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The Global Quarterly

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On the cover: "Throughout human history, in any great endeavour requiring the common effort of many nations and men and women everywhere, we have learned – it is only through seriousness of purpose and persistence that we ultimately carry the day. We might liken it to riding a bicycle. You stay upright and move forward so long as you keep up the momentum." – Ban Ki-moon

IN THIS ISSUE

ECONOMIC COMMENT

Emerging markets face a fiscal endgame

Vulnerabilities increase the risk of longer-term damage

By **MARIE ANTELME**

THE QUICK TAKE

- Covid-19 was an amplifier of existing systemic risks in emerging markets
- Recovery certainty around the world is waning as second-wave infections threaten
- Emerging markets will suffer painful growth shocks, but governments' fiscal positions will be defining
- South Africa's economic and fiscal dynamics compare poorly, highlighting the urgency of credible strategies

Marie is an economist with 20 years' experience in financial markets.

IT'S NINE MONTHS since China imposed a national hard lockdown on its economy. Starting in Wuhan in January, and spreading outwards, by the end of March the borders were closed, streets were empty and factories quiet. Most households could have only one person leave, once a day. The skies were empty. Only China was this strict. While containment was not as harsh elsewhere, there has been some form of closure in most countries as the pandemic spread through Asia, into Europe and the US, and then into antipodean emerging markets.

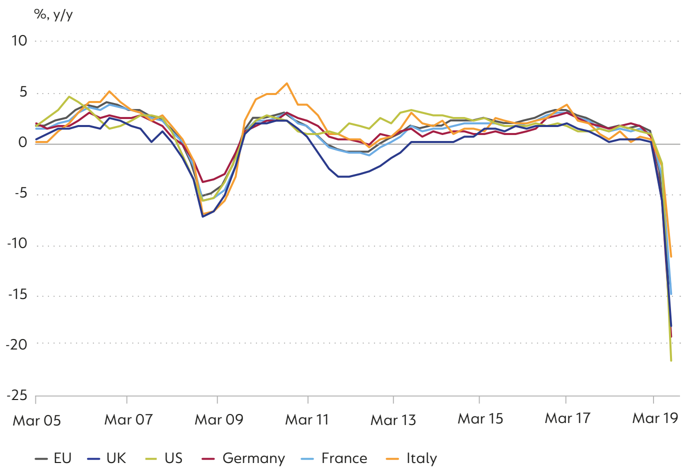
China's economic growth bottomed in the first quarter of 2020 (Q1-20), with GDP growth falling by an unprecedented 6.8% year on year (y/y). Since then, Covid-19 infection data officially show that infections have collapsed (12 new daily infections at the time of writing), which means that China has effectively contained the pandemic for now. Mobility data show that China is broadly back to normal – retail, vehicle and property sales, as well as fixed asset investment, are all recovering. Outside of cross-border travel (but including internal travel), China is returning to pre-Covid levels. China is also benefiting from the re-awakening of demand elsewhere, with export growth supported by demand for personal protective equipment and high-end electronics. Official estimates show GDP accelerated to 3.2% y/y in Q2-20, and available activity data suggest decent momentum has built in Q3-20. This should see China's GDP return to pre-Covid levels by next year, if sustained.

This is not what we see elsewhere. Most advanced economies initially implemented some form of lockdown, and aggressively increased fiscal and monetary support for healthcare systems, households and corporates. Despite this, the severity of lockdown and the associated collapse in activity have resulted in GDP growth contracting 21.5% y/y in the US in Q2-20, 13.9% y/y in Europe and 18% in the UK (Figure 1 overleaf).

While Q2-20 was undoubtedly the nadir of economic activity for most countries outside of China, 'second waves' of infection in a number of countries have prevented a return to more normal mobility, and economic activity is slowing again. Both the economic damage and fiscal cost of 'wave one' are still unknown as the next wave approaches. Early signs of an economic rebound in the second half of 2020 were relatively good, but momentum has started fading, raising the risk of a Q4-20 'double whammy' as growth falters as containment strategies intensify.

Figure 1

GDP CONTRACTION IN DEVELOPED MARKETS



Source: Haver

EMERGING MARKET VULNERABILITIES INTENSIFIED BY COVID-19

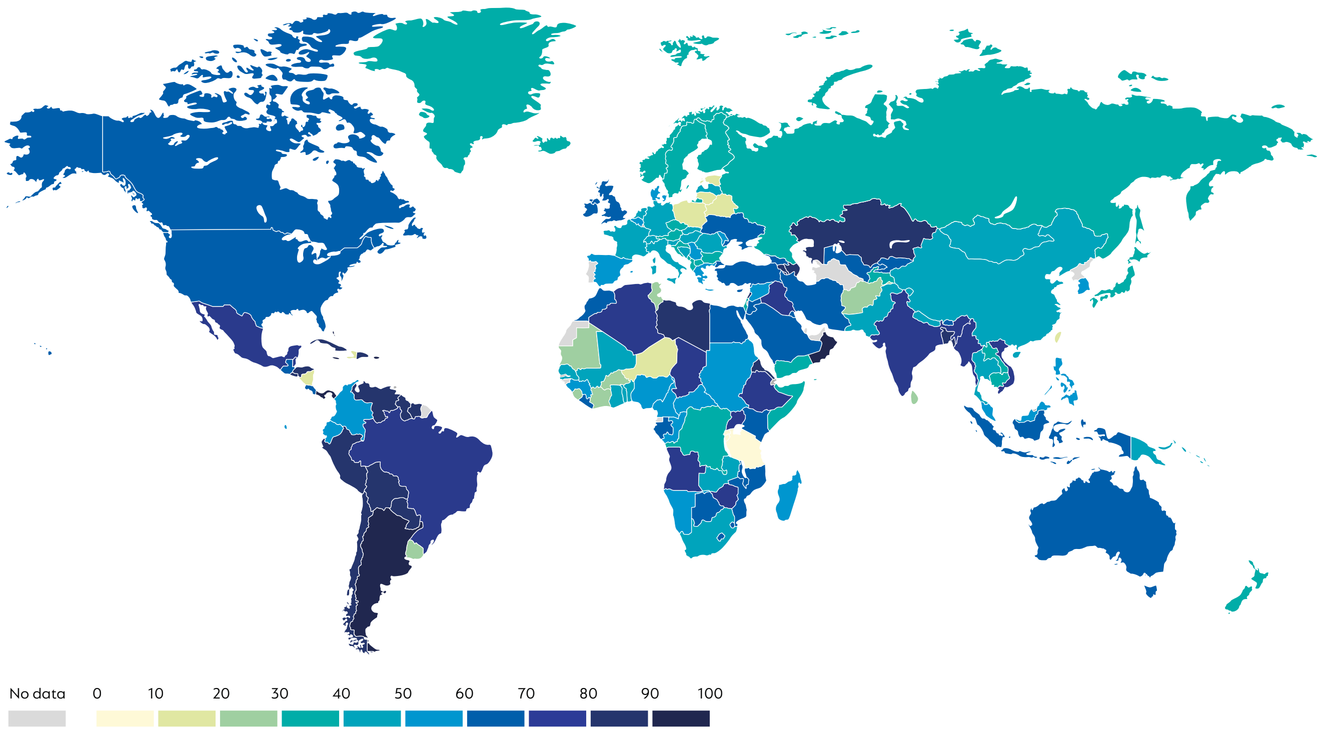
Within emerging markets, things are even more uncertain because the pandemic is not yet contained. While the efficacy of testing regimes varies greatly, available data show daily infection rates are still rising in many emerging markets and under-testing suggests these could be much higher. An inability to contain the pandemic limits the scope for recovery and raises the risk of repetitive lockdowns. The longer this continues, the more it delays any recovery and increases the risk of longer-term damage.

GDP data in emerging markets broadly mirror what has been seen in developed markets, with a record collapse in activity in Q2-20, and some Q3-20 rebound. But the policy tools available to emerging markets to help mitigate the impact of the pandemic on their economies are more limited than those of their advanced peers. So, while the economic impact is likely to last longer and be very painful in emerging markets, with yet- >

Figure 2

COVID-19: GOVERNMENT RESPONSE STRINGENCY INDEX

This is a composite measure based on nine response indicators including school closures, workplace closures and travel bans, rescaled to a value from 0 to 100 (100 = strictest). If policies vary at the subnational level, the index is shown as the response level of the strictest subregion.



Sources: Hale, Webster, Petherick, Phillips, and Kira (2020). Oxford Covid-19 Government Response Tracker – last updated 29 September, 15:30 (London time).

Note: This index simply records the number and strictness of government policies, and should not be interpreted as 'scoring' the appropriateness or effectiveness of a country's response.

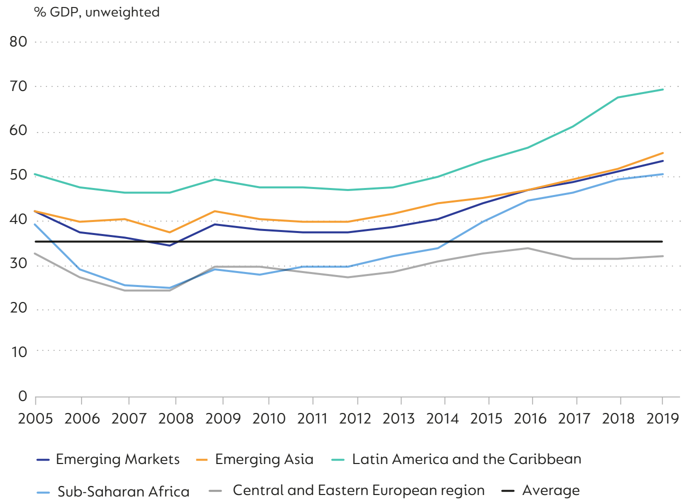
unknown social and political repercussions, the place of lasting vulnerability for most emerging markets will be fiscal policy.

EMERGING MARKET WINNERS AND LOSERS ARE ABOUT RELATIVE FISCAL OUTCOMES

The onset of the Covid-19 pandemic happened when many emerging markets were already fiscally vulnerable – GDP growth was weak throughout 2019 as incomes, profitability and revenues were all under pressure. In many countries, fiscal policy had already turned counter-cyclical, while debt positions were well above pre-Global Financial Crisis levels. Indeed, the IMF estimates that average debt to GDP in emerging markets was 38.8% in 2009, up to 53.3% in 2019, and will add another 20 percentage points of GDP in 2020 as the combination of fiscal support and revenue loss sees deficits balloon and debt ratchet up.

Figure 3

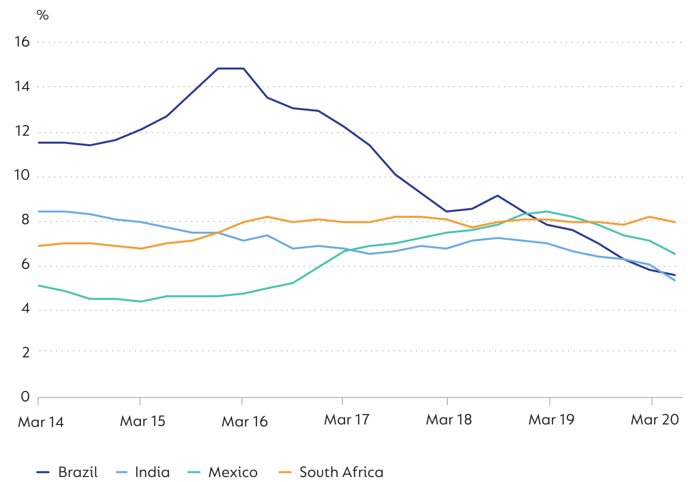
EMERGING MARKET DEBT



Source: UBS

Figure 4

SELECTION OF INTEREST RATES IN EMERGING MARKETS



Source: Haver

Looking ahead, it's hard to see any economic 'winners' emerging from the pandemic. Many economists talk of economic scarring; the idea that the painful economic injury imposed by the pandemic will have lasting, and visible, effects. There are, however, economies that will fare better in relative terms. Broadly, these will be those with shared characteristics that include:

- the realised ability to grow somewhat faster than prevailing borrowing costs;
- those with lower existing debt stock, which will help keep borrowing costs down;
- those with the capacity to ramp up production for manufactured and industrial goods, should demand (internal and external) recover; and
- those with credible governments, and fiscal and monetary authorities.

This may seem like a wish list. However, economies with these areas of resilience will be better able to attract funding and to sustain low interest rates, which will allow for some recovery in nominal growth. Their currencies should benefit from smaller current account deficits, or surpluses, and low inflation should allow policy rates to remain low.

There are relatively few emerging markets that enjoy this happy combination of factors. Among them are China, which for now is already on a path to recovery; some North Asian economies; and Central and Eastern European economies such as Hungary and Poland, which both benefit from their proximity to large markets and access to related supply chains. These countries also have lower starting debt positions and benefit from lower funding costs.

CASE BY CASE

However, for some of the other big emerging markets, the challenges are varied and significant. I discuss a few below:

India has not been able to contain the pandemic, and recent infection statistics put India among the most affected countries currently. India was also already in recession when the pandemic hit. Financial sector fragilities have undermined credit lending and support from the government last year had already helped increase the fiscal deficit. India's starting debt stock was relatively high at 72.2% in 2019, and borrowing costs are being contained by heavy support for the government by the national banks. India's ability to see a strong acceleration in economic activity will be key to its recovery, but while the pandemic spreads and lockdown remains tight, the prospect of recovery is further delayed.

Mexico has also had issues with testing, and unofficial estimates suggest both infection and mortality rates may be considerably higher than official data suggest. Here, too, growth was already weak heading into 2020, undermined by a change in domestic economic policy and the trade dispute with the country's biggest external source of growth, the US. While some of this risk has receded with the signing of the United States-Mexico-Canadian Trade Agreement, domestic growth strategies are not yet certain enough to sustain a strong recovery.

President AMLO's commitment to fiscal consolidation, while necessary longer term, has limited fiscal support in the pandemic. This could see Mexico's fiscal position in better relative shape than its emerging market peers listed here, but ongoing support for loss-making state oil company Pemex is a considerable future risk, as is a slow growth recovery.

Brazil also entered the pandemic on a fragile footing, with slow growth and the highest stock of government debt of the countries listed here, at 92% of GDP. Again, infection rates have not been contained, and goverment's pandemic strategy has attracted much criticism. Commitment to pension reform has helped lower borrowing costs, but as growth falters, there is reasonable concern whether this will hold. Here, too, banks have been a considerable support of goverment's borrowing needs.

No economy will emerge from this pandemic in a better position than it went in, and for most, the economic challenges that existed before will be exacerbated by the crisis. However, in all the above countries, as in many developed markets, governments have still been able to continue borrowing from financial markets at relatively low interest rates. This is owed in part to globally low yields, especially in developed markets; in some cases to the direct intervention of the central bank in funding the government; and in other cases, notably in Brazil, India and China, to the State-owned banks buying government bonds.

... WHICH BRINGS US TO SOUTH AFRICA

For now, infection rates have slowed, based on reasonably good testing practice and a hard lockdown early on.

But South Africa does not enjoy the mitigating conditions listed here. Instead, it faces a unique set of economic and policy challenges, and very few have been *caused* by the pandemic:

Growth – in real and nominal terms – has been slowing since 2013, when investment started to taper off, undermined by failing confidence, unrest and the reallocation of fiscal resources from investment to wages. As we stand, investment has contracted in real terms in three of the past four years, and took 11.5 percentage points off GDP growth in the Q2-20 crisis depth.

Government's financial position was already vulnerable and increasingly on an unsustainable path, undermined by three things: 1) revenue that was not as resilient as budgeters expected – for the reasons outlined above – and exacerbated by State capture; 2) expenditure, mostly on wages, State-owned enterprise (SOE) bailouts, and increasingly on debt service costs, was unable to adjust fast enough to falling revenues; and 3) economic policy has not been an enabler of economic growth.

In addition, unlike several of its emerging market peers, even the riskier ones highlighted above, South Africa does not enjoy low borrowing costs. Despite aggressive interest rate cuts by the central bank, government bond yields remain very high. In fact, the spread between swaps and government bond yields has widened, which means that domestic corporates can borrow at a lower onshore rate than the (supposedly) 'risk-free' government can.

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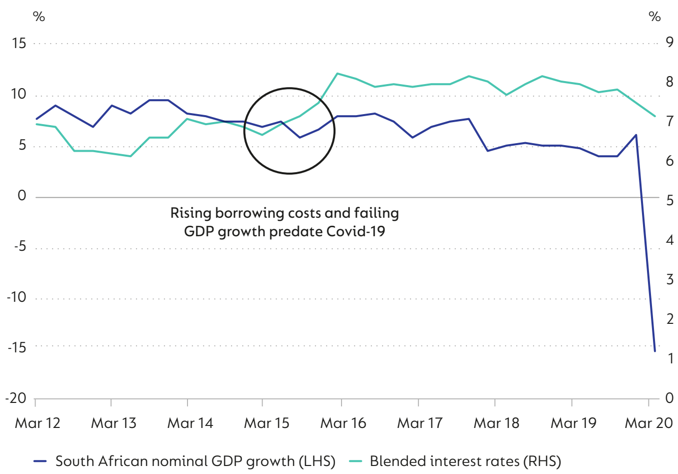
Figure 5

SOUTH AFRICAN NOMINAL AND REAL GDP GROWTH VERSUS INTEREST RATES



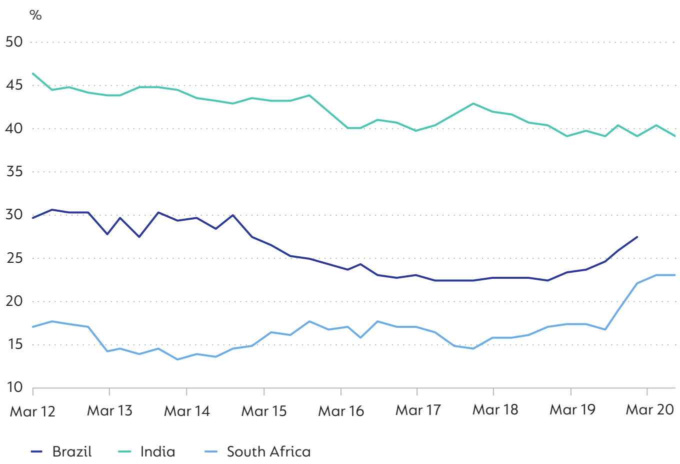
Source: Haver

This in part reflects the fact that in countries like Brazil (as well as India and China), the local banking system is much more supportive of State financing needs – where there are State-owned banks that own a lot more government debt than is seen in South Africa. They also have much less debt held by foreign investors. But it clearly also reflects the market's scepticism about government's ability to put the country and its balance sheet on a more sustainable path. As elsewhere, banks have accumulated government bonds, but they have done so where returns make sense, and they are unlikely to provide the kind of backstop seen elsewhere.

As a result, there have been several calls for the South African Reserve Bank (SARB) to step in and more aggressively accumulate government debt to help alleviate the high cost of borrowing.

Figure 6

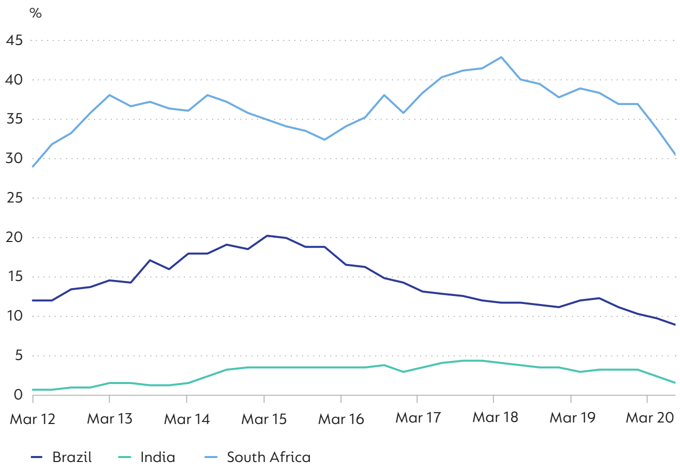
BANK HOLDINGS OF GOVERNMENT DEBT, % TOTAL



Source: Haver

Figure 7

FOREIGN OWNERSHIP OF GOVERNMENT DEBT, %



Source: Haver

The SARB has in fact intervened in the market since March but has been increasingly less present as financial dislocations eased. In August, the SARB bought just R350 million of government bonds. Importantly, the Monetary Policy Committee has been at pains to clearly articulate its view that high market rates reflect a long buildup of fiscal risk that does not have a monetary solution.

The biggest challenge is that the underlying debt dynamics are very problematic. Government needs to change the drivers of these, where possible, to ensure a more sustainable policy trajectory. Without this, any intervention will only yield temporary results, if any. If the SARB intervened aggressively without fiscal commitment to remedy the root causes of its weak position, the risk of foreign investors losing faith is material. South Africa relies on foreign funding, and while holdings have dwindled, they are still significant. In the event that they peter out further, the SARB would have to absorb some or all of the 29.9% of domestic debt foreigners hold, as well as the new issuance. It's hard to see where that would end, and the SARB understands this – heavy intervention could easily become a Pandora's policy box.

The currency would be the main casualty, and ensuing inflation would not only further undermine the SARB's credibility but also efforts to manage long-term rates as the curve reprices. If it's then forced to raise policy rates (or the market reprices short rates), the fiscal impact may be even worse, given the increase in short-term borrowing that would then need to be rolled.

CONCLUSION

A credible, targeted growth strategy, coupled with a sensible and durable commitment to moderating expenditure growth, is needed to reprice government risk. There are signs that government and its social partners in the private sector, including unions, are working towards this. It is not clear that whatever emerges will be enough, soon enough. There is a healthy and deserved scepticism about the government's commitment to implementing new fiscal and economic initiatives because there have simply been too many that were either grossly ineffective, poorly implemented, or mothballed.

It may be that the crisis is yet to come. Government's ability to fund a R700 billion shortfall this year looks as though it will be met. But large consecutive shortfalls in the region of R400 billion to R500 billion will be much more challenging. This reinforces the urgency with which these issues must be addressed, and the steepness of the South African yield curve suggests that within emerging markets, South Africa's case is among the most critical. +

SOUTH AFRICAN SECTOR REVIEW

Emergent themes add shine to resources

Transformation through green initiatives and new demand sources

By NICHOLAS STEIN and NICHOLAS HOPS

THE QUICK TAKE

- Unprecedented supply restraint meets a strong demand outlook
- The move to a green economy is a boon for commodity prices
- Management teams are committed to returning cash to shareholders

Nicholas Stein is an equity analyst with 11 years' investment experience.

Nicholas Hops is an equity analyst with seven years' investment experience.

THE FTSE/JSE RESOURCE 10 Index (JSE RESI) has more than doubled off its end-of-2015 lows. The index masks the performance of a number of its constituent shares, where the price rises have been even more spectacular. For example, Glencore, Anglo American plc and Kumba Iron Ore are up 120%, 650% and 1 934%, respectively. With good returns in the bag and healthy commodity prices, it begs the question why we still hold meaningful positions in the resources sector.

We believe that the commodity sector currently has several elements to it that are unprecedented versus historical cycles which, when combined, present a unique investment opportunity. We discuss these themes in more detail below.

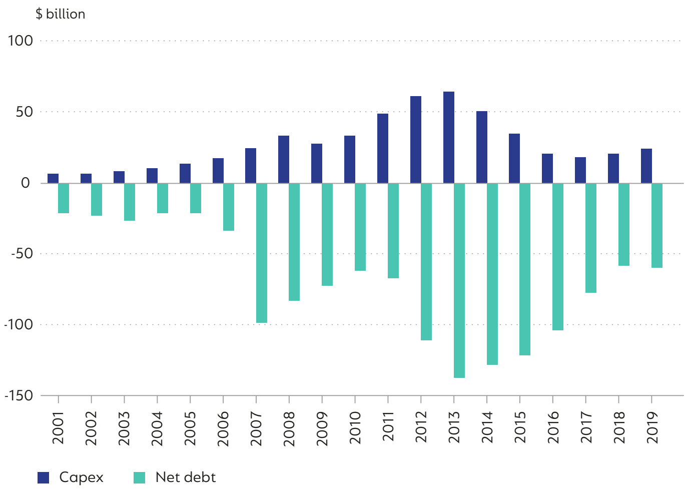
CAPITAL DISCIPLINE

If one considers the previous cycle ending in 2015, it played out broadly as follows: robust demand growth driven by China on which miners capitalised. They then extrapolated it into the future by living beyond their means (increasing debt levels and channelling it into capital expenditure to boost supply) – Figure 1 overleaf. Gearing works in a rising price environment, yet increased gearing is a contributing factor to a deflationary price environment. Over-exuberant investment into volume growth in good or benign times sowed the seeds for oversupply (bad times). This came to a head when there was a wobble in 2015. A deflationary price environment ensued and collided with stretched balance sheets. Low prices and high debt are a toxic combination. The JSE RESI fell 61%, while Anglo American and Glencore lost 80% and 72%, respectively. This led market commentators at the time to question the viability of many of these stocks. Glencore did a rights issue and Anglo American expressed a strong desire to do so.

This 2015 'near-death' experience is firmly entrenched in the minds of mining executives, many of whom have retained their positions in their respective companies. However, they now appear to appreciate the risk of price deflation caused by excess leverage and supply growth, and understand that high gearing and mining companies are not very compatible.

Figure 1

INDUSTRY CAPITAL EXPENDITURE AND NET DEBT



Source: RMB Morgan Stanley

On the back of 2015's wake-up call, companies have started running conservative balance sheets. Rather than anticipating demand growth and bringing forward supply using leverage (basically using balance sheets to balance the market), they're using retained earnings (and allowing commodity prices to balance the market). This places the miners on a firmer financial footing and the sector now lags cycles rather than leading them, resulting in far less slack in the system. Take the 2019 Brumadinho tailings dam disaster that saw Vale's production drop by 34% (c.64 million tonnes). There was simply no alternative supply source able to fill the missing tonnes, which, when combined with stronger-than-expected demand, sent iron ore prices up 68% from January 2019 to today.

While we don't expect this capital expenditure discipline to last forever, we expect it to continue as long as the current cohort of executives remains in place at the companies and/or while share prices remain at levels attractive to valuation-based investors.

CHINA IS GROWING STRONGLY

When it comes to commodities, the trajectory of the Chinese economy is critical, with c.50% of most commodities being consumed in the People's Republic. Of the key commodities, roughly 75% of the seaborne iron ore market goes into China, followed by c.50% of copper and nickel, 32% of platinum group metals (PGMs) and 13% of crude oil. China is heavily dependent on key commodity imports given its lack of an in-country natural resources base. Metallurgical and thermal coal are slightly different, as China has large resources and only relies on imports for higher-quality product and where coastal plants find it easier and cheaper to import product than to transport it from the inland coal-producing regions.

Overall, China still makes up c.20% of the seaborne coal markets, more in line with Chinese GDP as a share of the world's total at 19%. We expect GDP growth in China to continue slowing and the commodity intensity (consumption:GDP) of steel-related commodities to follow suit. Where we expect trend growth to be more resilient and, in some cases, to increase over the next 10 years, is in copper, nickel and PGMs, where moves towards a greener world have very positive implications for these metals.

GREEN CREDENTIALS

Miners are arguably transforming themselves into an ESG[1]-positive industry, spending billions of rands on initiatives such as community programmes, staff training and land rehabilitation, among others. Particularly over the last decade, we have seen a significant decrease in injury and fatality rates in the local mining sector.

The other critical point that perhaps gets overlooked is that you can't make energy-intensive industries greener without the use of certain commodities. Put differently, decarbonising the world requires the use of a number of commodities.

Reducing carbon dioxide (CO_2) emissions requires either a decrease in the population or for the existing population to use less energy. Both scenarios seem unlikely. The alternative is to focus on energy efficiency and reducing the CO_2 intensity per unit of energy generated through low (or no) carbon power generation. Indeed, it is in the latter area where much of the action is taking place today. Two areas of focus are the vehicle drivetrain and electricity production. In both cases, copper is a critical component, given its unrivalled thermal and electrical conductivity.

The vehicle drivetrain is in the process of shifting away from fossil fuel (oil) as a power source to electricity. A typical electric vehicle (EV) requires 150 kilograms of copper. Based on our inhouse assumption of a 25% battery electric vehicle penetration by 2030, combined with mass-hybridisation, this decarbonisation of the drivetrain would require an additional 4.3 megatonnes of copper and 1 150 kilotonnes of nickel. This incremental demand represented 19% and 49% of the 2019 supply base for copper and nickel, respectively, enough to push these markets into material deficits in the years to come.

[1] Environmental, social and governance factors

Efforts are also under way to transform the electricity mix away from fossil fuels such as coal and towards greener energy sources such as wind and solar. Wind and solar require multiples more copper per unit of power than coal and traditional sources (they require this for increased cabling, as well as generators, inverters and transformers). Investment firm Bernstein estimates that copper demand from wind energy will require an additional megatonne per annum of copper by 2030.

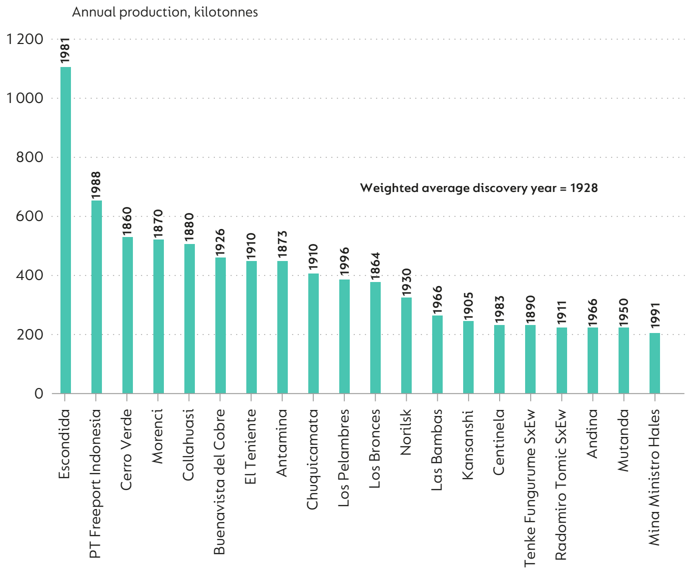
The PGMs also benefit heavily from the shift towards cleaner air and general decarbonisation. In the medium term, PGMs will benefit from increased regulatory pressure on car manufacturers to reduce emissions, with large fines for non-compliance. Adding palladium or rhodium to the catalyst of an emissions treatment system is a natural solution for vehicle and catalyst manufacturers. Longer term, the PGM complex stands to benefit from the arrival of the hydrogen economy, at least a few decades after it was first heralded.

The last 12 months have seen a step change in political will to tackle climate change from most political parties globally as well as large corporates. The most recent stimulus response out of Europe is a clear example, with a continental 'net zero' goal by 2050 and tens of billions of euros committed to the cause. China has also committed to being net zero by 2060.

There is broad consensus that to fully decarbonise, there is a large role for hydrogen to play across a raft of industries. Fuel cells can be used to power ships, heavy- and light-duty vehicles and even buildings, not to mention the burning of hydrogen for heat in heavy industry such as steel and cement manufacturing. Platinum in particular is vital in several elements of a hydrogen-based economy.

Figure 2

WORLD'S 20 LARGEST COPPER MINES' DISCOVERY DATES



Sources: USGS, Wood Mackenzie, corporate reports, Bernstein analysis

We should point out, however, that we aren't thematic investors. We don't see a bullish story for copper simply because it's 'green'. Rather, it's about a new source of incremental demand adding to a constrained supply base. We don't see this as incompatible with a reasonable outlook for thermal coal, which suffers from muted demand growth, virtually no new mine investment and prices that render half the industry unprofitable – a situation that we don't think will persist.

ANGLO AMERICAN

The Anglo American of today is very different from the one of 2015. Aside from the balance sheet (which is now strong), the company has disposed of a number of smaller, higher-cost operations, leaving it with a few large, low-cost, long-lived assets. This has seen return on capital employed improve. We expect further improvement as two key greenfield assets come into production, being Quellaveco (copper) and Woodsmith (crop nutrients). These projects, alongside a number of brownfield expansion opportunities, give Anglo American the most attractive growth profile of its peers over the next few years.

Anglo American's portfolio is well diversified across commodities and geographies. The company has a differentiated portfolio compared to its peers, owing to its exposure to PGMs and diamonds (PGMs are discussed above and overleaf). The outlook for diamonds is the most promising it's been for some time. While 2020 will be exceedingly tough for De Beers, 2021 onwards should see material improvements to the diamond markets owing to current supply discipline, the closure of Argyle (a large Australian diamond mine that has come to the end of its life), and improvement in demand as lockdown restrictions ease globally and on the back of increased diamond marketing by De Beers.

Anglo American has invested meaningfully in technologies to reduce its energy and water use at its assets. These investments are close to bearing fruit. In addition, Anglo American's exposure to copper, nickel and PGMs (over two thirds of normal earnings) positions it well to contribute to the decarbonisation journey we've been discussing.

Anglo American trades on seven times our assessment of normal earnings. This is compelling, given its favourable commodity mix and low-cost, long-lived positions in many of these commodities.

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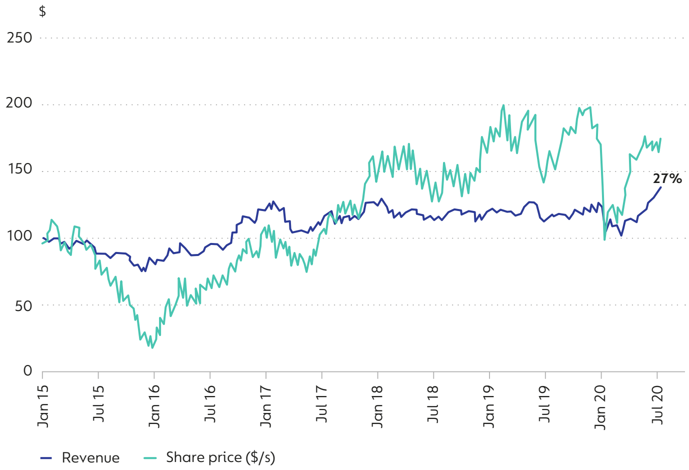
Figure 3

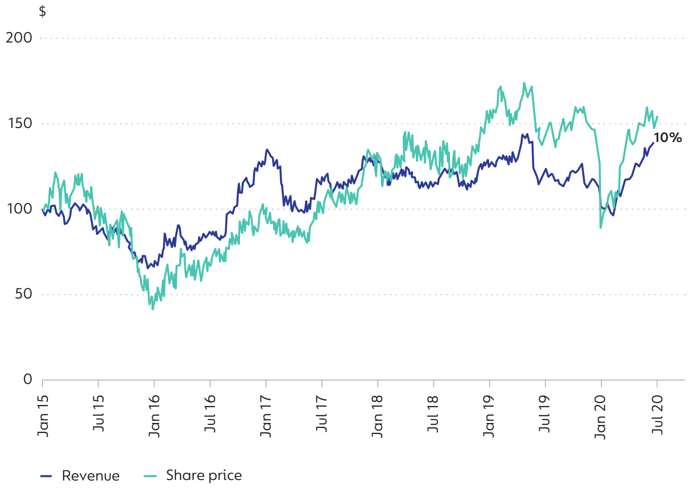
ANGLO AMERICAN SHARE PRICE AND UNDERLYING REVENUE BASKET



Source: RMB Morgan Stanley

Figure 4

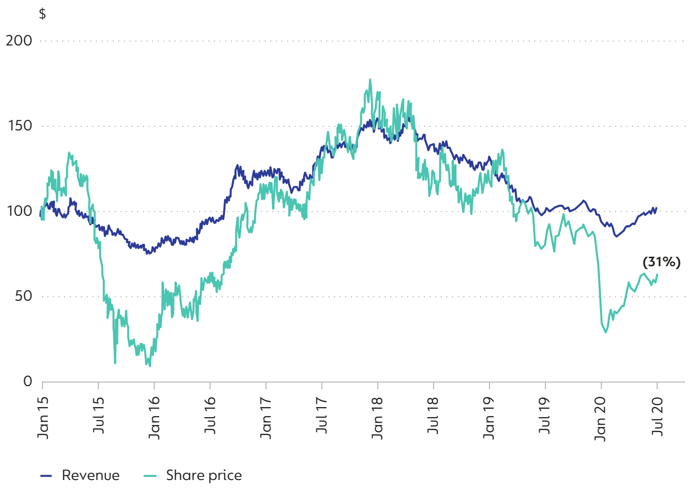
BHP BILLITON SHARE PRICE AND UNDERLYING REVENUE BASKET



Source: RMB Morgan Stanley

Figure 5

GLENCORE SHARE PRICE AND UNDERLYING REVENUE BASKET



Source: RMB Morgan Stanley

PGM STOCKS

We still see meaningful upside in the PGM sector, coupled with the potential for outsized cash returns in the short term. Northam Platinum is a small, growing PGM miner with a highly experienced and entrepreneurial management team. Investments in new, low-cost production at the bottom of the commodity cycle has put Northam in an excellent position to capitalise on this period of high prices. Production growth across three assets over the next few years should drive earnings and cash returns to shareholders, an area where Northam has been exemplary in committing to returning all surplus cash.

Impala Platinum has the potential to return even more cash to shareholders in the medium term, given the steady-state nature of its production and improved operational performance in recent years. Solid delivery by the management team has set the business up to be extremely cash generative in this environment, and we believe they will take further steps in the next 12 months to return shareholder capital. Northam and Impala are the two largest PGM positions within our equity portfolios.

GLENCORE

Glencore is one of the few companies whose free cash flow has been (and will likely continue to be) higher than accounting earnings. As such, a focus solely on accounting earnings misses just how cash generative Glencore is. At spot prices, Glencore trades on a 14% free cash flow yield and we see upside to most of Glencore's key commodities (copper, nickel and coal). Furthermore, Glencore has been good at returning large portions of this free cash flow to shareholders. We think figures 3 to 5 are instructive. First, they highlight the relative weakness that Glencore's commodity price basket has experienced versus Anglo American and BHP Billiton (largely owing to its larger coal exposure and the fact that it does not produce any iron ore).

We are bullish on the prospective outlook for Glencore's commodity basket, and, as mentioned, also on EV metals, which make up almost half of our normal profits.

Another point to note is how weak Glencore's share price has been relative to its commodity price basket. This decoupling started at the time that the US Department of Justice (DoJ) announced it was investigating Glencore. We note that the investigation likely centres on Glencore's holdings in the Democratic Republic of Congo – an issue which predates the company's listing.

We also note that Glencore's compliance department has grown notably since listing (from five members at listing to 150 now). If you make the assumption that the underperformance relates to the investigation and that Glencore would have performed in line with its commodity price basket but for this, the market is pricing in a c.$16 billion fine – over eight times higher than the highest fine the DoJ has levied in its history under the Foreign Corrupt Practices Act. We think the market is too penal in its assessment here. We also think the transition away from the old guard of management to new management – a process that has been under way for years and is nearing its conclusion – is not fully appreciated by the market, as highlighted by Figure 6.

Figure 6

CHANGING OF THE GUARD

	At merger	Now
CEO	Ivan Glasenberg	Ivan Glasenberg
Head of mining	n/a	Peter Freyberg
Copper marketing	Telis Mistakidis	Nico Paraskevas
Aluminium marketing	Gary Fegel	Robin Scheiner
Ferroalloy marketing	Stuart Cutler	Jason Kluk & Ruan van Schalkwyk
Iron ore marketing	Christian Wolfensberger	Jyothish George
Zinc marketing	Daniel Mate	Nick Popovic
Nickel marketing	Kenny Ives	Kenny Ives
Coal marketing	Tor Peterson	Tor Peterson
Oil marketing	Alex Beard	Alex Sanna
Copper industrial	Telis Mistakidis	Mike Ciricillo
Zinc industrial	Chris Eskdale	Chris Eskdale
Aluminium industrial	Gary Fegel	n/a
Ferroalloy industrial	Gary Nagle	Japie Fullard
Nickel industrial	Peter Johnston	Marc Boissonneault
Iron ore industrial	Mark Eames	n/a
Coal industrial	Peter Freyberg	Gary Nagle
Oil industrial	Alex Beard	n/a
Agriculture	Chris Mahoney	n/a

Management changes

Source: Glencore company reports

EXXARO

In our view, Exxaro's coal business is mispriced by the market. The bulk of earnings comes from Grootegeluk, one of the lowest-cost, longest-lived coal mines in South Africa. The company's fixed-price contract supplying Eskom (with inflationary escalations) ensures a high degree of margin and cash-flow stability. We are also bullish on thermal coal exports where margins and cash flows are anything but stable. The seaborne thermal coal price trades deep into the cost curve and is unlikely to be sustained at current low levels. Asian demand growth for thermal coal is offsetting European demand declines. A lack of willingness to build and fund new coal mines means supply is under pressure. As such, we expect thermal coal prices to increase.

If you exclude Exxaro's stake in Sishen Iron Ore Company (Kumba Iron Ore's only operating subsidiary), you are not paying anything for the coal business, which generates over R10 per share in annual earnings. While there is a risk around capital allocation errors as Exxaro spends outside of its core competency on clean energy initiatives, we view these as more than priced in. Exxaro's core competence is as a coal miner and returns from green investments are typically lower than those earned from mineral extraction.

TO CONCLUDE

The commodities sector is displaying remarkable supply restraint in the face of healthy margins and incentive prices in several commodities. The decarbonisation of the world that will take place over the next few decades is incredibly positive for metal demand and stands to produce strong price outcomes when combined with supply, which is yet to respond meaningfully. On top of this supportive earnings environment, management teams have committed to delivering material capital returns to shareholders, made more attractive by historically cheap starting valuations. +

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The portfolio positioning mentioned herein relates to Coronation managed strategies; however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a position'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 positions 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 positioning described herein.

EMERGING MARKETS

This is a tale of Davids and Goliaths

Bloated merchant acquirers face disruption in the Brazilian market space

By LISA HAAKMAN

THE QUICK TAKE

Cielo and Rede have dominated the Brazilian merchant acquiring industry for years

These two Goliaths have exploited their duopoly by overcharging and underserving merchants

Brazilian merchants have thus generally preferred cash over cards

Government levelled the playing field by removing card exclusivity rights

Lisa is a portfolio manager with 13 years of investment experience.

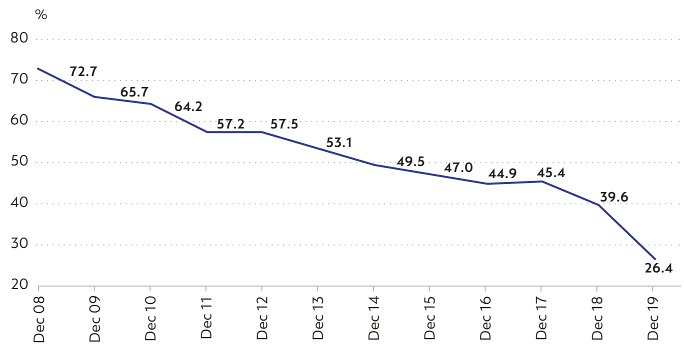
IN THIS STORY, the Goliaths are Cielo and Rede, two companies that have enjoyed and abused a cosy duopoly in the Brazilian merchant acquiring[1] space.

The first giant, Cielo, enjoyed exclusive rights to process Visa cards, while the second giant, Rede, had exclusive rights to process MasterCard.

[1] These enable retailers to accept card payments.

Figure 1

CIELO EBITDA* MARGIN



*Earnings before interest, taxes, depreciation and amortisation

Source: Bloomberg

Cielo is jointly owned by Banco do Brasil and Banco Bradesco (the largest and fourth-largest banks in Brazil, respectively), while Rede is majority owned by Itaú Unibanco (the second largest), which further cemented their position of strength. Together the two companies enjoyed a 90% market share of the merchant acquiring market in Brazil.

Like all bullies, they didn't play fair – both exploited their exclusivity by charging merchants extortionate fees while delivering very little value to their clients. As a listed company, Cielo was a market darling, as its extremely high margins resulted in strong returns for shareholders (Figure 1).

Cash has always been the preferred means of payment in Brazil, and under the reign of Cielo and Rede, there was little incentive for merchants to encourage the use of cards instead. All-in fees for accepting card payment were extremely high, and merchants had to lease or purchase the point-of-sale device from the merchant acquirer at a further cost. In fact, they had to lease or purchase two point-of-sale devices – one from Cielo and one from Rede – if they wanted to accept both Visa and MasterCard.

OTHER HEADWINDS

The structure of the Brazilian card market is a further prohibiting factor to card acceptance. In most countries, the merchant acquirer settles the transaction within 48 hours, while in Brazil, card transactions are only settled after 30 days. Furthermore, due to consumer affordability constraints, the Brazilian market has evolved to allow payments in interest-free instalments for everything from clothing to fuel to white goods. The merchant may tier its pricing to compensate for the implied financing it is offering the client, but this places a substantial working capital burden on the merchant who sells a product today and may only receive full payment in 12 months.

Together, these anomalies have caused a general reluctance to accept cards and, as a result, card usage has remained extremely low in Brazil, with credit card usage particularly low (Figure 2).

TOPPLING THE GIANTS

To foster competition in the merchant acquiring sector, the Brazilian government put an end to these exclusive rights in July 2010.

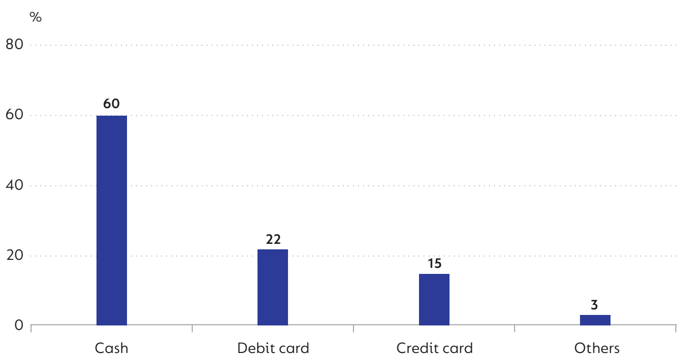
This paved the way for the emergence of new competitors and enabled a rapid disruption of the status quo. New entrants have succeeded by solving many of the pain points of accepting cards – high fees, poor service and a large working capital outlay.

We own two of these new competitors, the Davids in this story, Stone and PagSeguro.

Stone was founded in 2012, and primarily targets the small, medium and micro enterprise (SMME) market in Brazil. The company's key selling point at launch was a better quality (and cheaper) point-of-sale device (that accepted both Visa and MasterCard), lower merchant discount rates and superior service levels. Merchants are serviced via hubs located around the country, staffed by Stone agents. Besides better service, Stone's key differentiator is the software add-ons that merchants can use for order and sales management, invoicing, inventory management, cash and payments management, customer relationship management, logistics and e-commerce integration. Instead of merely facilitating payments, Stone's offering empowers businesses to perform better and enables all-important e-commerce integration.

Figure 2

PAYMENT METHOD MOST USED FOR IN-PERSON TRANSACTIONS IN BRAZIL IN 2018



Sources: Atlantico Study, Banco Central do Brasil 2018 Study

Stone also prepays the yet-to-be-received instalments to the merchants at affordable funding rates, and merchants can elect to have transactions settled immediately rather than only after 30 days, allowing businesses to manage their cash flow and grow faster. At the same time, this provides a valuable and risk-free revenue stream for Stone, which has the balance sheet to fund this prepayment.

PagSeguro entered the micro-merchant space in 2013 with a similarly differentiated approach. Its proposition is a very simple and affordable point-of-sale device, with transparent and standardised pricing for all clients. PagSeguro's offering is entirely digital, and all processes are standardised, allowing the company to keep costs low and hence offer compelling pricing to clients. This has allowed micro-merchants to accept card payments at a reasonable cost. PagSeguro also prepays the instalment sales and offers merchants immediate settlement to assist them with cash flow.

There is some risk that the structure of the market changes to a shorter settlement period, removing an important revenue source for both companies; however, we believe that merchant discount rates would increase to compensate, converging with the rate they currently charge for immediate settlement.

INNOVATION AND AGILITY

Both Stone and PagSeguro were able to gain market share quickly as a result of their differentiated propositions and their lower pricing, which has resulted in a reduction of the merchant discount rate for the country as a whole (Figure 3 overleaf).

As they've grown, they've also evolved to offer more services to enhance customer stickiness. Stone recently launched a basic banking product enabling electronic transactions, bill payments, and cash in and out, as well as working capital loans. As of 30 June 2020, 48% of Stone's merchants had subscribed for a bank account and 9% for credit. Stone continues to add software capabilities it believes will help clients, and the company is the preferred bidder for Linx, Brazil's largest software company, specialising in omnichannel retail. >

PagSeguro launched PagBank, a full-spectrum digital bank, to enhance its ecosystem. The bank has proved immensely popular, and the take-up by both merchants and external consumers has been impressive. PagBank has already amassed 4.9 million customers since launch a year ago.

TOO LITTLE, TOO LATE

The primary incumbents (Cielo and Rede) are now left with a conundrum. They previously each enjoyed a monopoly over their card network and hence had no need to invest in product or innovation or service. Their cost bases became as bloated as their revenue bases. As a result, they are now in a position where they cannot afford to cut pricing. They are also owned by their respective banks and hence do not offer the entire ecosystem of acquiring, banking and credit, as this would result in them competing with their parents. These companies have realised too late that it's better to disrupt yourself than be disrupted by others. Cielo, in particular, has been slow to improve its offering and has lost substantial market share (Figure 4).

Stone and PagSeguro's runway for growth is extremely long. They are well positioned to continue taking market share from the two incumbents. More importantly, the pie is also growing quickly. Card usage remains low in Brazil, but accelerated due to Covid-19 when a large proportion of personal consumption expenditure moved online – a habit we believe will continue even after the pandemic. We believe that the cash-to-card conversion is set to accelerate further, providing a structural tailwind for both these companies.

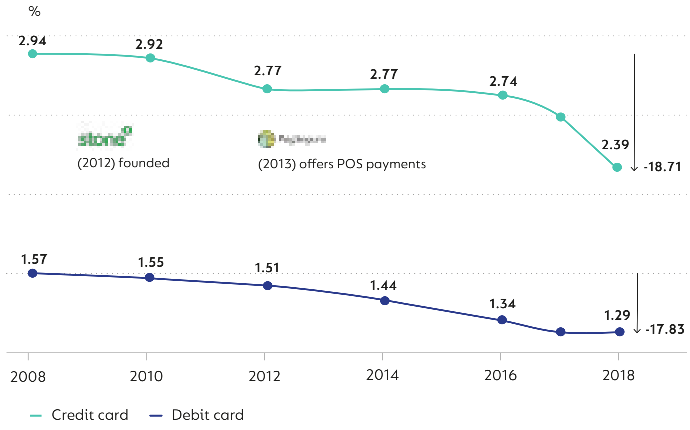
Our estimates assume that card penetration will increase from 33% to 56% over the next 10 years (Figure 5).

Consequently, we are excited about the prospects for these two companies, which are managed by smart and innovative teams. Both shares have performed well over recent months; however, we believe that they remain attractively valued over a longer-term horizon.

We feel that the market is overlooking the strength of their ecosystems and the length of their runways for growth. As such, we are confident that these Davids will topple the two Goliaths of Brazil's merchant acquiring industry. ✚

Figure 3

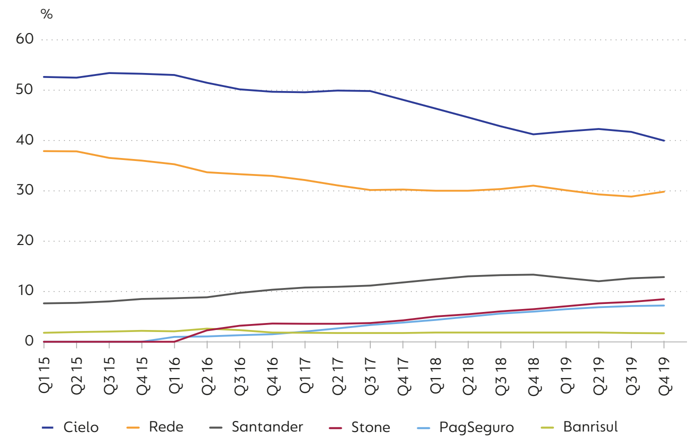
MERCHANT DISCOUNT RATE OVER TIME



Sources: Banco Central do Brasil, ABECS

Figure 4

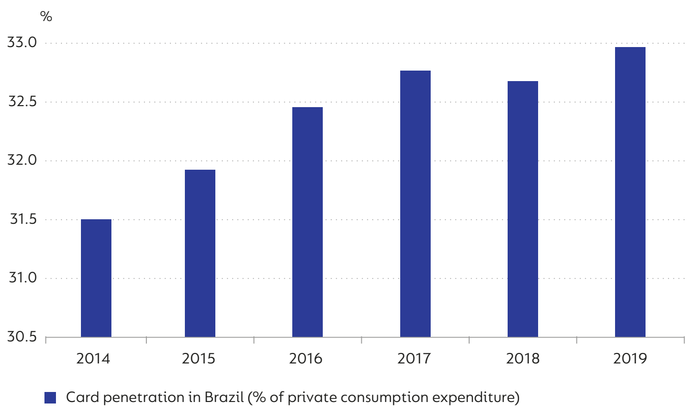
MARKET SHARE OF MAIN PLAYERS



Source: UBS

Figure 5

CARD PENETRATION IN BRAZIL



Source: Bradesco

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SOUTH AFRICAN BONDS

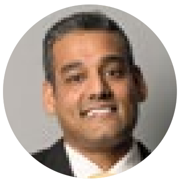
The debt trap continues to beckon

Yet SAGB valuation remains attractive in the longer end of the bond curve

By NISHAN MAHARAJ

THE QUICK TAKE

- Policy implementation, SOEs and political manoeuvring continue to hamper recovery
- Valuation of longer-dated SAGBs offers a significant risk premium
- ILBs in the front end of the curve offer an attractive opportunity
- Listed credit valuations are still unattractive given underlying fundamentals



Nishan is head of Fixed Interest and has 17 years of investment experience.

THE FIRST CASE of Covid-19 was detected in December 2019, but there was little to suggest how this little microbe would change human history. The world went into differing categories of lockdown to arrest the spread of the virus and allow time for the expansion of healthcare capacity. Ten months later, over 40 million people have been infected, just over a million souls have been laid to rest and the toll on the global economy is still uncertain. Many countries around the world eased lockdown measures as the levels of infection started to recede; however, there is now a rise in second waves of infection, which has heightened uncertainty.

The combination of accommodative monetary policy and fiscal stimulus, the likes of which have never been seen before, helped to soften the recessionary effects of lockdown and keep markets well buoyed. Levels of volatility will remain elevated, due to both the second wave of infections and upcoming geopolitical events (the finalisation of Brexit and the US presidential elections), which have placed big question marks on current valuations.

A PRECARIOUS POSITION

South Africa was precariously placed going into Covid-19, which meant the risk premium in local assets was already lofty. Despite South Africa's early move into lockdown, the poor implementation of policy decisions has highlighted the country's precarious financial situation. Risk premiums increased even further as foreign investors dumped South African assets at a ferocious pace. Local bonds were arguably the most vulnerable, since at the heart of South Africa's problems lay large amounts of debt that needed to be serviced at double-digit yields, amidst very subdued growth.

The All Bond Index (ALBI) is up 3.6% over the last 12 months (1.5% over the last quarter), but is still running behind cash (+5.6% over the last year). This performance was due to the poor showing from bonds with a maturity of greater than seven years. Shorter dated bonds were anchored by the 300-basis point (bp) reduction in the repo rate over the last six months. Only inflation-linked bonds (ILBs) have delivered worse performance, down 2% over the last 12 months (up 1.2% over the last quarter). The total returns of South African bonds

>

(both ILB and nominal) are even poorer when converted to US dollars (approximately -7% for the ALBI in US dollars) and compared to global bonds (6.8% World Government Bond Index return in US dollars), further emphasising how much local bonds have fallen out of favour.

South Africa's fiscal problem is the culmination of many years of poor policy choices. On the expenditure side, the wages of government employees have enjoyed real growth of 3% per annum since 2009, while the economy has only averaged real growth of 1.2% over the same period. This has meant tax revenue has not kept pace, forcing expenditure to be reduced in other, more productive areas.

State-owned enterprises (SOEs) have further crowded out productive expenditure due to their continuous demand for government support, and Eskom remains the biggest risk to the economy. Years of mismanagement have resulted in an unsustainable debt load and unreliable energy supply that place added pressure on the fiscus and reduce the long-term growth potential of the local economy.

Covid-19 has placed a further burden on government finances, as tax revenue will drop by c.R300 billion, which will force hard decisions to be made about further expenditure cuts and other reforms. Interest service costs will skyrocket to around 25% of tax revenue over the next three years, which will place South Africa on the precipice of a debt trap.

Markets have lost faith in policymakers' ability to right the situation. We need to see tangible steps put in place that detail how the bloated wage bill will be reduced, how Eskom will be set on a path to operational and financial stability, and how growth can be reaccelerated. Further disappointments include government's attachment to the beleaguered South African Airways and the scale of misappropriation of government tenders during the Covid-19 crisis.

SOME RAYS OF HOPE

In the past month, there has been some good news. The National Energy Regulator of South Africa has approved a plan to tender almost 12 gigawatts of power generation capacity, predominantly from renewables, and there seems to be consensus on a plan between labour, government and business that will address some of Eskom's problems. In addition, the Independent Communications Authority of South Africa has finally announced that high-demand spectrum will be auctioned this fiscal year, which will introduce between R8 billion and R12 billion of revenue. Another encouraging sign is that there have been some high-profile arrests on the back of the ongoing graft investigations.

South Africa faces yet another watershed budget at the end of October when Finance Minister Tito Mboweni will provide details on how he plans to enact R230 billion worth of savings over the next three years to take South Africa to a primary surplus and pull us back from the brink of a debt trap.

LOCAL BOND OUTLOOK

Despite the poor fundamental overhang, the valuation of South African bonds has adjusted to embed a significant risk premium. In previous publications, we have gone into detail regarding the risk premium embedded in South African government bonds (SAGBs) relative to their emerging market peers, both from a pickup relative to developed market bond yields and an implied real rate perspective. Figure 1 shows the amount bond yields can move before they break even relative to cash. At 100bps to 200bps breakeven, these are extremely attractive. In addition, bonds with a maturity of greater than 10 years offer the most value from this perspective.

In almost all cases where a country falls into a debt trap, the restructuring of debt through a haircut is the first avenue pursued, and these haircuts can vary between 15% and 60%. In the last column in the table, we take a scenario where, after four years, South African debt is haircut by 50%, and we show the total return of the various bonds, including the haircut, up until that point. Due to the higher yields and low cash prices on offer in the long end of the bond curve, once again bonds with a maturity of greater than 10 years outperform, providing further support to keeping duration allocations focused in this area of the curve.

Figure 1

AVERAGE BREAKEVEN RATES

Bond	Maturity	Yield	1y breakeven (cash @ 4%)	2y breakeven (cash @ 5.25%)	3y breakeven (cash @ 6.25%)	Total return (50% haircut)
R186	21-Dec-26	7.20%	0.82%	1.23%	0.82%	(12.68%)
R2030	31-Jan-30	9.39%	0.96%	1.68%	2.02%	(5.80%)
R2032	31-Mar-32	10.39%	1.02%	1.83%	2.32%	(3.36%)
R2035	28-Feb-35	11.18%	1.06%	1.93%	2.51%	(1.82%)
R2040	31-Jan-40	11.59%	1.03%	1.89%	2.46%	0.06%
R2044	31-Jan-44	11.63%	1.00%	1.82%	2.36%	1.46%
Average breakeven			0.98%	1.73%	2.08%	

Source: Coronation

ILBs have been a poor performer as an asset class, but as with the ALBI, the ILB bond curve is weighted heavily towards longer dated bonds. As is evident in Figure 2, over the last 12 months, ILBs out to seven years have produced decent returns relative to cash, offer an attractive pickup to their nominal bond counterparts and still provide inherent protection against higher inflation. Furthermore, the one-year forward real policy rate (the difference between the repo rate and one-year forward inflation) sits at -1%, which acts as a very strong anchor for short-dated real yields. The risk, which we believe to be negligible at this point, is that the South African Reserve Bank (SARB) moves the real policy rate into a marginally positive area.

LISTED CREDIT VALUATIONS SEEM EXTENDED

The listed credit market was not spared during the Covid-19 selloff; however, the recovery in listed credit spreads has far exceeded the quality of the underlying fundamentals. Once again, the listed corporate market is suffering from a supply/demand imbalance and the primary credit markets have dried up for most of the issuers in the market. Since the SARB relaxed prudential capital buffer ratios for banks, they can now afford to refinance upcoming debt maturities for corporates without forcing them to go to debt capital markets. At the same time, the risk/return characteristics of other asset classes have turned less favourable, making listed credit, with its reduced return volatility, a seemingly attractive opportunity set. Unlike investing in an equity, where one can double or triple one's initial investment, when one invests in a credit, the best one can hope for is to receive one's coupon payments on time and one's capital back at the end. The return profile is therefore discreet; that is, one continues to earn a steady interest rate (coupon) until maturity or default.

Even though underlying fundamentals might be deteriorating, the return of the South African corporate credit market has remained steady, predominantly due to there being large holders of individual issues, hence limiting secondary market activity and price discovery. This reduced volatility hides the underlying risk within the sector currently. In addition, the inclusion of structured products in a portfolio can also be used to reduce the volatility of returns of the underlying credit exposures due to inefficiencies in the mark-to-market process for structured products.

Figure 3 highlights why we believe underlying fundamentals are not being reflected in credit spreads. Bank credit loss ratios have increased dramatically following Covid-19 and are set to remain elevated for at least the next 12 to 18 months as the second-round effects of the crisis make its way through the economy. However, banks pay less for funding now than they did before the crisis or at any point during the last 10 years, despite credit loss ratios (a reflection of the condition of their lending book) being higher now than they were during the Global Financial Crisis, a situation we believe is not sustainable.

The margin of safety in the valuation of listed credit is not very encouraging either. In Figure 4 overleaf we list the yield coming off the SAGB 10-year bond, the yield on a floating credit (spread over three-month Jibar) and the equivalent fixed rate of the 10-year credit to maturity. As is evident, government bonds offer a much more attractive yield versus the underlying credit. The credit's fixed rate to maturity materialises at a much lower yield due to the low level of cash rates and the ability of banks to borrow money at a cheaper rate than government. As an aside, it is cheaper for the average South African to borrow money than the government, given prime is at 7%, highlighting how much risk premium is embedded in SAGB yields. Given current prevailing levels of credit spreads in the listed market and the underlying >

Figure 2

INFLATION-LINKED BOND RETURNS AND YIELD

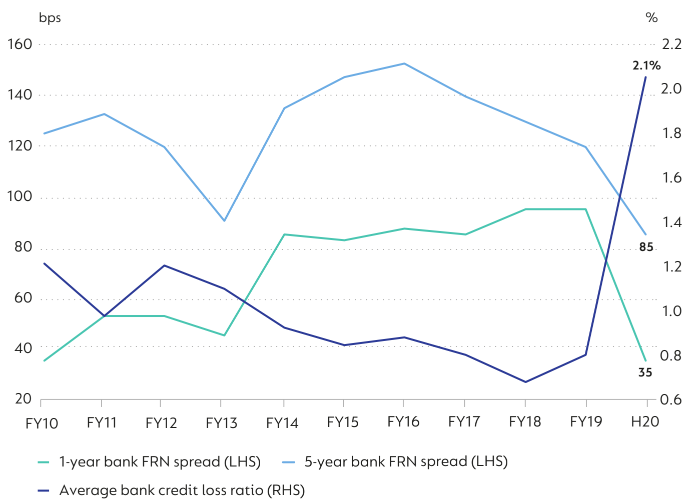
CILI* Index	Total return (last 12 months)	Real yield	Implied nominal yield @ 4.5% inflation	Equivalent nominal yield
1 to 3 years	7.6%	0.9%	5.5%	4.8%
3 to 7 years	7.2%	2.5%	7.2%	7.4%
7 to 12 years	1.7%	4.1%	8.8%	9.8%
Over 12 years	(10.4%)	4.8%	9.5%	11.5%

* Composite Inflation-Linked Index

Source: Coronation

Figure 3

AVERAGE BANK CREDIT LOSS RATIO VS BANK FLOATING-RATE NOTE (FRN) SPREADS



Source: Coronation

Figure 4

10-YEAR SAGB VS 10-YEAR FLOATING RATE NOTE

	Spread	Implied yield	Fixed rate to maturity
10-year government bond	-	9.65%	9.65%
10-year floating credit	3mJ + 1.5%	4.86%	8.58%

Source: Coronation

fundamentals, we believe credit to be an unattractive allocation option within a bond or multi-asset fixed income fund.

BONDS IN YOUR PORTFOLIO

In summary, South Africa is on the brink of a debt trap due to years of poor policy choices that have been exacerbated by the effects of the Covid-19 crisis. At the heart of the country's problems lies a large debt load that is being financed at exceptionally high levels of interest and ailing SOEs, key among them Eskom.

Policy choices are moving in the right direction; however, the political will to implement appears sluggish.

However, the valuation of SAGBs does embed a significant amount of risk premium, commensurate with the underlying risk, if not more. This valuation is specifically attractive in the longer end of the bond curve due to high yields and low cash prices. ILBs in the front end of the curve (greater than seven years) offer an attractive pickup relative to their nominal counterparts with inherent inflation protection, while listed credit is unattractive given expensive valuations.

We believe bond portfolios should have a neutral to overweight position to SAGBs in the longer end of the curve, an allocation to ILBs in the short end of the curve and low (if any) allocation to listed credit. +

Note: All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. 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.

STRATEGY UPDATE

Coronation Global Emerging Markets Strategy

By **GAVIN JOUBERT** *and* **SUHAIL SULEMAN**

Gavin is Head of Global Emerging Markets and has 21 years of investment industry experience.

Suhail is a portfolio manager and has 18 years of investment industry experience.

THE CORONATION GLOBAL Emerging Markets Strategy returned 11.3% during the third quarter, 1.7% ahead of the 9.6% return of the benchmark MSCI Global Emerging Markets Total Return Index. With this outperformance, the Strategy has provided a return of 3.6% in 2020, 4.7% ahead of the -1.2% return of the benchmark. If one looks back at how markets performed in the first quarter of 2020 and the general panic that accompanied the worldwide spread of the coronavirus, it is quite pleasing to have both positive absolute returns this year and alpha. Of course, the longer-term returns remain the most important consideration. In this regard, the Strategy has outperformed over all meaningful time periods since inception in 2008; by 4.8% p.a. over five years, 3.5% p.a. over 10 years and 4.4% p.a. since inception just over 12 years ago.

NOTABLE CONTRIBUTORS TO OUTPERFORMANCE

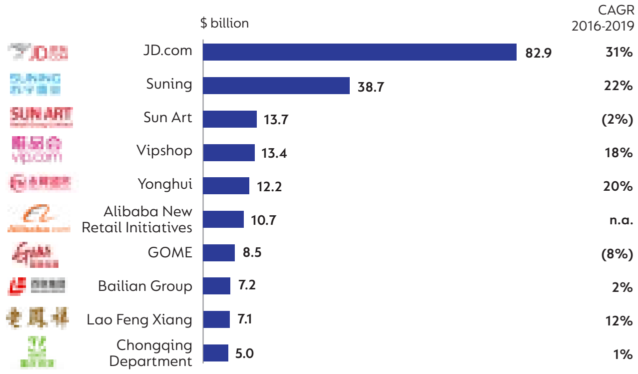
The largest contributor to outperformance in the quarter was Wuliangye Yibin. The Baijiu (local Chinese spirits) producer returned 34% in the period, providing 0.9% of alpha to the Strategy. Having clamped down hard and early – we have heard interesting first-hand accounts of the restrictions placed on daily life in China during its lockdown – China's economy has stabilised and returned towards normality faster than anticipated, and many Chinese shares have benefited from this.

The second-largest contributor was JD.com, up 29% to add 0.7% to alpha. JD.com can be thought of as the 'Amazon' of China; a large part of what it sells is its own inventory and deliveries use its own fulfilment infrastructure. China was already the country with the highest e-commerce penetration in the world prior to 2020; a combination of highly innovative e-commerce retailers that the mediocre pre-existing physical retailers struggled to compete with. The high level of adoption of digital payment methods further enables e-commerce. In spite of being already well established in the minds of the consumer, JD.com has benefited tremendously from the demand uplift that accompanied lockdowns.

We spoke about the 21% revenue growth in Q1-20 in our last commentary, but Q2-20 results (reported mid-August) were even better, with revenues up 34%, well above consensus of 27%. Even more impressive was the rise in operating profit, up 75% year on year, with margins rising to 2.8% from 2.1% in the same period last year. This led to a 50% increase in earnings per share. All this was driven by a 30% rise in active customers. Most importantly, this operating performance was accompanied by strong free cash flow generation.

Figure 1

NET REVENUE OF MAJOR RETAILERS IN CHINA, 2019



Sources: Goldman Sachs, company reports

Unsurprisingly, the share reacted very positively after the results announcement, moving from around $64 to as high as $83. JD.com was already the largest retailer in China heading into 2019 and this position of strength will be further enhanced by its operational performance in 2020.

Like several other US-listed Chinese companies, JD.com did a secondary listing in Hong Kong, raising $4 billion, and ended the quarter with $18 billion in cash, around 15% of market cap. The secondary listing was part of a wider move by prominent Chinese companies to reduce their exposure to US capital markets over fears that the US might unilate-rally impose onerous requirements on Chinese companies that they might not be able to meet, as the Chinese government is not fond of foreigners exercising regulatory oversight of Chinese-domiciled businesses.

JD.COM HAS BENEFITED TREMENDOUSLY FROM THE DEMAND UPLIFT THAT ACCOMPANIED LOCKDOWNS.

The list of companies that have done this now includes other Strategy holdings like Alibaba, NetEase and Yum China. This transfer of trading volume towards Hong Kong is part of the investment case for the Hong Kong Stock Exchange, which is a small position in the Strategy (0.5%).

Russian holding, Yandex, was the next-largest contributor. Up 30% in the quarter, it added 0.5% to alpha. Yandex has more than doubled from the low it reached in March (under $30) and we have trimmed the position as it has appreciated, having bought when it was under pressure in Q1-20.

The 2.1% position size that remains reflects the reasonable valuation and positive long-term outlook for Yandex, which has evolved beyond search to be a meaningful player in many other sectors such as ridesharing and e-commerce. More recently, Yandex has bid to acquire TCS, Russia's largest digital bank. The last two of the top five contributors to alpha were the underweight in Tencent, which lagged the market by being up only 3% in the quarter (0.4% alpha), and Brazilian digital payments solution provider StoneCo, up 37% for a 0.3% contribution to alpha.

QUARTERLY DETRACTORS

The biggest detractor was the underweight in Taiwan Semiconductor Manufacturing Company (TSMC), the third-largest stock in the index. TSMC was up 42% in the quarter and the underweight cost the Strategy 0.7%. We are very positive on the company but feel that a 3% position is more appropriate, given its risk-adjusted expected return and internal rate of return relative to the rest of the investment universe. TSMC reported excellent results for the first half of 2020 (net income up close to 90% versus last year). There have also been continued stumbles by one of its main competitors, Intel, which announced that it is at least a year behind schedule in manufacturing the next generation of 7nm chips. This means that TSMC's competitive positioning is probably the strongest it has ever been.

The Mexican holding company FEMSA (2.6% of Strategy) fell 8% in the quarter and cost 0.5% of alpha. Mexico continues to struggle in dealing with Covid-19 and most of FEMSA's main assets were negatively affected. The largest contributor to FEMSA, the convenience store chain Oxxo, which is about half of our sum-of-the-parts valuation, saw its operations hampered by lockdowns and bans on the sale of alcohol (a large contributor to sales). FEMSA's 15% stake in global brewer Heineken, which makes up roughly 25% of the company's valuation, was also hurt by the 8% decline in the share price of Heineken. Heineken has been under pressure as the index is weighted disproportion-ately toward premium beers, which tend to be sold on-premise (where margins are higher) rather than in supermarkets (lower margin). With global curbs on socialising, Heineken has seen volumes fall 12% in the first half of 2020.

Other material detractors were the underweight in Alibaba (up 36%; the +/-2% underweight position cost the Strategy 0.5%) and the combined exposure to Naspers and Prosus, which were slightly down in the quarter and cost the Strategy a combined 0.9%.

NEW BUYS IN THE PERIOD

There were three new buys in the quarter – Samsung Electronics, BGF Retail and PagSeguro. Samsung needs no introduction, as the Strategy has owned it at various points in the past, but developments in the chip and memory industries, which are increa-singly consolidated and with returns accruing to the top players disproportionately over time, led us to repurchase it into the Strategy.

Unlike TSMC, Samsung's share price remains below where it was before the Covid-19-induced market selloff that started in February. Despite a 40% recovery from the lows reached in March, Samsung still trades on less than 12 times forecasted earnings for the 2021 fiscal year, with a 3% dividend yield and close to a third of its market cap in cash. By quarter-end, Samsung was 2.2% of the Strategy.

BGF Retail is a South Korean convenience retailer and was bought into the Strategy (0.4% position) for the first time. BGF operates in the convenience value service segment, which is attractive in a country like South Korea where there is a very high degree of urbanisation, high population density and small household size.

The segment has doubled market share over the last decade to 7%, but this is still below that of regional peers with similar demographics and drivers like Taiwan and Japan. With challenged formats like department stores, hypermarkets and specialty stores still making up over 50% of retail sales in the country, there is still reasonable market share up for grabs. BGF trades on 14 times forward earnings, has a net cash balance and consistently generates returns on equity in excess of 20%.

The last new buy was PagSeguro, a Brazilian financial services company catering primarily to small merchants in that country. Small merchants make up the long tail of customers in Brazil, and have traditionally been averse to accepting card payments due to the high fees charged by the other acquirers and banks for this facility. PagSeguro already has 5.5 million active merchants using its payment functionality and 3.7 million using its fully digital bank accounts.

Like StoneCo, a Strategy holding we wrote about in the March quarter, PagSeguro is looking to take market share away from the incumbent acquirers and banks in Brazil as they earn outsized returns for the value they provide to customers. It is estimated that only 30% of micro-merchants currently accept cards. Brazil, like other countries, is increasingly adopting non-cash methods of payment, and PagSeguro is expected to continue to grow its 7% market share in the card acquiring industry (by value). Together with the 1.2% position in StoneCo, which benefits from similar market share gain potential, the Strategy now has +/-2% invested in the Brazilian payment providers covering the small- and medium-sized merchant segments.

STOCK POSITIONS EXITED

The Strategy sold both South African food retailers Shoprite and Spar during the quarter. These were small positions (combined 0.8%) and we felt the opportunities were better elsewhere, such as the new buys above. The most notable sale was that of 58.com, which we had held in the Strategy since late 2016 and was a top 10 stock in the Strategy for some time. 58.com was bought out by a private equity firm, which added the founder to the buyout consortium after its initial bid to secure the support of his high voting shares. We believe the buyout price significantly undervalued the business and was very opportunistic – the share had traded 25% higher than the proposed price as recently as January this year – and we lobbied the board to prevent the founder from exercising his voting rights due to the inherent conflict this represented (as he was both buyer and seller). These actions were not successful and only a nominal increase in the offer price was requested by the board; as a result, we sold the remaining exposure as the share price converged to the new buyout price. ✚

THE MOST NOTABLE SALE WAS THAT OF 58.COM, WHICH WE HAD HELD IN THE STRATEGY SINCE LATE 2016.

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STRATEGY UPDATE

Coronation Active Global Equity Strategy

By **NEIL PADOA**

Neil is Head of Global Developed Markets and has 12 years of investment experience.

AFTER A STRONG rebound in the second quarter of the calendar year (Q2-20), equity markets continued their gains, returning 8.1% in the third quarter of 2020 (Q3-30). Returns were broad based, with developed markets as a whole returning just under 8% and emerging markets continuing a recent run of outperformance, returning 9.6%. The US continues to outperform other developed regions, with a return of 9.4%, handily ahead of Europe's 4.5%. Most other asset classes also delivered a positive result.

The Fund returned 6.5% for Q3-20, approximately 1.6% behind the benchmark return of 8.1%. Over one year, the Fund has outperformed by 174 basis points (bps), and by 124bps over five years.

COVID-19 UNDERSCORES NEED FOR SERVICE EXCELLENCE

Salesforce was a top-three contributor to Fund returns over the final quarter of the financial year, with the share price climbing 26% in one day following the release of better-than-expected results. Organic revenue growth of 19% on a year-over-year basis in a quarter heavily impacted by Covid-19 is an excellent result and highlights the strong positioning of the company and demand for its software solutions. Salesforce is the global leader in customer relationship management software and has moved into adjacent areas, including the broader digitisation of customer-facing activities, such as marketing, e-commerce, data management and business intelligence.

While these trends were strong before Covid-19, the consequences of the virus have reinforced the need for businesses to invest in revenue-generating activities, to know their customers better and to be able to reach them online. Salesforce offers the tools to do this. The company sees a large opportunity ahead and continues to invest aggressively in adding staff at a time when many companies are laying people off. Salesforce is a well-managed, high-quality and fast-growing compounder with strong environmental, social and governance credentials, and we remain bullish on its outlook.

Bayer was a detractor over the final quarter of the financial year. We think the stock is materially undervalued at a seven times price-to-earnings ratio. This is due to continued uncertainty regarding the resolution of the Roundup litigation and regulatory uncertainty around its Xtend platform at a time when end-markets (principally corn, due to lower bioethanol demand)

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are temporarily depressed. Longer term, Bayer remains the leading crop science franchise, with significant opportunity to improve profitability from merger synergies, new products in the pipeline (e.g. short-stature corn) and scaling its digital agriculture initiative. While recent results have been disappointing, the range of potential outcomes remains tilted to the upside.

FUNDAMENTAL ANALYSIS REMAINS KEY

Earlier this year, we felt that there were attractive opportunities for those investors with a long time horizon and the ability to filter companies whose prices had been dislocated with little impact to their sustainable earnings power. After a sharp rally, these opportunities are now harder to find.

In addition, the need to reassess the prospects of many businesses continues as investors parse fundamental virus-induced behavioural changes from short-term noise. Fundamental changes, however, play to the strengths of fundamental investors, and we continue to find a select number of stocks with solid, long-term prospects that are reasonably priced.

Thank you for your continued support and interest in the Fund. ✚

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STRATEGY UPDATE

Coronation Global Managed Strategy

By **NEVILLE CHESTER** *and* **NICHOLAS STEIN**

Neville is a senior portfolio manager with 23 years of investment experience.

Nicholas Stein is an equity analyst with 11 years' investment experience.

THE PORTFOLIO HAD a solid quarter, delivering a positive return, benefiting from a significant number of tactical asset allocation moves during the year. Given the extreme moves in many asset classes and currencies, there have been significant opportunities for adding value as markets recovered from the lockdown-driven collapses around the world. The flooding of developed markets by central bank monetary easing and enormous fiscal stimulus programmes is still having an enormous impact on capital markets. In this environment, one has to be wary of getting caught up in short-term price moves when the underlying economic conditions remain treacherous.

We have trimmed the global equity position and re-established some put protection around the US election period, given high market levels and extreme uncertainty around the potential outcome. In contrast to global markets, the South African equity market looks extremely cheap. While we have successfully avoided owning a lot of South Africa-specific shares that have performed poorly, their valuations are now such that we cannot ignore the compelling investment opportunities. Also, the results that we have seen so far appear to indicate that operating performance has not been as poor as we expected. However, we are cautious about reading too much into current results as the economic damage from the harsh government lockdown will be felt for many years to come.

The global shares that are listed on the JSE are also generally still cheap, making the decision to own more JSE-listed shares an easy one. Of course, the path to achieving these returns will be bumpy, and any global selloff will still impact on the local bourse, even if our shares are not as richly rated as the developed market bourses. However, as long-term investors, the ability to own businesses on earnings yields in excess of 10% when short-term interest rates are below 4% makes compelling sense in the long term.

EMERGING MARKETS AND COMMODITIES ATTRACTIVE

In our global equity allocation, we have trimmed the developed market exposure but still maintain a large exposure to emerging markets. The rampant printing of US dollars, a disruptive and divisive election, and general mismanagement of the Covid-19 crisis do not bode well for the strength of the US dollar. After a decade of dollar strength, we expect a significant period of dollar weakness, as the US Federal Reserve Board follows a policy of maintaining negative real interest rates and, >

specifically, targeting inflation to be sustainably above 2% before contemplating hiking interest rates. This bodes well for emerging markets and commodities. Given this view, we have increased the weighting to commodities within the Portfolio, and own gold, platinum and copper. Gold should continue to benefit from flows related to dollar weakness, whereas platinum and copper stand to benefit from looming deficits, as supply has been impacted by better supply discipline and growing industrial demand.

FIXED INCOME EXPOSURE

Our fixed income exposure has remained focused on South African government bonds, where yields have remained stubbornly high despite virtually no yield elsewhere in global markets. Such is the lack of demand for domestic government bonds that even corporate credits are now trading below that of the sovereign. There is a greater expectation that a South African corporate will repay its debt than the State will.

While this is always a probability, given the fact that the majority of South African debt is denominated in rands and not dollars, there is, in our view, a very low probability of an actual default under the current government. Finance Minister Tito Mboweni has made himself very unpopular by pushing back hard against the fiscal profligacy that marked the prior decade under former President Jacob Zuma and is certainly proposing cost cutting – never before spoken about by an ANC Finance Minister.

With real yields in excess of 6% for longer-dated government bonds, any potential negatives are mostly accounted for, and any positive news can see the opportunity for meaningful capital gains. Global bonds continue to look incredibly expensive and guarantee the holders negative real returns for the foreseeable future.

Property is a difficult asset class in the current environment. Virtually all properties outside of logistics have been negatively impacted by lockdowns, with retail properties the worst affected, followed closely by office properties. It is difficult to see exactly how the world will return to normal and what this means for rental tensions in a market where undoubtedly demand for space will have reduced. While prices optically show great value, balance sheet strength is the only game in town, and we are being cautious to ensure that any exposure we have is to those companies with robust balance sheets that are able to resist significant declines in property values.

TO CONCLUDE

Looking ahead, we are still very excited about the potential return opportunities from the various asset class building blocks. Yields from just holding the existing assets should enable double-digit returns for the foreseeable future, with the potential for capital gains on top of that. While there is always risk in markets, the return potential is such that we have significantly increased the risk asset exposures in the Portfolio to take advantage of this mispricing. ✚

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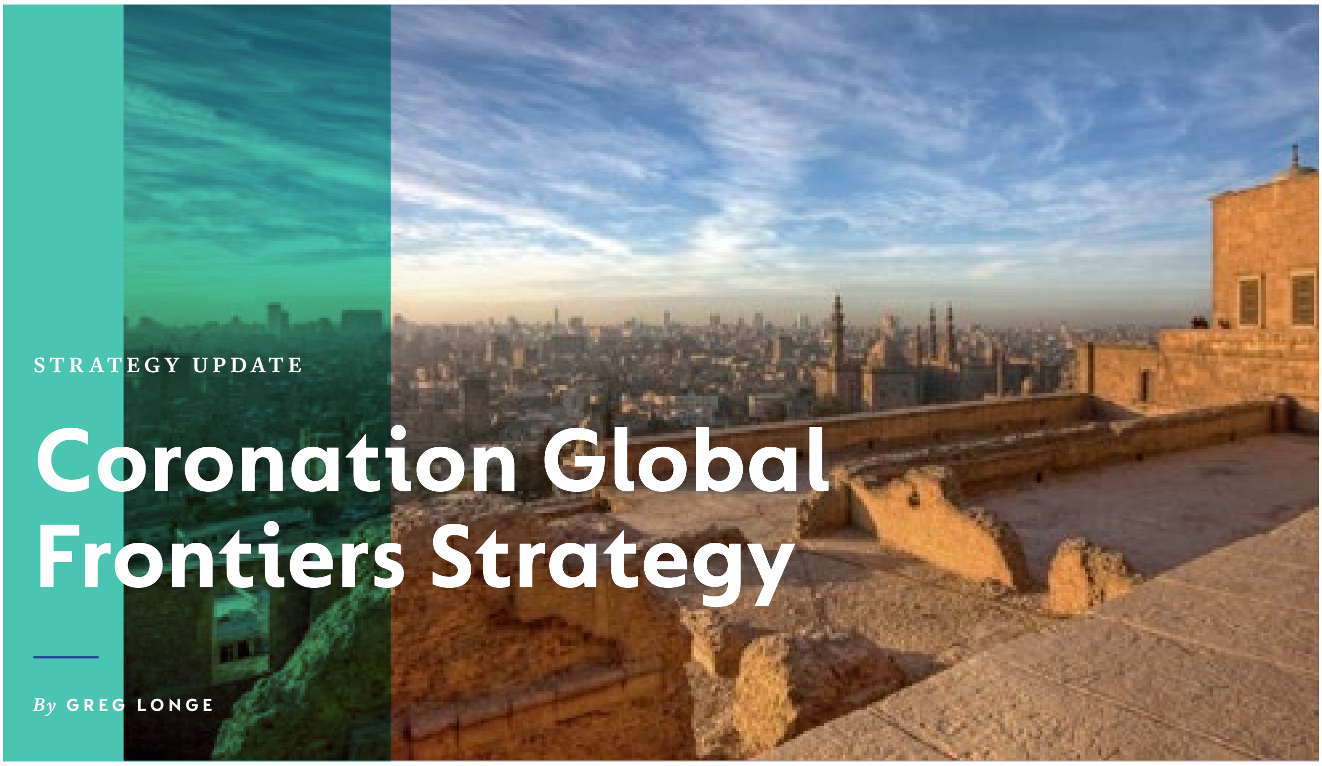

STRATEGY UPDATE

Coronation Global Frontiers Strategy

By GREG LONGE

Greg is a frontier markets investment analyst with seven years of investment experience.

THE THIRD QUARTER of the year (Q3-20) saw the Strategy up 4.9%, as the recovery off the March lows continued. Year to date, the Strategy has returned -11.2%, with the MSCI Frontier Markets Index down 8.8%. As a reminder, the Strategy performance numbers include the write-down of the in-country Zimbabwean (currently 61 basis points [bps] of Strategy) and Nigerian (159bps of Strategy) assets, as currency challenges persist in both markets. The index continues to use the official exchange rates. While the Strategy sold off significantly less than the market in the first quarter of the year, it has lagged the recovery seen in the second quarter of the year and in Q3-20.

Since inception, the Strategy has returned 0.5% p.a. against the index, which is flat. This is certainly well below our long-term, through-the-cycle expectations for the Strategy and reveals just how tough a period the last three years have been for these markets. Unlike developed markets, which have largely recovered back to 2019 levels and seem to go from strength to strength, propelled by free money provided by the large central banks of the world, many frontier markets trade at multi-year lows.

Over the past three years, not a single African market has shown a positive US dollar return, while across Global Frontiers, 10 of the 17 markets we follow are negative. Of the seven that are positive, only Ukraine (which has recovered from the Russian 'annexation' lows) has generated a good return of 17.1% p.a. The somewhat dubiously classified 'frontiers' trio of Qatar (+5.9% p.a.), Kuwait (+4.7%) and Saudi Arabia (+4.4%) are the next-best performers over this period.

QUARTERLY MOVES

For the quarter, the performance of the most significant markets for the Strategy was generally strong, with Bangladesh (+24.4%), Pakistan (+19.0%), Vietnam (+9.8%) and Egypt (+4.7%) all positive, and Kenya (-0.7%) largely flat.

The largest contributor to the Strategy's performance for the period was Dragon Capital, the largest position in the Strategy, which added 1.9% over the quarter. The next two largest contributors were Bangladesh's Beximco Pharmaceuticals (+1.0%) and VNV Global, an investment company focused on businesses with network effects (+0.7%).

The largest detractors were Tanzania Cigarette Company, which detracted 0.5% as a large block went through at well below market prices, and QNB Al Ahli (-0.3%).

During the quarter, the major buys were gold (via a miner and the metal), Vietnam (a basket of stocks) and Eastern Tobacco.

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We sold out of VNV Global due to valuation concerns, trimmed Turkey on concerns around a devaluation of the lira and finally exited our holdings in Argentina.

PANDEMIC EMPHASISES NEED FOR DEEP ANALYSIS

Having recently met over 40 corporates (virtually) at a conference, one of the standout themes has been how the local impacts of the global pandemic have differed so vastly across countries, sectors and even companies. We mentioned in the last commentary how Vietnam has emerged as one of the very best countries globally at containing the spread of the virus. This remains true.

A slightly different example this quarter is a comment from an Egyptian banking CEO who mentioned that 2020 isn't even in the top three most challenging years of the past decade. He considered 2011 (Arab Spring), 2016 (forex shortages) and 2017 (large currency devaluation) as far tougher operating environments than 2020. I doubt many US, European or even South African corporates feel the same. Understanding these nuances is an essential part of our investment philosophy.

Deep-dive, bottom-up fundamental research is key to understanding the impact of the pandemic on each country and each corporate in the Strategy. Only by performing the detailed work can we confidently identify those corporates best positioned to sustainably grow earnings through the cycle and buy them when valuations are compelling. Over time, this strategy should bear fruit for the long-term investor.

Thank you for your continued support. ✚

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