FIXED INTEREST REVIEW

The past year was one of surprises – more specifically, political surprises: Brexit, the election of Donald Trump as US president and, closer to home, President Zuma's recent cabinet reshuffle, which led to the country's downgrade to sub-investment grade (or 'junk status').

Asset class returns

Amid this volatility, there was varied performance across fixed income assets, emphasising the importance of judicious asset allocation. Government bonds had a tremendous year, returning just under 11%. In contrast, listed property did not manage to eke out 0%. Inflation-linked bonds (ILBs) also significantly underperformed the All Bond Index (ALBI), primarily due to expectations of lower inflation towards the end of the year, which caused a sell-off in real yields. A substantially stronger rand – appreciating from a significantly weakened base – negatively impacted investments in offshore assets.

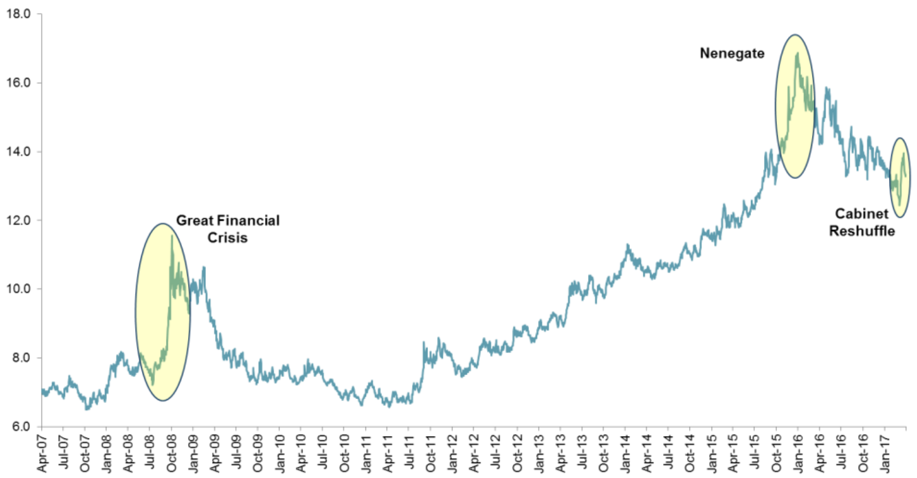
Fixed income asset returns for the year ending 12 April 2017

	% returns
All Bond Index	10.93%
Inflation Linked Bonds	2.45%
Preference share index	12.98%
Listed Property Index	-0.37%
Cash	7.21%
Rand/$	-9.23%

Fixed income market outlook

At the beginning of 2017, there were tentative signs of green shoots forming in the local economy, leaving us more hopeful than we had felt in a long time. However, political developments at the end of the March have threatened SA's nascent recovery. Currently, SA assets are not pricing in the degree of caution we believe is necessary. While the rand has steadily depreciated against the US dollar since the global financial crisis, it has been one of the best performing currencies among its emerging market peers over the past 12 to 15 months. Its performance has only been rivalled by that of the Russian rouble (which benefited from the rally in the oil price) and the Brazilian real, which rallied off the back of former president Dilma Rousseff's impeachment in August 2016.

SA rand versus the US dollar



Currency	Peformance (31 Dec 2015 - 19 Apr 2017)
Russian Ruble	31.2%
Brazilian Real	27.6%
South African Rand	16.1%
Israeli Shekel	5.9%
Indian Rupee	3.7%
Indonesian Rupiah	2.4%
Polish Zloty	-0.5%
Czech Koruna	-0.6%
Hungarian Forint	-0.8%
Mexican Peso	-7.7%
Turkish Lira	-20.5%

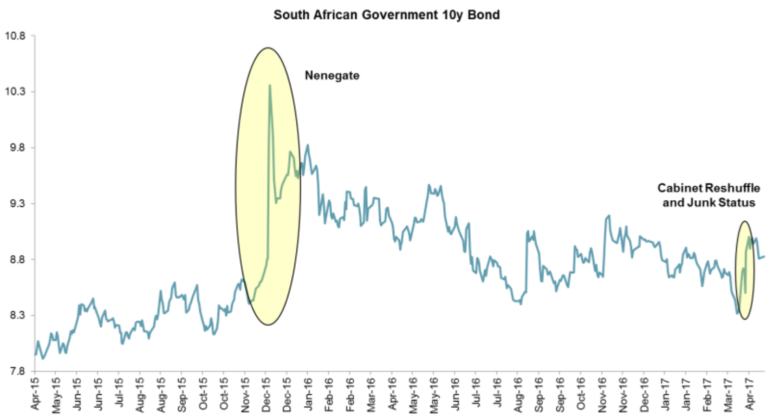
EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

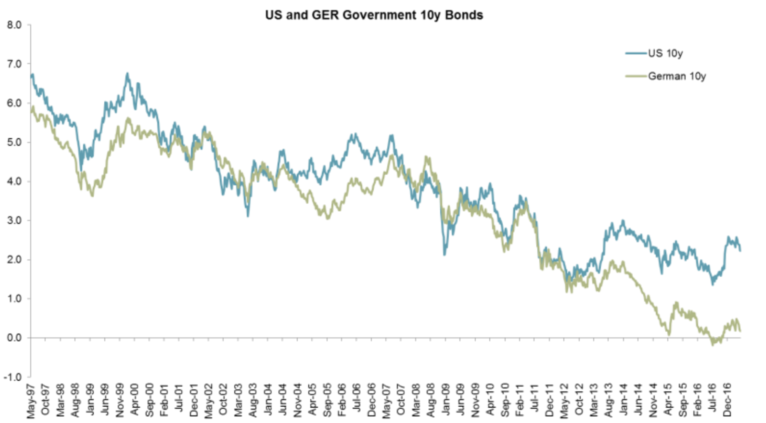
MAY 2017

Many emerging market investors are drawing parallels between SA and Brazil, which is one of the key reasons for the resilience of both the rand and the SA bond market. In fact, inflows into the SA bond market have accelerated post the cabinet reshuffle, totaling R35 billion year to date. This is greater than the acceleration we saw in 2012, when SA was included in Citigroup's World Government Bond Index.

Unfortunately, we believe that the parallel drawn between SA and Brazil is incorrect, for several key reasons. Firstly, the Brazilian government was a coalition government made up of equally strong parties that broke up their alliance in retaliation to the president's wrongful actions. SA has a one-party government. Secondly, unemployment in Brazil more than doubled in a very short period (from under 5% to 10%), which caused mass protest and public outcry, further intensifying calls for the president to step down. In SA, while the unemployment rate is already in double digits, it has not deteriorated significantly. Finally, foreign ownership of the local debt market in Brazil was under 15% (given the string of taxes that had been implemented previously to limit hot money flows into the country) and government bonds were trading at double-digits yields of 13% to 14% (implied real yields of more than 6%). Foreign local debt ownership in SA is already close to 40%, and local debt still trades in single digits.

Inflation expectations for 2017 have dropped considerably, which also acts as a strong anchor for bond yields. Furthermore, developed market bond yields remain at all-time lows, which in turn provides a very strong anchor for global bond yields. The yield on the US 10-year government bond is still significantly below its long-term average (despite the most recent sell-off sparked by Trump's election), while yields remain anchored at around 0% in Europe. For most of 2016, the German 10-year yield was below 0%, while in Switzerland, the entire bond curve traded below 0%. At one point during the year, a third of all government debt traded below 0% - some $7 trillion worth. We see these dynamics remaining in play for the next six to nine months.





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Our current outlook is summarised below:

1. Inflation will be well contained over the forecast period

Inflation is heading lower, driven primarily by lower food prices and subdued foreign exchange pass-through. With the recent drought having broken over most parts of the country, maize prices have already fallen by 60% and crop forecasts for 2017 are almost double last year's final crop. We expect CPI to average 5.5% in 2017 and 5.3% in 2018, with a bias to the downside.

2. SA growth will improve over the short term but long-term expectations remain concerning

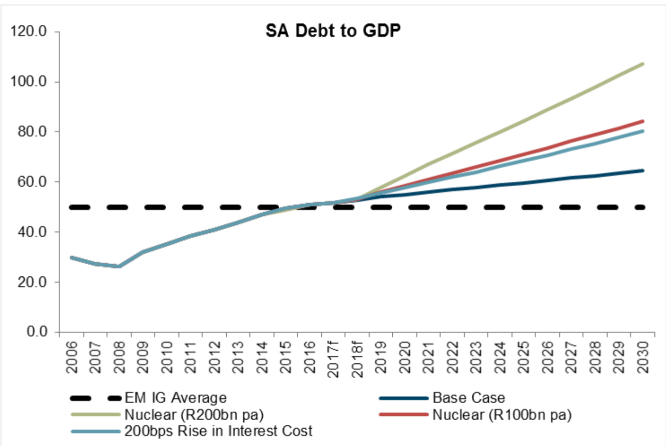
We expect GDP growth of around 0.9% in 2017 and 1.3% in 2018. Moderate upside surprises could come from a stronger recovery in trade, a larger contribution from agriculture and an increase in consumer spending as inflation moves lower.

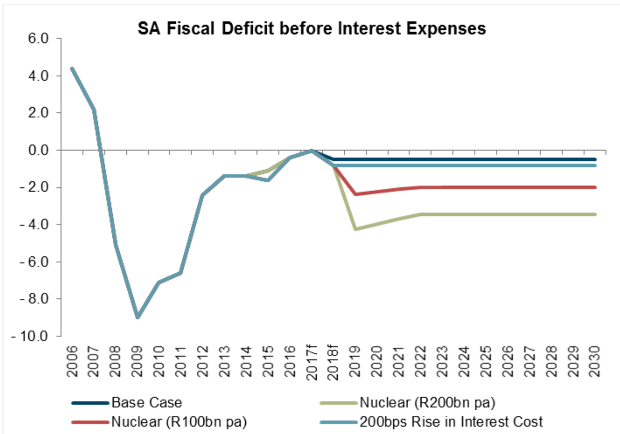
However, we are not optimistic about long-term growth, for two key reasons. The first is that corporate investment into the economy relies heavily on the predictability of policy and its implementation. Given current uncertainty, new investment into SA is likely to be cut back or delayed. Secondly, spending by high-end consumers (representing roughly two-thirds of total household expenditure) will be constrained by higher tax rates and limited fiscal relief.

Muted growth expectations and lower inflation traditionally give rise expectations of an interest rate cut, and our bias remains to see some reduction in the repo rate at some point in the next 12 months. However, the SA Reserve Bank is likely to keep rates on hold for the time being, given prevailing political uncertainty.

3. Fiscal metrics are likely to worsen

Within the current low-growth environment, SA's debt to GDP ratio continues to deteriorate, moving further away from the emerging markets investment-grade average of around 50%. Proceeding with nuclear procurement and increased support for state-owned entities (SOEs) will severely weaken the chance of moving back to this average.





Sources: SA Reserve Bank, Coronation

SA's rating outlook

EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

MAY 2017

	S & P	Fitch	Moody's
Investment Grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	
	BBB-	BBB-	Baa3
Sub investment grade	**BB+**	**BB+**	**Ba1**
Foreign Currency Outlook	**Negative**	**Stable**	**Negative**
Local Currency Outlook	**Negative**	**Stable**	**Negative**

Most likely in the next 1-3 months

Index	Inclusion Criteria	Status	Potential Outflow
Barclays Global Aggregate	IG Local currency rating from any 2 agencies	Included	$3-4bln
Citi WGBI	IG Local currency rating from either Moody's or S&P	Included	$6-9bln
JP Morgan IG	IG Local currency rating from all 3 rating agencies	Excluded from 31 May 2017	$0.75-1.5bln

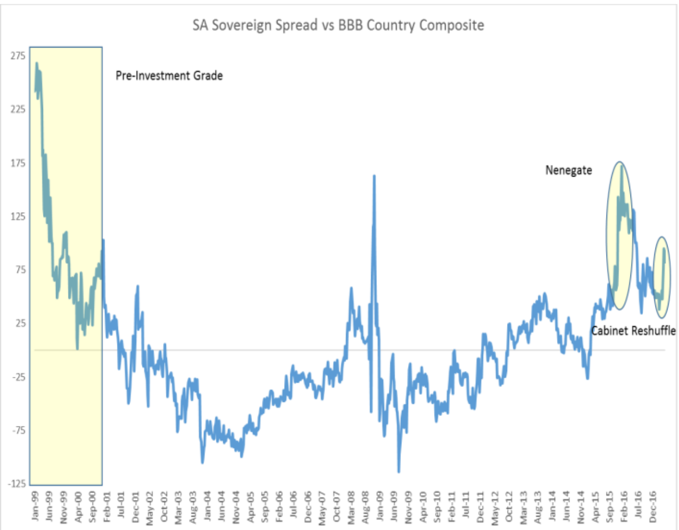
Sources: Coronation, Barclays

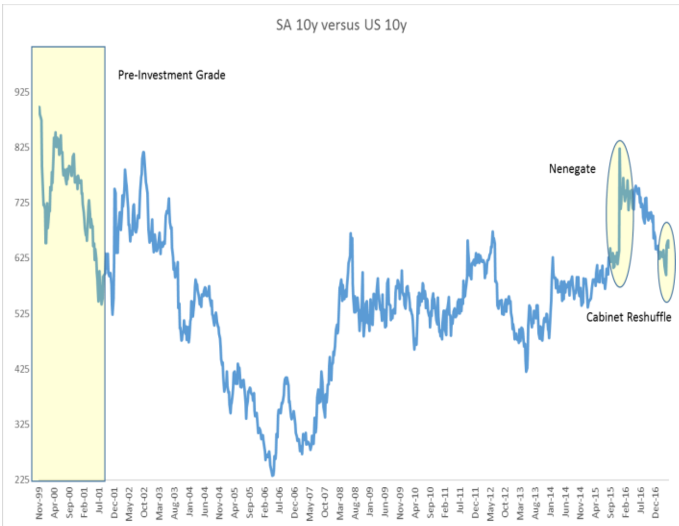
4. The global environment remains supportive for emerging markets

In the US, growth is ticking up (expected at between 2% and 2.5% in 2017) and inflation is up at 2%. The US Federal Reserve's rate hiking cycle is expected to be subdued and predictable, while Trump's policies are likely to be tamer than initially feared. Similarly, accommodative monetary policy in the EU is expected to continue throughout 2017. In China, positive growth is creating a better environment for commodity prices. All of this contributes to a favourable environment for emerging markets – however, investors should always remember that sentiment can change swiftly.

5. SA fixed income assets are closer to fair value, but there is no cushion against an adverse political outcome

Current valuations are attractive and SA government bonds compare favourably to their emerging market peers, offering high nominal and real yields. This is primarily due to global yields remaining well contained and inflation differentials between SA and the rest of the world narrowing (with SA inflation heading down while global inflation rises). However, against the current political and economic backdrop, one must consider whether these yields will offer adequate compensation if any negative political outcome leads to an adverse economic outcome. We do not believe they do, and for us there is currently insufficient margin of safety to hold government bonds.





In the corporate market, issuance was strong up until April, after a very subdued 2016. However, corporate activity has since ticked down again, and issuers are likely to wait for the political environment to settle before returning to the market. Debit issuance is ultimately a function of investment, which remains weak, and the low growth environment may further weaken credit metrics. We therefore remain vigilant of the risks emanating from the macroeconomic backdrop, and remain focused on fundamental research when allocating capital to corporate credit instruments.

LISTED PROPERTY

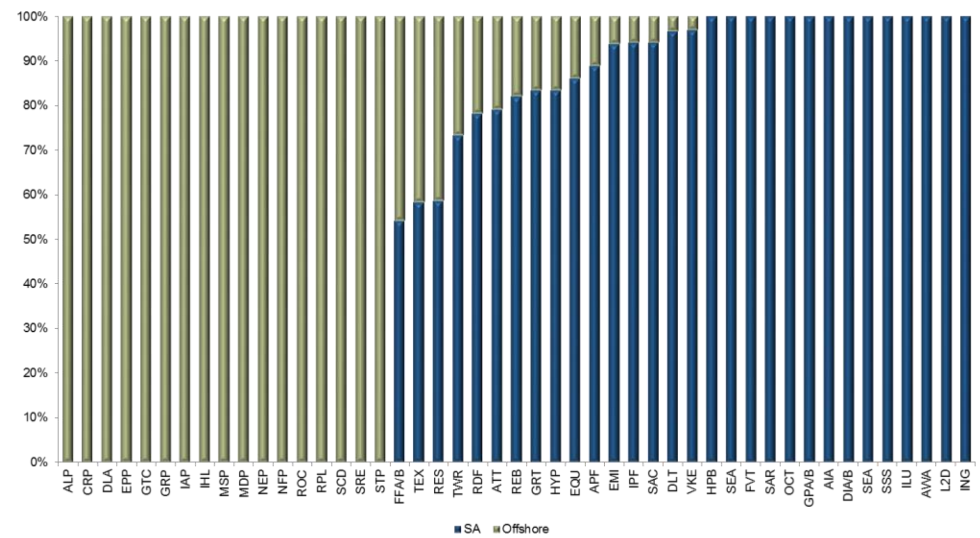
If we compare the SA listed property sector today to ten years ago, we can see the significant growth the sector has experienced, from a market capitalisation of close to R100 billion to almost R600 billion. Key to note is the growth in the offshore component within the sector, with the offshore exposure of the SA Listed Property Index (SAPY) jumping from 0% to 34% over this time. When investing in SA listed property, one must therefore be cognisant that you are not making a purely domestic asset allocation decision, but rather one with significant offshore implications.

Growth of the listed property sector

	2007	2017
SA sector market capitalisation	R98bn	R580bn
SAPY as % of ALSI	2.0%	5.5%
Market capitalisation Growthpoint	R19bn	R74bn
Clean forward yield	7.1%	8.0%
Rolling 10yr bond yield	8.4%	8.7%
Forward yield gap	-1.3%	-0.7%
Offshore exposure SA focused universe	0%	21%
Offshore exposure SAPY	0%	34%
Offshore exposure including inward and dual listed	37%	58%

Source: I-Net

Offshore exposure within the listed property sector

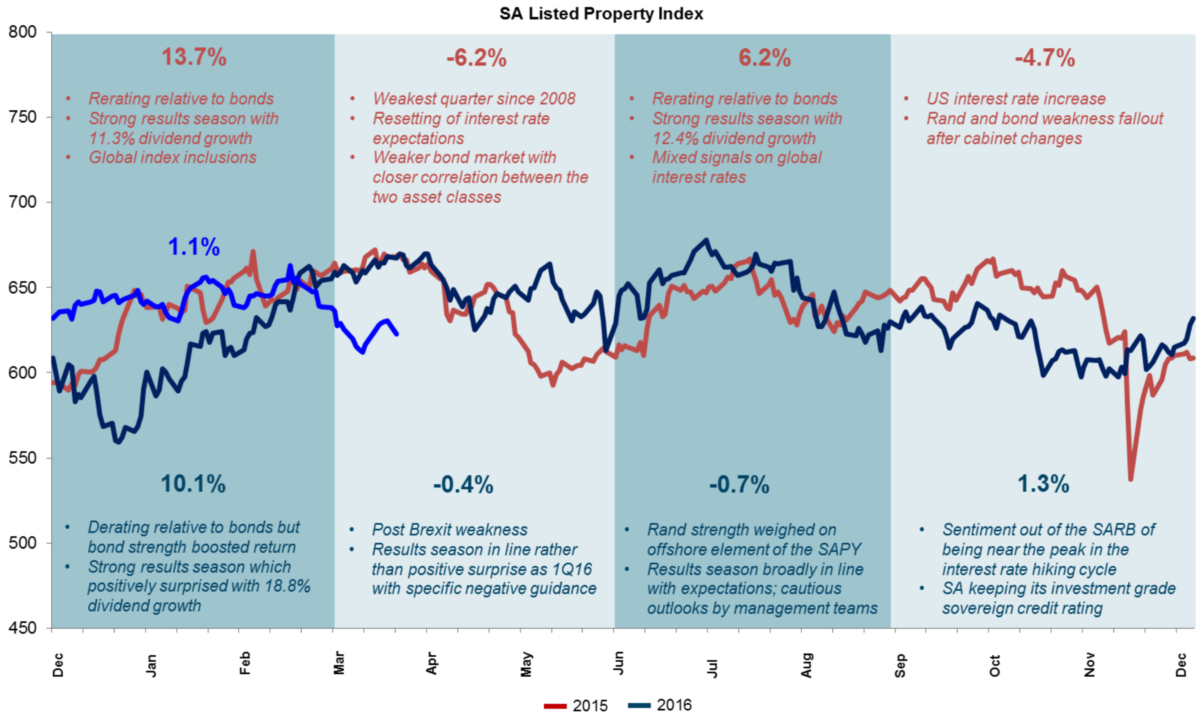


Source: Company data

2017 to date

The start of 2017 has presented a different trajectory to 2015 and 2016. Although there are some similarities (for example, we have seen relatively consistent capital raisings), the sector has not benefited from rand weakness as in previous years. We have also witnessed a more cautious approach by investors, and a marked preference towards higher-yielding, more defensive income streams. In addition, while the recent reporting season was solid (with dividend growth of between 7% and 9%), this did not provide the customary boost to sector performance. In our view, prospects for additional listings remain but are not as prevalent as in the previous two years, and the potential for corporate activity exists but is becoming less obvious from a strategic viewpoint.

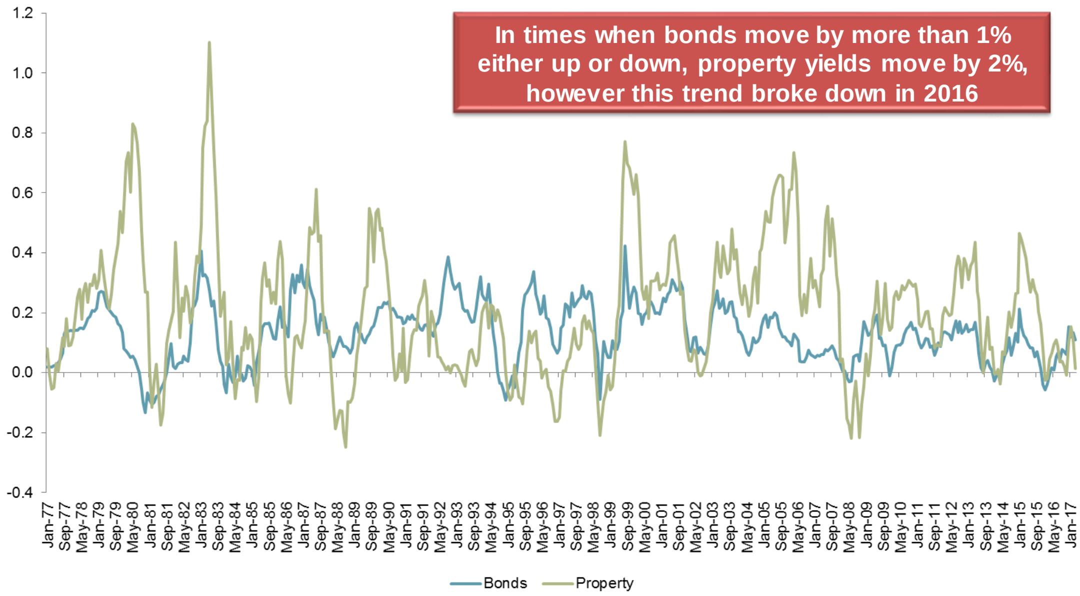
2017 vs 2016 and 2015



Sector returns

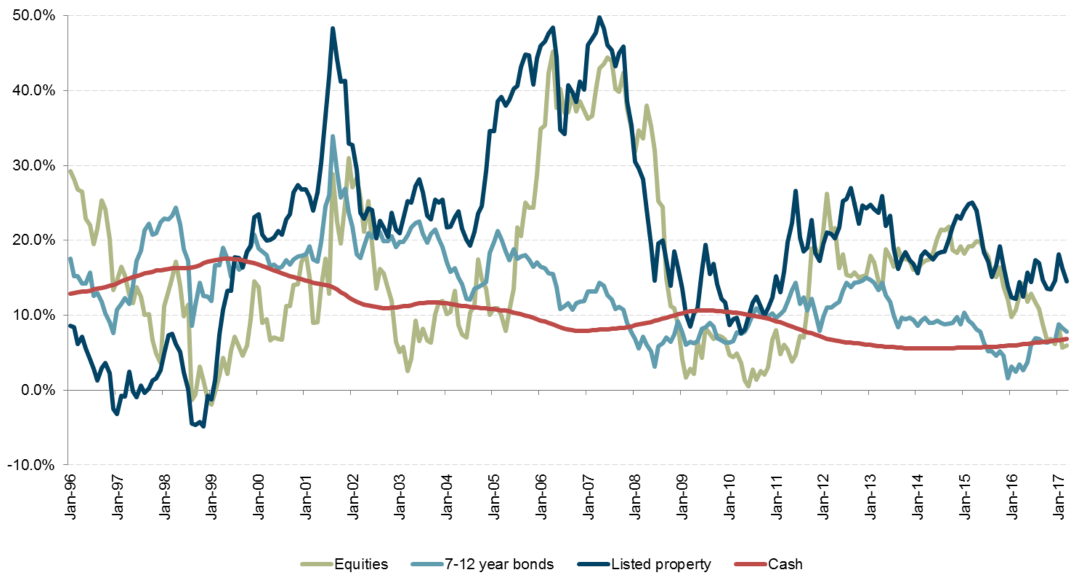
Property is often described as a hybrid asset class, as it has both an income return component (the high yield the sector offers) and an equity component (growth in underlying earnings streams). However, returns are more equity-like than bond-like – and one must bear in mind that similar types of return are accompanied by similar levels of volatility. In terms of asset allocation, investors should therefore not only focus on the income return component but also the earnings component. This is a high-risk asset class, and not as defensive as it used to be in the past.

Strong correlation between listed property and bonds remains



Source: I-Net

Returns* are more equity-like than bond-like



**Three-year rolling annualised returns*
Source: I-Net

Dividend growth is a key component of capital return

		Total return		Capital return	
	Total Return	Income return	Capital return	Return due to bond yield	Return due to dividend growth
2007	26.5%	7.5%	19.0%	5.3%	13.7%
2008	-4.5%	8.0%	-12.5%	-19.4%	6.9%
2009	14.1%	9.7%	4.3%	0.1%	4.2%
2010	29.6%	10.0%	19.6%	14.8%	4.8%
2011	8.9%	8.5%	0.4%	-1.2%	1.7%
2012	35.9%	8.9%	27.0%	17.1%	9.8%
2013	8.4%	6.8%	1.6%	-6.8%	8.3%
2014	26.6%	8.1%	18.6%	8.8%	9.8%
2015	8.0%	5.6%	2.4%	-2.9%	5.3%
2016	10.2%	6.4%	3.8%	1.3%	2.5%
Avg.	16.4%	7.9%	8.4%	1.7%	6.7%

Source: I-Net

The current direct property environment

We have concerns over levels of supply in both retail and office properties. In the retail market, around 100 new shopping centres are currently in development. Potential over-supply is starting to reflect in retailers' trading densities, which are dropping to low single-digit numbers. Given that standard lease escalations range between 6% and 9%, there is the real risk of negative reversions when leases are due for renewal. This will be compounded by slower retail sales growth. Similarly, although office vacancies have consistently remained at around 11% over the past two to three years, we are concerned about over-supply in Sandton, with over half of all SA office space currently in development situated there. Given low levels of GDP growth (the ultimate driver of office space demand), there is the risk that offices vacated upon relocation to Sandton remain unoccupied.

Our valuation view

The sector is currently yielding around 8%, which we believe is fair given that it continues to be supported by strong dividend growth. However, it too will be impacted by prevailing bond market uncertainty. In addition, listed property is becoming more accessible to mainstream equity investors (there are currently five property stocks in the FTSE/JSE Top 40 Index), resulting in increased volatility. Dividend growth prospects remain above inflation (especially given that the interest rate cycle has likely peaked, and should support stable or even lower interest costs) and we expect the sector to deliver double-digit long-term returns at more normalised bond levels. However, stock selection remains pivotal, as rating disparities within the sector still exist.

A selection of key current holdings

1. Attacq

Attacq provides access to a high-quality SA direct property portfolio. Following completion of the Mall of Africa in 2016, the development of Waterfall City at the Waterfall Estate between Johannesburg and Pretoria is currently underway. Given that the weaker economic growth environment does pose some risk to the share, it is currently trading at a 20% discount to its net asset value (NAV) excluding deferred tax – whereas the rest of the sector is trading at a 10% premium. We believe that the share price does not price in the continued value unlock potential within the Waterfall City development pipeline, or the catalyst that Mall of Africa – which is generating good trading densities and has recently secured both PwC's and Deloitte's new regional head offices – will provide.

2. Hammerson

Hammerson consists of a prime UK, French and Irish retail portfolio. It is currently trading at a 20% discount to its NAV while offering a 4.5% dividend yield, which we believe is attractive. As 40% of Hammerson's earnings base sits outside the UK, it offers a buffer against potential pound weakness post Brexit, while at the same time benefiting from stronger economic growth in the Irish economy. We have also seen active capital recycling in the UK market, with capital being deployed into more dominant centres like Brent Cross and Westfield JV in Croydon. At current valuations, we believe the share provides a good valuation entry point.

3. Liberty Two Degrees

Liberty listed 20% of the Liberty Property Portfolio on the JSE in December 2016, as Liberty Two Degrees. The share provides exposure to a prime SA retail portfolio, which includes the likes of Sandton City, Eastgate and Melrose Arch. Compared to its closest peer, Hyprop Investments, Liberty Two Degrees offers a dividend yield that is close to 1% higher and trades at a 25% NAV relative differential. We believe it provides good, defensive pure retail exposure.

CORONATION STRATEGIC INCOME FUND

Celebrating its 16-year anniversary in June, the Coronation Strategic Income Fund is the largest fund in its category, with over R25 billion of assets under management. As a truly flexible income fund – what we like to think of as a 'balanced income fund' – it invests in the entire range of fixed income assets, with the primary objective of creating an attractive yield and producing a reliable, consistent return profile aligned to our investors' requirements.

We also place particular emphasis on downside protection and capital preservation. To this end, we limit exposure to riskier assets: Listed property exposure is limited to 10%, and we place the same cap on offshore exposure – considerably less than many competitor funds.

The fund's benchmark is 110% of cash, and we target a return of cash +2% through getting the key asset allocation decisions right on a through-the-cycle basis.

What can you expect from the fund?

"A ship is safe in harbour, but that is not what a ship was built for." – William H. Shedd

To outperform cash over the long term, we place a certain element of capital at risk. Capital at risk can fluctuate over short measurement periods, and during such times, the fund may underperform cash. However, over longer periods, investors are more than adequately compensated for the additional risk taken.

To limit downside within the portfolio, we never position the fund towards a single outcome. Even if all indications point towards a certain result, we always acknowledge the probability that we may be wrong and ensure that we create a portfolio with a diversified set of assets. We also take a conservative approach to risk. So while we do invest in riskier assets, we always think about relationships that will balance overall return and look for offsets from other assets.

While we continue to target cash +2%, this is not always achievable over the short term – especially in volatile environments such this. In times like these, cash-type returns are a more realistic expectation.

Recent portfolio actions

1. Reduced duration to below 1 year

Leading into and immediately following President Zuma's cabinet reshuffle, we sold all government bond holdings to reduce the duration of the fund to just below one year – the lowest it has been for some time. We also increased bond hedges in the 10-year+ area of the curve. Despite this, the yield from the fund still comfortably sits at around 9%.

2. Selectively added corporate exposure

We added shorter-dated floating bank exposures (Standard Bank, FirstRand and Nedbank), increased our corporate ILB exposure through the secondary market (with real yields of close to 4%) and diversified our corporate exposure through new holdings in insurers (MMI and Old Mutual). We also added 'new style' Basel III Tier 1 and Tier 2 debt, including a large chunk of the Nedbank Alternative Tier 1 issuance (in the range of R1.5 billion).

3. Reduced domestic property exposure but increased exposure to dual-listed stocks

While the fund's listed property exposure remains largely unchanged year-on-year, there was significant trading activity during the year. We reduced our exposure to locally focused stocks (such as Growthpoint, Redefine Properties, Resilient, Rebosis and Hyprop Investments) and rotated into UK retail stocks after Brexit, as they were trading at very attractive valuations. Consequently, we increased our holdings in stocks such as Intu Properties and Hammerson.

4. Consistently maintained high exposure to offshore assets (currently 7.75% ex. option)

Despite the strong rally in the rand over the past 12 to 15 months, we still believe that given the current backdrop, holding decent offshore exposure within a portfolio provides the only protection against prevailing uncertainty in SA. However, we are cognisant that any positive political outcome in SA will skew the performance of the rand towards substantial strength. We have therefore implemented an option structure that provides protection against rand appreciation.

Fund performance

Performance* for periods ending 12 April 2017

	1 year	3 years (p.a.)	5 years (p.a.)	10 years (p.a.)	* Since Inception (p.a.)
Coronation Strategic Income Fund	9.4%	8.3%	8.6%	8.9%	10.6%
110% of STeFI 3 month index	8.0%	7.1%	6.5%	7.8%	8.7%
Alpha	1.4%	1.2%	2.1%	1.1%	1.9%
Cash	7.3%	6.5%	5.9%	7.1%	7.9%
Cash + 2%	9.3%	8.5%	7.9%	9.1%	9.9%

**Since inception, net of fees*

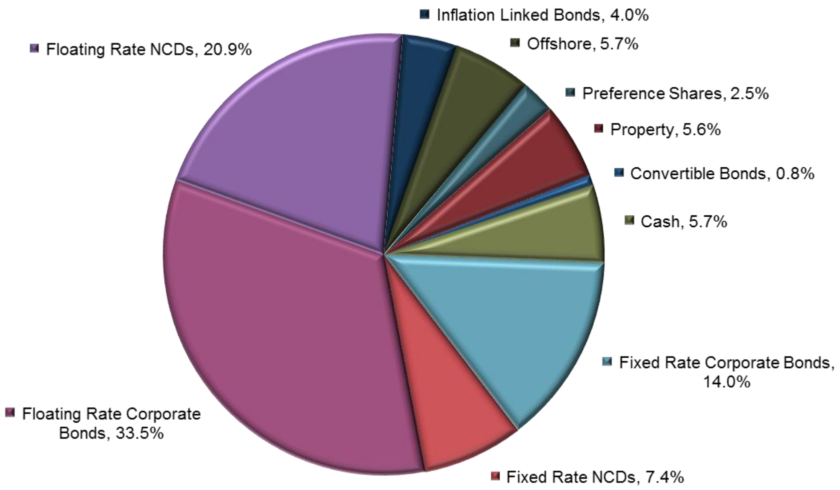
EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

MAY 2017

Portfolio positioning

Two key features of our current portfolio positioning are that the fund holds no government bonds (due to insufficient margin of safety) and is heavily invested in corporate credit (constituting between 80% and 90% of the fund). While the macroeconomic backdrop indicates that credit spreads should be widening, we still find selective value in the asset class. However, we are mindful that credit quality varies significantly among issuers, and place particular emphasis on the underlying fundamentals of the companies we lend money to. In addition, around 60% of the portfolio is currently invested in floating-rate assets, which are trading at between 200 and 220 basis points relative to cash. While preference shares also offer attractive yields, lack of new issuance constrains investment into the asset class.

Asset allocation: Strategic Income Fund



	Portfolio
Modified duration (incl. ILB)	1.07
Modified duration (excl. ILB)	0.84
Yield (NACA)	9.00%

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