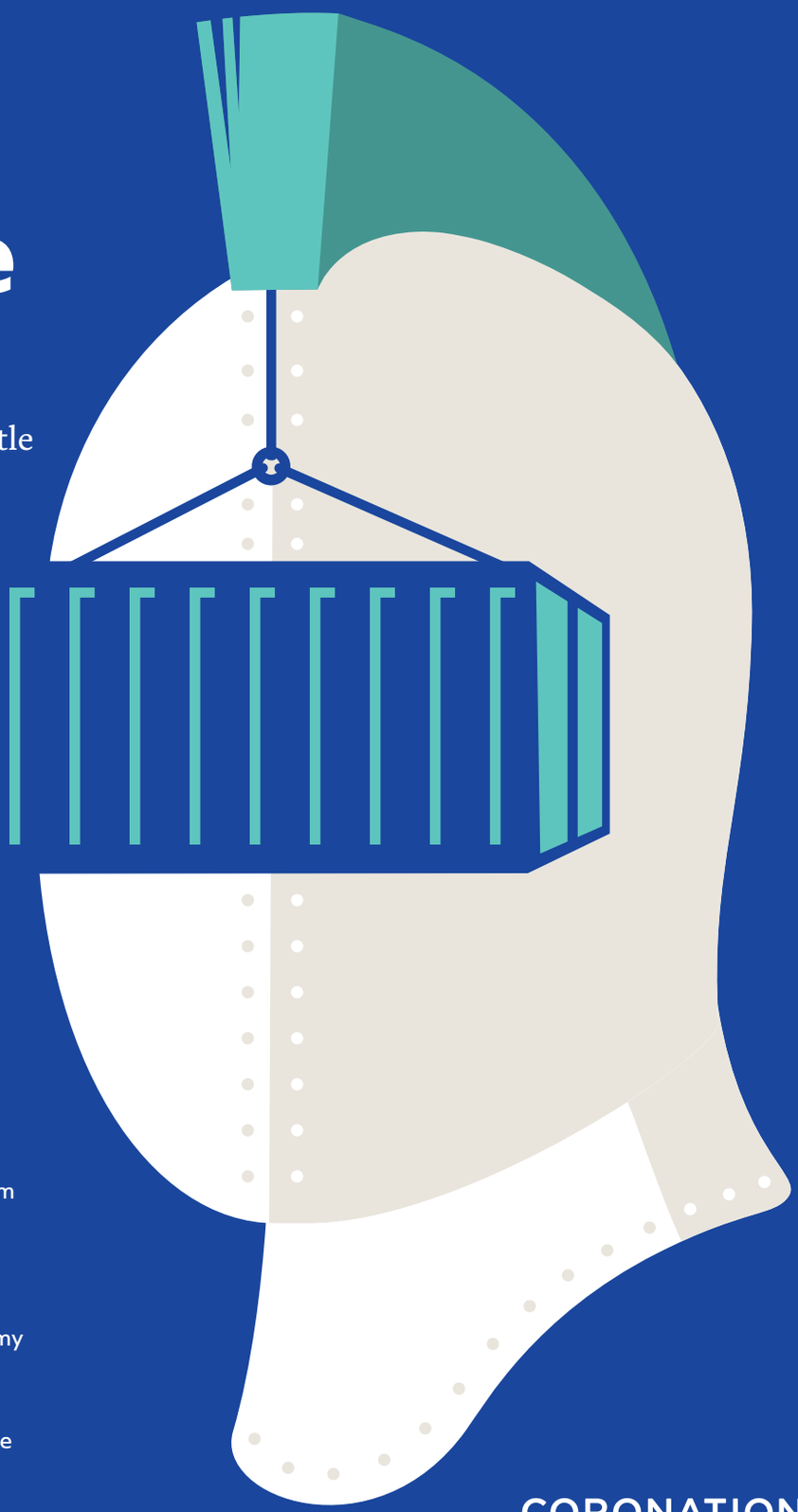
# corospondent

The Global Quarterly

# Trade wars

## Gearing up for battle





JULY 2018

CORONATION

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# Kirshni on point

## When it rains on your parade

**THE RECENT DOWNPOURS** have been a welcome relief for drought-stricken Cape Town. With it comes the confirmation that the city has staved off the possibility of Day Zero – the highly publicised date on which it was at risk of having to switch off its water supply. Despite this and the relaxing of water restrictions that will inevitably follow over the medium term, the city does illustrate the stark and significant effects of climate change and the behavioural adjustment needed for the 'new normal'.

It is impossible for me to write this quarter's column without referencing the bumper sports season we have just witnessed. For South Africa it all started in early June when the Springboks (for our international readers, that's the South African rugby team) returned to form by winning the test series against England – led by Siya Kolisi. Then came the FIFA World Cup 2018. Both my eight-year-old son and nine-year-old daughter are soccer crazy, so it has been a month filled with lots of sport watching, anxiety, >

Kirshni Totaram is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

tears and statistics. And the sensations – Gareth Southgate's waistcoat mania, the small country of Croatia with the biggest heart and French teen Mbappé showing signs of the brilliance that made Pele one of the greatest. I did not go into this World Cup supporting France, but one has to admire the joy and fun this team showed on the field and on the sidelines throughout the tournament, reminding us what the sport is all about in the first place. Even the pouring rain did not deter their parade. The world was amused with officials making sure to quickly cover Russian president Putin with an umbrella while French president Macron and Croatian president Grabar-Kitarović were left drenched – though both handled it with the utmost grace, resulting in global respect for them to skyrocket.

And then there has been president Trump and his unique brand of geopolitical chaos and "fake schmooze" (as the *Sun* newspaper aptly wrote). From trashing friends and flirting with foes in recent meetings with North Korean president Kim Jong-un, the NATO allies, Queen Elizabeth II and UK prime minister Theresa May, there has been no shortage of bizarre rhetoric. But probably the most baffling was the meeting in Helsinki between Trump and Putin. The less said about that at this stage, the better.

While on the theme of rain, it seems appropriate to acknowledge the drama in northern Thailand as 12 boys and their soccer coach became trapped in a water-logged cave system, extending what was meant to be a one-hour excursion to an 18-day ordeal. It turns out that the coach had previously spent time as a Buddhist monk and taught the boys how to meditate during their dire experience. Finding a state of calm amid terror and impossible odds is a lesson for us all in how to cope under extreme stress. For investors, it offers an example of the importance of remaining rational, unflustered and staying the course.

As a long-term investment manager, our constant challenge is to differentiate between newsflow which is short term and noisy and should be ignored, and newsflow which has a meaningful impact on the long term and leads to an impact on portfolio positioning. The boys' safe rescue was an incredible feat, showing that, through bringing together a team of experts with a common cause, you can harness their collective power and achieve the extraordinary – something we work hard to do every day for our clients.

The last few months also provided a much-needed reality check on the South African economy, as Coronation economist Marie Antelme unpacks in her comment on page 24. This is after the high levels of Ramaphoria experienced by the country (and the global investment community) at the beginning of the year. It is a stark reminder that, just like the decline of our dam levels, the deterioration in our political and economic health took a long time, and so will the remedy. Positive intent and feeling better have not been enough to motivate consumer spending overnight and boost growth.

But a lot has been done to start healing ailing parts of the South African political system in both ministerial and institutional areas. It was never going to be easy, and we are constantly reminded of the deeply entrenched vested interests. In addition, there is much work to be done to remedy broken parts of both the public and private sectors.

## MARKET MOVEMENTS

| | 2nd quarter 2018 | Year to date 2018 |
|---|---|---|
| All Share Index R | 4.54% | (1.70%) |
| All Share Index $ | (9.99%) | (11.41%) |
| All Bond R | (3.78%) | 3.97% |
| All Bond $ | (17.16%) | (6.30%) |
| Cash R | 1.76% | 3.59% |
| Resources Index R | 19.63% | 15.04% |
| Financial Index R | (6.02%) | (9.36%) |
| Industrial Index R | 3.96% | (4.35%) |
| MSCI World $ | 1.73% | 0.43% |
| MSCI ACWI $ | 0.53% | (0.43%) |
| MSCI EM $ | (7.96%) | (6.66%) |
| S&P 500 | 3.43% | 2.65% |
| Nasdaq $ | 7.27% | 10.65% |
| MSCI Pacific $ | (1.32%) | (1.88%) |
| Dow Jones EURO Stoxx 50 $ | (2.28%) | (3.72%) |

*Sources: Bloomberg, IRESS*

## FEATURED IN THIS EDITION

The term 'trade war' has come back into our common vocabulary as if this is something familiar and easy to understand. It is not. A trade war is essentially the escalation of the 'tit-for-tat' imposition of trade barriers, usually tariffs, on imported goods to protect local industries. Escalation in this behaviour tends to create ill will, raise costs, disrupt production, damage confidence and affect both growth and asset prices.

A brief glance into history shows trade wars tend to end badly. The first time when a government deliberately raised import tariffs sharply to protect domestic industry was in the US in the 1930s. Republicans then were protectionist and inward looking, and Herbert Hoover campaigned on a ticket to protect the farmers. Is this sounding familiar? While the direct impact on asset prices is hard to assess given the timing of the stock market crash in 1929, the trade wars of the 1930s undoubtedly extended the impact of the Great Depression.

Back to the present, the trade wars initiated by the US have been escalating and we asked professor Barry Eichengreen, internationally renowned economist and expert on the topic, for his insight into the dynamics of how this is playing out, which you can read on page 6.

On a musical note, I hope you enjoy investment analyst Chris Cheetham's article on the revival of the global recorded music industry on page 11. Led by streaming platforms such as Spotify and Apple Music, people are listening to music more than ever. We expect these platforms will gain more power over time, controlling a rapidly growing share of music distribution.

Locally we look at a South African success story, Aspen Holdings, on page 18. Through a series of smart acquisitions, it has transformed

itself into a global, geographically diversified pharmaceutical company. Quinton Ivan, head of Coronation's South African equity research, details why we believe it offers compelling value.

Thorough proprietary research is a key part of our investment process to get us to what we believe is a stock's fair value. In frontier markets, where the scarcity of information is not unusual, this research process is exceptionally rigorous. In Greg Longe's article "Treasure hunting" on page 15, he demonstrates how it is not about *what* you choose to buy, but also what you choose *not* to buy which can add significant value for our clients.

In August, we will be celebrating Women's month. I thought it relevant therefore to pen some thoughts on the issue, which you can read on page 9. At Coronation, we believe we are addressing gender diversity and equality at all levels. We are excited about our upcoming 2018 Women's Day event for our female clients, staff and for a selected group of schoolgirls, which will take place on 1 and 2 August in Johannesburg and Cape Town respectively. The keynote speaker is Olympic gold medallist Dame Kelly Holmes whom I had the pleasure of meeting recently. She will share how she overcame her disappointments and persistent injuries to become the first female athlete to win double gold for the 800 metre and 1 500 metre races in a single Olympics.

Another special guest at the Women's Day events will be Kristen Visbal, celebrated sculptor of 'Fearless Girl'. The statue, which stands facing the Wall Street Bull in New York, sends a strong message about workplace gender diversity, encouraging companies to recruit women to their boards. The plaque below the statue reads "Know the power of women in leadership. SHE makes a difference."

We have had no shortfall of excitement and newsflow over a wide range of topics thus far this year. It is one of the reasons the half-year vacation I took with my family was vital. We visited Slovenia, a magical and picturesque country often overlooked by the mass tourism industry. The time spent exploring its lush and green countryside was just the refresh we needed – I highly recommend you add this destination to your bucket list.

Lastly, on 1 July 2018, Coronation celebrated its 25th birthday. A big shoutout to all the staff and stakeholders who have been part of the journey and played a role in our success. In particular, I want to offer a great thank you to the clients who have supported us along the way. Without you, we have no business, and the privilege of managing your money is not something we ever take for granted.

Here's to the next 25! I hope you enjoy the read.

Kirshni

# Trade wars and the last economy standing

## But looks might be deceiving

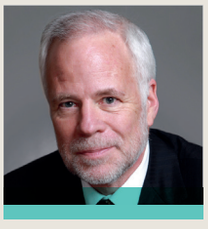
*By Barry Eichengreen*

**CURRENTLY THE US** economy is firing on all cylinders, while Europe and emerging markets are struggling. Does this mean that president Trump is right – that trade wars are 'easy to win'?

Superficial evidence points in this direction. The Purchasing Managers' Index, the best real-time measure of US economic activity, indicates that no less than 60% of managers saw conditions as continuing to improve in June. New orders, even export orders, expanded even faster than in previous months. The Atlanta Federal Reserve Bank's 'nowcasting' model shows US GDP increasing at a robust 3.8% rate in the second quarter.

In contrast, growth in the five large European economies (Germany, France, Italy, Spain and the UK) dropped in the second quarter. In emerging markets, meanwhile, financial difficulties are mounting. China's stock market and currency have lost ground with the ratcheting up of trade tensions. Other emerging markets have experienced capital outflows, forcing their central banks to tighten.

Barry Eichengreen is a professor of economics and professor of political science at the University of California, Berkeley, US, where he has taught since 1987. He is an internationally renowned economist who has written widely on the international economy and monetary systems. He is a former senior policy advisor at the IMF.



Rather than being destabilised by the White House's trade threats, the US economy appears to be thriving, while the economies Trump is attacking are buckling under the pressure.

But the evidence for the US is deceiving. The increase in manufacturing output and orders, including export orders, is a direct consequence of worries about trade policy actions. US companies are accelerating production to get more done before their supply chains and access to imported inputs are disrupted. European retailers are anxious to stock their warehouses with American goods before their governments slap retaliatory tariffs on US exports. This frontloading of production and sales bodes ill for the future. Demand and activity are being created today at the expense of demand and activity tomorrow.

One might ask why producers in Europe and emerging markets are not reacting similarly. The answer is that, in fact, many of them are doing just that. They have the same incentive to stock up on inputs and bring production forward before their trade relations are disrupted further. This explains why there is no discernible deceleration of economic activity in China, at least yet, despite the weakness of both consumption and fixed-asset investment. It explains why growth in emerging markets has not softened significantly despite the turmoil caused by higher US Federal Reserve (Fed) policy rates. It explains how growth in the big European economies still hovers in the 1.5% to 2% range despite the uncertainties surrounding the German diesel emissions scandal, the intentions of the new Italian government and Brexit. Producers there too are stealing from Peter in order to pay Paul. In other words, these observations also bode ill for the future.

The longer-run implications for the US economy are especially dire because Trump's tariffs target mainly intermediate inputs, not final goods, and handicap sectors disproportionately dependent on global supply chains. Steel and aluminium, the targets of Trump's 'national security tariffs', are inputs into production, so taxes on them make the final goods they go into more expensive. For every steel and aluminium industry job created, multiple jobs in downstream industries are lost. Whereas the US steel industry employs 145 000 workers, steel-using industries employ two million.

The same is true of the Section 301 tariffs imposed in response to China's intellectual property rights abuses – 52% of these tariffs target intermediate goods and another 43% tax imports of capital goods, which are themselves inputs into production. From an economic standpoint, this is known as shooting oneself in the foot.

The same is true of Trump's proposed tariffs on motor vehicles and parts. US automakers import a large fraction, even the majority, of the parts and components used in their assembly operations. No wonder then that Toyota, which builds Camrys at its plant in Kentucky, estimates that Trump's tariffs on automotive parts will raise the cost of its sedan by $1 800. And no wonder that the American Automotive Policy Council, representing the Big Three Detroit-based automakers, opposes the president's trade restrictions.

China, the EU and Canada are largely avoiding this pitfall. The EU's retaliatory tariffs target Kentucky bourbon and Florida orange juice, which are inputs into consumers' digestive systems, not into industrial production. China is targeting US soybeans, and Canada US maple syrup, ketchup and strawberry jam. These tariffs will impact the cost of living – imports from the US will become more expensive – but they will not disrupt manufacturing production. These countries have not been entirely able to resist the temptation to protect and subsidise their own steel industries. But, on balance, they are proceeding in a more sensible manner.

Will the Trump administration change course as evidence mounts of negative effects on the US economy? Would a negative reaction by the Standard & Poor's (S&P) 500, in which US multinational companies are disproportionately represented, rein in the president's worst instincts? Would Trump think twice following evidence that other countries in fact are prepared to retaliate, contrary to confident assertions by the president's trade advisor Peter Navarro? The answer, unfortunately, is no. Trump and his advisors understand neither global supply chains nor the distinction between intermediate and final goods. They do not understand that by cutting taxes and thereby pushing up the dollar, they themselves are causing the US trade deficit that the president finds so objectionable.

**Economists may regard a trade war as hard to win, but for Trump, it remains a political winner.**

So if the stock market reacts badly, Trump will ascribe this not to his own policies but to foreigners, stock market manipulators and the Fed. Trump has already warned other governments of further US action if they retaliate. Breaking with precedent, his economic advisor Larry Kudlow has intervened in the Fed's affairs, urging it to proceed "very slowly" with interest rate increases. Trump's commerce secretary Wilbur Ross has already criticised "antisocial speculators" for driving up steel prices.

The other reason for doubting a change of policy direction, aside from the fundamental ignorance of those at the top, is that Trump's dog-whistle politics appeal to his political base. Trump's bedrock supporters, like the president himself, see international trade as a zero-sum game. They see the mythical flood of merchandise imports, just like the mythical flood of Latin American immigrants (mythical because immigration from Latin America to the US is down, not up), as a fundamental threat to the country, and they are happy to see their president wall them off. Trump is simply delivering on the campaign promises that got him elected, and he is unlikely to turn back, however damaging the consequences. Economists may regard a trade war as hard to win, but for Trump, it remains a political winner.

So what should other countries do? They should carefully calibrate their response to avoid unnecessarily provoking an all-too-easily-provoked US president. They should target exports of bourbon and cranberries from the home states of the US Senate >

majority leader and House of Representatives speaker in an effort to drive a wedge between the president and Congress, in the hope that the latter might show some backbone and restrain an irresponsible executive.

Above all, other countries should avoid resorting to a further cascade of tariffs. If the US taxes Chinese products, China will divert those exports to other markets, intensifying import competition there and creating a temptation to ratchet up barriers against Chinese goods. The trade war could then go global and spiral out of control. A modicum of export restraint by China would help to limit this danger. That the Chinese authorities have begun intervening in the foreign exchange market to prevent their currency from weakening further and artificially goosing exports is a good sign from this point of view.

If there is a silver lining for South Africa, it is that the country depends less on global supply chains than many other emerging markets. Moreover, if the US economy weakens, the Fed will moderate its pace of tightening, which will help with South Africa's dollar funding costs. This may be scant recompense. But it is at least something. ✚

## South African impact

*By Marie Antelme*

South Africa is a small, open economy with global growth, trade and overall financial conditions having a meaningful impact on domestic economics. Initial estimates of the direct impact on global GDP of the first round of tariff increases imposed by the US on China were low, at 0.1 to 0.2 percentage points for 2018, with a slightly higher impact in 2019. This would have had a negligible impact on South Africa's GDP growth, off the current low base.

However, the newly announced escalation in planned tariff increases are likely to have a more meaningful effect on global growth into 2019 than initial estimates suggest, and the imposition of a global tariff on vehicle imports to the US would more directly impact domestic trade. South Africa exports both vehicles and parts to the US, and imports a proportion of both too. On a net basis, total trade in vehicles between South Africa and the US is about 1.9% of GDP.

More importantly, the indirect effect of an escalation in trade conflict may be much bigger, but is harder to measure. With the expansion of tariffs, the risk of a greater disruption to globally integrated supply chains has increased, and prices are likely to rise. Greater uncertainty would also influence confidence and investment, and may result in tighter financial conditions. The broader impact of a cyclical slowing in global growth on commodity prices and a drop in investor sentiment would see domestic terms of trade deteriorate and the currency weaken, leading to higher inflation and possibly prompting an increase in interest rates.

# L'Avenir des femmes

## Addressing the future for women

*By Kirshni Totaram*

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

**DESPITE PRESSURE FROM** governments, popular movements such as #MeToo and even investors, we have not seen meaningful change for women in the workplace. Women are still scarce in senior management positions and the average take-home salaries and bonuses of female employees still fall below those of their male counterparts.

Extensive research has been done on women in the corporate world in a variety of jurisdictions and sectors. Although the data and reporting have major flaws and should by no means be used as a definitive source, the consistency of the trend running through the data – across countries, industries and all sizes of companies – is worrying and requires pause for thought.

The results of the UK government's gender pay gap reporting procedure, which requires all employers in the UK with over 250 staff to report on the pay difference between men and women, shed more light on the ongoing problem. More than 75% of UK >

companies pay male staff more than their female counterparts, and 9 out of 10 women work for companies which pay them less. Only 11% of men work for a company where women earn more than they do. In addition, a common feature of the disclosure is the absence of women at senior management level, with women representing only 16% of executive committees in the top 350 companies in the UK, while some of them have none at all. While we acknowledge the current pay gap and inequality issues, the worrying part is the lack of a pipeline of women being skilled and trained to assume these roles in years to come, and that organisations have not been vocal about their plans to address this. This is despite the fact that women have outpaced men academically for more than 30 years. But not only companies remain underrepresented; the same can be said for political leaders, government officials and even pension fund boards of trustees where the number of women represented remains low.

While these trends are of serious concern and remain a big obstacle to having an economy that is more inclusive, some of their consequential effects are long-term societal problems which are often hidden. One of the issues I refer to here is the pensions gap – the pay gap that women experience has long-term implications, particularly for their retirement. Because they receive lower salaries and may contribute smaller proportions to their pension pots, their pension payouts are far less than those of men, a fact which is especially worrying as women generally live longer. Gaps in a woman's career which they take to have children, as well as a larger percentage of their income spent on the household and broader family, also take a toll on final pension amounts. There have been calls to address this material issue in many countries, but as yet we have not seen any corrective action.

To compound the problems we already have with the numbers is that most men in senior positions often find the current low representation of women at senior levels as being adequate and in fact an indication of a job well done. We find this perception among many women too – having been led to believe that small representations are adequate. This is once again a sign that the expectations from society in this regard simply need to be reset. In fact, one of the biggest challenges in addressing gender inequality is that many of the leaders required to do this are men who have their values entrenched by a patriarchal society.

I often get asked why we have such a small number of women in senior positions. The answer is not obvious or simple, and I have spent much time reflecting on it. Many women voice their reasons as follows: companies encourage workplace practices and barriers which hold them back or make them feel excluded; they have less guidance and opportunities for promotion at early levels and have to contend with maternity leave, children and part-time work. Furthermore, they reason that many companies adopt a 'one size fits all' approach, showing little recognition for the fact that the needs of men and women in the workplace are different and so too are their contributions. I also often hear that women 'self-select' out of the workforce because they are not as competitive as men, or are generally more risk averse. This intrigued me, as my own experiences and upbringing have proved different.

In their book, *The Why Axis: Hidden Motives and the Undiscovered Economics of Everyday Life*, economists Uri Gneezy and John List use experimental economics to determine whether women really are less competitive, or whether they are just socialised that way. Their answer was that women raised in a matriarchal society are just about as competitive as men raised in a patriarchal society. This finding does feel intuitively right. Societal conditioning plays a major role in the way girls and boys are brought up and cannot be overlooked. Girls are typically expected to be 'perfect' and as such grow up to be less risk averse than men, though this particular trait is not evident in matriarchal societies where women play large leadership roles.

Interestingly, countries which boast the best progress in female economic empowerment and the smallest gender pay gap are Iceland, Sweden and Norway, all of which have progressive attitudes towards women, especially with government-led initiatives in the workplace. Larger government spending on family benefits significantly reduces lower pay for women, while greater affordability of childcare could improve the number of women in the workforce, as does longer paid periods of maternity leave and shared parental leave. Encouraging more women entrepreneurship and improving opportunities in higher-paid roles through flexibility also helps to reduce the pay gap.

If women are not integrated into the economy, we miss out on skills, ideas and a different perspective. Efforts to achieve equality in the workplace are of benefit to everyone, as diversity leads to stronger business results and stronger businesses. To build future businesses that are dynamic and inclusive, we need to have equal opportunities for all and improve the pipeline of women with potential. We cannot be satisfied with a few high-profile women promoted to senior positions while the rest are left behind. When the most talented people can rise to the top regardless of what they look like or where they come from, we all end up winning.

At Coronation, we believe we are addressing gender diversity and equality at all levels. We have a majority female workforce with an average tenure of almost 18 years at top management level, and ranging between five and nine years across all other areas of the business. Our focus on gender diversity helped inspire our first annual Women's Day event last year in Johannesburg, where mentorship was one of the themes. The event led to the creation of our mentorship programme which was launched for 14- to 15-year-old schoolgirls and includes a number of sessions aimed at inspiring independent thinking by broadening a student's knowledge about money management and life lessons. The 2018 Women's Day event for our female clients, staff and schoolgirls will take place on 1 and 2 August in Johannesburg and Cape Town respectively. ✚

# Going with the stream

## Spotify and Apple Music lead the revival of the recorded music industry

*By Chris Cheetham*

Chris joined Coronation in June 2017 as an investment analyst in the Global investment team. Chris has 7 years' investment experience, is a qualified chartered accountant and a CFA charterholder.

**NOT MANY YEARS** have songs named after them, but Prince's apocalyptic hit "1999" defined a moment in time for many – including the entire recorded music industry. The year marked the peak in global album sales, with overall industry revenue subsequently dropping for almost two decades due to piracy and the unbundling of the album.

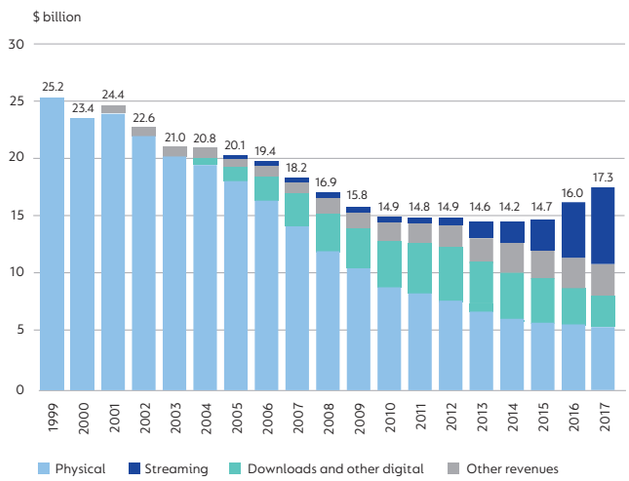
But a turning point has been reached, with streaming revenue growth offsetting declines in physical album sales and downloads. Today, industry revenue is still a third lower in nominal terms than in 1999, but since 2015 the industry has bounced back and the return to growth has now started to accelerate.

What contributed to the decline, why do we think the recovery is sustainable and who is expected to benefit? >

## THE MONETISATION GAP

The file-sharing platform Napster was launched in 1999, making it easy to exchange files while completely disregarding copyright laws. Lawsuits against the company only brought free publicity and soon university networks were clogged with MP3 file transfers as Napster reached 80 million users at its peak. Napster was ultimately shut down in this form, but it ushered in a plethora of similar sites, leading to an eruption of piracy that rattled the music industry to its core.

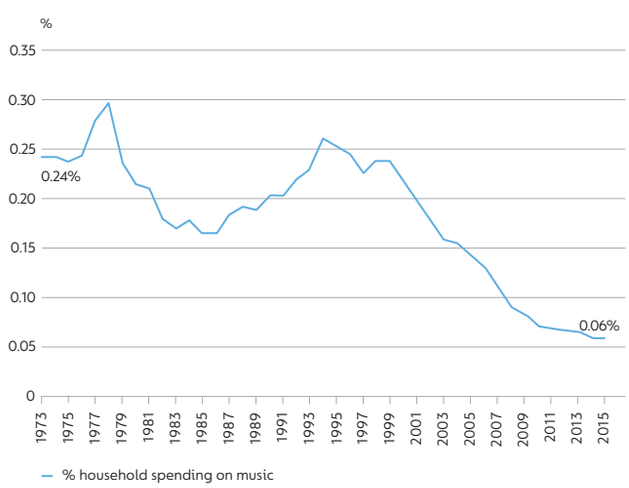
### GLOBAL RECORDED MUSIC INDUSTRY REVENUES 1999-2017




*Source: International Federation of the Phonographic Industry (IFPI)*

Album sales plummeted and the music industry, long very cushy and borderline complacent, struggled to adapt to the 'new normal'. To compete, paid downloads seemed the only viable option, offering consistent sound quality and a clear conscience as value propositions. Hindsight is always perfect, but this was a poor response and further disrupted the industry, effectively unbundling the album

### PERCENTAGE OF US HOUSEHOLD SPENDING ON MUSIC 1973-2016

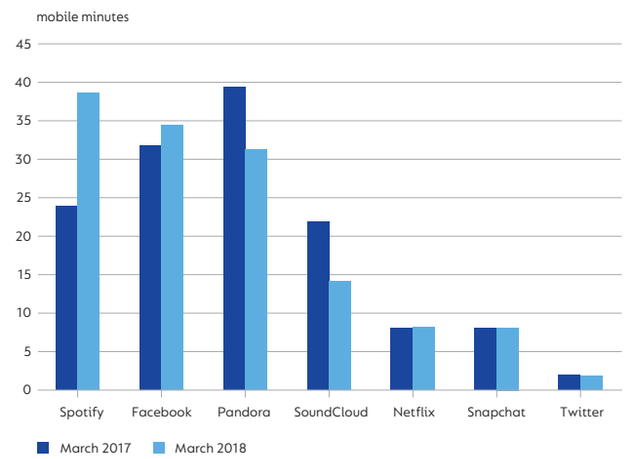



*Sources: Bank of America (BofA) Merrill Lynch Global Research, Recording Industry Association of America (RIAA) US Sales Database*

and enabling the cherry picking of tracks, with very negative effects on revenue. It also created a restrictive experience for the consumer with tracks stuck on certain devices, while inertia to spend a dollar on a single song meant that the lure of piracy remained.

YouTube emerged around the same time and established itself as a viable platform for music video streaming. Legendary record producer Jimmy Iovine estimates that 40% of all music listening today takes place via YouTube – a number confirmed by other sources – but it pays less than its fair share to the music industry. At the time, the music industry was forced to make original music videos available to YouTube on the basis that some revenue was better than nothing. The industry had its back against the wall.

### MOBILE MINUTES SPENT PER DAY ON EACH SERVICE




*Sources: comScore, Goldman Sachs Research*

## THE STREAMING OPPORTUNITY

People did not stop listening to music, they just stopped paying for it – with piracy and YouTube filling the gap. Estimates from market research firm Nielsen show continued increases in consumption, with Americans currently listening to around 30% more music than they did in 2015. Streaming is making it easier to listen to music and is expanding the overall market. Critically, it has finally provided the industry with an attractive means of monetisation.

People are embracing paid streaming because it is a great service at a reasonable price. In the developed world, $10 per month will buy you access to over 35 million tracks available at any time and on any device. Family and student plans are available at around half this price. It is easy to search and find songs, there are curated playlists tailored to your tastes, and you can download and play songs offline. Crucially, sound quality is first-rate and consistent. As such, users are engaged and spending an increasing amount of time listening to music via their mobile phones.

Streaming also fits squarely into changed consumer preferences, first towards mobile and secondly towards subscription as opposed to ownership, which is a key millennial trend. The shift to mobile is evident in all technology companies and has been a key enabler for streaming acceptance. Users can now hold their entire music library in one hand and listen to it via a myriad of

Bluetooth speaker options, which are steadily improving. Voice-controlled devices enabled by the likes of Amazon's virtual assistant Alexa should reduce the friction of song search, making the listening experience more enjoyable and helping to drive growth. Piracy remains a key risk, but it is becoming increasingly 'not cool' among younger consumers, and we believe that when shoppers are given the option of a quality service that satisfies their needs at a fair price, they will pay for it.

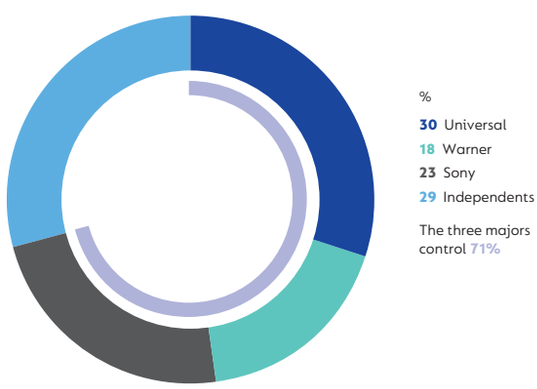
The number of paid streaming subscribers globally has exploded to almost 180 million at the end of 2017. Spotify is the market leader and currently boasts over 70 million paid subscribers. It expects to end this year with over 90 million, taking advantage of the strong structural growth drivers in the industry. With an additional 100 million ad-supported subscribers, one must not underestimate the amount of data that Spotify collects, enabling it to curate music in an extremely cluttered environment where thousands of tracks are added every week.

**We see tremendous value in UMG's music catalogue – it is the world's largest and continues to earn revenue from artists like The Beatles, Elton John and Queen.**

## SO WHO OWNS THE MUSIC?

Streaming platforms such as Spotify and Apple Music are synonymous with music today, but the three large record label groups Universal Music Group (UMG), Sony and Warner currently own the majority of the world's music. UMG, owned by the French-listed Vivendi, is the largest of the three and arguably the only investable record label group. Sony's music business makes up only a small portion of the sprawling conglomerate's earnings and Warner is privately owned. UMG owns iconic record labels like Geffen, Def Jam and Capitol Music Group, and represents leading artists such as Drake, Justin Bieber and Rihanna.

### RECORDED MUSIC CONCENTRATION



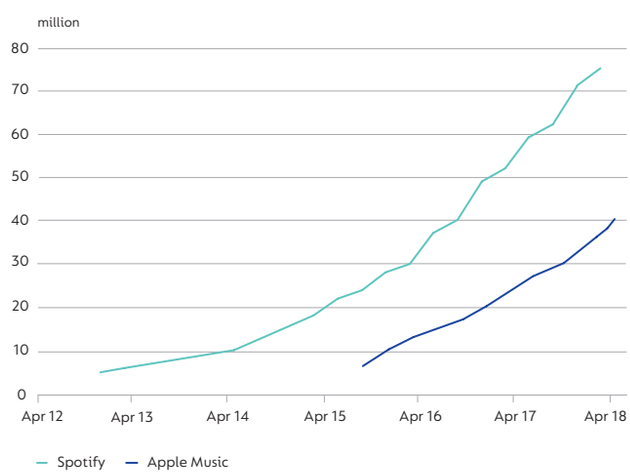

*Sources: IFPI, company filings*

So far, streaming has been a successful model for the music industry. It has evolved the industry from one-off album sales to annuity income, with revenue visibility from monthly subscription fees. Recorded music is now a less hit-driven business than in the past, as streaming allows the artist, label and platform to monetise a fan over her entire lifetime rather than in a single transaction. Unlike watching movies or TV series, we listen to our favourite songs over and over again. In fact, tracks older than 18 months account for the majority of listening time on streaming services such as Spotify today. As such, we see tremendous value in UMG's music catalogue – it is the world's largest and continues to earn revenue from artists like The Beatles, Elton John and Queen.

For every $10 paid to Spotify, around $5.50 goes to the record label, which then pays the artist it represents. It is the label's job to discover new artists and to finance them, providing creative expertise, studio time and access to songwriters and composers along the way. Labels are also responsible for promoting and marketing artists, ensuring that their music is distributed on streaming platforms, radio stations and in record shops around the world. They also collect and manage royalties from numerous sources. $1 then finds its way to the publisher, who represents the songwriter. Spotify only retains $3.50 in its capacity as distributor. There are no fixed dollar payments to artists; instead, the total revenue generated by the platform is shared out in these ratios and artists are paid in proportion to song play. The revenue pie is growing rapidly, and artists are increasingly embracing this new business model.

Streaming platforms such as Spotify and Apple Music have led the resurgence of the music industry. Looking ahead, could these platforms backward integrate, producing their own music and disrupting record labels just as Netflix displaced traditional entertainment studios?

### STREAMING MUSIC PAID SUBSCRIBERS




*Sources: Company reports and announcements, Atlantic Equities*

Music differs from audiovisual content. We listen to our favourite tracks repeatedly, making the back catalogue very important. >

People also consume music more regularly, and every streaming platform needs every good track to be appealing. A prisoner's dilemma has emerged, with the labels needing the platforms for distribution and the platforms needing the labels for content. With a delicate balance required, a semi-collaborative approach has emerged, with the aim of growing the market.

We expect platforms like Spotify to gain more power over time as they increasingly influence user demand and control a rapidly growing share of music distribution. We also expect Spotify to produce its own content around the fringes, but believe full-scale record label disintermediation is highly unlikely, with the big three labels still controlling over 70% of the world's recorded music, including the valuable back catalogues.

While the music industry is not yet 'partying like its 1999' again, it is in the very early stages of revival. We expect content owners and streaming platforms to thrive going forward as the industry recovery continues. Coronation owns both Vivendi and Spotify in its global strategies. ✚

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.


# Treasure hunting

## The value of proprietary, deep-dive research

*By Greg Longe*

Greg joined Coronation's Global Frontiers investment unit in February 2013 as an investment analyst. He studied at the University of Cape Town where he completed a Bachelor of Business Science in Finance degree in 2008 and a post-graduate diploma in accounting in 2009. Greg completed his audit training at Ernst & Young. He is a CA (SA) and CFA charterholder.

**HUNTING FOR TREASURE** (or undervalued shares) often takes you to unusual locations. Lyn's Bar VIP was no exception. Looking around me, I realised that 'bar' was perhaps too strong a word, 'VIP' definitely so. Upturned empty crates masqueraded as chairs around a mismatched collection of tables. The few patrons present lolled stretched out across the battle-weary bar, staring quietly into half-empty quarts of beer. It was only 10 a.m. but business had already begun. Or perhaps it had continued from the Tuesday night before. Posters, colours long faded, advertising a plethora of beers, musicians and now ancient sports stars, adorned the otherwise tired, grey walls. A fridge stood in a corner, light flickering. In walked Lyn, the lady I have been waiting 30 minutes to see. Finally, the work could begin.

A key part of our long-term, valuation-driven investment process is our proprietary research. It is this thorough, rigorous and in-depth work that helps us arrive at our estimate of a stock's fair value. And it was this research process that took me to Lyn's bar in Yopougon, a sprawling, mostly low-income suburb of one million people in Abidjan, Cote d'Ivoire.

Cote d'Ivoire on the West African coast is a country of 25 million people that has enjoyed an economic boom following a civil war >

that ended in 2011. The IMF expects the country to see average GDP growth of 6.8% per annum to 2023 – the 11th highest in the world. The beer market has long been controlled by Solibra, a subsidiary of the global Castel group. Markets with large, growing populations and strong GDP growth controlled by a monopoly brewer are typically very attractive ones for investors. Our interest was first piqued last year when our screening tools revealed that Solibra was trading on valuation multiples well below its global frontier brewing peers. It was time for the treasure hunt to begin.

We quickly did some further work and realised that information on the company was scarce. The four-page annual report was all in French, there was one sell-side analyst covering the stock and the website had little information. While this was an example of a particularly limited company profile, scarcity of information is not unusual in many of the global frontier markets where we invest. Often the lack of information creates both a sense of frustration and an opportunity. It was highly likely that any market or company research we did would not be widely appreciated or reflected in share prices. Inefficient markets create opportunities for the active investor.

At the time, Solibra's share price had sold off by about 30% over the past year. The investment opportunity was beginning to look very interesting. A monopoly brewer in an attractive market where there appeared to be mispricing due to market inefficiency warranted a closer look. It was time to do some detailed work on the company.

The following weeks saw us talk to a number of experts in African beer markets, begin building a valuation model and do as much Cape Town-based research as we could. It quickly became apparent that the reason for the share price moves was that Heineken was about to enter the market with a brewery in Abidjan. This did not immediately scare us off. We had seen competition enter monopoly beer markets before, often with limited success. Typically the barriers to entry in the beer industry are high and a well-run, aggressive incumbent can usually keep the new entrant at bay. We surmised that Heineken would likely gain a small market share, say 10% or 15%, a level at which it would struggle to make an adequate return on investment. Solibra would see a year of disruption, maybe take a small step back in profitability and then it would be business as usual again. With the share down 30%, the market was clearly pricing in a much direr outcome, which was surely an overreaction. The only way to be sure, though, would be to visit the market and do some on-the-ground research.

Flights were booked, bags packed, meetings arranged and schedules planned. The three days passed quickly; a whirlwind of sights, sounds and experiences. While no one from Solibra was willing to meet with us, the interviews we conducted with ex-employees, competitors, distributors and retailers (like Lyn's Bar VIP) proved invaluable. The message from Yopougon, from Cocody, from Marcory and the other neighbourhoods we visited was the same. The situation in Cote d'Ivoire was far worse for Solibra than we had initially thought. Heineken's entry was likely to have a much bigger impact on the beer market. While the Solibra share price had already fallen 30%, earnings were likely to come under significant pressure. Adjusting for our new outlook, Solibra no longer looked cheap; in fact, it looked expensive. Following the trip we decided not to invest in the company as the valuation was not compelling enough. That was August 2017. The share has fallen 50% since then.

While we will be the first to admit that we by no means get the investment call right all the time, this was one example of many where our detailed research process enabled us to avoid losing the capital entrusted to us by our clients. Also, it is not always about flying halfway across the world to do the work, as the next two examples show.

We met with a Greek jewellery retailer called Folli Follie in Cape Town last year. We were excited ahead of this meeting, since the company looked very cheap and the business prospects attractive. However, after the meeting and several discussions with industry experts, we decided not to invest in the company. While there was a lot to like, we were not able to sufficiently ease our concerns around the retailer's poor cash generation or understand the mismatch between the reported revenue growth and industry experts' more bearish outlook on Folli Follie's brands.

Our decision not to invest proved to be the right one when a short seller's report came out in May this year questioning the company's results, with numerous accusations made, including that store numbers were in fact much lower than reported. Since then, the share price has fallen more than 70% and trading in the share has been suspended. The company is strongly refuting the various allegations in the report, and investigations and audits are ongoing. We truly hope that the company will be able to demonstrate that the financial statements were not maliciously misstated. Only time will tell.

**While many people might see high profit margins as a good thing, we view it as a big risk when we cannot fully explain why a business should be so much more profitable.**

Finally, a last example worth mentioning is Pak Elektron, a manufacturer of appliances and electrical equipment in Pakistan. At first glance this company also looked interesting. The company traded on a single-digit price earnings multiple, and as a beneficiary of Pakistan's investments in the power sector, the business was growing strongly. However, when we compared the profitability of the company to similar businesses around the world, we saw that this business was significantly more profitable. While many people might see high profit margins as a good thing, we view it as a big risk when we cannot fully explain why a business should be so much more profitable. We did a deeper dive into the financials and conducted interviews with management and other sector participants but could not get the requisite comfort. We decided not to invest.

In February 2018, the World Bank announced that Pak Elektron had been debarred from participating in World Bank-financed projects for a period of 33 months due to collusive practices during bidding processes. The share price is currently down 50% since we first looked at the business in 2016. Although our research did not specifically identify collusive practices, we are heartened by the fact that the red flags we identified, similar to the concerns we identified in the case of Folli Follie, ensured that we avoided a large loss of capital.

The trip to Lyn's Bar VIP did not ultimately result in a new share in the portfolio. But unlike treasure hunting, it is both what you choose to buy and what you choose *not* to buy that matters for the portfolio investor. Spending hours researching a company only to conclude not to invest can sometimes be a bit disappointing. Ultimately though, safeguarding our clients' capital remains front of mind. In all markets, but especially those like global frontier markets where information is scarce, our proprietary, deep-dive research-driven investment process adds significant value. +

# Aspen Holdings

## A homegrown success story

*By Quinton Ivan*

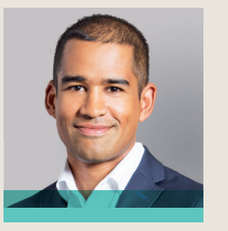
*"Medicine heals doubts as well as diseases"* – Karl Marx

**ASPEN HOLDINGS (ASPEN)** is a true South African success story. It listed on the JSE in 1998 via a reverse listing into Medhold. Shortly after the listing, it launched a hostile takeover of SA Druggists, acquiring a manufacturing plant in Port Elizabeth and the old Lennon drug business, a pioneer in generic medicines.

Today, Aspen is a supplier of branded and generic pharmaceuticals in more than 150 countries across the world, as well as consumer and nutritional products in selected territories. Through a series of astute acquisitions, it has transformed itself from a domestic company into a global, geographically diversified pharmaceutical company. It has also integrated into manufacturing and operates 26 manufacturing facilities at 18 sites across 6 continents. Its successful integration allows it to leverage its scale to reduce manufacturing and production costs, thereby protecting gross margins – an important attribute as Aspen operates in a highly regulated industry where government usually controls product price increases.

Aspen focuses primarily on niche therapeutic classes such as anticoagulants, anaesthetics, high potency and cytotoxic products as well as infant nutritionals. These products have several common traits. They are highly specialised and are difficult to manufacture, which protects Aspen from the threat of Asian competitors that

Quinton is head of South African equity research and co-manages Coronation's Core Equity strategy as well as the Presidio Hedge Fund. He also has research responsibilities for a number of retail, pharmaceutical and construction stocks. Quinton has 13 years' investment experience and joined the investment team in 2005.



tend to focus on simple, long production run products like antibiotics. They are also highly cash generative and post patent, which reduce the risk of a revenue fall-off from generic competition. All product portfolios are supported by a globally integrated, end-to-end value chain that spans product development, manufacturing, distribution and regulatory compliance.

The business has an enviable track record of earnings delivery, generating high returns and throwing off significant cash. It is managed by two of the country's most entrepreneurial managers, Stephen Saad (CEO) and Gus Attridge (deputy CEO), who together own 16% of the company, aligning their interests with that of shareholders. Saad has not sold a single share since listing.

Although Aspen operates in a highly regulated industry, this risk is to some extent mitigated by its extensive geographic footprint, with key markets being Latin America, Europe (West and East), South Africa, Africa and Australasia. There is a significant opportunity to unlock value through bedding down the recent anticoagulant and anaesthetic acquisitions and simplifying the current complex manufacturing process, thereby reducing costs. As both products are primarily dispensed within hospitals, there are scale benefits, as the acquisitions bolster the product basket that sales representatives can use to call on specialists. Aspen has a publicly stated target of delivering at least R2.5 billion of operating income from these initiatives by 2019. They are currently tracking ahead of budget in terms of both quantum and timing, which is material in the context of current group operating income of R9.2 billion.

Furthermore, this business is ripe with optionality, none of which is reflected in the current share price but is encompassed in the company's strategic activities, including:

- The successful launch of Orgaran, a low molecular weight heparin product that is very high margin as it is difficult to produce, in the US.
- The successful launch of infant nutritionals in China (or if Aspen decides to dispose of its infant nutritional division, it is rumoured that it would fetch between $1 billion and $1.5 billion).
- Concluding future acquisitions as multinationals look to exit their tail-end products. (Aspen has a phenomenal track record of concluding value-accretive deals.)

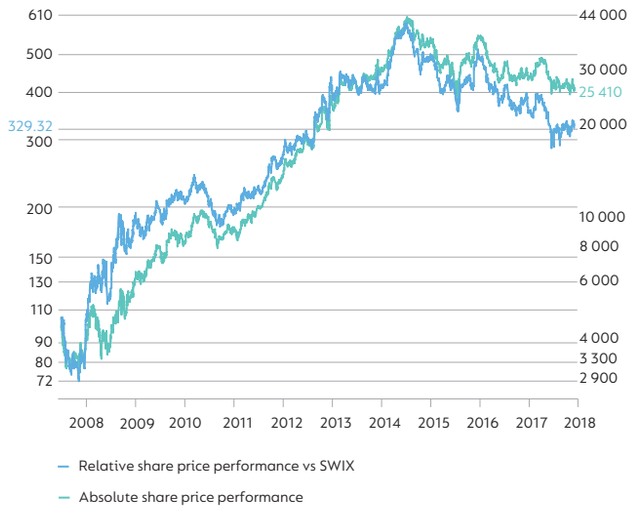
However, despite its fantastic track record and favourable growth prospects, the share has derated significantly, declining by 42% from its peak and underperforming the Shareholder Weighted Index (SWIX) by 47%, as shown in the following graph.

So what exactly spooked the market regarding the Aspen investment case? We address some of the market's key concerns below.

## A HIGHLY ACQUISITIVE BUSINESS MODEL, FUNDING ACQUISITIONS USING DEBT

Aspen embarked in earnest on its globalisation strategy around 2009 when it concluded the first of three transformational deals with GlaxoSmithKline (GSK). Post-2009, it globalised at a rapid pace, concluding several large acquisitions with Pfizer, Merck, AstraZeneca and Nestlé.

**ASPEN ABSOLUTE AND RELATIVE SHARE PRICE PERFORMANCE**




*Sources: IRESS, Coronation analysis*

Investors should rightly be sceptical of companies adopting a 'roll-up' strategy whereby they are simply acquiring earnings. However, each of Aspen's acquisitions has been strategically sound in our view. Aspen has extracted significant synergies through lowering the cost of goods sold by insourcing manufacturing and simplifying complex production processes. Furthermore, it has invested in its sales force and managed to arrest product declines and grow overall volumes, primarily as these products are rolled out in emerging markets where per capita use is low relative to developed markets.

Aspen is a highly cash-generative business. Members of the management team are significant shareholders and have behaved like true owner-managers over the years. They believe in Aspen's long-term prospects and that its equity is undervalued, and are rightly reticent to issue shares, preferring to fund acquisitions from debt.

Aspen has an internal free cash flow conversion (FCF%) target of 100% of earnings and has exceeded this level historically. FCF% has deteriorated in recent years as many of the large, global deals were consummated over a relatively short period of time, which resulted in a significant absorption of inventory. Site transfers also adversely impacted FCF%, with Aspen shifting production to new sites where it will be able to manufacture products at a cheaper price. This switchover requires the holding of buffer stock to avoid stock-outs – something frowned upon by customers and regulators alike. Working capital is a significant area of management's focus and FCF% should improve significantly going forward, which will allow the business to deleverage. This was evident in the most recent financial results, which saw FCF% improve to 92% of earnings.

## A LOW EFFECTIVE TAX RATE

Aspen's current effective tax rate is around 18%. It has declined meaningfully since 2009, the time of the first large, global acquisition. The decline also coincided with the establishment of Aspen >

Global (AGI), an entity registered in Mauritius. AGI employs more than 220 people and performs the following group functions:

- Conducts due diligence on all prospective deals;
- Arranges funding for deals;
- Acquires product portfolios from multinationals and owns the intellectual property for all products acquired;
- Assists with all regulatory and compliance matters, especially as these products are launched in new territories; and
- Assists with product transitioning from multinationals to Aspen as well as site changeovers.

It is important to note that AGI owns the global brands; other Aspen companies are thus effectively distributors of these products in various territories around the globe. Consequently, Aspen transfers price to ensure that its pricing is competitive globally. Transfer pricing is a common practice within global pharma and Aspen's tax rate is not out of line compared to other global pharmaceutical companies.

**ASPEN'S EFFECTIVE TAX RATE VS GLOBAL PHARMA PEERS**

| | 2013 | 2014 | 2015 | 2016 | 2017 | 5-year average |
|---|---|---|---|---|---|---|
| **Aspen** | **21.7%** | **21.3%** | **20.5%** | **29.5%** | **17.7%** | **22.1%** |
| Pfizer | 27.4% | 25.5% | 22.2% | 13.4% | 20.1% | 21.4% |
| Merck | 18.5% | 30.9% | 17.4% | 15.4% | 21.0% | 21.9% |
| Sanofi | 16.6% | 21.5% | 13.5% | 23.4% | 20.7% | 19.1% |
| GlaxoSmithKline | 23.0% | 19.6% | 19.5% | 21.2% | 21.6% | 21.5% |
| Dr Reddy's | 19.1% | 19.4% | 26.3% | 19.1% | 26.0% | 22.1% |
| Hikma | 25.9% | 21.7% | 18.9% | 22.3% | 25.7% | 22.4% |

*Sources: Company annual report, Coronation analysis*

Aspen's tax structures are not aggressive – they are well within the confines of Organisation for Economic Co-operation and Development (OECD) principles and are compliant with the necessary tax legislation. The South African Revenue Service conducted an international transfer-pricing audit on Aspen a few years back. It subjected the group and its tax structures to significant scrutiny, and found them to be compliant.

It is also important to note that AGI acquired these products from third-party multinationals at the time of acquisition by Aspen. There have not been any off-balance sheet structures or acquisitions from related parties, a consistent theme since the first GSK transaction in 2009. Furthermore, there are no outstanding tax claims or investigations in respect of AGI.

## A HIGH INTANGIBLE ASSET BALANCE, THE MAJORITY OF WHICH IS NOT AMORTISED

Aspen has a high intangible asset balance – R60 billion out of R116 billion of total assets – and an equity value of R42 billion. About 88% of these intangible assets are deemed to have an indefinite useful life, which means they are not amortised but tested annually for impairment.

Unlike conventional multinationals, Aspen is not a research and development company. Instead, Aspen's competitive advantage is to acquire and take over manufacturing of technically complex products in specialist areas. Its track record of manufacturing excellence and uninterrupted supply makes it a partner of choice for multinationals looking to exit tail-end products. This strategy derisks Aspen from the boom-bust cycle of new molecule launches.

All products that Aspen acquires are post patent, which means they have already been amortised by the originator over the patent period. As a result, Aspen's accounting treatment is not directly comparable to that of an originator company amortising products that are still under patent protection. The carrying value of Aspen's intangible assets is conservatively struck considering:

- Impairments over time have been minor due to Aspen's established track record of arresting and then growing once-declining products and reducing cost of manufacture.
- Intangible assets have never been revalued higher; they can only be impaired.
- R60 billion of intangible assets support R90 billion of revenue – Aspen's carrying value implies conservative valuations relative to earnings generated from its acquisitions. Elsewhere in the industry, transactions regularly occur where pharmaceutical products are acquired at significantly higher multiples.

## REGULATORY RISK: INVESTIGATIONS INTO EXCESSIVE PRICING IN THE EU AND UK

Aspen is currently under investigation for alleged abuse of dominance and excessive pricing. This relates to products that have a minor contribution (less than 3%) to group revenue, so any potential impact is likely to be insignificant. More importantly, these allegations should be viewed in the context of these products not having a price increase for nearly three decades. As a result, these products should either be priced for viability or discontinued. The fact that no new competitor products have been launched post these price hikes indicates that current pricing is not excessive and Aspen is not earning super profits. Furthermore, the allegations are contradicted by the Italian regulator's recent approval of a generic product that sells at a higher price than Aspen's product.

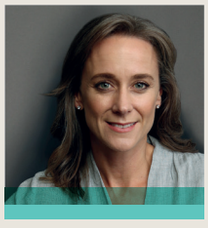
Heightened risk aversion has caused investors to ignore Aspen's fantastic track record and the ability of its management team to create value for shareholders. This has resulted in indiscriminate selling of its share, creating a disconnect between the current share price and its intrinsic value. Aspen trades on an attractive one-year forward price earnings of 13.5 times and 10 times our assessment of normal earnings. It offers compelling value, and investors who are able to set emotion aside and cut out the noise have a high probability of being rewarded handsomely. ✚

# Will politics disrupt the global recovery?

## Current high levels of tension fuel uncertainty

*By Marie Antelme*

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.



**AFTER THE LAST** few weeks, it is hard to know how to think about the outlook for global growth. On the one hand there is a good amount of data showing that global activity – led by the US – has picked up after the first-quarter malaise, although Europe and Japan have yet to fully recover their lost momentum. On the other hand, an escalation in political tensions, led by but not limited to trade relations between the US and its various trading partners, pose a meaningful downside risk to the improved outlook. To make things more complicated, it is also unclear to what degree the rise in trade tensions may be fueling the escalation in short-term activity, as producers act in anticipation of rising costs, and what this could mean for growth, policy setting and asset markets in the medium term.

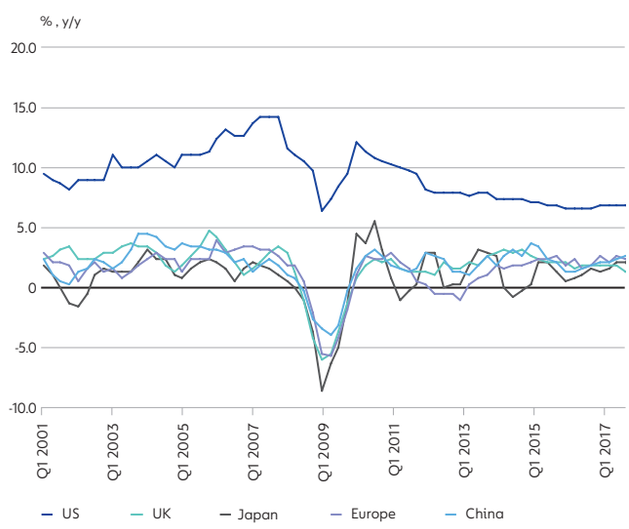
At the time of writing, the first round of tit-for-tat tariff increases on a cumulative $100 billion between the US >

and China has been implemented. More importantly, there are clear signs of this escalating. Not only has president Donald Trump announced his intention to add a further $200 billion on a wider range of targeted Chinese imports, he has also reiterated his threat to impose tariffs on all vehicle imports to the US, with the notable inclusion of the EU. He has criticised UK prime minister Theresa May's 'soft Brexit' proposal and has appeared to criticise US investigative agencies in support of Russian president Vladimir Putin.

Initial estimates of the direct impact of the first round of tariffs was reasonably limited at 0.1 percentage points of global GDP, while the second round estimates are closer to 0.5% over the next two years, according to the IMF. The knock-on effect through the disruption of globally integrated supply chains and confidence, and the lingering effects of uncertainty could be significantly bigger. While the issues related to trade hold potentially meaningful implications for global growth, the second round of tariffs creates a new paradigm of geo-political uncertainty, which is hard to assess but certainly challenges the assumed balance of global power of the past.

As these new dynamics start to play out, global economic fundamentals are reasonably sound. A sustained period of growth has helped stabilise global debt levels (in some cases more than others, with China being the notable exception), visible economic excesses are reduced, labour markets have tightened and global inflation is starting to reflect this normalisation, with policymakers signaling tentative returns to more normal settings. For markets, the dual and concurrent risk is that either policy normalisation happens faster than current pricing suggests as inflation responds increasingly to strong growth and limited economic slack, or as this happens, growth falters owing to an increase in uncertainty.

**DEVELOPED ECONOMIES AND CHINA: GLOBAL REAL GDP**

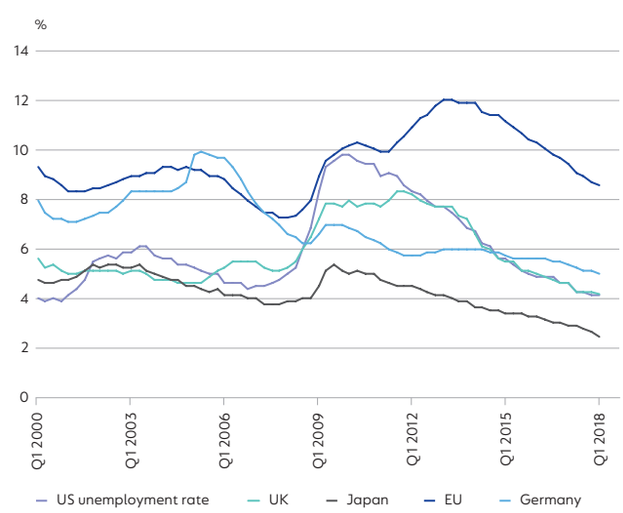



*Source: Datastream*

The US leads the pack in terms of both growth acceleration and tighter monetary policy, but with the escalation in political tension it also becomes the epicentre of global growth risk. Fiscal stimulus passed by the Trump government in December 2017 has helped growth accelerate to an estimated 4.8% quarter on quarter (q/q) seasonally adjusted and annualised (saa) in the second quarter, according to the St. Louis Federal Reserve 'nowcast' model, and on average forecasts for the next two years have been revised higher. With the acceleration in GDP growth, unemployment has fallen to a multidecade low, at just 4.0%. Inflation has also started to rise and is at or close to the US Federal Reserve's (Fed) target by most measures, while wages have started to rise too, suggesting that in the US, the Phillips curve remains relevant. In response, the Fed's Open Market Committee raised the funds rate to 2.0% in June, as widely expected. The post-meeting communiqué showed a median rate forecast by members of another two hikes this year, and three in 2019.

After a disappointing first quarter, European activity indicators have picked up moderately. The euro area final composite Purchasing Managers' Index edged up to 54.9 in June, and German May factory orders and industrial production rebounded after a weak start to the second quarter. Unemployment in Europe has also fallen in aggregate and is low in Germany at 5%. Against this somewhat more constructive economic backdrop, European political risks have resurfaced. In early June, the formation of an Italian coalition government of the two main populist parties with a Eurosceptic common philosophy, La Liga and Five Star Movement, saw Italian yields spike and raised renewed concerns about Italy's fiscal viability. The appointment of Giuseppe Conte as prime minister calmed fears while the market awaits the submission of Italy's 2019 Budget to the European Commission, due by the middle of October. Angela Merkel also faced a homegrown crisis with her stance on migration. A compromise agreement was reached at EU level at the end of June. While both risks have retreated, general support for mainstream parties in both regions has waned. On balance, growth should still be above potential at 2.2% in 2018 and about 1.9% in 2019, supported by solid domestic demand, but with downside risk, mostly associated with looming trade and politics. The European Central Bank acknowledged these dynamics by signalling an end to its programme of quantitative easing in the fourth quarter, keeping rates on hold at current levels until next summer.

**DEVELOPED MARKET UNEMPLOYMENT**



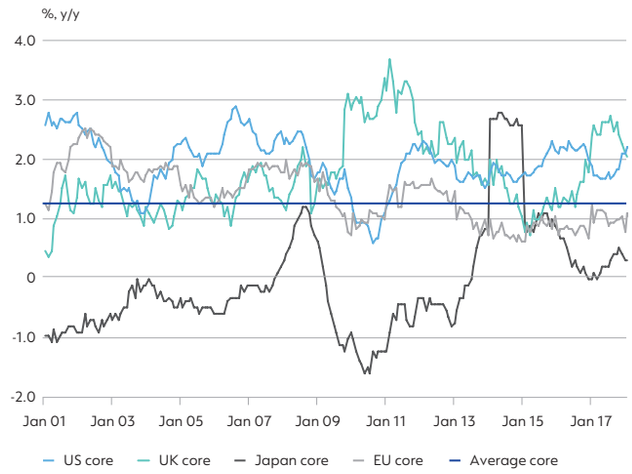

*Source: Datastream*

The UK continues a bumpy road to Brexit, with political upheaval weighing on economic activity. Prime minister Theresa May has faced ongoing internal and external challenges to the Brexit process, most recently with a series of resignations from members of her party. There are few completed milestones to point to which suggest progress is being made, and the risk of either a very strong compromise on Britain's part or a 'no deal' outcome is increasing as the March 2019 deadline approaches. Economic activity has returned to trend-like growth, with healthy growth in the services sector and a strong rebound in construction. A combination of the royal wedding, the hot summer and World Cup soccer is likely to have a lumpy influence on the data, with early numbers suggesting that services like restaurants have benefited at the expense of retail activity through the early summer. Unemployment in the UK has also fallen. With a currency- and fuel-induced surge in inflation (and despite longer-term growth deterioration), after a pause in May, the Bank of England is expected to continue to raise interest rates in August off the very low base in response. Thereafter, weaker growth data and moderating inflation should see the central bank on hold, as pressures from Brexit outweigh global cyclical influences.

In the East, growth in Japan has picked up after the cold weather of the first quarter affected output. Capex and construction in particular have recovered meaningfully, but consumption continues to lag. Here too the outlook is mixed: summer bonuses are set to increase to 4.2% from 3.9%, but heavy rains in western Japan may have a prolonged impact on production in the region. Inflation at headline level has picked up, fuelled by energy, but core inflation remains very low at just 0.7% in May and points to a central bank on hold at 0% for the foreseeable future.

Activity in China has held up well against the headwinds of tightening financial conditions. Policies implemented to moderate credit availability at 'shadow' institutions and through irregular structures, as well as efforts to improve credit quality, have seen a meaningful contraction in the credit impulse. Activity in most domestic sectors has slowed, led by property and broader domestic industrial sectors. Trade volumes have provided a helpful buffer and GDP in the second quarter is still 6.8%. However, the rise in trade protection and pending implementation of further measures, which are likely to see retaliation from the Chinese authorities, threaten the outlook for growth. Forecasters have started to make downward revisions to growth as they count the economic cost of the rise in trade tension.

**CORE INFLATION IN DEVELOPED ECONOMIES**




*Source: Datastream*

The impact of these interconnected and at times opposing forces for emerging markets is difficult to disentangle. However, an increasingly dislocated global cycle is hard to manage and is likely to see risk assets suffer in uncertain markets. A steeper rise in developed market interest rates than currently priced by the markets, or an unexpected slowing in growth would be unhappy outcomes for commodity producers, especially those who run large recurring deficits. It is possible that president Trump's ultimate strategy is to win on his electoral promises and that compromises may be made, alleviating the current high level of tension. But from this vantage point it seems unlikely at this time and the consequences are already emerging. ✚

# Realism sets in

## Despite positive moves, South Africa's fiscal position is still very vulnerable

*By Marie Antelme*

**ECONOMICALLY, IT HAS** been a very disappointing start to the year. After a long period of political and economic deterioration, the fast pace of political change after the ANC elective conference in December should have heralded the start of a recovery in confidence and growth. And in part, this did happen – president Ramaphosa moved swiftly to appoint a cabinet which mostly replaced poor ministers with good ones, the Budget delivered a decent political commitment to consolidation, Moody's not only did not downgrade the sovereign rating to subinvestment grade, it moved the outlook to stable, and consumer and business confidence improved visibly. But growth did not.

### WHAT HAS HAPPENED?

GDP growth contracted in the first quarter of 2018 by -2.2% quarter on quarter (q/q) seasonally adjusted and annualised (saa) and was just 0.8% year on year (y/y). While data from the fourth quarter of 2017 were particularly strong (surprisingly so, given the

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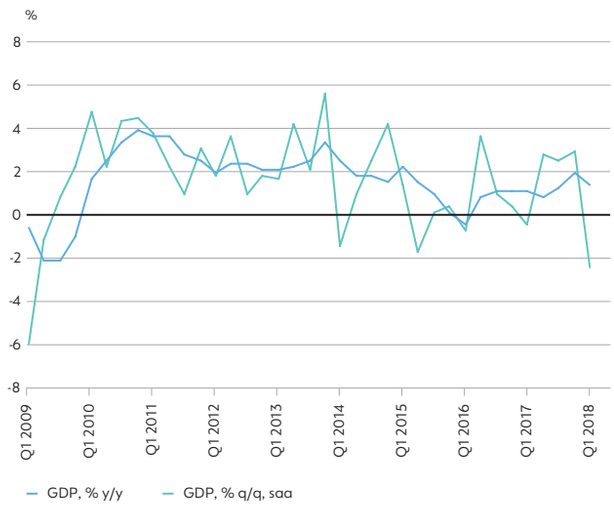
prevailing political uncertainty at the time), high-frequency data published in the first quarter of 2018 suggested that activity was a lot slower at the start of the year, and that the degree of deceleration was greater than expected. The biggest detractor was a 24.4% q/q saa contraction in agricultural production, which cut 0.7% off growth. Both mining and manufacturing output was significantly weaker following a surge in the fourth quarter of 2017, but weakness in other sectors, including utilities and construction, was more pronounced than expected. In particular, activity in the tertiary sector of the economy stagnated, with some resilience in finance and government the only real light spot overall.

**GDP, % Y/Y AND ANNUALISED**




*Source: Statistics South Africa*

Looked at from the expenditure side of the economy, fixed investment was surprisingly weak, falling -3.2% q/q saa, up just 0.2% y/y off a weak base. Again, the acceleration in the fourth quarter was stronger than expected. Another big disappointment came in with a fall in exports of -16.5% q/q saa and a total detraction from growth by net exports of -3.1 percentage points. Elsewhere, household spending slowed to 1.5% from 3.6% q/q saa. Accounting for 60% of real GDP, this is traditionally an important driver of growth momentum, and while the absolute rate of growth is a little weaker, it remains resilient – the slower moderation in the first quarter of 2018 is not surprising given the fourth-quarter surge.

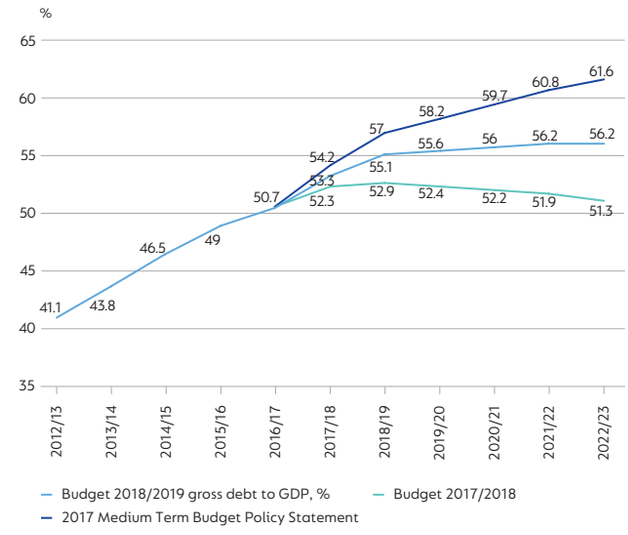
The weakness in net exports points to a widening current account deficit and may temper growth expectations further. While global activity slowed in the first quarter and is also expected to rebound later in the year, this remains a vulnerability, not only for better growth but also for the currency.

Looking ahead, there is good reason to expect growth to improve from here, albeit at a slower pace than hoped. First, data from the first quarter of 2018 were affected by a number of one-offs which should recover, including the impact of a smelter outage on platinum group metal output (23.3% of mining production), an oil refinery closure which handicapped manufacturing output, and seasonal adjustment related both to Black Friday retail spending late last year and the timing of the Easter holiday this year.

While high-frequency data for the start of the second quarter of 2018 have continued to disappoint (retail sales, mining, manufacturing, business and building confidence), households in particular are in a relatively good position to increase spending, with solid real wage growth seen, improved consumer confidence and reasonably solid credit metrics emerging in data from the National Credit Regulator. Growth of above 2% in household spending remains a reasonable expectation at this time.

A meaningful productivity and job-generating increase in capital investment is likely to take longer. It is the nature of large industries in South Africa to require long lead times for investment, and despite the changing political backdrop, policy in key sectors remains uncertain. The renewed debate about land expropriation is unhelpful too, and it seems likely that companies will need more certainty (and durable global demand) to generate meaningful capital commitments. That said, even a small increase in inventory accumulation could provide some short-term growth momentum.

**SOUTH AFRICA'S DEBT TO GDP**




*Source: National Treasury*

With growth disappointing, other concerns have become more heightened. South Africa's vulnerable fiscal position was rendered only slightly (and possibly temporarily) less so with the Budget that was tabled in February, and the decision to support revenues with a 1% increase in value-added tax. Sustained consolidation of the deficit and moderation in the pace of debt accumulation, which accelerated meaningfully after the financial crisis in 2009, require both an improvement in the pace at which revenue is collected as the economy grows (tax buoyancy) and a tight rein on expenditure, notably the wage bill. Low growth threatens the former, although there are some signs of improvement here. On the latter, the public-sector wage agreement, which almost resulted in a strike, was a little more generous than budgeted, and will add to expenditure over the next three years. While this is not yet enough to fully undermine Budget projections of a deficit of -3.6% of GDP this year from -4.3% last year, the added burden of state-owned entities under significant pressure means that South Africa's fiscal position is still very vulnerable.

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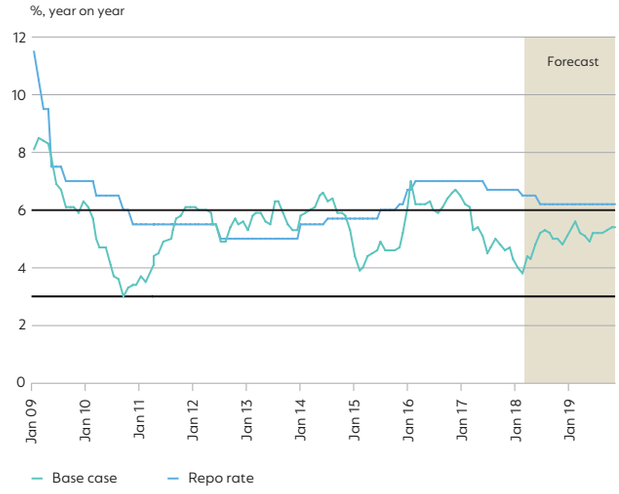
### CPI INFLATION PLUS FORECASTS




*Sources: Statistics South Africa, Coronation*

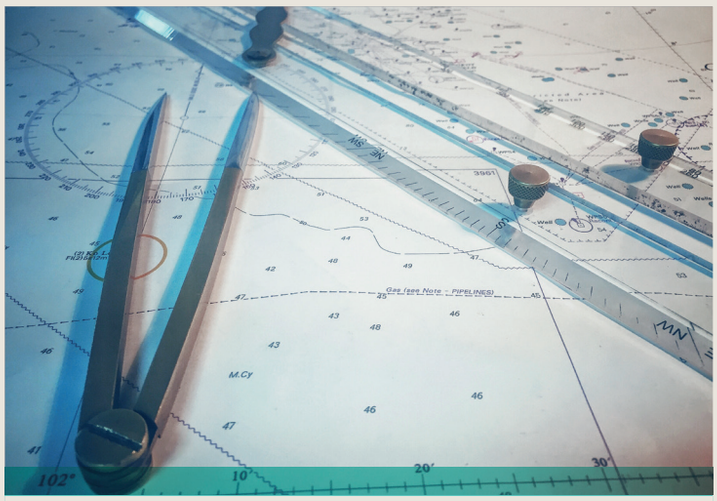
On a positive note, inflation remains very benign and interest rates should stay low. Available data suggest CPI will average about 4.8% this year, with a small tick up in 2019 to 5.2%. Low food inflation is the main anchor to inflation, but tail winds from the currency's strengthening at the start of the year can be seen in goods inflation, which is running at just 3.5% y/y. Services inflation has also moderated and is typically a slow-moving indicator; it should remain well contained in coming months. The biggest risk to inflation comes from a combination of the weaker currency and high international oil prices, although at this stage these are unlikely to be enough to unanchor headline inflation meaningfully above target, or, in our view, prompt a tightening in monetary policy at this stage.

### HOW TO THINK ABOUT THE ECONOMY GOING FORWARD?

The weak economic outcomes are a reality check, a reminder that the deterioration in political and economic conditions has taken time, and so will the remedy. At the end of the day, the practical reality of a weak economy in which both consumers and businesses have suffered low or contracting growth in an increasingly unstable political environment has created a situation where intent and feeling better are not enough to motivate spending.

To give credit where it is clearly due, a lot has happened to halt the deterioration in both political and macroeconomic variables. Significant changes have been made at both ministerial and institutional level, and various regulatory and governance changes were initiated to start healing ailing parts of the system. Committed political and business leadership has worked tirelessly to not just talk about these interventions, but to deliver justice and generate committed capital. However, this process was never going to be easy or straightforward, and we are reminded daily that not everyone wants the same thing – vested interests, poor practice (both public and private) and deeply ingrained but differing perspectives are all challenges which will need to be navigated to see an economic recovery.

For the remainder of this year and the next, with many uncertainties not limited to internal political dynamics, the 2019 election and global cyclical momentum, domestic fundamentals still support better growth than we have seen to date. Aside from the one-offs which we expect to reverse by the end of the first half of 2018, we anticipate a pickup in household spending, an area of resilience in the first quarter, and some improvement in net trade. We think capital investment will be less weak, but will take longer to recover, with growth forecast at 1.6% this year (1.8% previously) and a solid 2.2% in 2019. ✚



# International portfolio update

## CORONATION GLOBAL EQUITY FUND OF FUNDS

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Fund | 1 Jul 00 | 14.40% | 9.06% | 10.86% | 6.85% |
| Benchmark | | 10.73% | 8.63% | 10.27% | 4.77% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

The fund outperformed the benchmark for the quarter, bringing the rolling 12-month gross performance to 14.4% against the 10.7% returned by the MSCI All Country World Index (ACWI).

The slight advance in the index somewhat masks the significant decline in emerging markets, which fell 8.0% (in US dollar terms), underperforming developed markets by 9.0%. The decline was most likely due to a combination of fears of a global trade war and US dollar strength as the US Federal Reserve (Fed) raised interest rates by a further 0.25% in June. The US president is stoking the flames of a trade war, not only with China but also with his allies in Europe and Japan, all of which have vowed to retaliate. This unsettled the market at times.

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North America was the best performing region this quarter, rising 3.6%. The weakest return was from Japan which declined 2.8% (in US dollar terms). Europe also declined 0.9% (in US dollar terms), while the Vanguard Pacific ex-Japan Stock Index rose 1.8% (in US dollar terms). On a look-through basis, the fund is overweight North America, equal weight to Europe and underweight Japan.

Among the global sectors the best returns were generated by energy (+11.9%), information technology (+5.6%) and consumer discretionary (+3.5%) stocks, while the worst performing sectors were telecommunications (-4.2%), financials (-5.2%) and industrials (-2.8%). On a look-through basis, the fund benefited from its overweight positions in information technology and consumer discretionary and underweight position in financials. An underweight position in energy and an overweight position in consumer staples detracted from performance.

The strong returns this quarter were dominated by three of the underlying funds, Contrarius Global Equity, Maverick Capital and Egerton Capital.

Contrarius Global Equity generated alpha of 13.5% over the quarter, benefiting from its exposure to energy and consumer discretionary stocks. An example of the latter is Fossil which more than doubled over the quarter after strong sales in smart watches and a 5% year-on-year increase in sales. Twitter, a long-held position, also performed strongly, rising more than 50% over the period.

Maverick Capital benefited from its positions in technology and healthcare. Shire, a pharmaceutical company that had been a drag on performance in quarters past, finally came through and rose 19% after a takeover by Takeda Pharmaceutical. Facebook, up 29% over the quarter, added alpha as it recovered from its recent Cambridge Analytica woes.

Egerton Capital also benefited from holding Facebook, but 21st Century Fox and Safran also contributed strongly to the positive performance. 21st Century Fox was subject to a bidding war by Disney and Comcast which drove the price higher while aircraft engine manufacturer Safran rose 24% after Airbus announced a strong order book and delivery schedule.

**We remain of the view that investors are too complacent about the potential level of normal interest rates in the long term.**

The US economy is strong but there are concerns about overheating in developed economies and the impact of consequent inflation. In addition, the potential for a global trade war and other geopolitical issues will continue to weigh on global markets and investors' minds. However, we believe the key risk is the normalising of the interest rate cycle which is now under way in the US and will be followed in due course by the UK, Europe and Japan. After a decade of near-zero interest rates, the potential for missteps is great and the fall-out could be severe. But, perhaps in recognition of this, central banks are proceeding cautiously and gradually. As such, although we are cognisant of stretched valuations, we believe the US and global economy will be resilient for the remainder of the year and we remain supportive of the markets. The risks will only increase into next year.

## CORONATION GLOBAL EQUITY STRATEGY

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Strategy | 14 Nov 14 | 2.46% | 5.42% | - | 5.28% |
| Benchmark | | 10.73% | 8.19% | - | 7.33% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

The second quarter of the year created even more uncertainty after the turbulent first quarter. Investors' minds were increasingly occupied by the growing prospect of an intensifying trade war between the US and its major trading partners. President Trump and his administration seem intent on turning long-term allies into enemies, with their erratic but ongoing comments about putting America first with regard to trade. This has led to a series of tit-for-tat reactions from predominantly China. Even countries like Canada and trading blocs such as the EU have resorted to reactive measures to try and drive home the fact that the US should behave in a responsible way in a global trading village. While one can contextualise these measures as relatively small in a global trading environment, investors have been spooked as it is difficult to predict if and when these irrational actions will stop. In addition, down the line these actions have a direct impact on monetary policy and, as such, create more uncertainty.

With regards to the latter issue, we remain of the view that investors are too complacent about the potential level of normal interest rates in the long term. An analysis of the yield curve shows that while the Fed has clearly and continuously communicated its intention to increase interest rates two more times during 2018, only half of the market believes that to be true. In addition, the market only discounts a 10% probability of further rate hikes in 2019, while the Fed has indicated its intention (all other data points being equal) to raise rates twice during 2019. We are monitoring these statistics closely, as it could affect the equity risk premium in the medium term.

Against this backdrop, the MSCI ACWI returned 0.5% over the quarter, resulting in the year-to-date number still being slightly negative. Over the last year, the index return was 10.7%, slightly above the three-year annualised number of 8.6% per annum.

Returns in local currencies were on average more than 2% higher, but the stronger US dollar curbed reported returns in that currency. The US dollar was on average about 4% to 6% stronger than most of the other major currencies. Among developed markets, Japan was the laggard by a modest margin. Given the increased concerns from investors about a possible full-scale trade war, it was no surprise that emerging markets underperformed their

developed counterparts by over 8%, with more than half of this number being attributed to weaker currencies. The strategy has been somewhat sheltered against these moves, given our decision to hedge the bulk of our emerging market currency exposures. Within the emerging market universe, Brazil was the notable underperformer, given the increasingly complex situation on the domestic political front. Over the last 12 months (and over longer time periods), developed markets have now marginally outperformed emerging markets.

Within sectors, energy was the standout performer this quarter given the stronger oil price. Financials underperformed amidst trade war concerns and their potential impact on monetary policy. Telecommunication services were also weak. Over the last 12 months, energy and information technology were the strongest sectors, with telecoms and consumer staples underperforming the benchmark by around 15% and 11% respectively.

Our strategy slightly underperformed the benchmark over the quarter. The last 12 months have been tough in terms of relative performance. We remain ahead of the benchmark over the last two years, but still behind since inception. We continue to find value in the stocks we own, and in some cases have added to our positions.

Over the last quarter our most notable winners include stocks like Altice, Pershing and Imperial Brands, which have all detracted in the past. Other positive contributors were Facebook, Alphabet, global investment firm KKR & Co. L.P. and Advance Auto Parts. Laggards included Porsche and Tata Motors (on the back of trade war worries), Intu Properties, the airline holdings on the back of a higher oil price and the Brazilian educational stocks as the economy continued to shrink in the face of political and economic crisis. Our two big tobacco positions, British American Tobacco (BAT) and Philip Morris International (PMI), also detracted (discussed in more detail below).

Reflecting on the poor outcome of the last 12 months, it is clear that some of the portfolio's larger positions have detracted meaningfully. Altice, the tobacco stocks, the US pharmacy retailers, L Brands and Tata Motors were the big negatives. In most of these cases the investment thesis still holds, and we continue to be encouraged about the prospects of these companies. The developments in the US pharmacy sector are being monitored closely, with the potential entry of Amazon in that space. Conversely, Amazon was our biggest positive contributor over that time.

In last quarter's report we discussed our motivation for significantly increasing the strategy's exposure to tobacco stocks. We continue to do more research and have increased our conviction about the prospects for this sector in the light of continued changes in consumer preferences for next-generation products (NGPs, which include both vaping and heat-not-burn products). The strategy now has about 11% exposure to the sector, primarily in BAT, a stock we have worked on extensively given its dual listing on the JSE, and PMI, the owner of the iconic Marlboro brand outside of the US. PMI's share price came under significant pressure after investors were disappointed with its growth in heat-not-burn product sales in Japan. The sector is trading at a discount of over 30% to its historical average rating, and while we expect investor uncertainty to continue given all the news flow expected over the next few years, we think patient investors will be well rewarded.

More recently, we have also introduced Mondelēz International to the portfolio. This branded snack and confectionary group has been punished by investors worrying about branded consumer groups' ability to continue taking price increases in light of the rise of instore brands and lacklustre US packaged food sales growth.

We think the market underappreciates the fact that only 25% of Mondelēz's sales are in the US, with about 40% of group sales coming from emerging markets where its portfolio of brands is very strong and growing. The market seems to have lumped the stock with other US-centric names like Kraft and Campbell Soup where lethargic growth prospects have scared investors. In addition, the market also tends to price these stocks as bond proxies, and with the normalisation of longer-term interest rates, investors have shied away from holding consumer defensives. We consider this to be an opportunity to increase the strategy's exposure to high-quality holdings like Mondelēz, Anheuser-Busch InBev (AB InBev) and Reckitt Benckiser.

While the headlines would suggest a more cautious stance towards equities given the level of volatility expected by the market, we continue to be excited about the prospects for the stocks we own in the portfolio.

## CORONATION GLOBAL MANAGED STRATEGY

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Strategy | 1 Nov 09 | 2.36% | 4.64% | 6.74% | 8.33% |
| Benchmark | | 6.96% | 6.44% | 6.65% | 6.78% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

Global bond markets continued to come under pressure this quarter as investors further adjusted their interest rate expectations. Longer-term yields increased slightly in the US. In addition, the strength in the US dollar resulted in negative returns in dollar terms for most developed markets. The overall benchmark index returned -2.8% (in US dollars) over the quarter, resulting in a marginally positive return over the last 12 months. The US 10-year bond is now trading more than 50 basis points (bps) higher than a year ago.

Global property on the other hand had its best quarter in some years, returning 5.5% (in US dollars) over the quarter despite the strong US dollar. The US and Australian markets were the strongest (both yielding around 10% in local currency terms). The improved performance of this asset class was due to stronger than feared underlying profitability from real estate investment trust portfolios in markets such as the US, as well as a slight rerating as investor concerns about the demise of physical property in light of continued online penetration dissipated somewhat. These portfolios continue to trade at attractive valuation levels in our opinion, despite the stronger quarter. The global property benchmark index returned 6.3% over the last 12 months, significantly ahead of global bonds. >

Commodities were mixed over the quarter, with the oil price being the stand-out performer, increasing by 13%. Gold was down 5.5%, erasing all its gains towards the end of last year, and ending the last 12 months almost flat. Platinum was also down 8.5% during the quarter.

The strategy marginally outperformed its benchmark over the quarter. The last 12 months have been tough in terms of relative performance. We remain ahead of the benchmark over longer time periods and since inception. We are excited about the prospects for the positions in our portfolio, but caution against too high expectations given where the various asset classes are trading.

The strategy's asset allocation made a marginally positive contribution to performance over the quarter given the strength in the property sector. However, over the last 12 months, asset allocation detracted, as we remained underweight equities which performed the best in relative terms. This was to some extent compensated for by our overweight position in property.

**Prospects for the various asset classes are subdued in our opinion, and investors should calibrate their expectations accordingly.**

In terms of underlying asset class attribution, our equity holdings slightly underperformed their equity benchmark over the last three months, while the 12-month period was very tough (refer to prior commentary for detail).

Our property holdings underperformed the benchmark over the quarter, but did satisfactorily over the last year. Credit performed well both over the shorter and the longer term, but our physical gold position detracted, based on a weak gold price. Our decision to hedge some of our currency exposures added to recent performance, given the underlying strength in the US dollar.

Prospects for the various asset classes are subdued in our opinion, and investors should calibrate their expectations accordingly. Nevertheless, we keep finding exciting opportunities in the various categories, and while mindful of overall portfolio risk, we are selectively including some of these in the portfolio.

### CORONATION GLOBAL EMERGING MARKETS STRATEGY

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Strategy | 14 Jul 08 | 5.63% | 5.30% | 4.39% | 6.86% |
| Benchmark | | 8.20% | 5.65% | 5.19% | 2.92% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

In what was a very weak past few months for emerging markets (the MSCI Emerging Markets Index fell 8.0% over the quarter), the strategy returned -9.3% (gross of fees). The largest detractors over the period were the Brazilian education stocks Kroton and Estácio, which together detracted 2.4%. Porsche (-0.56%) was the only other stock that detracted by more than 50 bps. The main positive contributors were YES Bank (+0.50% contribution), Airbus (+0.37%) and Naspers (+0.36%). Over the past five years, the strategy is slightly (0.8% per annum on a gross of fees basis) behind the market, partly due to the recent tough period and partly due to a very good year in 2013 (19.3% alpha) dropping out of the five-year base. Over seven years, the strategy has outperformed the market by 2.1% per annum (gross of fees). The strategy has also just reached its 10-year track record (launched on 14 July 2008) and since inception it has outperformed the MSCI Emerging Markets Index by 4.0% per annum (gross of fees).

The Brazilian education stocks, after being significant positive contributors in both 2016 and 2017, have been large detractors so far in 2018. We wrote extensively about Kroton in the April 2018 commentary, but given continued poor performance of the Brazilian education stocks and their impact on the strategy's returns, we believe it worthwhile to briefly touch on them again. Even after appreciating by 20% so far in July, Kroton is still down 39% (in Brazilian real) year-to-date and down 23% over the past one-year period. In contrast, Estácio, while having declined by 20% this year, has appreciated by 70% over the past one-year period. Estácio's performance this year has been broadly in line with the average Brazilian consumer stock – in other words, its poor performance is largely due to macro factors (rising US rates and Brazilian politics/economic concerns driven in part by the truckers' strike and upcoming elections in October). Kroton's performance, besides being impacted by macro factors, has also been impacted by company-specific factors, as one would expect to be the case given the differential in performance between Kroton and Estácio.

During the quarter, Kroton reported its first-quarter results and while these results were in line with expectations, they reduced the company's earnings guidance for the year. (In contrast, Estácio's results and outlook were ahead of expectations.) Kroton also announced the acquisition of an education publishing/K12 school business (Somos Educação) at what appears to be a high price. These two events, as well as general economic concerns (and education industry concerns) resulted in the share coming under more pressure. Kroton is already far more efficient than Estácio (c. 30% EBIT margins versus. c. 15% EBIT margins for Estácio) and as such does not have this lever to pull.

As is typically the case when a large strategy holding is going through a tough period and is impacting the strategy's performance, we spent a significant amount of time on Kroton over the past several months with the aim of assessing whether the investment case still holds. Besides spending half a day in São Paulo meeting with several individuals from Kroton's management team earlier this year, in the past few months we have had separate calls with Kroton's CEO (twice), CFO, Head of Campus and Head of K12, to assess the Somos transaction and to discuss both the shorter- and longer-term challenges and opportunities for Kroton. In addition,

over recent months we have spoken with competitors (Estácio and others), former industry executives as well as three local Brazilian funds (two are shareholders and one has a negative outlook on Kroton) as we believe there is value in understanding different views). Our conclusion from all this work is that while Kroton is facing a tough year or two ahead, the long-term prospects remain very attractive: an underpenetrated market in a fragmented industry with the biggest players (Kroton is the number one player and Estácio number two) having the opportunity to take market share in what is a scale business, and a new growth driver in the form of entry into the K12 schools market where the market size is more than double that of the tertiary education market. On the Somos acquisition, while the price does look high at face value, there are synergies that can be extracted to bring the acquisition multiple down. Somos' most recent results (post the announcement of the acquisition) showed a 40% increase in profits, which brings the acquisition multiple down further. Furthermore, the asset brings diversification to Kroton as well as good cash generation with lower student defaults than in the tertiary sector. Somos provides a platform for a quick leap into Kroton's planned K12 expansion as it takes Kroton from having two schools to having 44 schools, which in turn makes it the largest operator in the K12 private market. Kroton now trades on less than 10 times 2018 earnings with a 4% dividend yield (Estácio's valuation is not dissimilar), which we believe is very attractive given its favourable long-term prospects. Today 5.4% of the strategy in total is invested in the Brazilian education companies, with 3.5% in Kroton and 1.9% in Estácio.

A client recently asked us whether, because we focus so much on the long term in assessing businesses and making investment decisions (five years and longer), we miss short-term data points. It is a valid question. The above discussion (12 Kroton-related calls with both management and outsiders in a three- to four-month period) hopefully answers the question to some extent. We do indeed focus on the long term (and in an increasingly short-term focused world, we firmly believe that truly taking a long-term view is a key competitive advantage), but we also spend a large amount of time assessing every new (and short-term by definition) development – whether that is an earnings release, an acquisition or some other event including macroeconomic events – and what they mean for both the short-term and long-term earnings streams of the business.

A sharp decline in short-term earnings (next one to two years) does have an impact on the long-term value of any business, although in many cases the impact is far less than the extent of the share price decline.

As such, while we are primarily concerned about the long-term (five years and longer) earnings stream, the next one to two years' earnings, even though they are short term, are important for us to understand. We model all businesses on five to six years and it is this earnings stream that determines our fair value. Within this five- to six-year period we will naturally model the next one to two years' earnings. To summarise, even though our focus is firmly on the long term (five years and longer), we certainly do not ignore the next one to two years' earnings. In addition, with cyclical assets we always build a down year into our five- and six-year modelling period; even though we may not know when such a down year will manifest, we know that it inevitably will.

Magnit, the number one Russian supermarket retailer by profits, has been the other main detractor from performance over the past several months, although it was a positive contributor over the quarter. During the quarter the company announced the potential acquisition of a pharmaceutical distributor, owned by a related party. The proposed acquisition was a big concern for us:

- We feel that management's time is better spent addressing current issues in the core food retail business which is underperforming.
- We question whether it is necessary to own a distributor in order to start rolling out a pharmacy strategy (which was the rationale given by Magnit management at the time of the announcement).
- Most importantly, we had corporate governance concerns regarding the transaction (the distributor for sale is owned by a related party, which had only recently bought a 10% stake in Magnit).

As a result, we had calls with a few other large shareholders. We drafted and sent a co-signed letter to the board expressing our collective concern about the transaction. We also held calls with the (independent) chairman and vice-chairman of Magnit as well as another independent director. We were encouraged by their constructive response to our concerns and how they intend to approach this and other issues. At the subsequent board meeting a few weeks ago, the CEO of Magnit (Khachatur Pombukhchan) tendered his resignation and Olga Naumova was appointed in his place. Naumova recently joined Magnit as an executive director from X5 Retail where she was head of X5's convenience business, Pyaterochka, which makes up c. 80% of X5's group revenue. She is largely credited with turning around this business (and hence the X5 Retail Group) over the past five years. With a new board, a new management team (besides the CEO, the new highly regarded CFO is also from X5 and one of the new directors, ex-Lidl UK CEO, is also involved in an executive role) and a still fragmented Russian food retail market, we believe that Magnit is very attractively valued at current levels and it remains a top 10 holding.

There were three new buys during the quarter: PMI (4.7% of strategy and the largest new position), AB InBev (2.1% of strategy) and YUM China (1.0% of strategy). Having previously sold out, we also added 1% positions in each of Alibaba and Altaba after reassessing Alibaba's fair value following a few related meetings and results announcements with additional disclosure. In terms of sells, we sold out of five positions (all of which comprised less than 1% of the strategy at end-March):

- YUM Brands (reached fair value);
- Puregold (reached fair value);
- Hering (close to fair value but with increasing risks in Brazil);
- Reckitt (better global consumer staple opportunities); and
- Steinhoff (which was down to a seven bps position at the time of sale and where our view was that the probability of there being no equity value increased as various assets continued to be written down).

In terms of other sells (reducing positions), we reduced the JD.com position (still 3.4% of strategy, but we wanted more of a balance >

between JD.com and Alibaba), the Heineken and Unilever positions (still 3.3% and 2.0% of strategy respectively, but we were buying other even more attractive consumer staples like Phillip Morris) and Airbus (still very attractive and a 3.2% position, but getting somewhat closer to fair value). In terms of other buys, we added to the Ping An Insurance, Femsa, Taiwan Semiconductor Manufacturing Company (TSMC) and Cognizant positions after share price declines in all of these with no change to what we think the businesses are worth.

For the nine-and-a-half-year period since inception of the strategy in July 2008 and until January of this year, we had on average a 1% exposure to tobacco companies. The reason for this was two-fold:

- Concern over the very long-term prospects for these businesses (declining volumes, increasing regulation and even more health awareness); and
- Valuation (they had benefited from the general upward rerating of all consumer staples).

Over the more recent past there have been two key changes. First, the development of successful reduced-risk products (vaping and heat-not-burn devices) has meant that for the first time in decades far safer alternative products are available and as a result total tobacco or nicotine consumption has started to increase instead of decline. Secondly, sharp declines (c. 25% this year) in the share prices of both BAT and PMI have brought their valuations down – BAT to c. 13 times December 2018 earnings and a 5.1% dividend yield and PMI to c. 16 times December 2018 earnings with a 5.3% dividend yield. As such, we believe that for the first time in several years these stocks are now very attractive, and BAT and PMI (both of which have high emerging market exposure – 43% and 55% respectively) are 5.3% and 4.7% positions in the strategy.

**AB InBev has a globally diversified business, with a strong presence in Africa (both South Africa and the rest of Africa), Brazil, Colombia, Mexico, China and the US.**

The tobacco companies still have many of the qualities that have always made them very good businesses – most importantly pricing power, stable earnings, very high return on capital and high free cash flow conversion. In addition, they now have attractive long-term growth prospects in our view, due to having reduced-risk products in their portfolio that provide an attractive, healthier alternative to traditional cigarettes.

In summary, the two main categories of reduced-risk products (vaping and heat-not-burn) do not involve burning, and it is largely the burning (combustion) and subsequent release of chemicals of traditional cigarettes that create the health issues. By avoiding combustion, the risk-reduced products eliminate the biggest issue with traditional cigarettes, which in turn is what makes them appealing.

Both BAT and PMI have vaping and heat-not-burn products, with BAT being the global leader in vaping and PMI the global leader in heat-not-burn with its IQOS (I Quit Ordinary Smoking) product. In our view, there is room for both products as they have a different appeal, and being global leaders respectively, there is a high probability of BAT and PMI taking disproportionate incremental market share and hence increasing their overall global market share. PMI's NGPs already contribute 13% of the group revenue and the company aspires to grow that to c. 40% of revenue by 2025 through a c. four to five times increase in NGP total revenue, from $4 billion to c. $18 billion. To put this $18 billion in perspectivet, PMI's total group revenue was $29.7 billion in 2017.

In terms of other new buys within the strategy, AB InBev has gone from being a market darling ('great management team') to being very much disliked ('only cost-cutters'), and the share price has followed this sentiment. Perhaps the truth is somewhere between these two extremes, but in our view global beer remains a very attractive industry (with oligopolies in many markets, strong brands, premiumisation opportunities, stable earnings, high return on capital and among the best free cash flow generation of any business).

There are two gorillas in this industry, AB InBev and Heineken, both of which have attractive long-term prospects. We continue to rate the AB InBev management team highly and believe that what they may not know about branding or segmentation (which is very little, according to the bear view) can be learnt from the SABMiller (South African Breweries) assets that they acquired, or can be brought in. AB InBev has a globally diversified business with a strong presence in Africa (both South Africa and the rest of Africa), Brazil, Colombia, Mexico, China and the US. Almost 60% of profits come from (lower-consuming and hence faster-growing) emerging markets. AB InBev trades on c. 19 times 2018 free cash flow (with South African Breweries revenue and cost synergies still coming, Brazil profits below normal, and Africa and China growing at a rapid rate) and with a 4% dividend yield, which we believe is attractive for an asset of this quality.

YUM China is the Chinese business that was spun out of YUM Brands (the global owner of KFC, Pizza Hut and Taco Bell). The company has c. 8 000 outlets in China (McDonalds as a reference point has 2 600 outlets and Burger King has 800) and continues to roll out 500 to 600 new restaurants a year. The vast majority (80%) of these outlets are KFC, with the balance largely being Pizza Hut. The royalty percentage paid by YUM China to its parent is far lower than industry norm, which in turn means higher margins and a higher return on capital can be achieved.

The fundamentals of a big brand fast food restaurant chain are generally attractive (convenient and affordable, defensive earnings stream and very good free cash flow generation). In addition, with still low penetration, YUM China can continue to roll out stores in China for many years to come, in our view. The fast food groups have been successful at addressing the needs

of a more health-conscious consumer (a clear long-term risk) with expanded menus. Home delivery has also become an important driver (16% of KFC's and 23% of Pizza Hut's sales in China are now deliveries). The company has a strong balance sheet (net cash c. 10% of market capitalisation) and will continue to generate a lot of free cash flow in the years ahead – a large part of which could be applied to share buybacks. There is also opportunity for margins to expand, in our view. All-in, we believe that YUM China is a high-quality business that can grow earnings by c. 15% per annum over the next five years, and at around 22 times free cash flow one year out, is attractive at current levels.

Members of the team continue to travel extensively to enhance our understanding of the businesses we own in the strategy, their competitors and the countries in which they operate, as well as to find potential new ideas.

In the quarter there were trips to Russia, South Korea, Taiwan and Singapore. In the coming months various members of the team will visit China, focusing on Chinese internet companies which remain the industry where the strategy has its main exposure to China. The weighted average upside to fair value of the strategy at the end of June was an attractive c. 53%.

## CORONATION AFRICA FRONTIERS STRATEGY

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Strategy | 1 Oct 08 | 18.06% | 3.30% | 5.21% | 10.23% |
| Benchmark | | 1.80% | 1.11% | 0.76% | 0.67% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

After a strong start to the year, the markets across Africa were weak over the past three months. Morocco (-12.3%), Nigeria, (-9.7%), Egypt (-9.3%) and Kenya (-9.0%) all recorded large declines during the quarter. Against this backdrop, the strategy's gross return was -5.9% during the quarter, while the FTSE/JSE All Africa ex-South Africa Top 30 Index was -6.6%.

On the African continent, many great businesses have globally recognised companies as majority shareholders. Multinational companies such as Nestlé, Heineken, AB InBev, Vodafone and BAT all have subsidiaries listed across Africa. We hold a number of these subsidiaries in the strategy. We believe the relationship with the multinational parent offers a number of real benefits, both to the subsidiary company and to minority shareholders:

- These companies have access to the world-class brands of the parent, as well as access to the latest technology and operational best practices.
- Multinationals often have strong balance sheets, deep pockets and access to favourable lending terms. We have recently seen an example of this in Nigeria where the lack of forex availability resulted in serious problems for local businesses. During this time, many international parent companies provided hard currency financing to their subsidiaries, which allowed them to continue with their operations.
- The parent company offers an additional level of governance and oversight. Governance standards are typically good as these subsidiaries must follow the (usually stricter) standards required by the parent's listing in more developed markets.

There are also several South African companies which control businesses across Africa. Our experience with these companies in South Africa, together with our interactions with local management teams, helps us to form a better view of the individual businesses and their strategies.

What really excites us are the valuations of many of these businesses. While the subsidiaries in Africa typically offer higher growth than the parent companies, they often trade on lower multiples. A case in point is Standard Bank, where two of its subsidiaries, Stanbic Holdings in Kenya and Stanbic IBTC in Nigeria, are positioned in the top five holdings of the strategy.

Standard Bank clearly views these two banks as attractive investments. In March 2018 it announced it would increase its stake in the Kenyan subsidiary from 60% to 75% and in June 2018 it increased its stake in the Nigerian subsidiary from 53% to 64%.

Over the past 12 months, Stanbic Holdings (Kenya) was up 33% while Stanbic IBTC (Nigeria) rose 37% in US dollar terms. As two of the largest positions in the strategy, these companies made meaningful contributions to performance. Despite the strong share price moves, we still view these banks as attractive. Both trade on single-digit price earnings multiples and current valuations do not reflect the earnings growth we expect to see over the next few years. Both these banks have excellent corporate banking divisions, but the profitability levels of their personal and business banking divisions are still low.

As the personal and business banking divisions gain scale, they should start to contribute meaningfully to earnings and will help to lower strategying costs for the corporate and investment banking divisions. As a result, we believe that the earnings are still below average for these banks.

While we like to own the subsidiaries of large multinational businesses, it does not mean that we will own these businesses at any price. There are many examples of companies we would like to own, but where valuations are simply too high. In addition, a business that is majority owned by a multinational can at times be a double-edged sword.

We have seen instances in the past where parent companies have taken actions that are in the best interest of the group rather than the subsidiary. We are cognisant of this risk and often engage with management teams on the topic, but up to now our experience has been that the benefits of investing alongside a strong multinational usually outweigh these risks.

Over the life of the strategy, these businesses have been large contributors to performance and we still hold a number of them in the portfolio.

These are just some of the businesses in the African universe that are currently very attractively valued. By owning these businesses >

that trade well below our assessment of intrinsic value, we believe investors will be rewarded over the long term.

## CORONATION GLOBAL FRONTIERS STRATEGY

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Strategy | 1 Dec 14 | 12.15% | 7.35% | - | 6.02% |
| Benchmark | | 1.80% | 1.11% | - | 0.97% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

The past three months were very tough for frontier markets. The strategy's gross return was -7.5% while the MSCI Frontier Markets Index was down 15.2% over the period. Ukraine (+29.7%) was one of only a few markets with a positive return over the past quarter. Morocco (-12.3%), Pakistan (-10.5%), Nigeria (-9.7%), Egypt (-9.3%), Sri Lanka (-6.3%), Bangladesh (-3.5%) and Kuwait (-0.9%) all declined, but the most significant contributors to the negative performance in frontier markets came from two markets – Vietnam and Argentina.

Over the past three months the stock market in Vietnam was down 16.8%. In the previous quarter's commentary, we said that while we liked the macroeconomic fundamentals of Vietnam, we found valuations simply too expensive and so had no exposure to Vietnam.

The largest decline during the quarter was in Argentina, which was down a staggering 41.6%. The Argentine peso has been under extreme pressure this year, particularly over the past three months, and the currency alone accounted for almost 30% of the country's negative performance.

Argentina is the largest constituent of the MSCI Frontier Markets Index, while Vietnam is the third largest. We have highlighted many times in the past that we size investments based on the return opportunity on an absolute basis, irrespective of the size of these investments in any particular benchmark. This is clearly demonstrated by the fact that we held no investments in Argentina or Vietnam during the quarter.

In June 2018 the MSCI announced that Argentina will be upgraded from the Frontier Markets Index to the Emerging Markets Index in May 2019. This announcement is in stark contrast to the current economic environment in the country where the currency moved from around ARS 20 to the dollar to almost ARS 29 to the dollar over the past three months, interest rates were increased to 40% and the country was forced to go to the IMF for a $50 billion financing deal.

While this upgrade sounds positive for portfolio flows, it is not necessarily the case. Argentina will move from the largest country in the MSCI Frontier Markets Index to an almost irrelevantly small constituent of the Emerging Markets Index. Two years ago, the MSCI announced that Pakistan would be upgraded from Frontier to Emerging effective May 2017. We saw the stock market in Pakistan posting strong gains in the run-up to the inclusion, but this was followed by a large decline over the following year when the country did not get the large expected portfolio inflows from emerging market investors.

Whether or not a specific company is included in the MSCI Frontier Markets Index does not change our view on that business. These announcements have virtually no impact on the underlying fundamentals of businesses and is an example of the inefficiencies that exist in financial markets. Frontier markets in particular are susceptible to this and present opportunities for bottom-up, valuation-driven investors willing to take a long-term view. Even though Pakistan is no longer in the official MSCI Frontier Markets Index, we continue to hold the businesses in Pakistan which we find attractive.

We visited a number of countries during the quarter, but our visit to Pakistan was one of the highlights. The stock market has been under pressure over the past year, driven by concerns over the political environment and the currency. However, the meetings with individual companies showed that many of these businesses are performing well. A number of these businesses now trade well below our assessment of fair value.

One example is Bank Alfalah, the leading retail and small and medium-sized enterprise (SME) bank in Pakistan. The growth potential for banks in Pakistan is significant. There are only 20 million bank accounts in a country with almost 200 million people and the loan to GDP ratio (below 20%) is low compared to other frontier markets, and extremely low compared to more developed countries. As the leading retail and SME bank, we believe Bank Alfalah has the potential to grow ahead of the market. Its strong Islamic banking franchise will help to keep the cost of funds low and it has opportunities to reduce the cost to income ratio after reorganising certain internal operations last year.

## CORONATION GLOBAL BOND FUND

| | Launch date | 1 year | 3 years | 5 years | Since inception |
|---|---|---|---|---|---|
| Fund | 1 Oct 09 | (0.65%) | 3.17% | 2.29% | 3.06% |
| Benchmark | | 1.36% | 2.87% | 1.14% | 1.23% |

*Annualised, quoted in USD gross of fees*
*Figures are quoted as at 30 June 2018.*
*Sources: Coronation, Bloomberg*
*Past performance is not necessarily a guide to future returns.*

For the most part, core developed government bond markets posted modest gains in local currency terms while peripheral and Eastern European markets posted negative returns. Emerging market debt was particularly weak and losses were compounded by weaker currencies. Corporate bonds underperformed government bonds once again as credit spreads continued to soften. The US dollar strengthened against all currencies, compounding losses in US dollar terms for unhedged positions. The fund returned -4.57% for the quarter and -0.65% over the last 12 months (gross of fees), against a return of -2.78% and 1.36% respectively for the Bloomberg Barclays US Aggregate Bond Index.

The economic narrative has become more complex in recent months. Central banks, led by the US, have begun to scale back asset purchases, and rising policy rates and tighter financial conditions are beginning to have an impact. China too is feeling the

effect of less credit growth adding to the headwinds for emerging markets. Meanwhile, the US administration's recent trade tariff hikes have added to investors' concerns that a broader trade war may develop. In the near term, US growth will be supported by fiscal expansion and the Fed will continue to tighten monetary policy as the output gap closes and wealth effects buoy consumers. A more meaningful slowdown remains a risk in late 2019 or early 2020.

US bond yields rose as high as 3.1% in mid-May, prompting talk of a breakout to the upside before falling back below 3% and ending the quarter at 2.85%. The Fed raised the Fed funds rate by a further 25 bps as expected in mid-June (upper bound now 2%); the latest dot plot was deemed to be slightly hawkish as it suggests two more moves are likely in 2018.

With short rates rising and markets acknowledging the potential for a slowdown in late 2019, the yield curve continued to flatten. While Europe and Japan resisted higher short rates, the rise in US short rates and a flatter curve have meant higher hedging costs for overseas buyers. With US issuance set to rise substantially in the wake of US tax cuts and the runoff of the Fed's balance sheet expected to accelerate, bonds hedging costs look set to rise further. Ultimately, this raises the prospect of higher US yields as foreign demand wanes.

**Within the UK, Brexit wrangling dominates the headlines, with definitive progress lacking, much to the annoyance of the business community.**

Despite being wary of longer-dated valuations, the US Treasury's current bias towards shorter-dated issuance may continue to contribute to a bearish flattening of the yield curve. With US breakeven rates of inflation relatively stable (despite higher oil prices), movements in the yield curve have manifested themselves in higher real yields. The real yields on a five-year inflation-linked instrument at 0.7% are at the highest level since 2009. The fund reduced its exposure to US government bonds during the quarter as it funded increased exposure to corporate bonds and emerging markets. The fund also switched a portion of its fixed-rate exposure into five-year inflation-linked securities.

European investors have had much to deal with over the last three months, with politics finally spilling over into markets. The Eurozone now has to contend not only with Brexit but also with a new Italian populist government which looks set to use domestic issues as a bargaining chip in the wider Eurozone reform debate. Migration has become a hot topic (especially for the coalition government in Germany) and individual states' attitudes to the subject are a reminder of just how divided Europe remains on many issues.

Europe's relationship with the US is also strained, as evident at a recent G7 summit. The imposition of tariffs (and subsequent retaliations) alongside the funding of NATO remains a live issue. Italian bonds performed poorly (down 5.2% in the last three months) in the wake of the Italian government's formation, with yields experiencing unprecedented moves (two-year yields rose from 0% to 2.75% before ending the quarter at 0.67%). In the predominant European countries, yields fell as the European Central Bank (ECB) remained dovish on rates, predicting rates would remain at current lows at least through the summer of 2019.

The central bank also announced its intention to reduce new asset purchases from the current €30 billion a month to €15 billion in the fourth quarter and complete purchases at the end of the year. Existing maturities will continue to be reinvested for an extended period with the market speculating that the ECB will skew those purchases into longer maturities, thereby maximising the duration impact of their actions. Within the UK, Brexit wrangling dominates the headlines, with definitive progress lacking, much to the annoyance of the business community. The Bank of England is inching closer to raising rates once again, with the result being that current bond yields look unappealing.

Emerging markets struggled throughout the quarter, with local currency debt particularly weak as investors unwound carry trades. Turkish bonds lost 10% in value, Indonesia 6% and Brazil 5%. Emerging market currencies endured a particularly harsh sell-off, the JP Morgan Emerging Markets Currency Index was down 10% during the quarter, with Argentina down over 30% and the South African rand, Turkish lira and Brazilian real down around 14%. Hard currency emerging market debt fared better but also succumbed to the wider sell-off in credit markets. The spread on the JP Morgan Emerging Market Bond Index widened from 3.2% to 3.9% during the quarter.

The fund added to local currency positions in South Africa and Turkey, and switched some inflation-linked exposure into fixed-rate exposure in Mexico. The fund also invested in local currency instruments in Indonesia and India via AAA-rated dual currency notes. The fund added hard currency dollar exposure via Qatar and Kenya, and reduced its South African dollar bonds in favour of local currency holdings.

Credit spreads continued to widen in the second quarter, with the weakness spreading from short, high-quality instruments that bore the brunt of the widening in Libor during the first quarter to longer-dated and lower-rated names in the last three months. European corporate bonds were particularly weak in June on the back of developments in Italy and the prospect of fewer asset purchases from the ECB. Financials suffered more than corporate credit, especially within Europe despite fears over rising trade tensions.

The US high yield markets proved to be an exception, with the high oil price lending support to the shale producers. This means that the ratio between US high-yield spreads and investment grade is at its tightest since the financial crisis. Much of the sell-off was flow related, as selling emerged on the back of exchange-traded fund outflows or managers reducing exposures, which helps to explain why cash markets widened more than hedging instruments such as credit default swaps. The fund increased its exposure to a number of credits during the quarter, including Redefine, Cromwell, Intu >

Properties and Remgro convertibles. Within fixed-rate instruments, the fund invested in new issues from FirstRand, Barclays Africa and Growthpoint, and added to MTN and Investec.

In foreign exchange markets, the US dollar outperformed all currencies, with the Fed's Broad Dollar Index up 5.6% over the quarter. There has been much debate as to the drivers of the dollar's move – are we seeing some realignment due to interest rate differentials, is this flow driven as investors flee riskier asset classes such as emerging markets, or is this reflective on some form of liquidity squeeze brought about by a shortage of dollars? The reality is that it is most likely a bit of all these factors, and US dollar speculative positioning is now somewhat extended, arguing for some let-up in the dollar's recent strength.

With significant outflows from equities and emerging market bond funds, and investors' appetite for risk having swung into deeply bearish territory, there is a strong likelihood that recent trends will abate in the short term. The caveat may be a continued escalation in trade tensions that contribute to a further weakness in riskier assets classes and drive investors into perceived safe havens.

The recent weakness in the Chinese currency has led some to speculate that China could use its currency to partly offset tariff increases. A more plausible explanation is that China has allowed its currency to readjust lower to realign it more closely with its trading partners, which have recently weakened against the US dollar. China is also battling to offset the tightening in one part of the economy brought about by its clamping down on excessive leverage by supporting other sectors of the economy via reductions in banks' reserve requirements and enhanced liquidity operations.

The fund is now underweight in developed markets (US dollars, euros, British pounds and yen) and overweight in emerging markets where we have increased our exposure into the sell-off. Our principal positions are in Mexico, South Africa and Turkey, with smaller positions in Indonesia, India and the frontier markets of Argentina and Egypt.

The fund remains underweight duration, predominately though a low duration position in Europe and no Japanese bond exposure. In the US, we are broadly neutral, with a bias towards the five-year area of the curve. The fund has added to its credit exposure and this now constitutes around half of the fund. Emerging market exposure has increased further as weaker exchange rates have made opportunities more attractive. As a result of the increase in corporates and emerging markets, the overall yield of the fund has increased considerably. We continue to hold a number of convertible bonds where we think the spreads are particularly attractive. We have previously expressed a view that volatility would increase as central banks remove stimulus, and we see no reason to expect that to change. ✚

# Global strategy performance

| | LAUNCH DATE | SINCE INCEPTION | 1 YEAR | 5 YEARS | 10 YEARS | 15 YEARS |
|---|---|---|---|---|---|---|
| **EMERGING MARKETS EQUITY** | | | | | | |
| Global Emerging Markets Equity Strategy | Jul-08 | 6.86% | 5.63% | 4.39% | - | - |
| Coronation Global Emerging Markets Equity Benchmark | | 2.92% | 8.20% | 5.19% | - | - |
| Alpha | | 3.94% | (2.57%) | (0.80%) | - | - |
| **GLOBAL FRONTIERS** | | | | | | |
| All Africa Strategy | Aug-08 | 8.89% | 16.16% | 4.79% | - | - |
| 3 Month USD Libor | | 0.71% | 1.80% | 0.76% | - | - |
| Alpha | | 8.19% | 14.36% | 4.03% | - | - |
| Africa Frontiers Strategy | Oct-08 | 10.23% | 18.06% | 5.21% | - | - |
| 3 Month USD Libor | | 0.67% | 1.80% | 0.76% | - | - |
| Alpha | | 9.57% | 16.26% | 4.45% | - | - |
| Global Frontiers | Dec-14 | 6.02% | 12.15% | - | - | - |
| 3 Month USD Libor | | 0.97% | 1.80% | - | - | - |
| Alpha | | 5.05% | 10.35% | - | - | - |
| **GLOBAL** | | | | | | |
| Global Equity Fund of Funds* | Jul-00 | 6.85% | 14.40% | 10.86% | 9.04% | 10.84% |
| Coronation Global Equity FoFs Benchmark | | 4.77% | 10.73% | 10.27% | 6.73% | 8.63% |
| Alpha | | 2.08% | 3.68% | 0.60% | 2.32% | 2.21% |
| Coronation Global Strategic Income | Jan-12 | 3.32% | 1.92% | 2.49% | - | - |
| 110% of 3 Month USD Libor | | 0.74% | 1.98% | 0.84% | - | - |
| Alpha | | 2.58% | (0.06%) | 1.65% | - | - |
| **SOUTH AFRICA** | | | | | | |
| Houseview Equity Strategy USD | Oct-93 | 10.62% | 2.83% | 2.67% | 6.74% | 14.66% |
| Houseview Equity Benchmark in USD | | 8.30% | 7.58% | 3.67% | 4.28% | 12.65% |
| Alpha | | 2.32% | (4.75%) | (1.00%) | 2.46% | 2.01% |
| Top 20 USD | Oct-00 | 16.51% | 5.44% | 3.64% | 8.40% | 16.66% |
| Coronation Top 20 Fund Benchmark in USD | | 10.29% | 7.58% | 3.90% | 3.03% | 12.00% |
| Alpha | | 6.23% | (2.15%) | (0.25%) | 5.37% | 4.66% |

* Strategy performance figures are quoted after the deduction of management fees levied within the strategy

Figures are quoted as at 30 June 2018

Sources: Coronation and JP Morgan

Past performance is not necessarily a guide to future returns