

LONG TERM OBJECTIVE

The Coronation Active Bond Strategy represents our best investment view for a specialist bond portfolio. The Strategy is managed in line with Coronation's long-term investment philosophy with asset allocation and bottom-up security selection being actively managed to generate targeted outperformance. The Strategy aims to consistently outperform the JSE ASSA All Bond Index over the medium to long term.

INVESTMENT APPROACH

Coronation is a long-term, valuation-driven investment house. Our aim is to identify mispriced assets trading at discounts to their fair value through extensive proprietary research. The fixed income portfolios are positioned on a long term strategic market view, but this is balanced by taking advantage of shorter-term tactical opportunities when the market lags or runs ahead of that strategic view. As active managers, we consider investment decisions across the full spectrum of potential return enhancers. These include duration and yield curve positions, inflation-linked assets as well as yield enhancement through credit enhanced assets. We aim to maximise returns by actively combining both a top-down and a bottom-up approach to portfolio construction.

STRATEGY RETURNS GROSS OF FEES

Period	Strategy	Benchmark	Active Return
Since Inception (cumulative)	1,222.9%	1,002.6%	220.3%
Since Inception p.a.	11.1%	10.3%	0.8%
Latest 20 years p.a.	9.5%	8.6%	0.9%
Latest 15 years p.a.	10.0%	9.1%	0.9%
Latest 10 years p.a.	9.4%	8.7%	0.7%
Latest 5 years p.a.	10.2%	9.6%	0.6%
Latest 3 years p.a.	10.9%	10.3%	0.6%
Latest 1 year	18.1%	17.2%	0.9%
Year to date	18.1%	17.2%	0.9%
Month	(0.4)%	(0.3)%	(0.1)%

ASSET ALLOCATION

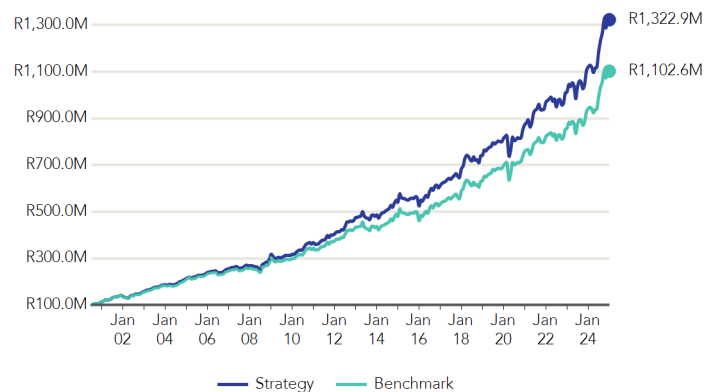
Asset Type	% Strategy
Fixed Rate Government Bonds	82.7%
Government ILBs	6.1%
Fixed Rate Other	2.4%
Floating Rate NCDs	2.4%
Cash	2.2%
Fixed Rate Corporate Bonds	1.6%
Corporate ILBs	1.4%
Floating Rate Corporate Bonds	0.7%
Other	0.5%

GENERAL INFORMATION

Inception Date	01 July 2000
Strategy Size *	R14.71 billion
Strategy Status	Open
Mandate Benchmark	JSE ASSA All Bond Index (ALBI)
Dealing Frequency	Daily
Base Currency	ZAR

*Strategy assets under management as at the most recent quarter end.

GROWTH OF R100M INVESTMENT



Benchmark: JSE ASSA All Bond Index (ALBI)

EFFECTIVE MATURITY PROFILE

Term	% Strategy	% Benchmark
0 to 1 year	4.7%	28.7%
1 to 3 years	1.2%	18.7%
3 to 7 years	13.2%	13.8%
7 to 12 years	36.6%	19.2%
Over 12 years	44.3%	29.9%

STRATEGY STATISTICS

	Strategy	Benchmark
Modified Duration (incl. inflation-linked bonds)	6.2	5.7
Modified Duration (excl. inflation-linked bonds)	5.7	5.7

PORTFOLIO MANAGERS**Nishan Maharaj - BSc (Hons), MBA**

Nishan is Head of Fixed Interest at Coronation and a portfolio manager across all fixed interest strategies. He joined Coronation in 2012 has 21 years' investment experience.

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Steve is a portfolio manager and analyst within the Fixed Interest investment unit, with 17 years' investment experience. Steve's current responsibilities include fixed income and property research responsibilities as well as co-managing the Coronation Active Bond Strategy and Coronation Bond unit trust fund.

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Seamus is a portfolio manager and analyst within the Fixed Interest investment unit with more than 20 years' investment experience. He manages assets within Coronation's specialist bond strategies. He also co-manages the Coronation Global Bond and Granite Hedge funds as well as the Global Strategic USD and Bond unit trust funds.

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Mauro is a portfolio manager and Head of Fixed Interest research. He co-manages various fixed income strategies for institutional and retail clients. Mauro joined Coronation in 2014 and has 13 years' investment industry experience.

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REVIEW FOR THE QUARTER

2024 was another impressive year for risk assets, as continued strength in the US economy and market saw developed market equities deliver jaw-dropping, high double-digit returns. Conversely, developed market bonds grappled with sticky inflation and unease about excessive government borrowing. The return of President Donald Trump this month introduces uncertainty around the direction of US policy, casting a shadow over expected returns for the coming year.

2025 is the year of the Snake, which is believed to bring transformation, renewal, and growth. In a world that has been fractured by increasing geopolitical tensions and growing inequality, global debt has steadily increased to c. US\$100 trillion and is expected to hit 100% of global GDP by the end of the decade. This is the shackle that needs to be shed for the world to enjoy transformative prosperity.

The US dollar powered ahead in the last few months of 2024, placing weakening pressure on most emerging market currencies. The rand ended the year at R18.84/US\$1, which is -2.55% weaker than at the start, despite being up c. 6% by the third quarter of the year. Despite this, the rand was still among the top performers in the emerging market universe. The FTSE/JSE All Bond Index (ALBI) was up 17.18% over the year, following a 100 basis point (bps) rally in bond yields over the same period, with the longer end of the curve (>12y maturity) producing a return in excess of 20%. Inflation-linked bonds (ILBs) significantly underperformed cash (8.21%) and bonds over the period, delivering a paltry return of 7.77%. This was primarily due to a slower path to a normal real policy rate, despite inflation ticking down much faster than expectations. Global bonds had a poor year as global yields climbed, with US yields up 50bps and the FTSE World Government Bond Index returning -2.87% in US dollars. South African (SA) bond outperformance was primarily due to the coalition of the Government of National Unity (GNU) in the middle of the year. This cooperative alliance helped reduce the local risk premium but will weigh on prospects for 2025.

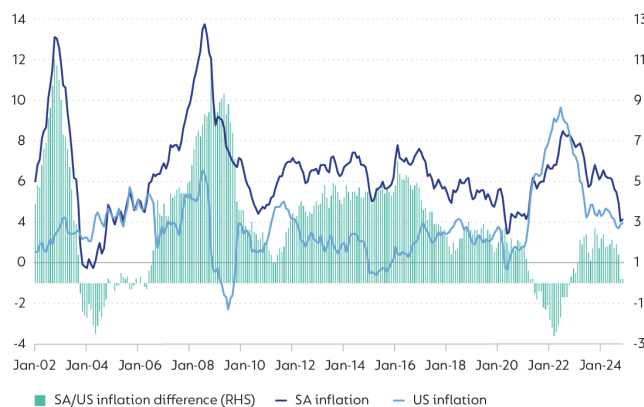
The significance of our inflation target

In SA, we have become accustomed to disappointment, either due to underestimating incurred damages or an inability to push through needed reform timeously. However, our shining light in the economic wilderness has been the South African Reserve Bank (SARB). The SARB maintained its independence and institutional credibility when everything was crumbling around it in the Zuma era. It is an institution that is filled with principled individuals of the highest caliber, who have performed their duties admirably. Unfortunately, in the last year, their pursuit of a lower inflation target at a point in the economic cycle when lower borrowing costs could aid a tepid recovery has been ill-timed.

One of the key arguments from the SARB has been that the current inflation target has remained too high relative to the rest of the world. However, there are two key rebuttals that question the durability of the SARB's case. Firstly, although many emerging markets have lowered their inflation target over time to a target that is below our 4.5% target, they have failed to sustainably maintain their inflation at that level. Secondly, the SARB has argued that our real policy rate needs to increase in line with the global real policy rate. However, as global inflation has remained high, ours has remained contained, narrowing the inflation differential significantly, thus reducing our need to track the global real policy rate higher. Figure 1 shows SA inflation relative to the US. It clearly illustrates that our inflation differential has narrowed from an average of 4% pre-pandemic to 2% post-pandemic.

Figure 1

SA vs US INFLATION



Sources: Coronation, Bloomberg

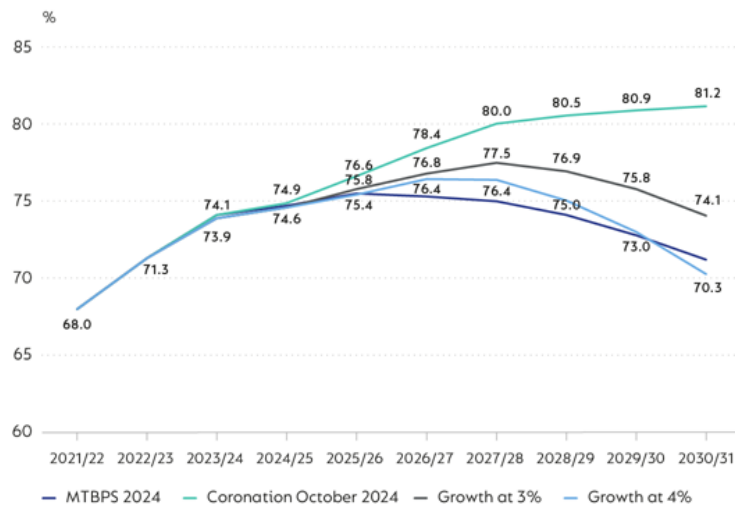
SA inflation will average at around 4.5% in 2024 and 4.2% in 2025, before ticking back up to an average of 4.9% in 2026. This provides the SARB with room to ease policy rates further to 7.25% by the second half of 2025. However, given that the SARB is likely targeting inflation lower than 4.5% (probably closer to 3.5%), it is unlikely rates will remain there for very long, especially in light of the uncertainty about the path of US policy easing due to the inflationary impact of the Trump administration's policy shift. Our forecasts see a reduction in the SA repo rate to 7.25% by the end of the first half of 2025, which aligns with market pricing. However, if an official change in target is communicated during the course of the year, the policy rate could revert to current levels, as per market pricing. We do believe that if the target is changed in 2026, the measurement date will be set for 2028, which would offset the need for an imminent move higher in the repo rate.

A heavy burden

Fiscal policy remains the Achilles Heel of the SA economy. The debt load will continue to increase towards 80% of GDP as acknowledged, but unaccounted for items continue to weigh on government expenditure. These include further support for State-owned enterprises – Transnet more immediately, and an increasing probability for Eskom if higher tariffs are not granted, or municipal debt is not repaid, municipal infrastructure upgrades, a larger wage bill, and high debt service costs. The only silver bullet is higher economic growth. Unfortunately, due to the slow pace of previous reform implementation, the magnitude of real economic growth that is required in order to stabilise and then reduce the debt load is around 3% to 4% (Figure 2). This is still some way off from our growth expectation of 2% to 2.3% by 2026, which is heavily dependent on the sustainability of the GNU. As such, although the noise around the fiscal trajectory has quietened for now, the risks posed to the economy if implementation falters or growth fails to recover over the next two to three years are still very high.

Figure 2

SA GENERAL GOVERNMENT GROSS DEBT; % GDP



Source: Coronation, National Treasury

Some cause for optimism?

SA government bonds (SAGB) spent half of last year languishing at the bottom of the performance table before turning course in the second half of the year following an unexpected positive turn in the SA political landscape. However, the jury is still out as to whether the ship can change course and do so swiftly. The risk premium in SA bonds has reduced significantly and, although absolute levels remain high at around 10% in the 10-year SAGB relative to global bond yields and other assets, SA bonds seem well priced for their underlying risks. Our bond fair value stack puts current trading levels marginally on the cheaper end of the fair value trading range.

Figure 3

SA BONDS IMPLIED FAIR VALUE

	Best	Worst
US 10-year	4.0%	5.0%
US CPI	2.0%	3.0%
SA CPI	4.5%	5.5%
SA credit spread	2.75%	3.25%
Implied SA 10-year fair value	9.25%	10.75%

Source: Coronation, Bloomberg

US bonds have sold off by 50bps over the last year despite SA bonds rallying by 100bps, which tightened our trading spread over the global risk-free rate (Figure 4). In large part, the risk premium was initially too aggressive, but the current trading levels have brought SA back to levels last seen when it was an investment-grade country, which suggests the market hopes for a more optimistic outcome.

Figure 4

SA 10-YEAR BOND VS US 10-YEAR BOND



Source: Coronation, Bloomberg

SA bonds offered quite a significant pickup relative to cash coming out of Covid, which was indicative of the large amount of protection in yields that were on offer relative to cash, with bond yields trading at some points twice cash levels. However, in the last 18 months, cash has risen and bond yields have compressed, pushing the ratio between the SA 10-year bond yield and cash back to the long-term average (Figure 5), further indicating a reduction in yield protection and more sanguine market expectations.

Figure 5

SA BONDS vs CASH



Sources: Coronation, Bloomberg

Uncertainty prevails

The absolute level of bond yields is still attractive given their long-term trading history, however, the risk premium and protection offered by these bond yields have reduced significantly leaving them, at best, at fair value if not slightly overestimating the SA turnaround. In addition, the world is entering a very uncertain period in which global borrowing levels are at all-time highs, with global yields at risk of pushing higher given the possible change in policy given recent geopolitical developments. As such, local bond investors, need to remain vigilant in a landscape of increasing risk.

ILBs have been the worst-performing asset class within fixed income for the last couple of years. In a Strategy of assets, one requires diversification and something that offers insurance in the event the base case doesn't materialise. As such, just because an asset has not performed well does not mean it does not deserve a place in the Strategy. ILBs are such an asset class, primarily because of their inherent risk-offsetting attributes and current valuation. ILBs offer protection if inflation materialises higher than expectations. At current levels, the real yields on offer are historically high (in excess of 4.5% across the curve, which implies a guaranteed return of CPI + 4.5%), and the total return on offer relative to nominal bonds remains attractive. This attractiveness is focused primarily on maturities of less than four to six years, as indicated in Figure 6. The cells highlighted in green show where the total return of the ILB (under an inflation assumption) is greater than the total return on offer by the nominal bond. The front end of the curve remains a better alternative to nominal bonds, due to its lower modified duration (capital at risk).

Figure 6

INFLATION-LINKED BONDS VS NOMINAL BONDS

Bond	Maturity	Real Yield	EXPECTED ILB TOTAL RETURN			Expected nominal total return
			CPI at 4.5%	CPI at 5%	CPI at 5.5%	
R210	Mar-28	4.51	9.24%	9.76%	10.28%	8.72%
I2029	Mar-29	4.67	9.42%	9.94%	10.46%	8.96%
I2031	Jan-31	4.72	9.44%	9.95%	10.46%	9.53%
I2033	Feb-33	4.87	9.62%	10.14%	10.66%	10.05%
R202	Dec-33	4.875	9.63%	10.15%	10.67%	10.20%
I2038	Jan-38	4.89	9.63%	10.15%	10.66%	10.93%
I2043	Jan-43	4.85	9.57%	10.08%	10.58%	11.14%
I2046	Mar-46	4.92	9.67%	10.18%	10.70%	11.20%
I2050	Dec-50	4.9	9.66%	10.18%	10.70%	11.22%
I2058	Jan-58	4.88	9.60%	10.11%	10.61%	11.26%

Source: Coronation

Local credit spreads are at historically tight levels due to low levels of issuance and large swaths of capital looking for a home with reduced volatility. The use of structured products, such as credit-linked notes (CLNs), has become ubiquitous within the local market. This sector has grown exponentially over the last five years and has reached a market size of over R100 billion. However, only a third of this market reprices, creating an inaccurate representation of asset volatility and pricing. CLNs mask the underlying/see-through credit risk as the issuing entity (predominantly local banks) is seen as the primary credit risk.

The increased usage of CLNs has not expanded the pool of borrowers, rather it has only served to concentrate it. This is due to the ability to limit the volatility of these instruments by not marking them to market based on the underlying asset price movements. The combination of attractive yields and no volatility is an opportunity that few would pass up, unless, of course, transparency of pricing is important to the underlying investor. As a result, there can be significant unseen risks within fixed income strategy's. Investors need to remain prudently focused on finding assets of which the valuations are correctly aligned to fundamentals and efficient market pricing. Except for a few opportunities, we view the local credit market as unattractive relative to other asset classes.

Despite a wobbly end to the year, risk assets enjoyed a relatively strong 2024. SA government bonds shone as they outperformed their emerging and developed market counterparts. The road ahead is less certain. Inflation has remained well behaved and is expected to remain close to the midpoint of the current target band. However, the SARB's reluctance to ease rates might prove to be a headwind to bond yields and the economy going forward. In addition, local growth has remained lacklustre, and the growth required to shed the burden of our current debt load remains much higher than expectations. The risk premium on SA bonds has been much reduced and is commensurate, if not too idealistic, with SA's economic future. In addition, global risks remain high as the incoming US president's policy direction might stoke inflation and push global bond yields even higher still. We continue to maintain a neutral position on local bond yields in light of their reduced risk premium, with very little exposure to local credit and a moderate allocation to ILBs given their attractive valuation and offsetting risk attributes.