SAFFRONWEALTH
FUND MANAGEMENT

SAFFRON SCI* QUALIFIED HEDGE FUND ONE
Quarterly Report – 30 June 2022

The fund returned 1.01% and 5.60% for the quarter and year respectively, while the benchmark (STeFI Index) returned 1.15% and 4.18%. On a rolling one-year basis, the fund beat the cash benchmark by 1.42%.

The ongoing war in Ukraine, upside inflation surprises, increasing central bank rates and lower GDP growth with growing fears of a recession have all contributed to the dismal markets. The Federal Reserve hiked by 75 bps at the last FOMC meeting, with the ECB expected to follow soon. South Africa, fearing elevated inflation, followed the DM banks' example and hiked by 50 bps at the last MPC meeting.

The US Federal Reserve announced a 75bps hike in the Federal Funds target rate, which lifted the range to 1.50 – 1.75%. The decision followed some sharp adjustments in interest rate market expectations as both inflation and inflation expectations surprised to the upside. May's CPI data printed higher at 8.6% y/y, despite the market expecting a moderation. Inflation expectations over the next year rose to 5.4% from 5.3% in May, as well as longer-term expectations to 3.3% from 3.0%. Unemployment estimates also softened, with 3.7% expected for 2022, 3.9% for 2023 and 4.1% for 2024 from the current 3.6%. GDP forecasts now stand at 1.7% in 2022 (previously 2.8%), 1.7% in 2023 (previously 2.2%) and 1.9% in 2024 (previously 2.0%). A further 50 to 75bps hike is expected at the July meeting, which should bring the rate closer to the Fed's current neutral estimate of 2.50%. The European Central Bank's (ECB) indicated that rates will rise by 25bps at the 21 July meeting with further increases at the September meeting, unless inflation looks likely to undershoot the latest projections.

The price of Brent crude (USD) continued to increase, by more than 9.0% over the quarter to a supply-constrained c.USD 115 / barrel. The Commodity Research Bureau (CRB) Commodity Index (-5.7%) and CRB Metals Index (-22.77%) softened losing some of the gains achieved in the first quarter. Copper (-20.2%), platinum (-9.4%), palladium (-14.8%) and gold (-6.15%) also lost over the quarter. The softening in metals prices negatively impacted the fiscal view on South Africa, weakening the local currency (USDZAR down -11.0%). The rand also depreciated against the EUR (-5.4%) and the GBP (-3.1%) over the period.

The VIX Index, a measure of market volatility, traded higher at 28.71 at the end of the quarter (+9.08). The J.P. Morgan Emerging Market Bond Index (EMBI) Sovereign Spread widened by 91 bps, ending the quarter at 461 bps. Emerging Market 5-year Credit Default Swaps widened significantly, with South Africa at 316 (+108 bps), Brazil at 295 (+87 bps) and Turkey at 847 (+294 bps) at quarter end.

In the South African asset class universe, the highly illiquid Inflation-linked bonds (CILI Total Return) was the top performer at +3.26%, followed by cash (STeFI) at +1.15%. Property (JSAPY), Equities (ALSI Total Return) and nominal bonds (ALBI Total Return) all had negative returns at -11.56%, -10.65% and -3.71% respectively. Over the past 12 months, inflation-linked bonds were the top performing asset class at +10.72% and Property the worst performer at +0.22%.

The SARB announced a 50bps increase in the repo rate in May, taking the policy rate to 4.75% from 3.50% before the start of the policy tightening cycle in November 2021. SA's inflation surprised above the 3-6% target in May. Headline CPI inflation accelerated to 6.5% y/y, its highest level since 2017, from 5.9% the previous month. Core CPI climbed from 3.9% to 4.1% in May. The major driver for headline CPI in May was broad-based food inflation, which rose to 7.8%. The CPI inflation forecast for 2022 was revised to 5.9% (previously 5.8%), 5.0% in 2023 (previously 4.6%) and 4.7% in 2024. The SARB now sees greater persistence in headline inflation remaining above the target midpoint of 4.5%. The SARB's Brent crude oil assumption for 2023 and 2024 was revised higher by USD10 per barrel, to USD90 and USD85 per barrel respectively. The underlying assumption is for the war in Ukraine to continue for the rest of year, impacting key commodity prices. The SARB's real GDP growth forecast for 2022 was revised lower to 1.7%, from 2.0% in March. At the time of writing, the FRA market priced in another 50 bps increase at the July meeting and a further 2.75% increase in the repo rate over the next two years. The 3-month JIBAR rate moved 64 bps higher to 5.01%, while 12-month JIBAR rose by 109 bps to 7.44% over the quarter, the effects of which will be seen in an increased running yield of the fund.

The 12-m T-bill average yield rose by 99bps to 7.04% at the end of June. In the SA bond market, foreign investors were net sellers, with a R33.4bn net outflow in June, R19bn in May and R12.9bn in April. The cumulative outflow for the last 12 months is at R288.4bn. In the SA bond space, the 1- to 3-years bucket returned +0.04%, the 3- to 7-years bucket returned -0.54%, the 7- to 12-years bucket returned -2.26% and the 12+ years bucket -5.19%. The top performing area of the curve for the year was the 1- to 3-years bucket at +4.26%. According to the SARB's May statement of assets and liabilities, the accumulated government bond holdings increased by R353m after a R659m decrease the month before. As at the end of May, holdings were at R40.2bn, leaving the cumulative increase at R32.1bn since secondary market bond-buying was announced in March 2020.

At the end of 2Q 2022, the fund was 2.51x geared, with an effective 26.51% allocation to cash. The largest asset class exposures were to Floating Rate Notes (49.07%) and Fixed Rate Bonds (17.53%). The Value-at-Risk (VaR) risk measure (99% confidence, 10-day period) calculated by the independent risk managers stood at 2.44%. The asset-pool is expected to outperform the gearing cost going forward, given the significant difference in the gearing cost versus the gross running yield of the underlying assets (8.38% per annum).

The fund aims to enhance total return through value opportunities that, on a geared and risk-adjusted basis, achieve or exceed our hurdle return of STeFI.