PRUDENTIAL HIGH YIELD BOND FUND
30 JUNE 2021

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY COMMENTARY

INCOME

MARKET OVERVIEW

Economic growth surprised to the upside in South Africa 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.

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 second quarter saw the return of issuers to the primary bond market after a traditionally quiet first quarter. Issuance volume (excluding government issuances) was R37.5bn, significantly higher than both the previous quarter (R16.5bn) and the corresponding second quarter of 2020 (also R16.5bn). The make-up of issuance for the quarter followed established trends, with the majority being floating rate notes while banks were the largest sector for issuance. We continue to see meaningful volume via private placements, although not to the same extent as was the case in 2020. Issuance activity has for a period been dominated by floating rate placements/auctions rather than fixed rate issuance. The return of issuers to the market, together with somewhat uncertain market conditions, may provide some opportunities to add to our credit holdings at attractive prices. The window of opportunity to accumulate cheap credit may be closing though, as credit spreads have for the most part been trending lower, towards pre-pandemic levels. The largest issuer in Q2 was FirstRand Bank which raised just under R6.1bn. In April the bank raised just under R3.1bn of subordinated debt – the auction attracting R7bn worth of bids. Then, in June, a further R3bn of senior debt was issued – attracting R6.7bn in bids.

The rally in bond yields was supported in early May by National Treasury announcing a R900m reduction in weekly nominal bond issuance volumes, to R3.9bn per week. This decision was driven by a lower national borrowing requirement and higher cash balances.

SA bonds posted a strong 6.9% return (as measured by the FTSE/JSE All Bond Index), remaining sought-after sources of yield for global investors compared to many other sovereign bonds. The yield curve between 10-year and 20-year bonds also flattened by 34bps, with the spread now down at 120bps from its peak of 216bps during the Coronavirus crisis in May 2020 and highlighting lower investor risk perceptions. Meanwhile, SA inflation-linked bonds produced 3.0% (Composite ILB Index) on the back of somewhat softer demand for inflation protection, and cash (STeFI Composite) delivered 0.9%.

PERFORMANCE

For the second quarter of 2021, the fund delivered a return of 7.8% (net), outperforming its benchmark, the FTSE/JSE All Bond Index by 0.9%. For the 12 months ended 30 June 2021, the fund returned 14.8% (net of fees), outperforming its benchmark by 1.1% over the same period.

STRATEGY AND POSITIONING

We began the quarter in a long-duration position, with our overweight position focussed on the part of the curve exceeding 20 years. As described above, long-dated bond yields rallied more than shorter-dated bonds over the quarter, causing the yield curve to flatten. The flattening of the yield curve favoured our overweight position in longer-dated bonds and helped the fund outperform its benchmark.

Following the outperformance of the long-end of the curve during the quarter, we reduced our exposure to longer-dated bonds exceeding 20 years and invested the proceeds into bonds with 7- to 12-year maturities. This resulted in a closing of the fund's overweight duration position in the 20-year-plus area and reduced our underweight position in 7- to 2-year maturity bonds. Overall, the fund's duration was reduced slightly (-0.15 years) as a result of the trades.

We have a positive view on the 12- to 20-year area of the bond curve relative to the 20-year plus area. In our view, investors are not being sufficiently compensated for holding long-dated bonds maturing beyond 20 years' time – with the spread differential between the 30-year and 20-year tenors being zero.

As of 30 June, 10-year government bonds yields were still somewhat elevated compared to their history, offering around 9.25% versus 9.5% at the start of the quarter, and equating to an after-inflation (real) yield of around 4.25% (assuming inflation of 5.0% over the next decade). This is substantially above our long-run fair value assumption of a 2.5% real yield. We believe these yields more than compensate investors for the risks associated with holding SA government debt.

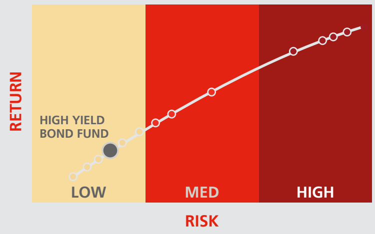
There was little opportunity to add to the fund's credit exposure during the quarter due to continuing limited fixed-rate issuance. Issuance activity has for a period been dominated by floating-rate placements/auctions rather than fixed-rate issuance. We continue to have capacity to add to our fixed-rate credit holdings within the fund.

The return of issuers to the market, together with somewhat uncertain market conditions, may provide some opportunities to add to our credit holdings at attractive prices. The window of opportunity to accumulate cheap credit may be closing, though, as credit spreads have for the most part been trending lower, towards pre-pandemic levels. The continued weighting of issuance towards floating-rate instruments, rather than fixed rate, will also be a hinderance. ■

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	B CLASS
1 year	14.8%	13.7%	15.0%
3 years	8.0%	9.2%	8.1%
5 years	8.2%	9.2%	8.5%
7 years	7.4%	8.5%	7.7%
10 years	7.8%	8.5%	8.1%
Since inception	9.8%	10.2%	8.9%

Inception date B Class: 1 April 2003

RISK/RETURN PROFILE:



FUND MANAGERS:
Roshen Harry and Gareth Bern

ASISA CATEGORY:
South African - Interest Bearing - Variable Term

BENCHMARK:
FTSE/JSE ALL BOND INDEX

INCEPTION DATE:
27 October 2000

FUND SIZE:
R284 700 504

Sources: Prudential, Morningstar & Deutsche Securities