

# corospondent

The Global US Quarterly

## Making Africa great again



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# Notes from my inbox

New year, new hope



*By Kirshni Totaram*

**SURELY THERE MUST** be a 'system overload' warning on its way!

What a year it has been. Looking back, it is hard to imagine that so many events occurred in 12 months only – it felt like decades had been compressed into shorter and shorter time frames.

Accelerated political and economic change is the only constant at the moment. Isolationism and populism continued to stoke unrest and strain relations between countries. For the first time in many decades, nuclear attack warning systems were tested in the US, as the erratic leader of the free world tweeted his country closer to the brink of nuclear war.

It was a year of profound political crisis, also in South Africa. At times, news headlines bordered on the surreal as we lived through a number of shocks. Long forgotten is the midnight hour cabinet reshuffle at the end of March which triggered a shock wave of >

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ratings downgrades, the effects of which will be felt for years to come. We lost our investment grade rating, which was secured through great fiscal discipline 17 years ago. This achievement by the first democratically elected government has had a tremendous positive impact on the domestic economy. The negative political events of earlier in the year delivered a major blow to the nascent economic recovery that was widely anticipated.

A culture of patronage and corruption was truly ripping South Africa apart, which is why the outcome of the ANC elective conference in December 2017 was such a highly anticipated and important vote.

It has been said that in South Africa the worst – and the best – never happens. For now, averting the worst may seem like an excellent outcome. Hope for the best has long faded. The election of Cyril Ramaphosa as president of the ANC could bolster South Africa, depending on how much stomach he has for a fight, and how he and his allies play their cards, as our guest columnist, Steven Friedman, suggests on page 8.

South Africa continues to face many deep-seated structural issues, such as a very uncompetitive labour force, poor education and low productivity. New leadership of the governing party can make a difference to some of the shorter-term issues, but to truly address the long-term issues will take decades, as we detail in our economic overview on page 10.

Still, politics matter – because they materially affect and shape the trajectory of business and the economy, changing investment opportunity but also increasing risks and uncertainty. We have seen both positive and negative political outcomes over the past 18 months.

Some of the most significant positive leadership changes in the last few months took place in Zimbabwe and Angola. Zimbabwe in particular was a watershed moment. It highlighted that there is indeed limits to the abuse of power, even in Zimbabwe. After 37 years of dictatorial rule, Robert Mugabe was ousted as Zimbabwean president.

The final overreach of placing his extravagant wife in direct succession while millions of desperate Zimbabweans face starvation unravelled nearly four decades of rule. So we are cautiously optimistic that the winds of change are blowing in the right direction. We know that forecasting the outcome of change and the intention of new roleplayers is tricky. But the people have demonstrated that their tolerance for long-serving dictators is wearing thin. This is a good thing for citizens and investors alike.

Without a doubt, one of the biggest cultural milestones over the past year has been the outpouring of confessions and accusations regarding sexual assault and harassment. The #MeToo movement has reached critical mass, with both *Time* magazine ('The Silence Breakers') and the *Financial Times* (Susan Fowler, who exposed harassment at Uber) choosing 'people of the year' to reflect this. It has galvanised a strong movement that I expect will meaningfully reshape many industries and traditional norms around the world. As Oprah Winfrey recently put it, "a new day is on the horizon ...".

No account of the past year would seem complete without mentioning Bitcoin. In our previous edition we articulated our views on blockchain (a revolutionary new technology which we believe has a very positive future) and Bitcoin (a cryptocurrency that we believe is firmly in the midst of the speculative bubble).

But the price movement of Bitcoin continues to confound. Bitcoin is an asset perhaps most similar to gold (a historic store of value) – as such it can and will be sustained indefinitely by a pool of willing buyers.

However, this 'currency of the future' (as heralded by the bulls) has a serious flaw. It is really, really volatile. One of the key attributes of successful currencies has been that they represent reasonable and stable value relative to goods and services. On a single day (22 December 2017), the currency managed to fall by a third, just to retrace all of its losses in less than 24 hours. Notwithstanding the fact that investors have earned outsized gains, this crazy volatility should raise serious doubts over Bitcoin's adequacy as a currency.

## LOOKING AT THE MARKETS

It may seem that someone forgot to tell the markets about the threat of nuclear war.

For the first year since records began, the S&P 500 scored a so-called 'perfect' calendar year – it delivered positive total returns (including dividends) every month of the past year. The Dow Jones Industrial Average, meanwhile, saw 70 fresh closing records in 2017, breaking a record dating back to 1896. The FTSE All-World Index advanced nearly 22% during 2017 and has now enjoyed its longest winning streak on record.

Confounding expectations, global bond markets also enjoyed a remarkable 2017. The Bloomberg Barclays Global Aggregate Bond Index returned more than 7%, its largest annual gain in a decade.

Flows into exchange-traded funds and index trackers hit record highs this year, significantly growing the share of savings assets that are now index linked. This indiscriminate inflow – at a time that the market grows increasingly expensive – seems absurd.

We have continually written about the risks of index-linked investing (which can never be 'passive investing'; choosing an index is the ultimate active decision). It will be interesting to watch this investment trend unfold over the coming years.

Despite the increasingly exuberant market levels, we continue to caution that more muted investment returns are to be expected from all asset classes. This makes achieving savings goals far more challenging. As such I emphasise again that in a low return world, the additional, compounded benefit of alpha (excess returns) becomes ever more vital. These excess returns (net of fees) will be crucial to the total returns earned by investors.

Emotion and fear cause massive stock market price volatility and obvious mispricing seems increasingly obscured, given the pace of change in a complex world. The positive here is that markets have not become efficient. Skilled and diligent investors can still



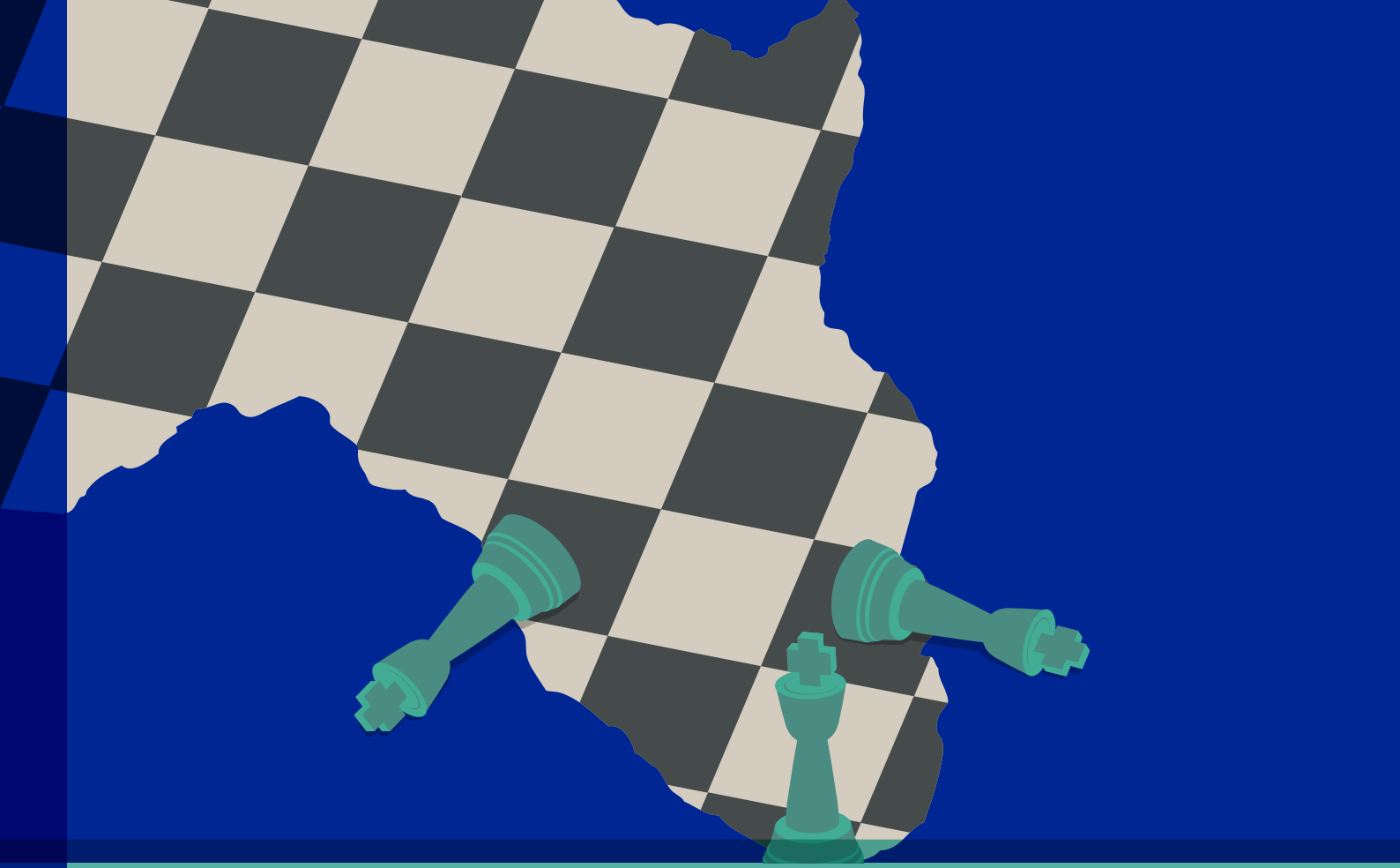
earn alpha through detailed analysis and unique insights. New opportunities emerge all the time, often a by-product of over-reaction, fear, greed and the short-term biases of many market participants. In this edition of *Corospondent* we highlight a number of these opportunities.

#### OUR COMMITMENT TO YOU

At Coronation, we understand that it is a great privilege to be entrusted to manage your assets. We recognise and value your appreciation of, and alignment with, our long-term investment approach. Without that alignment, our job of creating long-term

value for your portfolios would be near impossible. I therefore wish to extend my sincere gratitude for your loyalty and support over the years.

It is because of the trust you place in us that we tirelessly strive to improve and remain steadfast in our commitment to deliver investment excellence for our clients. +



FRONTIERS

# Making Africa great again

What now that the kings are gone?



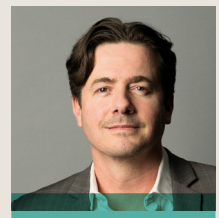
By Peter Leger

**“WE ARE GOING** to die, and that makes us the lucky ones. Most people are never going to die because they are never going to be born. The potential people who could have been here in my place but who will in fact never see the light of day outnumber the sand grains of Arabia.”

So starts Richard Dawkins’s *Unweaving the Rainbow*, which studies the relationship between science and the arts from his perspective as a biologist with a naturalistic world view. Dawkins explores the idea that science does not destroy, but rather discovers poetry in the patterns of nature. He concludes that human beings are the only animal with a sense of purpose in life. In his view, that purpose should be to construct a comprehensive model of how the universe works.

I have always thought of politics as the realm where a sense of purpose should collide with action. And the pinnacle of this realm would be the installed leader. ‘Make America Great Again’ must be right up there when talking sense of purpose. But so strong is this sense of purpose that a number of leaders seem keen on the idea of extending their stay in power. Indefinitely.

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Africa has had its fair share of leaders who have overstayed their welcome. Opposition has been aggressively managed. Leaders have ignored election results with little fear of consequence. And the sense of purpose is only curtailed by Dawkins's opening truism, where dying is the only limitation to a president for life. Uganda, for example, has recently scrapped the age limit of 75 years to allow President Yoweri Museveni to extend his 'brief' three-decade stay in power indefinitely. This is a very bad thing.

Where there is no challenge and no change, there is no accountability. A long-serving dictatorship wears down the division between political and commercial power. Leadership cannot tell the difference and government becomes a service for the elite, resulting in countries that have great wealth making only a few wealthy. So when this changes, it is a very big deal.

Why was the December election of the new ANC leader in South Africa so closely followed? It was arguably the most important vote since free elections in 1994, as many saw this as a moment when South Africa would either continue down the road of the state being used for personal gain, or a return of accountability to South Africa's politics. Ten years ago the National Prosecuting Authority brought 783 counts of corruption, fraud, racketeering and money laundering charges against president Jacob Zuma. And 10 years ago he became president of the ANC. That he has managed to avoid having these charges heard in court is a direct result of the position of power he has held. Imagine a South Africa where no term limit existed for our president or for the ANC, and where accountability could be delayed indefinitely. A chilling thought. How the transition of power plays out in 2018 will be market defining for South Africa.

To our north, José Eduardo dos Santos was president of Angola for 38 years, and Robert Gabriel Mugabe president of Zimbabwe for 37 years. Both left office within two months of each other towards the end of 2017. Isabelle (44), dos Santos's daughter, is Africa's richest woman today. Her business interests stretch the gamut of the Angolan economy. Doing business in Angola requires doing business with the family, suggesting that her wealth comes almost entirely from her family's power and connections. The new president came into office in September 2017. Since then he has set about dismantling the dos Santos hold and tearing down the original compromise government that was negotiated. Angola's state oil company has announced an investigation into "possible misappropriation" of funds. The former first family is no longer protected. The president has also issued an ultimatum for the return of foreign-held funds – a figure of \$30 billion. And the currency peg is to be ditched. He has to do this if any form of relationship is to be built with global financial institutions and foreign governments. These are very good things.

While this has been happening, and just a little bit east of Angola, president Mugabe resigned under huge military pressure, leaving a chronically failed state. In return, he is rumoured to have received a \$10 million bonus and a bevy of benefits. His final months in office made a mockery of Zimbabwe and its government. The economy

was starved of physical cash while Grace, Mugabe's wife, and his sons were making headlines for behaving badly and consuming conspicuously – an extreme case of government serving the elite.

Zimbabwe now has a new ruler: president Emmerson Mnangagwa. Much has been written about him and what might be. In fairness, he needs to do very little to make a big change. Yes, the country is in a shambles. It does not have a functioning currency and the US dollars that it uses are in short supply. A revaluation of 'zollars' (the nickname for Zimbabwe's electronic dollars) to dollars seems inevitable. But when you are heading at full tilt towards the edge of the cliff, just tapping the brakes and turning the wheel a little starts to look like skilful driving to your panicked passengers.

Instated in November, Mnangagwa's new cabinet consists mostly of Zanu-PF and military loyalists. Yet the crucial positions of finance and mining have both been filled by technocrats. The president, joined by his deputy, has visited the main opposition leader at his home; not to discuss a coalition government, but as a symbolic gesture of acknowledgement. The president has embarked on a major corruption crackdown, warning offenders to come clean and surrender ill-gotten gains. Grace Mugabe and her sons are being probed by the anti-graft agency over dodgy land deals and mineral trading. The family protection does not extend beyond the former president. Former ministers are facing corruption charges. Bids are being sought for state-owned enterprises which gorge on the little tax revenue available. And a moratorium on prosecution for repatriating ill-gotten offshore funds was announced. It is rather surprising how similar the Zimbabwean and Angolan hymn books are.

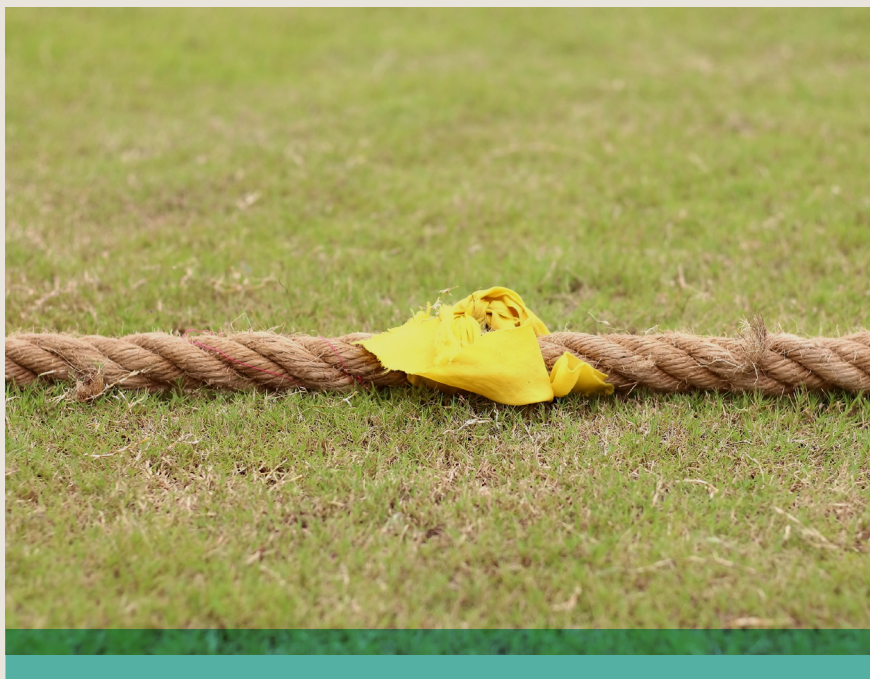
While our funds do not have any Angolan allocations, we hold a material level of exposure to Zimbabwean equities on behalf of our clients. These businesses have endured 'Dante's inferno' and still continue to be profitable today. We think there is a reasonable chance of a decent recovery in Zimbabwe. With some of the highest

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literacy rates in Africa, many of Zimbabwe's three million diaspora would like to return home. The country has rich institutional memory and structures. There is reasonable international goodwill, with the African Export-Import Bank, an international financial institution, having extended funding of \$1.5 billion and the UK

stating that it would like to assist in the recovery. The country needs a lot more. Exiled white farmers have been invited to return, with one farmer arriving at his grabbed farm under military escort to the sound of ululating workers. Even the black market 'zollar' rate has strengthened significantly from its lows. This could all just be hope, and stark realities remain to be addressed. Elections are planned for this year, which will provide more guidance on the road ahead.

While we are all to die, a lengthy status quo can beguile us into expecting more of the same. Three seismic leadership changes occurred in the last quarter of 2017, setting the scene for significant changes in 2018. We do not expect more of the same and are feeling very optimistic for what may come, both at home and north of our borders. The countries are now more aligned than ever to make the region great again. +



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GUEST COLUMN

# Divided we stand

Real change will depend on the will to fight

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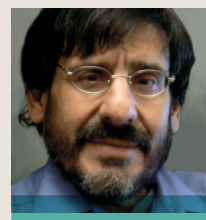
*By Steven Friedman*

**THE ANC AFTER** its December congress looks very much like it did before it – with only one change. But this change may make more of a difference than we are being told.

Last year, investors – and everyone else – were told repeatedly that the ANC conference would decide the direction of the governing party and the country. Either Nkosazana Dlamini-Zuma and the faction which supports president Jacob Zuma would win, turning government into a piggy bank for the connected, or Cyril Ramaphosa and the anti-Zuma faction would triumph, and quickly begin fixing corruption and state capture.

To anyone who knows the realities inside the ANC, this always seemed highly unlikely. It was very hard to see how a governing party increasingly unable to hold an internal election without the losers taking the winners to court could survive a hotly contested election in which one faction won everything and the other lost everything. It seemed inevitable that the losers would refuse to accept the result, creating a crisis for the ANC from which it might not recover. And so the only way out seemed to be some sort of

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a deal in which both factions received enough to persuade them to accept the result.

And so it proved. The ANC's top six leaders are split evenly between the two factions. Estimates of alignments on the national executive committee (NEC), which runs the ANC in the period between its five-yearly conferences, depend on your sources. But the safest method is to take the lists both sides circulated among their supporters and to check how many candidates from each were among the 80 members elected. If we do this, the NEC, like the 'Top Six', is divided down the middle.

So, either nearly 5 000 delegates voted spontaneously to produce the result needed to prevent the ANC from coming apart, or a deal was done to ensure this. What seems most likely is that neither faction would allow the other's candidate to become president by agreement and so there was an open contest for the presidency. Positions were then divided equally: faction leaders presumably told supporters to vote in ways which produced this result.

Whatever the method used, the result was the one the ANC needed to ensure that the election of a new leadership would stand. It achieved this by remaining divided – as it was before the conference. It again has a 'Top Six' split equally between the two factions and an NEC in which neither has a clear majority. This has produced a torrent of pessimism from commentators who were pinning their hopes on Ramaphosa winning in the 'winner takes all' result we were promised. The ANC's leader may have changed, they argue, but the ANC remains the same and so it will behave as it did before the conference.

This may seem logical but may be at most partially true. The result does show that the hope of many commentators and analysts that the Ramaphosa slate would win and then begin cleaning up the ANC and government without opposition was always a fantasy. The pro-Zuma faction was never about loyalty to one man. It is about using politics to acquire wealth which can be used partly to buy support. And it is a symptom of a reality which does not go away because one candidate wins an ANC presidential election: that many are still excluded from the marketplace, and that politics and government have become a way of creating opportunities which the market does not yet offer.

As long as that continues, there will be a strong faction in the ANC interested in access to public money, not boosting the economy.

Ramaphosa and his supporters cannot simply impose solutions on the ANC and government. They will need strategy and staying power if they want change. But this does not mean that nothing in the ANC has changed. Something obvious has changed – the presidency. To know why that is important, we need only look back over the past few years when the ANC was split as it is now – but with Zuma as president.

Because he presided over a divided ANC, he could not get whatever he wanted: if he could, Des van Rooyen would have remained finance minister, probably keeping the seat warm for Brian Molefe. But he could get some of what he wanted because the president has the power to appoint. He could fire finance ministers and appoint heads of the South African Revenue

Service and national prosecutors loyal to his faction. Ramaphosa will be able to do the same when, as seems likely, he becomes president of the country. This is not only a source of power in itself; it also sways politicians, and so the NEC may well turn out to be more solidly behind Ramaphosa than the numbers suggest.

Right now, calculating who will vote which way is complicated by the fact that some of the 80

elected in December were on both lists and some on neither. But Ramaphosa probably enjoys only a two-vote majority. The provinces and the ANC's leagues also sit on the NEC and here the split is 50-50.

But this may have changed already. Some members of the Zuma faction were supporting a sitting president and will switch to Ramaphosa. The provinces face a shake-up because of court actions and the movement of Zuma faction premiers into the national leadership. This may strengthen the Ramaphosa camp. He may well enjoy a working majority. Some in the Zuma faction may also shift priorities now that he does not control the presidency: Zuma himself may be a casualty since both factions may have decided that it is in the ANC's interest for him to go soon.

So, despite the deal and the apparent deadlock, we may well see significant changes in personnel: Zuma could go, and there may be a new Cabinet and new appointments in key posts. But changes to the underlying patterns which many want Ramaphosa to address will depend on how much stomach he has for a fight, and how he and his allies play their cards. +

The views and opinions expressed in this article are those of the author.

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SOUTH AFRICA ECONOMY

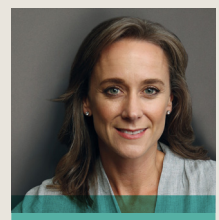
## A new 1994?

Cyril Ramaphosa's ANC needs to save South Africa from economic déjà vu

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*By Marie Antelme*

Marie is an economist within the Fixed Interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.



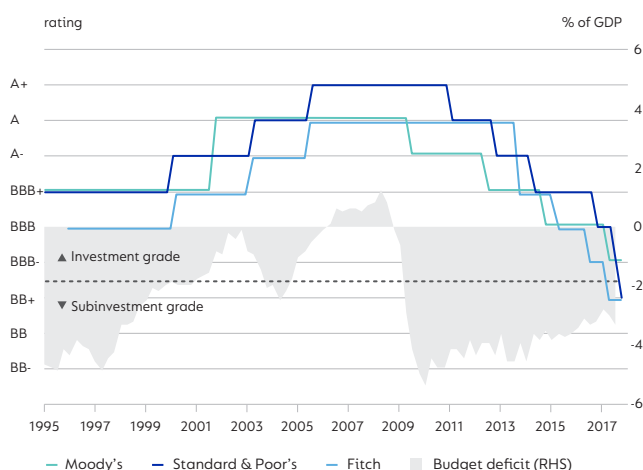
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**IT HAS BEEN** another brutal year. The economy has suffered the effects of political uncertainty which tightened its grip throughout the year and extended 2016's miserable performance. At a glance, it is hard not to notice that an alarming number of South Africa's economic metrics are back at levels that prevailed in 1994. Growth is set to average 1.4% over the last five years, assuming we manage even 1% in 2017, in a world which is growing at 3.6% (IMF estimate). This is below the 2.6% which prevailed from 1995 to 2000 (and that period included a series of emerging financial crises), although better than growth of 0.2% during the years before the first democratic election (1990 to 1995). It is well below the 'boom' years which preceded the financial crisis.

Critically, however, is that since 2015, on a per capita basis, real growth has been contracting – for the first time since the early 1990s. The fiscal position has deteriorated noticeably and the country's sovereign ratings have been downgraded five times since 2012, leaving South Africa with a subinvestment grade – back where we were in 1994.

#### SOUTH AFRICA'S CREDIT RATINGS VS BUDGET DEFICIT



Source: HSBC

#### HOW DID WE GET HERE?

It is 'easy' to say we lost our way, that the country was captured and that the global financial crisis derailed growth because commodity prices collapsed, which had a knock-on impact on the fiscal position and the economy more broadly. All of these reasons have some truth in them, but if we look very hard at the numbers, and our own history, we have to acknowledge that even without these developments, the economy would have faltered. An urgent remedy is required.

Much can be learned from looking at the composition of South Africa's growth in five-year (ish) clips from the period just before the democratic transition to where we are today. In this way we can see what drove output, and make an assessment of the conditions which influenced growth.

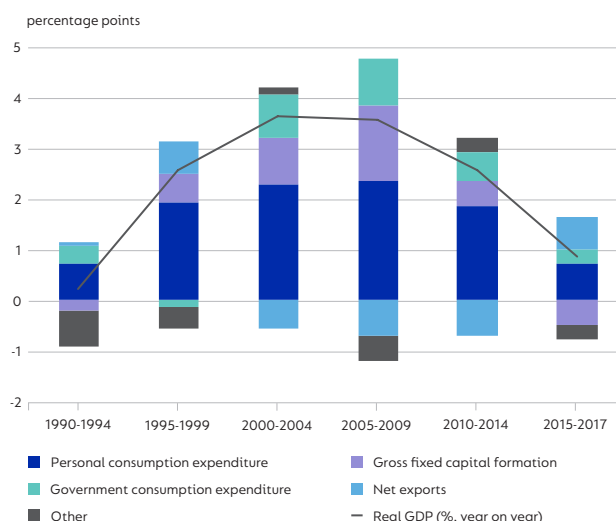
On many occasions, South Africa was affected by natural disasters or impacted by global events, ranging from the political and

economic sanctions of the 1980s to the emerging market and financial market crises that ensued in the late 1990s, and the financial crisis of 2008/2009. But throughout, domestic economic and policy decisions have had a meaningful impact on growth.

If we start with the period 1990 to 1994, average growth was just 0.2% and per capita growth fell at an average rate of -2.2%. This dismal performance came at a time when the apartheid regime was failing and the economy was suffering the lingering effects of the economic sanctions imposed on South Africa since 1986. The economy operated under a massive balance of payments constraint because there was no foreign funding available, which meant the country had to run current account surpluses.

In 1990/1991 the country suffered a debilitating drought. Household spending was nonetheless the biggest source of demand, aided by government consumption. Investment was negative and the country maintained a (necessary) small trade surplus.

#### CONTRIBUTIONS TO SOUTH AFRICA'S ECONOMIC GROWTH



Sources: South African Reserve Bank, Statistics South Africa

The post-1994 election period saw the economy liberalised and reintegrated into the global economy. Importantly, the trade boards were abolished, and regulations were relaxed and many discarded. The regulatory environment was simplified and access to global financial markets saw the balance of payments constraint ease.

Exposed to international markets, the domestic economy became more competitive and investment picked up. Government adopted the Reconstruction and Development Programme (RDP), with clear economic and social objectives, and began its implementation. Despite successive emerging market crises from late 1997 through 2000, average GDP was 2.6% and per capita growth turned positive, averaging 0.8% over this period.

The increase in investment and government spending through 2000 to 2004 saw the current account deficit widen, leaving net exports a detractor from growth and the country exposed to the vagaries of international capital. Government's economic policy >



through this time was determined by the Growth, Employment and Redistribution Strategy (GEAR), which broadly aligned policy to RDP objectives and was generally in line with Western liberal economic philosophy, advocating relatively tight monetary and fiscal policy objectives.

The independent South African Reserve Bank (SARB) adopted an official inflation target in 2000 and GDP growth accelerated to 3.6%. Social grant policy was implemented in 2004 and per capita income gains accelerated again to 2.4%. Over this period, inflation moderated from over 8% in the previous five years to 5.5%, and by 2004 debt to GDP was just 34.4%. Despite the improvement in growth and domestic fiscal position, there was much internal dissent about the effectiveness of GEAR to deliver the objectives of the RDP. Amidst much opposition, including from politically powerful unions, GEAR was never fully implemented, and commitment waned.

Domestic economic policy floundered from about 2005 to 2009, but growth was buoyed by the enormous uplift in global economic momentum, domestic credit growth and financial deepening, and crucially, the commodity boom. Consumer spending surged, the domestic housing market took off and capital expenditure boomed as government and the private sector began to prepare for the 2010 Soccer World Cup.

In 2007, Jacob Zuma was elected as the ANC president and became national president in 2009. By this time, GEAR had been abandoned and the fledgling Accelerated and Shared Growth Initiative never really saw daylight. Under president Zuma, the broad growth strategy fell under the National Development Plan, but economic vision became more diluted as the newly created department of economic development, the department of trade and industry, and the National Treasury all operated within different philosophical and capacity constraints. Despite this, South Africa's commitment to conservative economic policies, and the strength and resilience of its political and economic institutions saw rating agencies hold South Africa at high investment grade ratings through this period.

The period following the financial crisis (2010 to 2014) saw all GDP components deliver smaller contributions to output. In part this reflected the weak global environment and commodity price collapse, which had a material impact on mining and manufacturing as well as on government revenues. Through this period, government embarked on a counter-cyclical fiscal policy – expenditure increased to 31% of GDP, driving a more developmental agenda which manifested in a massive swelling of government payroll. GDP growth averaged 2.6%, but after a relatively long period of sustained growth in per capita GDP, this now started to stall.

In addition, political events from around mid-2012 started dragging on economic growth, which averaged at just 0.9% since 2014. Per capita GDP was falling for the first time since the early 1990s. There were three main reasons: global growth tailwinds had faded, commodity prices had been depressed, and lastly, extractive political policies undermined both confidence and the ability of economic institutions to provide an environment in which private sector investment could thrive. Consumer and

business confidence plummeted and with it, investment and consumption. Household spending – still the largest driver of growth but to a much smaller extent – was squeezed by depressed profitability, lower income growth, (at times) higher inflation and higher taxes.

Growth in the year ahead will probably be a bit better than over the past three years, provided the global backdrop remains as supportive as it has been last year. It seems reasonable that political uncertainty may moderate, and a few interventions to restore confidence will go a long way to easing some of the constraint on both investment and consumption. At this stage, inflation looks set to remain comfortably within target, especially following the Eskom tariff ruling awarding the state electricity provider an increase of just 5.2% in 2018. We see some room for the SARB to lower rates early in the year.

#### SOUTH AFRICA'S CPI FORECAST



#### MUCH HINGES ON DOMESTIC POLITICS

Newly elected ANC president Cyril Ramaphosa campaigned on a mandate of a New Deal for the country and the economy. In an op-ed in the *Business Day* on the eve of the ANC's December elective conference, Mr Ramaphosa put forth a number of practical proposals to improve confidence, boost growth and address endemic corruption.

Whether he can deliver on these remains to be seen, but he is certainly in a very powerful position as both president of the ANC and deputy president of the country, despite uncertain internal political constraints. And he has great experience and success as a skilled negotiator, so it seems reasonable to hope that with some capable, principled people backing him, he will be able to address some of the institutional challenges which inhibit growth to facilitate meaningful, pragmatic discussion between business, labour and the government, and possibly appoint capable people to key institutional positions and allow them to do their jobs. In many cases, institutions of good quality are still there, awaiting new leadership.



The biggest challenge to political and economic stability is South Africa's very high level of income and wealth inequality, and falling per capita GDP severely aggravates this situation. As we have seen in other countries, this outcome fomented at the heart of populist politics, and South Africa now has significantly fewer resources with which to meet this challenge.

To manage a very long road to ensure future economic stability, South Africa needs an economic vision which recognises honestly its failures, accepts fairly that both the public and the private sector are accountable, and acknowledges the available resources which we have to work with. We have indeed been here before – the democratic transition came with hope, and a broken economy. +



GLOBAL ECONOMY

# What's not to like?

International growth looks solid, but be wary of a concentrated consensus



By Marie Antelme

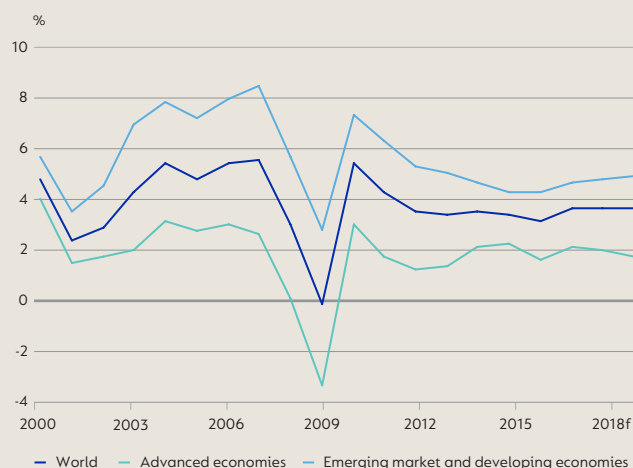


Marie is an economist within the Fixed Interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.



**DESPITE CONSIDERABLE POLITICAL** risk and heightened geopolitical tension, global growth in 2017 was the best in years. The world economy grew by 3.6% last year, and most economic indicators suggest at least a repeat is possible in the year ahead. In fact, on forward-looking data, including late-2017 Purchasing Managers' Index (PMI) surveys, IMF projections of 3.7% may be too low, and a number of forecasters have already boosted their estimates made at the end of last year. From an economic perspective, growth seems likely to continue swimmingly, at least for now. A closer look at drivers and risks suggests the upswing has been broad based and looks durable. And this is indeed a consensus view, but while a concentrated consensus is comforting, it also breeds complacency.

## GLOBAL GROWTH: REAL GDP



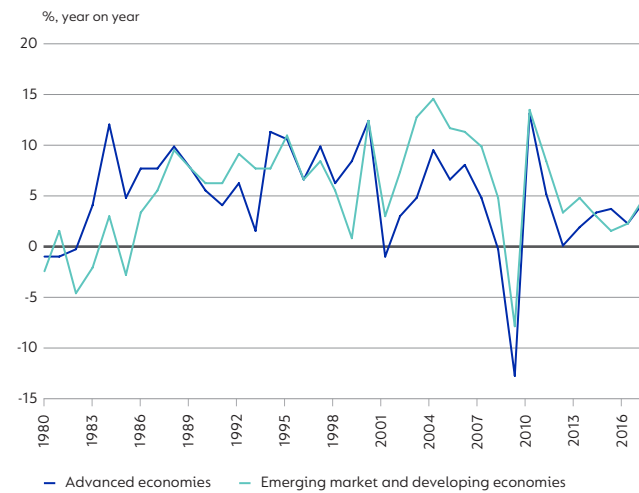
Source: IMF

One of the main drivers of the growth recovery of 2016 to 2017 has been a revival of global trade, despite the emergence of protectionist politics in some countries. The following graph shows the rate of change in the volume of import growth in developed economies, and the rise in export growth in emerging markets. For a long period after the crisis, both remained subdued, reinforcing weak growth outcomes in both emerging and developed markets, and putting commodity prices under significant pressure. This in turn had a material negative impact on growth, especially in emerging markets.





## GLOBAL TRADE: VOLUME OF IMPORTED GOODS AND SERVICES

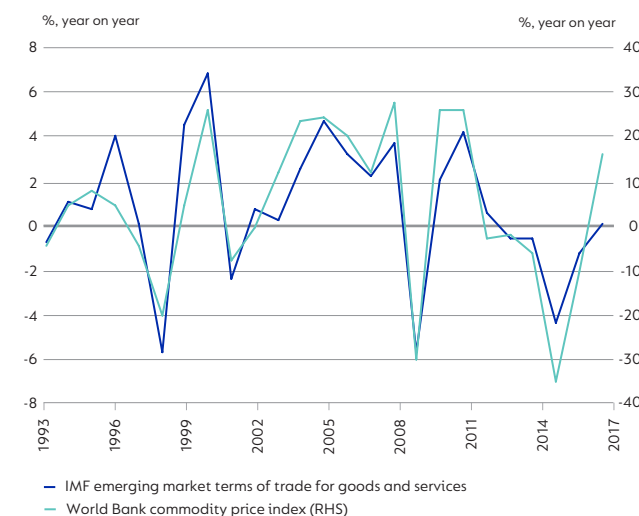


Source: IMF

While the recovery in industrial production in developed economies has been a significant driver of the acceleration in emerging market exports, very resilient growth in China also played a role, especially in supporting the recovery in commodity prices. Taken together, rising trade prices and volumes have been especially beneficial to the recovery in emerging market growth and currency performances.

Using World Bank data, the graph below shows the relationship between the change in commodity prices and the change in emerging market terms of trade for goods and services. The ongoing acceleration in commodity prices in the early part of 2018 certainly bodes well for emerging market terms of trade, providing fundamental support for these currencies.

## COMMODITY PRICES VS EMERGING MARKET TERMS OF TRADE



Source: Datastream

China continues to have a significant impact on growth and trade. Chinese GDP is expected to have expanded by 6.8% in 2017, driven by very strong and resilient property demand and investment, rising commodity prices and a very supportive global growth environment.

Concerns that slowing credit extension and monetary deleveraging would weaken growth and property activity turned out to be unfounded: household borrowing helped to extend the property boom last year. But the tide is turning, and property sales have slowed meaningfully. A greater focus on deleveraging suggests the weakness will continue. With the property market under increasing pressure, weakness could spill over to general activity and related commodity prices, although some of the slowing may be mitigated by relatively low housing inventory stock, improved profitability in the corporate sector and resilience in household spending. The IMF expects China's real GDP to slow to 6.5% in 2018, given tighter financial regulations and an ongoing policy focus on deleveraging.

Despite the decent acceleration in global growth, inflation has remained subdued. The reasons differ in each country, but a combination of excess capacity, persistently low wage increases despite tight labour markets, rising participation rates and, until recently, low commodity prices have all contributed. This has allowed central banks, especially in developed economies, to maintain very supportive monetary policies, even as growth picked up.

At this stage, it is difficult to find hard data which suggest that strong global growth is at risk. PMI surveys for manufacturing and services, which incorporate sub-indices for business activity, orders, inventories and sales, remain very strong – in many countries, these indicators are at multi-year highs. But a concentrated consensus should always ring alarm bells, and indeed, there are some persistent concerns:

1. If US growth holds up as well as it seems likely to – boosted at the margin by tax relief – it is possible that inflation could emerge more aggressively than current forecasts project, and that the US Federal Reserve raises the interest rate by more than the market expects. Given the breadth of the recovery, it is possible that unconventional monetary policy settings in other key central banks – the European Central Bank, the Bank of Japan, the Swiss National Bank and the Riksbank – may also move to more neutral positions. Tighter global financial conditions would hurt global growth.
2. Economic activity in China may slow down faster than expected, either prompting a return to aggressive credit extension, which over time threatens to undermine China's economic stability, or prompting a collapse in commodity prices.
3. Europe's economic challenges have diminished with the improvement in growth, but challenges of political, financial and fiscal sustainability and integration remain. A revival of trade protectionism is a clear risk, with North American Free Trade Agreement negotiations set to resume in January. Geopolitical risk, not limited to US relations with North Korea, the standoff in the Middle East, and immigration and refugees in Europe, remains as great a concern this year as it was in 2017.
4. Short of one (or more) of the above risks materialising, the prospects for good global growth remain positive. The more durable the period of positive growth, the more likely it is to become reinforcing, as healing economies improve fiscal positions, household balance sheets and corporate profitability and, importantly for long-term stability, bring about a general improvement in living standards. +



GLOBAL

# Alphabet

The next generation of big bets



*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.



CORRESPONDENT



**MUCH HAS BEEN** written about Google's dominance in search. In this article we explore the culture of the business and some of the hidden yet very valuable other assets of its parent company, Alphabet.

In his 2015 shareholder letter, Alphabet's CEO Larry Page wrote that "incrementalism leads to irrelevance over time, especially in technology, because change tends to be revolutionary, not evolutionary".

Alphabet is the holding company of Google. From its founding in 1998, Alphabet has worked to avoid the tendency of companies to become less innovative and more bureaucratic as they grow, allowing it to escape the fate of many prior tech titans like Nokia and Kodak. The company's continuous investment and innovation, driven by its ambitious goals, are likely to bear fruit over the short-, medium- and long-term time horizons. Besides the Google search engine, Alphabet has many 'hidden' assets. Seven of its products, many of which are in the early stages of monetisation, have over one billion users: Google Search, YouTube, Google Maps, Google Play, Android, Google Chrome and Gmail.

YouTube is now the most watched TV network globally, with over one billion hours watched per day. Google Maps has arguably the most comprehensive building and location information of any map provider. (Justin O'Beirne, a leading US cartographer and software engineer, estimates that Google Maps has a lead equal to six years on Apple Maps.) The Android mobile device operating system, with its Google Play app store, is accessed by two billion people every month. The Chrome browser is estimated to have a 55%, and growing, market share.

Longer term, seemingly the most successful 'moonshot' (or highly ambitious) project is Alphabet's self-driving car business, which has logged 30 times the autonomous miles in California of its peers, combined. Many of Google's platforms benefit from a first-mover advantage and network effects which create a moat that new entrants will struggle to overcome.

## CULTURE

Warren Buffett talks about the "institutional imperative" – the tendency of an institution to resist change to its current direction and to mindlessly follow company leaders or competitors. He tries to invest in companies that are alert to the problem.

Alphabet is such a company. This is evident in Larry Page's emphasis on first-principles thinking and "being unencumbered by the traditional way of doing things". As a manifestation of this, Google ran a revolutionary auction-based initial public offering in 2004, which upended the opaque practice of allowing a bank to allocate shares to chosen investors at a recommended price. Another example was how YouTube CEO Susan Wojcicki changed the way the company thought about its budget. Typically, companies allocate their budget according to the size of existing business segments. Her view was that the amount allocated should instead be related to the investments required to achieve the potential of the business. Luckily she did not give in to the institutional imperative; YouTube may otherwise not be Alphabet's next leg of growth today.

At Alphabet, people think about '10X goals', or building products and services that one day can be 10 times the size they are today. They believe that "if you hire the right people and set big enough dreams, you'll usually get there".<sup>1</sup>

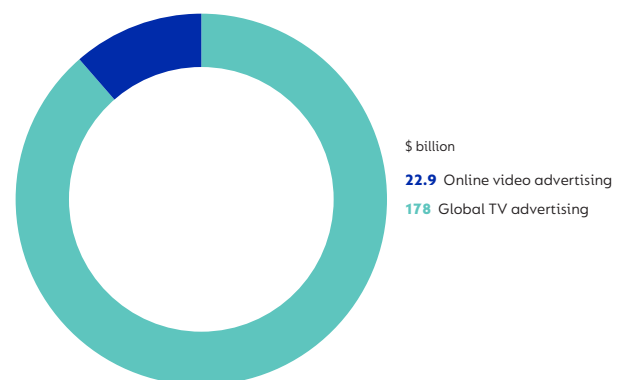
Alphabet management also emphasises the importance of small, entrepreneurial teams. Today, developing the best products is key, as customers have more information about products than ever before, distribution is practically free due to mobile devices being ubiquitous, and the cost of developing products is very low due to public cloud infrastructure. Small entrepreneurial teams allow Alphabet to iterate fast in order to make better products than competitors.<sup>2</sup>

## YOUTUBE

YouTube is the 'hidden asset' likely to make the biggest impact in the medium term. YouTube reportedly has 1.5 billion logged-in users who view videos every month. It is accessible across multiple devices and has a massive content library. Much of the content, often created by independent content creators, appeals to niche groups. Ever heard of PewDiePie, a Swedish gaming enthusiast with 56 million subscribers, or Smosh, a sketch comedy channel with 22 million subscribers? Traditional broadcast television is technically unsuited to deliver customised content to smaller groups at different times, giving YouTube a clear advantage.

YouTube had an early-mover advantage and now benefits from network effects, making it difficult for new entrants to disrupt its position. It was one of the first online video platforms and Alphabet invested heavily in its infrastructure, incurring losses for years. It built up a lead as a result of its ever-growing audience, which resulted in more content creators being attracted to the platform. Content creators are attracted by their ability to earn a commission of about 45% of advertising revenue generated from advertisements shown with their content. In turn, audiences are attracted to YouTube because it has the most content creators. >

## ESTIMATED GLOBAL TV ADVERTISING REVENUE IN 2017

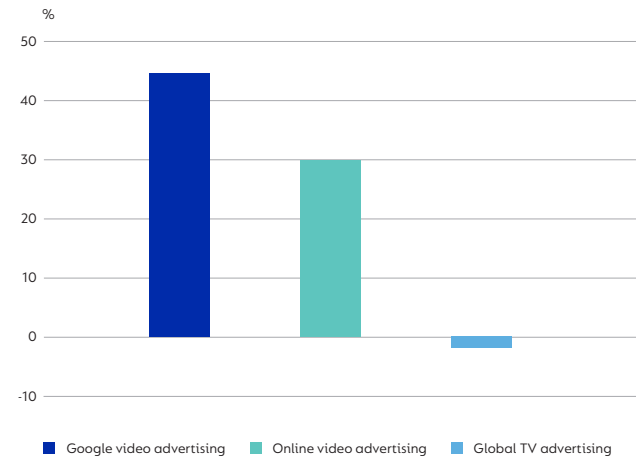


Sources: Bloomberg, Coronation

<sup>1</sup> How Google Works, by Eric Schmidt and Jonathan Rosenberg

<sup>2</sup> Ibid

## ESTIMATED 2017 GROWTH



Sources: Bloomberg, Coronation

Traditional TV advertising captures about 35% of the total advertising market globally (down from 40% in 2014), amounting to a potential income opportunity of about \$178 billion currently. Global online video advertising is still a fraction of this at c. 13% of total TV advertising spend – but it is growing rapidly.

Google, with a market share of more than 50% of the online video ad market, stands to take advantage of the shift towards online video advertising – and to take even more market share. Interestingly, reaching one billion hours of video viewing in 2017 was the achievement of a ‘10X goal’ set in 2012 when viewers watched 100 million hours a day.

## GOOGLE PLAY

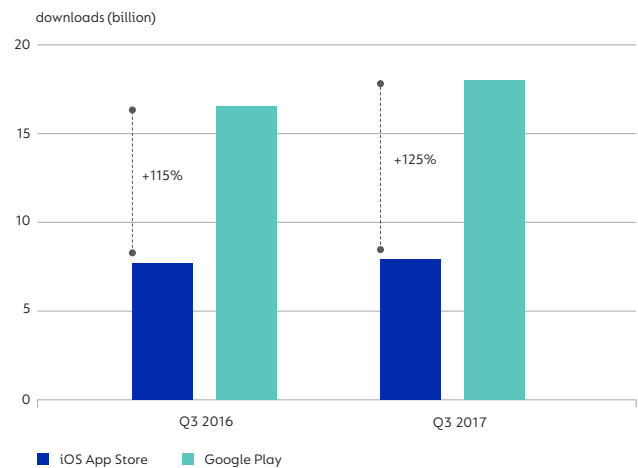
A second underearning asset is Google Play, Google’s app store. It generates revenue through mobile app sales and is a wonderful tollgate on digital consumption. Google takes a 30% commission of the revenue generated from app downloads and pays the remaining 70% to the app’s creator.

Google Play has always been distributed together with Google’s open-source Android operating system (which is now used by 87% of smartphones sold), affording it a massive advantage in building its user base. This early lead kick-started a network effect between app users and developers. The Google brand provides some level of comfort that payments will be managed properly, and app rankings give customers confidence in app quality. Together these features create a powerful moat which makes it difficult for competitors to displace Google Play and which could lead to search-like margins over time.

Android has an installed base of two billion users and Android smartphones outsells Apple by about six to one.

Apple recently stated a goal of driving \$50 billion of software and service sales by 2020. Stripping out non-app revenue from this, Apple could conceivably generate \$30 billion in app store revenue by 2021.

## WORLDWIDE APP DOWNLOADS BY STORE



Source: App Annie

Even if it only achieves average revenue per user of 40% of that of Apple, the Google Play store has the opportunity to reach a similar size, given its massive and rapidly growing installed base in emerging markets.

## MOONSHOTS

Alphabet’s ‘moonshot’ projects are the epitome of the think-big culture of the firm. The seeds planted today will likely see the company well positioned 10 years from now.

Waymo, Alphabet’s self-driving car project seems to be furthest along among Alphabet’s ‘moonshots’. Many are aware of Tesla’s autopilot function and Uber’s self-driving plans, but Waymo is improving rapidly, below the radar.

Between December 2015 and November 2016, Waymo drove 635 868 autonomous miles on public Californian roads. That is equivalent to driving from Cape Town to Johannesburg 732 times. When a Waymo car struggles with a decision, it disengages, allowing the driver to take over. Waymo disengaged only 0.2 times per 1 000 miles driven (equal to about once in five trips from Cape Town to Johannesburg). According to a recent report, this was four times better than the year before. This is phenomenal, considering the many complex scenarios and events that the car must consider.

The California Department of Motor Vehicles also recorded the autonomous miles driven by the 11 other firms registered to test cars in California. Together, they travelled just 20 000 miles, or 3% of Waymo’s distance.

The above is an illustration of the big ambition and relentless pursuit of goals that have served Google so well over the years.

## VALUATION

Alphabet’s significant investment spending has resulted in near-term margins being depressed. Its overall operating margins are



estimated to be 27% for 2017, compared to its search business margins of c. 50%. (Margins of similar businesses like Facebook are around 45%.) Clearly, many of Alphabet's younger businesses are immature and not yet operating at normalised margins. It is not inconceivable that YouTube could generate margins of 25% in time, or that Google Play could achieve search-like margins given the moats described earlier.

Last quarter, Alphabet reported net cash just shy of \$100 billion (13% of its market cap). Its impressive chief financial officer, Ruth Porat, previously from Morgan Stanley, instituted the first share repurchase when she joined Alphabet in 2015. It looks increasingly likely that US tax reform could result in a tax holiday for

repatriated cash, which could mean that more cash will be returned to Alphabet shareholders. Alphabet converts much more of its net income to free cash flow than the average business (about 106% compared to under 80% for the average company). Accordingly, a price/free cash flow multiple offers a better yardstick than a price/earnings ratio.

Stripping out net cash, Alphabet trades at 20.6 times its one-year forward free cash flow. This is less than the MSCI World Index's average multiple of 20.9 times (remember, the index constituents convert less of their earnings to cash). We believe this is good value for a business with leading market shares in attractive sectors that will drive growth at two to three times the market for many years. +

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently 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.



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LISTED PROPERTY

# Hammerson

Well positioned in an evolving environment



*By Anton de Goede*

**IT HAS ONLY** been 12 months since you last read about the UK-based retail landlord Hammerson in *Corospondent*, but what a year it has been for retail-focused property stocks around the world.

Amid continued growth in online retailing, a sharp increase in retailer bankruptcies in the US triggered feverish media coverage that predicted the demise of physical stores. Led by a sell-off in US retail-focused property stocks, companies in Europe and the UK also saw losses of up to 30% from the start of 2017. Shares were trading at discounts to their underlying net asset value of between 20% and 50%. This disconnect between the actual value of underlying properties and the value implied by the share prices offered the appropriate time for a myriad of consolidation opportunities across these regions, including cross-Atlantic portfolio mergers. Some publicly listed companies were also taken private. Towards the end of the year, share prices recovered by 10% to 30% as these boardroom discussions were announced.

One of the transactions announced in recent weeks was Hammerson's intended takeover of Intu Properties. Previously known as Liberty International or Capital Shopping Centres, Intu is a retail landlord with a large UK national footprint. It owns nine of the UK's top 20 shopping centres and has recently also gained exposure to the resurgent Spanish retail property market.

On behalf of our clients, we have been a long-standing shareholder of Intu, recognising the value of this footprint and dominance in the UK retail landscape. We believe the tie-up between Hammerson and Intu is important for both sets of shareholders.

As a reminder, 60% of Hammerson's portfolio is exposed to the UK, split between shopping centres, retail parks and outlet centres, with the remaining 40% providing exposure to mainly French and Irish shopping centres and a selection of outlet centres in major European cities.



Anton is a property specialist with specific responsibility for listed property-related research across the Coronation investment team. He joined Coronation in 2008.







The investment case for Hammerson, which we presented 12 months ago, still stands. In this article, we focus on two important considerations relating to its prospects after the proposed transaction has been implemented.

#### PORTFOLIO DOMINANCE

An enlarged Hammerson portfolio will have an estimated value of £21 billion, making it one of the three biggest European retail property groups, with 18 centres above 90 000m<sup>2</sup> in size. This enlarged portfolio will introduce two major differences.

First, its exposure to UK shopping centres will increase from 36% to 64%. This should have a growing positive impact on the company, as Hammerson has proven that it can manage shopping centres through different cycles; over the last nine years, which included extremely tough years for retail landlords, it experienced

only one year of negative like-for-like net rental income growth in its UK shopping centre portfolio.

Hammerson is well positioned to weather the uncertainty of the current consumer environment and could even benefit from it as retailers gravitate towards proven retail locations and landlords. With exposure to 17 of the top 25 UK shopping centres, Hammerson enjoys a very enviable position for any landlord. Retailers have embraced the concept of flagship units – they spend more money on these units in strong locations, using them as key points of engagement with customers.

The importance of a flagship retail unit cannot be overemphasised. It is now estimated that a retailer can achieve a national footprint in the UK with as few as 25 to 50 stores, compared to 100 to 200 stores in the past. This is all due to the increase in online retail. In addition, in a world where retailers have no choice but to embrace e-commerce, >

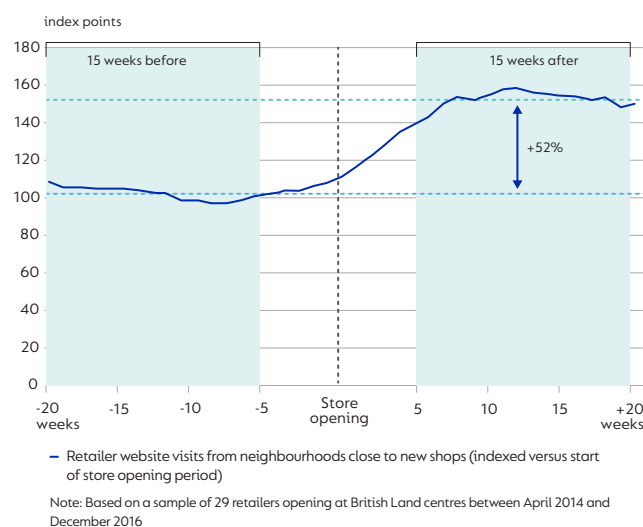


maintaining omnichannel customer interaction becomes important. (Omnichannel refers to using various channels of seamless client interaction, from a physical store to pure online shopping.)

The interplay between a physical presence and a retailer's online strategy is very important in the current retail environment, which is dominated by the omnichannel approach. A study conducted by Hammerson peer British Land and Connexity Hitwise found that when a new store opens, the traffic to such a retailer's website from that location increases by 52% from the 15 weeks prior to opening to the 15 weeks post opening. This increase is even more pronounced when a retailer has a footprint of fewer than 30 stores.

UK department store John Lewis has been a pioneer in embracing omnichannel retailing and is reaping the rewards; an omnichannel customer spends on average much more compared to either a pure physical store or online customer. UK retailers have been much earlier adopters of omnichannel retailing; the e-tailing shake-up currently witnessed in the US has been raging on for the past five to ten years in the UK due to its high internet retailing penetration.

#### PHYSICAL STORES BOOST ONLINE INTEREST



Sources: British Land, Connexity Hitwise

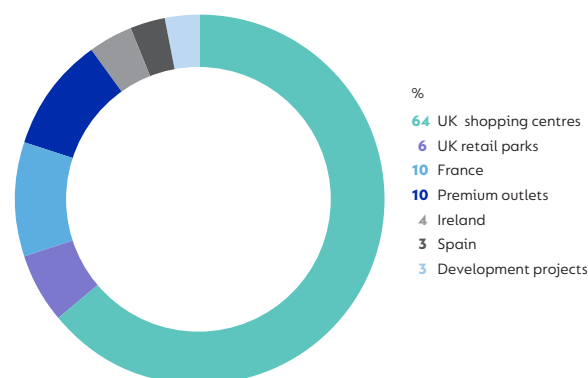
#### PORTFOLIO DIVERSIFICATION

The second major difference between the current and the enlarged Hammerson portfolio is the decrease in non-UK European exposure, from 40% to 27%. The enlarged portfolio presents a healthy balance between the benefit of a stronger, more defensive portfolio in the UK and still being sufficiently diversified into Europe. We anticipate that the portfolio will regain a higher exposure to Europe over the medium term, and management has confirmed that this is part of its strategy.

Hammerson's European exposure, especially its premium outlet centre segment, has been driving earnings over the last few years. Although the Intu takeover initially decreases the exposure to this growth segment, the larger prospective balance sheet provides an opportunity to speed up gaining further exposure to these segments in the medium term.

As part of the integration of the two portfolios, management anticipates that at least €2 billion of UK assets will be sold. Not only will this result in a natural portfolio reweighting towards Europe, it will also create balance sheet capacity for development projects in the pipeline which are earmarked for higher-growth regions, including Ireland and Spain. The money may also be used to buy (or extend) potential premium outlets.

#### HAMMERSON'S PORTFOLIO SPLIT



Source: Company reports

#### STRATEGIC MANAGEMENT

The benefits of portfolio dominance and diversification can only be reaped if management can extract this value, both strategically and operationally. The anticipated deal should drive operating cost synergies and result in potential lower debt refinancing, which is where the calibre of Hammerson's management team should shine through.

Since Hammerson's move to focus only on retail assets, the company has consistently delivered a better operational performance than Intu. Its UK shopping centre portfolio achieved on average a 3.5% outperformance in like-for-like net rental income per annum since 2009 against the Intu portfolio. In the more recent past, it also consistently outperformed Intu on leasing versus estimated market rental levels, by 5% to 6% on average per annum. We believe the Intu portfolio offers latent rental growth prospects; by combining the portfolios under Hammerson's management, this should be unlocked at a faster pace.

Strategically, Hammerson has proven itself a good allocator of capital, often confounding initial market skepticism relating to acquisitions or disposals.

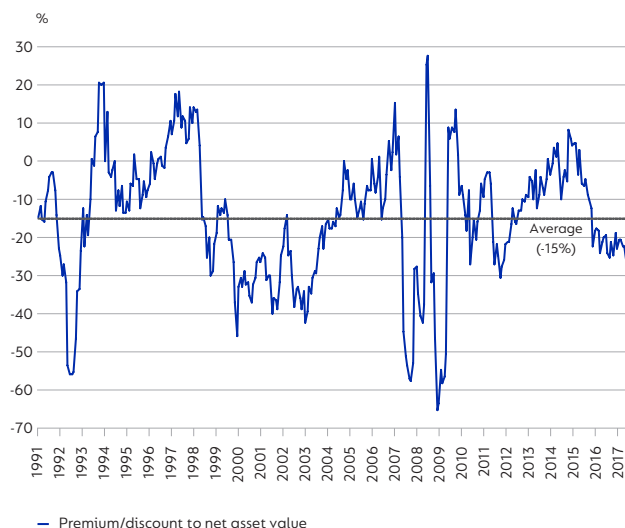
Its recent entry into Ireland is a prime example where growth earned from its exposure more than compensated for initial concerns over the entry price into the country. Gaining exposure to the high-growth premium outlet business proved to be a stroke of genius. Hammerson read the evolving consumer shopping patterns correctly. Its management will be able to strategically tap into that which is best in class in the Intu portfolio, enhance it and apply it across the enlarged portfolio.



## CONCLUSION

Independent from the takeover offer for Intu, Hammerson continues to focus on its core portfolio. Capital from smaller mature assets is recycled for investments into growth assets and regions. Through these sales, the company is strengthening its balance sheet, and positioning itself to placate investors who continue to be concerned about the large capital requirements of its development pipeline. The retail market is polarising, and retailers who benefit from either dominance or convenience are proving to be the winners. Hammerson is now in an even better position to benefit from this trend. The enlarged portfolio is a clear market leader in the UK, and the accompanying benefits of this position should surely allay the fears of investors who are concerned about the potential negative impact of Brexit on property values. Although there are signs of a marginal repricing in shopping centres due to this uncertainty, the discount to net asset value at which Hammerson trades remains unjustified, especially since the proposed takeover of Intu should enhance both earnings and net asset value. We therefore believe that Hammerson remains a sound investment opportunity, which is being mispriced by the market. +

## HAMMERSON'S PREMIUM/DISCOUNT TO NET ASSET VALUE



Sources: Reuters, Coronation

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INTERNATIONAL OUTLOOK

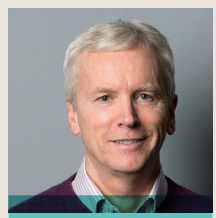
# Navigating in unchartered waters

Valuations are high and uncertainty is increasing

• • •

*By Tony Gibson*

Tony is a founder member of Coronation and a former CIO. He established Coronation's international business in the mid-1990s, and has managed the Global Equity Fund of Funds strategy since inception.



CORRESPONDENT



**THE MSCI ALL** Country World Index posted a positive total return of 24% in US dollars during 2017. Global equity markets have continued to benefit from a combination of broad-based economic growth, low inflation, tax changes in the US and supportive central bank policies. Over the course of the year, emerging market equities have outpaced developed market equities by more than 13%, with an impressive US dollar return of 37%.

## BROAD-BASED GROWTH

Global economic growth continues to impress, with JP Morgan estimating that global real GDP has expanded at a solid 3.7% annual rate during the second half of the year. That said, there is some evidence that growth by that measure has cooled to an estimated 3.0% pace in the fourth quarter. This is due to two near-term drags – the 30% rise in energy prices in the second half of the year and the impact of China's credit tightening on credit-intensive sectors like housing and infrastructure. But the global expansion is now so broad based that there are likely to be positive feedback effects, supporting financial conditions as well as business and consumer sentiment. Indeed, JP Morgan's measure of global consumer confidence has reached its highest level in over a decade, suggesting that any impact on purchasing power from higher oil prices is likely to be modest.

Following the 0.25% rate hike by the Federal Reserve (Fed) during December, some observers are concerned that the associated flattening of the US yield curve is pointing to a significant slowdown ahead for its economy. But arguing against that view is the growing likelihood of US fiscal stimulus associated with the recently approved tax cut package that became the Republican Party's number one objective.

Additionally, the fact that overall financial conditions remain buoyant, as reflected in high stock prices, tight credit spreads and the very high level of Bloomberg's Financial Conditions Indexes argue against an imminent slowdown.

Although Fed funds futures are pricing in two further rate hikes in 2018, projections by Fed officials are pointing to the need for twice that amount of tightening. The Fed's view will have been reinforced by the passage of the tax cut package, which is widely expected to add more than \$1 trillion to US debt over the next decade.

In contrast to the Fed, interest rate normalisation by the European Central Bank (ECB) and the Bank of Japan is expected to proceed much more slowly, with core inflation in the euro area having stalled at 0.9% in November, while core inflation in Japan remains zero on a year-on-year basis. That said, the euro area economy continues to power ahead, with economic sentiment in December at a 17-year high. Growth has been strong of late and appears to be broadening, with deflationary risks having all but disappeared. Politics suggest that fiscal spending could increase in some countries, including Germany. Inflation could tick higher and force the ECB to start talking about rate rises.

ECB president Mario Draghi could of course find some way to extend quantitative easing well past September 2018 in a difficult balancing act that increases the risk of a policy error. Japan's economy also remains on a solid footing, as reflected in a very strong Purchasing Managers' Index reading for November and a government survey showing stronger capital spending growth in the most recent quarter.

The focus on China is less on interest rate policy, which remains neutral for now, and more on credit policy. New regulatory efforts were announced to reign in excess credit growth and reduce the implicit guarantees embedded in continuing risky, off-balance sheet lending. This has created uncertainty in China's financial markets, triggering rising bond yields and volatility in domestic equities.

With the government aiming for a soft landing, the most likely scenario for 2018 seems to be further deceleration in credit-intensive sectors like housing and infrastructure, offset by a stronger contribution from export sectors that benefit from improved global growth and the decline of nearly 10% in the trade-weighted currency since early 2016.

## THE RISKS OF COMPLACENCY

Looking ahead to 2018, conditions for global equity markets continue to look reasonably good in the context of a broad-based global expansion and generally accommodative monetary policy. But valuations are a concern, particularly in the US, where the Shiller cyclically adjusted price earnings ratio is at the 95th percentile of its historic range since 1926.

Valuations outside of the US are generally less elevated, and on conventional metrics, the MSCI Europe, Australasia and Far East, and the MSCI Emerging Markets indices trade at 14.9 and 12.3 times estimated earnings respectively, compared to the MSCI USA Index at 18.7 times. Against the backdrop

of still-low global bond yields, this suggests that global equities remain attractive relative to fixed income, albeit somewhat less so than was the case over the past few years.

Global markets saw some geopolitical-related wobbles, specifically around Brexit and US politics, but even the German, Dutch and French elections caused only very minor disturbances. But overall, the market trajectory over the last 12 months, if not 23 months, has been almost unique in history – leading to an increasing number of commentators making a fundamental case that equity and credit markets are at bubble valuations. They point to charts supporting their thesis that the market is technically overbought and sentiment is at extremely positive levels, which could potentially trigger a correction. Meanwhile, the momentum in markets remains upwards, with bearish sentiments having to be tempered at the moment. Despite warnings, the majority of investors simply appear to have adopted a momentum and yield strategy; that is, they will remain invested in risk assets until the market turns. >



Given that we are at the start of a new calendar year, some perspective is called for. As outlined, the market environment for equity and credit markets has been quite extraordinary in 2017. It is worth noting that, historically, US equities perform best in the second half of an American presidential term. However, this pattern has been distorted over the past decade by the bounce-back from the deep recession of 2008 into 2009, followed by the flood of central bank liquidity injections – and related suppression of yields which in turn fed a global rotation toward momentum-driven equities, dividend-yielding equities and corporate debt.

That said, it must be pointed out that the suppression of yields by central banks over the last five years is really only a tailwind to a decline in yields that has been in progress since the early 1980s. While there is little doubt that, as quantitative easing programmes around the world are slowly shut down, yields will rise, the strategic outlook will also depend on background forces that have contributed to lower yields for a long time. This global excess of mobile liquidity should continue to buoy equities into 2018. Responding to a modest but synchronised upturn in the global economy, pragmatic investors continue to direct mobile capital toward equity risk. Investors reason (or rationalise) that with no viable alternatives, this will remain the most prudent allocation of client assets. Worryingly, complacency hides risks posed by the eventual end of central bank bond buying and overdependence on index funds, especially those that are leveraged. The key point is that asset price appreciation in equities, credit, sovereign bonds and other asset classes has been strong throughout the careers of the majority of people currently employed in finance – but logic suggests that this dynamic seems likely to come to an end.

## STRUCTURAL PROBLEMS ALLEVIATED BUT NOT SOLVED

Risks are mounting. These include the unravelling of western geopolitical alliances, the drift toward military miscalculation in Northeast Asia, and slow but relentless economic transformations within countries and economic regions. Although many individual investors worry that equities are overvalued, they continue to rotate their capital (and hope) towards, for example, momentum-driven cryptocurrencies or cash-burning shares such as Tesla. As highlighted, in the short term, reasonable growth, excess liquidity and negative real interest rates will continue to support the rotation toward economic and equity risk. But later this year and into 2019, events will most likely trigger an abrupt repricing of risk. The knock-on effect of this will, if current trends are any guide, further inflame populist antipathy toward ruling elites and the status quo around the world.

The causes of the political uncertainty in western industrialised nations are not hard to find. A sharp decline in economic prospects, stagnating real wages, job insecurity, pension systems under threat and growing inequality have combined to create a sense

of discontent. These are largely the result of long-term structural problems. The recent global cyclical upswing will alleviate some of these in the short term, but it will not solve them. And although the global economies are growing and unemployment has fallen, wages remain stubbornly low.

Statistics from the IMF show that while unemployment has fallen to below 6% across advanced economies, annual wage growth has barely moved above 2%. We may be experiencing an upturn but for many, little has changed or improved. Against this backdrop, the impending end to central banks' expansive monetary policy, or quantitative easing, of the past decade is another source of uncertainty. The tricky part is that normalising monetary policy means undoing 10 years of monetary stimulus. This is something that, in our opinion, investment markets are too com-

placent about and unprepared for. Central bank balance sheets have never been so large and are in unprecedented territory. Simply put, interest rates are extremely low and global debt is extremely high.

## WHAT CAN GO WRONG?

While the current benign inflation environment has dampened investor fears, more forward-thinking commenta-

tors recognise that we are in uncharted waters. Today's low financial market volatilities are deceptive and underestimate the underlying risks and uncertainties – the point is that the long-term effects of quantitative easing are not fully understood and that the impact of reversing this process therefore remains unknown. Uncertainty of this type should be reflected in increased risk and therefore the pricing of risk. This leaves investors with a conundrum: how to explain the discrepancy of high levels of uncertainty coexisting with financial market complacency.

The implicit message at present therefore seems to be that, due to the high levels of uncertainty, risk cannot be accurately priced. Equity markets are very clearly ignoring the uncertainty at present. This will, as is always the case, change at some point. In the mean time, both investors and policymakers will enjoy the upswing while it lasts, knowing that it will not last indefinitely. Investors should therefore prepare for a return of volatility. In a period of uncertainty, portfolio diversification is becoming increasingly vital.

Concerns as to where inflation is headed leaves investors with continued uncertainty as to where interest rates will wind up. But it would be reasonable to conclude that a significant inflation shock would be a major negative force affecting today's investment portfolios. Despite deflation being the dominant fear since the 2008 financial crisis, it seems likely that a meaningful increase in inflation from here would trigger larger portfolio losses than a depression. While depressions are bad for risk assets and good for quality bonds, inflation is very bad for bonds and mildly bad for stocks.

As things stand now, bonds would do particularly badly given their very low real yields. However, shares could get more severely hit





given their extremely high valuations. Although we do not know if an inflation surge is inevitable, it is something that investors should have in the forefront of their minds when they think about what could go wrong for their portfolios.

This does not mean we need to prepare for an abrupt multi-asset sell-off, but it is likely to mean a strategic change in the asset return

environment that investors will not be used to. This will also have profound implications for the structure of the finance industry and the question of active versus passive stock selection. An unanticipated low return outlook will challenge the methodology and even the goal of investments, all of which have been predicated on the belief that returns from asset markets are higher than the return demanded to fund the savings needs of society. +



#### FACTFILE

# Coronation Strategic Bond

## OVERVIEW

Coronation Strategic Bond has a proven track record of consistently outperforming bond markets. The actively managed strategy invests across all the different fixed income instruments. It has a flexible mandate with no duration or term restrictions. It invests in the traditional fixed interest assets, but can also have exposure to listed property, preference shares and inflation-linked bonds (ILBs), which are typically excluded in most specialist mandates. This flexibility allows the strategy to maximise every opportunity in the SA fixed interest space. The strategy aims to offer better returns than the JSE ASSA All Bond Index (ALBI) over the medium to long term.

## INCEPTION DATE

1 January 2008

## PORTFOLIO MANAGERS

Nishan Maharaj, Mark le Roux and Adrian van Pallander. Nishan is head of Coronation's Fixed Interest investment unit and has 15 years' investment experience. Mark is a senior member of the unit, which he headed for more than a decade. He has more than 25 years' experience in managing both traditional and alternative fixed interest portfolios. Adrian is a portfolio manager and has 16 years' investment experience.



## COMPELLING TRACK RECORD

The Coronation Strategic Bond strategy has delivered a gross annualised return of 10.1% (9.8% net of fees) since inception in 2008. The strategy has outperformed its benchmark (the JSE ASSA ALBI) by 1.5% per annum (1.2% per annum net of fees).

### STRATEGY RETURNS GROSS OF FEES IN RANDS (AS AT 31 DECEMBER 2017)

Period	Strategy	Benchmark	Active return
Since inception (cumulative)	161.7%	127.7%	34.0%
Since inception per annum	10.1%	8.6%	1.5%
Latest 5 years per annum	7.7%	6.3%	1.4%
Latest 3 years per annum	8.0%	6.9%	1.1%
Latest 1 year	11.1%	10.2%	0.9%
Year to date	11.1%	10.2%	0.9%
Month	5.7%	5.7%	0.0%

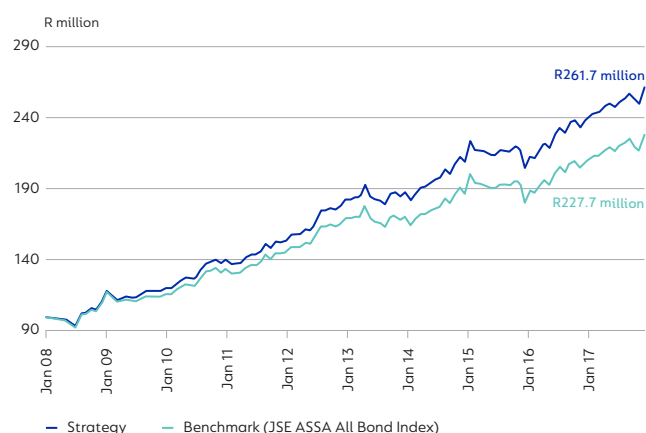
Source: Coronation

### STRATEGY RETURNS NET OF FEES IN RANDS (AS AT 31 DECEMBER 2017)

Period	Strategy	Benchmark	Active return
Since inception (cumulative)	154.0%	127.7%	26.3%
Since inception per annum	9.8%	8.6%	1.2%
Latest 5 years per annum	7.3%	6.3%	1.0%
Latest 3 years per annum	7.7%	6.9%	0.8%
Latest 1 year	10.7%	10.2%	0.5%
Year to date	10.7%	10.2%	0.5%
Month	5.7%	5.7%	0.0%

Source: Coronation

### GROWTH OF R100 MILLION INVESTMENT



Source: Coronation

## PORTFOLIO CONSTRUCTION

The portfolio is positioned according to a long-term strategic market view, but this is balanced by taking advantage of shorter-term

tactical opportunities when the market lags or runs ahead of that strategic view.

As an actively managed strategy, investment opportunities across the full spectrum of potential return enhancers are considered. These include duration and yield curve positions, inflation-linked assets as well as yield enhancement through credit enhanced assets. Coronation's highly rated fixed interest investment team is quick to take advantage of opportunities as they present themselves in a changing environment.

Coronation's own proprietary fundamental economic and fixed income research forms the backbone of the investment process. Returns are maximised by actively combining a top-down approach (deriving the macroeconomic view which drives the bond investment cycle) and a bottom-up approach (generating a fair value for bond yields) in portfolio construction.

A portfolio with the required targeted modified duration and yield curve position is constructed by the careful selection of individual instruments on the basis of the expected return they can contribute to the performance of the strategy. We make use of derivatives for risk management when optimal to do so.

## ASSET SELECTION

Projected total returns for each instrument in the strategy's universe are calculated based on Coronation's view of the overall future direction of interest rates, the shape of the yield curve going forward and expected changes in credit spreads for particular bonds over the course of the following 12 months.

These factors are balanced against their liquidity and credit risk constraints; for example, due to its higher tradeability and low-risk nature, a government bond will carry a higher inclusion limit than a nongovernment bond.

Coronation maintains a very conservative approach to credit risk; the strategy aims never to put capital at asymmetric risk. Credit selection is primarily focused on mitigating downside risk. We combine detailed analysis with rigorous pricing techniques, drawing from the knowledge and experience of our broader investment team during this process. Our aim is to ensure that the credit spread adequately compensates us for the underlying risk of the entity.

Detailed proprietary research is conducted on issuers and structures to determine their full spectrum of risks and to determine a fair value for the assets, both at issue date and during the life of the instrument.

Our property investment strategy includes fundamental analysis of individual counters. We invest where we believe the total return as a result of our fair value yield and distribution growth (together with a healthy margin of safety) is superior to that of the other investable asset classes.

Coronation incorporates environmental, social and governance factors when evaluating investments. For debt securities, we assess the impact on issuer cash flows and the ability to repay debt, and require additional credit spread to compensate for the

risk. Governance factors such as corruption and political risk can also affect sovereign issuers' willingness to repay their debt.

## CURRENT POSITIONING

In Coronation's view, the strategy's current neutral positioning in government bonds reflects appropriate levels of caution, given the risks in 2018 emanating from potential policy inaction and the possibility of SA's exclusion from the Citigroup World Government Bond Index.

SA government bonds should benefit from renewed optimism and contained inflation. However, given the aforementioned risks, at current levels, these bonds are trading at their fair value; we require more attractive levels to enter overweight positions.

The strategy's yield remains attractive relative to its duration risk and it is invested only in assets and instruments that we believe have the correct risk and term premium, to limit investor downside and enhance yield.

The strategy reduced exposure to corporate credit over the second half of 2017 as spread-tightening rendered certain issues unattractive. However, we continue to maintain holdings in those issues where we see selective value.

In the listed property sector, the current weighted average yield of 7.9%, when combined with its projected 5% to 7% annualised distribution growth over the next few years, results in an attractive total return relative to long bond yields.

The volatility of the FTSE/JSE All Bond Index (ALBI) represented above may be materially different from that of the Strategic Bond Fund. In addition, the holdings in the accounts comprising the Strategy may differ significantly from the securities or components that comprise the FTSE/JSE All Bond Index (ALBI). The FTSE/JSE All Bond Index (ALBI) has not been selected to represent an appropriate benchmark to compare the Strategic Bond Fund's performance, but rather is disclosed to allow for comparison of the Fund's performance to that of a well-known and widely recognised index.

The content of this factfile and any information provided may be of a general nature and is not based on any analysis of the investment objectives, financial situation or particular needs of any potential investor. As a result, there may be limitations as to the appropriateness of any information given. It is therefore recommended that any potential investor first obtain the appropriate legal, tax, investment or other professional advice and formulate an appropriate investment strategy that would suit the risk profile of the potential investor prior to acting upon such information and to consider whether any recommendation is appropriate considering the potential investor's own objectives and particular needs. Neither Coronation Fund Managers Limited nor any subsidiary of Coronation Fund Managers Limited (collectively "Coronation") is acting, purporting to act and nor is it authorised to act in any way as an advisor. Any opinions, statements or information contained herein may change and are expressed in good faith. Coronation does not undertake to advise any person if such opinions, statements or information should change or become inaccurate. This factfile is for information purposes only and does not constitute or form part of any offer to the public to issue or sell, or any solicitation of any offer to subscribe for or purchase an investment, nor shall it or the fact of its distribution form the basis of, or be relied upon in connection with any contract for investment. The value of the investments may go down as well as up and past performance is not necessarily a guide to future performance. Coronation Fund Managers Limited is a full member of the Association for Savings and Investment SA (ASISA). Coronation Asset Management (Pty) Ltd (FSP 548) and Coronation Investment Management International (Pty) Ltd (FSP 45646) are authorised financial services providers.

## ASSET ALLOCATION (AS AT 31 DECEMBER 2017)

Asset type	% strategy
Fixed rate government bonds	65.9%
Fixed rate corporate bonds	14.0%
Property	8.8%
Floating rate corporate bonds	7.0%
Corporate inflation-linked bonds	1.6%
Fixed rate negotiable certificates of deposit (NCDs)	1.0%
Fixed rate other	1.0%
Floating rate NCDs	0.4%
Cash	0.2%
Preference shares	0.1%

Source: Coronation

The strategy maintains higher than normal holdings in listed property counters that offer strong distribution and income growth with upside to their net asset value valuations.

ILBs had a tumultuous year, underperforming bonds and cash considerably. Given the current implied market breakeven inflation levels, we still see little value in ILBs with a maturity of greater than seven years. +