

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)	519.6%	165.2%	354.4%
Since Inception p.a.	10.3%	5.4%	4.9%
Latest 15 years p.a.	10.2%	5.6%	4.6%
Latest 10 years p.a.	9.2%	5.0%	4.2%
Latest 5 years p.a.	9.5%	4.4%	5.1%
Latest 3 years p.a.	9.7%	4.0%	5.7%
Latest 1 year	10.4%	4.9%	5.5%
Year to date	6.4%	4.5%	1.9%
Month	(0.2)%	0.2%	(0.4)%

ASSET ALLOCATION

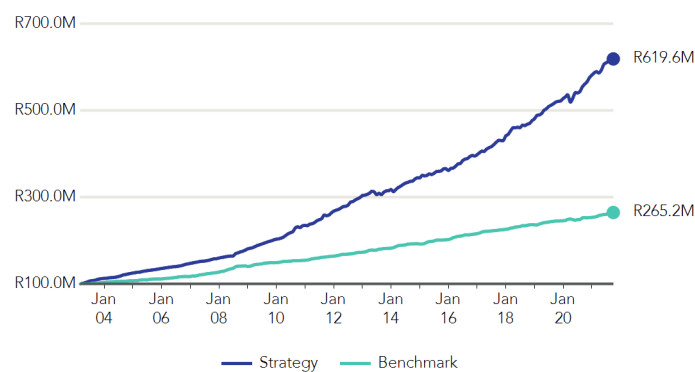
Asset Type	% Strategy
Corporate ILBs	49.6%
Fixed Rate Government Bonds	15.9%
Fixed Rate Corporate Bonds	13.1%
Floating Rate Corporate Bonds	11.8%
Government ILBs	6.2%
Fixed Rate NCDs	1.0%
Cash	0.8%
Other	0.8%
Floating Rate Other	0.4%
Floating Rate NCDs	0.3%
Fixed Rate Other	0.1%

GENERAL INFORMATION

Inception Date	01 March 2003
Strategy Size *	R6.24 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	7.2%
1 to 3 years	32.5%
3 to 7 years	30.6%
7 to 12 years	14.1%
Over 12 years	15.6%

STRATEGY STATISTICS

Modified Duration (incl. inflation-linked bonds)	3.8
Modified Duration (excl. inflation-linked bonds)	1.9

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 (SA) was among the worst performers within emerging markets, as the rand lost 5.2% against the dollar (two thirds of which was in September alone) and the benchmark bond widened by 40 basis points (bps) over the quarter (close to 50bps wider from the start of September). The FTSE/JSE All Bond Index was down 2.1% over September, bringing its return for the quarter to 0.4% and 12.5% over the last 12 months. Inflation-linked bonds (ILBs) performed significantly better as real yields held despite the selloff in nominal bonds, putting their return for the quarter at 2.0% and 15.8% over the last 12 months. Global bond yields have also seen a significant move wider, with the FTSE World Government Bond Index down 2.3% over the month, led primarily by the move wider in US bonds yields (up 50bps from their quarter lows). The pace of the selloff has, in part, also contributed to the weaker risk backdrop for emerging markets.

Locally, monetary policy is in the enviable position of being supportive of SA's growth recovery. Most major developing economies have already started (in some cases they are close to finishing) their rate normalisation process. SA government bonds (SAGBs) are still the most attractive emerging market bonds due to their high implied real yield, and SA policy rates remain quite negative. This has raised concerns about the SA Reserve Bank (SARB) falling behind the inflation curve and has contributed towards the poor sentiment towards SA assets.

Local inflation breaks from peers

SA's inflation outlook is considerably different relative to its emerging market counterparts, due in large part to very little demand side pressure or credit extension. Inflation is expected to remain close to the midpoint of the target band over the medium term, hence lessening the pressure on the SARB to increase rates aggressively in the short term. However, to keep inflation expectations under control, reduce the need to hike rates aggressively later and provide policy room to react if a crisis does rear its head again, it will likely start the process of gradual monetary policy normalisation by the end of 2021. In addition to adopting a gradual approach to hiking rates, policy rates are expected to peak at much lower levels than in previous cycles. Our expectations are for a gradual rise in the repo rate to between 5.5% and 6.0% by 2023/24.

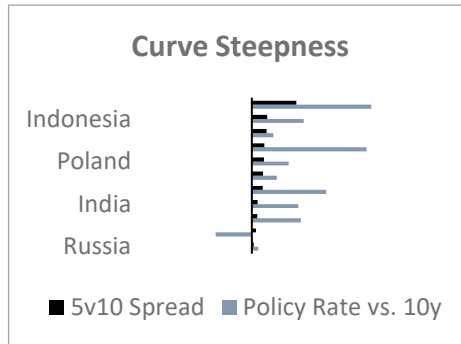
Bad weather ahead?

The clouds of SA's precarious fiscal position continue to darken the outlook for the local economy. The cyclical tailwinds from strong commodity prices are not going to last forever, and the expenditure pressures continue to mount. The recent revisions to SA GDP numbers, combined with the better-than-expected tax revenue for 2021/22, implies a lower starting position for SA's debt to GDP ratio. However, the trajectory of this debt is concerning and more needs to be done to turn this around. Expenditure requirements are only going to increase from here, given the ailing financial health of local state-owned enterprises and municipalities. This places pressure on reform implementation as an accelerant for growth. Although much has been done over the last year to provide the platform for higher growth, the pace of implementation, combined with the lack of State capacity, has meant that longer term expectations for growth are still anchored at c. 1.5%-2.0%, quite a way from the 3.0%-3.5% required.

Capital expenditure growth and employment, which are key for growth, are challenged by policy complexity and low levels of confidence. The only socially palatable way to avert a debt trap is to accelerate the pace of reforms, simplify policy and implement quickly. This will go a long way to re-instill investor and consumer confidence, which will contribute to a more sustainable and higher growth path. The ship has set sail in the right direction, but the sea is rough, and much courage is needed to stay the course.

Despite the risk posed by the deterioration in SA's fiscal position, the valuation for SAGBs remains quite appealing and suggests that a large part of the risk is already reflected in bond yields. SAGB's still have the highest real yield among the emerging market universe, and Figure 1 shows that SA's yield curve remains the steepest among its peers. This indicates that, from a global perspective, SA still has a relatively high embedded risk premium. The 10-year SAGB trades at close to the highest multiple of cash, meaning that bond yields can selloff more than 100bps before they start to underperform cash.

Figure 1 Comparison of steepness of emerging market yield curves



Source: Coronation, Bloomberg

Our fair value estimate for the 10-year SAGB, which uses the US 10-year Treasury note as the risk-free rate, the inflation differential between SA and the US, and SA credit risk premium, still suggests there is a significant risk residual in SA government bonds.

$$\text{SA 10-year Fair Value} = 2.0\% (\text{expected US 10-year}) + 5.5\% (\text{expected SA inflation}) - 2.5\% (\text{expected US inflation}) + 3.66\% (\text{current SA/US credit spread}) = 8.66\%$$

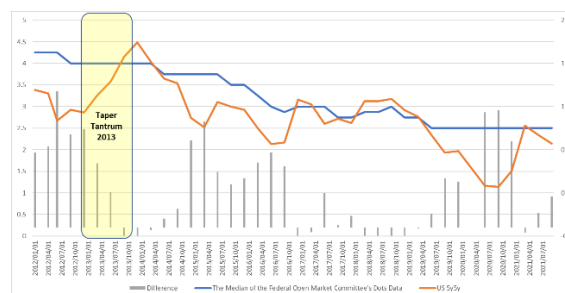
Our assessment fair value compares favourably to current trading levels of 9.7%. This, combined with the evidence presented through implied 10-year bond yields, the steepness of the SA yield curve and where SAGBs are trading relative to cash, leave us confident that current bond yields reflect adequate compensation for the underlying fundamental risks.

US to wind up stimulus

At its September meeting, the Federal Open Market Committee, indicated that it was closer to starting its process of reducing the size of its asset purchase programme by the end of 2021, with tapering to be complete by the second half of 2022. The suggested pace of the reduction is quicker than the market expected; however, this was balanced by increased emphasis on the decoupling of tapering and rate hikes. In 2013, when the Federal Reserve Board (the Fed) reduced its asset purchasing, it injected a huge amount of volatility and uncertainty into market, which caused risk assets to sell off aggressively. This time around, we think a few key things have changed:

1. The process of tapering is much more familiar concept than it was in 2013 and much more is known about the process/method.
2. The announcement of tapering in 2013 was a surprise and no forewarning was given. In fact, in the months leading up to that tapering, the Fed had revised its expectations of the long-term neutral rate lower. This time, it has signalled their intentions well in advance.
3. In 2013, the Fed's expected long-term neutral rate (as disclosed in their projections) was 4.0%, yet five-year, five-year rates (5y5y) – market expectations for five-year rates in five years' time – were at 2.75%. The Fed also didn't downplay the risk that policy rates would go higher once tapering ended. This resulted in an aggressive repricing of US 10-year rates to represent long term expectations. Currently, the Fed has guided to the longer-term policy rate being 2.5% and explicitly decoupled higher policy rates from the end of tapering. In addition, current 5y5y rates are at 2.15%, just marginally below the Fed's expected long-term neutral rate at 2.5% (Figure 2).

Figure 2: US Rate expectations versus FED long term rate expectations



Source: Coronation, Bloomberg

It is for the above reasons that we do not believe that tapering this time around will result in the amount of volatility that was created in 2013, or a large selloff in risk assets. Of course, there will be some volatility around the event, but it won't be the announcement/start of tapering that would cause it.

Reward for risk

In previous reports, we have spoken in detail about the listed credit markets and our view that valuation does not adequately compensate for the underlying risks in most tradable listed credit instruments. This remains the case. In fact, spreads have continued to compress making most of the asset class unattractive in our view. The increased amount of money being allocated to interest bearing funds combined with a drop off in issuance levels in the listed credit market has exacerbated the supply/demand imbalance. As such, we continue to remain cautious on this asset class. A new segment of the credit market has presented itself, which we believe warrants investment. Sustainability-linked bonds (SLBs) are a new domestic asset class but are well established internationally. Unlike green bonds, which restrict the use of proceeds from the bonds to be invested only in ESG-linked projects, SLBs reward lenders by providing a funding benefit if certain sustainability targets are met within a defined period. This funding benefit is reflected in a tighter credit spread (0.05%-0.1%) after a specified period, provided that the sustainability targets are met. These targets can be anything from greenhouse gas emissions and photovoltaic capacity, to water-use efficiency and green building certification. Issuance has been small (approximately R3 billion year to date), but this is a segment that will grow. Spreads have been more attractive than those of traditional listed credit, as is generally the case with a newer and lesser understood asset class. Coronation has been an anchor investor in this new segment and, provided valuation stays attractive, we will continue to support this segment going forward.

Value in shorter dated ILBs

For inflation linked bonds (ILB's), our preference remains for government ILB's with a maturity of below 8 years and/or corporate ILB's given their attractive pick up relative to their government counterparts. Government ILB's with a maturity of less than 8 years have attractive absolute real yields (close to historic highs), trade at attractive levels (if not better) relative to nominal bonds with similar maturities and provide protection in the event that inflation materialises above 5% over the medium term.

Valuations outweigh risks

The local economic recovery remains on track, as inflation will remain under control and growth recovers. Medium-term expectations for inflation remain contained, while longer term expectations for growth are below the needed level to avert continuing concerns of SA entering a debt trap at some point in the future. However, current valuations remain attractive, both relative to local and global alternatives, suggesting the embedded risk premium is sufficient to compensate for the underlying risks currently. The start of the tapering of the Fed's asset purchase programme should not inject the same amount of volatility and uncertainty into markets, like it did in 2013 and, therefore, should not have the same negative an impact on SAGB's. We continue to view SAGB's in the 10 to 15-year area of the curve as the most attractive asset and advocate overweight positions for bond portfolios.