 2021 we made a few changes to the **offshore allocation** of the fund. We purchased US dollar-denominated SA government bonds which we hedged back into rand using currency futures. These purchases were funded from the sale of SA government bonds. We maintained our exposure to **US high yield corporate bonds** while selling our holdings of US dollar-denominated **Growthpoint bonds**.

We reduced our positioning in **SA listed property**, which has been the best-performing sector (and asset class) so far this year, recording a 20.1% return over the six months to the end of June 2021. Earnings have been broadly flat, and our modest positioning therefore reflects our belief that risks around property company earnings remain high, combined with the continuing relatively high debt levels in the sector. We have ensured that we are holding high-quality companies with strong balance sheets within our small exposure to the sector.

SA nominal bonds enjoyed strong returns in the second quarter, and the fund benefitted from this exposure. We continue to be constructive on this asset class and the fund's exposure is tilted towards shorter-dated maturities, which we believe offer attractive medium-term returns compared to cash.

We maintained our exposure to **inflation-linked bonds (ILBs)** during the quarter even though the gap between ILBs and cash real yields narrowed on the back of the rally in ILBs (as the 10-year ILB rallied by 80bps), while cash real yields remained steady. ILB real yields are still attractive compared to their own history and our long-run fair value assumption of 2.5%, hence we are constructive on this asset class. Relative to cash, we believe the medium-term return outcome for ILBs will be superior.

Lastly, we believe that **SA cash** offers poor prospective real returns and have therefore allocated capital to more attractive asset classes, as mentioned above. ■

Sources: Prudential, Morningstar & Deutsche Securities