

LONG TERM OBJECTIVE

The Coronation Strategic Bond Strategy is an actively managed fixed interest solution that allocates across all the different fixed income instruments. The Strategy has a flexible mandate with no duration or term restrictions. The Strategy invests in the traditional fixed interest assets, but can also invest in listed property, preference shares and inflation-linked bonds, which are typically excluded in most specialist mandates. This flexibility allows the Strategy to maximise every opportunity in the domestic fixed interest space and produce superior returns for clients. The Strategy aims to consistently outperform the JSE ASSA All Bond Index over the medium to long term.

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)	307.7%	264.5%	43.2%
Since Inception p.a.	9.2%	8.4%	0.8%
Latest 15 years p.a.	8.6%	7.9%	0.7%
Latest 10 years p.a.	8.2%	8.0%	0.2%
Latest 5 years p.a.	7.8%	8.2%	(0.4)%
Latest 3 years p.a.	8.5%	7.4%	1.1%
Latest 1 year	10.5%	9.7%	0.8%
Year to date	10.5%	9.7%	0.8%
Month	2.0%	1.5%	0.5%

ASSET ALLOCATION

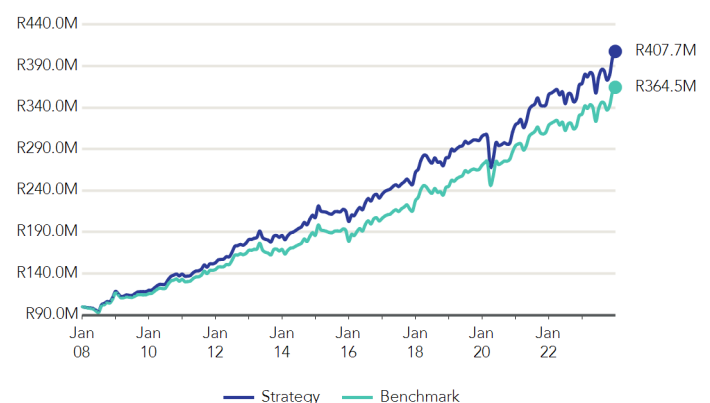
Asset Type	% Strategy
Fixed Rate Government Bonds	84.8%
Government ILBs	3.7%
Property	3.4%
Cash	2.8%
Floating Rate NCDs	2.7%
Fixed Rate Corporate Bonds	1.3%
Fixed Rate Other	0.7%
Floating Rate Corporate Bonds	0.6%

GENERAL INFORMATION

Inception Date	01 January 2008
Strategy Size †	R3.80 billion
Strategy Status	Open
Mandate Benchmark	JSE ASSA All Bond Index (ALBI)
Dealing Frequency	Daily
Base Currency	ZAR

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

GROWTH OF R100M INVESTMENT



Benchmark: JSE ASSA All Bond Index (ALBI)

EFFECTIVE MATURITY PROFILE*

Term	% Strategy	% Benchmark
0 to 1 year	5.3%	28.7%
1 to 3 years	1.3%	18.7%
3 to 7 years	4.6%	7.1%
7 to 12 years	37.5%	20.5%
Over 12 years	47.9%	35.2%

STRATEGY STATISTICS*

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	5.9	5.7
Modified Duration (excl. inflation-linked bonds)	5.7	5.7

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 20 years' investment experience.

**Adrian van Pallander** - BScEng, HTSdip, CFA, FRM

Adrian joined Coronation in 2002 and is a portfolio manager within Coronation's Fixed Interest investment unit. He is responsible for managing a portion of the fixed interest assets across all strategies as well as analysis, asset allocation modelling and portfolio construction monitoring. He has 21 years' investment experience.

**Seamus Vasey** - BCom (Hons), MSc, CFA

Seamus is a portfolio manager and analyst within the Fixed Interest investment unit with more than 19 years' investment experience. He manages assets within Coronation's specialist bond strategies. He also co-manages the Coronation Global Bond and Granite Hedge funds as well as the Global Strategic USD and Bond unit trust funds.

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

Mauro is a portfolio manager and head of Fixed Interest research. He co-manages various fixed income strategies for institutional and retail clients. Mauro joined Coronation in 2014 and has 13 years' investment industry experience.

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* For SA Fixed Income investments only. Excludes international investments, equities, property and preference shares.

REVIEW FOR THE QUARTER

Strategy positioning

The performance numbers for the year hide the tremendous uncertainty and uneasiness that most investors felt throughout the year. Dollar index declines (3% in 2023) spurred stronger emerging market performance, with many of SA's peers gaining well over 5% against the US dollar. Due to its many problems, SA significantly lagged its peer group's currency performance, with the rand down 7% versus the US dollar. This was also reflected in the marginal widening of SA's credit spread relative to both emerging and developed markets. Despite a rollercoaster of a year in global bond markets, 10-year bonds in both the US and SA settled only 30 to 40 basis points (bps) wider from where they started in 2023. Over the last year, the FTSE World Government Bond Index returned 5.2% in US dollars, with the local FTSE/JSE All Bond Index (ALBI) returning 9.7% in rands (2.1% in US\$). This was a strong performance by local bonds, as cash and inflation-linked bonds (ILBs) only returned 7.8% and 7.1%, respectively, over the same period. Despite local bond yields still ending the year wider, it was the high starting yields on offer and relative outperformance of the bonds with a maturity of less than 12 years that bolstered the ALBI's returns.

Calendar year 2024 is the year of the wood dragon in the Chinese zodiac and is meant to bring evolution, improvement, and abundance. It is the perfect time for rejuvenated beginnings and laying the foundation for long-term success. SA is in deep need of all these things as it continues to tread water near the abyss of despair and irrelevance. The country has three major problems that include:

- 1. Electricity shortages:** Underinvestment in both generation and transmission capacity has led to severe power shortages that have capped growth. Even if the system moved towards an acceptable level of performance, it would still cap growth in the 2%-2.5% range. Massive bailouts have also diverted funds from productive spending and strained government finances.
- 2. Logistic constraints:** Underinvestment and incompetent management have seen a disastrous fall from grace in the internal transport and harbour networks. This has cost the country significant revenue due to lost exports and has also meant that it could not maximise the benefit from the recent commodity boom. In addition, further funds will need to be diverted to sure up Transnet's balance sheet and return the network to an acceptable capacity level.
- 3. A frail implementation of the rule of law:** This is both in the implementation of state-owned company governance controls and the policing of serious crime on the ground. The failure to ensure the prevalence of the rule of law in the country has led to reduced business and investor confidence and a significant loss of profits due to high levels of corruption and illegal enterprise. Once again, government finances are placed under further pressure due to the need for capital injections and lost tax revenue.

The electricity and logistic problems are a direct result of government's constrained expertise and poor track record of delivery in these industries, and the solution would be for government to provide a platform for private sector investment into those industries, thus allowing the private sector to play a more significant role in driving reform. There is precedent for this littered across the globe. Even in the US, where the space programme was a crowning achievement by the State and was used to propel innovation in that economy, the private sector has now taken over to drive the next phase of evolution (SpaceX, Virgin Galactic and Blue Origin).

The repairing of the rule of law will take significant resources to rebuild credibility and competence in key institutions, weed out corrupt entities and arrest the growth of corrupt enterprise. The resources being drained by the electricity and logistic problems could be utilised to restore law and order. Again, the private sector should be enabled to participate here too. There are no quick or easy solutions to any of these issues, but there are solutions. They do, however, require swift action to ensure the country does not fall off the cliff.

The prolonged prevalence of these issues has meant that growth has remained lacklustre, and government finances have remained strained. More recently, we have seen increased pricing pressures due to the higher cost of doing business in SA. This unfortunately results in a grim outlook with longer-term growth in the 1.5%-2% range, inflation uncomfortably around 5.5%, budget deficits of around 5%-6% of GDP and the debt-to-GDP ratio on the path to 90%.

Local bond yields have felt most of the pressure from the deteriorating fundamental backdrop as yields remain elevated, well above nominal GDP and with no sign of respite. This situation remains unsustainable, and although the SA government has some breathing room over the next three to five years due to levers that can be utilised to fund the country, these are only temporary reprieves. If crucial reforms are not enacted, then we will remain firmly on the path to financial obscurity.

Despite resilient activity indicators and central banks holding policy rates steady, December saw global markets reprice for a 'soft landing' as inflation continued to ease, and commentary became more dovish. The growing financial market consensus is that inflation will continue to moderate, albeit at a slower pace than seen in the past few months, and that policy rates will start to come down during 2024.

In the US, the Federal Reserve Board (Fed) left the Fed funds rate unchanged at a 5.25%-5.5% target range at its Federal Open Market Committee (FOMC) meeting in December. The FOMC reiterated it will continue to monitor the impact of policy tightening on the economy and is willing to keep policy settings tight should inflation remain elevated. However, the FOMC indicated it would be open to easing in 2024 if the economy weakens and inflation eases.

US headline inflation slowed slightly to 3.1% year on year (y/y) in November from 3.2% y/y in October, but core inflation remained unchanged at 4% y/y. The modest decline was due to lower energy prices, which was partly offset by increases in the prices of housing, food, new vehicles, and apparel. While price pressures have retreated from previous highs, a strong labour market continues to power consumer spending and the broader economy.

The SA economy contracted by 0.2% quarter on quarter (q/q) in the third quarter of 2023 (Q3-23), following revised growth of 0.5% q/q in the second quarter of the year. An intensification of logistical challenges and persistent loadshedding put immense pressure on both primary and secondary sectors, which all contracted except for a very small positive contribution from utilities. The services sectors were able to grow at a modest pace despite these challenges. On the expenditure side, household spending and gross fixed capital were weak, with limited offset from an increase in public employment, which boosted government spending and considerably weaker imports. Early data for the fourth quarter of 2023 remains weak, raising the risk that SA entered a recession in the second half of the year.

The rand ended the month at R18.30/US\$1. SA's idiosyncratic problems and the turn in global risk sentiment continued to weigh on the ZAR.

Headline inflation slowed to 5.5% y/y in November from 5.9% y/y in October, while core inflation increased to 4.5% y/y from 4.4% y/y. Lower headline inflation was due to a cut in retail fuel prices, which was slightly offset by higher food prices. Recent survey data from the Bureau for Economic Research suggests that food prices have remained elevated, albeit off peaks, reflecting the weaker currency and a high-cost operating environment. Elsewhere, price changes remain a bit of a mixed bag: household furnishings and appliances prices fell after previous gains, alcoholic beverages and tobacco prices fell, both taking some pressure off core goods prices. However, this was partly offset by rising vehicle and recreational items prices. Core services inflation remains well-anchored, mostly because of weak rental inflation, which provides an offset to stickier prices in other core items.

At the end of December, shorter-dated fixed-rate negotiable certificates of deposit (NCDs) traded at 8.77% (3-year) and 9.30% (5-year), higher than the close at the end of the previous month. Our inflation expectations suggest that the current pricing of these instruments remains attractive due to their lower modified duration and, hence, high breakeven relative to cash. In addition, NCDs have the added benefit of being liquid, thus aligning the Strategy's liquidity with the needs of its investors. The Strategy continues to hold decent exposure to these instruments (fewer floating than fixed), but we will remain cautious and selective when increasing exposure.

The last 18 months have seen aggressive rate-hiking campaigns across most developed and emerging markets. Inflation is easing, which should allow central banks to begin easing monetary policy. This monetary policy pivot should help support emerging markets as capital flows towards the higher yields on offer. SA, specifically, is in dire need of capital to fund its burgeoning deficits as growth falters and inflation remains towards the upper end of targets. This reprieve will only prove temporary unless reform implementation is accelerated through increased private sector participation. For now, SA's bond yields still provide an attractive alternative to cash given their high embedded risk premium, albeit some of this premium has reduced with the rally last quarter. We would advocate for slightly overweight positions in bond portfolios, focused on maturities of less than 12 years, together with decent allocation to sub-8-year maturity ILBs.

ILBs are securities designed to help protect investors from inflation. They are indexed to inflation so that the principal amount invested and, hence, the interest payments rise and fall with the inflation rate. ILBs have offered protection to investors over the last quarter. However, current breakeven inflation across the ILB curve averages between 5.5% and 6%, which is well above even our own expectations for inflation over the medium term. It is only the shorter-dated ILBs (I2025, 1.3 years to maturity and I2029, 6 years to maturity) that flag as cheap from a valuation perspective. Risks on the inflation front still remain elevated, and these shorter-dated ILBs, due to their inherent inflation protection, warrant a decent allocation within portfolios.

Credit markets have remained relatively subdued. Net issuance this year has been paltry, with most of the issuance on the back of refinancing maturing bank-senior and subordinated debt. Despite the poor fundamental backdrop in SA, credit spreads have continued to tighten this year as net supply has dwindled. Senior bank credit has compressed significantly, with the gap between 5- and 7-year terms almost non-existent. The compression of term premium in credit spreads indicates a market that is hungry for yield at any cost and not what one would expect in the poor economic environment. Subordinated bank credit (AT1 and AT2) has seen a similar compression, with AT2 spreads now just 30-40bps above senior spreads. This compression is quite dramatic, and although banks remain well-capitalised and very far from failure, given the nature of the instruments, we feel current pricing to be too optimistic.

Given their tight valuations, we consider current credit spreads unattractive and see better alternatives elsewhere. Current pricing of global interest rates and credit markets offers an attractive, risk-adjusted opportunity for investors.

The local listed property sector was up 9.9% over the month, bringing its 12-month return to 10.7%. The operational performance will remain in the spotlight as an indicator of the pace and depth of the sector's recovery. The current poor growth outlook, combined with an increase in cost base due to higher administered prices and second-round effects on loadshedding, will weigh on the sector's earnings in the coming year. We believe that one must remain cautious due to the high levels of uncertainty around the strength and durability of the local recovery.

Outlook

We remain vigilant of the risks from the dislocations between stretched valuations and the local economy's underlying fundamentals. However, we believe that the Strategy's current positioning correctly reflects appropriate levels of caution. The Strategy's net yield remains attractive relative to its duration risk. We continue to believe that this yield is an adequate proxy for expected Strategy performance over the next 12 months.

As is evident, we remain cautious in our management of the Strategy. We continue to invest only in assets and instruments that we believe have the correct risk and term premium to limit investor downside and enhance yield.