corospondent

The Coronation Fund Managers Personal Investments Quarterly

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CORONATION

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and approved manager of collective investment schemes.
7th Floor, MontClare Place, Cnr Campground & Main Roads,
Claremont 7708. PO Box 44684, Claremont 7735.
Client service: 0800 22 11 77 E-mail: clientservice@coronation.co.za

www.coronation.com

NOTES FROM MY INBOX

NOT ALL DOOM AND GLOOM

By Pieter Koekemoer

Pieter is head of the personal investments business. His key responsibility is to ensure exceptional client service through a combination of appropriate product, relevant market information and good client outcomes.

Our big news this quarter is a meaningful fee cut across our international and lower-risk funds. We are simplifying the fee structure across our flagship multi-asset funds to the same flat fee – regardless of risk budget or geographical profile. This change follows a comprehensive fee review in 2015 that has already added significant value to our clients' portfolios.

Equity market returns recovered strongly since June. At the time of writing, the FTSE/JSE Capped All Share Index recorded a 15% return in the year to date, compared to just more than 2% at the end of June. The MSCI All Country World Index showed a similar gain, with a 17% year to date rand return. Equity markets often move quickly, as we have seen recently. If you are not there, you end up missing out. The recent gains follow a roughly three-year period of mediocre returns from local shares, which motivated especially more conservative investors to switch from low-risk multi-asset funds with some equity exposure (for example, Coronation Balanced Defensive) to even more stable managed income funds (for example, Coronation Strategic Income). This is an understandable but unfortunate trend, which we unpack in more detail on page 6.

We also want to draw your attention to an overhaul of our approach to client reporting. We will start implementation with new transaction confirmations and statements that will be rolled out during November. Our aim is to simplify the documents we send you and provide you with more meaningful and relevant information. We hope that you will like the changes.

RETIREMENT DEFAULT REGULATIONS

I was pleased to read that the latest Nobel prize in economics was awarded to professor Richard Thaler, whose research in behavioural economics uncovered the importance of 'nudging' people into making better decisions for the long term without removing their individual freedom of choice. You can see the influence of his thinking in the new retirement default regulations which were recently adopted in SA. This initiative is a rare example of enlightened policymaking, which is likely to help many South Africans to retire more comfortably.

The core idea shaping the regulations is to make sure that retirement fund trustees provide more guidance to fund members at the most important decisionmaking points, without limiting their ability to make different choices if they deem such choices to be more appropriate to their specific needs. It requires all retirement funds to have a default investment portfolio; to make it the default to preserve retirement benefits when changing employers; and to have access to a trustee-endorsed retirement income option at the point of retirement. The regulations will come into effect on 1 March 2019 to give funds adequate time to implement the necessary changes.

IN THIS EDITION

Unfortunately not all the news is good. This issue of *Corospondent* examines some of the concerning geopolitical headlines that have dominated the news for some time. To give context and analysis, we turned to the chief foreign affairs commentator at the *Financial Times*, Gideon Rachman, for his insights. On page 13 is his exclusive assessment of the current Korean crisis. In a sobering read, he warns of the risk of nuclear attacks if the North Korean leader is faced with the prospect of the collapse of his regime.

While the global environment seems overcast, Europe is shakily emerging as an unexpected bright spot. Our economist Marie Antelme explores the reprieve granted to the continent after the latest round of elections. She argues that Europe should embrace this window of opportunity for economic reform.

Bitcoin has become an unavoidable topic. When the *Financial Times* runs a headline confirming that the CEOs of the world's largest asset manager and the US's largest bank agree on the need to 'crush' Bitcoin, you know that the topic has taken on supernova status. On page 8, Neville Chester dissects and destroys the investment case for the current batch of cryptocurrencies. While we remain excited about the possibilities of blockchain technology and expect reputable digital currencies soon, we do not believe one of the current contenders will play this role.

There is no shortage of *true* investment opportunities in this edition, and we include analysis of the SA retail group Spar and of Airbus, the European aircraft manufacturer. Airbus has long been an unloved stock and may look like an unexpected addition to our portfolios, especially our Global Emerging Markets Fund. But our extensive research shows that Airbus is trading well below our estimate of its fair value, and that the company has a long runway (yes, pun intended) of growth.

This is a bumper edition – we hope you enjoy the read. ■

Pieter

MARKET MOVEMENTS

	3rd quarter 2017	Year to date 2017
All Share Index R	8.9%	12.6%
All Share Index $	5.0%	13.8%
All Bond R	3.7%	7.8%
All Bond $	0.0%	8.9%
Cash R	1.8%	5.6%
Resources Index R	17.8%	12.4%
Financial Index R	5.1%	4.0%
Industrial Index R	7.4%	17.0%
MSCI World $	4.8%	16.0%
MSCI ACWI $	5.2%	17.3%
MSCI EM $	7.9%	27.8%
S&P 500	4.5%	14.2%
Nasdaq $	6.2%	24.0%
MSCI Pacific $	4.0%	15.7%
Dow Jones EURO Stoxx 50 $	8.5%	25.2%

Sources: Bloomberg, IRESS

ANNOUNCING FEE CUTS

FEES ON OUR INCOME-AND-GROWTH AND INTERNATIONAL FUNDS FURTHER REDUCED

By Pieter Koekemoer

Pieter is head of the personal investments business. His key responsibility is to ensure exceptional client service through a combination of appropriate product, relevant market information and good client outcomes.

As your independent fund manager, we know that our primary job is to add value to the investments that you have entrusted to us. We do this through disciplined application of our long-term investment philosophy, by hiring the best investment professionals and by ensuring that we have a simple and needs-orientated fund range at a fee proportionate to the outcomes you receive. If we cannot produce top after-fees performance over meaningful periods, we will not remain worthy of your trust.

We also know that markets evolve and that client preferences change over time. As a result, we continuously review our fund positioning and the management fees we charge to ensure they remain competitive, fair and appropriate.

We conducted a major fee review in 2015 that affected most of our funds (see the July 2015 edition of *Corospondent*). The key aim then was to simplify and standardise our fee approach. We introduced pioneering performance-related fee structures for our equity-biased funds and fixed fees for all lower and moderate risk multi-asset funds.

These changes have already resulted in meaningful fee reductions over the past two years.

Following the reductions in 2015, we now announce further fee cuts to our income-and-growth and international funds, as indicated in the table opposite.

All our flagship multi-asset funds will charge the same fixed fee of 1.25% for direct retail investors. This is the fee currently charged by our largest fund, Coronation Balanced Plus.

Charging one fee rate regardless of risk budget or geographical focus makes it easier for investors to focus on optimising their long-term investment outcomes by remaining in the fund most appropriate to their needs.

Coronation has made significant progress in attracting allocations from large overseas investors, including leading international retirement funds. As our international business continues to grow, we can share some of the scale benefits with all clients through lower fund management and administration charges in our global funds.

We have also made changes to the way we disclose fees. From this month, we show both one- and three-year total expense ratios on our fact sheets, and provide more information on the component costs that make up fund expenses. Existing investors can also now obtain an effective annual cost disclosure for their specific fund selection via Coronation Online Services.

We have shown over the years, time and time again, that we value our investment track record far more than our profitability or our market share. Every decision we make is driven by the sincere desire to deliver the best possible investment outcome for our clients. The latest fee reductions should confirm this commitment. ■

FEE CUTS ON SOME OF CORONATION'S FUNDS

Funds	New A-class fee	Fee reduction
Balanced Defensive & Capital Plus	1.25%	15 basis points
Global Capital Plus, Global Capital Plus [ZAR] Feeder Fund, Global Managed & Global Managed [ZAR] Feeder Fund	1.25%	25 basis points
Global Opportunities Equity Fund & Global Opportunities Equity [ZAR] Feeder Fund	0.85%	50 basis points
Global Equity Select Fund & Global Equity Select [ZAR] Feeder Fund (change in fee at benchmark)	1.05%	20 basis points

Investors in the affected funds will receive a more detailed communication explaining the exact terms of the fee changes affecting their funds. You can also refer to the relevant Minimum Disclosure Documents for more detail. The fee reductions shown in the table relate to A-classes (available to direct investors) and may in some cases differ for D- and P-classes. As part of implementing lower fixed fees, current discounts for negative short-term performance applicable to Coronation's Balanced Defensive, Capital Plus and Global Capital Plus funds will be phased out on 1 October 2018. Global Equity Select charges a performance-related fee which remains unchanged, except for a reduction in the fee at benchmark and the overall fee cap. All other affected funds charge fixed fee rates. The changes to the fees charged in Balanced Defensive and Capital Plus are effective from 1 October 2017. The changes to international fund fees are subject to regulatory approval and are likely to be implemented during January 2018.

Source: Coronation

FAIR FEES IN ACTION: THE TOP 20 CASE STUDY

The Coronation Top 20 fund is one of SA's premier equity funds. It has added significant value over the last 17 years, outperforming the market index by, on average, 4.5% per year (net of fees). An investment of R10 000 at the launch of the fund is worth around R200 000 today. If you opted to buy the market index at the time, your current investment value would be around R100 000. Top 20 continues to do well, outperforming at least 80% of all general equity funds over all periods at the moment.

The fee we charge for managing Top 20 has always been linked to the investment growth we deliver. In periods where we add significant value, the fee is increased in proportion to the level of outperformance produced (up to a capped level). If we fail to beat the market index, even by 0.01%, we reduce the fund's fee by 0.5%. This means you only pay a higher fee when your investment has outperformed the market. We know that you can easily own a portfolio that would simply replicate the performance of the market index by buying one of the many passive products available in the market. We are confident of our ability to outperform these indices over the long term.

In 2015, we changed the performance measurement period used to calculate whether a discount is due, from two to five years. At the time, Top 20 was recovering from a poor performance period in 2014. This decision meant that the weak performance would stay in the base for longer, but we knew it was the right thing to do, as this change aligned the discounting period to the fund's minimum recommended investment term.

Applying the fee structure described above resulted in an audited total expense ratio of 0.62% for the retail class of the fund. This means Top 20 investors incurred only 40% of the typical active management fee for a fund that over the last two years beat the market index *and* 94% of the funds in the general equity category.

AVOID THE POST-RETIREMENT TRAP

WHY MANY RETIREES NEED TO TAKE ON MORE RISK, NOT LESS

By Pieter Koekemoer

Pieter is head of the personal investments business.

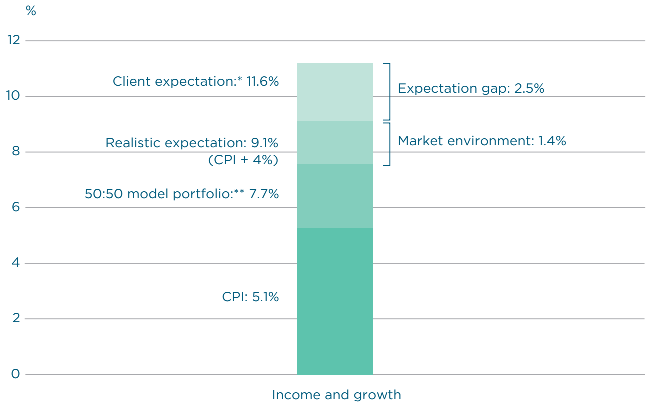
Investors in our income-and-growth funds (Coronation Capital Plus and Coronation Balanced Defensive) may feel unhappy with their recent returns, due to a confluence of factors.

First, the markets have until recently been going nowhere. Equities, bonds and cash have barely beaten inflation over the three years to end-September. Further, with the three asset classes having delivered similar returns (roughly 7% per year) over this period, investors were not compensated for taking on additional risk.

This has resulted in a subdued performance over the recent years, which may have been experienced as particularly painful due to an additional factor: unrealistic expectations. Notwithstanding forewarnings from ourselves and other investment managers, many investors did not expect the sharp slowdown in market returns over the past three years. In fact, a recent client survey showed that the return expectations for these funds remain on the high side.

The survey found that the average expectation of an 11.6% annual return for income-and-growth funds are almost similar to the 12.4% expected for long-term growth funds – an unrealistic assumption given that income-and-growth funds take on significantly lower risk. In our view, a more realistic return expectation for our absolute return funds is CPI plus 4% (in the case of Capital Plus) and CPI plus 3% (in the case of Balanced Defensive). Unfortunately, in the recent past this was a near-impossible target to achieve, given the mediocre returns delivered by the underlying building blocks.

ACKNOWLEDGE THE EXPECTATION GAP



* Average return expectation for existing investors in our income and growth funds who participated in a survey conducted during June and July 2017.

** 50:50 model portfolio used as proxy for income and growth fund, with asset allocation set at 35% local equity, 10% global equity, 5% local property, 35% local bonds and 5% local cash.

Source: Coronation

In reaction, many frustrated investors across the industry have moved their savings away from income-and-growth funds which have exposure to shares (equities). An estimated R20 billion has been withdrawn over the past year, and a lot of the money has ended up in more conservative options, including managed income funds and cash deposits.

After all, why take on more risk by investing in shares if you can get the same level of return from lower-risk options? Recent performance provides part of the answer: markets rally when you least expect it. At the time of writing, the 7% average return from equities over three years mentioned earlier has morphed into 10.4% per year, while cash and bonds are still at 7% per annum.

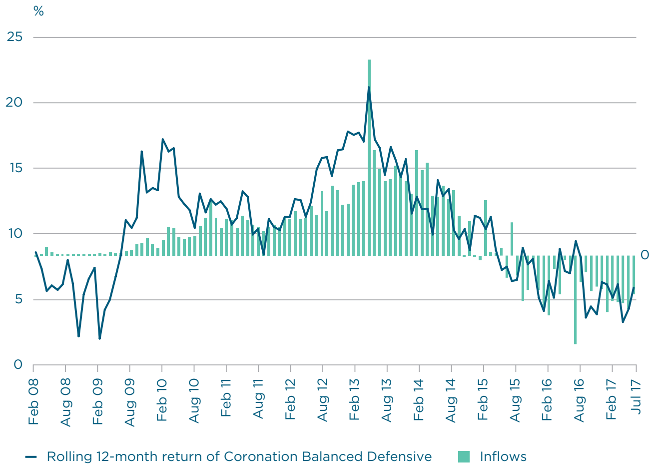
Conservative investors need some exposure to growth assets to be able to maintain their spending power through retirement. Ultimately, we strongly believe that the key risk that more conservative income-and-growth investors need to avoid – counterintuitively – is not taking on enough risk.

Also, we see better days ahead for shares. We are more upbeat about domestic equities than we were three years ago when the market was expensive. There are many SA businesses for which the expected returns going forward look better than they have for quite some time. Most of that has to do with the fact that the base is so low.

If our macroeconomic outlook improves just a little bit, and companies are able to improve their topline only by a small margin, one can easily expect to see a decent improvement in earnings.

Further, investors should avoid falling into the trap of chasing returns, as is clear from the graph below. Investors tend to commit capital when returns *have* been good and withdraw *after* they experienced a tougher time. We do not believe this to be an appropriate investment strategy for long-term investors. Ultimately, one requires the patience to look beyond any short-term pain and avoid locking in any losses by selling low and buying high.

DO NOT FALL INTO THE TRAP OF CHASING RETURNS



Source: Coronation

INVESTMENT LIMITS AND BENCHMARK CHANGES

To ensure we maximise investment outcomes for our clients in Balanced Defensive and Capital Plus, we are making incremental changes to their risk budgets.

This will bring these funds' ability to take risk in line with the limits applicable to their existing fund classification categories, while still allowing the retention of their dual objectives (delivering real growth over time while preserving capital over the shorter term). We believe these changes will further enhance client outcomes over time.

The funds' ability to invest in growth assets (defined as equity, listed property and commodity holdings) will increase. For Balanced Defensive, its risk budget will increase from 40% to 50% and for Capital Plus from 60% to 70%.

The maximum effective equity exposures will remain at 40% for Balanced Defensive and 60% for Capital Plus to ensure the funds remain compliant with the equity limits applicable to the SA – Multi-Asset – Low Equity and Medium Equity categories respectively. This change in strategic asset allocation limits will become effective on 1 November 2017.

In line with increasing the risk budget for Capital Plus, we will also be changing its dual objective from a 12-month capital preservation target to an 18-month capital preservation target. The primary objective of outperforming CPI plus 4% over the long term will remain unchanged. Capital Plus remains in our view the appropriate portfolio to fund an income drawdown programme over an extended period of time.

To better reflect the difference in positioning between the two funds, the benchmark for Balanced Defensive will be changed to CPI plus 3% from Cash plus 3% (with cash returns measured using the Short Term Fixed Interest Three-Month Index). Both Capital Plus and Balanced Defensive are clean-slate funds focused on producing real returns, and it therefore remains appropriate to measure long-term outcomes against an inflation target. Using the same base metric for both income-and-growth funds makes positioning easier to understand and more clearly communicates return expectations. ■

THE BITCOIN BUBBLE

BUT THE FUTURE OF BLOCKCHAIN IS BRIGHT

By Neville Chester

Neville is a senior member of the investment team with 20 years' investment experience. He joined Coronation in 2000 and manages Coronation's Aggressive Equity strategy.

When is a bubble not a bubble? When it is a new paradigm, of course! Throughout history, every time a bubble gathers momentum, there has always been a strong and often logical (though not always) explanation for why there was no bubble. Towards the end, the defenders become louder and more assertive against the naysayers, until it all comes crashing down.

Bitcoin was recently described by Jamie Dimon, the CEO of JP Morgan, as a "fraud". I prefer the term used by the *Financial Times*: "mass delusion". A fraud implies a conscious effort by a group of individuals to steal money from another, whereas what we see with Bitcoin is not that.

I would, however, categorise the raft of 'Initial Coin Offerings', or ICOs as they are referred to, as something more akin to fraud. Increasingly companies, in a completely unregulated fashion, are launching myriads of copycat 'coins' in the hopes of raising cash from gullible participants who are hoping to cash in early on the next Bitcoin.

But we are getting ahead of ourselves. Some non-millennials might be asking: what is Bitcoin? Bitcoin is a virtual currency which was launched off the back of a new advance in technology called blockchain. The key attribute of this technology, and what makes it such a potential game changer, is that the record of ownership is contained in a distributed ledger. This allows independent verification that each Bitcoin is indeed unique and not simply a virtual copy. The way Bitcoin was constructed also ensured that there would be a limited supply of Bitcoins (21 million, if you're interested), creating a 'rarity' of supply – important support for the value of any commodity.

In any debate about investing in Bitcoin, zealous promoters will argue 'blockchain' back at you, usually with some comments about how old-school finance is going to be undermined by blockchain in the future and why many established bankers and economists do not believe in Bitcoin because it is a competitor to their existing interests. This is unfortunately confusing two concepts.

Blockchain is indeed a revolutionary technology and it will redefine our future relationships with many financial institutions. The ability to independently verify ownership of any asset without the use of an intermediary is very powerful. This is why the biggest investors in exploring the technology of blockchain are the big financial institutions. Bitcoin, however, is just a product launched using the blockchain technology. One of thousands, in fact.

A supposed benefit of cryptocurrencies is that they are presumed to protect your assets from central banks which are printing fiat money at a rapid rate post the financial crisis. However, today there are over 1 000 cryptocurrencies in existence (including the humourlessly named Titcoin, used in the adult entertainment industry) against around 180 fiat currencies. And the list is growing every day.

Is Bitcoin a currency? A functional currency has two key attributes:

- It is a store of value.
- It is a medium of exchange.

Given the extreme volatility we have seen in Bitcoin prices, it fails the first test. It also largely fails the second, despite a number of vendors being prepared to accept it. The reality is no one is actually pricing their goods in Bitcoins; they price them in dollars or an equivalent fiat money and then accept payment via Bitcoin. This is due to the first point: the valuation of Bitcoin varies wildly from day to day.

The majority of transactions that Bitcoin is being used for are speculative trading, circumvention of capital controls in countries like China and Venezuela, and for concluding other illegal transactions. The settlement time is also prohibitively long for effective day-to-day transactions. It can take up to an hour for transactions to be confirmed as valid. This is not a realistic scenario while waiting in a queue at your favourite store.

So is Bitcoin an asset and can you invest in it? The fundamental step is to determine the value of a Bitcoin. And here even the most messianic of Bitcoin promoters cannot come up with a fundamental basis for what the value of a Bitcoin could be.

The reason is that the basis for any valuation is ultimately a discounted cash flow of the return the asset generates. Whether valuing a government bond, a property or a company, the value of the asset is determined by the value of the cash flows the asset will ultimately generate. And Bitcoin generates nothing. It is a speculative investment in that the value of a Bitcoin is determined only by the price someone else will want to pay for it.

This is why the punters of Bitcoins and other cryptocurrencies are so fervent in spreading their message: the more people are buying it, the greater the chance of selling it for a profit. When fewer people buy it, the likelier the chance of a loss.

Without a doubt, the current situation of quantitative easing has facilitated the growth in cryptocurrency bubbles (and many other asset price bubbles).

While interest rates have been held artificially low, the cost of speculating has been very low. If you can borrow money cheaply, your opportunity cost of buying assets with no yield is low. However, as interest rates start to normalise, as in the US currently, with murmurs also growing louder from the UK and Europe, the implied cost of holding an asset that generates no yield will rise.

The future of blockchain is bright and in all likelihood, some time in the future, we will see central banks adopt and promote a virtual interchangeable version of digital currency, but one that will be stable and traceable to prevent the facilitation of criminal activity. It will not be Bitcoin. ■

EUROPE'S REPRIEVE

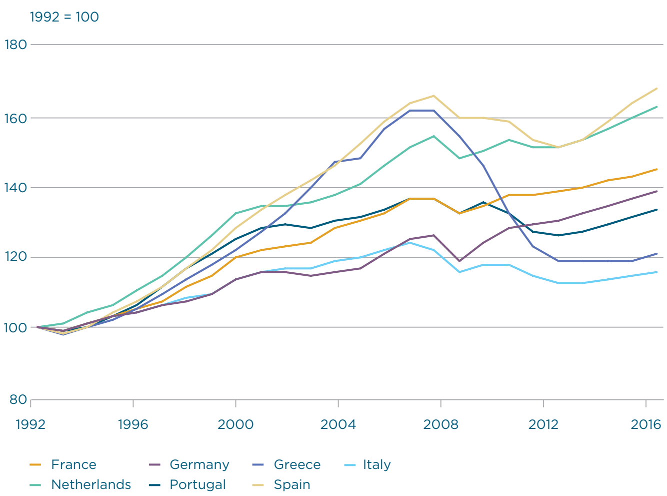
BUT GERMANY NEEDS TO DO MORE

By Marie Antelme

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

Europe has been the big surprise this year. Reeling from the unexpected decision by the UK to leave the EU, and Donald Trump's election win in 2016, it was hard *not* to expect a populist victory in a vulnerable Europe in 2017. Many in Europe have suffered deeply during a decade of slow recovery, and economic hardship has contributed to political outrage, especially against outsiders. Concern about populism was even more pronounced because the global financial crisis, followed by the Eurozone sovereign debt and banking crises, had already triggered a crisis of confidence in the EU and its monetary union. Against this background there was very real concern that the emergence of populist political parties would be the death knell for a weakened Europe.

RELATIVE REAL GDP GROWTH



Source: IMF

In Europe, populist parties on both sides of the spectrum have been more visible, more vocal and perhaps more entrenched than in either the US or the UK. The election calendar in 2017 was also unusually packed, with each country's own populist politicians proposing various, and sometimes extreme, alternatives to the status quo. Still, most offered a common anti-immigration narrative, forcing centrists to adopt it as an electoral issue. The economic implications seemed bleak. And as the polls ahead of the Brexit vote and US election were so misleading, nervousness grew about an adverse outcome in at least one of the elections.

ELECTION RESULTS

The first key European country to hold elections this year was the Netherlands. It has a rather complex electoral system which allows for a broad level of representation in the Binnenhof. Coalitions are common, and it seemed unlikely that populist firebrand Geert Wilders of the Party for Freedom (PVV) would gain a ruling majority. Nonetheless, his strong views on immigration were widely telegraphed, especially since the Netherlands is traditionally one of the more tolerant EU members. Wilders' campaign called primarily for the de-Islamification of the Netherlands and more sovereign independence, "including from the EU". On the day, the PVV gained the second-most votes, but failed to attract a meaningful coalition partner.

The elections in France were perhaps the most important and least certain. Emmanuel Macron, running as an independent, campaigned for wide-ranging economic reform and a strengthening of relations with the EU. The campaign of the Republican nominee, François Fillon, was plagued by controversy. But their challenger, the established anti-EU populist Marine le Pen, remained consistently popular in the run-up to the election. Macron's victory not only secured him the presidency, but his new party, La République En Marche, gained the parliamentary majority. A resounding victory for French Europhiles, with a mandate for much-needed labour reform within France.

It was supposed to be the most predictable election of the year that ultimately sprung the biggest surprise. The outcome in Germany confirmed that Europe has only seen a political reprieve and not resounding support for moderate politics. As expected, Chancellor Merkel won her fourth term, but there was a significant shift in underlying political dynamics. Instead of a Grand Coalition, Merkel will have to rebuild her coalition with liberal alliances. There is also now a blemish on the political landscape with a swing in support towards the right-wing populist Alternative for Germany (AfD). Again, centrist candidates lost support due to immigration concerns.

While the electorate supported European unity, it is clear that deep divisions remain, specifically regarding immigration and fiscal union, and these are close to the surface. Nonetheless, diminished political risk, surprisingly strong European growth momentum, recovering labour markets and a supportive global context are serving a potent cocktail for Europe.

GDP growth may remain comfortably above 2% this year, and is expected to stay at about the same rate in 2018. With unemployment in Europe (currently 9.1%) at multi-year lows and further support for a tightening labour market, there may be a cyclical opportunity to integrate further, to bring Europe from an "imperfect monetary union to a true economic continent" (according to the French finance minister Bruno Le Maire). But the opportunity is more likely to be a window than a door.

EUROPE'S OPEN FLANKS

The path to closer European integration is full of obstacles, on all flanks:

Economic flank: closer fiscal union

This is arguably the biggest risk factor for the EU. The current monetary union lacks key features crucial for long-term stability, above all greater *fiscal* union at a centralised level. Members have given up their exchange rates, but the failure to further unify their fiscal policies has weakened the union's ability to react to shocks. Unfortunately its most powerful (and fiscally conservative) members have weakened the move towards a sufficient centralised fiscal policy. Without it, the EU remains hamstrung in tackling future challenges.

Political flank: immigration

The immigration crisis of 2015 revealed that Europe fundamentally disagrees on immigration politics, which has emerged as a poisonous and divisive political narrative.

No unified vision for Europe

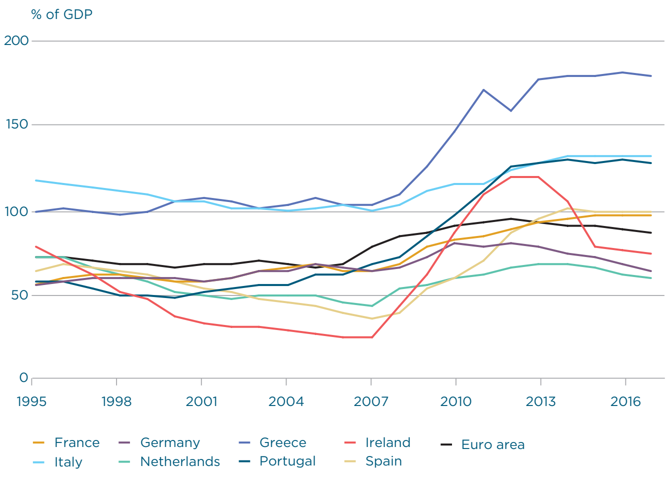
The aforementioned economic and political weaknesses are compounded by a lack of common vision. This, in turn, has led to the emergence of political alternatives in Hungary and Poland that have been moving very far away from the political centre. A new agenda needs to provide potential areas of cooperation, to ensure focus and build momentum.

CONTINENTAL DIVIDE

A first step in rebuilding the European project is recognising the deepening divisions, inequality and ongoing economic hardship following the global financial and European crises. This has undermined trust in EU institutions, threatening the broader European identity and terminating integration efforts. Countries which had to be bailed out have suffered slow and painful economic transitions. The process has deepened the North-South economic and political divisions, and reinforced the dominance of the stronger countries in institutions and policymaking. Externally, immigration, terror threats and attacks, a re-emergence of national identity and concerns about East-West geopolitical uncertainty all challenge the existing framework.

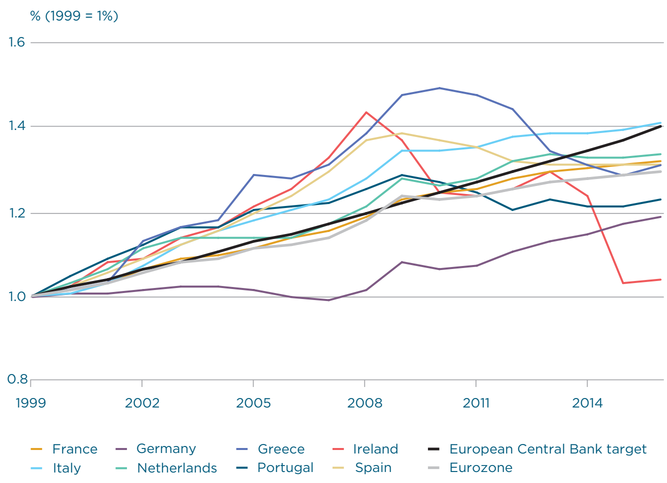
Germany, the biggest economy within the EU, has benefited enormously from conservative policies in the period between 2002 and 2009, especially in the labour market, and after that from the weaker euro. Germany is running a current account surplus at a breathtaking 8.6% of GDP (at the end of 2016), and growing at 2.1% year on year, above its estimated long-term potential. Germany has low government debt to GDP (65%) and is running a small fiscal surplus. It also has the loudest voice in EU decisionmaking.

GROSS DEBT



Source: IMF

EUROPEAN WAGE GROWTH



Source: UBS

France's position has been largely overshadowed by Germany, but regional momentum and revived hope of reform and stronger growth have boosted its GDP to 1.8% year on year. France's debt levels are high at 96% of GDP, and its deficit is persistent at -2.8%. But for the first time in years, French confidence is on firmer ground and Macron has a very real opportunity to reinvigorate the economy. Credible domestic reform will also boost France's ability to promote a reform agenda to Europe.

The so-called 'European periphery' – Ireland, Spain, Portugal and black-sheep Greece – saw their domestic financial systems buckle under massive debt burdens. In Ireland and Spain, private debt and poorly regulated banking systems were the root cause, while in Portugal and Greece profligate fiscal policy during the boom saw deficits bulge and debt rise. All suffered ballooning current account deficits as debt increased. As the crisis hit these vulnerable economies, the bailout of the banking systems led to a sharp rise in an already large stock of debt. All four sought financial assistance.

Through a painful adjustment, Ireland exited its reform programme, and has managed to recover. The other three are taking longer to recuperate. Still, economic stability in Spain has improved meaningfully, and Portugal too is on a firmer footing. In Greece, the fiscal interventions required to stabilise the sheer burden of its debt has left the economy in an almost semipermanent recession. The situation has become so dire that eight years into its reform programme and seven prime ministers later, the EU and IMF are at loggerheads about how to proceed. The IMF is advocating debt relief for Greece, while the EU, which has already lowered debt service and extended the repayment periods for Greek debt, is reluctant to do more.

THE WAY AHEAD

At this stage, France offers the best options for a new integration agenda. France's proposal, presented by Macron at the Sorbonne in late September – after the German election – stated explicitly the need for Europe to consolidate against the present threat of populism. Macron called for "the refoundation of a sovereign, united and democratic Europe". Amongst his wide-ranging proposals were a bigger EU budget to fund investment and provide a cushion against shocks, a simplified European Commission, an EU intervention force with a unified frontier police force, educational initiatives across EU institutions, funding for innovative research and an overhaul of agricultural policy. He fell short of directly proposing a European Monetary Fund with oversight by a single finance minister, but has mooted these in the past. The importance of these proposals is twofold. France, by implementing tough reform at home is claiming its place as a significant driver of EU integration. Also, by offering a wide-ranging menu of reforms, Macron gives Europe options to choose a path forward.

Earlier this year, the European Commission released a report that called for more efficient economic structures, a financial union (including a banking union and a capital markets union), a fiscal union which will promote fiscal sustainability and stabilisation and, ultimately, a political union with democratic accountability, legitimacy and stronger institutions. The report sees these unions slowly evolving in parallel. However, it acknowledges that short-term measures need to be ambitious in order to be meaningful.

The challenge, as always, is getting it done. Of the bigger, more influential European economies, only France really has presidential commitment, with adequate domestic backing, to push the reform agenda. And that is not enough.

STRONGER TOGETHER

It is possible that economic reform in France will see a strong economic revival. President Macron has already implemented labour reform that will go a long way to addressing France's economic malaise. In doing so he is supporting regional growth, boosting confidence, reinforcing credibility and creating a platform for a new debate on European integration.

But what Europe really needs is for Germany to set aside its fiscal conservatism and take responsibility for the union and the role it plays. It needs to make a bigger economic commitment to the stability of the EU. Unfortunately, Germany's election outcome does not give much hope – despite the possibility of a more liberal, pro-Europe coalition, Germany remains fiscally conservative.

For many young Europeans, their only experience of being part of the EU has been miserable – high unemployment, fiscal constraints, poor wage growth, ongoing risk of economic crisis, banking fragility, systemic risk and external threats to their safety. There is a major risk that these voters opt out rather than integrate if nothing changes. Stronger economies may help counter the risk, but current growth will be put to the test soon: the next two years bring a host of fresh elections to the European calendar. If current growth falters, this optimism fades. ■

THE KOREAN CRISIS

ONE MISSTEP AWAY FROM CATASTROPHE

By Gideon Rachman

Gideon is the chief foreign affairs commentator at the Financial Times *and a globally respected journalist. He joined the* Financial Times *in 2006 after a 15-year career at* The Economist*, which included positions as a foreign correspondent in Brussels, Washington and Bangkok.*

After years of rumbling away in the background, North Korea has pushed its way to the very front of the international agenda. The North Korean regime led by Kim Jong Un is closing in on developing a nuclear missile that can hit the United States. But Donald Trump has vowed that North Korea will not be allowed to threaten the US with nuclear weapons. The US president has also repeatedly suggested that the US is prepared to take preemptive military action to prevent this from happening. Speaking at the UN, he even threatened to "totally destroy" North Korea, if it threatened the US.

Some sort of final crisis may now be in the offing. The Chinese government has compared the US and North Korea to two trains heading towards each other, at top speed. The question is whether either side is prepared to slam on the brakes.

It is highly likely that there are secret diplomatic contacts between Washington and Pyongyang – so the crisis could yet be resolved by negotiations. Alternatively, if North Korea is ultimately unwilling to freeze its nuclear programme, the US might indeed stage a military strike. But the strongest possibility is that America will ultimately decide that attacking North Korea is too dangerous – and will finally have to tolerate the North Korean nuclear threat.

The Americans know that any attack on North Korea could spark devastating retaliation against South Korea – and against US military bases in the region. North Korea probably now has more than 20 nuclear weapons – and they are dispersed in secret locations. Even if the US succeeded in 'taking out' all of North Korea's nuclear weaponry, the Pyongyang regime could still launch a devastating conventional artillery attack on South Korea, whose capital, Seoul, lies just 56 km from the North Korean border. American estimates suggest that up to one million Koreans could die if war broke out on the Korean peninsula.

North Korea is such a closed society that even academic specialists struggle to interpret its behaviour. The mainstream view is that Mr Kim's pursuit of advanced nuclear weapons is motivated by a search for security.

The North Korean leader has seen what happened to other dictators who failed to acquire these weapons – Saddam Hussein of Iraq and Muammar Gaddafi of Libya – and concluded that only nukes can guarantee his survival. North Korea would also be devastated by American retaliation – if it was unwise enough to attack US bases in South Korea, or elsewhere.

For that reason, it seems unlikely that either side actually wants a war. But it remains possible that North Korea and the US will stumble into a war by accident. The two key leaders – Presidents Kim and Trump – are both unpredictable and given to bombastic rhetoric. The dangers that they will miscalculate each other's actions – with catastrophic consequences – are real.

The Chinese government, North Korea's neighbour, is critical to hopes of a peaceful solution – but faces a complex set of calculations. Mr Trump has repeatedly tried to persuade Beijing to exert more economic pressure on North Korea, threatening that the US will take unilateral military action if China fails to force Mr Kim into line. China has sought to placate Mr Trump by toughening sanctions on Pyongyang. But the Chinese also have to consider how Mr Kim might react if he is forced into a corner. The risk that the North Korean leader will use nuclear weapons first will surely rise if he is faced with the prospect of the collapse of his own regime – and his own certain death.

It is also important to be realistic. The Kim regime currently shows little interest in diplomacy, or in responding to the tentative efforts at rapprochement from the new South Korean government.

For the moment, therefore, the world will have to trust in deterrence, containment and luck to avoid a catastrophe on the Korean peninsula. ■

SPAR

DUSTING ITSELF OFF

By Tumisho Motlanthe

Tumisho Motlanthe joined Coronation in 2007. A CFA charterholder, Tumisho researches SA retailers and food producers, as well as hotel and leisure companies.

Alfred Pennyworth: *"Took quite a fall, didn't we, Master Bruce?"* Thomas Wayne: *"And why do we fall, Bruce? So we can learn to pick ourselves up."* – Batman Begins (2005)

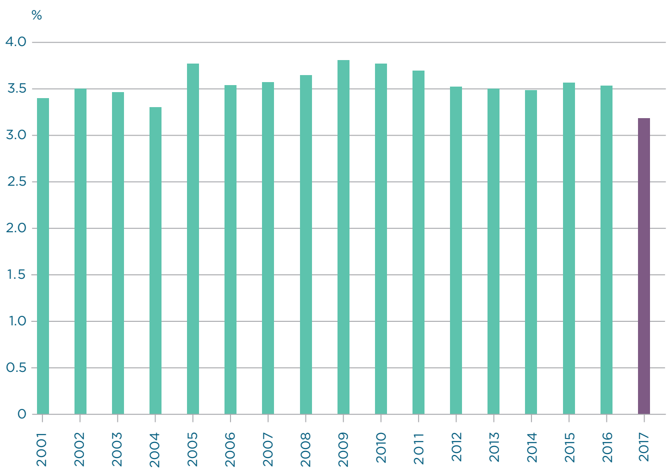
Four years ago, when we last wrote about Spar SA, the company had just turned 50 years old. Having faithfully served its communities throughout the decades, and handsomely rewarded investors since listing in 2004, the business and its share price were solid outperformers ... until about a year ago. From a high of R219, the share has tumbled nearly 25%.

Recent earnings have disappointed and some valid concerns are being raised around Spar as an investment. We too have wrestled with these concerns, and having concluded that the challenges are surmountable, we explain our thinking in this article.

IS PARADISE (REALLY) LOST IN SA?

In the six-month period to end-March 2017, Spar SA reported its lowest ever operating margin of 3.11%. This was a shock to the market and to us. Here was a business that, with metronome-like regularity, delivered 3.5% as a matter of course. While a difference of less than 0.4% may not sound like much, it is actually a 10% reduction in profitability levels – on margins that are already this thin! Compounding this was the fact that total revenue had declined in real terms, driven by a 5% decline in volumes through the retailer's distribution centres.

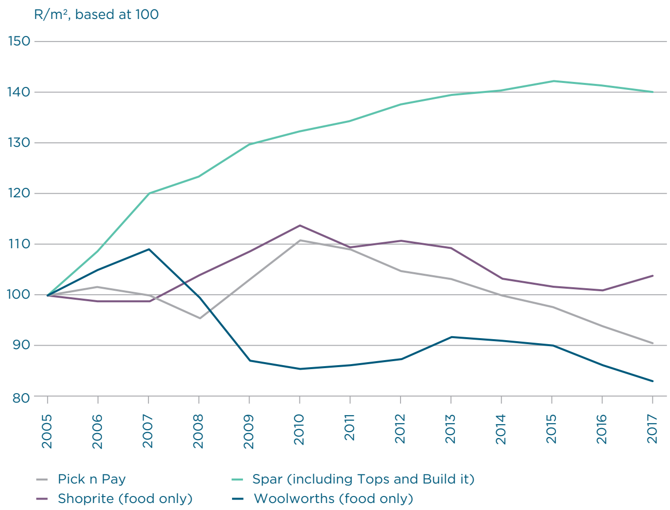
SPAR SA EARNINGS BEFORE INTEREST AND TAX



Source: Company financials

The following graph shows the evolution of retail space productivity in real terms, relative to 2005. What is clear is just how well Spar has managed this. Over the last two years, however, it has been declining, due to a number of reasons. First, Spar's excellent execution over many years has built a high base. Importantly, the economy is much weaker and consumers are very distressed. In addition, Spar is experiencing challenges with its business model. While the economy should recover eventually, the big fear is that Spar's model may fall down.

SA SUPERMARKETS: REAL TRADING DENSITY



Sources: Company financials, management guidance, Coronation estimates

We have spent a lot of time speaking with various people in the organisation as well as outside of it (competitors, suppliers, franchisees), thinking through these issues and contextualising recently reported numbers against long-term history. These channel checks have provided invaluable insight into the business model. We believe the model will withstand current pressures and that the market's fears are overdone.

Some of the factors we considered are:

- **Loyalty of franchisees.** Given the current difficulties, some of Spar's independent franchisees are currently weighing up the pros and cons of staying or leaving. Though it might be tempting to exit the agreement, the costs would almost certainly outweigh the benefits:
  - Being a member is financially lucrative. Spar carries the stock burden, so franchises have become a lot more cash generative over time. Ten years ago, its creditor days (the average time a company takes to pay its creditors) were at parity with stock days (the average number of days the company holds its stock before selling it). Now, creditor days are twice as long.
  - Spar's systems and processes are easy to use, freeing up franchisees from having to deal with suppliers and investing in fleet.
  - The transparent nature of the agreement with Spar engenders trust. Franchisees can easily compare it with that of competing retailers. Spar suffered only a single defection in the last year – the agreement is evidently compelling.
- **Limited threat of independent buying groups**. As beneficiaries of down-trading over the last few years, these retailers have managed to increase their market share. However, they are unable to effectively compete for Spar's customers in two key categories: fresh food and prepared/convenience meals. This limits their ability to entice Spar's franchisees away en masse, which lowers the risk of Spar being replaced as the wholesaler of choice.
- **Coordination of retail strategy**. Because the agreement between Spar and its franchisees is voluntary, it is no surprise that execution varies from store to store. This has resulted in differences in what customers find on shelves and in terms of the services offered (even within the same format), and has added to the difficulty of drawing new customers into their stores. Management has now confirmed two big, compulsory initiatives for all franchisees:
  - Money market counters and kiosks are part of the SA customer experience. These provide another reason for consumers to enter the store and two additional opportunities (sending money and receiving money) for Spar to build a long-term relationship with the customer.
  - The 'My Spar Rewards' programme has to be very visible in-store. The programme is being heavily promoted after Spar historically undervalued the importance of loyalty programmes.
- **Price perception set to improve.** Consumers wrongly view Spar as expensive, regardless of the store format. The company's previous marketing campaigns have not shouted loud enough about price. Future campaigns will see more price-focused advertising that clearly highlights how much consumers can save. Across the stores, all franchisees are now also running off a single point-of-sale system, which will allow promotions to be pushed seamlessly across the stores.
- **Space growth.** Spar's recent store roll-out has been slowed due to the weak environment. Franchisees have grown skittish about opening stores, while new property developments have been delayed. The company still has a healthy pipeline of new sites in areas where they lack a presence, and this will come on-line in the near to medium term.
- **Sustainable profitability.** We believe Spar's long-term profitability is higher than that reflected in today's margins. Operating costs have outgrown revenue, gross profit margins declined and volumes were negative – all simultaneously for the first time. Not the usual service we have come to expect over the years! In fact, volumes have never been negative over a full 12-month period. Pleasingly, volumes have picked up even as food inflation has come down, and there is every chance that volumes will finish the year in the black. Given Spar's largely fixed-cost base, this improvement suggests great potential for fatter margins in future. We expect 3.5% may be sustainable in the foreseeable future.

Once the environment stabilises and starts to improve, Spar should be off to the races. We expect the business to return to at least maintaining (and even growing) its retail space productivity. Along with the normalisation of margins, the earnings recovery should be strong off what we believe is a low SA earnings base.

EUROPEAN ACQUISITIONS

In recent years, Spar bought related retail businesses in Ireland, South-West England and Switzerland. Were these European acquisitions a mistake?

We think the acquisitions were strategically important, and see them as a natural extension of the business, given the limited scope for big store roll-out in SA as the group protects franchisee profitability. All the European businesses work on the same model as in SA, and in fact three of them are Spar licensees in those countries. In our view, management is staying within its circle of competence, reducing the risk of the acquisitions. Some R2.1 billion has been spent on these acquisitions and, seeing as they were acquired on price/earnings multiples of between seven times and 14 times, with good earnings growth potential, they make financial sense too.

Ireland – huge convenience opportunity

In developed markets, food retail formats are more clearly defined than what we are used to in SA, each with its own set of strengths and weaknesses. In BWG, Spar SA has acquired multiple banners (brands) which play in various formats. We estimate that 70% of group sales is in the convenience sector (think KwikSpar in SA), and BWG is the biggest player in this market in Ireland. We are excited about the very attractive fundamentals of this format:

- The convenience market looks set to take share from other formats, given rising income levels and an evolution in Irish lifestyles. DINK (dual income, no kids) households are on the rise, while elderly people living in cities increasingly demand prepared meals. These developments underpin a more stable demand, enhancing the defensiveness of the format.

- Convenience retailing is hedged against price debasement from discounters, given its different mix of products. Discounters have brought price deflation to fruit and vegetables, as well as to high-value groceries. In contrast, convenience stores specialise in home meal replacement, emergency buys and treat purchases. They also offer very high service levels, while stores are located in busy thoroughfares where discounters are not present.

- Store productivity is high given the heavy footfall through a small space, as well as the high price points of (and high margin on) goods.

In Ireland, distribution facilities are underutilised, which presents an attractive opportunity to drive volume. In SA, franchise loyalty sits between 80% and 85%, but this is far lower in Ireland (in the 60s). Franchisees also typically have more power given their size, where big players can run 50 to 200 stores, compared to only five to ten in SA. Over the last two years, loyalty has been increasing as Spar has proven its distribution expertise in Ireland, while demonstrating an ability to distribute the whole category basket.

In conjunction with our positive revenue outlook, we think margins have some way to go before reaching their true long-term potential. While margins are around 2% today, these should get above the 2.5% level and tend towards 3%.

Switzerland – a right-sized bet

The acquisition of Spar Switzerland appears to have been a bit rushed on the back of successful purchases in Ireland and the UK. Though management knew they were buying a sub-scale business (which has a market share of only 1% versus the top two players with a combined 80%), it turns out their due diligence intelligence was poor. Profits have fallen since acquisition. Sadly, of the European acquisitions, management paid the highest multiple for this one.

What is reassuring is that Spar has managed the size of its up-front investment accordingly. Spar only acquired 60% of this business versus 80% to 100% of its UK and Irish acquisitions. Furthermore, of Spar's R2.1 billion European investment, only a third was spent on this business.

Although it has disappointed, there are some early signs of a turnaround. Spar has relocated the former head of its KwaZulu-Natal distribution centre to take charge of the Swiss business, with the help of two other SA colleagues. After months of revenue decline, Switzerland has at the time of writing completed six consecutive weeks of sales growth. The Swiss operation represents 8% of group revenue, and while it does not make any money at the moment, just getting it back to a reasonable margin level will be very positive for group earnings, while growing revenues will provide further upside.

CONCLUSION

While Spar SA looks different today than it did four years ago, its essence remains the same. Fundamentally it remains an above-average return generator and converter of earnings into cash, with stable margins. Also, its management has a good track record of allocating capital. The business has stumbled in the last year, but much of this is because of the very subdued environment.

Spar is one of those agile businesses that, when faced with adversity, will emerge wiser and stronger. Given its current valuation – it trades on 12.5 times our assessment of normal earnings while offering a 4.5% dividend yield – we like the share more than we did a year ago, and we own a lot more of it as a result. Like the dark knight himself, we expect Spar to rise, and to contribute positively to our portfolios in the process. ■

AIRBUS

HEADING FOR CRUISING ALTITUDE

By Iakovos Mekios

Iakovos is an analyst within Coronation's Global Emerging Markets investment unit. He joined the business in 2013 and is a CFA charterholder.

Few displays of human ingenuity and technological progress are more impressive than the commonplace sight of massive metallic tubes flying people largely safely and reliably into airports across the globe. Aircraft are complex machines that inspire awe in the observer, but when it comes to investing in companies that are involved in either building or operating them, the experience has not always been quite as rousing.

We have always approached investing in air travel with caution. Airbus was a case in point. While it has been on our radar for the last few years, its past as a state-controlled entity with low profitability, a heavy and at times poor investment rate, and governance failures had kept us on the sidelines.

The business was born in the late 1960s and is an amalgamation of various European aerospace and defence companies that were put together over time with the ultimate goal of creating a pan-European champion that would compete with its US counterparts in these strategically important industries. In its commercial aircraft division, the most significant part of its business – which now accounts for 75% of revenue, followed by defence and space with 16% and helicopters with 9% – Airbus reached technological parity with its key American competitor, Boeing, in the early 2000s.

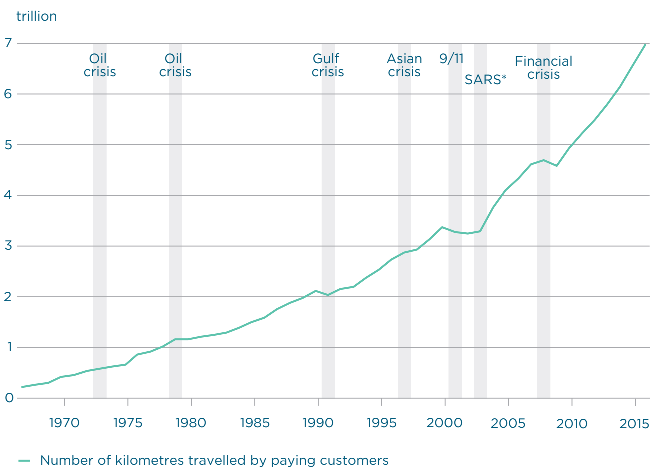
While Airbus (then known as EADS) was listed on the Paris stock exchange in 2000, its full privatisation started in earnest in 2012 when its French, German and Spanish state-owned shareholders agreed to limit their aggregate holding to a maximum 30% of the shares outstanding. By that point, the business was an established duopolist (along with Boeing) in commercial aviation and commanded market share of some 50%.

After decades of outsized investment, it was finally allowed to focus more on commercial priorities. The newly promoted management team at the time signalled this shift in mentality by taking rational decisions relating to its commercial aircraft product cycle: it decided to launch updated versions of its current programmes (known as 're-enginings' due to the application of a new, more capable engine on an aircraft body that was only slightly updated) rather than new, clean-sheet designs. The main advantages of 're-enginings' are that they are quicker to execute, carry lower technological risk – which is mainly borne by the engine makers instead of the aircraft manufacturers – and require significantly lower capital expenditure. Still, due to the long time lag in aviation between product launch and entry into service, the impact of these decisions will only start being evident at the end of this decade and even more so in the 2020s.

SECULAR GROWTH

The most important external variable driving the Airbus commercial aircraft division's long-term revenue growth is, of course, air travel. Ever since aviation became commercialised in the 1950s, air traffic has proven to be very resilient to external shocks. Wars, aviation disasters, natural phenomena, epidemics and economic crises have only temporarily stalled the growth in the number of annual air passengers. Air travel has recovered every time and has correlated well with the growth in countries' GDP per capita (as is evident from the graph on the following page).

WORLD PASSENGER AIR TRAVEL



* Severe Acute Respiratory Syndrome

Source: Airbus

This resilience speaks to the strength of the human desire to explore the world and to maintain personal connections. In fact, it seems that the demand for travel is almost insatiable: markets such as Europe and the US have been deemed 'mature' for decades, but keep growing at a reasonable pace as air travel frequency continues to increase.

MORE MONEY, MORE FLIGHTS

Sources: International Air Transport Association, Tourism Economics 'Air Passenger Forecasts'

The best example to illustrate this is the busy North Atlantic air travel market. Unlike other categories where structural growth subsides within a couple of decades, it is hard to imagine an end to air traffic growth in this century.

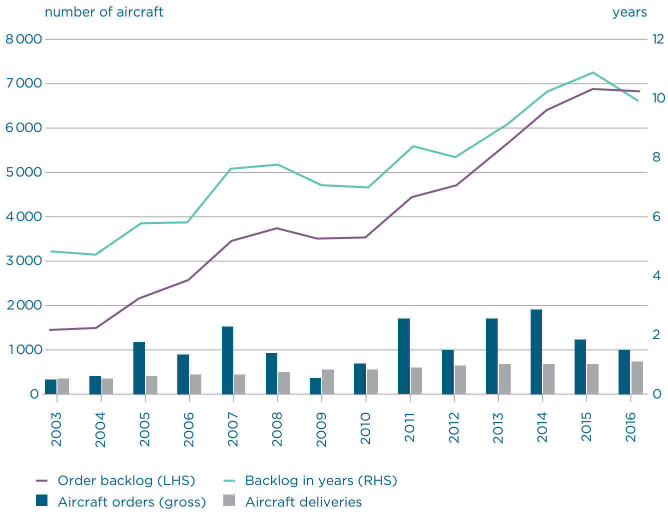
PASSENGER TRAFFIC BETWEEN EUROPE AND THE US

Source: Airbus

BACKLOG AND PROFITABILITY

In order to meet the global demand for aircraft, Airbus has been steadily increasing its production capacity. Backed by a very strong order backlog (worth almost 10 years of production at current production rates), the company is adding to its product suite and upgrading some of its current

AIRBUS COMMERCIAL ORDERS AND DELIVERIES



Sources: Airbus, Coronation

bestsellers. Still, its current earnings are abnormally low. This is due to the development of three new programmes, the A350, A320neo and A330neo. Airbus uses the cost accounting method to compile its financial statements, unlike Boeing which relies on 'programme accounting'. Airbus incurs the upfront launch costs of a new aircraft programme before the corresponding sales ultimately more than offset these costs over the programme's lifespan of 25 to 30 years. As the A350, A320neo and A330neo programmes mature, they will not only boost the revenue line, but also reverse the dampening effect they have on profitability and strongly improve free cash flow generation.

On top of this, the company's bottom line is currently affected by currency hedges. Its currency exposure is hedged out for many years in the future, and as a result of the weaker euro, maturing hedges have been expiring in the red. Over time, as hedges unwind, the business should benefit from any US dollar strength: the majority of its revenue is denominated in dollar, while a significant percentage of costs is linked to the euro and the British pound.

RISKS

The A400M military transport aircraft programme has been a problematic remnant from the 'old Airbus' era. The company has had to budget provisions of more than €6 billion in aggregate due to cost overruns and capability shortfalls. The resolution of the aircraft's woes depends on sensitive negotiations between Airbus management and government customers that could take longer than is currently anticipated.

Naturally, the global business cycle will affect aircraft demand (as well as military and helicopter orders), but we believe its large order backlog should insulate Airbus from sharp cyclicality. Moreover, barriers to entry are high:

new aircraft from competing manufacturers – Chinese and Russian in particular – appear at least 10 to 15 years away from becoming credible, commercial alternatives to the duopoly's products.

Although governance has improved materially in the last few years, Airbus faces outstanding investigations on alleged past transgressions. If these were to result in fines, we believe Airbus has the balance sheet to withstand them comfortably. We take governance into account when deciding on the quality of a business and we incorporate our view into the fair value multiple we assign to the company.

VALUATION

The stock trades on 18.5 times its expected 2018 earnings, which may seem like a rich multiple to pay for a European industrial. However, we believe the current price only partially discounts the profitability improvements that Airbus should deliver by the end of the decade, and almost completely ignores a second leg of profit uptick in 2020 to 2025 as new aircraft programmes enter maturity. Accordingly, Airbus recently became a holding in our Global Emerging Markets Equity and Global Equity (developed market) portfolios. The stock is eligible for both international strategies, as Airbus has more than 55% exposure to emerging markets, both by revenue and by its order book. This is the result of the rise of Middle Eastern carriers and the growth of the Asian middle classes, which have shifted global aviation eastward and increasingly towards emerging markets.

Commercial aircraft manufacturers are investments with very long cycles. In our view, this gives long-term investors such as ourselves an edge. We are able to look at a company's earnings and free cash flow generation potential many years out – key to appreciate the value we believe lies in Airbus. ■

ZIMBABWE

RETURNS THAT SOUND TOO GOOD TO BE TRUE ...

By Floris Steenkamp

Floris joined Coronation as an investment analyst in the Global Frontiers unit in 2014. Previously, he was an audit manager in the financial services division of PricewaterhouseCoopers.

You may think that the countries with the best-performing stock markets are those whose economies are booming, and those that enjoy large foreign investment inflows and stable political environments. However, when you look at the list of the best-performing stock markets thus far in 2017, you will find that the top spots are occupied by some unlikely candidates. Markets like Argentina and Kazakhstan (both up by more than 40% year to date in US dollar) saw strong recoveries from very low bases, but the real outliers are the two countries right at the top of the list, which are there for completely the wrong reasons.

In Venezuela, the stock market gain of more than 1 000% merely reflects the currency printing and hyperinflation in the economy. The official exchange rate is not the rate at which people unofficially exchange US dollars and the stock market gains therefore largely signify the true currency devaluation.

There are parallels that can be drawn between Venezuela and the second-best performer, Zimbabwe, which is up 189% year to date (to end-September). You would think that the performance in Zimbabwe – which adopted the US dollar as its official currency – should not reflect a currency devaluation, but in reality the country has created a new form of currency printing. As a result a dollar in a bank account in Zimbabwe is no longer worth the same as a physical US dollar elsewhere.

The problem with adopting the US dollar for Zimbabwe, which imports more than it exports, is that the dollars in the economy reduce if there are not enough foreign investments or international funding to plug the gap. After adopting the US dollar in 2009, Zimbabwe experienced a few years of economic growth, with renewed interest from foreign investors. However, in addition to the severe decline in agricultural output which turned the country from a net maize exporter to a net importer over the past three decades, a number of factors more recently resulted in accelerated outflows of US dollars.

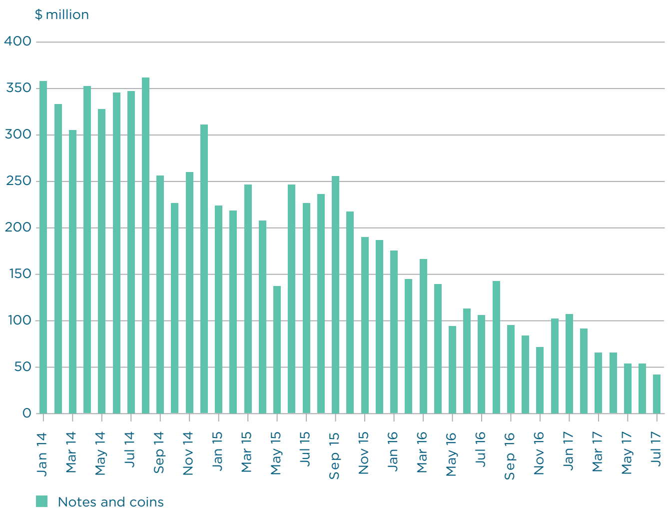
Exports declined as gold, which accounts for almost a third of Zimbabwe's exports, fell from above $1 700 per ounce in 2012 to below $1 100 per ounce in 2015.

As Zimbabwe's largest trading partner, the fact that SA's rand lost almost half of its value against the dollar between 2012 and 2016 has left Zimbabwe completely uncompetitive. It became much cheaper to import, hitting local businesses hard. It also meant that the US dollar value of diaspora remittances reduced, dropping by almost 18% in 2016 alone.

Net direct foreign investments slowed from $473 million in 2014 to $255 million in 2016, and portfolio investments also turned negative last year.

It has also become almost impossible for the country to access international funding, as these lenders are demanding significant reforms. This means that the physical US dollars in the economy are now close to being depleted, which is evident from the following graph showing the decline in currency held by the commercial banks.

NOTES AND COINS HELD BY COMMERCIAL BANKS IN ZIMBABWE



Source: Reserve Bank of Zimbabwe

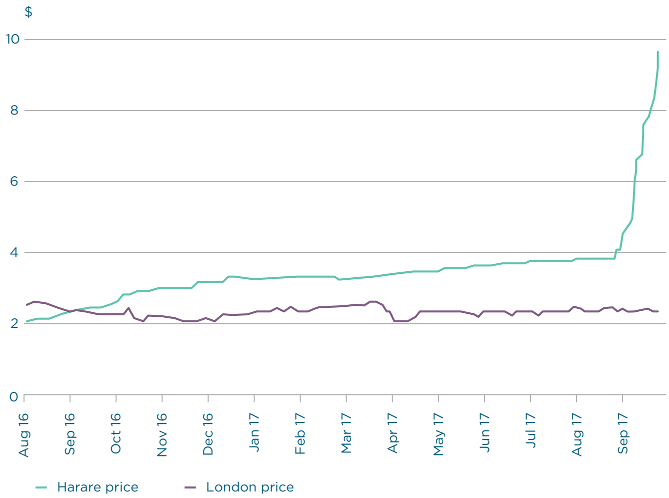
The cross-border flow of dollars, particularly out of the country, has become more and more regulated, with imports of basic food products and the inputs of net exporters being prioritised, while the capital of investors is (much) lower down on the list. This means that for all practical purposes it has become impossible for a foreign investor to repatriate funds.

In 2016 the cash shortages became so problematic that the Reserve Bank started printing the so-called 'bond notes', basically a new form of local currency that officially holds the same value as the US dollar. However, what started as $10 million in bond notes injected into the market in November 2016 grew to at least $175 million, with talk of much more to come. The combination of the US dollar shortage and the fact that foreign companies do not accept bond notes as payment for imports meant that people were quickly willing to pay more than one bond note for one US dollar. From anecdotal evidence, the premium was between 10% and 25% earlier this year, but this recently increased to around 60%. In many ways this is similar to the black market for US dollars in Venezuela.

Objective evidence that there is a large difference between a physical US dollar and an electronic dollar or bond note in Zimbabwe is the fact that the share price of Old Mutual, which is listed in both Zimbabwe and London, trades at vastly different values on the different exchanges. Many investors track this difference as an estimate of the effective currency devaluation.

The following graph shows that Old Mutual's Zimbabwean-listed shares, which traded at parity in August 2016, were almost four times more expensive than the London-listed shares at the end of September 2017. Stated differently, the Old Mutual share price in Zimbabwe needs to be impaired by 73% to reflect the same share price as the London listing.

OLD MUTUAL SHARE PRICE



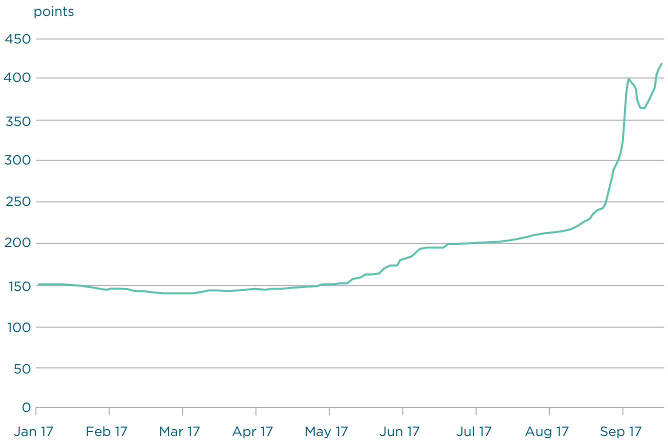
Source: Bloomberg

At ATMs in Zimbabwe, people struggle to draw more than $20 per day, and the money they do get can either be in the form of US dollars or bond notes, with the latter being much more likely. Although locally produced food products are still priced at a level fairly similar to what they were at the beginning of the year, signs of hyperinflation are emerging, with some imported products tripling in price over the last few months.

With the hyperinflationary mid-2000s still fresh in investors' memories, they are doing exactly what they did during that time and are using all cash trapped in Zimbabwe – either in the form of bond notes or electronically such as a bank account balance – to buy assets that store value. Property prices rise as people put their cash into real estate and companies are even reporting a jump in the sales of electronic goods.

But the most conspicuous reaction is the way people have been piling into the stock market. Locally listed Zimbabwean equity prices have seen excessive and unwarranted gains, with share prices now well above our estimates of fair value. Using these quoted prices, our African-focused portfolios showed large paper gains. However, as these gains are not realisable, we had to evaluate our valuation methodology for these companies to ensure that we do not overstate performance, and that both new investors into these funds and clients who want to withdraw funds are treated fairly. As a result we have impaired a significant portion of the value of all in-country Zimbabwean assets to account for the unwarranted gains.

ZIMBABWE INDUSTRIAL INDEX



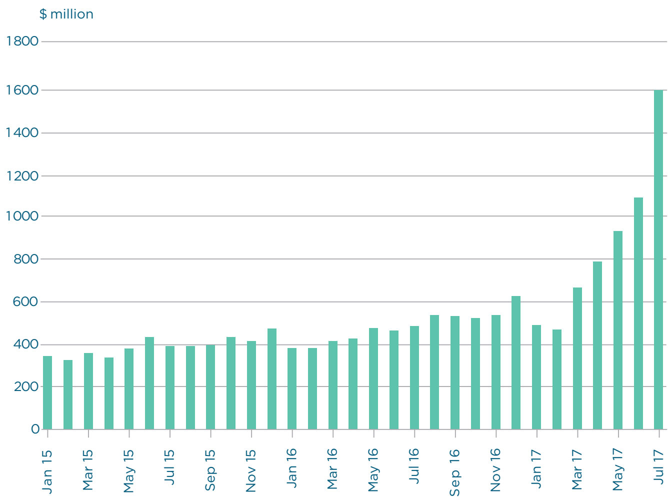
Source: Bloomberg

The Zimbabwean exposure of our African portfolios is largely concentrated in Econet Wireless and Delta Corporation. With returns for the first nine months of this year of 243% and 212% respectively, these two companies still contributed positively to the funds' overall returns over this period, despite the write-downs.

Although the operating environment in Zimbabwe is currently extremely challenging, these two high-quality businesses are entrenching their moats as the dominant players in their respective industries.

A good example is EcoCash, Econet's mobile money business. With a market share of close to 100%, this business is thriving in the current environment. Zimbabwe's cash

VALUE OF MOBILE TRANSACTIONS IN ZIMBABWE



Source: Reserve Bank of Zimbabwe

shortages resulted in a spectacular rise in the number of transactions on its mobile money platform, as demonstrated by the graph above. This environment is driving a massive acceleration in the adoption of mobile money technology, which has transformed this business. From simply providing an alternative option for payments a few years ago, EcoCash is now an absolutely fundamental part of the economy.

Africa has experienced a number of currency crises over the years. We know they do not last forever and we have seen the positive outcomes of being invested in countries like Egypt and Nigeria when their currency situations improved. We do not know when this will happen in Zimbabwe, but what we do know is that at some point something has to give. If shelves are empty and filling stations run dry, the country will be forced into significant interventions, and with its recent traumatic events still fresh in memory, this might well play out much faster this time around. The signs of hyperinflation are already clearly visible and the possibility of a watershed moment is as real as it has ever been, with increased discontent among the general public, more reports of political infighting and government's finances basically depleted. ■

We still view the Breadbasket of Africa as a country with immense potential and our focus is on owning the high-quality companies that will emerge from this volatile environment as stronger businesses.

SA ON THE BRINK

BUT WE HAVE BEEN HERE BEFORE

By Marie Antelme

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

The SA economy might grow by 0.7% this year. If we are lucky. The numbers tell us that there has been very little spending by households, whose incomes are under pressure, and no-one is investing.

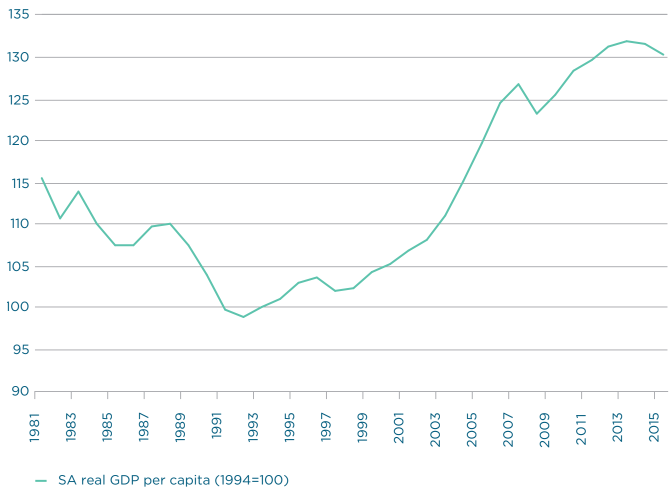
The real story is more complicated. Households' incomes are stagnating because there has been no employment growth, and while inflation is more subdued, it has not compensated for a bigger tax burden. Consumers who can afford to spend have not done so because confidence has plummeted. Investment has not grown because government has an expenditure cap, and its revenues have disappointed. Companies have not invested because profitability has been poor and they, too, are worried about the economy. The latest business confidence data from the Bureau for Economic Research (BER) suggest that 65% of respondents think current conditions are unfavourable.

There are only three things that make economies grow: absorbing more labour (creating jobs), investing in better infrastructure (creating capacity) and combining the employed labour and better infrastructure in more productive ways (total factor productivity). These seemingly simple requirements are inherently enormously complex, and rely on an implicit fabric of socioeconomic and political stability, predictability, governance, ingenuity, education and time.

Where does government fit in? Government's job is not to make economies grow; its job is to implement policies which enable the private sector to invest in growth. These include creating and reinforcing institutions which facilitate, educate, oversee, regulate, implement and police economic and social policies. In practice, the impact of government on the economy is much more complex. Feedback loops between policies and their economic translation often have unintended or unanticipated consequences. Often, it is not even policy, but a lack of policy that can have a damaging impact on the economy. A failure of confidence can have long-lasting and far-reaching repercussions.

This gives us a framework within which to assess the way in which the economy has grown and evolved since democracy, and a way of articulating some of the challenges we now face. The graph below is the best illustration, showing real per capita GDP since the run-up to democracy, and three distinct periods of post-democracy growth.

SA REAL GDP PER CAPITA



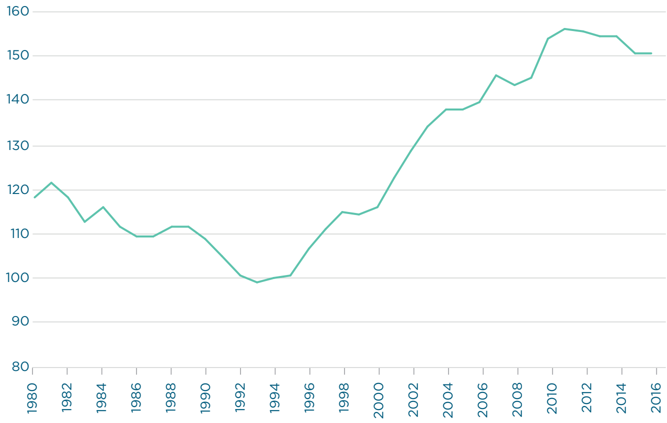
Source: Statistics SA

1994 – 2001

In 1994, the ANC inherited an economy that was almost bust. Per capita GDP growth had been contracting in real terms for more than a decade amid international sanctions and a collapse in private investment, with an apartheid government which scrambled to create capacity which the private sector would not. The government deficit ballooned to -7.1% of GDP in 1993, and by 1996 debt accumulated to 48.2% of GDP. Inflation surged.

The incoming government liberalised and simplified internal institutions (abolished trade boards and subsidies, etc.), opened up trade with the rest of the world, implemented a new economic framework and initiated a fiscal reform programme (which included the Medium-Term Expenditure Framework budgeting process) to ensure transparency and improve participation. The economy benefited enormously from resurging confidence. Investment boosted productivity and potential growth estimates were revised higher to 3.6%[1].

SA PRODUCTIVITY



Source: Organisation for Economic Co-operation and Development (OECD)

Still, the period was not plain sailing ... The Tequila Crisis in 1995, as well as meltdowns in Asia (1997) and Russia (1998) all rocked SA's fragile markets and saw growth contract. With few fiscal resources and a central bank with a flexible mandate, the main policy rate surged to 21.85% in September 1998, the currency plummeted and higher inflation followed, peaking at 9.3% year on year in November of that year.

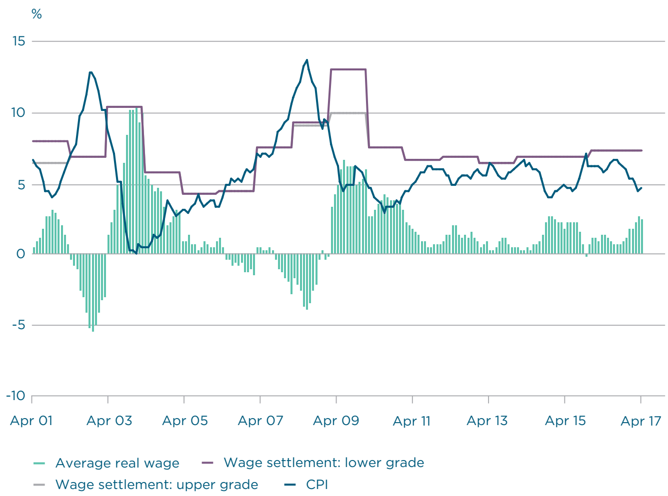
The official implementation of the inflation target from 2000 provided greater transparency and stability to monetary policy. During this time, real GDP averaged, with some volatility, at 2.9%.

2002 – 2009

The 2001/2002 currency crisis led to a spike in inflation and prompted the recently inflation-targeting central bank to raise the repo rate from 13% in September 2001 to 17% a year later. But the weaker currency boosted competitiveness and manufacturing output surged in a world where global growth was accelerating. The modern rise of China in turn raised commodity prices and was the catalyst for a multi-year boost to domestic terms of trade. As SA's growth momentum increased, job creation improved, credit was extended to a wider proportion of the populace and a combination of conservative budgeting and upside surprises to nominal GDP facilitated a healthy dose of fiscal healing. Gross government debt fell steadily from its 1996 peak to 26% of GDP in March 2009 as the primary deficit moved into surplus. Growth during this period averaged a robust 4.4%.

By 2009 government implemented textbook-true counter-cyclical fiscal policy in response to collapsing growth amid the global financial crisis. Government expenditure surged from 28.7% of GDP in 2008 to 33% by 2016 ... and then did not budge. Much of the increase went to a massive expansion of the government wage bill as the state's employment rose from 24% of total employment in 2008 to 27%. On top of hiring, civil servants were awarded large employment-adjusted real increases. The massive increase in government employment further boosted the last driver of domestic growth – an accelerated emergence of the middle class.

SA PUBLIC SECTOR WAGE AGREEMENTS

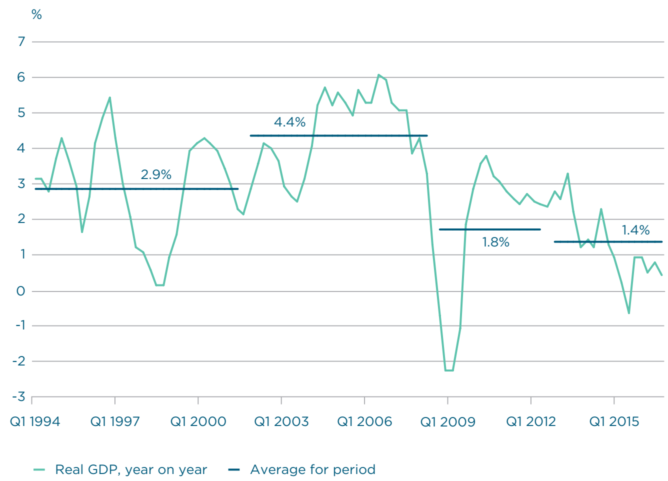


Sources: Statistics SA, National Treasury, JP Morgan, Coronation

2009 TO DATE

After an initial recovery (real GDP growth reached about 1.8%), growth has slowed steadily since 2012, averaging 1.4% since that time, but clearly slowing more recently. An absence of sustainable drivers in a weak global economy offers some

SA REAL GDP



Source: Statistics SA

[1] N. Ehlers, L. Mboji and M. Smal, "The pace of potential output growth in the South African economy", South African Reserve Bank Working Paper, Research Department. March 2013.

explanation, as do idiosyncratic domestic events, including a rise in strike activity in 2012 to 2014, a crisis in electricity provision and the drought in 2015/2016. Still, the malaise has persisted even as these factors subsided.

A closer look at the data offers some clues: both household spending and overall capital expenditure have contributed less than before. Households have been under pressure from slow employment growth, spikes in inflation and a growing tax burden. Businesses have scaled down investment in capacity because global growth has been poor, compounded by a weak domestic economy. The most distressing reality though is that confidence levels of both businesses and consumers have tumbled to levels not seen since the early 1990s.

Businesses specifically have cited political uncertainty as a key constraint on investment in the BER's business confidence survey. Households think future domestic economic conditions will be worse than today. This combination of low employment growth and poor capacity expansion (in SA's case, this has fallen below capital replacement) has led to lower productivity and a significant deterioration in our estimated potential growth rate. The latest SA Reserve Bank assessment calculates this at about 1.1% for this year.

SA has few levers to pull to generate higher growth: the 'democratic dividend' is certainly a thing of our past; a helpful upswing in global GDP will help, but the kind of boost from terms of trade which facilitated employment and investment before is unlikely in a world of high leverage and excess capacity. SA's own middle class could help, but only if employment, education and confidence improve. In short, we have no low-hanging fruit. Growth from here will require focus, commitment and a meeting of minds that are currently very far apart.

Much hinges on the political outcome of the ANC elective conference in December. There is a huge amount of guesswork, branch counting and slate speculation about the combination of candidates who may be elected to the National Executive Committee, and importantly, the 'Top Six'. I honestly do not know what the outcome will be. I do know that a continuation of the status quo – the blatant theft, state capture without recourse and utter incompetence at strategic state institutions – is likely to reinforce the domestic constraints on growth. With this comes lower credit ratings, a weaker currency, probably higher interest rates and certainly fewer fiscal options as government finances continue to deteriorate. Still, assuming that this is the only outcome may be risky. Much has changed – the exposure of graft may constrain future fraud and public awareness makes legal recourse more likely.

SA has been on the brink before. Maybe the challenge is bigger and the rot more ingrained. Maybe not.

Importantly, there are people willing to do the 'right' thing, possibly even with their branch vote. A small shift in the leadership outcome could make a great deal of difference to key institutions, strategic ministries and regulators. Perhaps most important of all, some indication that politics in SA have shifted will reopen communication between the private sector and government, lifting very depressed confidence and opening the door, even just a crack, for better growth outcomes than seem possible now. ■

BOND OUTLOOK

AN EERIE FEELING OF STABILITY

By Nishan Maharaj

Nishan is head of Coronation's fixed interest investment unit. He joined the business in 2012 and has 14 years' experience in the investment industry

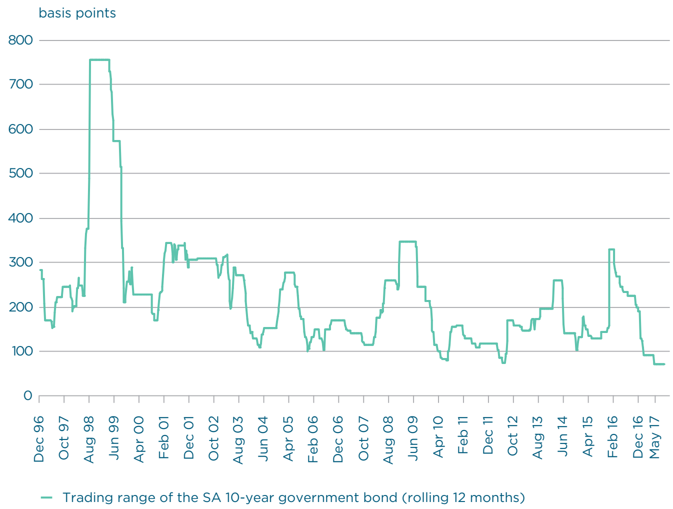
The performance of many fixed-income asset classes over the last quarter has masked increasing divergence in longer-term market expectations, resulting from heightened levels of uncertainty. Uncertainty is a familiar bedfellow of investors, and increased uncertainty historically manifests itself in asset prices. SA finds itself at the arduous intersect of extraordinary global and local uncertainty. Globally, the direction of monetary policy, the impact of unwinding quantitative easing and increasing political disruptions continue to obscure the macro picture. Locally, the outcome of the governing party's leadership race and more importantly, its effect on policy implementation, remain crucial for the struggling local economy. Despite all of this, SA assets have continued to defy the gravity of local fundamentals.

This past quarter saw the All Bond Index (ALBI) gain 3.7%. Its returns for the year to date and over a rolling one-year period, at 7.8% and 8.2% respectively, are both well above cash. While the yield of the long-term section (12 years and longer) of the ALBI is well above 9.5%, it has been the three- to seven-year area of the bond curve that provided the best performance year to date and over 12 months. The shorter end of the bond curve has been anchored by expectations of a lower repo rate, which was eventually cut in July.

In addition, strong emerging market bonds have buoyed local bonds. Over the previous quarter, the ALBI's performance in dollar (-0.6%) was behind that of the JP Morgan Emerging Markets Bond Index (+2.4%). Still, the ALBI's performance year to date (+7.8%) is in line with emerging markets (+8.8%). Over a rolling one-year period, the ALBI (+9.1%) is far ahead of the emerging market index (+4.2%). SA's high yield relative to its emerging market peers has helped attract foreign capital and prevented any material widening in yields (capital loss), thus far.

The SA 10-year benchmark bond started the quarter just above 8.8%, touched a low point of 8.4%, but spent the majority of the quarter between 8.5% and 8.6%. Despite the elevated levels of uncertainty, bond yields have not been volatile. Over the last year, the benchmark bond's trading range (the difference between the highest and lowest traded yield) has narrowed steadily to below 100 basis points – the lowest level in the last 20 years. This hardly seems to reflect a high level of uncertainty.

SUBDUED VOLATILITY



Sources: IRESS, Coronation

There are a few interlinked reasons that explain these low levels of volatility in the local bond market. First, it is important to distinguish between volatility and uncertainty. Volatility occurs when uncertainty suddenly materialises in definitive actions that impact asset prices. Since the Nenegate crisis, there has been an increase in uncertainty, but not an increase in definitive policy actions that have had an actual impact on underlying asset prices. Also, the market holds very different views on the implications of possible policy actions, providing very little guidance as to how asset prices should/could behave.

To us, the major concern is that the prolonged lack of definitive policy actions will further undermine a lacklustre economy, eventually triggering a stark reaction from the market. At the moment, the current subdued volatility is feeding an underlying complacency about possible market outcomes. Over the last year, low levels of volatility have allowed investors to safely earn the yields offered by local bonds. But stability begets instability – investors extrapolate current stability and expect that things will always remain fine. The slightest unexpected negative event may then trigger an overreaction, and the ultimate outcome may be much more dangerous. There is only one way to protect our investors against this risk: by only investing if the underlying assets are cheap enough to withstand any short-term deterioration in fundamentals and/or volatility.

So, are SA bonds cheap enough? One way of determining the fair value of SA government bonds is by doing a calculation (demonstrated below) featuring the global risk-free rate (US 10-year bond rate), the inflation premium required when investing in local assets (the difference between expected SA and US inflation) and the riskiness of SA as a borrower (SA's credit default spread).

All inputs used in the following calculation come directly from the valuations implied by the markets. For instance, the 10-year US and SA inflation rates are implied by the 10-year nominal and inflation-linked bonds.

SA BONDS: CHEAP OR EXPENSIVE?

As at 29 September 2017

US 10-year bond		2.33%
US 10-year implied inflation	minus	1.85%
SA 10-year implied inflation	plus	6.08%
SA credit spread	plus	2.39%
SA 10-year fair value	=	**8.95%**
SA 10-year current trading level		**8.55%**
Difference between the fair value and its current level		**(0.40%)**

Conclusion: the SA 10-year bond is 0.4% more expensive than our estimate of its fair value.

Sources: IRESS, Coronation

It is evident that SA government bonds are expensive relative to their fair value. One could argue that market expectations for SA inflation are too high and should be closer to between 5.2% and 5.5%, but similarly, the current level of the US 10-year bond probably should also be higher (perhaps 2.8% to 3%), given the impending unwinding of the US quantitative easing programme. Also, the absolute level of the SA credit spread may require extra scrutiny: the current level could be more reflective of the global 'risk-on' environment, and not SA's precarious fiscal situation.

The key takeaway remains that SA government bonds are somewhere between fair value and expensive. In the short term, the global backdrop remains supportive, with growth pushing higher, inflation heating up (but contained) and global yields remaining complacent. However, local valuations do not offer any margin of safety against bad news. It is therefore difficult to justify a long/overweight duration position in the SA 10-year bond yields.

So why are SA 10-year bond yields continuing to trade at more expensive levels?

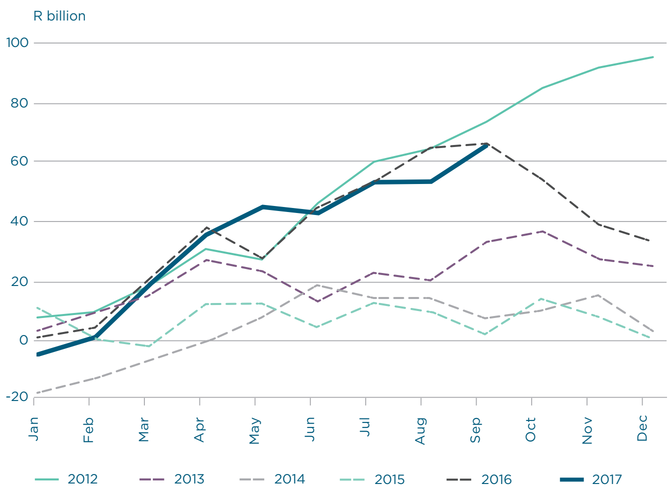
To start with, the market expects more interest rate cuts. Consumer inflation has moved lower and is expected to remain well behaved over the next two years. Meanwhile, the faltering economy is growing well below its potential, which has lowered both the SA Reserve Bank's and the markets' expectations of short-term rates in the first half of the year.

Following the SA Reserve Bank's repo rate cut in July, the market expects the repo rate to move lower by another 0.5% over the next six to nine months. This has enhanced the attractiveness of SA bonds relative to cash and acted as a strong anchor for the bond market, keeping the upside on yields well contained. There has, however, been a much larger force keeping SA bond yields trading at expensive levels.

Foreign inflows into the local bond market have been substantial this year, at approximately R70 billion. This ferocious buying spree is almost on par with the pace of accumulation seen in 2012 when SA was included in the Citigroup World Government Bond Index (WGBI). But in 2012, the outlook for the economy was much better. In addition, SA's credit metrics were much healthier and among the strongest of its emerging market counterparts, whereas now SA is staring down the abyss of subinvestment grade.

SA is currently benefiting from a flow of capital towards emerging market bonds. The market expects that global inflation will undershoot targets in the shorter term, that the unwinding of quantitative easing will not have much of

INFLOWS INTO SA BOND MARKET



Source: JSE

an impact and that developed market bonds will remain well behaved. Unfortunately, all of these assumptions are based on shorter-term outcomes that can dissipate quickly. Market expectations for US rate hikes are still materially below what the Federal Reserve (Fed) is guiding – to such an extent that the current market pricing of the long-term Fed target rate is 1% below the Fed's own guidance (1.75% versus 2.75%). Investors are buying emerging market (and SA) bonds because they offer much higher yields, but the underlying assumptions about US yields are either very stretched or at risk of being too optimistic.

Also, consider that if SA were to be downgraded to below investment grade, it could result in the mandated selling of R120 billion to R150 billion worth of SA government bonds by passive trackers of the Citigroup WGBI. It is quite difficult to see the current pace of inflows continuing to contain yields if that event were to occur – especially in light of the fact that the SA government also needs to fund itself to the tune of R180 billion to R190 billion every year. Foreign inflows need not reverse, but just abate, for the yields of SA government bonds to succumb to the supply dynamics.

The underlying mix of factors driving the current level of yields in the SA bond market is concerning. Low volatility has increased complacency, supported by aggressive short-term inflows into the bond market. This has created an eerie feeling of stability despite a steadily deteriorating local backdrop. Meanwhile, the international environment is becoming less friendly for carry trades. Yet investors continue to revel in delusions fuelled by the accommodative global monetary policies of yesteryear.

Local bonds are at levels deemed to be on the expensive side of fair value, and do not offer a sufficient margin of safety if one of the short-term supportive factors should fall away, or the economy suffer a further deterioration. We remain cautious in our approach to investing in the local bond market. Only when bond yields are cheaper than fair value and offer an adequate buffer against expected adverse volatility will we look to deploy capital meaningfully into the asset class. ■

A DECADE OF DISTORTION

THE GRIM LEGACY OF THE FINANCIAL CRISIS

By Tony Gibson

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

INVESTOR COMPLACENCY

As we approach the 10th anniversary of the global financial crisis, there is again much to worry about. In one word, complacency is the biggest investment risk at present. Over the past ten years, new risks have appeared – more specifically in the areas of volatility and liquidity. Quantitative easing has created the delusion of permanent liquidity, as well as encouraged the mispricing of risk. Pretty much every asset class is currently making new highs, supported by a range of positive factors. The strongest of these supports is the steadily improving rate of global growth (albeit to levels well below those prevailing in the last decade before the crash), coupled with inflation remaining subdued. Investors have concluded that the combination of these factors will be positive for corporate earnings. Additionally, this is within an environment in which monetary policy remains very accommodative. Although central banks wish to 'normalise' monetary policy, the fear of a policy error is holding them back from implementing the process any faster than 'extremely gradually'. Essentially, investment markets are currently in a positive virtuous circle.

As mentioned, global inflation remains low, despite improving growth. In the US, the country at the top end of developed market inflation, the core inflation index is increasing at an annual rate of only 1.4%. This is well below the Federal Reserve's (Fed) inflation target of 2%. In Europe, the core inflation rate is currently 1.2% – again well below the 2% target set by the European Central Bank (ECB). In Japan, inflation is running at a mere 0.5%. Even in emerging markets, inflation presents no meaningful pressure, with the Bloomberg inflation index for emerging markets currently at 3.4%. The net result is that, despite the intention to normalise monetary policies, central banks continue to expand their balance sheets to support growth in the developed nations.

Research suggests that, over the past 12 months, the sum of the ECB, Fed and Bank of Japan balance sheets has grown by 11.4%.

The combination of improving global growth, moderate inflation and supportive central bank policy has therefore provided a positive backdrop for global equity markets this year. And barring a shocking turn of events in North Korea (as discussed on page 13), that same positive combination seems likely to continue to support equity markets in coming months.

Given the prevailing investor complacency, equity valuations need to be monitored carefully. It can be argued that global equity markets trade at reasonable valuations, with price earnings ratios for the MSCI World, MSCI Europe, Australasia and Far East, and MSCI Emerging Markets indices trading at 16.4, 14.5 and 12.6 times forward earnings respectively. Put another way, earnings yields of 6.1%, 6.9% and 7.9% on these equity markets respectively still seem quite competitive relative to prevailing government bond yields. To give this context, for example, the real yield on 10-year inflation-indexed US Treasuries is trading at only 0.3%. Real yields in Europe and Japan actually remain negative.

THE GREAT UNWINDING

This relatively benign interest rate environment for developed market nations should give emerging market central banks latitude to ease monetary policy on a discretionary basis in response to country-specific inflation trends. To illustrate this, in August we saw rate cuts in India, Indonesia and Colombia, while rate cuts are expected soon for Brazil, Hungary and Russia. The weakness of the US dollar this year has also given emerging market central banks more latitude to opt for easier monetary policy where appropriate.

There are of course several sources of economic uncertainty beyond the North Korean issue. The disruptive force of Hurricane Harvey is likely to add volatility to US economic data in coming months – at a time when the country has to grapple with the ongoing potential for a government shutdown. There is also concern that China's negative credit impulse could slow growth in coming months. Still, recent Chinese data have been notably resilient, with the official Purchasing Managers' Index strengthening to a solid 51.7 in August, which is the second-highest reading for the year.

On the current state of complacency, it should be recalled that a decade ago, subprime problems were thought to be contained, global stock markets were scaling record highs, negative interest rates were unimaginable and barely anyone had put the words 'quantitative' and 'easing' together. However, this state of Nirvana met its demise soon after, and quantitative easing has been a feature of the economic and investing landscape ever since. Therefore, despite the current sanguine approach from investors, the Fed's announcement that it will begin rolling back quantitative easing should be seen as a defining moment in the post-crisis era. That said, many investors remain dismissive about its implications.

ARTIFICIALLY LOW COST OF CAPITAL

A further point that investors should not overlook is the fact that borrowing costs for companies are at record lows. It must, however, be pointed out that the overall borrowing cost for companies is depressed largely because of historically low government bond yields. Credit spreads – the difference in yield between a treasury bond and a company bond – are still some way from their tightest levels of prior cycles. For instance, credit spreads for US investment-grade companies are currently around 135 basis points (bps). They were actually well below this level in 2007 and in 1997. Meanwhile, European investment-grade spreads now trade at about double their 2007 level of near 60 bps. The conclusion of this is to remind investors that the corporate sector is not necessarily mispricing risk; it is the whole interest rate curve that is distorted by ongoing central bank interference.

In addition to the distortions caused by the prevailing (artificially low) cost of capital, there is a broader societal theme that worries us. Ageing populations, global sourcing of goods and services, and technical innovations are widening gaps in income, job opportunities, living standards and ideology. Secular headwinds continue to disrupt the lifestyles of many people around the world. The symptom of this is the loss of middle-class jobs, wages and benefits, and therefore prospects for a more secure and prosperous future. It is this erosion of the middle class that has triggered a backlash against the status quo – be that against global trade, capitalism, the financial sector or political leaders.

HIGHER TAXES, FEWER SERVICES

Unfortunately, the dearth of well-paying jobs, resulting wage stagnation and the loss of faith in the future will intensify over the next decade as technology increasingly eliminates or automates tasks – including in the labour-intensive service sector. The real worry is that while job anxiety, frustration and loss of confidence are likely to increase populist pressures to protect jobs, incomes and living standards, governments will have limited ability to respond. This is due to the fact that a growing share of public sector revenue will be absorbed by the pension and healthcare needs of ageing populations and an inevitable rise in debt service costs.

Of course, this gradual unwinding of the social order has been partially masked over the past decade by distortions set in motion by well-intended central bank monetary manipulation. Implemented as an emergency measure to prevent the deep 2008 to 2009 recession from spiralling into a self-feeding deflationary contraction, central bank bond buying has caused, in addition to investor complacency, public sector complacency that fed excessive spending and overregulation. Inevitably, over the next decade, a widening gap between public sector income and spending will lead to higher taxes – for fewer services.

If the distortion of borrowing costs had been short-lived, for say, two to three years, the impact of 'normalising' interest rates (and central bank balance sheets) would have been limited in scope and duration. Instead, the protracted suppression of interest rates has had an excessive impact on public spending, borrowing and debt service costs.

Since the Fed became a major buyer of new debt issued by the US Treasury, spending has been unconstrained over the past 10 years and US federal debt has doubled, from $10 trillion to $20 trillion. Fed intervention not only reduced the cost of new deficit spending, it also significantly lowered the cost of rolling over maturing debt. Hence, while the total debt doubled over the past decade, the annual cost of servicing the US federal debt has stayed nearly flat.

AN UNSUSTAINABLE 'NEW NORMAL'

In our opinion, this situation is ultimately unsustainable. As the Fed (soon to be followed slowly by the Bank of England and the ECB) steadily reduces bond buying, a slow but steady normalisation of interest rates will begin. In 2007, the US paid an average of 5% on its $9 trillion federal debt. This year, the US is paying only 2.28% on its $20 trillion debt. A doubling of the debt is masked by cutting the interest rate in half. As interest rates slowly normalise over the next five to seven years, so too will the cost of servicing a further relentless rise in the total US federal debt. If, for example, the average interest rate paid on debt rises to 2.4% next year, 3% in 2020, and 4% by 2024, the annual cost of servicing the US debt will double. Simply put, during the next presidential term (from 2021 to 2024) the president and Congress must spend an additional $80 billion to $100 billion each year – not on schools, healthcare, defence or Social Security, but to pay the rising cost of servicing the federal debt. The majority of Americans do not yet seem to appreciate the gravity of the debt service problem set to explode in the next decade.

There are of course those commentators who believe that we are today in a 'new normal' – and that there is an implicit guarantee that interest rates will remain extremely low for many years to come. In our opinion, it will be unwise to indefinitely suspend sound economic thinking. Investment trends do always revert to normal with time. The current level of developed market interest rates is abnormal – and will not endure in perpetuity.

As long-term investors we just do not know how the current set of uncertainties will play out. Investors must therefore give thought to how to navigate the challenges that lie ahead. Not least of these challenges is the fact that most (known) asset classes are highly priced due to excess liquidity and investor complacency. Setting risk tolerance guidelines is one of the steps when it comes to exposure to risk investments. Within risk investments, finding underpriced investments is rare. The focus is therefore more than ever on identifying stocks that can produce real earnings growth on a sustainable basis. ■

DOMESTIC FLAGSHIP FUND RANGE

Coronation offers a range of domestic and international funds to cater for the majority of investor needs. These funds share the common Coronation DNA of a disciplined, long-term focused and valuation-based investment philosophy and our commitment to provide investment excellence.

■ INCOME ■ GROWTH

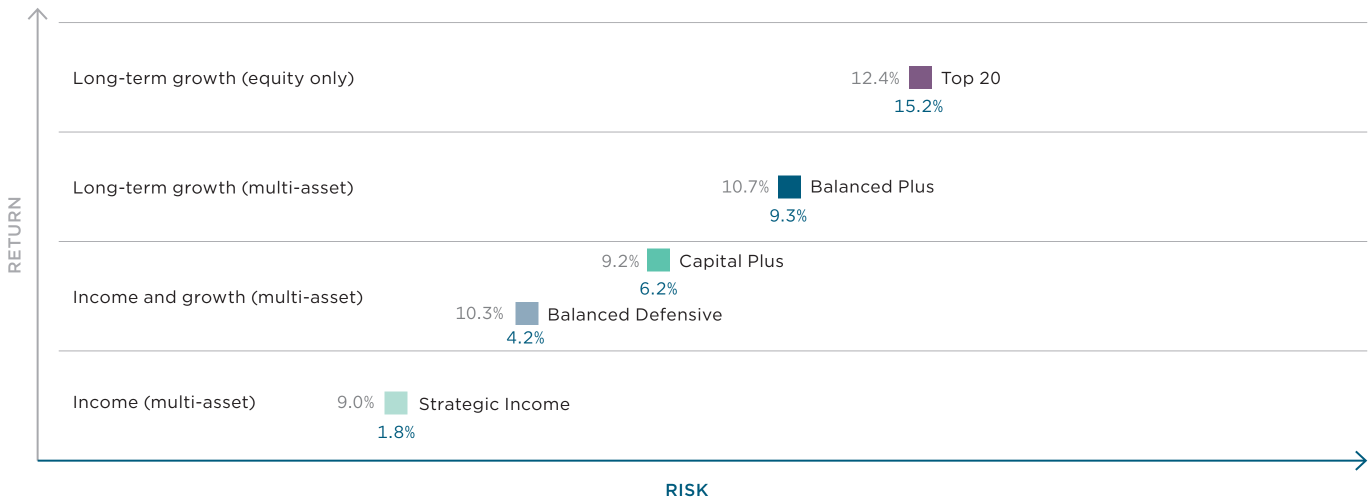
	INVESTOR NEED				
	INCOME ONLY	INCOME AND GROWTH		LONG-TERM CAPITAL GROWTH	
FUND	STRATEGIC INCOME Cash†	BALANCED DEFENSIVE Inflation†	CAPITAL PLUS Inflation†	BALANCED PLUS Composite benchmark† (equities, bonds and cash)	TOP 20 FTSE/JSE CAPI†
FUND DESCRIPTION	Conservative asset allocation across the yielding asset classes. Ideal for investors looking for an intelligent alternative to cash or bank deposits over periods from 12 to 36 months.	A lower risk alternative to Capital Plus for investors requiring a growing regular income. The fund holds fewer growth assets and more income assets than Capital Plus and has a risk budget that is in line with the typical income-and-growth portfolio.	Focused on providing a growing regular income. The fund has a higher risk budget than the typical income-and-growth fund, making it ideal for investors in retirement seeking to draw an income from their capital over an extended period of time.	Best investment view across all asset classes. Ideal for pre-retirement savers as it is managed in line with the investment restrictions that apply to pension funds. If you are not saving within a retirement vehicle, consider Market Plus, the unconstrained version of this mandate.	A concentrated portfolio of 15-20 shares selected from the entire JSE, compared to the average equity fund holding 40-60 shares. The fund requires a longer investment time horizon and is an ideal building block for investors who wish to blend their equity exposure across a number of funds. Investors who prefer to own just one equity fund may consider the more broadly diversified Coronation Equity Fund.
INCOME VS GROWTH ASSETS[1]	91.3% / 8.7%	60.5% / 39.5%	41.9% / 58.1%	17.2% / 82.8%	0% / 100%
LAUNCH DATE	Jul 2001	Feb 2007	Jul 2001	Apr 1996	Oct 2000
ANNUAL RETURN (Since launch)	10.5% †7.8%	10.2% †6.2%	12.8% †6.0%	15.2% †13.6%	19.2% †14.7%
QUARTILE RANK (Since launch)	1st	1st	1st	1st	1st
ANNUAL RETURN (Last 10 years)	9.0% †6.9%	10.3% †6.0%	9.2% †6.0%	10.7% †10.3%	12.4% †9.2%
STANDARD DEVIATION (Last 10 years)	1.8% †0.6%	4.2% †1.6%	6.2% †1.6%	9.3% †9.7%	15.2% †16.2%
BEST PERFORMING 12 MONTHS (return and date range)	18.7% Nov 2002 - Oct 2003	21.2% Jun 2012 - May 2013	33.8% Aug 2004 - Jul 2005	49.3% Aug 2004 - Jul 2005	68.9% May 2005 - Apr 2006
WORST PERFORMING 12 MONTHS (return and date range)	2.6% Jun 2007 - May 2008	2.0% Mar 2008 - Feb 2009	(6.2%) Nov 2007 - Oct 2008	(17.4%) Sep 1997 - Aug 1998	(31.70)% May 2002 - Apr 2003
FUND HIGHLIGHTS	Outperformed cash by 2.1% p.a. over the past 5 years and 2.7% p.a. since launch in 2001.	Outperformed inflation by 4% p.a. (after fees) since launch, while producing positive returns over all 12-month periods. A top-performing conservative fund in SA over 5 years.	Outperformed inflation by 6.8% p.a. (after fees) since launch, while producing positive returns over 24 months more than 99% of the time.	No. 1 balanced fund in SA since launch in 1996, outperforming its average competitor by 2.4% p.a. Outperformed inflation by on average 8.8% p.a. since launch and outperformed the ALSI on average by 1.3% p.a.	The fund added 4.5% p.a. to the return of the market. This means R100 000 invested in Top 20 at launch in October 2000 grew to more than R1.9 million by end-September 2017 – nearly double the value of its current benchmark. The fund is a top quartile performer since launch.

[1] Income versus growth assets as at 30 September 2017. Growth assets defined as equities, listed property and commodities (excluding gold).

Figures are quoted from Morningstar as at 30 September 2017 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

RISK VERSUS RETURN

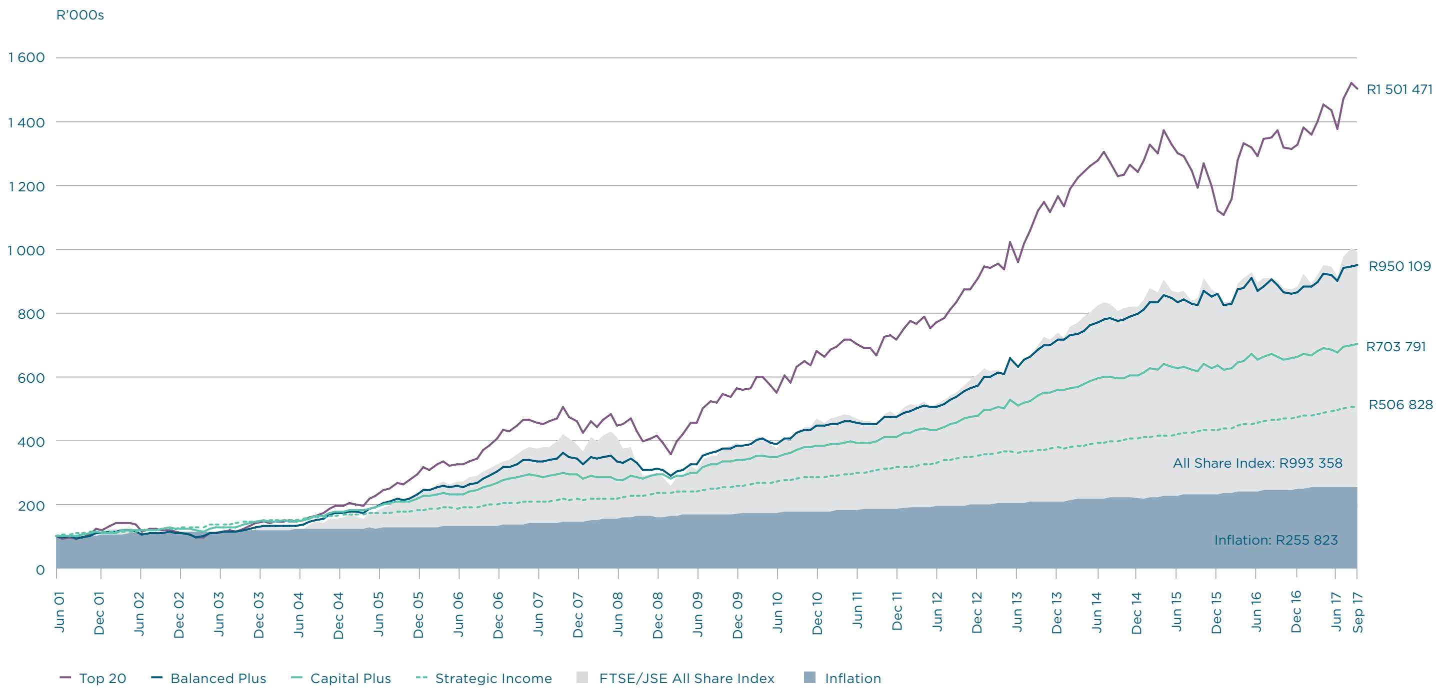
10-year annualised return and risk (standard deviation) quoted as at 30 September 2017.
Figures quoted in ZAR after all income reinvested and all costs deducted.



Source: Morningstar

GROWTH OF R100 000 INVESTED IN OUR DOMESTIC FLAGSHIP FUNDS ON 1 JULY 2001

Value of R100 000 invested in Coronation's domestic flagship funds since inception of Capital Plus on 1 July 2001 as at 30 September 2017. All income reinvested for funds; FTSE/JSE All Share Index is on a total return basis. Balanced Defensive is excluded as it was only launched on 2 February 2007.



Source: Morningstar

INTERNATIONAL FLAGSHIP FUND RANGE

■ INCOME ■ GROWTH

INVESTOR NEED

	DEPOSIT ALTERNATIVE	CAPITAL PRESERVATION	LONG-TERM CAPITAL GROWTH (MULTI-ASSET)	LONG-TERM CAPITAL GROWTH (EQUITY ONLY)	
FUND[1]	GLOBAL STRATEGIC USD INCOME [ZAR] FEEDER GLOBAL STRATEGIC USD INCOME US dollar cash (3 Month Libor)†	GLOBAL CAPITAL PLUS [ZAR] FEEDER GLOBAL CAPITAL PLUS [FOREIGN CURRENCY][4] US dollar cash (3 Month Libor)*	GLOBAL MANAGED [ZAR] FEEDER GLOBAL MANAGED [USD] Composite (equities and bonds)†	GLOBAL OPPORTUNITIES EQUITY [ZAR] FEEDER GLOBAL OPPORTUNITIES EQUITY [USD] MSCI ACWI†	GLOBAL EMERGING MARKETS FLEXIBLE [ZAR] GLOBAL EMERGING MARKETS [USD] MSCI Emerging Markets Index†
FUND DESCRIPTION	An intelligent alternative to dollar-denominated bank deposits over periods of 12 months or longer.	A low-risk global balanced fund reflecting our best long-term global investment view moderated for investors with smaller risk budgets. We offer both hedged and houseview currency classes of this fund. In the case of the former, the fund aims to preserve capital in the class currency over any 12-month period.	A global balanced fund reflecting our best long-term global investment view for investors seeking to evaluate outcomes in hard currency terms. Will invest in different asset classes and geographies, with a bias towards growth assets in general and equities in particular.	A diversified portfolio of the best global equity managers (typically 6-10) who share our investment philosophy. An ideal fund for investors who prefer to own just one global equity fund. Investors who want to blend their international equity exposure may consider Coronation Global Equity Select, which has more concentrated exposure to our best global investment views.	Our top stock picks from companies providing exposure to emerging markets. The US dollar fund remains fully invested in equities at all times, while the rand fund will reduce equity exposure when we struggle to find value.
INCOME VS GROWTH ASSETS[2]	96% / 4%	60.4% / 39.6%	33.1% / 66.9%	0.4% / 99.6%	2.5% / 97.5%
LAUNCH DATE	Aug 2013 Dec 2011	Nov 2008 Sep 2009	Oct 2009 March 2010	Aug 1997 May 2008	Dec 2007 July 2008
ANNUAL RETURN[3] (Since launch)	2.6% †0.5%	5.6% †0.5%	7.5% †7.0%	6.9% †6.0%	3.9% †1.3%
QUARTILE RANK (Since launch)	1st	1st	1st	1st	1st
ANNUAL RETURN (Last 5 years)	1.9% 0.5%	3.1% 0.5%	7.2% 6.8%	9.7% (4.1% over 10 years) 11.6% (4.8% over 10 years)	5.6% 4.2%
QUARTILE RANK (Last 5 years)	-	1st	1st	1st	1st
BEST PERFORMING[5] 12 MONTHS (return and date range)	36.7% Feb 2015 - Jan 2016	34.8% Jun 2012 - May 2013	48.9% Jan 2013 - Dec 2013	66.2% Apr 1999 - Mar 2000	49.7% Mar 2009 - Feb 2010
WORST PERFORMING[5] 12 MONTHS (return and date range)	(15.4%) Mar 2016 - Feb 2017	(10.6%) Jun 2016 - May 2017	(4.7%) Jan 2016 - Dec 2016	(36.1%) Oct 2002 - Sep 2003	(37.5%) Mar 2008 - Feb 2009
FUND HIGHLIGHTS	Outperformed US dollar cash by 2.1% p.a (after fees) since launch in December 2011.	Outperformed US dollar cash by 5.1% p.a. (after fees) since launch in 2008.	No. 1 global multi-asset high equity fund in SA since launch in October 2009.	Both the rand and US dollar versions of the fund have outperformed the global equity market with less risk since their respective launch dates.	Both the rand and US dollar versions of the fund outperformed the MSCI Emerging Markets Index by more than 2% p.a. since their respective launch dates.

1. *Rand- and US dollar-denominated fund names are included for reference.*
2. *Income versus growth assets as at 30 September 2017 (for US dollar funds). Growth assets defined as equities, listed property and commodities (excluding gold).*
3. *Returns quoted in US dollar for the oldest fund.*
4. *Available in US dollar Hedged, GBP Hedged, EUR Hedged or Houseview currency classes.*
5. *Quoted in rands.*

Figures are quoted from Morningstar as at 30 September 2017 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

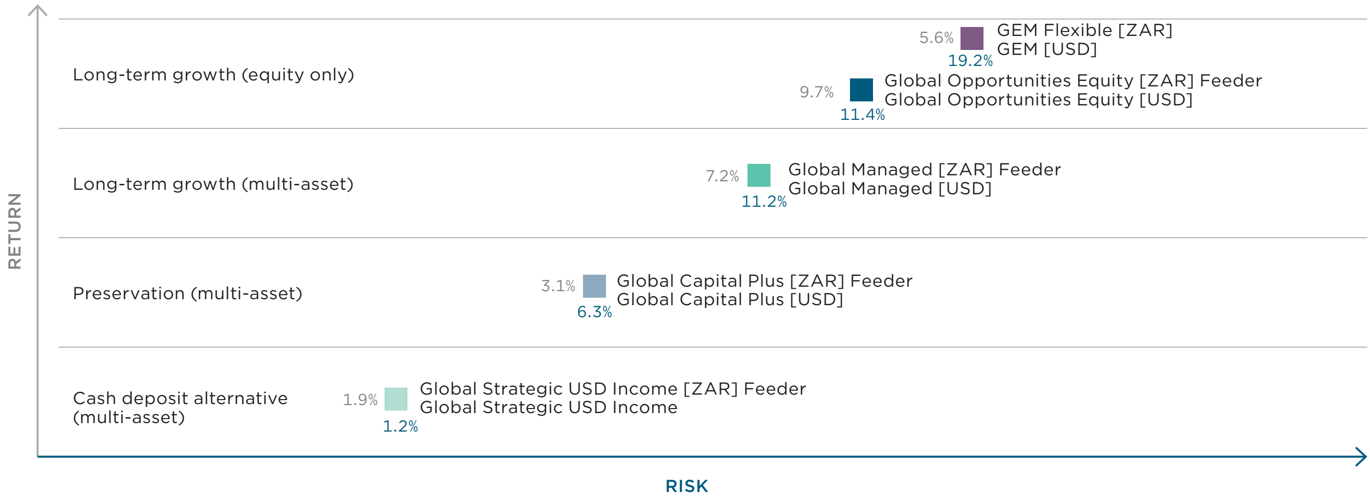
HAVE YOU CONSIDERED EXTERNALISING RANDS? IT IS EASIER THAN YOU MIGHT THINK.

The SA Reserve Bank allows each resident SA taxpayer to externalise funds of up to R11 million per calendar year (a R10 million foreign capital allowance and a R1 million single discretionary allowance) for direct offshore investment in foreign currency denominated assets. If you want to invest more than R1 million, the process is as easy as:

1. Obtain approval from SARS by completing the appropriate form available via eFiling or your local tax office. Approvals are valid for 12 months and relatively easy to obtain if you are a taxpayer in good standing.
2. Pick the mandate that is appropriate to your needs from the range of funds listed here. You may find the 'Choosing a Fund' section or 'Compare Funds' tool on our website helpful, or you may want to consult your financial advisor if you need advice.
3. Complete the relevant application forms and do a swift transfer to our US dollar subscription account. Your banker or a foreign exchange currency provider can assist with the forex transaction, while you can phone us on 0800 86 96 42, or read the FAQ on our website, at any time if you are uncertain.

RISK VERSUS RETURN

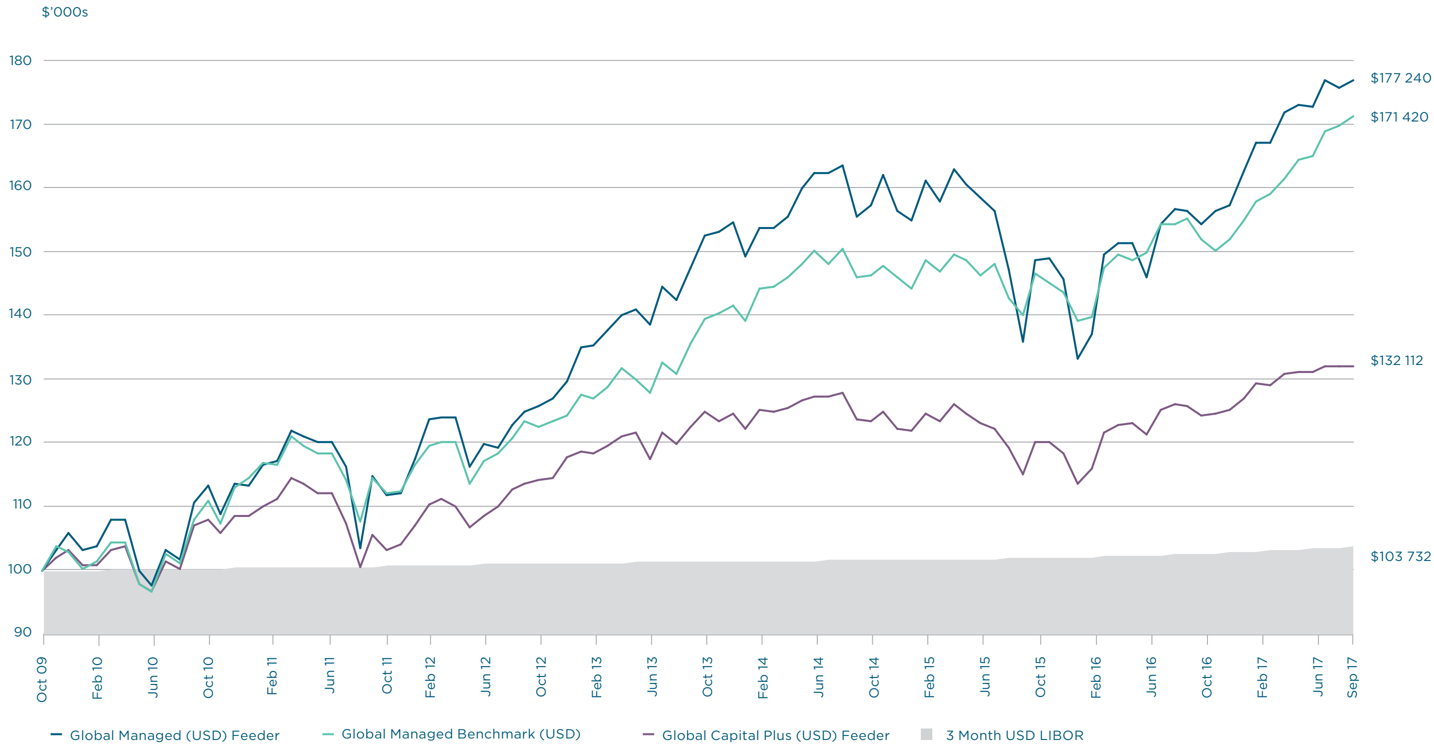
5-year annualised return and risk (standard deviation) quoted as at 30 September 2017. Figures quoted in USD (for the oldest fund) after all income reinvested and all costs deducted.



Source: Morningstar

GROWTH OF $100 000 INVESTED IN OUR GLOBAL MULTI-ASSET FUNDS ON 29 OCTOBER 2009

Value of $100 000 invested in Global Managed [ZAR] Feeder and Global Capital Plus [ZAR] Feeder since inception of Global Managed [ZAR] Feeder on 29 October 2009. All returns quoted in USD. All income reinvested for funds. MSCI World Index is on a total return basis.

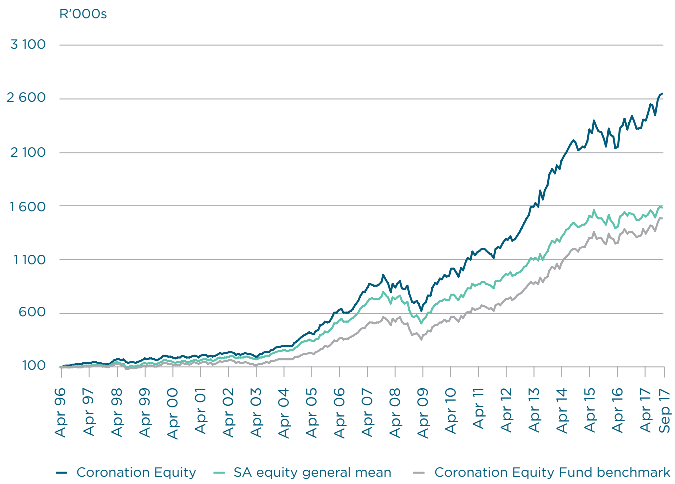


Source: Morningstar

CORONATION EQUITY RETURNS VS EQUITY BENCHMARK

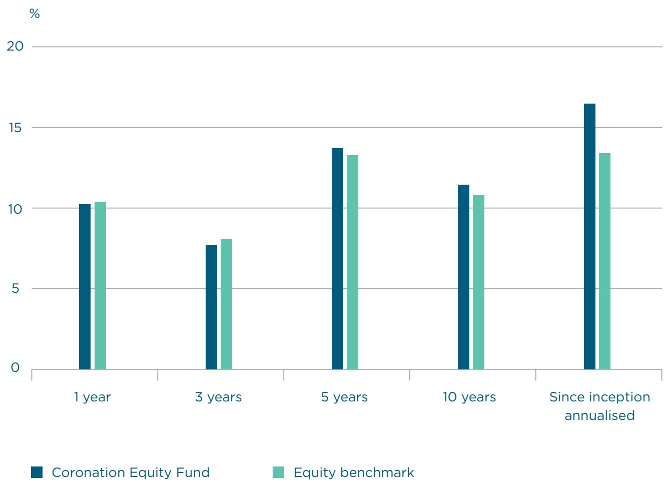
5-YEAR ANNUALISED RETURNS	CORONATION EQUITY	EQUITY BENCHMARK	ALPHA
2001	12.37%	9.38%	**2.99%**
2002	12.15%	7.14%	**5.01%**
2003	14.63%	13.49%	**1.14%**
2004	13.82%	10.46%	**3.36%**
2005	23.32%	19.44%	**3.88%**
2006	26.84%	23.91%	**2.93%**
2007	31.53%	30.40%	**1.12%**
2008	20.70%	20.09%	**0.60%**
2009	19.31%	19.37%	**(0.06%)**
2010	15.97%	15.12%	**0.85%**
2011	9.83%	8.65%	**1.18%**
2012	11.54%	10.60%	**0.94%**
2013	22.51%	20.60%	**1.91%**
2014	17.58%	17.78%	**(0.20%)**
2015	13.76%	14.72%	**(0.96%)**
2016	14.11%	14.44%	**(0.33%)**
4 years 9 months to 30 September 2017	12.41%	11.77%	**0.64%**
ANNUALISED TO 30 SEPTEMBER 2017			
1 year	10.31%	10.43%	**(0.11%)**
3 years	7.73%	8.11%	**(0.38%)**
5 years	13.73%	13.30%	**0.43%**
10 years	11.52%	10.83%	**0.68%**
Since inception in October 1993 annualised	16.53%	13.42%	**3.11%**
Average outperformance per 5-year return			**1.92%**
Number of 5-year periods outperformed			**14.00**
Number of 5-year periods underperformed			**4.00**

CUMULATIVE PERFORMANCE



An investment of R100 000 in Coronation Equity on 15 April 1996 would have grown to **R2 648 718** by 30 September 2017. By comparison, the returns generated by the fund's benchmark over the same period would have grown a similar investment to **R1 484 348**, while the average competitor would have grown a similar investment to **R1 581 495**.

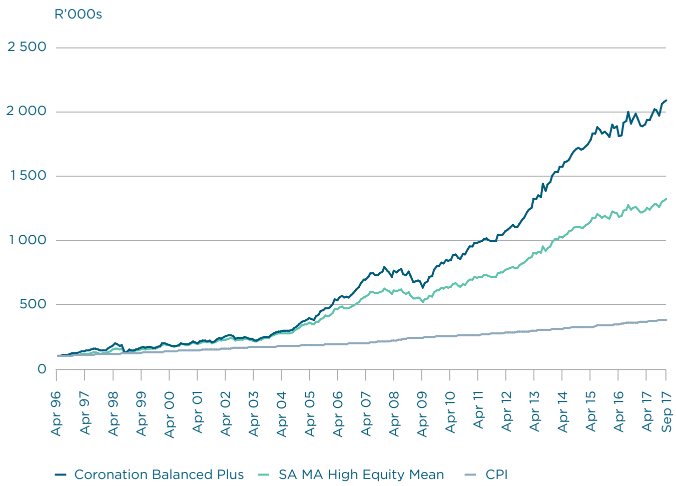
ANNUALISED RETURNS TO 30 SEPTEMBER 2017



CORONATION BALANCED PLUS FUND VS INFLATION AND AVERAGE COMPETITOR*

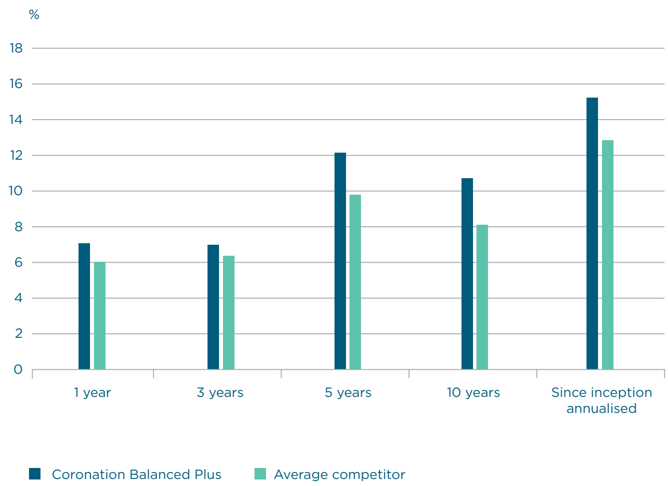
5-YEAR ANNUALISED RETURNS	CORONATION BALANCED PLUS	INFLATION	REAL RETURN
2001	14.38%	7.41%	**6.97%**
2002	10.73%	8.04%	**2.69%**
2003	14.68%	7.33%	**7.35%**
2004	13.82%	6.68%	**7.14%**
2005	20.53%	5.85%	**14.68%**
2006	22.43%	5.54%	**16.89%**
2007	25.35%	5.17%	**20.18%**
2008	19.28%	6.41%	**12.87%**
2009	17.60%	6.82%	**10.77%**
2010	13.97%	6.71%	**7.26%**
2011	9.49%	6.94%	**2.55%**
2012	10.81%	6.36%	**4.45%**
2013	17.98%	5.39%	**12.58%**
2014	15.57%	5.19%	**10.38%**
2015	14.05%	5.54%	**8.51%**
2016	12.69%	5.67%	**7.02%**
4 years 9 months to 30 September 2017	11.32%	5.50%	**5.83%**
ANNUALISED TO 30 SEPTEMBER 2017	**CORONATION BALANCED PLUS**	**AVERAGE COMPETITOR**	**ALPHA**
1 year	7.08%	6.01%	**1.06%**
3 years	6.98%	6.34%	**0.65%**
5 years	12.13%	9.81%	**2.32%**
10 years	10.69%	8.11%	**2.58%**
Since inception in April 1996 annualised	15.24%	12.81%	**2.43%**
Average 5-year real return			**9.23%**
Number of 5-year periods where the real return is >10%			**7.00**
Number of 5-year periods where the real return is 5% - 10%			**8.00**
Number of 5-year periods where the real return is 0% - 5%			**3.00**

CUMULATIVE PERFORMANCE



An investment of R100 000 in Coronation Balanced Plus on 15 April 1996 would have grown to **R2 086 564** by 30 September 2017. By comparison, the SA multi-asset high-equity sector over the same period would have grown a similar investment to **R1 321 407**.

ANNUALISED RETURNS TO 30 SEPTEMBER 2017



** Median of Peer Group is the median of the fully-discretionary retirement portfolios of the largest managers as published in performance surveys and calculated by Coronation Fund Managers.*