CORONATION

ABSOLUTE BOND STRATEGY

INSTITUTIONAL STRATEGY FACT SHEET AS AT 31 MARCH 2022

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)	544.8%	173.4%	371.4%
Since Inception p.a.	10.3%	5.4%	4.9%
Latest 15 years p.a.	10.2%	5.7%	4.5%
Latest 10 years p.a.	8.9%	5.0%	3.9%
Latest 5 years p.a.	9.7%	4.3%	5.4%
Latest 3 years p.a.	9.3%	4.4%	4.9%
Latest 1 year	9.8%	5.9%	3.9%
Year to date	2.0%	1.7%	0.3%
Month	0.8%	0.9%	(0.1)%

ASSET ALLOCATION

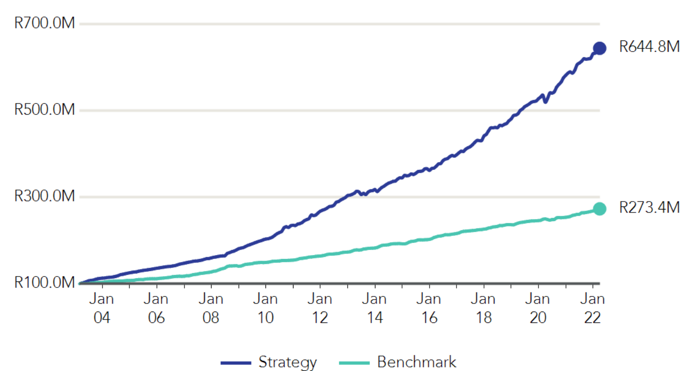
Asset Type	% Strategy
Corporate ILBs	48.8%
Fixed Rate Government Bonds	19.6%
Fixed Rate Corporate Bonds	14.3%
Floating Rate Corporate Bonds	9.3%
Government ILBs	5.8%
Other	1.0%
Cash	0.6%
Floating Rate Other	0.4%
Floating Rate NCDs	0.1%
Fixed Rate Other	0.1%

GENERAL INFORMATION

Inception Date	01 March 2003
Strategy Size *	R6.12 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	0.9%
1 to 3 years	44.6%
3 to 7 years	21.8%
7 to 12 years	20.9%
Over 12 years	11.8%

STRATEGY STATISTICS

Modified Duration (incl. inflation-linked bonds)	3.8
Modified Duration (excl. inflation-linked bonds)	2.1

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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 19 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 11 years' investment experience.

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REVIEW FOR THE QUARTER

The first quarter of 2022 (Q1-22) saw a significant increase in financial market volatility. Global inflation expectations for this year have more than doubled from a year ago (5.1% currently from 2.1% previously), while expectations for growth have moderated (4% current from 4.6% previously). US monetary policy is now expected to move into restrictive territory, with the Federal Reserve Board (the Fed) funds rate anticipated to end 2022 at 3.1%. Looking ahead, the Fed is expected to hike in increments of 0.5% (previously 0.25%) for at least the next two meetings of this year. Russia's invasion of the Ukraine has placed risk on tenterhooks, while fanning concerns about global stagflation on the back of the resultant surging oil and other commodity prices. The hangover from Covid-19 and its many variants had already rendered economic outcomes relatively uncertain, and current geopolitics has only served to further muddy the outlook and perplex investors.

Local bonds still delivering strong returns

South Africa (SA) has proved to be the prettiest among its ugly siblings. In Q1-22, the rand has appreciated more than 9% against the US dollar (only outdone by the Brazilian real), ending the quarter at R14.61/$1. The terms of trade boost (higher export prices relative to import prices) on the back of higher commodity prices has been the primary driver of the rand's outperformance. SA government bonds (SAGBs) returned 1.86% over the quarter, ahead of cash and inflation-linked bonds (ILBs) that returned 0.93% and 0.31%, respectively. Over the last 12 months, SAGBs have returned an impressive 12.37%, well ahead of cash (3.64%) and ILBs (10.76%). This outperformance has been driven by a flattening of the yield curve, that saw bonds with a maturity of 12 years returning 17.77% over the last year. The combination of rand appreciation and bond returns has made SAGBs the best performer in the global bond universe, well ahead of global bond indices, which have been dragged into negative territory due to the sell off in US bond yields.

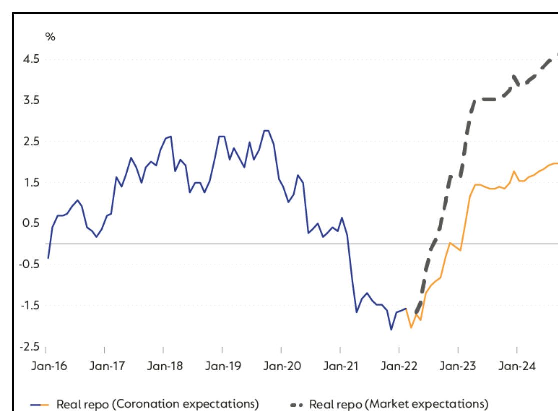
SAGB investors are still faced with assets that trade at historically and comparatively high yields, suggesting a significant embedded risk premium. However, considering recent global gyrations, a reassessment of the risks and repercussions thereof is warranted. Locally, fiscal and inflation risks must be reevaluated considering recent commodity price moves, while from a global perspective the impact of stressed US bond yields needs to be factored into current valuations.

Inflation expectations move higher

SA's inflation was expected to average 5.5% in 2022 and 4.6% in 2023 prior to the move in commodity prices. Consequently, the South African Reserve Bank (SARB) was expected to continue the normalisation of interest rates at a very gradual pace taking the nominal repo rate to between 6% and 6.5% by the beginning of 2024, hence maintaining the real repo rate within the 1.5% to 2% range. However, things have changed significantly since the start of the year, with white maize and oil prices higher by 12% and 42%, respectively. Despite the poor demand backdrop in SA, given that a large part of the inflation basket is comprised of food and fuel related items, the longer these prices stay high, the stickier inflation becomes at higher levels and the more likely it becomes that this elevates other prices in the basket (second round effects of higher food and fuel prices). Inflation is now expected to average over 6% for 2022 (peaking above 6.5%) before coming down to an average above 5% in 2023. The risks, however, are very much tilted to the upside and surveyed expectations for longer term inflation are now at 5.5% (up from 4.8%). Therefore, it is highly likely that the SARB will accelerate the path to reaching a nominal repo rate of between 6% and 6.5% in the first quarter of 2023. This would help to anchor inflation expectations at a lower level and keep pace with the expected path of global monetary policy normalisation.

In the years preceding Covid-19, the average real repo rate averaged 1.6%, which is lower than our expectations of 1.9% by end 2024 (Figure 1). Current market pricing for the real repo rate based on our expectation for inflation, suggest a real repo rate of 4.5% by end 2024, which is almost triple what it has been historically and double our expectations. This suggests that current market pricing embeds a significant inflation premium, which translates into a high embedded inflation premium for bond yields. It is highly likely that the market expectations for inflation recede as inflation prints materialise lower, thus compressing the inflation premium in bond yields.

Figure 1: South Africa's real repo rate expectations



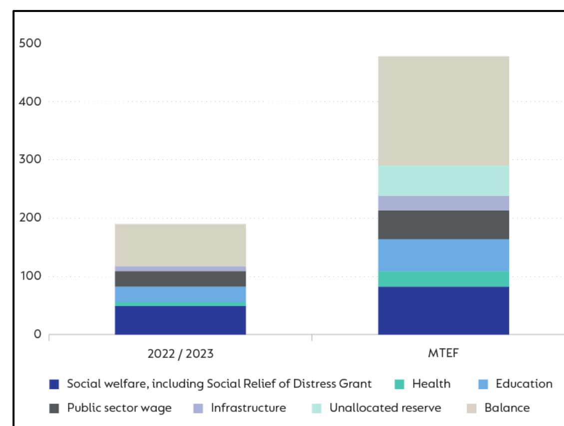
Sources: Bloomberg, Coronation

Elevated commodity prices supportive of fiscus

The flipside of higher commodity prices, specifically higher metal prices, is that the price of SA's exported products increases relative to its imported prices. This means that SA receives more money for the same volume of exports and, of course, if volumes increase, then there is a significant multiplier effect. Tax revenue is likely to increase as company earnings increase and SA's current account remains in surplus, reducing its reliance on portfolio flows. Fiscally this translates into a lower deficit, due to higher tax revenue that should imply a lower borrowing requirement. The precedent set in the March budget, saw 55% of the windfall revenue used to reduce the borrowing requirement while the other 45% was spent on funding free tertiary education, along with higher municipal and healthcare wages.(Figure 2) Unfortunately, these do not have a significant growth dividend and are very hard to recoup, making it an unproductive recurrent expenditure.

At current prices, government can expect another R100 billion in tax revenue next year, which will hopefully be spent on reducing the known risks in the economy. Namely, the Eskom debt overhang, ailing municipal and state-owned-enterprise finances, and a permanent solution to the basic income grant debate. Thankfully, SA's starting position is better than it has been and the debt-to-GDP ratio is expected to peak at 75% in five years. This is by no means an insignificant debt load, but, relative to peers, this is no longer outrageous. This makes the prospects of SA entering a debt trap a much lower probability over a five- to 10-year horizon.

Figure 2: SA Fiscal: Expenditure Allocations



Sources: Bloomberg, Coronation

Value shifts to the 10-year area

With the debt trap issue being kicked into the long grass, it is worth looking at SAGB breakeven relative to cash-based on our new expectations for the repo. On average, breakeven to cash has come down by 25 basis points (bps), but remains historically high (Figure 3)

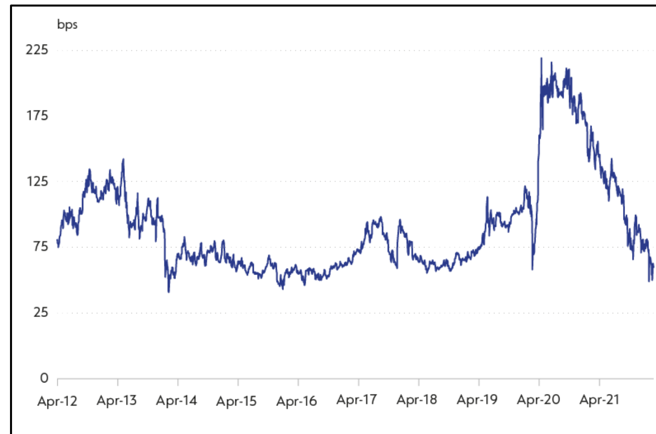
Figure 3: SA Government Bonds/cash breakeven rate

Bond	Maturity	Yield	1-year breakeven (cash 6%)	1-year breakeven (cash 4.5%)
R186	21 Dec 26	8.09	0.74	1.24
R2030	31 Jan 30	9.55	0.74	1.04
R2032	31 Mar 32	9.93	0.69	0.94
R2035	28 Feb 35	10.29	0.65	0.88
R209	31 Mar 36	10.26	0.57	0.77
2040	31 Jan 40	10.55	0.61	0.80
R214	28 Feb 41	10.53	0.55	0.73
R2044	31 Jan44	10.58	0.57	0.76
AVERAGE BREAKEVEN			**0.64**	**0.90**

Sources: Bloomberg, Coronation

In addition, the value shifts more towards the 10-year area of the curve. This shift in value is reflective of the recent risk premium compression that has occurred between the 10- and 20-year areas of the yield curve (curve flattening), which is now at historical norms. (Figure 4) SAGB's, therefore, still embed a significant risk premium, both in terms of inflation expectations and relative to cash, with the value point now being the 10-year area of the yield curve.

Figure 4: SA Government Bonds: 20-year bond minus 10-year bond



Sources: Bloomberg, Coronation

The recent rise in US bond yields has raised concerns of an imminent sell off in emerging market bond yields, similar to the taper tantrum of 2013. First, it is important to point out that although the emerging market debt load has escalated, in developed markets, more specifically the US, the increase has been sharper. The weighted average maturity of US debt is just over five years, which means the cost of funding the debt load is closely connected to what happens with short-term rates. This argues for the real funding rate of US debt to remain relatively low compared to history, and for the cost of debt funding to remain below real growth. Over the decade preceding the Covid-19 crisis, the average real US 10-year yield versus realised inflation (represented by US Personal Consumption Expenditure Index) has averaged 0.77% (Figure 5). This implies that, going forward, this real rate should be, at most, between 0% and 0.5%, which puts the long-term US 10-year fair yield, assuming a long-term US inflation outcome of 2.5% to 3%, at 2.5% to 3.5%. In the short term, we can expect volatility in the US 10-year bond as inflation prints higher; but 2.5% to 3.5% is where US yields should settle.

Figure 5: US 10-year bond minus US personal consumption expenditure index (year on year)

Sources: Bloomberg, Coronation

The current level of the US 10-year bond remains in the range of 2.5% to 3.5% and SAGB yields are still more than 700bps above US yields (Figure 6). This suggests a significant risk cushion to absorb a move in the US 10-year yield to levels that would be deemed fair with longer term expectations.

Figure 6: SA 10-year bond yield minus US 10-year bond yield

Sources: Bloomberg, Coronation

Inflation Linked Bonds

The recent rally in ILB's has compressed real yields, however they still remain well in excess of the SARB's forecasted neutral real policy rate of 2.1%. Real yields with a maturity of less than 10 years, trade anywhere between 2-3.5% with the implied breakeven inflation rate between ILB's and nominal bonds below expected inflation over the next two years. South African inflation is expected to peak in the second quarter of this year at approximately 6.5%, before retreating to 5% by mid 2023. This puts the expected average inflation at 6.2% for 2022 and 5.4% for 2023. Geopolitical risks continue to pose an upside risk to the inflation forecasts over the short to medium term. As such, we continue to believe that ILB's with a maturity of less than ten years, are quite attractive from a real return and inflation protection perspective.

Conclusion

Geopolitical tensions have increased the risk of higher global inflation and a faster normalisation of global monetary policy. SA has benefited from a significant terms of trade boost that provides more breathing room for the fiscus. However, that will place pressure on the SARB to normalise rates at a similar pace to global central banks. SAGB's still trade at historically high yields and are elevated compared to their emerging markets counterparts. The current market pricing of interest rate normalisation in SA also suggests that the embedded inflation premium in bond yields remains excessive and that yields have a significant risk buffer to absorb higher local inflation and higher US bond yields. We continue to advocate long duration positions, that are now focussed in the 10-year area of the yield curve.