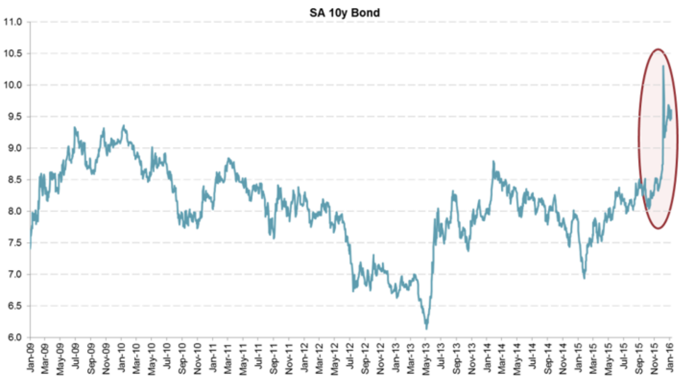
FIXED INTEREST REVIEW

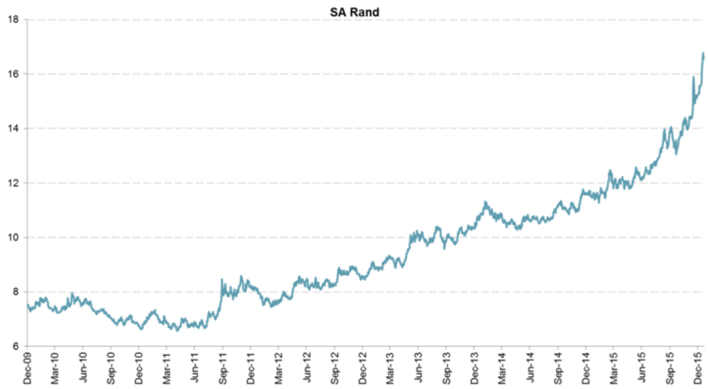
2015 was a pivotal year for the SA economy, with key developments affecting the bond and credit markets:

1. Loss of confidence among foreign investors

The damage caused by the replacement of finance minister Nhlanhla Nene in December 2015 should not be underestimated. Long-term bond yields blew out to 10.5% (from 8.5%) following the announcement. The move represented a huge vote of no confidence by the bond market and could add massively to South Africa's interest bill over the next three years. The loss of credibility due to political interventions at National Treasury and the outflow of foreign money contributed to further sharp losses in the rand.

Market shock





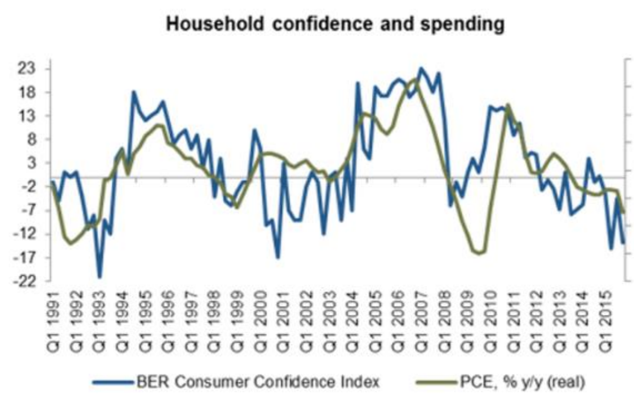
Source: Bloomberg

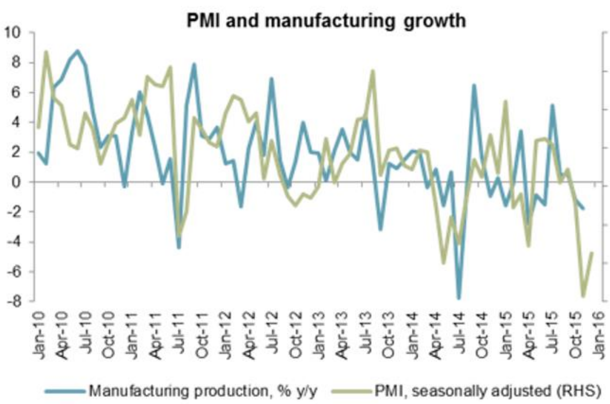
According to all measures, the rand is now substantially undervalued after considerably underperforming its emerging market peers over the past five years. The pressure on the currency has receded slightly - however, there is sufficient justification for the rand to remain at the current depressed levels. Conversely, there are also enough reasons to expect a consolidation to a level of R14 to R14.50/dollar over the next two to three quarters.

2. Disappointing domestic growth outlook

GDP growth is expected to be less than one percent this year, with traditional drivers under pressure. The consumer remains constrained and further taxation will only tighten purse strings. Fixed investment is falling, and until business and consumer confidence recovers, no meaningful investment can be expected. Manufacturing data suggest further downside. Lower growth means lower tax revenue, ruling out increased state spending to bolster the economy.

Weak fundamentals

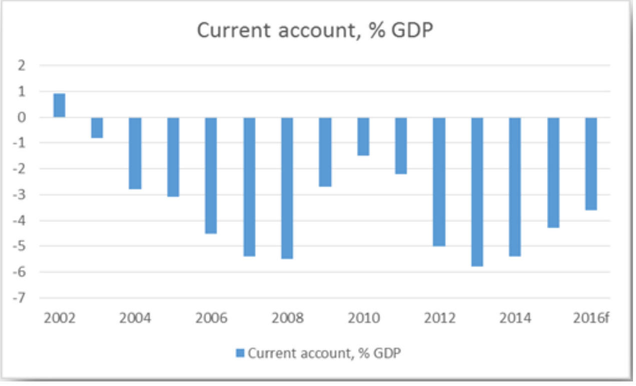




Sources: Statistics SA, Bureau for Economic Research, SA Reserve Bank

However, the currency slump and more competitive prices suggest we may finally see a recovery in exports, which have been a recent detractor from growth. A significant improvement in exports may help provide a sufficient cushion against an economic recession. The falling oil price has improved terms of trade and imports should moderate in the weak economy; a narrowing in the current account deficit to 3% of GDP is therefore likely.

Improved terms of trade may assist current account

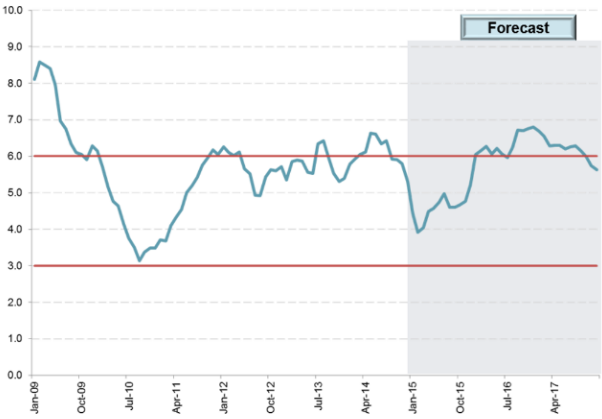


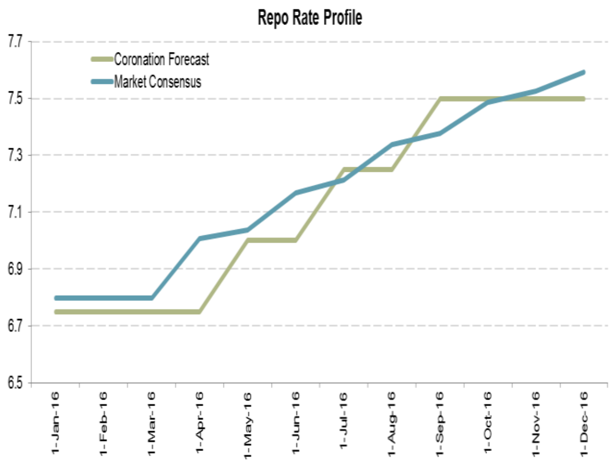
3. The inflation outlook has deteriorated

Inflation is expected to remain outside the SA Reserve Bank's (SARB) target band for the next two years, compelling the monetary authorities to raise interest rates. There remains considerable upward pressure on inflation. Apart from the depreciation of the rand, the impact of negative base effects, higher food prices due to drought (maize prices doubled in 2015 and sustained culling will lead to meat shortages), increases in electricity prices and other administrated prices (including an expected sharp hike in water tariffs) each pose upside risks.

Combined with the weak domestic economy, these pressures are creating a stagflationary environment, leaving the SARB in an extremely difficult position. We believe the rate hike of 50 bps in January was in part an effort to restore institutional credibility in the domestic context (given the events in December), as well as due to the deteriorating inflation outlook. The SARB has revised its inflation outlook significantly, incorporating a lot of bad news into its inflation forecast. Future rate hikes will probably be by 25 bps each, taking the repo rate to 7.5% by the end of the year. A real rate of 1% will continue to be accommodative relative to SA's history.

Inflation and interest rate outlook



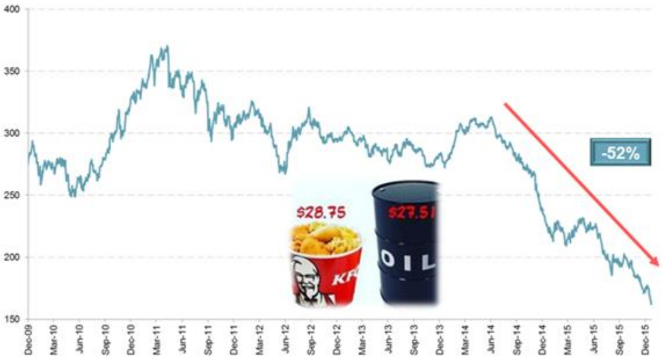


Source: Coronation

4. Commodity slump

A sharp decline in commodities is contributing to pressure on SA and other emerging markets. Oil prices have declined after the lifting of sanctions against Iran and a slowdown in China, which the market is seeing as a complete 'wheels-off' event. We believe this is overdone, and that China should experience a soft landing. While it is difficult to call a bottom to the commodities slump, we expect a turning point may be near.

Commodity index



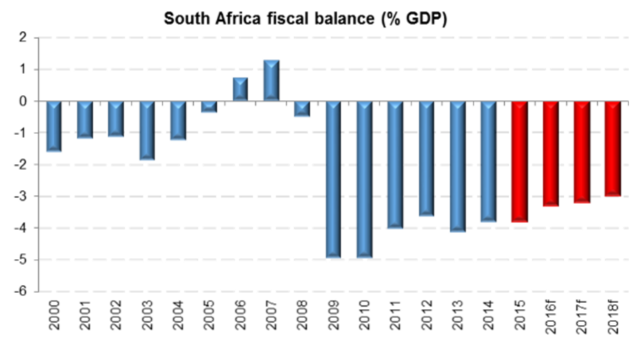
Source: Bloomberg

5. Increased focus on local differentials

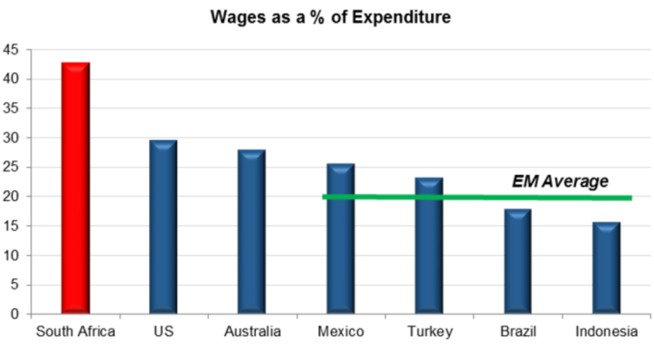
The market's reaction to the long-telegraphed increase in US interest rates has been very benign. Over the past four to five years, movements in the US 10-year bond yield accounted for 70% to 80% of global bond yield trends. However, in the last 18 to 24 months, investors started focusing more on local market differentials. This scrutiny is not positive for SA. A lack of fiscal discipline and political uncertainty have contributed to the country differentiating itself from its peers in all the wrong ways. A downgrade to sub-investment grade has already been priced into the SA bond market. This is probably valid for now. However, SA can still be saved from a downgrade.

Government expenditure will have to be reviewed. More than 80% of spending cannot be touched as it is allocated to social spending and wages. The latter poses a major problem for SA, which spends eight times more on state wages than on infrastructure, with 45% of the budget allocated to wages – far more than other countries. The best course of action would be suspending government hiring and capping higher wages. A combination of the revenue- and spending-side interventions may give SA a stay of execution from moving to sub-investment grade in June 2016. (*Note: This was to some extent addressed in the mild tax increases and a partial hiring freeze announced in the 2016 Budget, which was presented after this presentation.)*

SA's fiscal predicament



Source: National Treasury, Coronation



Source: Haver

A large risk to the domestic bond market would be SA's exclusion from the Citi World Government Bond Index. This would be triggered by a downgrade (by at least two rating agencies) of both our foreign currency and domestic currency debt to sub-investment rating.

SA's rating outlook

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

The biggest threat of a downgrade is on the foreign currency side, but we have sufficient margin of safety on the local currency ratings.

Factoring in a number of variables (including the rand/dollar exchange rate, the US 10-year bond yield, one-year market rate expectations and emerging market bond spreads), SA bonds look cheap from a valuation perspective. However, domestic risk and inflation premiums have been adjusted higher and the latest spike in yields reflects factors (including political and fiscal developments) external to the valuation model. Local bonds are reflecting this change in risk premium - only once the hard decisions have been made, will valuation trump fundamentals.

Given the market's very bearish outlook on future inflation, inflation-linked bonds (ILBs) have grown expensive relative to nominal bonds. The markets expect inflation to average above 7.5% for the next 10 to 15 years, and above 8% further out. (Inflation has not averaged above 6% in these tenors since the beginning of inflation targeting.) As the SARB has recently shown vigilance, with real yields rising, inflation-linked bonds are looking expensive.

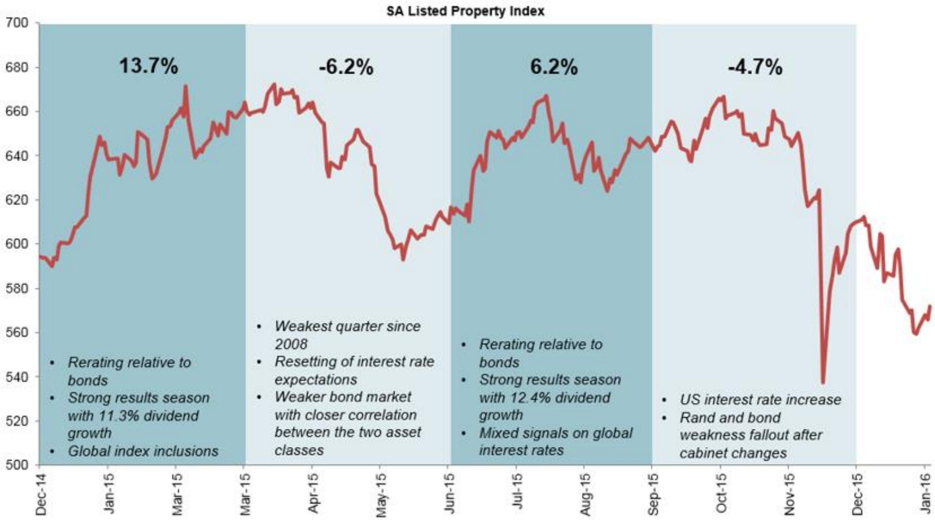
Credit spreads have been widening since the curatorship of African Bank in late 2014, and continued to grow larger due to regulatory developments and increased issuance in the banking sector. A deterioration in macroeconomic fundamentals will continue to push credit spreads even wider. We are avoiding credit issues that are adversely geared to further commodity and economic depreciation. Recent corporate issuances show that pressure in the credit market is increasing. Also, the jury is still out on how some of the state-owned enterprises are going to finance themselves this year. The Eskom 2023 dollar spreads, which until recently averaged around 300 to 400 basis points, spiked up to 700 basis points recently. This funding avenue seems too expensive and is now closed to these organisations.

Preference shares continue to look attractive amid rising interest rates and increased pressure on banks to buy back these assets. As for cash, floating rate bank assets look more appealing.

LISTED PROPERTY

2015 was a volatile year in the listed property sector with four quarters of distinct return profiles. (Most of the sector's positive returns came through in the first quarter.) Returns were driven by either strong dividend growth, index inclusions or bond market moves.

What happened in 2015?

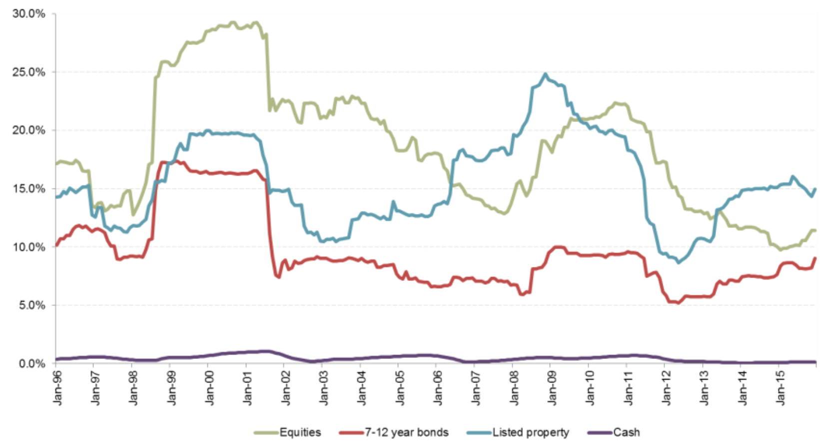


Sources: INet, Coronation

The year was also characterised by an increased appetite for offshore exposure: Of the nine new listings in the sector, five were inward offshore listings (companies with offshore portfolios that were listed in SA). Corporate action also featured strongly, with Redefine finally taking over Fountainhead; Growthpoint securing Acucap and Sycom; and Fortress acquiring Capital Property Fund.

The most important development in 2015 was listed property's progress in establishing itself as a mainstream investment. The FTSE/JSE Top 40 Index now includes six property companies, with the prospect of another two inclusions this year. However, the asset class has also seen much greater volatility, with its returns more unstable than those of equities.

Property returns grow more volatile

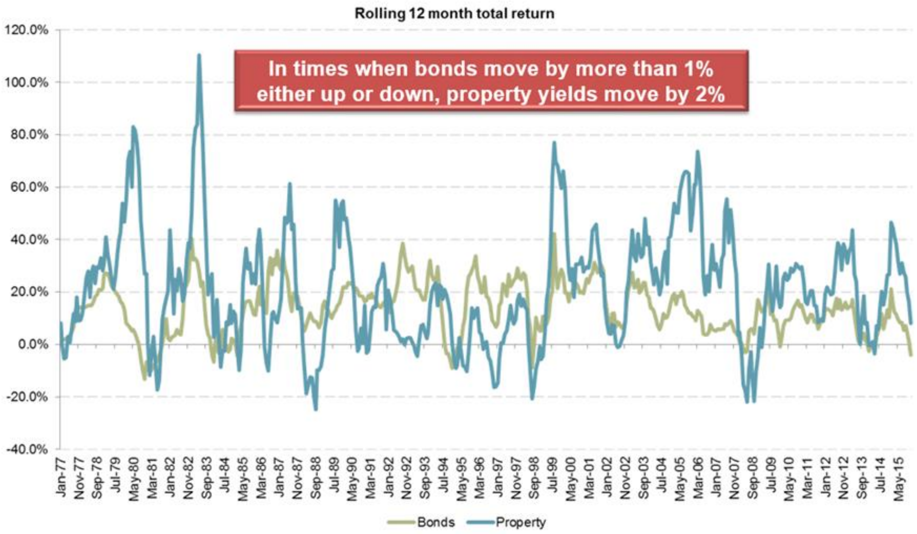


Source: INet

EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

The prospects of listed property in 2016 will be influenced in large part by the bond market; there is a 68% correlation between the property and bond market. However, property is much more volatile: When bond yields move up or down by 1%, listed property yields move by 2%. Given the uncertainty surrounding SA's investment grade rating, volatility in the bond market (and listed property) should persist for the next 6 to 12 months.

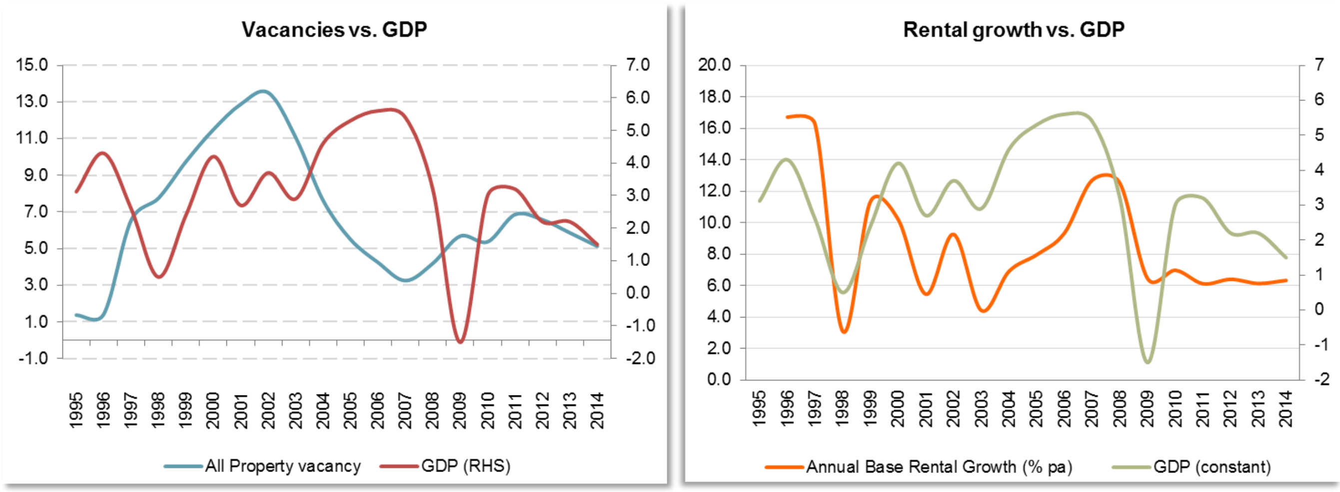
Strong correlation between listed property and bonds



Source: INet

The weaker macro environment is also bound to start impacting fundamentals, although the effect varies across different sectors. Over the past four to five years, the office sector has stood its ground amid a slower economic environment and vacancies have been stable.

Vacancies and rental growth



The office property sector is usually the most negatively impacted by an economic downturn, but current vacancies are defying the pressure. Some 6% of office stock is currently being developed (40% of which is in Sandton), which is high in historical terms. Office rentals are still seeing positive growth.

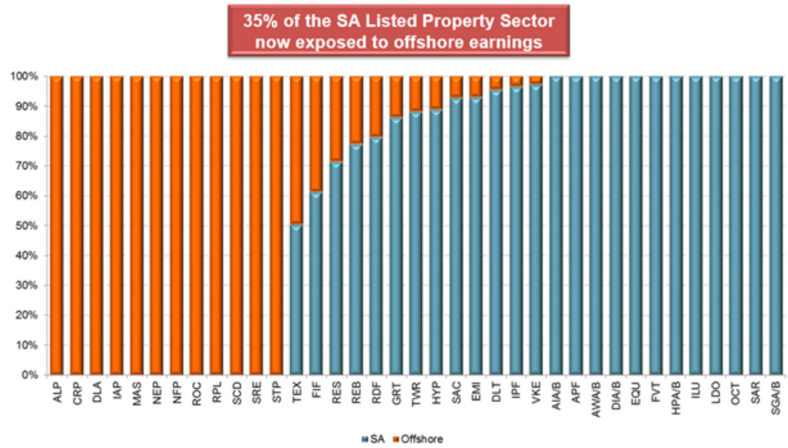
Retail is usually more defensive, but may see headwinds as tenants face business failures. Overdevelopment remains a factor and retail property's performance will vary across income levels and centre size. Industrial vacancies are holding up, but rent levels are capped.

As a geared asset, property will be impacted by rising interest rates. However, 75% of the current debt in the sector is hedged for two to four years. Consequently, the negative impact of rising interest rates on their income statements will be muted over the two to four years. Given the sharp rise in the cost of funding (debt and equity), pursuing external avenues of growth in South Africa is becoming more challenging. Property companies will have to focus on internal portfolios and creating value from existing assets.

While the local conditions could start impacting corporate SA, resulting in much higher vacancies and lower dividend growth, the 35% offshore exposure within the listed property sector should provide a buffer against this weaker domestic environment.

Listed property is down 3% for the year to date. We believe current levels offer an attractive entry point over the medium to longer term, potentially presenting investors with double-digit returns over the next three to five years. We continue to believe that positive dividend growth (above inflation) despite the weaker economic environment remains possible, with expectations of 7% - 9% per annum for the next 36 to 48 months. We believe investors should focus on the income offered by listed property, and that capital returns should be viewed as a bonus.

Listed property's offshore exposure



Source: Company data

A preferred holding is Growthpoint, South Africa's largest listed property company which has a well-diversified portfolio. Due to its size, the company has access to better quality properties and a substantial development pipeline. It has attractive offshore exposure via its majority shareholding in Growthpoint Australia, and recently established a joint venture with Investec and the International Finance Corporation for projects in Sub-Saharan Africa.

CORONATION STRATEGIC INCOME FUND

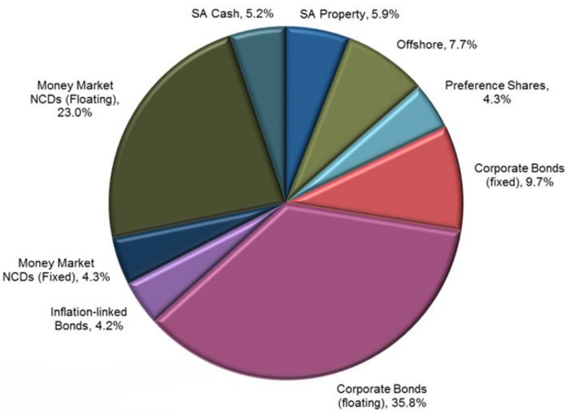
Strategic Income is a balanced fixed income fund that can invest across the full range of income-generating asset classes including money market instruments such as negotiable certificates of deposit as well as government, parastatal, corporate nominal and inflation-linked bonds, listed property, offshore bonds and preference shares.

We seek to enhance yield as rates decline and aim to protect capital in a rising interest rate environment. The fund's 25% risk budget is made up of a maximum of 10% in listed property and 15% in "other" assets (sum of preference shares [max 10%] and offshore bonds/cash [max 10%]), due to the volatility of those asset classes. The fund has a flexible mandate with no duration or term restrictions and an objective of achieving capital growth and a competitive annual yield.

Strategic Income continued to see a positive performance in December thanks to its offshore component, which provided a buffer amid large sell-offs. 2015 was a tough year to deliver returns, but the fund performed in line with our benchmark (110% of cash). Over the long term, the fund aims to deliver cash plus 2% and has achieved this goal over its 15-year track record. However, over shorter periods, the fund may deliver cash times two (in a bull market), while struggling to beat cash after fees (in depressed conditions).

The fund yield is currently at 8.98%. We are maintaining our conservative stance in the portfolio. After the medium-term budget speech last year, duration was reduced significantly through the selling of government bond futures. Following the sharp selloff in December, we bought back these futures, increasing duration. Also following the selloff, we have locked in some of our foreign exchange gains. The fund's offshore exposure has been reduced from 7.7% recently, to just more than 5% currently. Other recent portfolio actions included selectively adding corporate exposure (Standard Bank, FirstRand, Nedbank, MMI and Old Mutual) and increasing property exposure.

Coronation Strategic Income Fund asset allocation
As at 31 December 2015



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