EXECUTIVE SUMMARY
CONVERSATIONS WITH CORONATION

MARCH 2014

2013 – AN EXTREMELY DIFFICULT YEAR FOR FIXED INTEREST ASSETS

While 2013 started off on an euphoric note – bond yields rallied to all-time lows; inflation expectations were significantly reduced, suggesting that the tide of easy money was here to stay for many years to come; and emerging market bonds appeared to offer exceptionally good value – it turned out to be an extremely difficult year for fixed interest assets, especially those in emerging markets.

As is clear from the table below, most domestic fixed interest asset classes (except listed property) underperformed cash by quite a large margin over the year. This was primarily due to the selloff in many emerging market assets and currencies, which also caused great damage to the rand.

Instrument	Return
Cash (Stefi)	5.32%
All Bond Index	0.60%
All Bond Index (1-3y)	4.40%
Barclays Govt Inflation Linked Index	0.75%
Preference Shares	4.57%
Listed Property (J253)	8.39%
USD/ZAR	-17.28%

One of the key drivers of valuations in emerging markets (specifically fixed interest assets) during 2013 was the US Federal Reserve's (Fed) decision to start reducing its large-scale asset purchase programme. Following the Fed's first hint at tapering in May last year, US 10-year bond yields rallied from 1.5% to 3%. This doubling in yield resulted in a re-pricing of emerging market bond and interest-bearing instruments, with investors questioning the value these markets offered.

South African government bonds soldoff aggressively as foreign investors first went on a buyers' strike and then became net sellers of our debt towards the end of 2013. South Africa suffered the steepest currency depreciation (almost 25% against the US dollar) among the grouping of emerging market countries with the worst underlying economic fundamentals (termed the "Fragile Five"). This brought the currency depreciation to 40% over the past 2.5 years as the country's struggle with gaping current account and fiscal deficits intensified.

As a result, the combination of a weaker currency and selloff drove external valuations of local bonds closer to our view of fair value (see chart below).

SA bonds at more attractive levels

Source: Bloomberg

OUR VIEWS ON FIXED INTEREST FOR 2014

Despite a tough 2013 and turbulent start to 2014, we are more optimistic about the prospects for emerging markets and emerging market fixed interest assets in the year ahead. This is premised on our view that the emerging market selloff has removed a layer of uncertainty and volatility from asset prices, particularly local government bonds and the rand, which now reflect what we believe to be fair value.

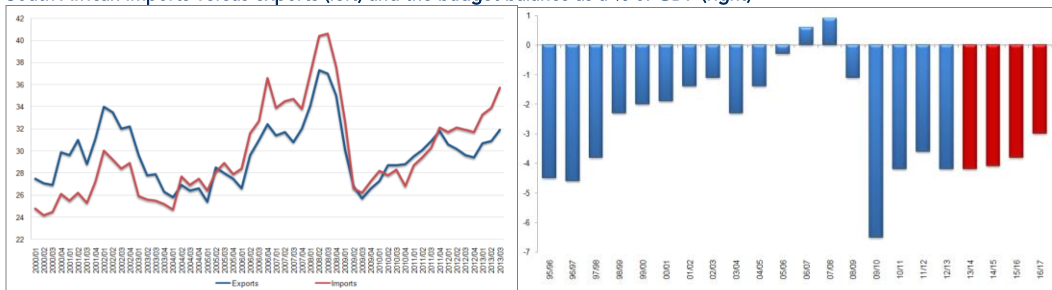
A summary of the key points supporting our optimistic outlook include:

- The depreciation in the rand and start of the interest rate hiking cycle will help reduce the current account deficit, although progress during the first half of this year will remain slow.
- Government has recognised the need to curb spending, which should help the fiscus to consolidate.
- There has been a sharp upward adjustment in interest rate and inflation expectations. Food inflation is the major risk to our outlook for inflation, however, we believe the market is too pessimistic on the repo rate and that interest rate expectations are overdone.
- A large part of the adjustment in the local fixed interest market has already occurred as a result of the capital flows out of emerging market bond funds, leaving valuations at much more attractive levels.
- Overall, we believe the level of the rand weakness has been overdone and that the currency now reflects too much negativity both from a macroeconomic and socioeconomic perspective. We believe an appreciation of the rand in the near term is more likely.

Let's discuss some of the domestic and external factors that support the aforementioned views in more detail:

Twin deficit recovery: Our analysis indicates that the country's twin deficit predicament will slowly start to diminish. The weak rand should start to translate into decreasing import volumes and increasing exports, resulting in a recovery of the current account deficit. In turn, government's willingness to curb overspending should help the fiscus consolidate. One of the major drivers of the fiscal deficit has been government's wage bill. While salary increases between 2009 and 2012 averaged 8.3% (well ahead of inflation during that period), government now projects that this will come down to 1.3% by the end of 2016/2017. We don't believe this is realistic, but we are encouraged by the sentiment and actions of government to help realise a consolidation of the fiscus.

South African imports versus exports (left) and the budget balance as a % of GDP (right)

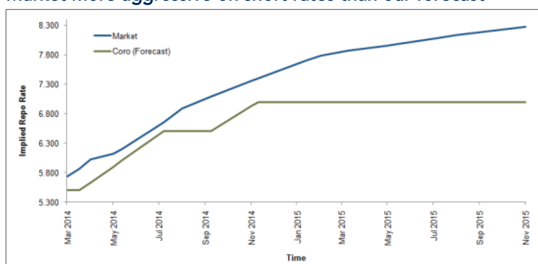


Sources: South African Reserve Bank (left-hand chart) and National Treasury (right-hand chart)

Expectations for short rates are too pessimistic: The South African Reserve Bank's (SARB) surprise interest rate hike of 50bps in January triggered a sharp correction, with the market now pricing in at least five more interest rate hikes of 50bps each before the end of this year. We believe this to be an overreaction as the main reason behind the SARB's decision to hike rates, in our opinion, was to protect the currency. The bank seems particularly concerned that the currency weakness will feed through to inflation.

Further supporting our view is the SARB governor Gill Marcus's comment that real interest rates were undesirable. Given our forecast that inflation should peak at around 6.5% to 7% and the fact that domestic demand remains weak, we don't expect short rates to move by more than 150bps before the end of this year.

Market more aggressive on short rates than our forecast



Source: Coronation

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Inflation to return within target by 2015: We do not expect an elevated breach of the upper band of the inflation target. As stated earlier, we expect inflation to peak at between 6.5% and 7%, but return within the target band during the course of 2015. The year-on-year (yoy) inflation figure of 5.8% for January, however, highlights the biggest risk to our outlook – food prices. In the recent past, food prices have made a limited contribution to inflation, but we are concerned that the 40% (yoy) increase in maize prices will continue to feed into inflation during the course of the year. Mitigating this is the fact that many food price spikes have historically been relatively short-lived.

Longer-dated government bonds should continue to offer value: The correlation between the US 10-year government bond and the SA 10-year government bond has effectively been 100% over the past number of years (see chart below). Any material change in US rates should therefore have a significant impact on local government bond yields. However, US 10-year yields have maintained a tight range of 2.8% to 3.1% since tapering was announced, indicating that the market is relatively happy with this level going forward. The risk is that short-term interest rates in the US start adjusting to higher levels (an adjustment in short rates will have an impact across the curve). But given the muted outlook for inflation and growth in the US, we don't foresee a material shift in short rates for at least the next year to year and a half. Local government bonds, especially longer-dated bonds, should therefore continue to offer value due to the carry yield.

SA bonds continue to follow US trends

Source: I-Net Bridge

HOW DID THE CORONATION STRATEGIC INCOME FUND PERFORM?

Coronation Strategic Income, our flagship domestic managed income fund, aims to provide a higher level of income with greater diversification than a traditional money market or pure income fund. Since its inception in July 2001, the fund has produced an annualised return of 11.2% (beating cash by 3% p.a. after fees). Over the past three years – a very abnormal period for fixed interest assets worldwide - the fund has delivered almost double the return offered by cash. But, as we have been warning investors for some time, returns had to normalise, and that happened in 2013. In what was a very trying year, we are pleased to have delivered a return of 7.2% (beating cash by more than 2% after fees).

	1 Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)	* Since Inception (p.a.)
Coronation Strategic Income Fund	7.2%	9.8%	9.8%	9.8%	11.2%
110% of STeFI 3 month index	5.5%	5.8%	6.8%	8.2%	9.1%
Cash	5.0%	5.3%	6.2%	7.4%	8.2%
CPI	5.4%	5.7%	5.4%	5.8%	5.7%

Looking at the contributions to the fund's total return in 2013, the largest part of the return (8.34% gross of fees) came through in the form of yield (approximately 50% of the overall return). The other significant contributor was the fund's offshore component, adding 25% of the overall return. And, as expected during a period of rising yields, duration cost the fund approximately 1% in terms of overall return.

Over three years, the picture looks slightly different. On an unannualised basis, the fund produced a gross return of almost 36%. Again, yield contributed almost 50% of the overall return and the foreign component 17%. While inflation-linked bonds only made a small positive contribution over the one-year period, its longer-term contribution over the three years totalled 16% of the overall fund return.

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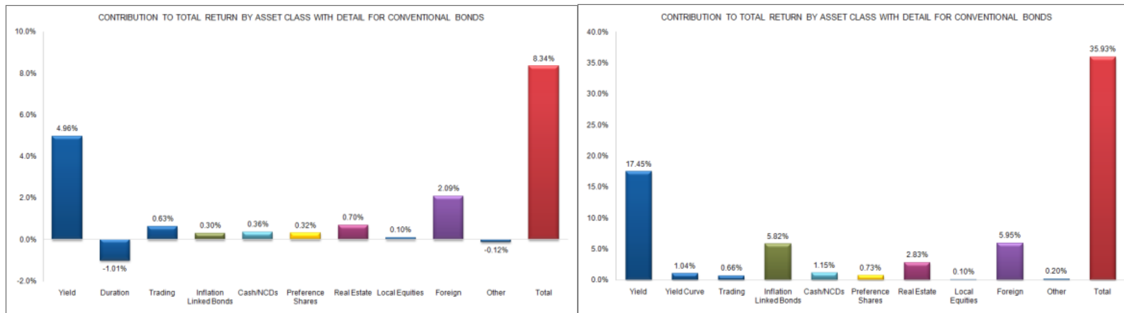
Contribution analysis over 1 year (left) and 3 years (right) to 31 December 2013



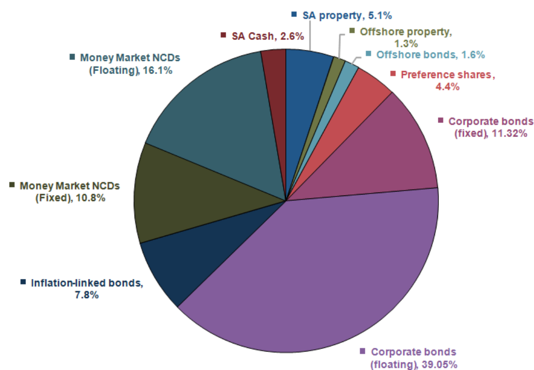
Positioning the fund

Given the selloff in the bond market, we have started to increase duration by adding exposure to longer-dated bonds, three- and five-year NCDs as well as longer-dated bank bonds (we remain very selective on corporate credit, however). We have also been adding floating-rate assets (which perform well when interest rates rise), and selectively increasing our exposure to domestic listed property.

Inflation-linked bonds (ILBs) are fairly priced in our opinion at present, but we are finding some value in the medium-dated area. As the rand weakened to what we believe is an undervalued level, we've started to hedge the fund's offshore exposure to below 2%. We also continue to hold very little cash, which offers flat to negative real returns.

For a more detailed discussion on the current portfolio holdings, please refer to the webcast (Password: February2014).

Current portfolio positioning of Coronation Strategic Income



Source: Coronation as at 31 January 2014

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