CORONATION
ABSOLUTE BOND STRATEGY
INSTITUTIONAL STRATEGY FACT SHEET AS AT 31 MARCH 2019

CORONATION
TRUST IS EARNED™

LONG TERM OBJECTIVE

The Coronation Absolute Bond Strategy aims to protect capital regardless of the interest rate cycle. This Strategy therefore offers lower volatility and greater focus on capital preservation when compared to traditional bond portfolios.

INVESTMENT APPROACH

Coronation is a long-term, valuation-driven investment house. Our aim is to identify mispriced assets trading at discounts to their fair value through extensive proprietary research. The fixed income portfolios are positioned on a long term strategic market view, but this is balanced by taking advantage of shorter-term tactical opportunities when the market lags or runs ahead of that strategic view. As active managers, we consider investment decisions across the full spectrum of potential return enhancers. These include duration and yield curve positions, inflation-linked assets as well as yield enhancement through credit enhanced assets. We aim to maximise returns by actively combining both a top-down and a bottom-up approach to portfolio construction.

STRATEGY RETURNS GROSS OF FEES

Period	Strategy	Benchmark	Active Return
Since Inception (cumulative)	393.3%	140.9%	252.4%
Since Inception p.a.	10.4%	5.6%	4.8%
Latest 15 years p.a.	10.2%	5.7%	4.5%
Latest 10 years p.a.	10.2%	5.2%	5.0%
Latest 5 years p.a.	8.9%	5.0%	3.9%
Latest 3 years p.a.	9.9%	4.9%	5.0%
Latest 1 year	7.1%	4.8%	2.3%
Year to date	2.5%	1.7%	0.8%
Month	0.6%	1.1%	(0.5)%

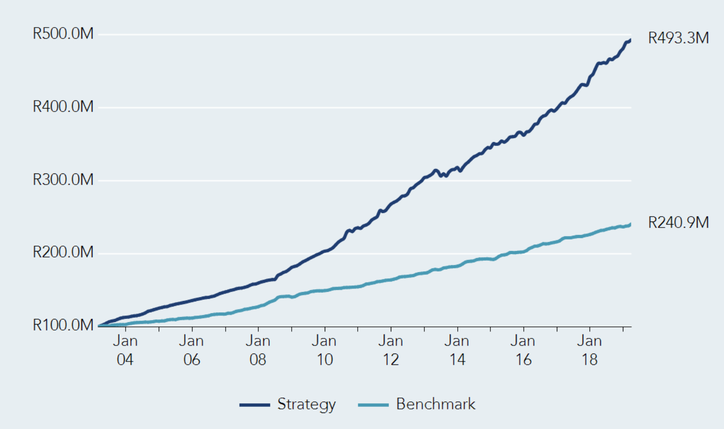
ASSET ALLOCATION

Asset Type	% Strategy
Corporate ILBs	39.3%
Floating Rate Corporate Bonds	26.8%
Fixed Rate Corporate Bonds	17.8%
Fixed Rate Government Bonds	5.2%
Cash	4.2%
Fixed Rate NCDs	3.5%
Government ILBs	1.4%
Floating Rate NCDs	0.9%
Other ILBs	0.7%
Fixed Rate Other	0.2%

GENERAL INFORMATION

Inception Date	01 March 2003
Strategy Size	R6.47 billion
Strategy Status	Open
Mandate Benchmark	Consumer Price Index (CPI)
Performance Target	CPI + 2% (gross of fees and taxes) over a rolling 12 month period
Dealing Frequency	Daily
Base Currency	ZAR

GROWTH OF R100M INVESTMENT



Benchmark: Consumer Price Index (CPI)

EFFECTIVE MATURITY PROFILE

Term	% Strategy
0 to 1 year	2.6%
1 to 3 years	16.6%
3 to 7 years	38.9%
7 to 12 years	30.8%
Over 12 years	11.1%

STRATEGY STATISTICS

Modified Duration (incl. inflation-linked bonds)	3.8
Modified Duration (excl. inflation-linked bonds)	1.6

PORTFOLIO MANAGERS

Nishan Maharaj - BSc (Hons), MBA

Nishan is head of Fixed Interest and responsible for the investment unit's process and performance across all strategies. He also manages the majority of fixed interest assets. Nishan has 16 years' investment experience.

Mauro Longano - BScEng (Hons), CA (SA)

Mauro joined Coronation's Fixed Interest investment unit in 2014 and is responsible for co-managing the Strategic Cash and Medical Aid Cash strategies. In addition to this, he is involved in credit research and pricing. Mauro has 8 years' investment experience.

DISCLAIMER

REVIEW FOR THE QUARTER

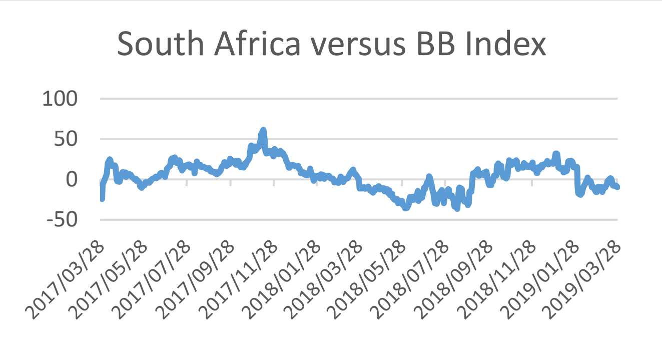
The All Bond Index (ALBI) returned 3.8% over the last quarter, bringing its return over the last 12 months to 3.5%. Inflation-linked bonds continued to lag nominal bond performance, producing 0.6% over the last quarter and -3.1% over the last 12 months. In dollars over the quarter, South African bonds returned 2.8%, in line with the 2.9% returned by other emerging markets (as measured by the JP Morgan Government Bond Index – Emerging Markets Global Diversified Composite). However, they remain quite a laggard over 12 months (-15.6% versus -7.5%). The 10-year benchmark bond traded in quite a narrow range over the quarter (9.47% to 9.08%).

The sustainability of South Africa's investment grade rating will remain a key concern. Credible monetary policy has caused inflation and inflation expectations to gravitate towards the midpoint of the band (4.5%), yet it remains adequately accommodative given the subdued growth profile. Growth, or the lack thereof, remains at the core of South Africa's structural problems. Cyclically, growth should pick up to approximately 1.3% in 2019 and 1.8% in 2020. However, the risk to this outcome is to the downside, given the threat of load shedding, the effect it has on business and consumer confidence, and how rising electricity-related costs affect corporate profitability. The burden of low growth and state-owned enterprise (SOE) support weighs heavily on fiscal policy. Until more concrete structural reforms are put through, it is up to fiscal policy to provide a supportive growth environment and support for SOEs in a manner that does not widen the fiscal deficit or increase South Africa's debt burden. Up to now, this has been well managed, as is evident in the February budget, where despite the R23 billion per year capital injection for Eskom, National Treasury still managed to limit fiscal slippage by cutting expenditure, primarily through a reduction in the wage bill. Unfortunately, given Eskom's precarious financial and operational position, the SOE still poses immense risk to both the fiscus and the economy.

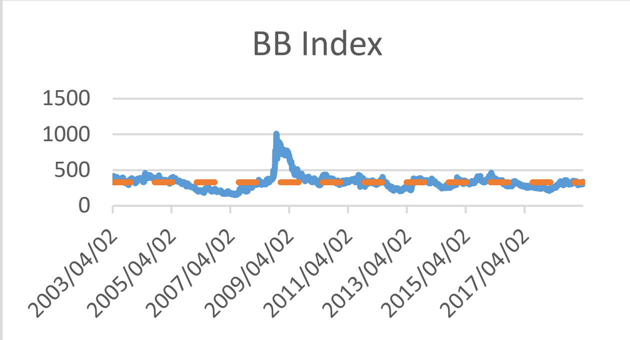
Global monetary policy has again turned accommodative. Following the US's about-turn on monetary policy, the European Central Bank followed suit a few weeks later. Global bond yields have plummeted, with the US 10-year Treasury Note continuing to rally to below 2.4%. An amazing 20% ($10.3 trillion) of all issued government bonds now trade with yields below zero. In previous periods, this proved to be quite supportive for emerging market government bonds; however, this time around, given the inversion of the US yield curve (10-year rates trading below cash rates), more caution has been exercised. An inverted US yield curve has been a successful predictor of all recessions over the last 30 years; however, the period between curve inversion and the onset of recession varies between 12 and 24 months. Therefore, over the short term, we might see this 'goldilocks' period for emerging markets continue, supporting their currencies and bond yields. Over the longer term, we still see fair value for US bond yields being above 3%. Growth in the US has come off in the shorter term due to the government shutdown at the beginning of the year and the tax cuts of 2018 coming out of the base, but is still expected at 2.5% for 2019 and 2.0% in 2020. Furthermore, wage inflation has continued to prove quite sticky, which should keep headline inflation close to the 2.0% level. Market expectations of interest rate cuts in the US seem premature at this stage, with the economy growing at 2.5% and inflation at 2%. A 1.0% real policy rate still seems appropriate given the prevailing conditions, which suggests a 3.0% nominal long bond rate at the minimum (2.0% inflation plus 1.0% real policy rate). The risks posed to global bond yields are therefore to the upside.

The key consideration for a South African bond investor is whether the yield on offer by South African government bonds compensates them for the underlying risks that the economy faces. The main areas of concern are the effect of South Africa losing its investment grade rating, the impact of higher global yields on South African bond yields and how South African bonds fare relative to their emerging market peers. South Africa's credit spread has and continues to trade at a sub-investment grade level. The South African credit spread trades in line with the BB rated sub-investment grade index (around 10 basis points [bps] more expensive than current index levels), while the sub-investment grade index trades close to its long-term average. Both metrics suggest that South Africa, even if Moody's were to move the country to sub-investment grade, at worst could see a widening of between 10 bps and 20 bps.

South Africa's government bond relative to emerging market peers, both from a nominal bond and an implied real perspective (using two-year expected average inflation), appear quite attractive. Two of the three countries with higher implied real yields include Brazil that has yet to pass a massively unpopular pension reform initiative to reduce its debt to GDP ratio from 80%; and Mexico whose largest SOE (petroleum company Pemex) is in dire need of further financial support that will weigh on the Mexican fiscus and hence, credit worthiness.



Source: Bloomberg



Source: Bloomberg

In the table below, we show South Africa's government bond relative to its emerging market peers, both from a nominal bond perspective and an implied real perspective (using two-year expected average inflation). Once again, South Africa features as quite attractive relative to its peers, especially considering that Brazil has yet to pass a massively unpopular pension reform initiative to reduce its debt to GDP ratio from 80%, while Mexico's largest SOE (petroleum company Pemex) is in dire need of further financial support that will weigh on the Mexican fiscus and, hence, credit worthiness.

	Nominal Yield	Implied Real Yield
Brazil	8.97	4.87
Mexico	8.01	4.03
Indonesia	7.60	3.96
South Africa	**9.00**	**3.81**
India	7.35	3.67
Russia	8.19	3.53
Average	6.18	2.18
Turkey	17.18	2.12
Malaysia	3.76	1.80
Chile	3.97	1.04
China	3.06	0.89
Poland	2.83	0.66
Israel	1.81	0.48
Hungary	2.87	-0.12
Czech Republic	1.78	-0.41

Source: Bloomberg

If we construct a fair value for South African 10-year bonds using the global risk-free rate (US 10-year yields), the expected inflation differential (between South Africa and the US) and South Africa's credit premium, the result is 8.92% (3.0% + (5%-2%) + 2.92%). Current levels of 9.0% on South Africa's 10-year government bond therefore compare quite favourably to our fair value estimate. Given the long-term risks the local economy faces, predominantly from a further deterioration in Eskom, one would look to move to a more neutral to slightly underweight allocation to South African government bonds, as levels move through our fair value estimate.

Given that we expect inflation to average 5.3% over the next two to three years, only the bonds that have an implied breakeven inflation of close to 5.3% look interesting. This rules out any ILB with a maturity longer than the year 2029. In addition, ILBs carry a materially longer modified duration (capital at risk) than nominal bonds. The I2046 has a modified duration of 20.4 years, while the R2048 (equivalent nominal bond) has a modified duration of 9.8 years – therefore if both the ILB and nominal curve move 100 basis points (bps) higher, one would lose 10.6% more being invested in the I2046 than the R2048. This means that to be invested in longer end ILBs, the implied breakeven needs to be quite a bit lower than the current 5.9% (closer to 5.3%) for it to be an attractive investment. Shorter end ILBs, however, at current levels of a 3% real return and a more realistic break-even inflation do look much more attractive and do warrant positions in a bond portfolio.

Chronic load shedding and poor local sentiment will continue to weigh on South Africa's growth outcomes. Inflation should remain under control, allowing policy rates in South Africa to, at worse, remain stable. Global monetary policy has once again turned more supportive for risk sentiment, which should help buoy emerging market valuations over the shorter term. At current levels, South African government bonds trade cheap to fair value estimates. However, given the longer-term risks posed to the economy from further SOE deterioration, allocations should be kept at a neutral level.