ANCHOR CAPITAL

STRATEGY & ASSET ALLOCATION

3RD QUARTER 2017

EXECUTIVE SUMMARY

This report outlines our high-level views of financial markets and our asset-allocation decisions. In this edition, Blake Allen explores the global oil market fundamentals in some detail (see page 36-38) and highlights why we think Royal Dutch Shell offers investors an attractive equation in this context (see page 39). Henry Biddlecombe takes a detailed look at the global bedding industry and explores our investment thesis for Steinhoff International and, in the context of global mandates, Tempur Sealy (see page 30-35).

The fundamentals for domestic equity have deteriorated somewhat during the quarter. Facing a 'toxic combination' of a strong rand and a weak domestic economy, the earnings outlook has worsened. By our estimation, consensus earnings forecasts have meaningful downside risk from current levels. We have, consequently, cut our domestic equity allocation from overweight to neutral.

During the previous quarter, both the rand and the SA bond market were driven far more by global than by domestic factors. Despite deteriorating domestic fundamentals, the global search for yield and the rand's correlation with buoyant Emerging Equity Markets gave both asset classes unexpected strength. While we remain concerned that weaker fundamentals will ultimately drive these variables lower, the power of global fund flows will most likely continue to drive these markets in the shorter term (i.e. at least the next 12 months). From this perspective, there appears to be upside potential to SA bonds and we have pragmatically increased our allocation to the asset class accordingly. From a currency perspective, our 12-month mid-point projection on the rand is R14.00/$1 against R14.75/$1 previously. While political risks have not abated and institutions continue to come under attack in SA, it is clear that the carry trade has proven a material support for emerging market (EM) FX.

Globally, the "Reflation Trade" has lost some of its lustre. In the previous quarter, inflation data was weaker than expected, and some cyclical indicators softened. Similarly, the market's confidence in US President Donald Trump's reform agenda is now at rock bottom, with the "Trump Trade" entirely priced out of the market. Yet, the global economic upturn associated with reflation is still intact and remains the central thesis driving global asset markets.

Both global equities and bonds performed well during the previous quarter (2Q17), reflecting a continued trend of good GDP growth, but now somewhat lower levels of inflation. The simultaneous strength of both markets (bonds and equity) also suggests that liquidity remains an important driver of asset price appreciation. For this reason, the impending withdrawal of liquidity based stimulus (i.e. quantitative easing [QE]) by the world's major central banks is a crucial development which is revisited in more detail below. While the withdrawal of QE is the most important development in global bond markets, the continued trend of strong double-digit earnings growth is the central theme for equities (moderating to high single digits two-years out). Thus, equities have the potential to at least validate – though we think they will do more – the higher market prices that have been created, to some degree, by extreme levels of liquidity. We think bonds will fare less favourably on this score.

In light of the recent strong performance of global equity indices, we have reduced our 12-month expected return for the asset class to 7% in US dollar terms. On a risk-adjusted basis, this remains comfortably superior to what is on offer in the bond market. Thus, offshore, we retain our longstanding position of overweight equity / underweight bonds.

The following table summarises our key judgements at an asset-allocation level, while the remainder of this report provides supporting analyses for these judgements.

ASSET CLASS	BENCHMARK WEIGHT	CURRENT STANCE			EXPECTED RETURNS (ZAR)	RECENT CHANGES
		UW	N	OW		
LOCAL	**100%**					
Equity (ex. Prefs)	65%		■		14%	↓
Bonds	20%		■		10%	↑
Property	8%		■		10%	
Preference Shares	2%			■	11%	
Cash	5%	■			7%	
Alternatives	0%			■	9%	
OFFSHORE	**100%**					
Equity	65%			■	11%	
Government Bonds	5%	■			3%	
Corporate Credit	15%		■		6%	
Property	10%		■		4%	↓
Cash	5%	■			5%	
Alternatives	0%			■	4%	

UW = Underweight; N = Neutral; OW = Overweight

TABLE OF CONTENTS

01 ASSET ALLOCATION

The following table illustrates our "house view" on different asset classes. This view is based on our estimate of the risk and return properties of each asset class in question. As individual Anchor Capital portfolios have specific strategies, and distinct risk profiles, they may differ from the more generic "house view" illustrated here.

ASSET CLASS	BENCHMARK WEIGHT	CURRENT STANCE		
		UW	N	OW
LOCAL	**100%**			
Equity (ex. Prefs)	65%			
Bonds	20%			
Property	8%			
Preference Shares	2%			
Cash	5%			
Alternatives	0%			
OFFSHORE	**100%**			
Equity	65%			
Government Bonds	5%			
Corporate Credit	15%			
Property	10%			
Cash	5%			
Alternatives	0%			

UW = Underweight; N = Neutral; OW = Overweight

02

EXPECTED RETURNS ON UNDERLYING ASSETS

The table below illustrates our return estimates for the broad underlying asset classes shown in the asset-allocation table above. The other aspects of asset allocation, principally risk and portfolio considerations, are covered in the asset-specific discussions, which comprise the bulk of this report.

ASSET CLASS							
EQUITY	PE1	E2 G%	EXIT PE	DIV %	RETURN	ZAR	ZAR RETURN
LOCAL EQUITY	15.1	13%	14.7	3.3%	14.0%	-	14.0%
Resources	13.1	21%	12.0	2.4%	13.0%	-	13.0%
Financials	10.2	10%	10.0	5.1%	13.0%	-	13.0%
Industrials	17.7	13%	17.5	3.0%	15.0%	-	15.0%
OFFSHORE EQUITY	15.4	8%	14.9	2.5%	7.1%	3.9%	11.1%
Developed Markets	16.4	8%	15.8	2.5%	6.2%	3.9%	10.1%
Emerging Markets	11.9	8%	11.9	2.6%	10.6%	3.9%	14.5%

Note: Sector weightings are by Market Capitalisation; Offshore Equity benchmark is MSCI World; "PE1" is 12-month forward PE; "E2 g%" is our estimate of earnings growth over the 12-month period, commencing in 12 months time; "exit PE" is our estimate of the PE multiple in 24 months time; "Div %" is our estimate of the dividend yield over the next 12 months; "Return" is our return estimate, over the next 12 months, implied in the tables assumptions about earnings growth, dividends and changes in PE multiples; offshore markets are estimated in USD, local markets in ZAR; "ZAR" is the currency effect of translating into ZAR; "ZAR Return" is our estimate of ZAR market returns over the next 12 months as implied in the other columns of this table.

BONDS, PROPERTY AND CASH	YIELD	CAPITAL	LC RETURN	ZAR	ZAR RETURN
BONDS					
Local Government Bonds	8.8%	1.6%	10.3%	-	10.3%
Offshore Government Bonds	2.3%	-3.5%	-1.2%	3.9%	2.8%
Offshore Corporate Credit	2.4%	-0.4%	2.0%	3.9%	6.0%
PROPERTY AND REFERENCE SHARES					
Local Property			10.2%	-	10.2%
Local Preference Shares	11.0%	0.0%	11.0%	-	11.0%
Offshore Property	4.5%	-4.0%	0.5%	3.9%	4.4%
CASH					
Local	7.1%	0.0%	7.1%	-	7.1%
Offshore	1.2%	0.0%	1.2%	3.9%	5.1%

Benchmark SA bonds are the South African 10 year government bond; The Benchmark Offshore Bonds are the US 10 Year Government Bond, and the Bloomberg Global Investment Grade Corporate Bond Index; The Local Propoperty benchmark is the JSAPY Index; Offshore Property is the S&P Global REIT Index. Yield % for property is our estimated one year forward income yield; "Capital " is our estimate of the capital appreciation or depreciation of an instrument over the next 12 months; "LC Return " is our estimate of the total return, i.e. yield + capital, that the instrument will generate over the next 12 months in its local currency; "ZAR" is our estimate of the currency effect of translating non-ZAR yields into ZAR; "ZAR return" is our estimate of the "LC Return" in ZAR.

03 GLOBAL MACROECONOMICS

Two global themes are noteworthy at present: first, the momentum behind global monetary policy continues to shift, albeit gradually, away from the extraordinary accommodation we have seen for the past decade. Secondly, Europe remains in a very welcome recovery mode. Although some cyclical indicators have been somewhat softer during the past quarter (2Q17), the recovery thesis remains intact in Europe, and this is true at both cyclical and structural levels.

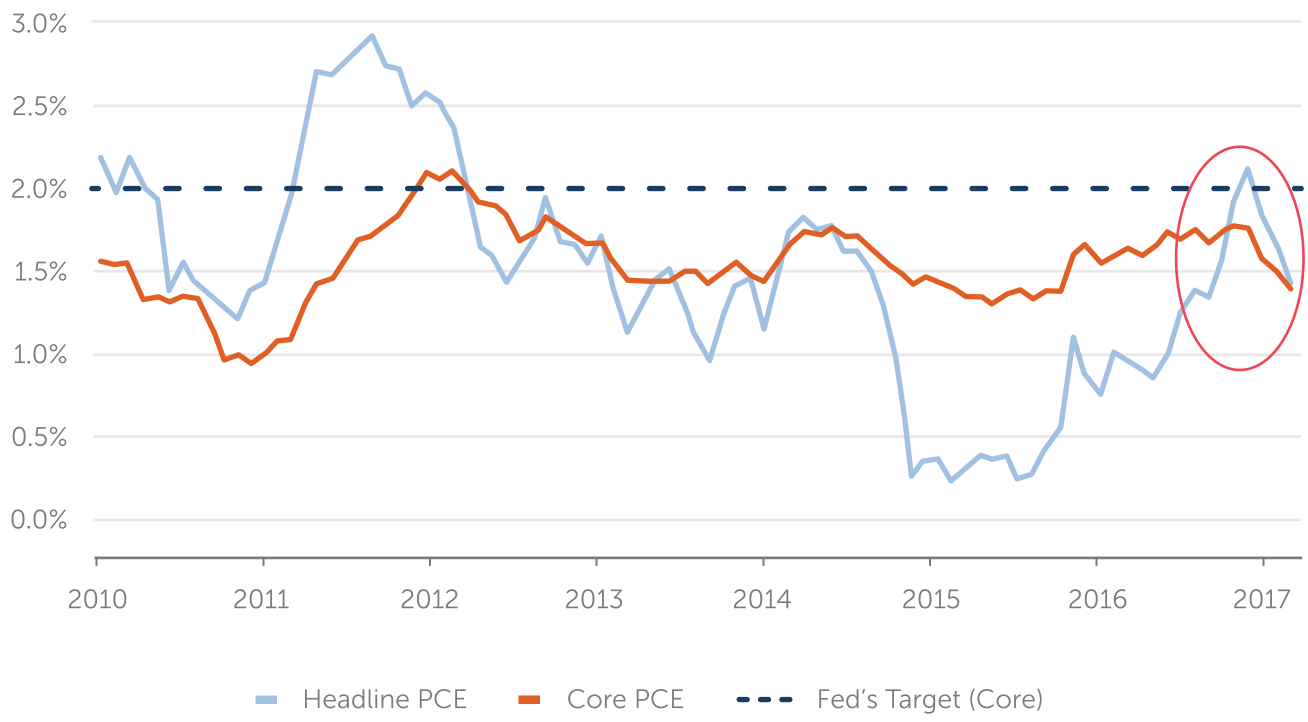
Although developed market (DM) bond yields have drifted lower during the quarter, global central banks remain committed to gradually withdrawing the extraordinary monetary easing that has characterised the post-global financial crisis (GFC) period. We continue to expect bond yields in the US and the EU to gradually drift higher. This is in part because of the effects of the withdrawal of QE, an important component of the normalisation of global monetary policy. A major event of recent weeks was a speech by European Central Bank (ECB) President Mario Draghi, showing a far less dovish tone, followed in subsequent days by similar sentiments from the Bank of England (BOE) Governor Mark Carney, and the Bank of Canada (BOC) Governor Stephen Poloz.

It is paradoxical to note that, while the US Federal Reserve (Fed) has been hiking interest rates over the past 18 months, financial conditions in the US have actually eased. This reflects, in large part, the countervailing effects of higher financial asset prices and a softer US dollar. But, as extremely low interest rates seem to have negative economic consequences, the gradual increases we are currently seeing are probably still, on balance, supportive of growth.

One of the key risks to global growth remains the current phase of the US economic cycle. As the US is now effectively at full employment, continued robust GDP growth risks tipping the US economy into an "overheated" phase associated with spikes in wages, inflation, and/or the risk of Fed overreactions. This remains, for now, only a risk, and our base-case view is for the US to remain in a pro-growth, pro-equity economic phase for at least the next 12 months.

The above-noted risk of an inflation spike may seem off-key in light of the recent slump in US inflation metrics (Figure 3.1). It is true that recent inflation weakness suggests that the timeline for inflation normalisation will be, yet again, somewhat longer than previously expected.

Figure 3.1: US inflation slump dampens the "reflation trade":



Source: Federal Reserve of St Louis

But, provided the US economy continues to grow at about 2% p.a., tightness in the labour market should start to feed through into wage hikes, and ultimately into broader inflationary pressures. We now, however, only anticipate that core personal consumption expenditures (PCE) will reach the Fed's target of 2% in CY2019, not in CY2018 as previously estimated. We also expect a recovery in oil prices over the next two years, with Brent trading towards $60/bbl (see section entitled *The Oil Market* below). This should further support a recovery in US inflation.

One of the major "bright spots" on the global economic scene is Europe. The region has lagged the post-credit crisis recovery of the US but is now finding a more confident stride. This improvement spans a number of factors, from cyclical growth metrics, to political change, to inflation and monetary dynamics. This important development is elaborated below in the section titled *The European recovery*.

Figure 3.2: Anchor Capital current macroeconomic forecasts:

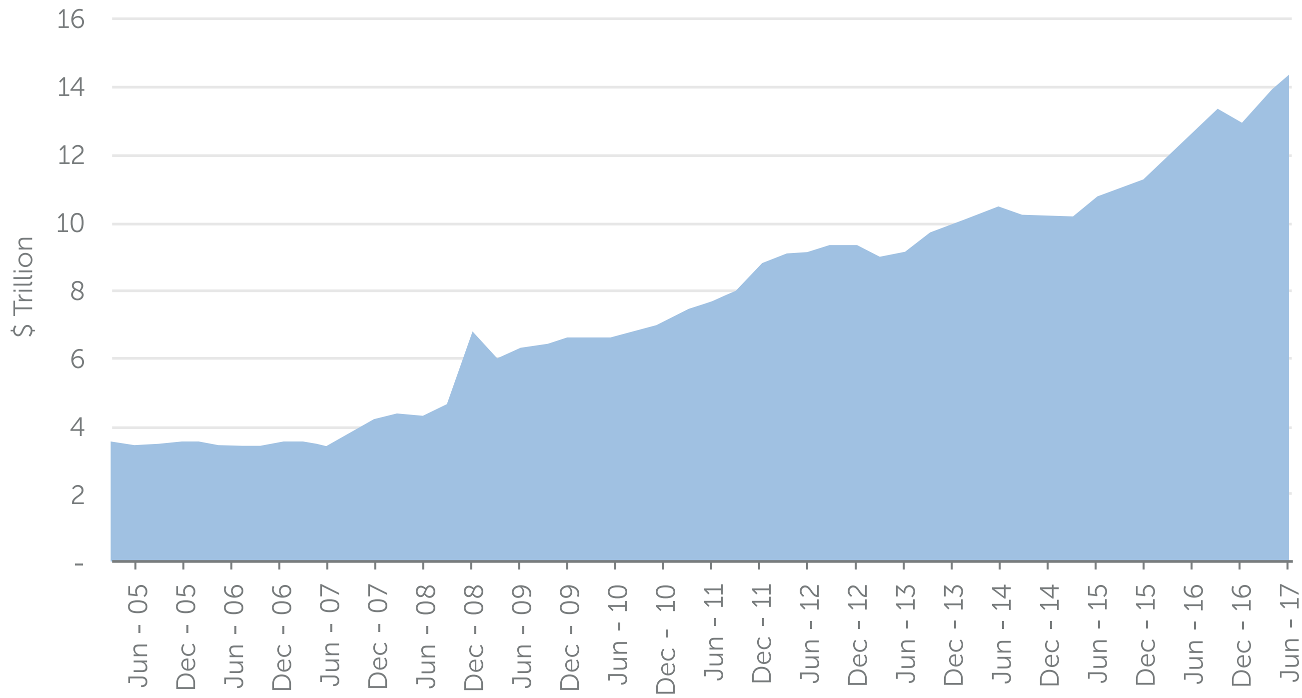
	2016A	2017E	2018E
GDP GROWTH (% ON PRIOR YEAR)			
World	3.0	3.3	3.5
USA	1.7	2.2	2.2
China	6.7	6.7	6.3
Euro Area	1.6	1.8	1.7
SA	0.6	1.0	1.5
INFLATION (%; YEAR AVERAGE)			
USA core PCE	1.7	1.7	1.9
EU CPI ("HICP")	0.3	1.9	1.6
SA headline CPI	6.6	5.3	5.6
INTEREST RATES (% AT YEAR END)			
Fed funds	0.75	1.50	2.00
Number of Fed hikes	1	3	2
US 10 YR Govt Bond	2.44	2.55	2.80
SA 10 YR Govt Bond	8.92	8.45	9.00
Currency (At Year End)			
USDZAR	13.74	13.75	14.30
EURUSD	1.05	1.15	1.20

Source: Bloomberg; Anchor estimates

3.1 Quantitative easing and monetary normalisation

Since the GFC, the central banks of the US, Europe, Japan and the UK have more than doubled the size of the assets they own; essentially printing money to buy up bonds to inject liquidity into the system and avoid the global economy seizing up. It now appears that this massive and sustained liquidity injection is reaching the end of its road. How will this take place and what will the implications be for global markets? This section touches briefly upon these questions.

Figure 3.1.1: Central Bank Assets (US, EU, Japan and the UK):

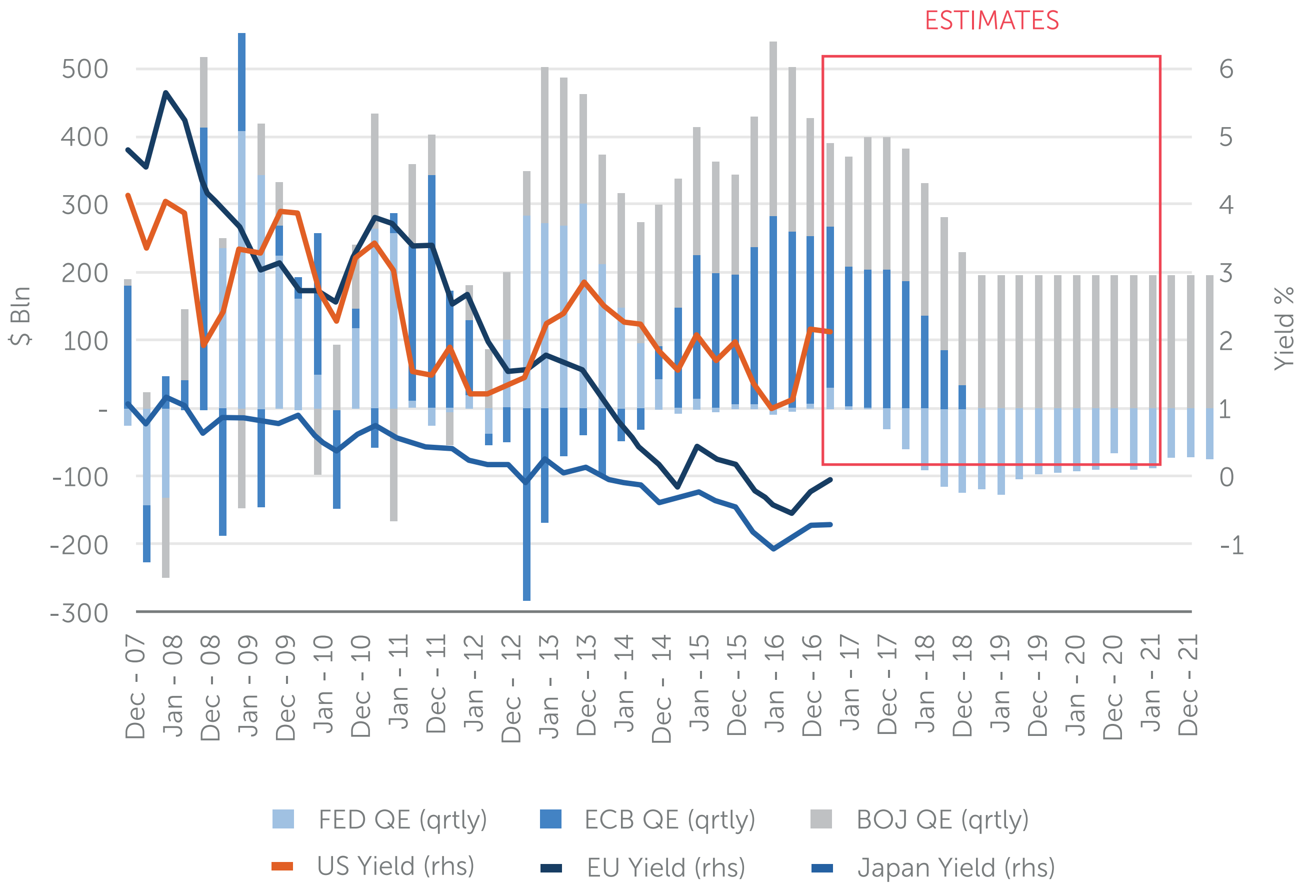


Source: Bloomberg, Anchor Capital

The US did the bulk of the early lifting in terms of QE, taking its balance sheet from around $1trn to c. $4.5trn with three rounds of bond buying over 5 years from 2009-2014. Japan has been expanding its balance sheet for years, but it started aggressively expanding it in mid-2013 and is still going strong. The country has now grown its balance sheet to the same size as that of the US, despite the Japanese economy being only a quarter of the size. The Japanese central bank is increasing its balance sheet by about $65bn p.m., buying predominantly bonds but also spending about $5bn p.m. on exchange traded funds (ETFs) and listed Japanese property companies.

Japan seems nowhere close to achieving its inflation target and, as such, it is likely the country will keep increasing the size of its balance sheet for the foreseeable future. The EU was somewhat late to the party, starting its QE in early 2015. The ECB is currently expanding its balance sheet by about $70bn p.m. and is scheduled to do so until the end of this year, with thoughts that it will announce a gradual reduction of its balance sheet expansion later this year. This should see the EU gradually reduce the size of the balance sheet expansion throughout the course of 2018, with its balance sheet expansion likely to halt towards the end of the year. Presumably the process of shrinking the ECB balance sheet is some way off. The US has recently announced the mechanism for starting to reduce its balance sheet which is likely to start later this year.

Figure 3.1.2: Quarterly Liquidity Injections by the US Fed, ECB and Bank of Japan:



Source: Bloomberg, NY Fed, BOJ, ECB, Anchor Capital

Since the Fed stopped buying additional bonds in 2014, it has maintained the size of its balance sheet by reinvesting the proceeds of any maturing bonds. The unwind will happen by ensuring that going forward it only reinvests those proceeds to the extent that it exceeds the monthly caps (initially $10bn p.m. but ratcheting up to $50bn p.m.). Given that we have full transparency to the bonds the Fed owns, we've been able to model the maturity schedule and in practice the Fed will be allowing an average of around $30bn p.m. of its balance sheet to roll off without reinvesting.

Having grown accustomed to receiving around $140bn p.m. in liquidity injections for the better part of the last four years, the question now is what happens when that drops to a net injection of around $40bn p.m. towards the end of next year? All else being equal, the removal of $100bn p.m. of demand for government bonds each month is likely to put upward pressure on global yields, but of course supply and demand are not the only things determining bond yields, the path of inflation and the strength of the economy are likely to play a meaningful role too. If inflation and growth develop in line with our estimates, it is likely that we'll see upward pressure on global yields from the unwind of QE.

3.2 Monetary tightening in China, should we be concerned?

During the past decade, roughly the post-GFC period, China has been the engine of world GDP growth. Increasingly, that engine has been fuelled by unsustainable debt accumulation. As we have noted previously, however, what is unsustainable in the long term can be sustained for a number of years. Thus, Chinese debt accumulation has both driven the growth upon which equity markets have fed, and presented one of the central risks that make these markets unstable. This story continues to evolve.

Recently, in an effort to reign in this debt accumulation, the People's Bank of China (PBoC) has been tightening its monetary stance: although the official lending rate remains low, there have been restrictions on liquidity, which are reflecting in higher inter-bank lending rates (Figure 3.2.1). This has raised a concern that these tighter monetary conditions may cause the Chinese economy to falter (in the case of China, 'faltering' would be GDP growth at or below 5% p.a.).

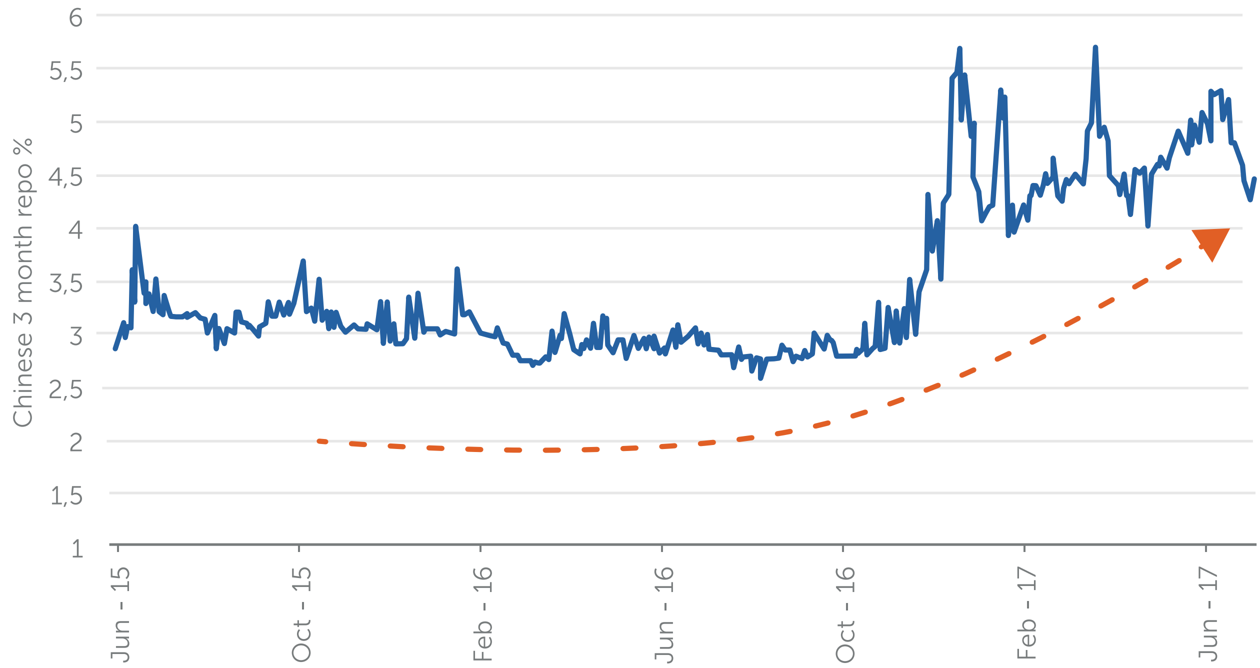
At first glance, such an event would not affect all countries equally. Amongst EMs, India would probably be the least affected, as its exports to China are far lower than its EM peer group. In the DM space, the relatively closed economy of the US would likely hold up best. The problem, however, with this "first glance" is that it seems to underestimate the ever-increasing extent of global integration. Thus, while exports are only a small component of US GDP, domestic economic activity is significantly affected by the "wealth effect", of which US equity prices form a significant component. As these prices are driven largely by the earnings of multinational corporations, US domestic economic activity is rather more vulnerable to global financial developments. Hence, the structure of the US equity market actually renders the country rather "open". Indeed, the entire global economy appears to be dependent on the Chinese growth outlook.

How, then, do we interpret tighter Chinese monetary policy? While tighter liquidity does create the risk of financial stress, it also suggests underlying resilience in the Chinese economy. These are, in our view, two sides of the same coin. Thus, in tightening monetary policy, the PBoC also indicates that it judges the economy to be able to withstand higher rates. One might ask, however, why we could not simply identify this resilience in the data itself? And why there is a need to infer economic resilience on the basis of the PBoC's actions? This question relates to the problem of the opacity of China, and the lingering suspicion that Chinese data do not accurately reflect the underlying economic reality. Thus, the market at times evaluates China's data in light of economic proxies (the oil price, in early 2016, was one such proxy). We do not view the PBoC's actions as a substitute for the economic data, but it does provide a kind of validation to the strong reported growth numbers.

We do not expect Chinese monetary tightening to move quickly or go very far; indeed there are already signs it is partly reversing course. It seems that the PBoC, like the rest of the world's major central banks, is moving very gradually, and facing extremely low domestic inflation levels, therefore little incentive to get carried away with monetary tightening. Thus, in short, tighter monetary policy in China has not changed our view towards risk assets globally.

The historical context of China's debt accumulation is important to note, and it could be argued that it reflects a low level of institutional development. At this stage, China lacks the institutional infrastructure to channel large amounts of savings into equity instruments. Therefore, by default, these savings flow into banking deposits, and subsequently into loans. It appears, consequently, that the debt problem may be eased by China's continuing, and quite rapid, institutional deepening and the associated drive towards "financial liberalisation".

Figure 3.2.1: Tighter liquidity in China is reflected in higher interbank rates:

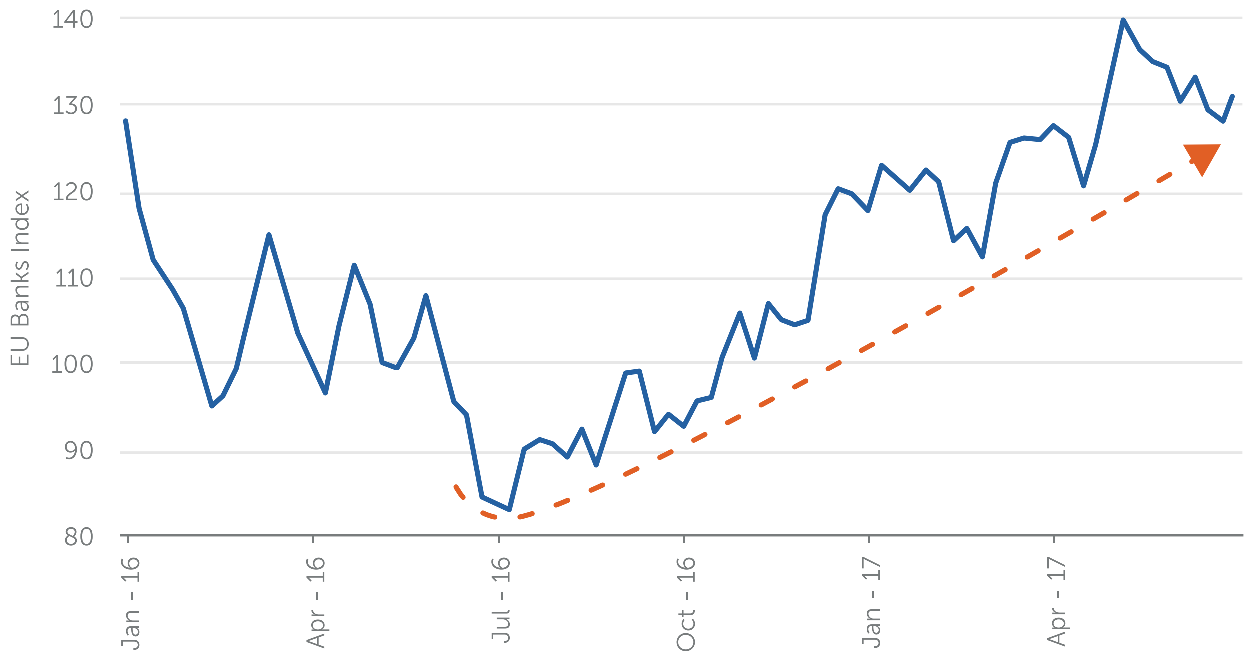


Source: Bloomberg; Peoples Bank of China

3.3 The European recovery

The European situation continues to evolve in a beneficial direction, with positive developments in both politics and economics reinforcing each other. Thus, in simple terms, better economic growth has reduced Euroscepticism, thereby reducing the risks of political disruption, which further bolsters confidence and growth. Further, French President Emmanuel Macron's proposed reforms, should they succeed, would further bolster the investment case for Europe, as they would improve the structural drivers of growth on the continent.

Figure 3.3.1: EU banks reflect a much-improved macroeconomic outlook:



Source: Bloomberg

For some years, the French economy has been stifled by prohibitive labour law, and a bloated state. Macron's election campaign, however, proposed an agenda of radical reform that should, if implemented, seriously improve French growth prospects. The pro-market campaign expectations look to be on track for implementation, as France's legislature is now about the most pro-market it has been in decades. The last three presidents have also tried to liberalise France in this fashion, and were defeated by union strike action. Why, then, do we think Macron will succeed? In addition to the above-mentioned pro-market majority, Macron represents a decisive break with the status quo, having defeated both populists and the establishment. In our view, France appears to be ripe for change, and to be willing to make some difficult but pro-growth structural adjustments.

As the second largest eurozone economy, France's improved prospects coupled with Germany's existing cyclical strength seem likely to decisively tip the balance of the eurozone into a structurally positive growth story (taken together, the two countries account for about 50% of eurozone GDP). Indeed, a much improved European picture further tips the scales of global growth towards a pro-cyclical, pro-growth, global macroeconomic picture. The main risks to our more positive assessment of Europe stem from the effects of a stronger euro (e.g. less competitive exports; lower inflation), and from continued weakness in Italy.

Figure 3.3.2: Surging German business confidence portends further strong GDP growth:

Source: Bloomberg; Ifo; Destatis

04
DOMESTIC EQUITY

In the latter part of the quarter, domestic equities gave up much of their recent gains and have now delivered a mere 3.3% for the first six months of 2017, trailing behind cash and bonds. The recent relapse in equity markets can be ascribed to essentially four factors, some interrelated:

1. A shock SA 1Q17 GDP number reported in June (0.7% contraction on annualised basis), pushing the country into a technical recession. This had a disproportionate negative impact on domestic-focussed companies such as Banks and Retailers; Banks have lost about 3% of their value since this report. During June, Moody's also downgraded SA's credit rating by one notch and maintained a negative outlook, citing concerns over institutional deterioration in the country.
2. The release of the revised SA mining industry charter, which contains many provisions which we believe are not practical to implement. This resulted in a sharp sell-off of mining stocks, especially companies with SA asset concentration. Possibly the most contentious aspect of the new charter pertains to a 1% royalty of turnover to be paid to BEE shareholders prior to any ordinary dividends, which appears to be in contravention of company law. At the time of writing, the implementation of the revised charter had been suspended.
3. A market correction in global technology stocks, impacting on Tencent and hence Naspers during June.
4. An unexpectedly strong rand over the quarter, weighing heavily on dual-listed and industrial hedge counters.

A key tenet of our overweight positioning within domestic equities has been a favourable view on Naspers (20% of the index), a bias towards rand weakness (leading to translation gains for JSE-listed companies with non-SA earnings) as well as a favourable valuation backdrop for Diversified Mining companies, despite lower commodity prices.

These conditions have not played out over the past quarter, with resource shares, in particular, being hurt by negative sentiment toward mining regulation in SA, and share prices following spot earnings lower, despite apparently attractive valuation levels.

Strong rand + weak economy = toxic combination for equity returns

A key challenge for portfolio construction currently has been the toxic combination of a strong rand and a very weak domestic economy. From an equity market perspective, this is the worst of all worlds: dual-listed stocks remain pressured by a strong rand, while domestically sensitive counters remain subdued due to a moribund economy and lack of earnings momentum.

These apparent contradictions have arisen more as a result of rising levels of attractiveness for the global "carry trade," rather than improving domestic or EM economic trends. In turn, the carry trade improvement can best be illustrated by the spread between US 2- and 10-year interest rates; this differential is now the lowest it has been since Trump's election victory, suggesting the market is now very sceptical of his ability to enact tax reform and other growth-inducing initiatives which would prove inflationary. We believe the market has possibly moved to the point of being too pessimistic on this front, suggesting that DM bond yields have some upside risk from current levels. This would be especially true if the Fed begins shrinking its balance sheet, and European QE continues to be tapered. This development would crimp spreads currently available on EM currencies, reducing the attractiveness of the carry trade. At the margin, this is what we believe has supported the rand, rather than growth considerations.

Figure 4.1: Spread between 2- and 10-year US rates - Markets betting Trump will be wholly ineffective:

Source: Bloomberg, Anchor Capital

Crisis of confidence in SA economy

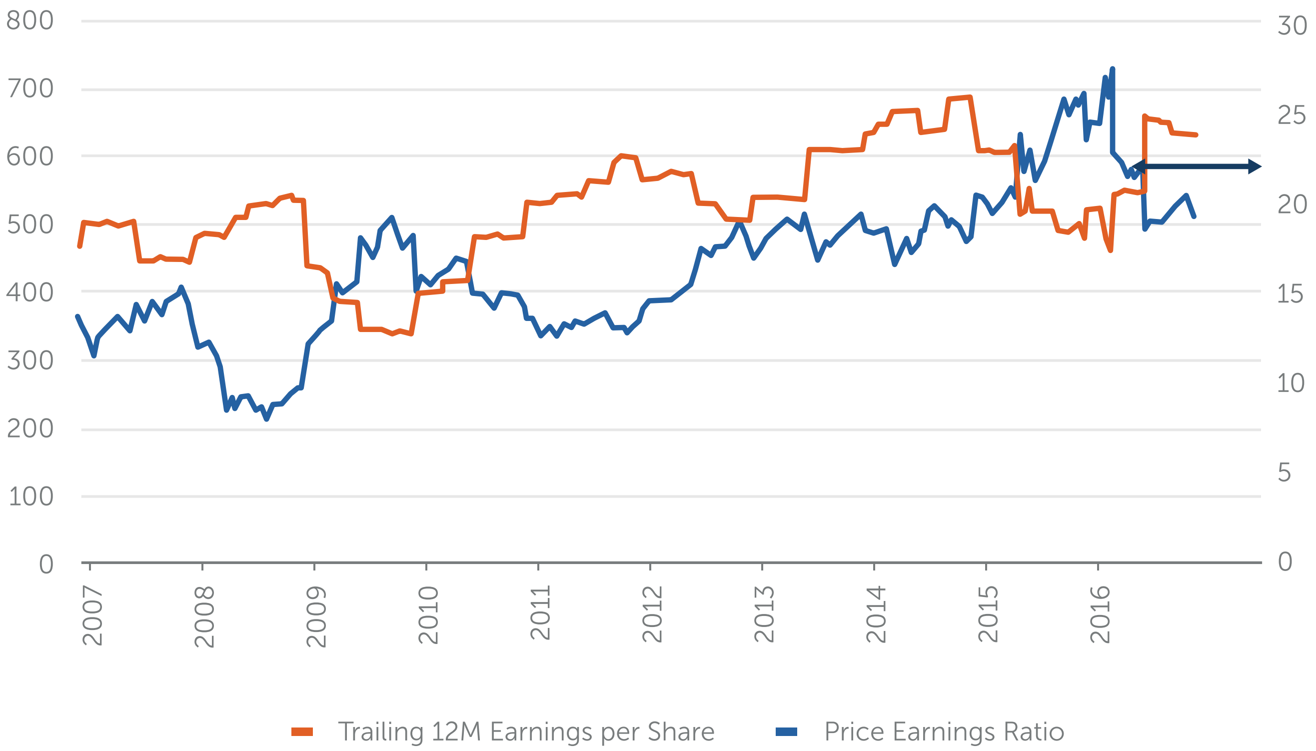
Despite the strong rand, SA's economy is suffering from a severe crisis of confidence. This is as a result of the ever-deteriorating governance environment in the country, and is now manifesting in consumers holding back on everyday decisions – from buying cars and houses, to dining out at restaurants. We are seeing this play out in a growing number of companies making concerning statements about the state of trading conditions, especially post 31 March 2017. We believe consumers and businesses are effectively in a holding pattern and adopting a "wait and see" approach until the December 2017 ANC elective conference. This set of circumstances is particularly damaging for economic growth as it is essentially the confidence of consumers which holds any modern economy together. In particular, we are concerned about a possible freezing up of activity in the housing market in SA – this could well result in falling prices on low levels of liquidity, impinging on collateral values for bank loans in a stressed job market. This could exacerbate banks' unwillingness to extend – or even consumers' appetite to take on – more credit.

At a portfolio level, we have no exposure to credit retailers as we believe they are the most exposed to a creaking SA economy. While valuations appear attractive at face value, we are concerned about steadily rising earnings risks. Our banks overweight is predicated partially on valuation considerations and lower earnings risks compared to discretionary retailers, but largely due to portfolio construction considerations in the context of heavy global exposure elsewhere.

Earnings prospects deteriorating

Given the above narrative, it should come as no surprise that domestic earnings prospects are deteriorating. The JSE SWIX Index has essentially tracked sideways for the past two years, but this has been matched by a lack of any meaningful advancement in earnings, leaving multiples unchanged:

Figure 4.2: JSE SWIX P/E multiple and earnings per share- A two-year earnings recession:



Source: Bloomberg

Consensus expectations too high in many cases

We believe that consensus expectations for earnings growth over the coming 6 - 12 - month reporting period remain too high in many cases. Key examples, where we believe the market is likely to prove at least 5% too aggressive on earnings expectations, despite recent downgrades, include the following companies:

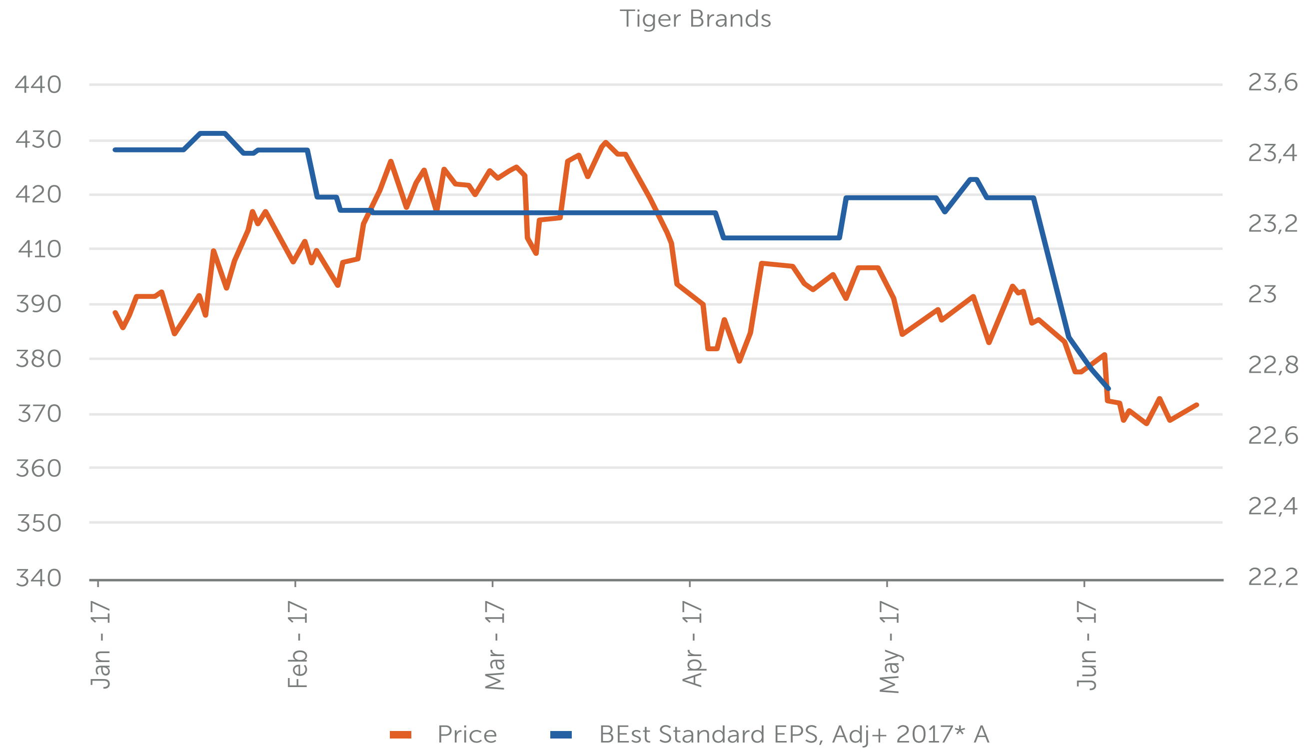
Figure 4.3: Selected JSE-listed companies likely to still miss earnings expectations...

	BBG CONSENSUS	ANCHOR	% DIFFERENCE
Bidvest (FY17)	11,12	10,37	-7%
Tiger Brands (FY17)	22,74	21,44	-6%
Sasol (FY18)	41	28	-32%
Impala Platinum (FY18)	1,5	-0,5	n/m

Source: Bloomberg, Anchor Capital estimates

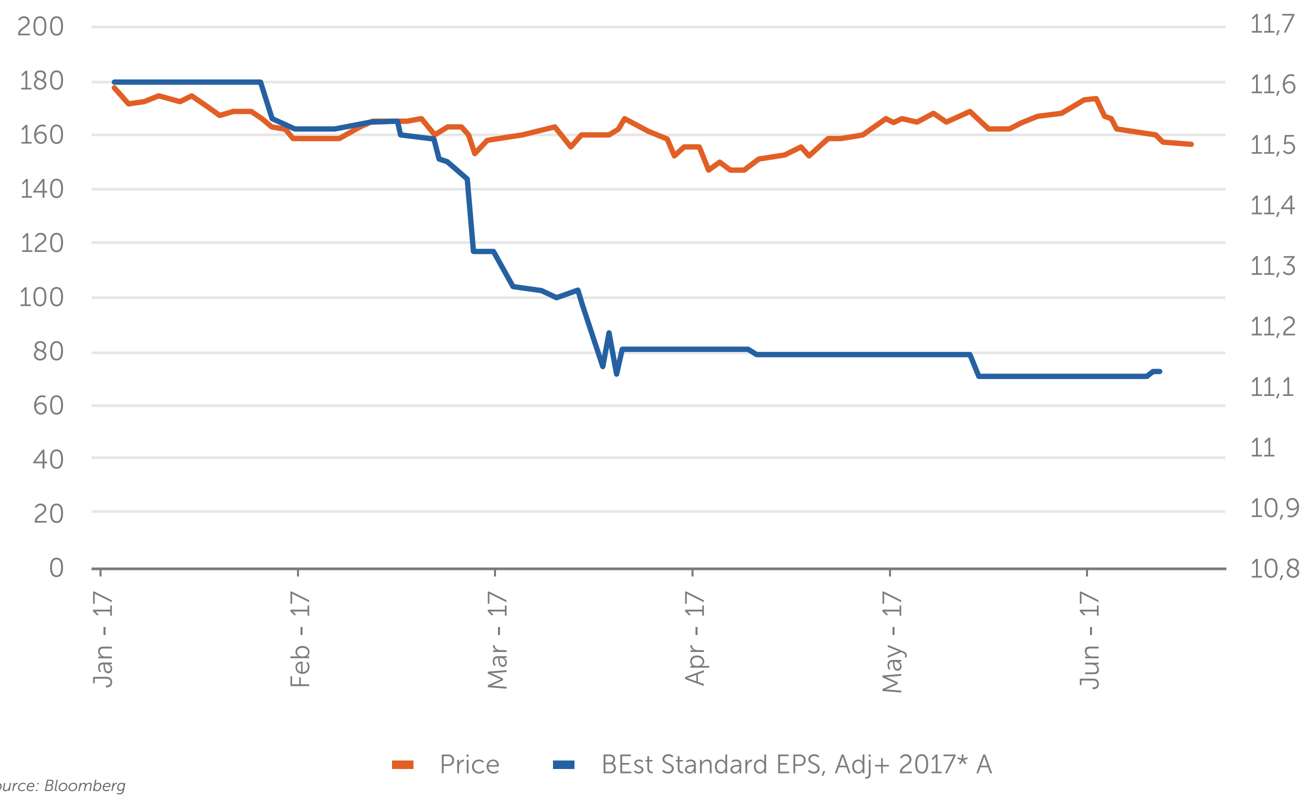
...despite sharp recent downgrades

Tiger Brands:



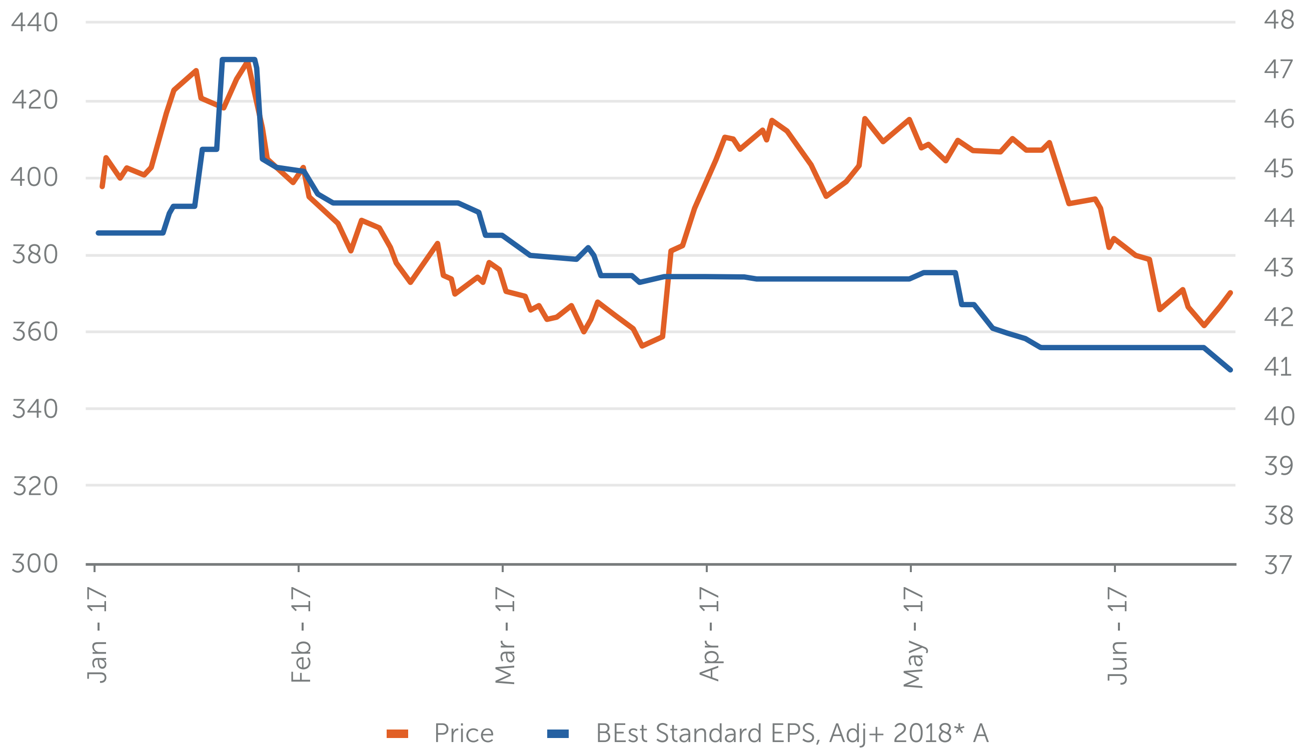
Source: Bloomberg

Bidvest:



Source: Bloomberg

Sasol:



Source: Bloomberg

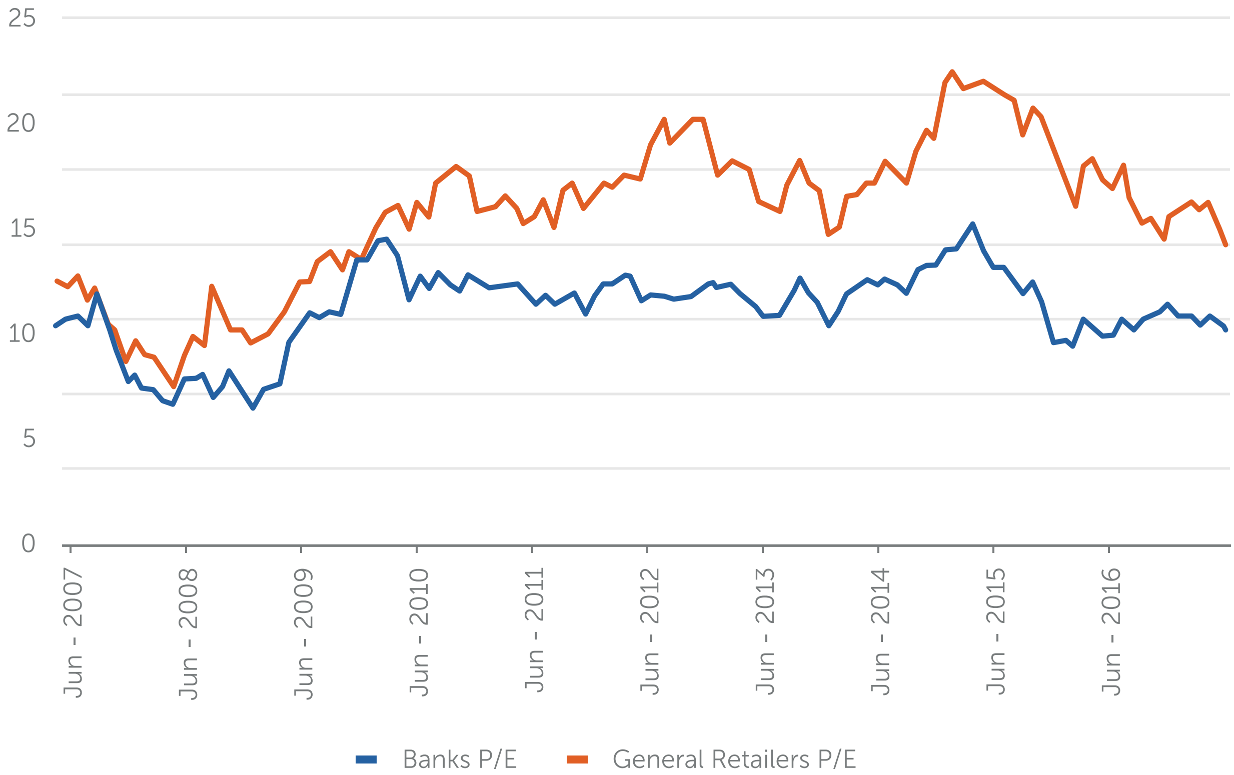
While the market has begun to price in this trend via falling share prices, we believe the actual downgrade cycle may not have run its course.

As always, we view it as dangerous to make overt pronouncements on the overall direction of equity indices from general observations about the economy. This is because of the construct of most indices on the JSE not properly representing the SA economy. Nevertheless, we see risk of earnings slippage in the following sectors:

- Banks (via rising loan delinquencies, slowing loan growth and possible pressure on fee income margins given rising competition) – albeit earnings are likely to be more defensive than retailers.
- General and apparel retailers – lower consumer demand impacting on turnover and margins.
- Diversified industrials – Bidvest, Nampak being key examples of companies heavily exposed to the business cycle in SA.
- Listed property – negative rental reversions and rising vacancies are key risks here.

We estimate that the above category of companies account for approximately 40% of the market cap of the SWIX Index. Valuations of banks and retailers, in particular, have begun to price in bad news (see Figure 4.4) and arguably offer value (which could prove a value trap in the absence of better earnings prospects beyond our year 1 forecasts). However, the risk is that a very weak economy and possible earnings recession may require a much weaker rand to offset the impact of moribund equity prices in these sectors via translation gains on industrial hedges. As a consequence, in the absence of material currency weakness from here, we believe the risk to domestic equity performance is rising. We have therefore down-weighted our equity stance to a neutral weighting from an asset-allocation perspective.

Figure 4.4: Banks and General Retail trailing P/E multiples- Beginning to price in a worse environment:



Source: Bloomberg, Anchor Capital

...retailers still trade at a meaningful premium to banks, suggesting scope for further outperformance of banks in the context of higher relative earnings risks in retail.

Source: Bloomberg

Within domestic equities, we continue to favour banks over discretionary retailers (Banks outperformed General Retail by 13% in 2Q). We are avoiding diversified industrial exposure and we are overweight industrial rand hedges such as Steinhoff and Richemont. A very important distinction to make is that we are not merely overweight industrial rand hedges solely in expectation of a weaker currency. A more important consideration is that we want exposure to businesses that are growing their earnings in real (and constant currency) terms. Finding this in purely SA assets is becoming increasingly challenging, given the structural economic backdrop in the country.

Our projected 12-month total returns for domestic equities is 14%, which is approximately 400-bps higher than our projected return from fixed-income assets. Given this narrowing spread, we no longer believe the risk/reward warrants an overweight stance toward equities.

Key to our assessment of total returns is that we expect some de-rating of equities across the board, mostly in industrials. Outside of industrial hedges (mostly Naspers), we expect rising earnings risks and our year 2 earnings growth forecast of 13% for industrials is predicated, to some extent, on an economic recovery in SA beyond CY17. Approximately 3 ppts of this growth is Naspers alone, suggesting 10% earnings growth for the rest of industrials – we would have to cut these figures if SA's recessionary conditions persist beyond 2017, and the risk in this regard is skewed to the upside.

Figure 4.5: Projected 12-month total returns – domestic equities:

	12-M FWD P/E	YR +2 G	EXIT P/E	DIV %	12M EST. TOTAL RETURN
Resources	13.1	21%	12.0	2.4%	13%
Financials	10.2	10%	10.0	5.1%	13%
Industrials	17.7	13%	17.5	3.0%	15%
SA Equity	15.1	13%	14.7	3.3%	14%

Source: Anchor Capital

05 OFFSHORE EQUITY

Global equities, at present, are benefiting from a "benign" economic backdrop. Strong earnings growth, improving GDP growth, and still-low interest rates are all supportive of equity valuations. There is, however, a legitimate concern that global equity markets have fallen into complacency, indicated by extremely low levels of volatility. While this does present a short-term risk, our view is that corporates will continue to deliver at least reasonable earnings growth (Figure 5.1.), and that a US recession is not on the horizon, for at least the next 12 months; consequently, we think, the default direction for global equities remains upwards.

At the headline level, consensus earnings growth remains very high, at about 30% over the next 12 months. It must be borne in mind that a fair portion of this number derives from the reversal of losses, or the normalisation of near break-even positions, in a number of large Energy, Materials, and Pharmaceuticals companies. Nevertheless, even if one strips out these effects, global corporates are still expected to deliver solid double-digit earnings growth over the next 12 months. Following this period of earnings "normalisation", we still expect a respectable two-years forward earnings growth of about 8% for MSCI World.

In absolute terms, this earnings outlook still sees the MSCI World trading at about a 20% premium to its longer-term average forward PE (Figure 5.1.). EMs, by contrast, trade at only a 7% premium to their long-term average PE. Relative to the bond market, however, MSCI World is still attractively valued. As the valuation gap between DM and EM has continued to widen, since 2011, the latter now appears to offer good value relative to DM equities. We have, consequently, retained our preferences for equity over bonds. Similarly, we would look to opportunistically add exposure to appropriate EM assets. Within DM, the European growth recovery has not been fully reflected in valuations, and still presents some good valuation opportunities.

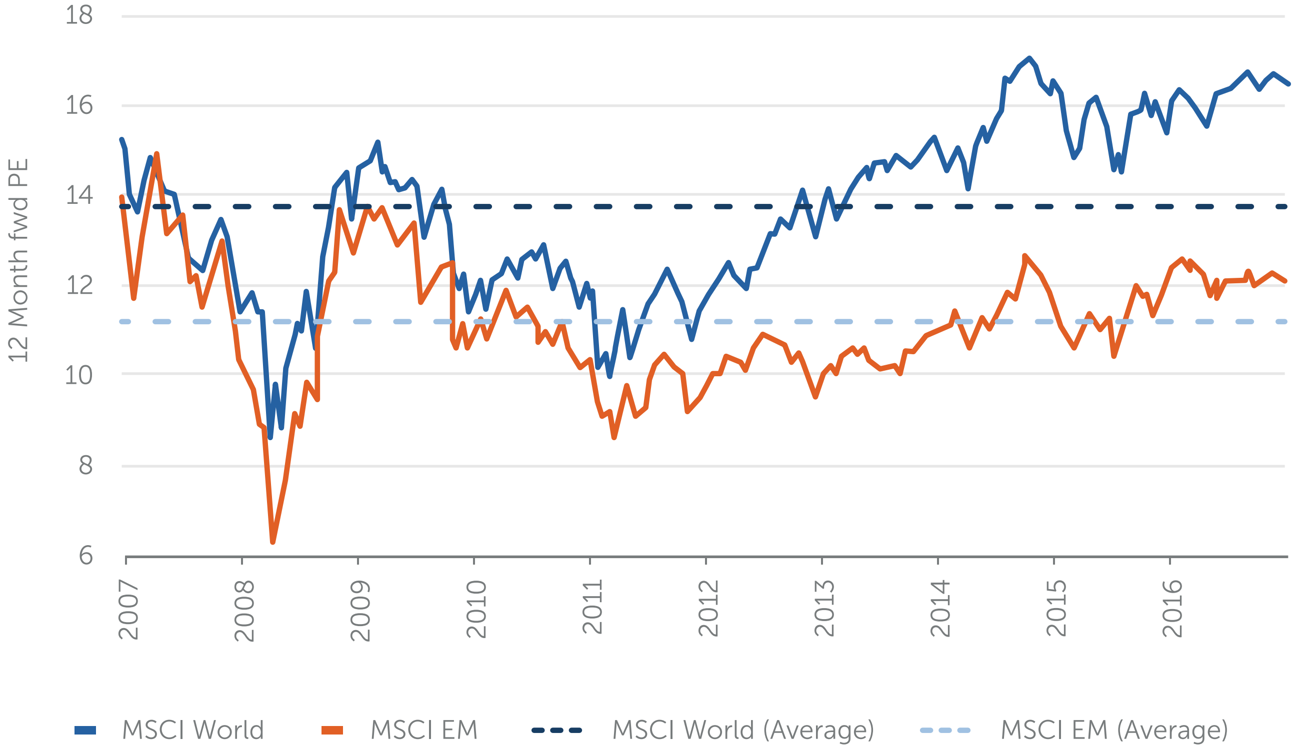
Given these preferences, our approach has been to manage risk within equities, as opposed to creating diversification by replacing equities with bonds. This has involved taking profits in shares that had become overvalued, particularly in the Tech sector, and rotating capital into sectors that have been unduly weak. Specifically, we trimmed our weightings in PayPal and Activision Blizzard – both very strong performers in 2017 – in early June, but we retain these two as holdings. In light of the strong performance of equity markets in FY2017 to date, we have modestly dialled back our 12-month expected returns from global equities from 8% to 6%.

Figure 5.1: Global earnings growth is still very strong:

SECTOR	TRAILING PE	12-MONTH FWD PE	CONSENSUS EARNINGS GROWTH
MSCI World	21.5	16.5	30%
Consumer Discretionary	19.2	16.4	17%
Technology	24.6	18.0	37%
Consumer Staples	23.8	20.0	19%
Financials	16.3	12.9	27%
Health Care	23.5	16.8	40%
Industrials	22.6	17.1	32%
Property	20.0	24.4	-18%
Telecoms	19.0	14.1	35%
Utilities	20.6	16.0	29%
Materials	20.7	15.6	33%
Energy	49.2	20.5	140%

Source: Bloomberg

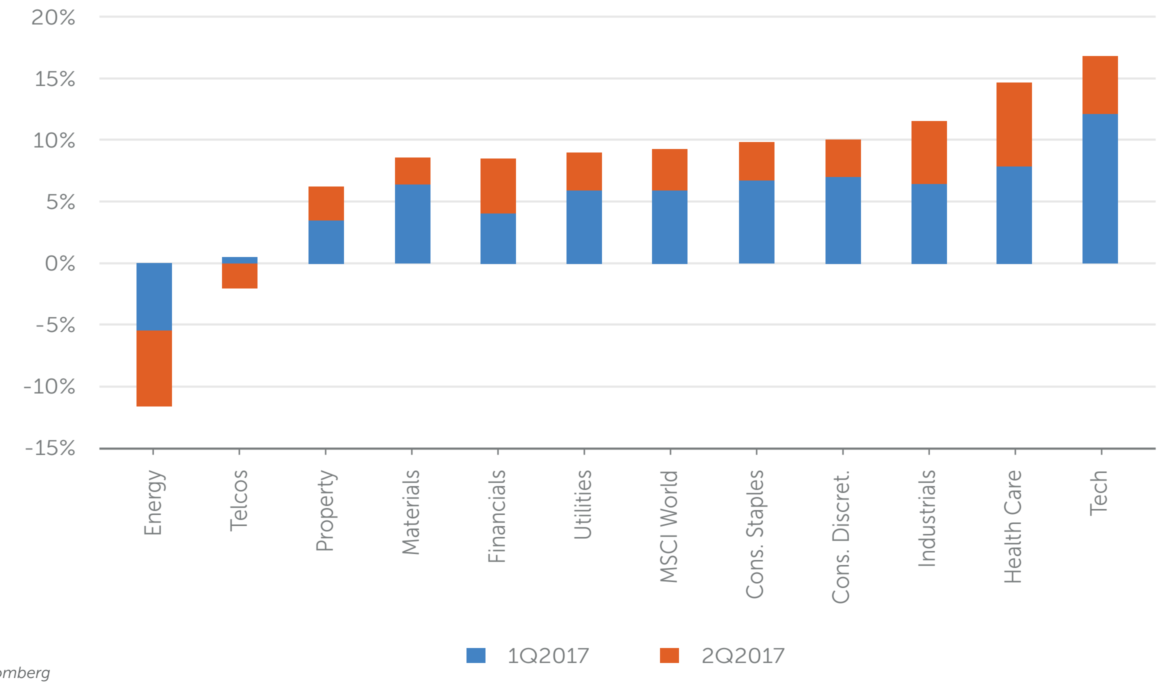
Figure 5.2: Forward PE multiples:



Source: Bloomberg, Anchor Capital

The underlying phenomena of the two catchphrases of 2017 – "The Trump trade" and "The reflation trade" – have continued to develop. In the first case, the Trump trade is now entirely priced out of the market. This trade can be identified by tracking the relative performance of those companies which would benefit most from Trump's policies (e.g. tax cuts, infrastructure spending). In our view, the pendulum has now swung too far in the pessimistic direction on this particular trade. In the second case, although the reflation trade has lost some of its gusto, the result of the softening of some key cyclical indicators, and a reversal of the inflation improvement in the US, this trade is still the basic thesis that is playing out in global asset markets at present. While on the one hand this softening is disappointing, it should be recalled that the post-GFC expansion has been able to sustain itself for such a long period because it has been so tepid, thereby avoiding the typical overheating which ends such expansions. A moderated reflation trade is, therefore, something of a blessing in disguise.

Figure 5.3: Sector performance, 1H17:



Source: Bloomberg

The Energy sector has been particularly weak during 1H17. While we have largely avoided this sector for some years, the recent sharp sell-off in oil, which we think is overdone, has created a tactical buying opportunity in the related Energy equities. In this sector, our company of choice is Royal Dutch Shell PLC ([Shell]; see section 5.3 below).

The following table shows the recent shift we have made to equity sector allocations within offshore equity, as well as our sector weightings relative to benchmark. The main shift during the quarter was to reduce exposure to some overly toppish Technology stocks, and to increase our exposure to Energy. Relatedly, the oil market, and the investment case for Shell, are discussed in more detail below.

Figure 5.4: Our sector allocations vs MSCI World weightings:

EQUITY SECTOR WEIGHTINGS	MAX UW	UW	N	OW	MAX OW	RECENT CHANGES
Consumer Discretionary				■		
Technology				■		↓
Health Care				■		
Financials				■		
Industrials		■				
Consumer Staples		■				
Utilities	■					
Telecoms	■					
Energy		■				↑
Materials		■				

Source: Bloomberg

In the section that follows we take a look at the dynamics of the US mattress market and the implications for our investments in Steinhoff and Tempur Sealy (the latter which we have recently taken profits on).

5.1 Bouncing on the bed: A brief review of investment opportunities in the US mattress market

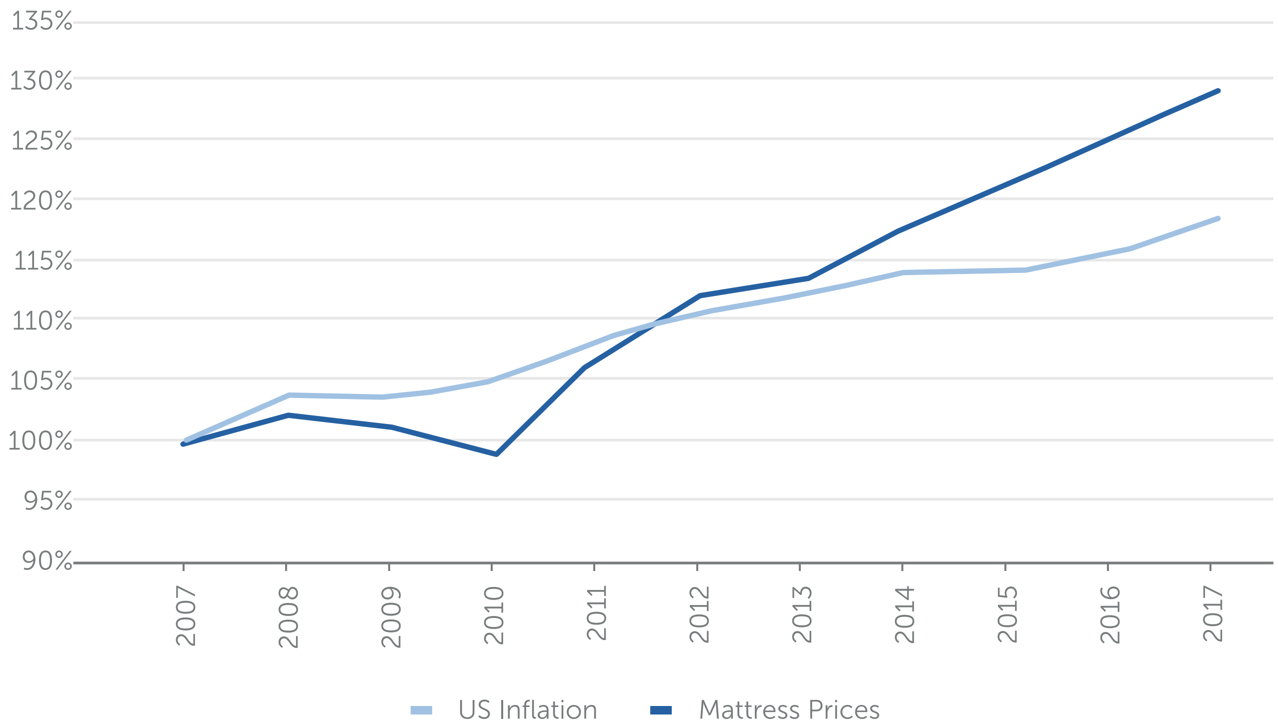
One may be forgiven for overlooking the seemingly dull business of mattress retailing in the age of red-hot biotechs and hyperbolic FANG stocks (Facebook, Amazon, Netflix, and Google), however the last 5 years have seen a series of large acquisitions and a rather public corporate spat which set off an epic shakeup of the US mattress market. The scene is set for a battle of the brands – with a siege on retail space and an advertising dollars arms race. Amid the chaos, investors will be rewarded for backing the winners and in this short piece we present the case for our own choices.

Healthy industry economics:

The economics of the mattress market are fascinating, and are surely the construct of master marketers who have made their fortunes by spinning homogenous blocks of foam and wire into multi-thousand dollar branded lifestyle purchases that warrant a day-trip to a specialty store. Consumers seem to spend as much as they can afford, with the fear of years of discomfort outweighing any consideration of price/ value. Seemingly infinite product differentiation makes price comparisons between retailers difficult, and "jargony" features such as "memory foam technology from NASA" add several hundred dollars to premium models.

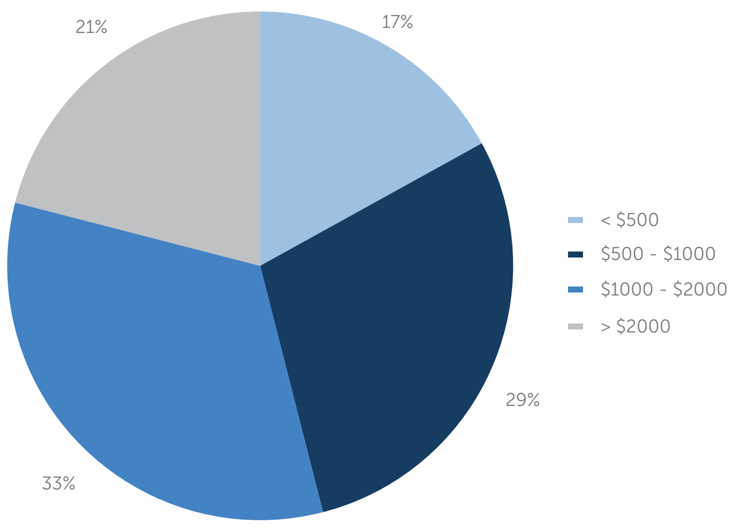
The results speak for themselves. Over the last 10 years, the average price of a mattress sold in the US has risen well ahead of inflation. Additionally, more than 50% of mattresses sold in the region are priced over $1,000. The margins in the industry reflect the profit opportunity – with a typical manufacturer and a typical retailer both making a gross margin in the region of 40%.

Figure 5.1.1: US CPI vs mattress prices:



Source: Mattress Firm, Anchor Capital

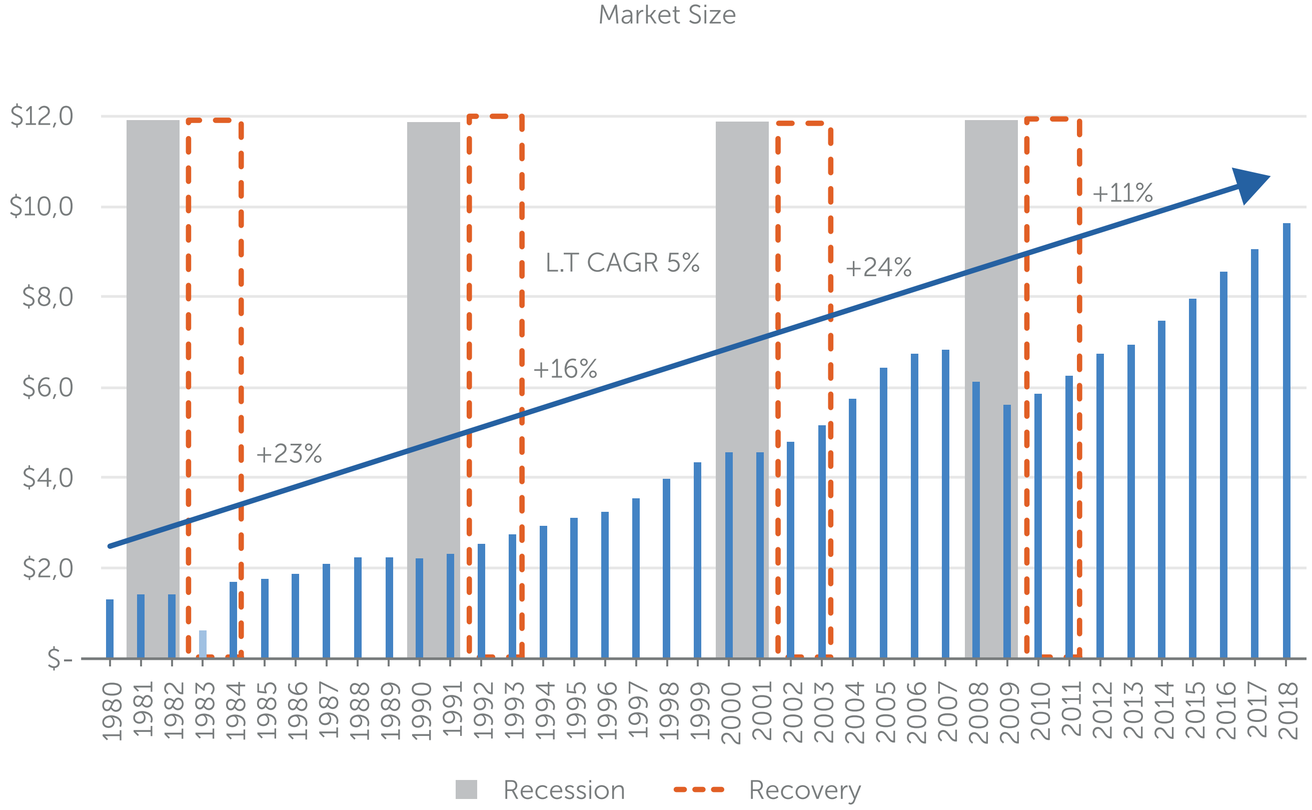
Figure 5.1.2: Mattress spend per price band:



Source: Mattress Firm, Anchor Capital

Additionally, the US mattress market has grown by a phenomenal 5% CAGR for the last 37 years - and has repeatedly demonstrated rapid post-recession recovery. This trend looks set to continue, with growth expectations for 2017–2019 north of the trend at 6.5% p.a. This rather strong tailwind will benefit the entire industry, and players who are able to grow their share of the market could report double-digit revenue growth.

Figure 5.1.3: Market size:

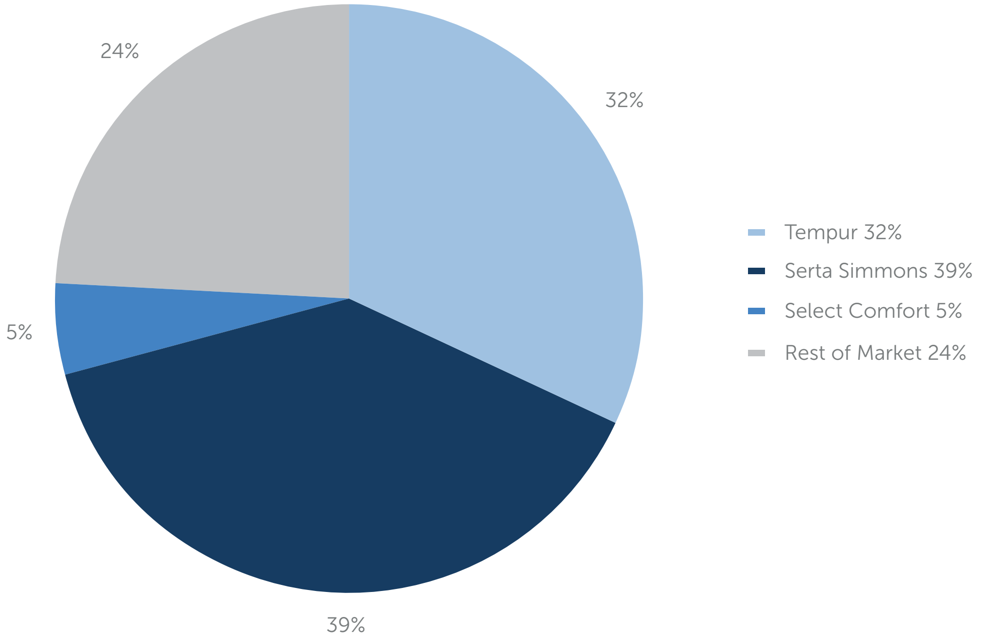


Source: Mattress Firm

A changing landscape yields opportunity

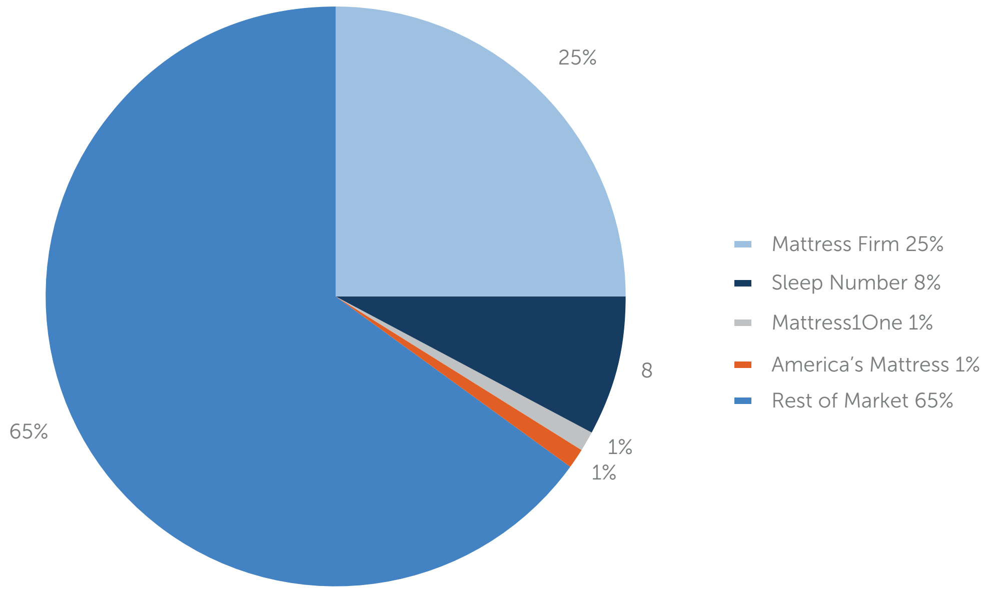
Given these stats, you may conclude that this is an industry well-suited to vertical integration – and you'd be correct. Interestingly though, most of the integration of the US mattress market has been horizontal. This may be explained by the natural conflict of interest between manufacturers and their retailers, where there would likely need to be market realignment in the event that a first-mover positions themselves as a vertically integrated retailer. There would almost certainly be net losers and net winners in this instance, and we believe this scenario is currently playing out after Steinhoff's acquisition of Mattress Firm and the subsequent fall-out between Mattress Firm and Tempur Sealy.

Figure 5.1.4: Manufacturer market share:



Source: Tempur Sealy

Figure 5.1.5: Retailer market share:



Source: Tempur Sealy

Prior to 2016, Steinhoff, the world's largest vertically integrated bedding retailer, had no presence in the US market. After its acquisition of Mattress Firm, the largest retailer of mattresses in the US, it would be just six months before the first casualty of this rather hostile market entry would fall.

In late January of this year, Tempur Sealy – Mattress Firm's largest supplier - announced that it had elected to terminate its supply agreement with Mattress Firm after the retailer demanded several "significant economic concessions", which Tempur Sealy management deemed unacceptable. Overnight, the severed relationship meant 40% of Mattress Firm's sales and 20% of Tempur Sealy's sales had evaporated. While Mattress Firm has since delisted, the Tempur Sealy share price fell 32% in response to the news.

Four months later, in a move that would make their intentions clear, Steinhoff announced the acquisition of Sherwood Bedding – the manufacturer of Mattress Firm's house-brand mattresses. We believe this acquisition marks the beginning of a meaningful vertical integration process which could unlock a significant high-margin opportunity in the world's most lucrative mattress market.

Both Tempur Sealy and Mattress Firm have since announced detailed plans for market share "recapture", with Tempur Sealy choosing to accelerate advertising spend through its remaining retail channel – and with Mattress Firm signing a new supply agreement with remaining supplier Serta Simmons to plug the gaping 40% hole in the retailer's showroom floor.

This new landscape, while uncertain, yields two investment opportunities which we find attractive.

Tempur Seally: worst-case scenario initially priced in

After the loss of their largest single customer, the market was quick to reprice the equity of Tempur Sealy - the US' second-largest producer of mattresses. The share sold down from $67 to a low of $43, wiping out $1.4bn of the company's market value. Investors had taken a dim view of the new outlook for Tempur Sealy, assuming that the business would be able to recapture little of the 20% in lost revenues.

Given the company's 40% market share pre-contract termination and the brand equity of the high-end Tempur-Pedic and mainstream Sealy brands, we felt this was probably too pessimistic. Tempur Sealy management seemed to agree, and in a rather telling move adopted a stockholder rights plan that would protect shareholders from an opportunistic acquirer looking to snap up the arguably undervalued business.

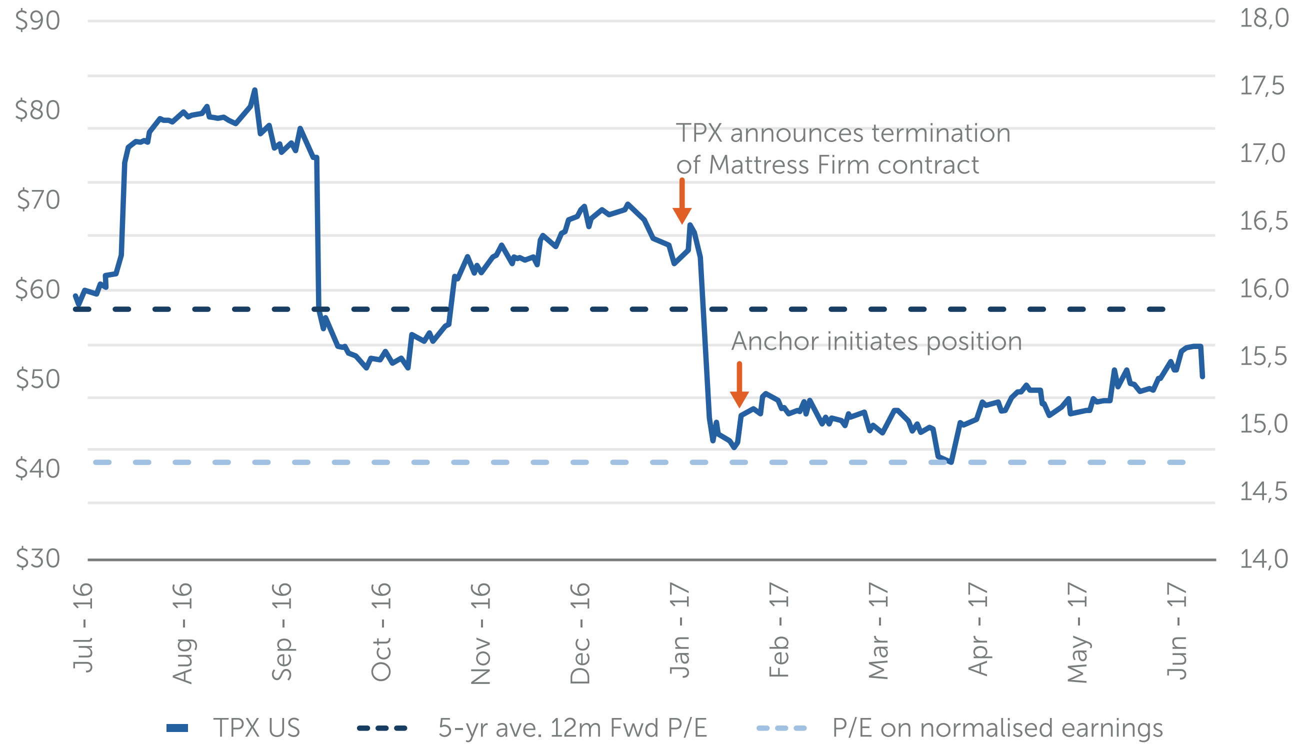
The mechanics of the shareholder rights plan or "poison pill" would effectively force a potential hostile acquirer to either engage with the Tempur Sealy board to negotiate deal terms, or risk being diluted by a factor of 50% through a punitive issue of discounted shares to existing shareholders (excluding the acquirer).

Shortly after the rights plan was announced, we initiated our position in the business for the following reasons:

- Management have guided to $400m-$450mn in EBITDA for FY17. This implies the recapture of at least 50% of the lost Mattress Firm sales. Given the strength of the Tempur-Pedic and Sealy brands, we believe this is a realistic scenario. The group plans to accelerate its advertising spend as a percentage of sales to assist in driving sales through its remaining retailers, who quite rightly have identified Mattress Firm's discontinuation of the brands as an opportunity to capture a greater market share alongside Tempur Sealy itself. We estimate that this implies normalised earnings of $3.41/share, placing the share on an attractive 14x normalised earnings at the time of investment.

- Tempur Sealy has a flexible operating cost base, and in the event of a low rate of sales "recapture" the team is in a position to eliminate up to $100mn in operating costs within one quarter. This saving would equate to $1.30 in post-tax earnings per share (40% of our estimate of normalised earnings), giving management a high level of flexibility to respond to changing market conditions. We have since taken profits on Tempur following strong share price performance.

Figure 5.1.6: Tempur Sealy share price performance vs 12m fwd P/E:



Source: Anchor Capital

Steinhoff: betting on successful execution

The acquisition of Mattress Firm by Steinhoff in August 2016 meant that the South African-based retailer had inherited the US' largest mattress retailer, with a footprint of over 3,500 stores and pro-forma sales in excess of $3.8bn.

Despite Tempur Sealy accounting for over 40% of Mattress Firm's cost of sales for FY16, we are confident that the group will at least be able to recapture half of this revenue through the renewed supply agreement with Serta Simmons and the expansion of Mattress Firm's house-brand range after Steinhoff's acquisition of manufacturer Sherwood Bedding.

We believe effective execution at Mattress Firm could conservatively add 7.5% to group net operating profit after tax (NOPAT) per share, growing at least in line with the US mattress market in years ahead (6.5% p.a. forecast). This is based on a conservative set of assumptions, namely:

- Mattress firm recapturing at least half of the lost Tempur-Pedic and Sealy sales. This is roughly in line with Tempur Sealy's own forecasts.
- Group gross margin maintained at 40%. We feel this is easily achievable given the integration of Sherwood Bedding and the apparently favourable terms of the new Serta Simmons supply agreement.
- Recovery of operating margins to 10%. The integration of several recent acquisitions has recently suppressed group operating margins. As this process is completed and synergies are realised, operating margins should at least return to historical levels.

Figure 5.1.7: Mattress Firm impact on Steinhoff NOPAT:

MATTRESS FIRM IMPACT ON STEINHOFF NOPAT	
Revenue	$3,040,000
Operating margin	10.0%
EBIT	$304,00
NOPAT	$189,340
EUR/USD	1.14
NOPAT (EUR)	£215,848
Steinhoff FY 16 NOPAT per share	£328
Combined Pro-forma NOPAT per share	£353
Incremental NOPAT per share	7.6%

Source: Anchor Capital

Importantly, this forecast does not consider the significant opportunity to merchandise a more complete range of Steinhoff's general merchandise across Mattress Firm's footprint alongside the mattress lines, which could add material incremental revenue growth.

Fortunately, the positive outlook for Mattress Firm coincides with a positive outlook for the remainder of the business. While we believe evidence of successful execution in the US mattress market should assist in driving a rerating of the share, we also highlight:

- **Improving returns on capital employed.** Steinhoff's recent acquisition trail has put pressure on group returns, with group return on equity dropping from 14% for FY14 to just 8% for FY16. Management have affirmed that we should expect this trend to reverse going forward, with fewer acquisitions planned and improving margins across the business.
- **A French furniture market primed for material growth.** Management have guided that a post-Macron France is a more confident France, with consumers inclined to spend more. Furthermore, the French furniture market is just 0.32% of French GDP vs Germany at 0.76% - a gap which Steinhoff expects to start closing. Given that the region accounts for almost 1/3rd of group revenue, this theme represents a significant tailwind for the business.

Steinhoff now trades on a multiple of just 12.3 times forward earnings, with a healthy double-digit earnings growth profile going forward. These metrics, combined with strong market fundamentals and management focus on consolidation and efficiency make for what we view as a compelling investment.

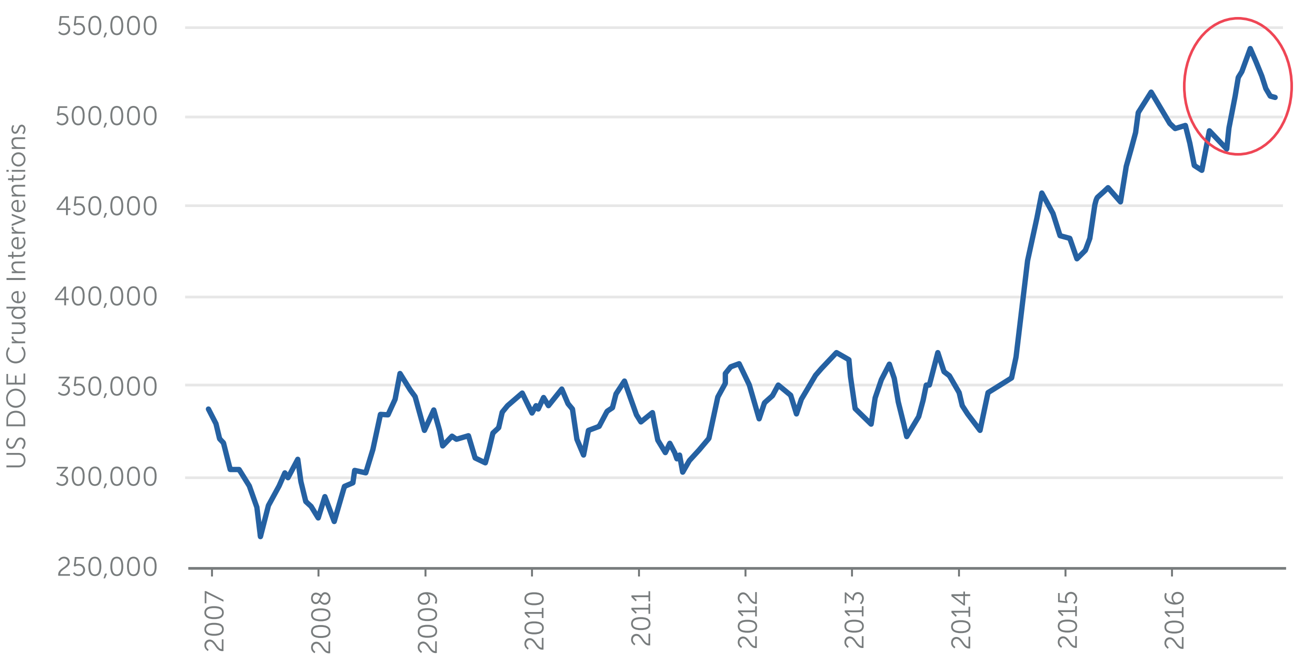
5.2 The oil market

Oil prices were sharply lower during 2Q17, reflecting disappointment that "OPEC 2.0" (OPEC + Russia) did not extend production cuts announced last year, thereby increasing concerns that stubbornly high levels of global oil inventories would continue to weigh on prices.

The oil market, in the past three years, has largely been a tug-of-war between OPEC and US tight oil (also known as US shale, or "unconventional" oil). What is distinctive about US shale is that it has a very short lead-time to production; thus, the industry can respond very rapidly to price signals, thereby dampening the extreme boom/bust pattern that has typified the oil market in the past. Initially, US tight oil significantly damaged OPEC's oligopoly power, but the cartel has regrouped, and its latest supply restriction agreement includes a number of other nations, most significant of which is Russia. This broader group, dubbed "OPEC 2.0", appears to have recovered some of the original OPEC's lost oligopoly power.

Although shale efficiencies (e.g. barrels per new well) have continued to rise dramatically (Figure 5.2.1), costs have also risen significantly in the past year, such that the 2017 shale cost curve has effectively remained in-line with 2016 levels. Up to 2017, the shale cost curve fell dramatically each calendar year. Further, the oil industry outside of shale has been remarkably successful at cutting costs. It remains to be seen how much of this is genuine efficiency, and how much is actually "cutting into muscle". It appears, however, that the cost differentials between shale and non-shale have converged to some degree.

Figure 5.2.1: Stubbornly high oil inventories:



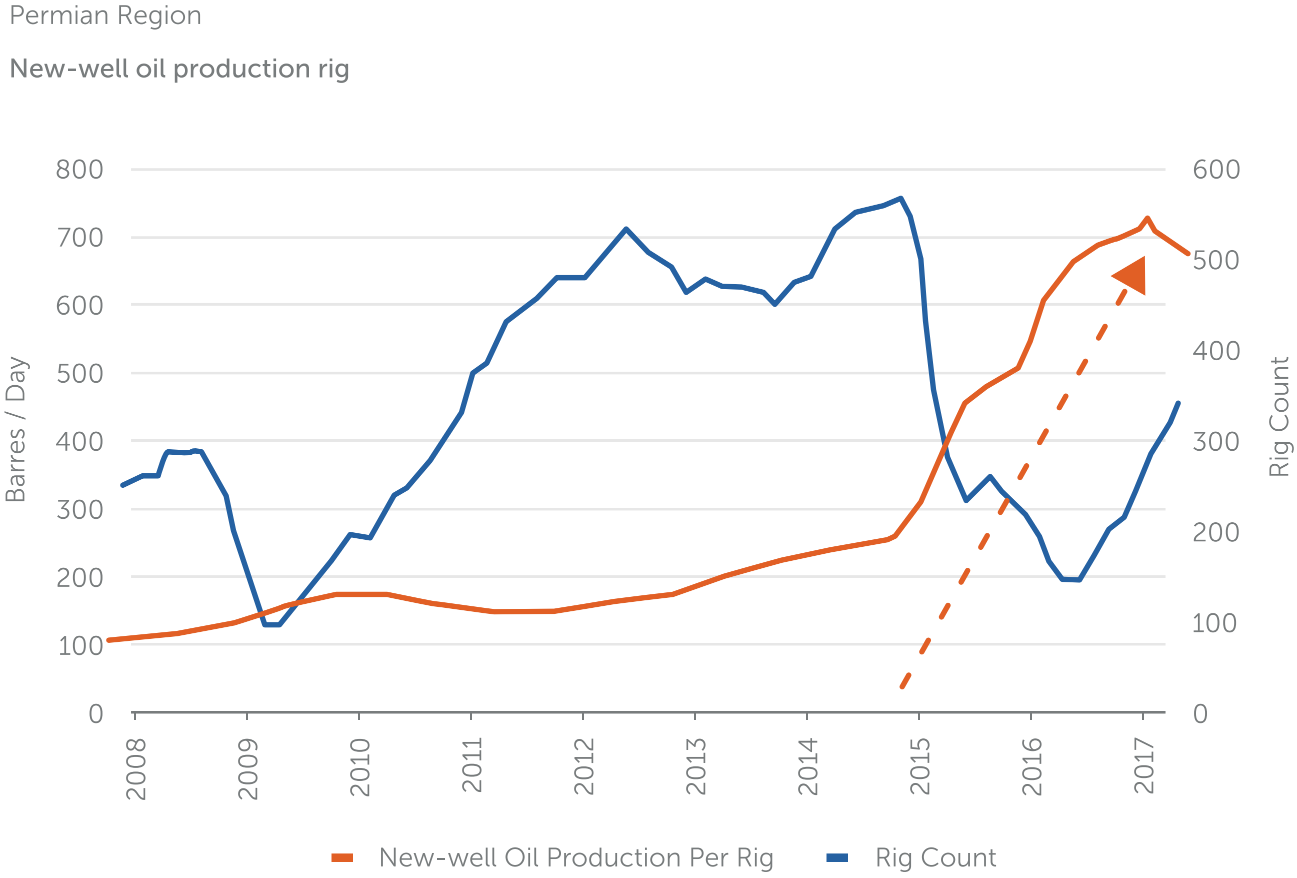
Source: Bloomberg

Figure 5.2.2: Global oil supply and demand:

	2015	2016	2017	2018E
Supply (MMBPD)				
OECD	26.8	26.5	27.3	28.6
U.S (50 States)	15.1	14.8	15.6	16.7
Canada	4.5	4.6	4.7	4.9
Mexico	2.6	2.5	2.3	2.3
North Sea	3.1	3.1	3.1	3.0
Other OECD	4.6	4.6	4.7	4.7
Non-OECD	69.9	70.7	71.0	71.6
OPEC	38.0	39.0	39.2	39.9
Former Soviet Union	14.1	14.2	14.3	14.3
China	5.2	4.9	4.8	4.7
Other Non-OECD	12.7	12.6	12.6	12.7
Total World Supply	96.7	97.2	98.3	100.2
Consumption (MMBPD)				
OECD	46.4	46.9	47.1	47.5
Non-OECD	49.0	50.1	51.3	52.6
Total World Consumption	95.4	96.9	98.5	100.1
Total Stock Draw	(1.3)	(0.2)	0.2	(0.1)

Source: Bloomberg Intelligence

5.2.3 US tight-oil productivity has surged in the past 2 years:



Source: US EIA Productivity Report

The most recent developments of this tug-of-war appear, therefore, to have moved in a direction that is ultimately bullish for oil prices: not only has OPEC regrouped as "OPEC 2.0", but the cost curve of US tight oil has, for the first time, not shown a year-on-year decline. A third important factor to consider is capex adjustments. Following the oil price collapse of late 2014, capex budgets were slashed by roughly $900mn. It will be a few years before these capex reductions are felt in actual production levels.

Spencer Dale, BP's chief economist, presented an elegant and simple picture of the oil market as it is likely to unfold for the remainder of 2017. To paraphrase his view: the oil market was roughly in balance at the start of 2017; during this year, the "OPEC 2.0" agreement took about 1.8mb/d off the market; while global oil demand has been growing by about 1mb/d each year for the past few years, and is likely to continue at this pace. These inventory "pulls" will be offset by strong growth in US "tight oil" which, even under very optimistic assumptions, is unlikely to exceed 1mb/d in 2017. Thus, the stock draws (1.8mb/d + 1mb/d) should comfortably exceed new supply (+1mb/d), and tighten the oil market in the second half of 2017.

That was the short-term picture. BP's longer-term estimate is for oil demand to grow by around 20mb/d over the next 20 years. Tight oil, however, according to the company's estimates, can grow by only 5mb/d over that period. Thus, while the ability of shale to dampen price spikes in both directions is acknowledged, it appears that this unconventional source of supply does not have the ability to push the longer-term market balances into oversupply. Thus, tight oil cannot, in their view, cap the oil price in the longer term.

Lastly, the oil market is unique in that its supply dynamics are determined not only by corporate profitability concerns, but also by national budgets in major producer countries. By BP's estimates, these major economies don't balance their books "anywhere near $50." This, again, suggests a medium term to oil prices somewhere north of $50/bbl.

In summary, there are both short- and longer-term drivers of higher oil prices coming into view, such that a medium-term price of around $60/bbl (Brent) now seems quite reasonable. This modest optimism fully takes into account the price-lowering effects of the shale revolution, and the current surplus of oil resources. This is a bullish sign for the Energy sector, which has been in the doldrums this year.

5.3 Royal Dutch Shell

Although we do form a view on commodity prices, it must be acknowledged that these are typically very erratic and difficult to forecast. Thus, in gaining exposure to the Resource sector, we have looked for investment prospects that would benefit from commodity price upside, but for which the investment thesis would still be sound, even in the absence of such pricing improvements. We think Shell is one such company.

The potential for very significant efficiency improvements to drive earnings growth is one of the key reasons why Shell is currently our preferred energy company. This can be illustrated by the company's published return and free cash flow (FCF) targets: while the company earned a return on average capital employed (ROACE) of only 8% during the heady oil price days of 2013-2015, when Brent averaged $90/bbl, its targeted efficiency improvements are so radical that even in an environment where Brent averages $60/bbl, it still expects to earn a higher ROACE, something in the region of 10% p.a., during the 2019-2021 period. Similarly, organic free cash flow is expected to rise to $20bn–$25bn p.a. during that period, from the level of $5bn p.a. in the 2013-2015 era. This large projected increase in FCF reflects efficiencies and a modest recovery in the oil price. But it also reflects Shell's project pipeline, which gives the company one of the best, if not the best, growth profiles amongst the energy majors.

Figure 5.3.1: Shell's ambitious return and growth targets:

RETURN METRICS	2013-2015 AVERAGE	2019- 2021 AVERAGE
ROACE	8%	~10%
Organic free cash flow	$5 Bn p.a	$20 - 25 Bn p.a
Brent price	~$90	~$60

Source: Shell Company reports

Historically, Shell was known as a great innovator but it was also a very bureaucratic company (the former UK and Dutch corporate structure played a part). It did very exciting things in energy exploration but financial returns were not as important. This is now changing because of new leadership under Ben van Beurden, who became CEO in January 2014. He has an absolute focus on creating a world-class investment case for Shell. We are beginning to see the fruits of this.

Our investment thesis for Shell is largely predicated upon the potential of these efficiency improvements, and the fact that the very high dividend yield of about 7% p.a. is now well supported by FCF. Shell also provides optionality on a higher oil price. Should the price move closer to $60/bbl, as we expect it will (and as Shell's forecasts suggest), then we think the share price has scope to rise by 25% or more. This implies an increase in the price/book ratio from 1.2x to 1.5x.

If oil prices continue to languish through to the end of 2018 (at $45/bbl or lower), then there is a risk that the company may be forced to lower the dividend slightly in that year. Yet, such weak prices (not our base case, but a risk scenario) would most likely be associated with a weak growth environment, very low bond yields, and consequently a heightened "search for yield". Hence, there is a degree of defensiveness associated with high-dividend paying stocks, which would be supported by such a prioritisation of yield. In summary, we think Shell represents an attractive investment opportunity and we have included the share in our model portfolio.

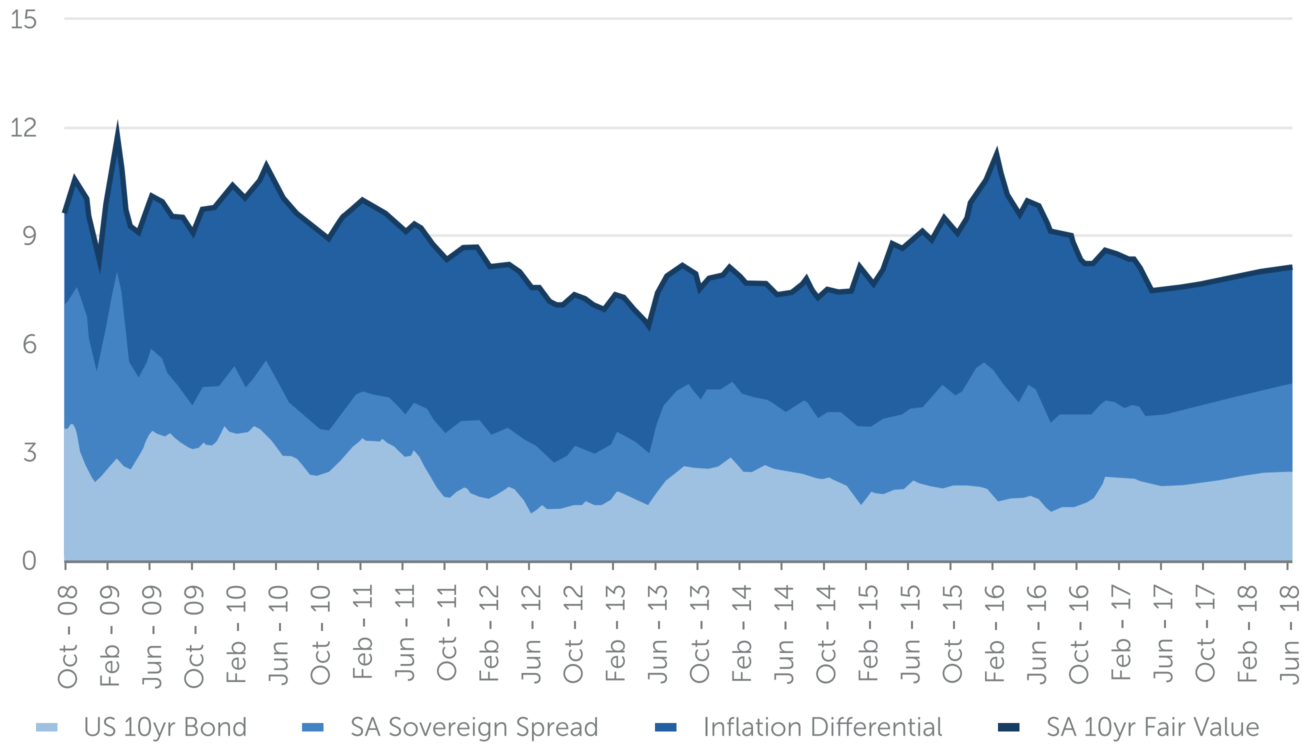
06 DOMESTIC BONDS

We expect a total return of 10.20% on the SA 10-year benchmark bond for the next twelve months. This comprises of 8.65% interest income with a capital gain of 1.55% as yields move towards our target of 8.45%.

We had previously been projecting the yields to push up towards 9.30% reflecting the sudden and disastrous cabinet reshuffle that took place in the days before we published our last strategy document. The global macro environment has proved to be more forgiving than we had expected and the market has been interpreting that the events will hasten the removal of the corrupt faction from the SA government. Whilst we do not agree with the market's Goldilocks interpretation, the yields were able to trade to 8.42% at their strongest during the quarter. In essence, we now expect that bond yields will be volatile and we have reverted back to the target level that we set in our January Strategic Asset Allocation document.

In estimating the bond yield, we start with our model of the fundamental value of the bond. This is based on the sum of three factors: the yield on the US 10-year bond, a SA credit risk premium (based on credit default swaps), and the inflation differential between SA and the US.

Figure 6.1: The modelled fair yield of the SA 10-year bond over time:



Source: Thomson Reuters

In looking forward, we have already stated that we see the US 10-year bond yield at 2.55% at the end of the period, with US inflation pushing towards 1.9% over our twelve-month horizon.

The stronger rand for the last 18 months, along with improved rainfall and slumping consumer demand will result in lower inflation for much of 2017 and 2018. We see inflation averaging 5.1% for the next year. This gives us an inflation differential of 3.2%, on average, over the next year.

We see the SA credit default swaps (CDS) as fair at 2.50%. It is worth noting that we anticipate SA being downgraded further by Standard & Poor's over the next twelve months. This is part of our thinking that the CDS spread will increase from the current 1.90% towards 2.50%.

Aggregating the US 10-year bond at 2.55%, the inflation differential at 3.20% and the CDS at 2.50%, we get to a fair yield for the SA 10-year bond of 8.25%. We sense that a cautious view towards risk might see the market trade slightly higher than the fair value in the near term. Therefore, we think that a target yield of 8.45% is reasonable.

On a longer-term basis, we think that SA inflation will trend back towards the 6.0% level with which we are more familiar. Therefore, whilst there is an underpin for bonds at 8.45% right now, this will dissipate during late 2018 and we expect that the long-term fair yield for SA bonds will be in the 9.00%-9.50% range. Over the next 12 months, we believe that low inflation and expectations of interest rate cuts will keep our bonds anchored around the 8.45% level.

It is perhaps more interesting to the consumer that on the back of the recession (which is likely to escalate), we bring our expectations of interest rate cuts forward towards 4Q17. The South African Reserve Bank's (SARB's) Monetary Policy Committee (MPC) is naturally very hawkish and therefore, we expect that they will delay the interest rate cut for now. We expect that this will be a shallow cutting cycle, with no more than maybe two or three cuts of 0.25% each for the entire cycle, due to the weaker rand keeping the MPC cautious about rate cuts.

We see two distinct risks to our forecast. The political situation in SA remains fluid and any dramatic changes to the status quo will spike bonds either weaker or stronger. In this context, we are cautious of being too underweight bonds in a highly uncertain environment.

We are also concerned about the normalisation of yields as stimulus is slowed in Europe and the US. For now, we think that the lacklustre performance of the US economy will keep global interest rates in check. Should the US economic growth accelerate, then our domestic interest rates will be pressured upwards.

Domestic credit spreads

This year has been marked by a dramatic slowdown in the issuance of SA corporate bonds, with only a handful of issuers returning to the market in the last few weeks of the quarter. The slowdown of the SA economy has meant that many corporates have held back on investment and consequently not found it necessary to borrow money. We have also seen that banks are either extending their issuances for longer dates - gone are the three-year bonds, they are now looking to issue for ten years.

This dearth of issuance has increased the buying pressure on the market. Credit spreads for quality corporates have remained unduly tight.

In this context, we are very selective of the credits in which we invest. Our approach is to rather hold cash than to lend money to a corporate at too low a yield.

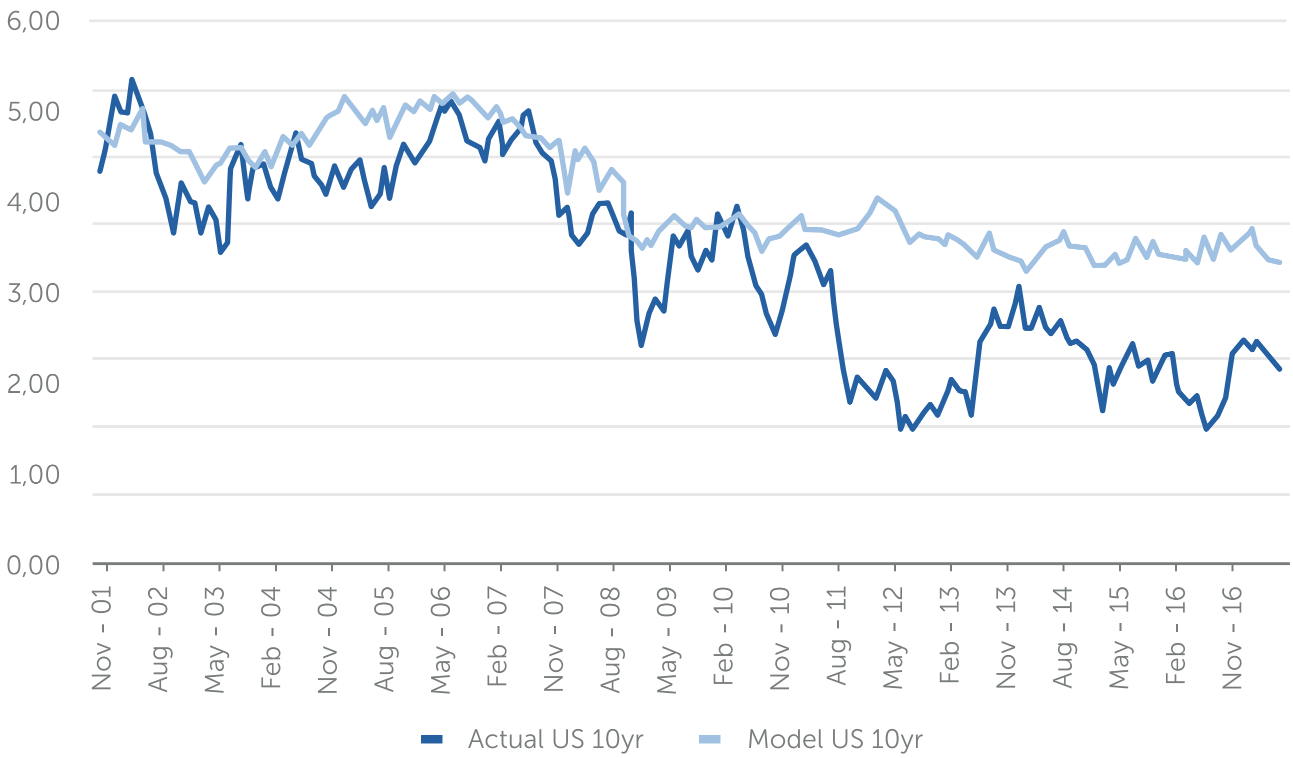
In the near term, we do not expect the recent political events to have a material impact on corporate bonds. It is clear, however, that the risk premium payable by state-owned enterprises (SOEs) is likely to continue on its upward trajectory. We have a negligible exposure to SOEs and we have been underweight the government sector for a while.

07 OFFSHORE BONDS

We are expecting a loss of 1.45% on US 10-year treasury bonds over the next twelve months. This is comprised of interest income of 2.15% being offset by capital losses of 3.60%. Over the period, we expect yields on US treasury bonds to increase from 2.15% to 2.55%. This call effectively means we are "sticking to our guns" on rising US rates, in spite of the recent slump in US core inflation noted above. The impending unwind of QE that is discussed above (see section 3.1), is a key driver of this continued expectation that US rates will rise modestly. While these projected rate rises may seem negligible, they are extremely significant because the entire world's assets are effectively priced with reference to US yields.

Our regression of the US bond yields against a combination of short-term rates, core inflation, the manufacturing index and curve steepness continues to show that US bonds are unattractive, with an implied fair yield of 3.31% being significantly more than the 2.15% that is on offer in the market.

Figure 7.1: Modeling the US 10-year bond using macro fundamentals:



Source: Thomson Reuters

The bond yield can deviate from the regression model for a long period of time. There are a number of factors that might cause such a deviation in the yield of bonds from their fair value. Currently, the most important of these factors is the massive amount of global stimulus that has been injected into the market by central banks. The aggressive buying of government bonds by global central banks has resulted in an artifically low bond yield in the markets.

It is our view that the central banks (particularly in Europe and the US) are likely to pare back their stimulus. The US Fed anounced that it expects to start reducing the holding of fixed-income instruments, effectively unwinding the QE that took place in the aftermath of the GFC of 2008. This will be a slow process which accelerates over time. The impact for the next 12 months will be negligible in terms of quantum of bonds. As a result, the market has brushed off this anouncement without reaction. We expect that the Fed will reduce the balance sheet from its current $4.8trn towards $3.0trn through this process. This means that the balance sheet (and support of the bond market) is likely to remain bigger than it was before the GFC.

The ECB has continued to support the market by buying bonds onto its balance sheet. We expect that it will announce a slowdown of these purcashes during the first half of 2018. We would expect these events to remove some of the support for bonds from the market and to also narrow the gap between our modelled fair yield and that on offer in the market.

Our estimate of the fair yield for US bonds has declined from 3.66% last quarter to 3.31% currently. This reduction in fair yield is reflective of the fact that the US economy has been lacklustre for the first half of 2017. The economic data that has been released has not lived up to the expectations of a growth acceleration. We note that, in this regard, the Fed has reduced its inflation expecations for 2017 down to an average inflation rate of 1.7%. We suspect that this will slowdown the pace of interest rate hikes for the rest of this year and next.

Figure 7.2: US 10-year TIPS real yields over time:

Source: Thomson Reuters

We look at the real yields (yields above inflation) as priced in by the US 10-year inflation linked bonds. From Figure 7.2 above, you can see how real yields compressed from an average of 2% before the 2008 GFC to a level of -0.50% at the height of QE. The anouncement that the Fed would stop buying bonds in 2013 resulted in a 1% increase in real yields. These are currently at 0.38%. We expect that the reduction in stimulus in Europe will have a smaller impact than we saw with the US tapering and we have modelled on an increase of 0.40% in real yields towards 0.75%.

It is likely that the US will experience a recession some time over the next 10 years. Therefore, we model, on average, expected inflation of 1.8%, which is in line with where it currently stands and is moderately below the Fed's 2.0% target. Adding the real yield and inflation gives us a target of 2.55% for US 10-year bonds.

Our yield estimate has declined from 2.70% at the end of 1Q to the projected 2.55%. This is reflecting the lacklustre performance of the US economy for the first half of the year. Whilst we think that some economic acceleration is to be expected, it appears that this is likely to be less than we had originally been hoping.

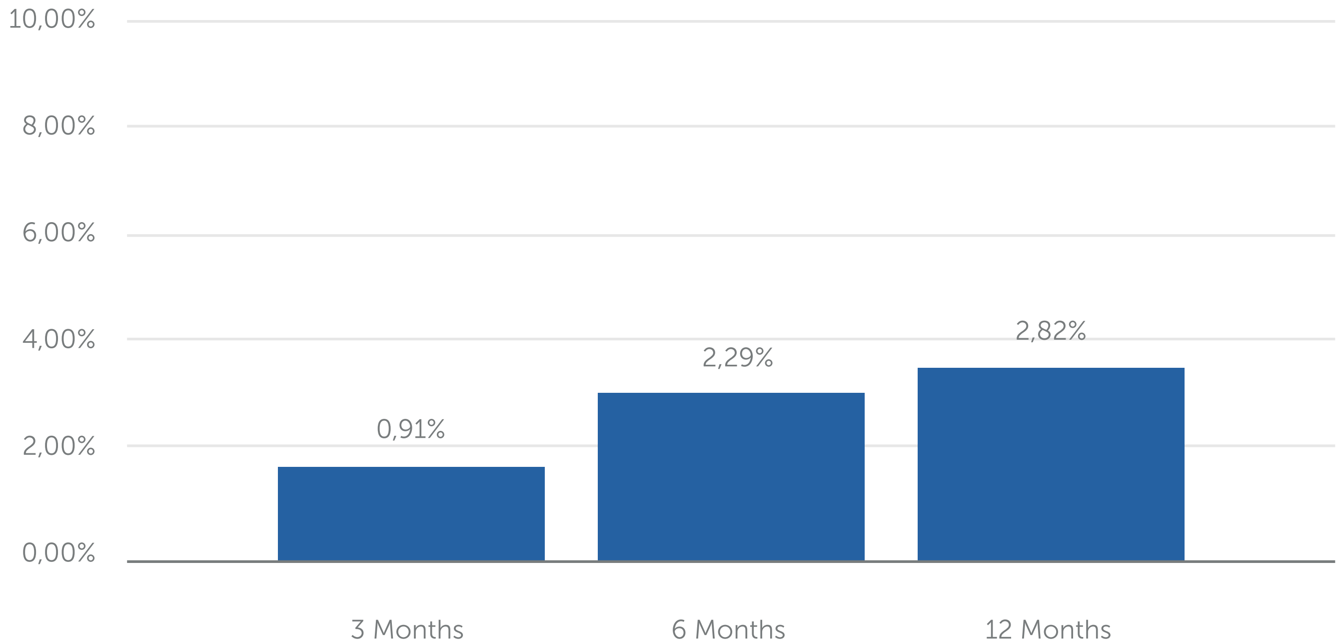
The risks to our view are of a political nature in that the ability of the Trump administration to deliver on its fiscal stimulus remains to be seen. The market has been sorely disappointed and the uncertainty coming from the administration has weighed down the economy without a counterbalancing stimulus. We think that some positive surprises are due and that President Trump must surely be able to deliver something. This lines up well with our view that rates are likely to increase a little over the period.

The market is currently pricing in two interest-rate hikes for the next twelve months. This is in line with our expectations. Therefore, we are finding that the yield curve will likely shift upwards on a parallel basis over the next year. We acknowledgbe that 2017 is a year where the number of risk factors to our forecast is particularly high, with risks slightly skewed towards higher interest rates than our forecast. This is also likely to be the year where active management of risk will be of greatest importance to your investments.

08 PROPERTY

A glance at the returns for 3, 6 and 12 months for the SA-listed property benchmark illustrates that returns are far from bountiful. Indeed the last 3 months have been spent thrashing around the zero line.

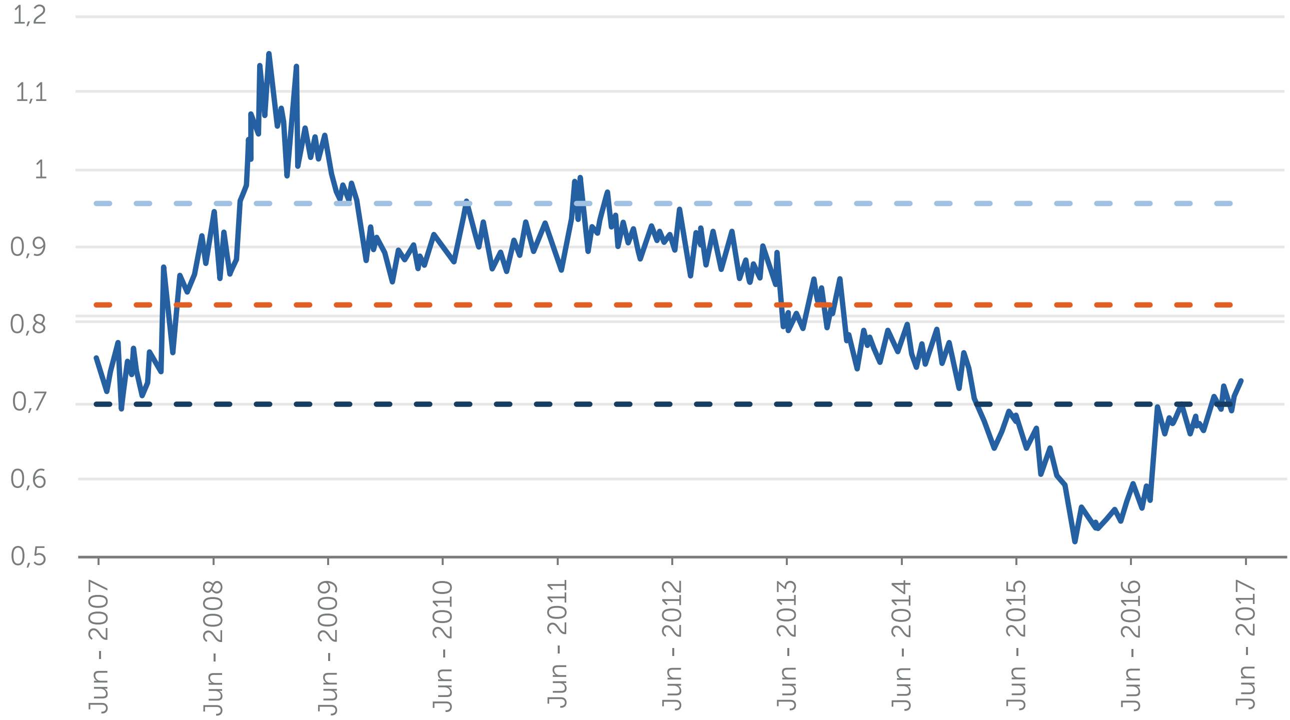
Figure 8.1: SA Property (JSAPY) total return:



Source: Bloomberg; Anchor Estimates

What does this mean for the outlook for the sector and optimal positioning? Our base case is unchanged in terms of the 12-month forecast return. At the index level, a historic yield of 6.2% growing at approximately 6.5%, should translate into a return of 12.7%. We temper this down to approximately 10.2% by forecasting a further de-rating of the property yield relative to the bond yield (R186). This is the relationship that shows the highest correlation and explanatory ability of property returns in SA. Currently at 70%, we forecast this moving up to 75% and towards the 10-year average of 82.5%. However, we acknowledge that a growing offshore component in the local index probably means that this long-term average cannot be looked upon in the same light, and that a de-rating has indeed already occurred from clearly "overbought" levels reached in 2015/2016 after a 7-year bull market in listed property

Figure 8.2: Domestic property yield relative to bond yields:



Source: Bloomberg

At a macro level we therefore think that portfolios can be constructed that have higher forward yields than we have seen in some time (c. 7-8%), and that the sector is beginning to offer some value.

However, current local investment conditions, adequately covered in the equity commentary, has meant that growth in distribution forecasts are in the process of being tempered – and in some cases slashed – by the companies reporting results. In the last quarter :

- Redefine revised their DPS growth range from 7.5%-8.5% to 7.0%-8.0% for FY17.
- Dipula revised their DPS growth guidance range down to 5%-6.5% YoY (previously 6%-7% YoY).
- Delta Property fund forecasts zero DPS growth YoY for FY18 (consensus before the results was c. 5% YoY).
- Accelerate Property Fund announced that due to their investment programme in the Fourways node their distribution would not grow in FY18 and probably not FY19 either.

This growth environment is unchartered in SA and the de-rating that has occurred on the back of it is natural. Our stance is therefore not to try and pick the potential bottoming of a de-rating process and rather maintain a neutral weighting at the present time.

09 THE SA RAND

We are projecting a rand vs dollar exchange rate in the range of R13.00/$1 to R15.00/$1 in twelve months' time. The midpoint of our range is R14.00/$1, which is our base-case forecast. The SA exchange rate is notoriously difficult to forecast, hence, we acknowledge that there is a large degree of possible variance between our forecast and the realised outcome.

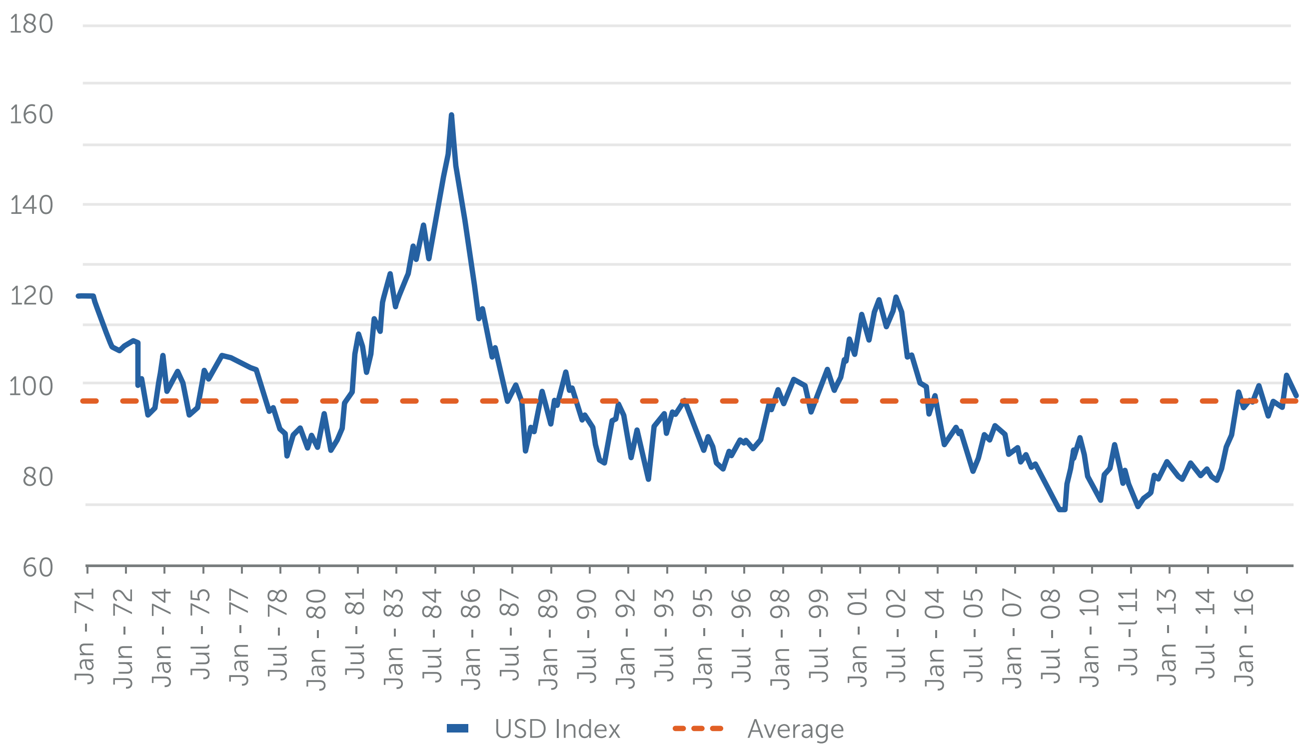
We had previously been projecting the rand at R14.75/$1 to reflect the sudden and disastrous cabinet reshuffle that took place in the days before we published our last strategy document. The global macro environment has proved to be more forgiving than we had expected and the market has been interpreting those events as hastening the removal of the corrupt faction from the SA government.Whilst we do not agree with the Goldilocks interpretation from the market, the rand was able to trade to R12.55 vs the dollar at its strongest during the quarter. Some political posturing from our Public Protector and our Minister of Mineral Resources has seen the rand weaken to around R13.40/$1 at the time of writing this document. It is clear that political expediency will require a degradation of SA property rights coupled with a degradation of the quality of our institutions, whether we are talking about nationalisation of assets or interference with SARB. This, coupled with an already complicated policy mix will continue to weigh on the domestic economy and the rand.

Perhaps the most worrying about the ANC succession conference in December is that recent polling and threats by the SA Communist Party (SACP) to contest the election on its own should the corrupt faction remain, implies that a victory by the Gupta faction in December will make it impossible for the ANC to retain its majority in the 2019 election. We should be worried about what populist or nefarious means might be deployed to ensure a Gupta victory in 2019. This means that should the Gupta faction win the succession debate, then the rand will likely be a victim of the desperate attempt to control the 2019 outcome. Hence, there is significant risk to our forecast above.

The swift move to junk by both Standard & Poor's and by Fitch have dealt the country a psychological blow. Business confidence is at a low. Unilateral and poorly thought out actions like those of our Public Protector or the announcement of the new mining charter have only served to further dampen consumer and business enthusiasm. Slower growth (and tax collection) are inevitable. This will keep a damper on the rand, although in the near term imports will slow as business investment and consumer spending drop. This negative feedback loop that has been created may well spark further ratings downgrades in 2018. Although it is possible that Standard & Poor's will further cut our rating early in 2018, we expect that Moody's will prove more patient and that we will only face its downgrade towards the end of next year.

As we stated earlier, the global environment has been very forgiving. The carry trade is, however, running out of steam. We are seeing a correlated global growth cycle. Across the world the narrative from central banks has shifted to the timing and approach towards further reduction of stimulus. All of this heralds a reduction in the benefits that the search for yield has up to now provided for the rand.

Figure 9.1: Index of US dollar strength vs a basket of DM currencies:



Source: Bloomberg

We include a chart above showing the relative strength of the US dollar against a basket of currencies including the Japanese yen, the British pound, the Canadian dollar and the euro. One can see that the average is dominated by the strong US dollar in the 1980s. Over the last 25 years, the US dollar has rarely been as strong as it is today. We think that a scenario with growth in the US battling to sustainably exceed 2.5%, coupled with global policy normalisation (European tapering), should see some return of the US dollar to weaker levels. This is in line with our view of the carry trade slowly reversing. In short, we think that the dollar will gradually reverse its gains against DMs, with EM currencies also coming under pressure.

Based on the idiosyncratic difficulties that SA faces and the less supportive global environment we are calling for the rand to weaken to R14.00/$1.

10 PERFORMANCE SUMMARY

	FUND PERFORMANCE							BENCHMARK PERFORMANCE					
	Start Date	Annualised p.a.	Since inception	12 Month	6 Month	3 Month	Jun 2017	Since inception	12 Month	6 Month	3 Month	Jun 2017	Performance vs Benchmark
UNIT TRUSTS													
Anchor BCI Equity	Apr-13	15.7%	85.5%	-2.07%	2.5%	0.9%	-3.3%	58.0%	0.3%	3.3%	0.0%	-3.8%	27.5%
Anchor BCI SA Equity	Jan-15	2.0%	4.9%	-4.4%	-0.9%	-0.6%	-3.7%	10.2%	0.3%	3.3%	0.0%	-3.8%	-5.3%
Anchor BCI Flexible Income	Jun-15	8.0%	17.3%	7.0%	4.0%	1.9%	0.2%	17.9%	8.7%	4.2%	2.1%	0.7%	-0.6%
Anchor BCI Managed	Jan-15	4.5%	11.2%	2.2%	3.7%	1.6%	-1.5%	29.0%	10.4%	5.5%	2.2%	0.7%	-17.8%
Anchor BCI Worldwide Flexible	May-13	13.1%	66.1%	1.47%	1.9%	0.4%	-0.1%	45.9%	9.4%	5.0%	1.9%	0.6%	20.1%
Anchor BCI Property Fund	Nov-15	-0.4%	-0.7%	2.8%	3.2%	1.5%	0.5%	5.3%	2.8%	2.3%	0.9%	0.3%	-6.0%
Anchor BCI Global Capital Feeder	Nov-15	-3.5%	-5.8%	-9.02%	-2.1%	-1.0%	0.0%	-0.8%	-8.3%	-3.1%	-1.7%	0.1%	-5.0%
Anchor BCI Global Equity Feeder	Nov-15	5.5%	9.4%	10.3%	11.8%	5.3%	0.9%	10.6%	5.6%	6.0%	1.6%	-0.3%	-1.2%
Anchor BCI Bond Fund	Feb-16	11.3%	16.1%	9.29%	4.8%	2.0%	-0.5%	14.8%	7.9%	4.0%	1.5%	-0.9%	1.3%
Anchor BCI Diversified Stable Fund	Feb-16	6.6%	9.5%	6.2%	3.5%	1.2%	-0.6%	7.5%	3.6%	2.9%	0.8%	-0.7%	2.0%
Anchor BCI Diversified Moderate Fund	Feb-16	4.9%	7.0%	4.59%	3.2%	1.1%	-1.4%	6.2%	2.0%	2.7%	0.5%	-1.3%	0.8%
Anchor BCI Diversified Growth Fund	Feb-16	3.0%	4.2%	1.8%	2.9%	0.7%	-2.1%	6.2%	1.5%	2.4%	-0.1%	-1.8%	-2.0%
Anchor BCI Africa Flexible Income	Mar-16	2.9%	3.8%	0.76%	0.6%	1.5%	-0.3%	13.0%	9.7%	4.7%	2.3%	0.8%	-9.2%
HEDGE FUNDS													
Long Short Equity*	Mar-13	9.9%	49.2%	3.3%	2.7%	1.4%	-1.1%	37.7%	9.3%	4.5%	2.2%	0.7%	11.6%
Property Long Short*	Jan-14	13.0%	53.4%	7.4%	4.2%	1.2%	-0.4%	34.7%	10.0%	4.8%	2.4%	0.8%	18.7%
OFFSHORE													
High Street Equity - Dollars	Jun-12	13.8%	90.7%	22.4%	17.6%	7.7%	0.9%	76.3%	18.9%	11.0%	4.2%	0.4%	14.4%
High Street Equity - Rands	Jun-12	24.9%	204.4%	9.7%	12.6%	5.5%	0.4%	181.2%	5.6%	5.5%	1.5%	-0.3%	23.3%
Offshore Balanced - Pounds	Jun-12	11.7%	73.7%	15.7%	14.2%	6.7%	1.5%	47.3%	9.8%	8.0%	3.4%	0.3%	26.4%
Offshore Balanced - Rands	Jun-12	22.7%	177.9%	3.7%	9.4%	4.5%	1.0%	135.3%	1.5%	2.6%	0.7%	-0.4%	42.6%
Global Dividend - Dollars	Jan-14	9.5%	36.2%	16.3%	14.9%	6.5%	1.3%	31.1%	18.9%	11.0%	4.2%	0.4%	5.1%
Global Dividend - Rands	Jan-14	14.9%	60.5%	4.2%	10.0%	4.3%	0.8%	53.9%	5.6%	5.5%	1.5%	-0.3%	6.7%

** Please note that the March figures for hedge funds are estimates and will be finalised later in April.*