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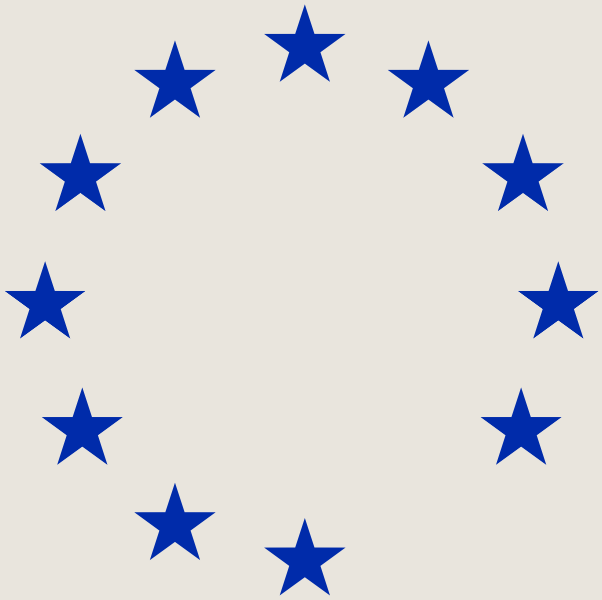
The Global Quarterly



A dog's Brexit

OCTOBER 2018 SPRING EDITION

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Going forward from here

What might go right?

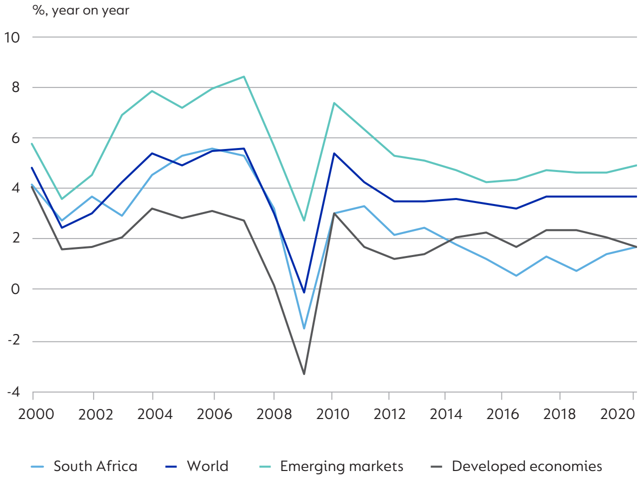
By Marie Antelme

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

IT HAS BEEN a consistently disappointing year for growth. After a decade in which growth barely topped an average of 1.5%, accompanied by a grinding deterioration in the political environment and institutional integrity, it was not hard, arithmetically, to justify a sentiment-driven reprieve this year. Indeed, at the start of this year, the drivers of growth seemed broadly in line. Global growth accelerated into the fourth quarter of 2017, domestic terms of trade were elevated, the US was set to deliver a decent taxpayer boost to already strong output activity, and low global inflation pointed to only a slow normalisation of very accommodative global monetary policy settings.

Then a number of things went wrong. Global growth momentum, especially in developed economies, slowed meaningfully in the first quarter of 2018. The US saw GDP moderate to 2.2% quarter on quarter seasonally adjusted and annualised (q/q saa), from 2.3%, >

RELATIVE GDP GROWTH

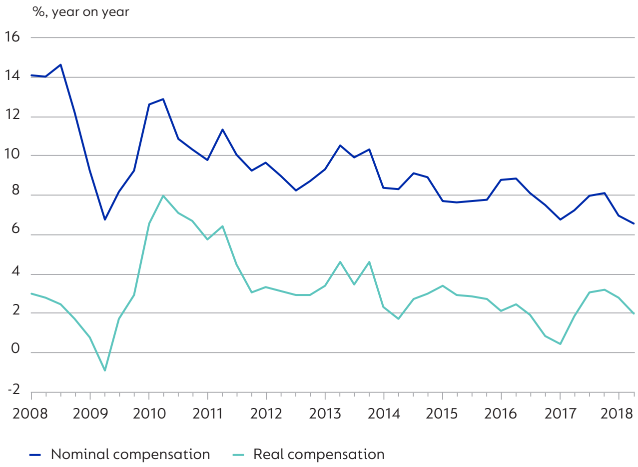


Source: IMF

but in Germany growth slowed to 1.5% q/q saa from 2.2%, and Japan's economy registered a contraction. Some of the slowing reflected one-offs which reversed in the second quarter, but the disruption stalled the momentum which built through 2017. While global growth is still robust, it has become more uneven and, importantly, visible risks have increased. And they are all to the downside.

In South Africa, high-frequency data were discouraging to start with: mining production contracted and manufacturing was weak, affected by refinery closure and other disruptions. Net trade fell hard in the first quarter, with an iron ore derailment at least in part to blame. Agriculture was much weaker than expected, affected by the drought, and a high base.

HOUSEHOLD INCOME UNDER PRESSURE



Source: South African Reserve Bank

From an expenditure perspective, data for the first half of this year point to households under immense strain. Real household income has been under pressure since 2010. With the value-added tax hike, and another year in which there was effectively no adjustment for bracket creep, consumers have seen a meaningful increase in their tax burden relative to income. Household spending contracted 1.3% y/y in the second quarter of 2018, off a low 1.0% y/y in the first quarter. In addition, gross fixed capital formation contracted for the second consecutive quarter as government and public corporation spending fell, offsetting a nascent recovery (albeit important) in private capex. The various supply-side one-offs led to a massive inventory contraction, which took an additional 2.9 percentage points off GDP. Net trade was the only real positive, with a recovery in export volumes.

By mid-year, hopes of a speedy recovery were dashed. Output data have improved, but momentum is too slow, for now, to meet high hopes of a post-Zuma recovery this year. It has all taken a lot longer than expected.

As we head into 2019, it is hard to be optimistic, because a number of things have now deteriorated:

- Global growth is slowing, and has become more uneven.
- Global trade volumes are under pressure and trade tensions have risen.
- Higher US interest rates, and possibly elsewhere, in coming months, imply a more adverse environment for emerging market assets.
- High oil prices threaten inflation and reduce real incomes.
- Domestic policies remain messy despite the best efforts of the new administration.
- Domestic employment and wage data are still weak.
- Profitability is under pressure.
- Sentiment has deteriorated.

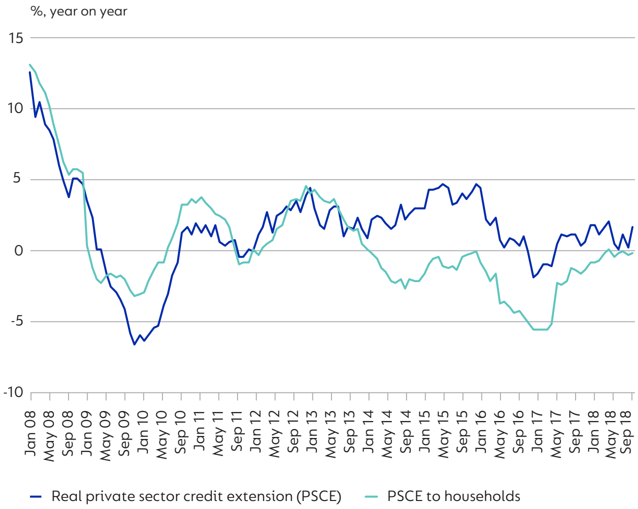
While these developments make it hard to expect a meaningful acceleration in growth in South Africa, I still think the worst is behind us. So let us indulge in a little sideways thinking. What could go right?

With South Africa having scored so many own goals in terms of policy and political rhetoric that negatively affected sentiment and growth, and having suffered a number of 'one-offs' which affected output, there is some merit to the argument that the country may benefit from stability in these areas. The economy, demonstrably, has not grown. Without growth there is limited room for a deceleration – you cannot fall off a cliff if you have not climbed it! Growth is always a function of a combination of labour absorption (consumption), capex and productivity gains. In turn, consumption is a function of income growth and a willingness to spend, while capex usually requires a change in capacity constraints and an improvement in expected returns, and is usually the biggest driver of efficiency (productivity).

The protracted period of economic malaise has seen deleveraging (except the state). There are few visible excesses, and credit growth in real terms is low but stable. Importantly, consumers should see some easing in their very constrained positions in coming months. Most recent data suggest a modest acceleration in credit extension to households.

Consumer confidence, which undoubtedly overshot in the first half of the year, remains elevated by historic standards and is historically consistent with stronger spending. Household leverage has declined, and debt service costs remain low. Household saving has turned positive, which suggests some cushion has been rebuilt. While higher fuel prices are a rising headwind, the rate of change should slow in early 2019, and we expect food inflation to remain reasonably low. Importantly, we do not expect a similar increase in the household tax burden in 2019/2020. The outlook for employment is stable, and it is possible that government's infrastructure plan could improve employment at the margin. Similarly, the extension of the youth employment tax incentive should also help.

REAL CREDIT GROWTH

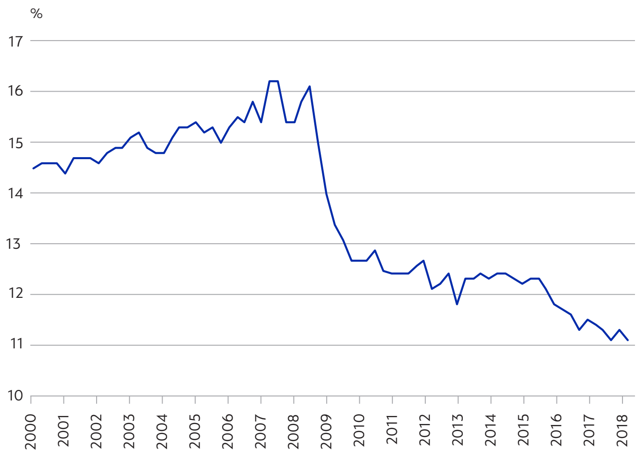


Source: South African Reserve Bank

While gross fixed capital formation was very weak in the first half of 2018, private capex was positive. The available data show that companies have increased investment in non-residential structures and transport equipment, and recent data for building plans passed have visibly picked up. In addition, inventories, run down excessively in response to interrupted mining and manufacturing supply, have room to recover.

It is likely that a meaningful acceleration in domestic demand will push the current account deficit wider. It is also possible that the sharp depreciation in the currency and recent moves to simplify tourist visa requirements could facilitate a bumper tourism season in the year ahead. The currency may be vulnerable, but some offset is possible too, if we get just a few things right.

INVENTORIES TO GDP



Source: South African Reserve Bank

With this in mind, we expect growth to recover moderately in the third quarter and accelerate further into 2019. With a real growth forecast of 0.8% this year and 1.8% next year, the forecast still implies a relatively constrained acceleration and modest growth in 2019, only just at or slightly below potential. This not only implies a return to an uninspiring past, but also an environment in which core inflation should remain low. Our forecast for inflation is for CPI to average 4.6% in 2018 and rise to 5.4% in 2019, despite the weaker currency and acceleration in oil prices. In this context, we are unlikely to see an aggressive interest rate cycle, despite the risk that the South African Reserve Bank Monetary Policy Committee (MPC) may decide to moderately increase nominal rates as inflation ticks up. We expect real rates to remain accommodative. Our base case is for interest rates to remain on hold through mid-2019, acknowledging the risk that the MPC may opt to start gradually raising rates should rising headline inflation threaten long-term expectations. It is, however, worth highlighting that within this relatively benign base case, considerably faster and more inclusive growth is needed to ensure fiscal and social stability.

What drives sentiment? More and more bad news has driven domestic sentiment weaker for a decade. While this year has certainly taught us that lost momentum and a deficit of trust take more than we had thought to heal and in turn translate into committed capital, either by households or businesses, it is possible that, at the margin, the rate of deterioration has bottomed. ✚

A dog's Brexit

It was always going to get messy

By Marie Antelme

THE TIME IS now desperately short. In less than six months, the UK will leave the EU, either with a ratified withdrawal agreement and political decree or without one.

Should the UK leave with a withdrawal agreement in place, it will be in a negotiation holding period with the EU. It is also possible that negotiations progress sufficiently but fail to make the deadline and the EU agrees to an extension, but this is not an option on the table at this stage. This means that British Prime Minister Theresa May has until the end of the year – and perhaps a little longer – to craft the required documentation that satisfies a range of different groups whose interests are not aligned. Formally, what she has now is the 'Chequers plan' – and no one likes it.

The agreement needs to be worded in a way that clearly resolves three crucial conditions for the UK's withdrawal, but at the same time leaves sufficient flexibility for these politically fragile issues to be open to some interpretative differences.

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

The first two conditions, which have already been agreed in principle, are the commitment to continue paying the UK's financial obligations of about £39 billion to the EU, and the rights of EU citizens living in the UK or moving to the UK during the transition period.

The critical sticking point is the Northern Irish border 'backstop', where negotiators on all fronts have failed to find phrasing that conveys a suitable resolution to both the EU and the UK, and takes into account Ireland's fragile political legacy.

WHAT IS THE 'IRISH ISSUE' AND WHY HAS IT BEEN SO HARD TO RESOLVE?

At this time, Ireland is an independent country and a member of the EU. Northern Ireland, however, is part of the UK and is, for now, part of the EU. Depending on what negotiators agree is going to be the future relationship between the UK and the EU, the UK will either exit the Single Market or the Customs Union, or both.

Thereafter, the EU requires that some kind of border is erected to ensure both quality checks and tax collection between the two entities remain intact. The issue is, however, Ireland and Northern Ireland. Most parties accept that for reasons of acute historical sensitivity, any physical border infrastructure between them is politically unacceptable.

The need for a backstop agreement related to Northern Ireland is a form of guarantee should no final agreement be reached during the transition negotiations. As such, the EU requires that the backstop agreement be reasonably explicit. Prime Minister May is looking for flexibility in the wording of the agreement because she is hoping the issue will resolve itself as the future relationship and trade negotiations evolve, and because she needs to balance the interests of both her own divided party and the Democratic Unionist Party (DUP) – its Northern Irish coalition partner.

The DUP is adamantly against integrating with Ireland and is seemingly open to a hard border with its neighbour. The EU has consistently argued that even if a border is avoided, Northern Ireland must stay in full, permanent regulatory alignment with the EU and be bound by the oversight of the European Court of Justice. This would misalign part of the UK to the rest of it, challenging the UK's constitutional integrity, and is wholly unacceptable to the DUP. The situation seems at this stage to be intractable.

While the withdrawal agreement between the EU and the UK still seems in its infancy, the economic reality of not reaching any agreement may still outweigh the political cost of agreeing something to avert a disorderly unravelling of the process as the deadline arrives.

Even if there were an accelerated compromise with the EU, in which most of the detailed negotiation is deferred to a transition period after the March 2019 deadline and possibly extended beyond the current transition period of January 2021, such an agreement will probably require some capitulation by May on key issues of independence. This will only postpone the tough talk.

TROUBLE AT HOME

In the UK, underlying tension would remain unresolved in the case of an accelerated compromise with the EU. A considerable challenge in negotiations is the distance between the 'Brexiteers', 'Remainers' and the DUP. May still needs to maintain close relationships with these domestic political groupings, which advocate a wide spectrum of views.

May received a mandate to manage the UK's exit from the EU after the 2016 UK referendum, but there have been many vocal supporters of various outcomes. These range from a 'hard' Brexit to those who did not want to leave the EU at all and would be willing to concede some pooling of sovereignty to maintain a close relationship.

What has complicated negotiations is the capacity for the associated political parties of this range of ideologies (the most obvious of which is the Labour Party) to use the current impasse to their own political advantage.

WHAT ARE THE ALTERNATIVES?

For all scenarios, there are any number of possible permutations, given the unknown path of travel in the coming days and weeks, and how little we currently have to go on. Also, even if May manages to get all parties to agree to the withdrawal agreement in time, or to an extension, there is no guarantee that the transition negotiations will deliver an agreed outcome. A 'hard' Brexit may still happen in the end.

A 'no Brexit'

The UK government abandons its Brexit plans. This would require another referendum (with a 'remain' majority outcome) and, given the current political configuration with a coalition government, another election. This seems highly unlikely given the time at hand, but possible if May fails to deliver an acceptable proposal and Westminster calls for another vote. The EU would still have to agree to an extension of the deadline.

A 'soft Brexit'

The UK manages to negotiate concessions to trade and non-trade barriers, in line with other countries who have free trade agreements with the EU. It is also possible that some transition is agreed for the financial services sector. This is unlikely to be enough to avoid losses, but they would be less and spread over a longer period.

A 'hard Brexit'

The UK fails to reach any agreement before the March 2019 deadline and reverts to World Trade Organisation Most Favoured Nation status with the EU from April 2019. This will bring into play a host of trade and non-trade barriers, even if some suspension is negotiated for a short period to insure the economies do not seize. This does imply significant losses to both goods and services trade and – especially for the latter – possibly a large associated decline in the UK's financial services sector. A 'hard Brexit' outcome is still possible, even if the withdrawal agreement deadline is met in some way or another, but the negotiation process fails and the transition period ends with no agreement on the way forward. >

A ‘muddle through’

It is possible that the EU and UK agree to a holding pattern, with the UK complying to rules existing for other countries with whom the EU has preferential arrangements. However, countries such as Norway within the European Economic Area, or Switzerland, have concessions to single market conditions in their agreements, which would require a considerable compromise to the UK’s current position.

THE OUTCOME WILL BE A BALANCE OF NEGOTIATING POWER

The closer we move to the March 2019 deadline, the harder it will be to measure with any real certainty where the balance of power in the negotiations lies. On the one hand, the distance between the warring factions within the UK’s political spectrum leaves both opportunity and incentive to disrupt an already seemingly impossible task, although there seem to be emerging signs of greater support for the Prime Minister within the Conservative Party. On the other hand, May needs the EU to agree to her proposal even before she gets UK parliamentary approval.

The EU can dictate the required level of detail and has the capacity to agree to or deny an extension. It is both a larger and more closed economy than the UK, and will arguably be less affected by a trade disruption than the UK. The EU at this stage seems reasonably united, which would facilitate the ratification process, where the range of opinion across the UK cabinet, parliament and society is well heard.

Success requires a meeting of minds, even if it is a hostile one, and time may still be the biggest driver of closure. But even in a best-case scenario, this presents a challenging basis on which to negotiate going forward.

There is not a single part of the process which is likely to be easy. In fact, there are so many known and visible obstacles to success that it is hard to imagine how an agreement, no matter how vague, will be reached. For now, it still seems possible that a no-deal price outweighs the cost of a compromised agreement, but patience and time are running out. ✚

TECHNOLOGY

Disruption

How companies avoid obsolescence through innovation

By Humaira Surve

Humaira is an analyst within the Global Developed Markets investment unit. She joined Coronation in 2012 after working for Accenture. She holds an MBA from INSEAD.

DISRUPTION IS NOTHING new; in fact, human progress has always been driven by the advent of new technologies and processes which lower cost, increase convenience or improve product performance. Disruption in the market is usually driven by an innovation – a challenger company develops a new solution, initially with limited applications, a niche customer base and a relatively high cost structure compared to an incumbent business's existing products.

Over time, with technological advancements, either the cost structure or the technological capability of the innovation improves significantly. Eventually, what once appealed to a limited audience begins to draw in customers once loyal to the established business. These established companies often knew

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about the existence of the new innovation but either failed to realise the potential market size or adapt their business to take advantage of the technology.

Companies that are unwilling or unable to adapt their organisational structure to one better suited to respond to new innovation often find themselves the casualties of disruption. Take Xerox, for example. The printing solutions group actually invented the first personal computer (PC) in the 1970s with a graphic user interface and a mouse. However, it failed to commercialise its success because it did not have the retail sales knowledge to do so. Microsoft founder Bill Gates, however, grasped the promise of the technology for retail customers and developed an organisation well suited to serving this market. Xerox ultimately failed to commercialise its own invention.

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The Great Atlantic & Pacific Tea Company, better known as A&P, was a chain of US grocery stores which operated very successfully from the 1920s onwards and earned above-market returns on investment for decades. A&P was a relatively small-format grocery store located in urban areas and charged lower prices than competing stores. It was able to earn high returns despite its low prices due to its cost efficiency. Several technological and social changes around the 1950s resulted in a dramatic shift to a new format, which resulted in A&P shrinking significantly.

The two key technological changes that disrupted A&P's business model were the advent of affordable automobiles and the mass production of refrigerators. The former led to increased sub-urbanisation and the latter allowed people to make fewer but larger shopping trips. This favoured the supermarket format which began developing in suburbs. Supermarkets had large parking lots and stocked a greater variety and volume of product. Supermarkets drew customers from further afield than an A&P store could, resulting in a larger volume of sales than an A&P could support.

These volumes allowed the supermarkets to use their fixed cost infrastructure, such as their supply chains, much more efficiently than the A&P stores. Eventually they achieved a lower cost structure, allowing them to charge lower prices, take market share and then dominate for the next several decades.

MODERN TECH THREATS

Key technologies leading to market disruption today are always-on connectivity, mobile devices, cloud computing, artificial intelligence (AI) and machine learning.

Always-on connectivity has increased product and service transparency to customers, with product and service prices and reviews easily accessible through the use of mobile devices on review sites like Booking.com – a share we own – or by asking friends on social media.

As a result of this transparency, to win in business today, a company's product or service has to be great; there must be some practical or emotional appeal. It is no longer good enough to control the distribution channel, because alternatives are often available at the click of a button rather than a drive away.

Cloud computing has lowered the cost of starting a new business. A smart entrepreneur can rent processing power and storage by the minute, prototype a new application (app) in days and then acquire customers globally via an app store.

MACHINE LEARNING AND ARTIFICIAL INTELLIGENCE

Machine learning and AI are probably less familiar to most than the other three technologies described here. Machine learning is a subset of the broader scientific concept of AI.

Normal PCs or servers perform relatively mechanical tasks at a much faster rate than humans are able to achieve. An app is simply a set of instructions that is broken down into smaller subinstructions, which are then executed in a linear manner.

AI, on the other hand, aims to imbue computers with interpretative capabilities. The popular technique of AI today, called machine learning, involves the setup of a computerised neural network. This network is then trained using masses of sample data, like images of cats, for example. Once the network is trained, it can be used to make inferences.

Results of a recent study in *Nature Medicine* journal showed that multimedia parent company Alphabet's DeepMind AI system was able to diagnose eye diseases such as glaucoma from retinal scans at an error rate lower than that of eight different human retinal specialists. Alphabet is a holding in our portfolios.

EVALUATING DISRUPTION

How does one evaluate the investment potential of businesses in the face of these technological changes? Unfortunately, there is no easy answer; each business has to be assessed on its own merits. There are several factors to consider in the process.

It is important to have a view on the impact, if any, of these technologies on the industry in which the business operates. For example, the mobile internet has driven mass adoption of social media, which has increased users' time spent accessing various social media products. This has led to an increase in the inventory of advertising real estate (scrolling creates an endless stream which can be dotted with advertisements) and lowered digital advertising prices relative to traditional media.

The development has been great for companies like Facebook and Alphabet, but very negative for traditional media (newspapers) and advertisers such as WPP. By understanding where we are in the shift from old to new media, we can get a sense of how much opportunity remains.

While the best technology platforms still have many years of growth ahead due to these secular shifts, they are also investing significantly in future opportunities.

It is just as important to understand the competitive advantage or 'moat' a business has with respect to a technological change. It is not good enough for a disruptor to be better than traditional companies; for a business to thrive in the long term, it has to have something that makes it better than other companies using the new technology.

Management with a long-term focus is a starting point. Amazon founder Jeff Bezos' annual letter to shareholders has wonderful nuggets of wisdom. He emphasises the importance of customer obsession and not focusing too much on process or bureaucracy at the expense of really understanding what would delight the customer.

The best companies are aware of and embrace the big trends. In Amazon's 2016 shareholder letter, Bezos says: "The outside world can push you into Day 2 if you won't or can't embrace powerful trends quickly. If you fight them, you're probably fighting the future. Embrace them and you have a tailwind."

These big trends are not that hard to spot (they get talked and written about a lot), but they can be strangely hard for large organisations to embrace. The importance of risk-taking was mentioned in another of Bezos' annual letters: "In business, every once in a while, when you step up to the plate, you can score 1 000 runs. This long-tailed distribution of returns is why it's important to be bold. Big winners pay for so many experiments." Managed risk-taking is critical for businesses to thrive, especially when technology has accelerated the pace of change.

"In business, every once in a while, when you step up to the plate, you can score 1 000 runs. This long-tailed distribution of returns is why it's important to be bold. Big winners pay for so many experiments." – Jeff Bezos

TOP COMPANY PICKS

Three companies we believe will thrive over the long term despite the many disruptive trends mentioned above are Alphabet, Facebook and Vivendi.

In terms of equity positioning, we see value in Alphabet – it owns platforms such as Google, Google Maps, YouTube, Android, Gmail, Google Chrome and Google Play, which boast over a billion users each.

Alphabet's current growth rates are multiple times higher than the market (3% to 5%) and GDP, with projected revenue growth of 22% in 2018 and 19% in 2019, while its net cash balance sheet is robust compared to the market as a whole.

When considering investment spending and undermonetised assets, Alphabet's earnings are below normal, while its global platform and scale create tremendous optionality. We believe Alphabet has the talent, technologies, resources and intention to proactively defend its platforms and improve the reliability of their content.

Online social media company Facebook has one of the strongest network effects among consumer technology companies. It operates a two-sided network – not only does Facebook improve if more friends are on it, it also becomes more attractive to the other side of the network – the advertisers. The more advertisers that use the platform, the more Facebook is able to invest in improving its product quality. By re-investing in both new research and development, and employees and technological infrastructure, it is able to increase its moat.

People often forget that the company also owns Instagram and WhatsApp, both of which are undermonetised and benefit from similar network effects. Facebook recently signalled significant near-term spend to strengthen security, which we believe will only reinforce the company's position many years from now. Facebook trades on a 23 times price to normalised earnings multiple[1], excluding cash, and should grow its revenue at least at a high-teens rate over the next five years. It converts over 100% of earnings to free cash flow, far in excess of the average company in the MSCI World Index.

Another top pick is French media conglomerate Vivendi, whose crown jewel asset is music publishing business Universal Music Group (UMG). Music industry revenues were decimated

[1] In normalising earnings we have applied a lower than current margin, given expectations that Facebook will invest in security and privacy capabilities.

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by piracy with the advent of the internet. The rise of unlimited music streaming, which has been enabled by fast, mobile internet has increased the value proposition of licensed music relative to both piracy and more unwieldy consumption forms like individual track downloads.

We believe the music industry is on the cusp of many years of significant growth, as technology has increased the size of the addressable market. Paid streaming subscribers make up just about 8% of the overall smartphone installed base currently. UMG owns the rights to libraries of irreplaceable music and will be a significant beneficiary as the number of streaming music users explodes. At the current share price, you are not paying much for any of the other assets that Vivendi owns besides UMG.

Disruption has always been around. It creates risks but also opportunities. A strong secular driver in its early innings, an assessment of the business's competitive advantage and a long-term oriented culture that encourages measured risk-taking are features we believe set some businesses apart. ✚

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Outlook for platinum group metals remains positive

Despite new vehicle technology, global car sales still drive demand

By Nicholas Hops

Nicholas is an equity analyst within the South African investment team. He joined Coronation in 2014 and is a CFA charterholder.

The South African platinum group metal (PGM) industry has been in a near decade-long downturn as demand shocks and a pessimistic outlook pushed prices to what we believe to be unsustainably low levels. Unprofitable supply has been slow to reduce due to high barriers to exit. Sentiment towards the sector is incredibly low due to the deep-level, labour-intensive nature of the South African industry, as well as concerns surrounding the long-term demand for PGMs as the European diesel share declines and the world shifts towards electric vehicles.

The negative sentiment is so great that despite a 36% increase in the industry's rand revenue basket to near all-time highs, most equity prices continue to trade at distressed levels. Only Anglo American Platinum (Amplats) has had a positive return over this period.

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PGMs comprise five precious metals, of which platinum, palladium and rhodium are the most important. These are referred to as '3E' metals. The demand side of the 3E market is dominated by catalytic converters for internal combustion engine (ICE) vehicles, making up 70% of global demand.

We are optimistic about the market for the following reasons:

- The outlook for global vehicle sales is good, driven by emerging markets.
- We expect 3E demand to grow over the next decade as environmental legislation in China and the rest of the world forces automakers to use more metal in their vehicles.
- We feel new legislation is being underestimated – in the next five years, China, the largest vehicle market, will have the strictest emissions standards in the world.

The balance of the market is split between jewellery and industrial catalysts, with 9% and 21% respectively. We expect this portion of demand to see slight growth over the next decade. The negativity on the demand side has been driven by the outlook for European diesel sales as well as the rise of battery electric vehicles (BEVs). While the outlook for European diesel vehicles is negative, it is important to note that they make up only 12% of 3E demand, which we expect to decline even further.

We are believers in the long-term prospects of BEVs, but are cognisant of the various challenges facing the technology. The primary hurdles to rapid adoption are range anxiety, a lack of infrastructure, high costs and long charging times. We have done a significant amount of work on the future of the automotive industry, travelling the world to talk to industry players and work with automotive consultants. The megatrends of electrifying the drive train, as well as using cars as a service instead of individual ownership – as demonstrated, for example, by Uber and autonomous vehicles – will shape the industry over the next few decades.

Our key takeaway from the work we have done is that the industry's transition will be evolutionary rather than revolutionary; it is not all going to change overnight.

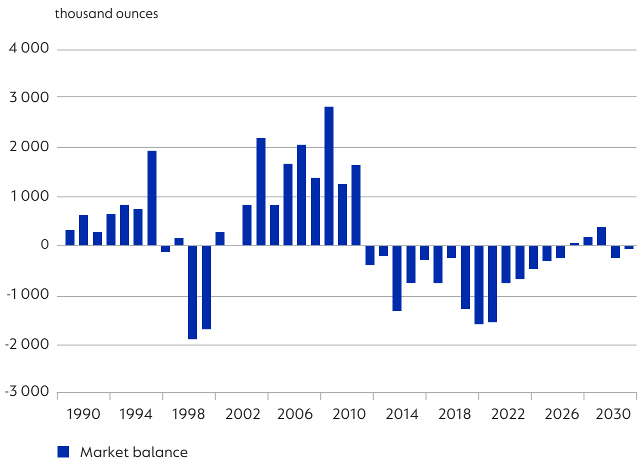
Importantly, we see a period of mass hybridisation over the next decade before BEVs start to become more affordable for the mass market. We anticipate a shift towards a portfolio of technologies, including BEVs and a variety of hybrids, as well as fuel cell vehicles. As investors in the PGM sector, our biggest concern is BEV adoption, as these have no PGMs in the vehicle at all. In our forecasts to 2030, we expect BEVs to make up 19% of global light-duty vehicle sales, up from 1% today. We expect traditional ICE vehicles as we know them to decline from 96% today to 28%. There is also some potential for fuel cells in the vehicle mix, given their suitability in long-distance and haulage applications. In addition, the Chinese and Japanese are championing the technology and are investing hard behind it, which cannot be ignored. Fuel cells are very PGM intensive and stand to be a material boost to demand, if successful.

Gasoline vehicles use predominantly palladium in their converters, instead of platinum. Palladium is in material deficit and now trades at a $180 per ounce premium to platinum where it historically traded at large discounts. Industry feedback we have gathered is that platinum is a superior metal for catalysis and that a growing price differential will swing the original equipment manufacturers back towards platinum over time. Many in the market have looked at the platinum surplus and declared that the metal is doomed; our view is that, given their fungibility, platinum and palladium must be considered together. When looked at in this way, the market is in a growing deficit. Of the 3E metals, platinum is most important for South African producers, as it is makes up 60% of the ounces extracted from our mines.

Considering all our demand expectations, we see 3E demand increasing 11% by 2030, while the market rhetoric seems set on declining demand. The negativity surrounding the PGM markets is not dissimilar to that surrounding thermal coal a few years ago. It has now become clear that despite being a 'sunset' industry, thermal coal will be around for a number of decades to come, and thermal coal prices are up over 100%. The outlook for mined supply of 3E metals over this period is muted, with growth from Russia offsetting declines from South Africa. Secondary supply of PGMs through the recycling channel is set to increase materially off today's base. Beyond 2030, we see large reductions in South African supply as many mines come to the end of their economic lives.

Coupling our supply and demand expectations gives us an average market deficit of 500 000 ounces, or 2.6% of annual demand, each year over the next 12 years. These deficits are substantially more pronounced in the near term and we expect prices to react strongly over this time frame. We have excluded potential investment demand from these balances, which may prove conservative.

GLOBAL 3E MARKET BALANCES



Sources: Johnson Matthey, company annual reports, Coronation analysis

Negativity towards the industry also stems from the deep-level, high-cost nature of the majority of South African mines. We have mitigated this through the selection of the highest quality plays in the sector – Northam Platinum and Amplats.

Northam is a medium-sized producer with two producing mines, run by an entrepreneurial management team that has taken advantage of the industry downturn by making smart acquisitions. Production growth from its Booysendal mine over the next five years will help the group double production. Booysendal is the key asset in Northam's portfolio and while it is underground, it is shallow, capital light and mechanised, requiring a smaller labour component. Northam is well positioned to generate cash flows and at current metal prices is on a nine times price earnings ratio.

Amplats is the world's leading producer of PGMs and has undergone a remarkable portfolio transition in the last five years. Shedding itself of high-cost, deep-underground mines and focusing on its key Mogalakwena asset have allowed Amplats to pay the first dividend in the sector since 2013. Mogalakwena is a unique asset as it is an open pit, which means it comes with significantly less operational complexity and standout margins. It has material expansion capability over the next decade and we believe management will pursue this. Amplats has several options to expand the size of its portfolio over the next decade with high-quality, low-labour ounces. At today's spot prices, Amplats trades on an 11 times price earnings ratio for the 2019 year.

The sentiment around PGMs has left equity prices in the sector lagging recent improvements in the basket price. Thanks to their high-quality operations, both Northam and Amplats can generate material cashflows in today's price environment and we believe equities are yet to reflect this fact.

Combining Northam and Amplats, and on a look-through basis with Anglo American, we have a 6% exposure to the PGM sector in our house portfolios. ✚

New Oriental

China's competitive education system drives strong growth

By Paul Neethling

"We need to focus on both basic education and advanced education. We need to have key primary schools, key middle schools and key universities. We need to have a stringent exam system in order to keep the top talent in key middle schools and key universities." – Deng Xiaoping

Deng Xiaoping was the paramount leader of the People's Republic of China from 1978 to 1989. He led China through far-reaching market economy reforms, which started opening up China to the global economy.

I wonder if Deng could have foreseen what the Chinese education system has become today? It has moved from a system where students were selected based on political and family backgrounds in the early 1970s to one which, while still highly selective, is focused on academic achievement and is exam-centric. There is little autonomy on admissions; all public universities and high schools are required

Paul joined Coronation in October 2016 as an equity analyst within the Global Emerging Markets investment unit. Paul is a qualified chartered accountant and a CFA charter holder. He has six years' investment experience.

to admit students based on scores achieved in the National College Entrance Examination (commonly known as *Gaokao*).

The *Gaokao* is a nine-hour exam over two days and is a source of anxiety for children from a young age – as well as for their parents. Due to huge demand, key universities such as Peking University and Tsinghua University have the lowest acceptance rates in the world (much lower than the top US 'Ivy League' schools).

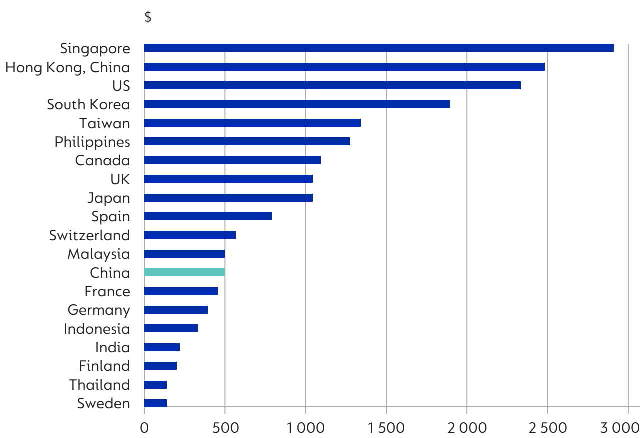
The system clearly works for China, which is focused on innovation. In 2016, China produced 4.7 million science, technology, engineering and mathematics (STEM) graduates. This is 80% more than India, in second place with 2.6 million STEM graduates and more than eight times the US, in third place. It is also not just quantity over quality. A recent study by Qingnan Xie of Nanjing university and Richard Freeman of the US National Bureau of Economic Research found that in 2016, 24% of scientific papers had an author with a Chinese name or address (37% when Chinese language papers are included).

Given the extremely competitive nature of the education system, after-school tutoring (AST) is used extensively by parents to give their child an edge. In China, AST is considered a must should you wish your child to receive the best possible education and achieve the best subsequent career path. Parents who can afford AST make use of it from as early as preschool.

The Chinese AST market is forecast to grow in the low- to mid-teens, driven by a combination of the relaxation of the one-child policy, increasing urbanisation, rising wealth levels and AST penetration growing to levels closer to those of developed Asian peers. When asked to rank spending priorities for increased family income, Chinese consumers rank their children's education as the highest priority. The graph below illustrates that China's education spend per household lags other countries. This should grow as household income grows.

New Oriental Education & Technology Group, a recent addition to our global emerging markets strategy, is the largest and most

EDUCATION EXPENDITURE PER HOUSEHOLD



Sources: CLSA, Euromonitor

recognised provider of private educational services in China (mainly AST and overseas test preparation, which help students to prepare for foreign admission exams).

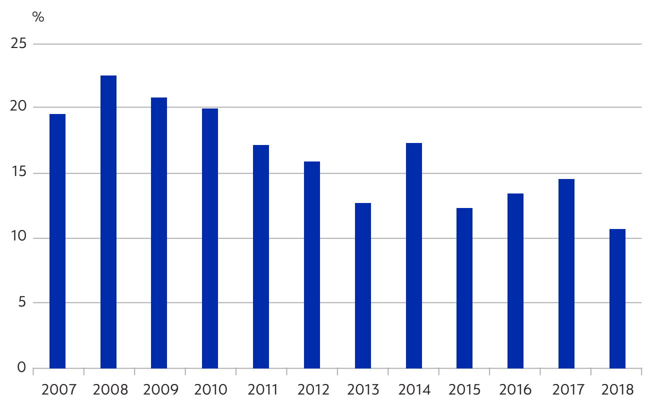
New Oriental has 6.3 million student enrolments per year (excluding online enrolments), a network of 1 081 learning centres and over 28 000 teachers, and operates in 75 cities.

New Oriental and industry counterpart TAL Education Group are by far the biggest players in this fragmented market. Despite years of above-industry growth, they each only have low single-digit market shares. With real benefits to scale (a national footprint, the best teachers, proprietary content and computerised systems with the most data), they should continue to consolidate the market over time.

New Oriental's strong capacity rollouts in recent years have led to lower class utilisation levels, as learning centres take some years to mature. This, along with investments into online to offline (O2O) – combining physical classroom teaching with online teaching resources – and pure online education initiatives, has led to New Oriental reporting decade-low operating margins in its 2018 financial year. However, these investments drive growth and strengthen competitive positioning.

As current high investment spending and low utilisation levels normalise (lower and higher, respectively), operating margins should revert to levels materially higher than the current 10.7%.

OPERATING MARGIN



Source: Company annual reports

More recently, New Oriental's share price has come under pressure (along with industry peers') as a result of the State Council releasing a document to regulate extracurricular training institutions as a measure to ease students' heavy workload. While the regulations could result in a few short-term hiccups such as longer approval times for expansion plans, leading to slower revenue growth, our view is that the regulations strengthen the position of the industry leaders.

Smaller independent operators will struggle to abide by the new, higher standards, which set out required teaching qualifications, minimum class sizes – at three square metres per learner – and >

business and educational licences. Consequently, we believe the regulations have enhanced New Oriental's ability to consolidate the industry and report above-market growth rates over the long term, which offsets the potential shorter-term hurdles.

We used the recent share price weakness as an opportunity to build a position in New Oriental, which currently trades on 20 times forward earnings and 14 times forward free cash flow (upfront payment terms result in over 100% conversion of profits into free cash flow), and has 27% of its market cap in cash and short-term liquid investments on the balance sheet.

The founder, Michael Yu, is still involved as executive chairman and owns 13% of the company. Strong brand equity, a defensive earnings stream and returns on equity consistently in the high teens to low twenties add to New Oriental's attractiveness.

We believe the extremely competitive education system that Deng reinstalled in China is enduring and will ensure that there is always a place for AST in China. Just like Deng believed in key schools and universities, we believe that key AST providers in China (New Oriental and TAL) will continue to grow at above-market rates for many years to come. ✚

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein may currently be held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.

There is always noise

Tighter financial conditions are the greatest near-term threat to global growth

By Marie Antelme

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

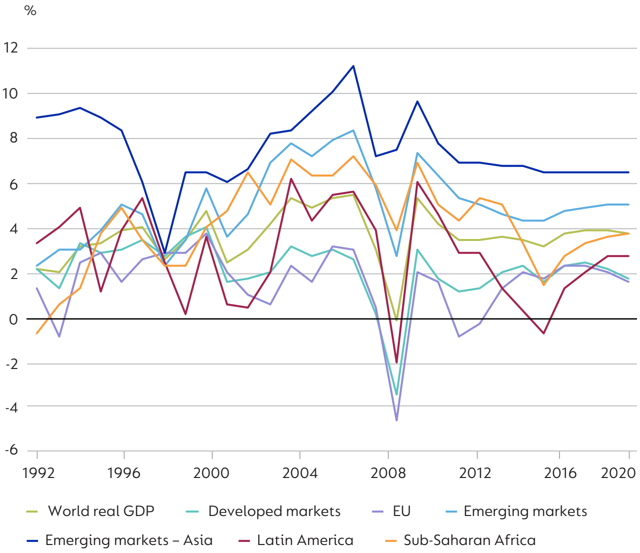
THERE IS PERHAPS one universal truth about economics and that is that there is always 'noise'. This is particularly difficult to sift through at the moment, where the visible risks are numerous and have potentially large implications for economies, policy setting and asset prices.

Available economic data suggest that global growth is still running at a healthy clip. The October IMF World Economic Outlook still forecasts global growth at 3.9% this year – in line with the April assessment – and at 3.9% in 2019. Healthy employment gains have helped offset moderating trade volumes, and capital investment is an ongoing support for good quality growth, especially in developed economies.

But the composition of growth has become more uneven, and the risks, mostly downside, have become greater. Growth remains generally strong in advanced economies, but momentum has slowed visibly in the EU and Japan, and to a lesser degree in the UK. >

In contrast, US GDP continues to grow above potential, with strong employment gains and rising inflation. For developed economies, GDP should be 2.4% in 2018 and 2.2% in 2019.

GLOBAL GROWTH STRONG, BUT LESS SYNCHRONISED



Source: IMF

For emerging and developing economies, growth is forecast at 4.9% in 2018 and 5.1% in 2019, but this forecast implies quite a wide variance across countries.

Recent market volatility highlights that the risk of a sharper tightening of global financial conditions is the biggest risk to the outlook for growth. US Federal Reserve (Fed) policy is, as always, central to global developments.

Given the strong, broad-based growth being experienced in the US, the Fed is on track to continue raising interest rates over the next two years – at this stage ahead of its counterparts in other countries. This should, on balance, support the US dollar, but it also implies tighter financial conditions in emerging markets and the likelihood of developing economies becoming more restrictive. Were the Fed to tighten more quickly than the markets expect, a broader range of countries could come under pressure.

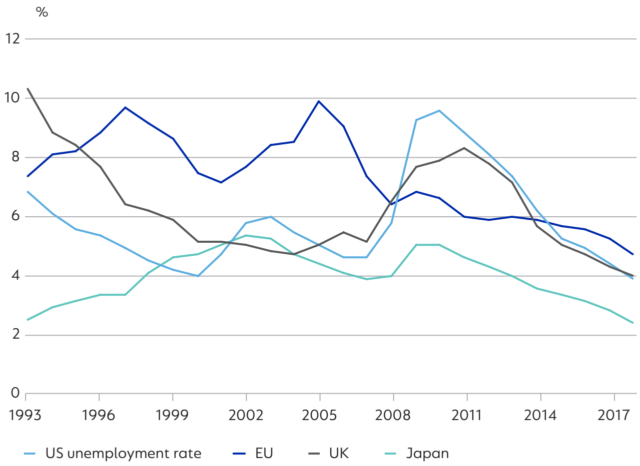
The next visible area of risk is a further escalation in trade tensions, with ongoing implications for growth, investment, asset prices and confidence. The US has initiated adverse trade actions against a wide range of countries, but most aggressively against China. Recent negotiations suggest some conciliation with the North American Free Trade Agreement (NAFTA) partners, and talks have started between the US, the EU and Japan. However, the threat of higher tariffs across a bigger base of Chinese imports is becoming increasingly likely.

The high oil price is also becoming a source of concern. Since June, Brent crude oil prices have risen from $72 per barrel to over $80 per barrel – a level last seen in 2014. Historically, high oil prices have contributed to slowing global growth as rising inflation erodes real incomes and undermines spending. In a world where support from trade is moderating, making economies more reliant on domestically driven growth, this becomes a greater risk.

Turning to country specifics, the US economy is poised to continue growing strongly over the next two years. Substantial fiscal stimulus has fuelled already strong domestic demand, which is in turn supported by healthy employment gains and still-accommodative monetary policy.

GDP is forecast at 2.9% in 2018 and a slightly more moderate 2.6% in 2019. With the unemployment rate at multiyear lows, strong growth is likely to be increasingly accompanied by rising inflation and expanding domestic demand, rising demand for imports and a wider current account deficit. The upcoming midterm elections could have a meaningful impact on fiscal policy into the 2020 presidential election.

DECENT QUALITY GROWTH



Source: IMF

In Europe, data suggest that the recovery off 2018's first-quarter weak spot has peaked. Underlying currently strong growth, sentiment indicators and industrial production growth have started to moderate. GDP for the region as a whole is forecast at 2.1% this year and 1.8% in 2019.

The European Central Bank has signalled an end to its quantitative easing programme from December 2018 and has already started tapering monthly purchases, but has stated that the policy rate will remain unchanged until at least the middle of 2019.

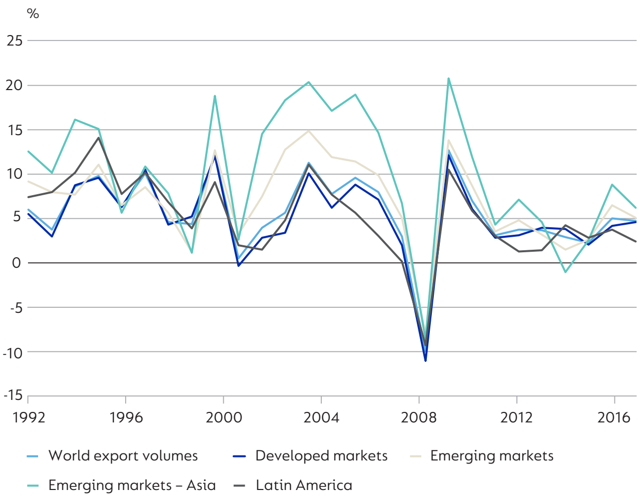
With talks under way, there is some agreement among NAFTA negotiators, which bodes well for a de-escalation of trade tension with the US. An intensification of tension is still a visible risk to European growth, with the US threatening to raise the tariff on imported European vehicles from 2.5% to 25%. Germany is Europe's biggest car manufacturer, but, with healthy domestic growth, smaller peripheral producers may be harder hit. Encouragingly, the start of trade talks between the US and both the EU and Japan perhaps limits some of this risk at the time of writing.

The UK's journey to Brexit has, to date, not been a big issue for the EU, but as the March 2019 deadline approaches (and an agreement or extension is needed well before this time), countries within Europe and the UK will be at risk of negotiations failing. In the UK, Prime Minister Theresa May still faces complex and considerable challenges in facilitating an agreement with the EU and then at home – here with a combination of her own divided party, its coalition partner and the opposition. Time is short.

Amid this uncertainty, the UK economy continues to muddle along. On balance, it has lost momentum since the referendum in 2015, but data have been mixed more recently. Unemployment has fallen steadily and, at 4.0%, is at multiyear lows. Retail sales data have recently been stronger and the economy is expected to grow 1.2% in 2018 and an uncertain 1.3% in 2019.

Japan's economy continues to grow at a solid pace, with growth of 3.0% registered in the second quarter of 2018 and an overall expectation that the economy will expand 1.1% for the year. A series of natural disasters will disrupt output in the second half of 2018, but here too, unemployment is very low, at 2.4%, and strong corporate profit growth has lifted capital expenditure.

EXPORT VOLUMES UNDER PRESSURE



Source: IMF

Preparations for the 2020 Summer Olympics in Tokyo could see spending elevated through the early part of 2019. Headwinds for growth include trade uncertainty and the scheduled value-added tax increase, which could disrupt consumption in late 2019.

Elsewhere in Asia, China is at the forefront of the trade conflict with the US. While official data still show GDP running at about 6.5% year on year, activity data have softened. The negative impact of slowing credit impulse has weighed on construction and general infrastructure, although retail, property and even trade has held up reasonably well. Recent data, however, suggest that the trade sector is now showing signs of the impact of US tariff increases, with the latest round of 10% of $200 billion of Chinese imports effective 24 September likely to weigh further. Offsetting policy measures, including a softer stance on credit growth and a range of tax cuts are unlikely to fully offset the intensifying impact of trade tensions on sentiment and investment in China.

More broadly, emerging markets have experienced powerful crosswinds in recent months. The strong US dollar, rising interest rates, rising oil prices, trade tensions and areas of geopolitical conflict all impact emerging economies in different ways. While global policy setting is still broadly supportive of emerging market growth, markets have started to differentiate between economies with specific vulnerabilities or political uncertainties.

On balance, interest rates have increased across emerging markets, with the most vulnerable economies experiencing significant currency depreciation and higher policy rates. In economies such as Turkey and Argentina, growth is likely to slow sharply as a result. Elsewhere, oil exporters such as Russia may benefit from higher prices, but here too, political uncertainty and the ongoing risk of US sanctions will weigh on the outlook and the currency.

While the global backdrop is reasonably strong, with areas of decent quality growth, the outlook for emerging markets remains satisfactory. However, it seems unlikely that conditions in developed economies will improve from here. The threat of higher US rates than the market expects, along with a stronger US dollar and ongoing wider trade tensions, all suggest that the outlook for emerging markets is likely to remain challenging, albeit to different degrees, in coming quarters. ✚

Third quarter in review

SOUTH AFRICA GLOBAL BALANCED VIEW

Globally we continue to reduce exposure to what looks like a very expensive US market in favour of the rest of the world where valuations are more reasonable. Emerging markets continued their recent underperformance, returning 1% for the quarter (with returns now flat over a rolling 12 months). Although the portfolios have benefited from their exposure to global equities, our position in emerging market equities has detracted from performance. Notwithstanding this detraction, we believe that our emerging market equity exposure currently offers compelling value.

In the US, on the back of continued robust economic growth and rising short-term rates, the US 10-year government bond yield ended above 3.0% at quarter end, its highest level in almost seven years, lifting most developed market bond yields along with it. The Citigroup World Government Bond Index (WGBI) declined by 1.6% in US dollars for the quarter. The two-year rolling returns for the WGBI are now a negative 2.2% per annum – a stark reminder that bond investments are not riskless. The portfolios have benefited from being underweight in global bonds.

The US economy is notably strong (the unemployment rate just hit a 50-year low) and other advanced economies are still growing faster than long-term sustainable rates. This, coupled with central bank policy rates that we believe are still too low for a non-crisis global economy, makes it appear almost inevitable that interest rates will rise. We therefore continue to remain cautious on the outlook for global bonds.

The impact of tightening global financial conditions and US dollar strength has already been felt across a number of asset classes – especially in emerging markets where domestic and external vulnerabilities have been exposed, and a number of emerging market currencies have demonstrated extreme volatility and have depreciated significantly.

The rand has not gone unscathed and depreciated a further 3% against the US dollar over the quarter, bringing the total depreciation to almost 13% for the year to date. Given the unfolding global macroeconomic environment, coupled with weak domestic economic fundamentals, the currency continues to look vulnerable. Domestically, things remained tough during the quarter under review as the local economy dipped into recession. In September, President Cyril Ramaphosa announced a new economic stimulus package, but despite this being a step in the right direction, it is likely that it will take time to gain traction.

Looking at the markets, domestic consumer-facing businesses reflected this harsh reality, with numerous companies reporting results below expectations.

Overall, the JSE experienced a difficult quarter, with the FTSE/JSE Capped Shareholder Weighted All Share Index declining 1.7%, dragging down rolling 12-month period returns to a paltry 0.4%. The poor returns for the quarter were driven by weak performance from the industrial sector (-8%). The financial sector performed strongly, mainly driven by the life and non-life sectors that were up 12% and 17%, respectively. The resources sector had another good quarter and was up 5%, with platinum stocks (+26%) having a very strong three-month period on the back of a rising platinum group metals basket price.

With local bond yields ticking up, the All Bond Index returned only 0.8% for quarter. We continue to maintain our very low exposure to fixed-rate bonds, with this position partly offset by our overweight position in listed property, which we believe offers very attractive risk-adjusted returns.

We continue to maintain reasonable exposure to resources based on our assessment of their long-term value. Our preference for Anglo American (+6%) over BHP Billiton (+2%) – based on a more attractive commodity mix and valuation – continued to contribute to performance for the quarter. Our platinum exposure, mainly through Northam (+9%), also added to performance during the period under review.

We remain cautious on the outlook for global bonds. A strong US economy, coupled with still too low central bank policy rates, makes it almost inevitable that interest rates will rise.

In the media sector, Naspers' declined on the back of a pull-back in the Tencent share price, of which the short-term earnings expectations have been revised downwards. This is due to delays in the licensing of new online games, and proposed regulations to protect minors from the adverse effects of online games. We think tighter regulations will favour established players like Tencent, and as such we remain optimistic on the longer-term prospects for their online gaming business.

We are also encouraged by opportunities across the business, as well as its outstanding investment portfolio, which we believe is still underappreciated by the market. A further positive is the management team's actions around portfolio optimisation and the steps taken to reduce the discount to its underlying intrinsic value. This includes the unbundling of Multichoice – most likely to be completed in the first quarter of 2019.

The MTN share price declined after surprise announcements by the Central Bank of Nigeria (CBN) and the Nigerian Attorney General that MTN was in violation of certain foreign exchange control regulations and that it should repatriate $8 billion to the country and pay an additional $2 billion in back-taxes.

These actions have undermined the investment case for foreign investment in Nigeria; as a result the tone of more recent public announcements by the CBN has been more constructive. We believe a worst-case scenario is more than reflected in the current MTN share price and remain hopeful that an amicable resolution can be found.

Some of our consumer-facing domestic holdings had a very challenging quarter and experienced double-digit share price declines. At this point we are asking ourselves whether the weakness is a cyclical or structural phenomenon. Has the earnings quality of food producers and retailers structurally changed? We do not believe this to be the case.

In an economy with high structural inflation, it is extremely challenging for management to navigate a low-volume growth environment. Only a small recovery in economic growth will significantly ease this burden. The issue has been exacerbated by the current low food inflation environment and, for producers, by additional imports on shelves because of a strong rand at the beginning of the year. As such, we believe some of these pressures will abate and continue to selectively add to the consumer stocks.

We continued to build a position in Quilter, the second largest advice force and platform in the UK, following its recent unbundling from Old Mutual. The UK savings market is substantial and the need for financial advice has increased dramatically, given recent pension reforms which give individuals more control over their retirement savings. This should act as a structural tailwind for the business.

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UK property had another disappointing quarter, mainly due to the economic uncertainty surrounding Brexit and, in some instances, concerns around gearing levels. While we are cognisant of the risks surrounding the investment cases of the stocks we hold, we believe that they are incredibly cheap.

This has certainly been a testing quarter but in this volatile and uncertain world, our objective remains building diversified portfolios that can absorb unanticipated shocks. We will stay focused on valuation and seek to take advantage of attractive opportunities that the market may present to us and, in so doing, generate inflation-beating returns for our investors over the long term.

GLOBAL EMERGING MARKETS

The Coronation Global Emerging Markets Strategy had a poor third quarter, with the largest negative detractors over the period being Indian Financials, YES Bank and Indiabulls Housing Finance. Other notable detractors were JD.com, Magnit and Naspers. Having no commodity exposure also detracted in what continued to be a good period for commodity prices.

The declines in YES Bank and Indiabulls Housing Finance merit further discussion, even though there has subsequently been some recovery in the shares. The default of one of the Indian property financing companies (IL&FS), together with rupee currency depreciation and rising Indian bond yields, triggered a large sell-off. However, in our view the long-term prospects for the industry remain very attractive due to a young, urbanising population, low home ownership and attractive economics.

Aside from strong long-term drivers of the financial services industry in India and ongoing market share opportunities for private banks, YES Bank (the sixth-largest private bank) has a strong franchise and a long track record of delivery.

With volatility at above-average levels in emerging markets, we were more active than usual, having made five new buys during the quarter – four in China and one in Brazil.

The largest new buy over the quarter was a 1.6% position in New Oriental Education & Technology Group (which we discuss in more detail on page 16), one of the leading after-school tutoring businesses in China, which we increased to 2.6% into weakness during October. The recent share price declines in the sector were driven by a number of factors, including the impact of trade wars on equities in general and regulatory tightening.

In our view, given the increasing emphasis on quality education in China and the fierce competition for entry into tertiary institutions, Chinese tutoring businesses have attractive long-term prospects.

The second-largest new buy during the quarter was a 1.2% position in Wuliangye Yibin, the second largest premium baijiu (a local Chinese white liquor) company in China. The baijiu spirits market in China makes up almost 90% of all spirits consumption in China. Wuliangye's baijiu offering covers the whole market (with price points as low as $5 a bottle), but a shift over time to the ultra-premium and premium Wuliangye products provides both higher revenue and higher margins.

There were smaller buys in Li Ning (China; sports apparel), NetEase (China; online gaming) and Itau Unibanco/Itausa (Brazil; private bank). The strategy's total Brazilian exposure was 9.7% of strategy at the end of September (with a large part of this in the two leading tertiary education companies, Kroton and Estácio), but this has increased due to market movements (positive moves in both equities and the currency) in October to around 11% of strategy.

Members of the team continue to travel extensively to enhance our understanding of the businesses we own in the strategy, their competitors and the countries in which they operate, as well as searching for potential new ideas. Over the past 20 months we have done detailed work (modelling, fair value and research report) on 43 new companies, 10 of which have made it into the portfolio, making up 24% of the strategy today. In the quarter there were two trips to China as well as trips to India and Russia. The coming months will see trips to China, India and Brazil.

GLOBAL MANAGED

Despite more clouds gathering on the horizon of global growth prospects during the quarter, global equity market participants preferred to focus on continued strong profit growth numbers – especially out of the US – to register very strong returns over the period.

The MSCI All Country World Index returned 4.3% over the quarter, almost matching the year-to-date number of 3.8%. At the same time, investors have had to adjust their interest rate expectations for the US upwards. This was in response to a US economy continuing to surprise on the upside in terms of growth and its sustainability. We continue to monitor escalations in the trade war dialogue, primarily between the US and China.

However, we believe investors should use their judgement when headline-grabbing pronouncements are being made. As we argued in the prior quarter, we think the bigger issue that investors need to focus on is the process of interest rate normalisation in the US.

The Global Bond Index generated negative returns over the last three months, resulting in a negative 1.3% return over the last year. We continue to exercise caution with regards to the bond market, despite the weakness over the last few years.

Another notable development over the quarter was the increased cost of capital in emerging market equities, which underperformed their developed market peers by 6%, on top of an underperformance of almost 10% in the prior three-month period. This has meant that over most periods, emerging markets have now underperformed developed markets, with the US equity market continuing to be the stand-out performer over the last decade.

Emerging market currencies shared in this adjustment, with the Russian ruble, South African rand and Indian rupee all depreciating by around 12% during 2018. The Turkish lira is down almost 37%, but we view this as mostly self inflicted. Developed

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economies' currencies generally depreciated only slightly against the US dollar over the quarter (around 2%).

Healthcare was the best-performing equity sector this past quarter, with information technology again registering a strong performance. Laggards were energy (after a very strong second quarter), utilities and real estate.

Listed property had a tough quarter, with essentially a flat performance. UK property continued to suffer from a weaker fundamental outlook, with further uncertainty regarding the Brexit outcome muddying the waters.

Against the backdrop of rising interest rates, it was perhaps not surprising that the gold price came under more pressure. We have added marginally to our position in physical gold and continue to view it as a hedge against a world ruled by uncertainty.

Notable winners over the year included Advance Auto Parts (discussed below), Amazon, Airbus, Twenty-First Century Fox, (in response to sale of bulk of the business to Disney), and Alphabet.

It is worth taking a closer look at Advance, the second-largest retailer in the auto parts sector in the US, serving both do-it-yourself customers and the professional mechanical workshop. We initially invested in this stock in August 2017 after we met the new management team at a conference in the US.

> **Despite Argentina's challenging macroeconomic environment and short-term volatility, a number of businesses are performing very well, and should provide investors with attractive returns in the longer term.**

At the time their operating margin was about half that of the industry leader, and the new team had concrete plans to partially close the gap. At the same time, unusual weather had also adversely impacted industry sales, and there was a lot of speculation about Amazon making a stronger push into the category. We thought the weather issue was temporary and believed that the category was less attractive to an online retailer than generally believed. While the management team has yet to deliver on its promise to increase margins, a more normal winter has seen industry volumes pick up again. The Amazon threat has also subsided, with the result that the stock has been our biggest contributor to alpha over the last year.

Our equity exposure is below benchmark, and we have continued to reduce our credit positions. We have added marginally to property but are mindful of the risks posed by further increases in interest rate expectations.

AFRICA AND GLOBAL FRONTIERS MARKETS

Africa Frontiers

On 1 October, the Coronation Africa Frontiers Strategy turned 10 years old. The past decade of investing in Africa has been one of ups and downs, delayed flights, dodgy meals and strange ailments, but also a decade of inspiring meetings, new friends and exciting experiences. How these years and events have impacted our lives would take far more than a quarterly commentary to communicate, but there is nothing like turning a year older and passing a significant milestone to spend some time in reflection.

If someone told us that we would need to navigate coups, currency shortages, the Ebola virus, the Arab Spring and terrorism attacks, we might have thought twice about what we were getting ourselves into.

While macroeconomic and political headlines have been depressing, how have markets performed? Regrettably for index investors, not well. The FTSE/JSE Africa (ex-SA) Top 30 Index has returned -1.4% per annum over the past decade, while the MSCI Africa (ex-SA) Index has not done much better and is down-1.8% per annum.

It has been a particularly tough period for Africa investors. We estimate that during 2015 and 2016, Africa (ex-SA) assets under management fell 48%, with 11 funds closing and another 11 left with less than $10 million assets under management – a truly unforgiving 24 months for the asset class.

Most of the markets have had tough recent years, with Egypt the only major market up in US dollars (+4.2%), while Kenya (-5.5%), Zimbabwe (-7.5%) and Nigeria (-9.0%) were down over the past year.

Egypt continues to benefit from the structural reforms and an IMF deal implemented two years ago. Company fundamentals remain very healthy and operating results have generally been strong. Nigeria and Kenya have suffered from government missteps. In Nigeria, the $2 billion tax claim and $8 billion dividend repatriation dispute with MTN have resulted in its country risk premium increasing for many investors.

Unsurprisingly, the market has come under pressure. It was hoped that Kenya would finally lift its interest rate cap, but parliament decided that the cap was here to stay. This, coupled with an increase in taxes on mobile money transactions, weighed on Safaricom and the banking sector which make up a big part of the Kenyan market.

In Zimbabwe we recognise our holdings at internal fair values, as we have done since September 2017. The currency market remains challenging and we believe that this is the most appropriate valuation methodology at this time. During the past month we have updated fair values for the annual results and changes in the operating environment.

Looking forward to the next 10 years, we remain energised and excited. There are many businesses with strong fundamentals and exciting prospects that the market has yet to appreciate. We cannot wait to see how they perform over the coming decade.

Global Frontiers

The past quarter was tough for frontier markets. Following a large sell-off in the previous quarter, Vietnam (+4.2%) was one of only a few markets with a positive return over the past three months. Nigeria (-15.1%), Kenya (-14.1%), Sri Lanka (-11.4%), Egypt (-10.2%) and Argentina (-9.4%) all had meaningful declines.

In US dollars, the stock market in Argentina is down approximately 46% over the past 12 months. During the quarter, the pressure on the Argentine peso intensified. The currency moved from 29 peso/US dollar to more than 40 peso over the past three months and has now lost more than half of its value since the start of 2018 when it traded at around 19 peso to the dollar.

In August, the central bank increased interest rates to a staggering 60% in an attempt to stabilise the currency, and at the end of September, interest rates were increased further to 65%.

We met with a number of Argentine companies in September. Given that the macroeconomic environment in Argentina is clearly very challenging, we were expecting management teams to be fairly pessimistic. However, the meetings with individual companies showed that a number of businesses are in fact performing very well. Several businesses have revenues linked to hard currency and are benefitting from the devaluation.

Despite the difficult macro environment, these businesses should see profit margins expanding. On top of this, we were impressed with management teams' thinking around capital allocation, with several companies using their depressed share prices as an opportunity to buy back shares. This is something which we believe will create significant long-term value for shareholders.

At the start of the quarter, the strategy had no exposure to Argentina, despite Argentina being a very large constituent of the MSCI Frontier Markets Index. We base our investment decisions on bottom-up valuations of companies and not on their weight in a particular index. Following the large declines in share prices in Argentina, the valuations of a number of these businesses now look very attractive, trading well below our assessment of fair value. As a result, we had increased exposure to Argentina to 8% by the end of the quarter.

We have said before that Vietnam is an exciting country with strong GDP growth, booming exports and several quality businesses that we would love to own at the right price. Between April 2018 and July 2018, the stock market in Vietnam lost almost 25% of its value, while the earnings of businesses continue to grow. This offered an opportunity to achieve exposure to Vietnamese businesses at attractive valuations and, by the end of the quarter, Vietnam accounted for 5% of the fund.

Our valuation-driven investment approach helped us to avoid overpaying for shares in Argentina and Vietnam at times when these markets were incredibly well liked. In the same way, we believe this approach helps us to identify opportunities to buy quality businesses at attractive valuations when these markets fall out of favour. We believe that Argentina is currently a great example of a country where there are good businesses that are temporarily out of favour. While there might be a lot of volatility in the short term as the country works through its economic issues, we believe that the businesses we hold in the strategy should provide investors with attractive returns in the longer term. ✚

The detailed strategy commentaries are available on our website.

25 Years of Changing Lives.

At Coronation, we have been investing in South African communities for the past 25 years.

Since day 1, our CSI strategy has aligned with our philosophy of investing for the long term, and is premised on our belief that education lies at the heart of breaking the cycle of poverty in South Africa.

In 2018, we launched a unique project called Capsule that integrates all of our main CSI partners into a collaborative, measurable programme serving the full ecosystem surrounding a primary school.

Capsule empowers contributors from the whole community with skills to help them rise above their challenges, with a core focus on education in literacy and numeracy.

Coronation's holistic approach to uplifting society is grounded in earning the trust of our communities, day by day, year after year.