CORONATION

ABSOLUTE BOND STRATEGY

INSTITUTIONAL STRATEGY FACT SHEET AS AT 30 JUNE 2021

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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)	510.6%	160.9%	349.7%
Since Inception p.a.	10.4%	5.4%	5.0%
Latest 15 years p.a.	10.3%	5.6%	4.7%
Latest 10 years p.a.	9.4%	5.0%	4.4%
Latest 5 years p.a.	9.7%	4.2%	5.4%
Latest 3 years p.a.	9.8%	3.9%	5.9%
Latest 1 year	12.8%	4.9%	7.9%
Year to date	4.9%	2.8%	2.1%
Month	0.6%	0.3%	0.3%

ASSET ALLOCATION

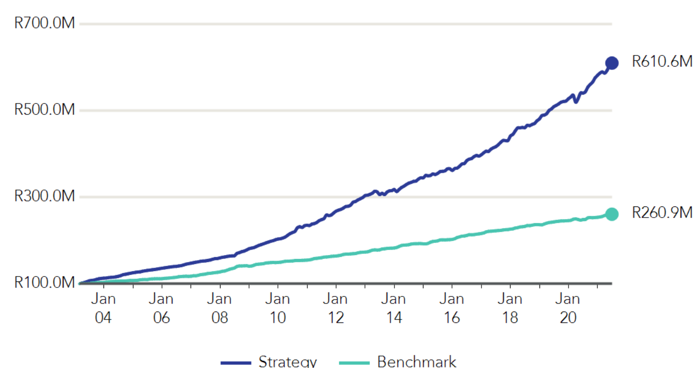
Asset Type	% Strategy
Corporate ILBs	49.3%
Fixed Rate Government Bonds	17.4%
Fixed Rate Corporate Bonds	13.3%
Floating Rate Corporate Bonds	11.9%
Government ILBs	5.5%
Fixed Rate NCDs	1.0%
Other	0.8%
Floating Rate Other	0.5%
Cash	0.2%
Fixed Rate Other	0.1%

GENERAL INFORMATION

Inception Date	01 March 2003
Strategy Size *	R6.32 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

*Strategy assets under management as at the most recent quarter end.

GROWTH OF R100M INVESTMENT



Benchmark: Consumer Price Index (CPI)

EFFECTIVE MATURITY PROFILE

Term	% Strategy
0 to 1 year	7.1%
1 to 3 years	31.8%
3 to 7 years	31.6%
7 to 12 years	12.8%
Over 12 years	16.7%

STRATEGY STATISTICS

Modified Duration (incl. inflation-linked bonds)	4.0
Modified Duration (excl. inflation-linked bonds)	2.0

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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 all fixed interest assets. Nishan has 18 years' investment experience.

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

Mauro is head of Fixed Interest research and a portfolio manager within the team. He co-manages the Strategic Cash Strategy along with the Strategic Income and Money Market unit trust funds, and recently started co-managing the Property Equity Unit Trust. Mauro has 10 years' investment experience.

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REVIEW FOR THE QUARTER

South Africa's (SA) recovery has been elevated by the current global environment, translating into strong asset price performance. The rand is up c.3% against the US dollar this year, with most of that performance coming through in the second quarter of the year (Q2-21). This is broadly in line with its emerging market peer group (except Brazil, which has enjoyed a more significant recovery in its currency following the commencement of its preemptive rate hiking cycle), but what has set SA apart is the performance of its local bonds.

Despite the yield on the 10-year bond being 30-40 basis points (bps) higher since the beginning of the year, the FTSE/JSE All Bond Index (ALBI) has returned 5% this year (6.9% over the 2Q-2021). This has been led by the strong performance of bonds with a maturity of > 12 years, as the yield curve has continued to flatten. Inflation-linked bonds (ILBs) had a poorer quarter returning c.3% but remain ahead of ALBI returns, year to date (7.7%). Both ALBI and ILB returns remain well ahead of cash for the quarter (0.9%) and the year (1.7%).

SA's economic and asset price recovery has not been solely due to global factors. Local developments, including the lifting of the minimum threshold for energy generation licensing to 100 megawatts; the sale of a majority stake in South African Airways to a local consortium; the sidelining of Ace Magashule, following his arrest by the National Prosecuting Authority; and the sentencing of former president Jacob Zuma to 15 months in prison for not testifying at the Zondo commission, have also helped to improve investor belief in SA's reform agenda.

In the first quarter of 2021 (Q1-21), SA's GDP was stronger than expected at 4.6% quarter on quarter (q/q) seasonally adjusted annualised (saa), compared to a revised growth of 5.8% q/q saa in the fourth quarter of 2020. Positive contributions came from financial and business services, mining, manufacturing, transport and trade sectors. From the demand side, household and government spending slowed down but remained positive contributors to GDP, while inventories provided a strong boost as these were drawn down at a slower pace than before. The new restrictions could dampen third-quarter GDP this year, despite efforts made to limit the impact on the broader economy.

Headline inflation accelerated to 5.2% y/y in May from 4.4% y/y in April. Core inflation was stable at 3.1% y/y in May vs 3.0% y/y in April. The inflation uptick largely reflects base effects related to fuel and somewhat higher food and apparel prices. The South African Reserve Bank left rates unchanged in May, but more recent comments from Monetary Policy Committee members suggest some growing caution about the outlook for inflation.

We believe inflation will hover around 5% for the next 18 months, we do not see a sustained move through the top end of the inflation band (6%). The recovery in growth this year is supported by the low base in 2020, the bounce in commodity prices, the rebuilding of inventories, and a slightly more optimistic consumer. Growth this year will be more than 4% and just above 2% in 2022. As a result, one can expect the next move in interest rates to be higher, albeit this would most likely only take place at the end of 2021 or in the first quarter of 2022. Higher growth and higher commodity prices imply stronger tax revenue, which provides more breathing room for the fiscus. In addition to this, government has continued to hold the line on the government employee wage freeze, which keeps SA on the path of fiscal consolidation.

Despite the recent recovery in local bond yields and the flattening of the yield curve, SA bond yields remain elevated, and the curve remains steep. Arguably, the fiscal metrics two years ago were better, but expectations were for significant deterioration.

Currently, fiscal metrics are at their worst since the GFC but should get better over the next two years, suggesting the curve flattening. Secondly, bonds yields are very elevated relative to cash rates. This is illustrated in the bond breakeven rates relative to cash, which measures how much bond yields can sell-off before their return equals cash. Not only are the breakeven rates elevated, but the 5- and 10-year bonds have very similar break-evens, suggesting the overall level of bond yields remain very high relative to cash and price in a healthy risk premium. Overall, this suggests there is still significant room for bond yields across the curve to compress (reduce) and the yield curve to flatten.

Over the last six months, concerns around rising inflation and excess liquidity in global markets have heightened expectations for interest rate normalisation in both developed and emerging market economies. The impact of this will be felt in SA government bonds (SAGBs) through rising global bond yields and a rising repo rate.

The current steepness of the bond curve and high bond breakeven levels relative to cash suggests a limited passthrough of rising short rates (repo rate) into local bond yields. However, this is not a certainty. All previous periods of interest rate hikes in SA have had a knock-on effect in the bond market, resulting in higher bond yields. The current landscape/risk premium should however mean that the passthrough should be reduced. In an interest rate hiking cycle, shorter-dated bond yields are generally more sensitive to change in cash (repo) rates, while longer-dated bonds yields have a lower sensitivity.

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The 5-year (R186) and 9-year (R2030) bonds will therefore generally be more sensitive to movements in the repo rate and should experience a more significant move higher in yields than the rest of the curve in an interest rate hiking environment. We believe the 12- to 15-year bonds are attractive, and our analysis indicates that only in the event where all bond yields move higher by 2%, do the 12-year and 15-year bonds underperform their 5- and 9-year counterparts. This supports the case for holding bonds in the 12- to 15-year area of the curve, as it offers the most attractive return prospects if the repo rate is normalised over the next two years.

Table 1

		Move Up in Yield				
Bond	Maturity	200.00	150.00	100.00	50.00	
R186	21 December 2026	4.99%	5.65%	6.32%	7.00%	Total Return
R2030	31 January 2030	4.55%	5.65%	6.77%	7.93%	
R2032	31 March 2032	4.38%	5.68%	7.03%	8.43%	
R2035	28 February 2035	4.23%	5.67%	7.17%	8.75%	
R2037	31 January 2037	4.00%	5.52%	7.11%	8.79%	
R2040	31 January 2040	3.85%	5.42%	7.08%	8.85%	
R2044	31 January 2044	3.51%	5.14%	6.89%	8.76%	
R2048	28 February 2048	3.18%	4.86%	6.68%	8.63%	

Sources: Coronation and Bloomberg

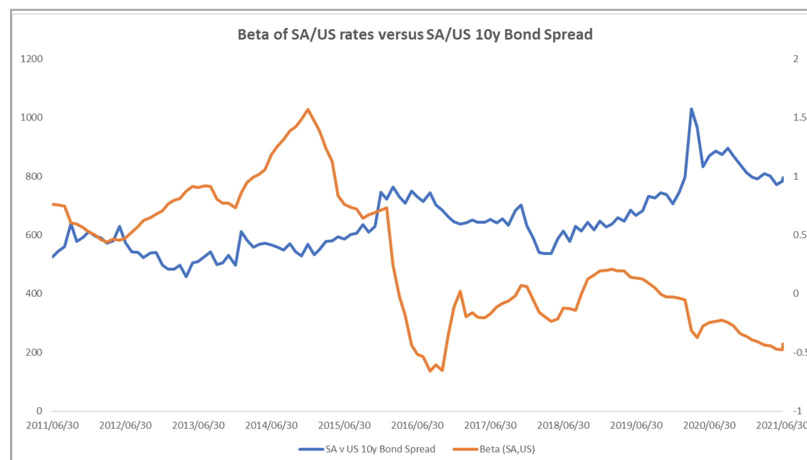
Global monetary policy normalisation will take the form of a tapering in bond asset purchase programmes, followed by a rise in policy rates. This will result in global bond yields moving higher over the next few years. Historically, the pace and magnitude of the rise in global bond yields have had significant repercussions for the local bond market.

More specifically, the more sudden and sizable the sell-off in global bond yields, the larger the rise in local bond yields. Currently, the US 10-year Treasury Bill (a proxy for global bond yields) is at 1.50%, and pricing in the forward market puts expectations for this rate to be at 2% to 2.25% over the next two to three years.

The magnitude of recent moves is not large by historical standards, although the pace of the future repricing will remain unpredictable. Local bonds have generally had a high beta (a relative measure of volatility between two assets) with US 10-year bonds. However, the spread between SA bonds and US bonds are at historically wide levels, primarily due to the deterioration in SA's fiscal metrics.

It is plausible that with SA's fiscal metrics recovering, this spread is too wide and should narrow, implying that even if US bonds were to selloff, the equivalent sell-off in SA bonds should not be as severe. As the spread between SA and US bonds has widened, the beta between the two has decreased; that is, the influence of US rates on SA rates has diminished. This further suggests that the risk premium embedded in SA bonds should absorb a significant amount of the widening in global bond yields.

Figure 1



Sources: Coronation and Bloomberg

In constructing robust portfolios, we must look for assets that provide us with some protection if the tail risk becomes a reality. ILBs provide portfolios with protection in the event inflation prints higher than expectations. Currently the real yields on offer are higher than longer-term averages, while the actual inflation average required to provide a better total return than nominal bonds is below 5% for ILBs out to 9 years. Our current expectations are for inflation to hover around 5% for the next 12 to 18 months, making ILBs with a maturity of less than 9 years relatively attractive. The Strategy's exposure is concentrated in the 4-5-year area. Longer dated ILB's will have a better return profile, but the hurdle for them to outperform nominal bonds is significantly higher, making them less attractive than nominal bonds.

Table 2: Impact of inflation on inflation-linked bonds

Bond	Maturity	Current Real Yield	Inflation required to beat nominal bond	Current Nominal Bond Equivalent
R197	07 December 2023	1.3300	4.36	5.75
I2025	31 January 2025	2.2100	4.13	6.43
I2029	31 March 2029	3.1300	5.27	8.56
I2033	28 February 2033	4.0200	5.56	9.81
I2038	31 January 2038	4.2400	5.94	10.43
I2046	31 March 2046	4.2700	6.03	10.55
I2050	31 December 2050	4.2400	5.98	10.47

Sources: Coronation and Bloomberg

The prospects for the local economy have improved as reform progress has gathered momentum, and global developments have provided tailwinds to the local recovery. Inflation is moving higher but should remain under control despite uneasiness around global inflation. The recovery in growth should gain more traction and spill into next year, which will provide more breathing room for the fiscus.

SAGBs, despite their recovery in the last quarter, still embed a significant risk premium relative to cash. The steepness of the yield curve makes the 12- to 15-year area attractive, even if the local rate hiking cycle starts sooner than expected. For bond portfolios, we continue to advocate overweight exposure to SAGBs focused in the 12- to 15-year area of the curve and allocations to ILBs with a maturity of less than eight years.