ANCHOR

STRATEGY & ASSET ALLOCATION

4TH QUARTER 2017

EXECUTIVE SUMMARY

This report outlines our strategic views on global financial markets and our corresponding asset-allocation decisions. The quarter just ended (3Q17) saw global equities deliver stellar returns, in-line with what is turning out to be an extraordinary year for asset prices. Domestic equities were up 7% in the quarter, in-line with broader emerging markets (EMs). In general, it was the most cyclical regions and asset classes that led the charge.

Going forward, we think the outlook for South African assets will reflect a tug-of-war between generally supportive global factors, and the political and fiscal challenges on the domestic front. While we expect decent returns from domestic equities, in the region of 12% over the next year, this does not exceed our expectation of bond returns by a sufficient margin to justify an overweight allocation. We retain, therefore, our neutral allocation to both domestic bonds and equities.

On the global front, the key drivers of asset markets remain the broad-based normalisation of monetary policy, and the increasingly synchronised and self-reinforcing improvement in the growth environment. Although inflation statistics have underwhelmed, central banks have not been cowed and remain on their gradual tightening trajectory. GDP growth prints, on the other hand, have exceeded expectations and pushed many forecasters, including ourselves, to raise their numbers.

Yet this very welcome buoyancy exists in tension with warning signals deriving both from the analysis of business cycles, and from a consideration of classic bear-market indicators. It appears that many of the world's major economies are moving into the late stages of their business cycles, while some major equity markets are approaching the advanced stages of their bull markets.

Although we still expect solid double-digit earnings growth from global corporates, our return expectation falls somewhat short of these levels. This differential reflects our understanding of the effects of a late-stage business cycle on asset-class returns. In relative terms, and in spite of these concerns, we still think equities win out over bonds, and we retain our preference for the former asset class. In what follows, the details of these analyses are unfolded.

ASSET CLASS	BENCHMARK WEIGHT	CURRENT STANCE			EXPECTED RETURNS (ZAR)	RECENT CHANGES
		UW	N	OW		
LOCAL	**100%**					
Equity (ex. Prefs)	65%				12%	
Bonds	20%				8%	
Property	8%				11%	
Preference shares	2%				11%	
Cash	5%				7%	
Alternatives	0%				9%	
OFFSHORE	**100%**					
Equity	65%				11%	
Government bonds	5%				5%	
Corporate credit	15%				6%	
Property	10%				10%	↓
Cash	5%				5%	
Alternatives	0%				4%	

UW = Underweight; N = Neutral; OW = Overweight

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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 portfolios have specific strategies, and distinct risk profiles, they may differ from the more generic house view illustrated here.

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Equity	65%				11%	
Government bonds	5%				5%	
Corporate credit	15%				6%	
Property	10%				10%	↓
Cash	5%				5%	
Alternatives	0%				4%	

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	14.9	11%	14.7	3.1%	12.0%	-	12.0%
Resources	13.7	5%	13.0	2.2%	2.0%	-	2.0%
Financials	10.5	10%	10.0	4.9%	10.0%	-	10.0%
Industrials	17.5	14%	17.5	3.1%	17.0%	-	17.0%
OFFSHORE EQUITY	15.8	8%	15.3	2.4%	7.2%	3.8%	11.0%
Developed Markets	16.7	8%	16.2	2.4%	7.2%	3.8%	10.9%
Emerging Markets	12.7	8%	12.3	2.5%	7.2%	3.8%	11.0%

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	8.6%	-0.3%	8.3%	-	8.3%
Offshore government bonds	2.4%	-0.7%	1.6%	3.8%	5.4%
Offshore corporate credit	3.3%	-0.8%	2.5%	3.8%	6.3%
PROPERTY AND PREFERENCE SHARES					
Local property	7.0%	3.5%	10.5%	-	10.5%
Local preference shares	11.0%	0.0%	11.0%	-	11.0%
Offshore property	4.0%	2.0%	6.0%	3.8%	9.8%
CASH					
Local	6.8%	0.0%	6.8%	-	6.8%
Offshore	1.2%	0.0%	1.2%	3.8%	4.9%

Note: Benchmark SA bonds are the South African 1 year government bond; The Benchmark Offshore Bonds are the US 10 Year Government Bond, and the Bloomberg Bond Investment Grade Corporate Bond Index; The Local Property 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

ANCHOR INSIGHTS

Staff from across the Anchor Group provide insights into our thinking, strategy and view of the world. In this quarter, Tamzin Nel gives an insider's view on Anchor's culture and the importance communication plays in our organisation. Liam Hechter looks at the optionality inside RMI, with a special focus on Hastings plc.

OUR ENTHUSIASM IS CONTAGIOUS, LET'S COMMUNICATE

Tamzin Nel

Just over five years ago, I received an SMS from our CEO, Peter Armitage, "Your enthusiasm is contagious, when can you start?" Then, these few words were my formal offer of employment. Now, these few words succinctly summarise Anchor Capital's hiring policy.

Since that SMS, we have evolved markedly as a company – with hundreds more staff members, thousands more clients, many more investment products, advanced capabilities and skill sets, increased earnings, offices across the country (including Cape Town, Pretoria and Durban, to just mention some) – and our operations have been formalised and streamlined with policies, processes and systems. This comprehensive quarterly strategy and asset allocation document is one example of the output we are now capable of producing and is a mere indication of the endless intellectual debate, thought and calculation by some of the brightest minds in the country. It epitomises our investment philosophy and process.

However, what has not changed at Anchor Capital is our hiring policy - we hire energetic people with a "can-do" attitude. Anchor Capital has evolved because of its people, simply because the people are the company and our people are the best. Peter often describes Anchor Capital as "a room filled with people, wrapped in a brand" and this is important for you, the private client, as the investment philosophy and process which is at the head of our business means nothing to you if it does not manifest in some manner or form in your portfolio. The people at the heart of our business are responsible for this flow of information and for making sure that your experience of our overall strategy is pertinent and meets your specific investment needs, objectives and constraints.

We hope that the contents of this document are enlightening and thought-provoking, but we also realise that it might be overwhelming. Whilst going about our daily lives, we are constantly bombarded with both internal and external information which might consume us and leave little time for what really matters - to actually live! However, this is your reminder that you are not alone. At Anchor Capital, we want you to understand the context of the world in which you live and how it impacts your finances. We cannot control markets but we can help to control what actually matters to you – that you are indeed living, whilst making a living.

We are a young business but our well-diversified range of local and global investment products, as well as our skilled and established team, mean that we are also a world-class asset manager. We, the employees, and most of you, our clients and stakeholders, can and should take ownership of this. Just as businesses need clear objectives, defined plans, timelines and responsibilities which can be delivered and measured, we view your individual portfolio in much the same way.

We can help our clients understand the drivers of global markets (pg. 12, Global Macroeconomics section), outlines our thoughts on the fiscus (pg. 18), value banks versus retailers and platinum versus diversified miners (pg. 21 – 24), highlight some of the dimensions and developments of global markets (pg. 25 – 32) and cover, in quite some detail, fixed income (pg. 33 – 36) and property (pg. 37 – 40). However, what matters most to us is that your personal asset allocation, whilst falling in-line with our general strategy, also suits your individual risk and return profile. It is important for us that you have the correct offshore exposure, are appropriately structured from a tax perspective, that you are appropriately diversified from a share, sector and asset class perspective.

By way of personal experience, I have recently re-learnt the profound benefits of communicating with those around you and people knowing and hearing that they are valued. As only one breath in the body of the private client team I wish to convey to you that we are here to communicate with you. We are here not only to teach but to listen and understand you – our client. Anonymity breeds lack of responsibility and trust and there is nothing that we feel more responsible for than our clients entrusting us with their wealth. There is research which reiterates that clients believe that they only want performance, but what they actually want is to feel that they are being taken care of. At Anchor Capital, we aim to provide our clients with both.

RMI Holdings & Hastings plc

Liam Hechter

During mid-December 2016, while most fund managers and analysts were gearing up for their year-end holidays, RMI made perhaps its most significant announcement since its start of life as a separately listed holding company in 2011. The announcement being a debt-funded acquisition of an associate stake in fast-growing, agile, digital UK direct lines short-term insurer, Hastings Group Plc (HSTG), went largely unnoticed by the analyst community.

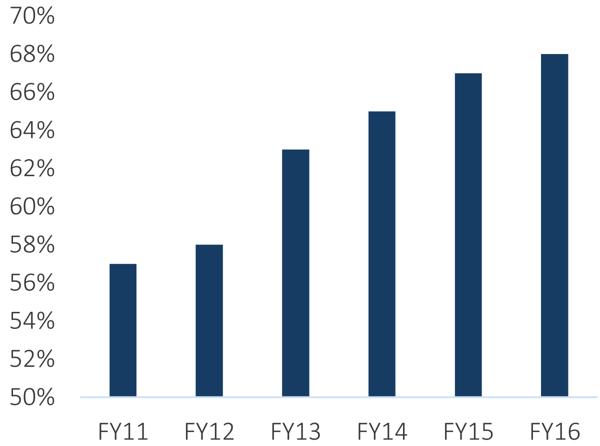
We have often written about the optionality embedded in a business such as RMI. We admire and look for businesses that want to diversify, but with a strict focus on the need to find areas for capital deployment that will enhance the return-on-capital profile of the Group and not detract from it. Strict discipline around capital management has become a rare commodity among the domestic management teams and we find the 29.9% acquisition of Hastings to be a good example of this. Hastings generates a return on capital employed of close to 50% (as of the latest reported numbers) and we feel this high-return profile should be sustained as the business continues to take market share in the UK motor-insurance space and scale benefits contribute to increased profitability.

Importantly, we believe RMI did not overpay for the associate stake with the acquisition price of GBP2.40/share, representing a forward 11.4x earnings, or put another way, a 25% discount to what we would have considered fair value for a business with similar characteristics.

The UK motor-insurance market is one we have tracked closely for several years, as one the core holdings in our offshore High Street Equity Portfolio has been Admiral Plc, another direct lines UK short-term insurer. Over the past few years, the UK market has been open for disruption by online insurance aggregators, also known as price comparison websites (PCWs). The UK has been one of the most rapid adopters of this technology with over two-thirds of all motor insurance now written through PCWs. The real losers in this space are the larger incumbents whose legacy systems and large broker networks have not reacted quickly enough to the changing consumer behaviour. In a very short space of time, the need for taking car insurance from a broker disappeared as consumers could shop around for an insurance quote in a matter of minutes from the comfort of their living room sofa.

The rise of PCWs has also led to a rise in the number of insurers who solely focus on algorithms that could accurately price risk within split seconds, or within the time it takes the potential client to click “submit”. The real value proposition for the client comes down to lower insurance premiums as a very costly intermediary is removed from the selling process, with the value shared between both the insurer and the client.

PCW penetration (UK)



Source: Hastings; Anchor

Focussing more specifically on the Hastings business model, we find the unique manner in which the underwriter operates in a separate profit centre to the retail business particularly appealing. There is an inherent conflict between the underwriter and the retail business. The underwriter is incentivised to maintain a targeted loss ratio (Hastings has a targeted loss ratio of 75%-79%), which results in strict pricing discipline, while the retail business is incentivised on volume and the additional value extracted from each new client.

A typical transaction would involve the retail business requesting a quote from a potential client on the PCW which is then forwarded to the underwriter, who quotes the retail business a premium value the underwriter believes will result in the targeted loss ratio being met.

Should the client accept the quote, the retail business has to pay the underwriter’s quoted premium to the underwriter and may then charge the client a rate that is slightly lower (essentially taking a small loss on the premium), if the retail business believes they can extract more from the client in the form of value-added services, such as premium financing. This entire process happens within a matter of split seconds, therefore the accuracy of the insurance algorithm is what separates the insurers who make profits on underwriting from those that don’t. Most general insurers in the UK don’t make underwriting profits. Hastings does.

Another important dynamic at play is the understanding of pricing elasticity. For every 1% drop in the value of an insurance quote, volumes are likely to increase by 6%. Therefore the retail business’ ability to predict the potential revenue from value-added services they will gain by discounting the insurance premium by a few percentage points, plays an important role in driving volume for the underwriter.

Make no mistake, this business relies very heavily on proprietary algorithms and data built up over time, giving the Group a healthy economic moat protecting the business from the threat of new entrants.

Management have made public their intention of reaching 3mn policies during 2019, an increase of 20% over a two-year period. By making public the targeted loss ratios, management are effectively stating that growth must not be at the expense of profitability (maintaining set margins). We think this will translate to an EPS CAGR of c. 20% for at least the next two years, while the cash build-up reduces the leverage ratios thus freeing more cash with which to make dividend payments.

By our estimates of future EPS growth, Hastings Plc is trading on a 12m rolling forward PE of 13.5x and a 12m rolling forward dividend yield of 4%.

Coming back to the attractiveness for both RMI and OUTsurance, it appears as there may be attractive synergies between OUTsurance’s direct approach and the digital approach from Hastings, especially in Australia, a market that seems ready for the adoption of PCWs. OUTsurance already has an established direct-lines insurer in the form of YOUI. There is perhaps the opportunity for Hastings and YOUI to join forces and establish themselves as market leaders in the PCW space, should the Australian market present such an opportunity, although nothing has been formally communicated. For now, we are happy to be holders of both Hastings in our offshore portfolios and RMI in the domestic portfolios.

04 GLOBAL MACROECONOMICS

In our previous Strategy report (July 2017), we noted that the two key drivers of global markets were the approaching normalisation of global monetary policy, and the increasingly synchronised quality of global economic growth. Those two factors remain in force and, in light of recently sanguine financial markets, have given wider currency to the notion of a "beautiful normalisation": that is, a normalisation which does not derail economic growth. However, as explored in previous editions of this report, the global business cycle (though particularly in the US) appears to be reaching a mature phase. Although the cyclical indicators may not be flashing red lights, some are flashing orange. Macro strategy at present, then, appears to demand a kind of triangulation between asset allocation, the "beautiful normalisation" and the warning lights of a maturing business cycle. This will form the connecting thread of this quarter's report.

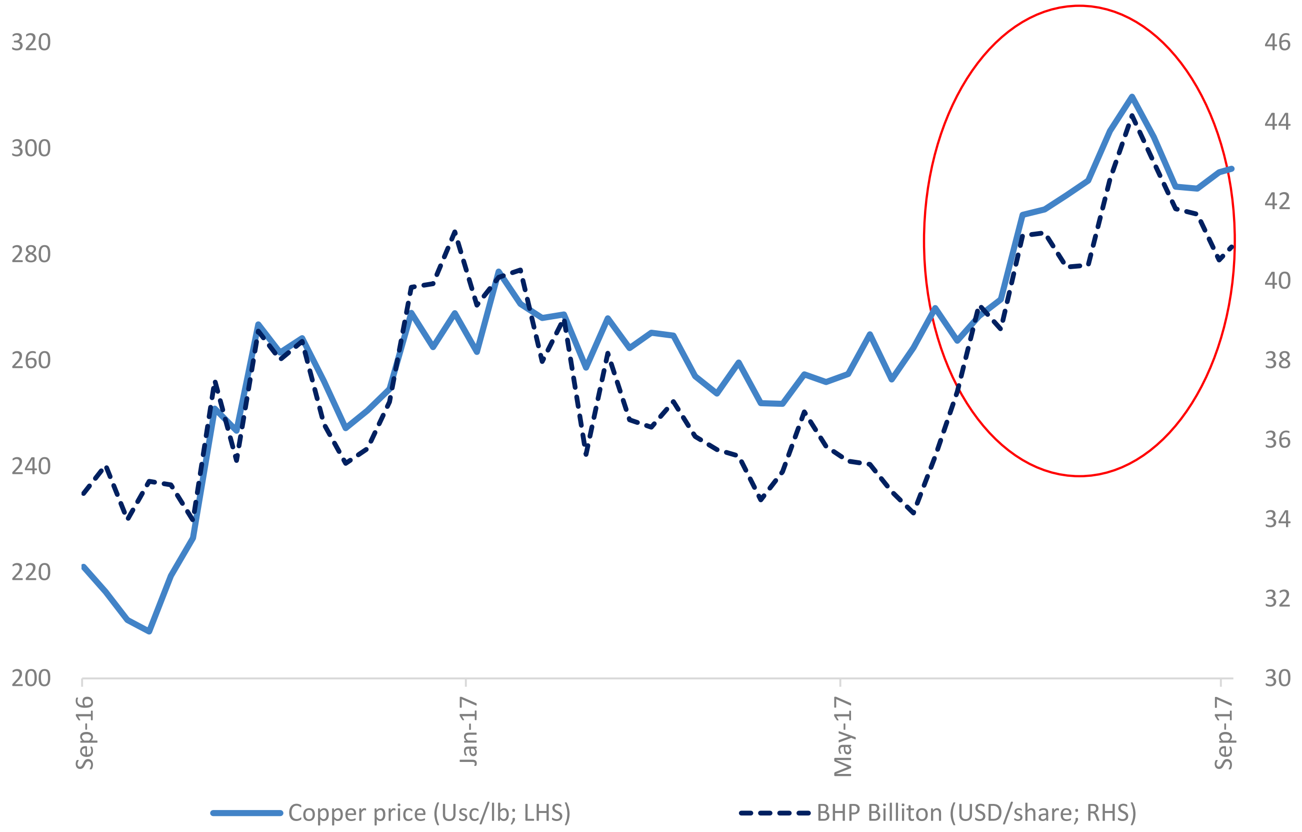
Both currencies and commodities saw dramatic moves during the quarter just ended. Currency movements, particularly the euro vs the US dollar rate, reflected movements in interest rate differentials between the US and other major economies. Weakness in the US dollar is also associated with increasing risk-appetite, which was registered in commodity price strength seen during the quarter (Figure 4.2 and 4.3). Movements in interest rates, currencies, commodity prices and equity markets are all interconnected phenomena. One of the most noteworthy features of the prior quarter was the degree of pro-growth buoyancy in these key variables.

Figure 4.1: Our current macroeconomic forecasts

	2016A	2017E	2018E
GDP growth (on prior year)			
- World	3.2	3.5	3.5
- USA	1.5	2.3	2.3
- China	6.7	6.8	6.4
- Euro Area	1.8	2.2	1.9
- SA	0.3	0.6	1.3
Inflation (year average)			
- USA core PCE	1.8	1.6	1.8
- EU CPI ("HICP")	0.2	1.5	1.4
- SA headline CPI	6.3	5.1	5.3
Interest Rates (year-end)			
Fed funds	0.75	1.50	1.75
Number of Fed hikes	1	3	1
Us 10 Yr Govt Bond	2.44	2.40	2.55
SA 10 yr Govt Bond	8.92	8.60	8.75
Currency (year-end)			
USDZAR	13.74	13.75	14.30
EURUSD	1.05	1.18	1.18

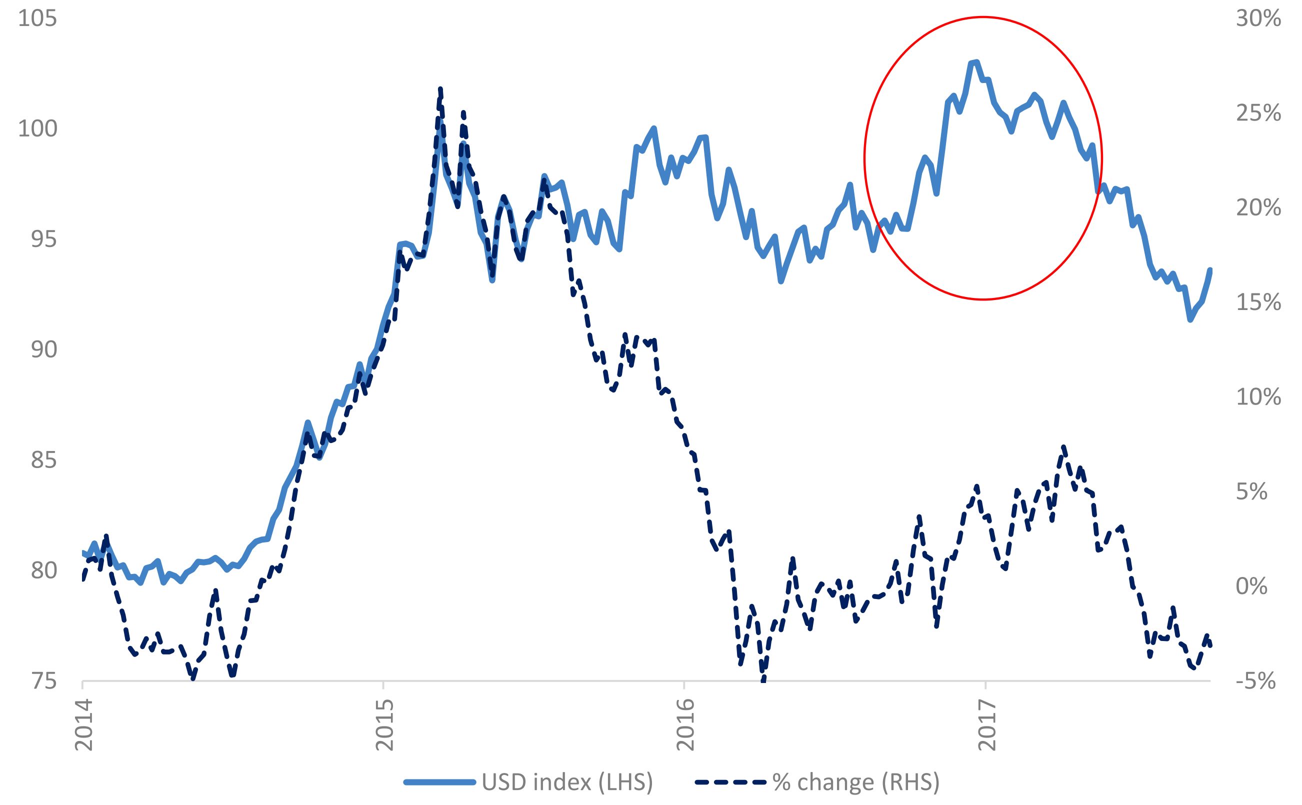
Source: Bloomberg; Anchor estimates

Figure 4.2: Commodities reflected an improving growth environment



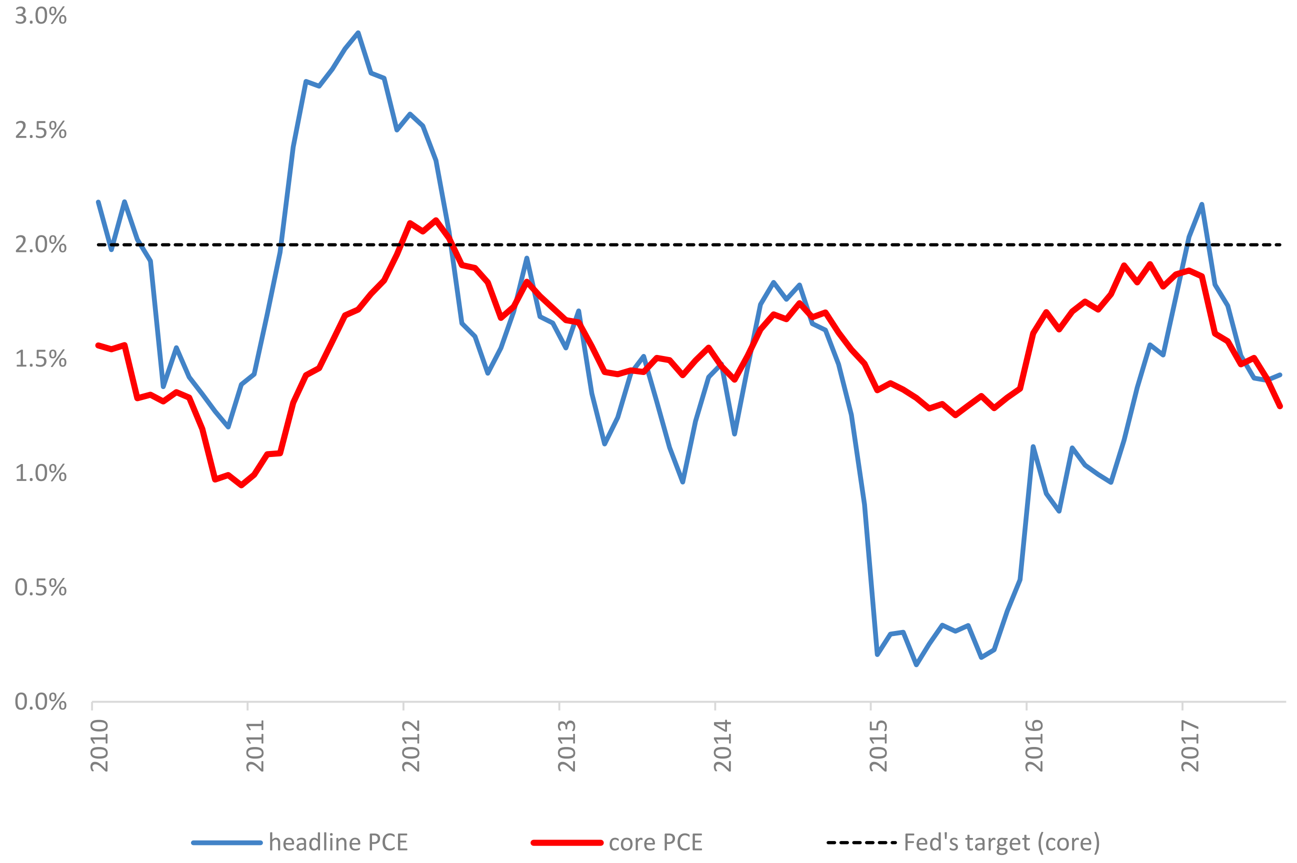
Source: Bloomberg; Anchor estimates

Figure 4.3: US dollar weakness has characterised 2017



Source: Bloomberg; Anchor estimates

Figure 4.4: Slumping US inflation failed to prevent Fed hikes



Source: Bloomberg; Anchor estimates

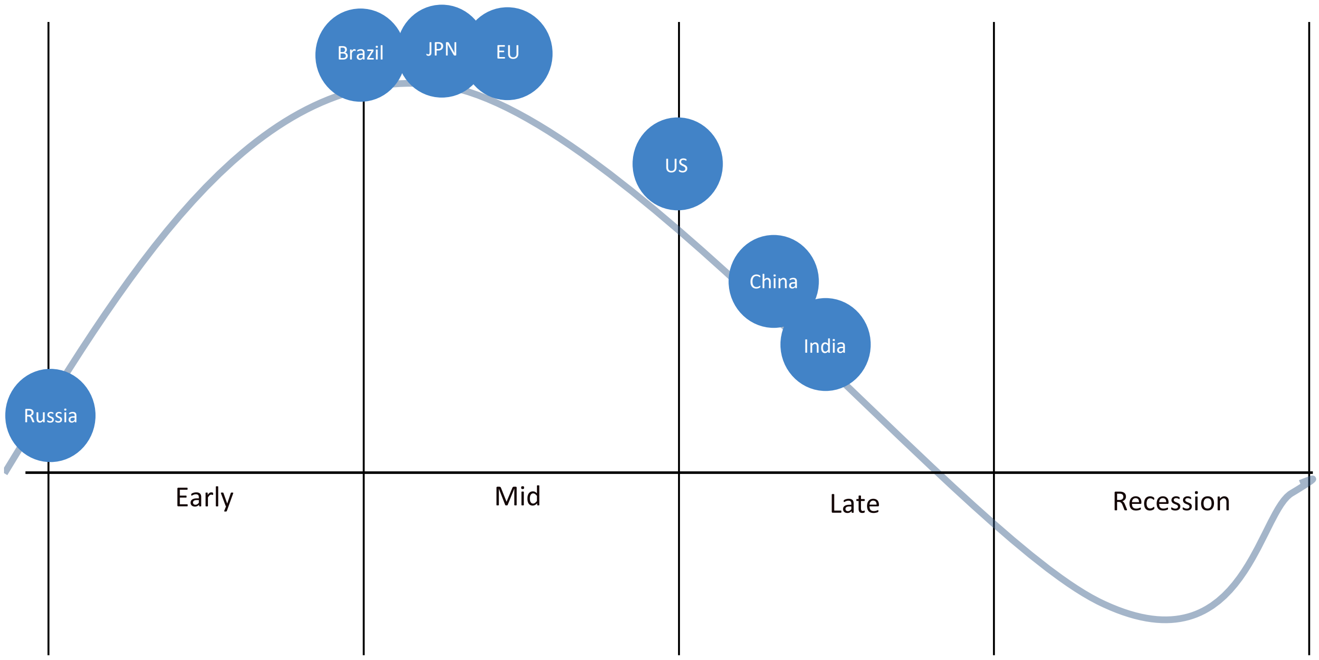
Fed Chair, Janet Yellen surprised markets in September by warning of the risk of hiking too slowly. This hawkishness seemed out of step with an inflation print that has continued to wilt at levels comfortably below the Fed's 2% target. One of the keys to understanding this move lies in the Fed's emphasis that rates are calibrated with reference to where it expects inflation to be in the medium term, and not relative to historical prints. This is both because rate hikes take 12-24 months to exert their full effects on inflation, and because some central drivers of inflation operate with a similar time lag. In particular, the recent US dollar weakness and oil price rebound are both inflationary and, while they may reflect very rapidly in headline CPI, it takes somewhat longer for them to filter into the more important core PCE number.

The emphasis on both kinds of lags – from US dollar movements to effects on inflation, and, in the opposite direction, from interest rates to inflation – has characterised the Fed's discourse for some time. One might recall Stanley Fischer's Jackson Hole speech of 2015, which preceded the first rate move of this hiking cycle, in which he noted the "considerable lags" between a movement in the US dollar and its effect on inflation. Similarly, he highlighted that "because monetary policy influences real activity with a substantial lag, we should not wait until inflation is back to 2% to begin tightening." The point of this flashback is to emphasise that the impulse to continue gradually hiking, in spite of sub-par trailing inflation prints, is consistent with an apparently longstanding understanding of inflation at the Fed. The bank has not changed tack.

The past quarter's cyclical growth indicators continued to underwrite the theme of synchronised global growth. One of the most welcome features of such a growth story is that it effectively erases the risk that strong GDP prints are anomalous, won by means of a "beggar thy neighbour policy" of currency manipulation. Synchronicity is also more likely to result in self-reinforcing growth momentum. It is noteworthy that 2018 is the first year since 2007 in which no major economy is expected to be in contraction.

The 2017 year has seen GDP surprise on the upside, to varying degrees, in Europe, China, Japan and the US. We have consequently raised our GDP estimates for most regions in 2017 and 2018, although with a little more caution in the latter year. While we do expect eurozone growth to remain strong in 2018, the effects of this year's sizeable euro rally may weigh on growth, as the region's exports become relatively more expensive.

Figure 4.5: Major economies are at different stages of their respective business cycles



Source: Bloomberg; Anchor estimates

Our 2018 GDP forecasts have also been held in check by our assessment of the business cycle in major economies. That all major economies are growing does not mean they are all at the same stage of their cycle. The apparent simplicity of synchronised growth must allow for a more nuanced picture of business cycles which are, inevitably, not entirely synchronised.

While cyclicality suggests a repetitive and therefore predictable pattern, the reality is that each business cycle is unique and complexly related to tactical and structural cycles. Having said that, we have plenty of indicators that give us a rough idea of where we are. In this regard, we track variables such as: GDP growth, employment, industrial production, trends in income, credit and corporate profitability, as well as inventory levels, monetary policy and fiscal policy. On the basis of this analysis, we estimate that Russia and Brazil are in the early stages of their business cycle, Japan and Europe are mid-cycle, while the US, China and India are within, or moving into, the late stage of their respective expansions.

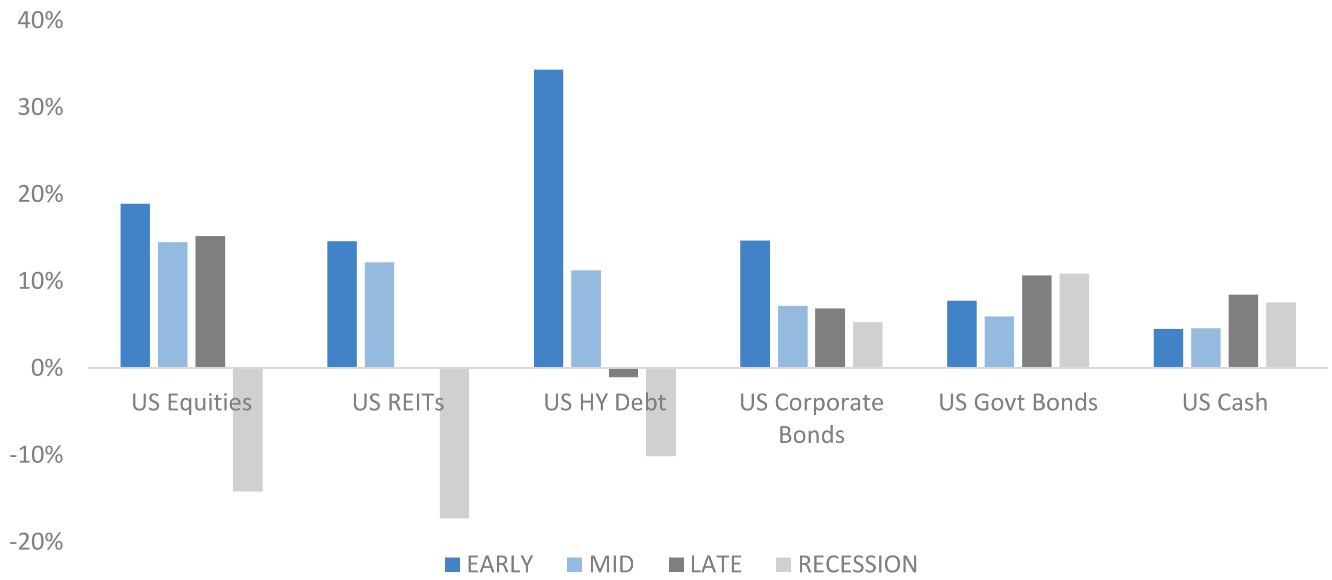
These 7 economies make up about 70% of global economic activity. China's position in the business cycle is probably the most challenging to estimate. The economy and the data supplied by the government are notoriously opaque, while the government has a heavy hand in guiding the economy. Further, many of these economies are closely linked: a recession in China, for example, would likely cut the business cycles of commodity exporting economies, like Brazil and Russia, short.

While the US is moving into a late stage of its business cycle, and China and India appear already to be there, we think the 'late stage' could last for an unusually long time. This is probably the most important judgement in this entire report. It is supported by a number of observations, two of which are: the current US expansion has been very tepid by historical standards, roughly half the quantum of a normal expansion. Second, as noted above, the world economy is moving more decisively into a synchronised growth phase which appears to be self-reinforcing. There is also a self-reinforcing link between asset prices and GDP growth: while the latter clearly drives the former, asset prices also drive growth via the wealth effect. This is part of the reason both bull and bear markets can get into self-fulfilling spirals.

Consequently, the current synchronicities suggest that any future slowdown in growth is more likely to come from overheating, as opposed the spreading of zones of weakness which might tip the scales of global growth into recessionary or stagnationary territory. The latter scenario was a central risk as recently as June 2016, when worries about Brexit threated to add the UK economy to its already soft Japanese, tepid European and recessionary Brazilian counterparts; thereby, as it were, tipping the scales in the wrong direction. As the world economy has now shifted so decisively away from this scenario - yet without, as yet, signs of overheating - our judgement is that, at present, it is appropriate to retain our existing pro-growth bias.

Financial markets tend to anticipate changes in the business cycle, and to move ahead of shifts in the coincident indicators. Our global strategy process forms asset class preferences on the basis of their expected 12 month return profiles. Business cycle analysis also helps us to form expectations of these returns. Thus, if one divides previous business cycles into four approximate phases, it is possible to estimate the performance of different asset classes at each stage (Figure 4.6). In general, much of the result is quite unsurprising: equities perform well in a growth environment, poorly during recessions, while bonds deliver the converse performance. But it also presents some complexities: although US equities have, on average, performed quite well in a late-cycle period, the data are not normally distributed by any means. While equity returns during the two late-cycles of the 1980's were stellar, about 32% in each of the periods ending December 1981 and December 1989, they were poor in the two late-cycle periods thereafter: minus 9% for the phase ending December 2000, and 6% for the late-cycle of 2007. In short, business cycle analysis suggests that we should expect lacklustre returns from equities, and not be overly bearish on the medium-term outlook for bonds. Our outlook for these asset classes is considered in more detail in the following sections of this report.

Figure 4.6: US asset class performance across business cycle phases (1974-2016; average annual return)



Source: Bloomberg; Anchor estimates

05 DOMESTIC EQUITY

At the end of 2Q17, we made the call to downgrade our stance on domestic equities to neutral from overweight, citing rising earnings risks to “SA Inc.” in the context of a steadily weakening domestic economy. This proved premature, as the equity market rallied 7% (SWIX) in the face of continued appetite for EMs (the MSCI Emerging Markets Index, for example, delivered a 7% US dollar return).

The performance delivery was pretty broad-based, with Banks up 8% and General Retailers up 5%, but the strongest gains came from Basic Materials, which rose 18%. These have tracked commodity prices higher, resulting in an even better “spot” earnings outlook than previously envisaged. Index heavyweight, Naspers lagged its key value driver, Tencent, during the quarter and delivered only a 1.5% gain.

From a forward valuation perspective, domestic equities by our estimates are at roughly the same levels as at end-2Q17 (see Figure 5.1 below). This is a function of the following:

- A 4% weaker rand against the US dollar – this lifts the earnings base on translation gains for rand-hedge industrial counters.
- A very strong bulk and industrial commodity price environment, lifting the earnings bases of the diversified miners.

It is notable from Figure 5.1 that investors could expect single-digit total returns from the Resources sector, in the absence of higher ratings than current levels. This is because earnings bases are much higher, and hence our year-2 earnings growth assumption is lower. However, these analyses need to be considered with caution: free cash flow yields remain very high in the diversified mining space, and many companies will continue to de-lever rapidly. This could continue to buoy share prices. Furthermore, our earnings figures do not incorporate spot commodity prices – in the case of Anglo, earnings would be 20% higher. Nevertheless, we have moderated our overweight position in the diversified miners on the back of the stellar performance achieved during the past quarter.

Our 12-month total return expectation from domestic equities is 12%. While offering only a 3.5%-4% premium to our expected return from fixed income, we retain our neutral stance on the asset class.

Figure 5.1: Domestic equities - valuation metrics and total return expectations

	12-M FWD P/E	YR +2G	EXIT P/E	DIV %	12M EST. TOTAL RETURN
Resources	13.7	5%	13.0	2.2%	2%
Financials	10.5	10%	10.0	4.9%	10%
Industrials	17.5	14%	17.5	3.1%	17%
SA EQUITY	14.9%	11%	14.7%	3.1%	12%

Source: Anchor Capital

Perception relief rally versus fiscal reality?

Investors in South African equities presently have the complicated task of weighing up the likely impact of two forces, namely, domestic politics and the current fiscal trajectory. For the first time in a while, we feel these could prove to be opposing forces as they pertain to investment markets in the coming months.

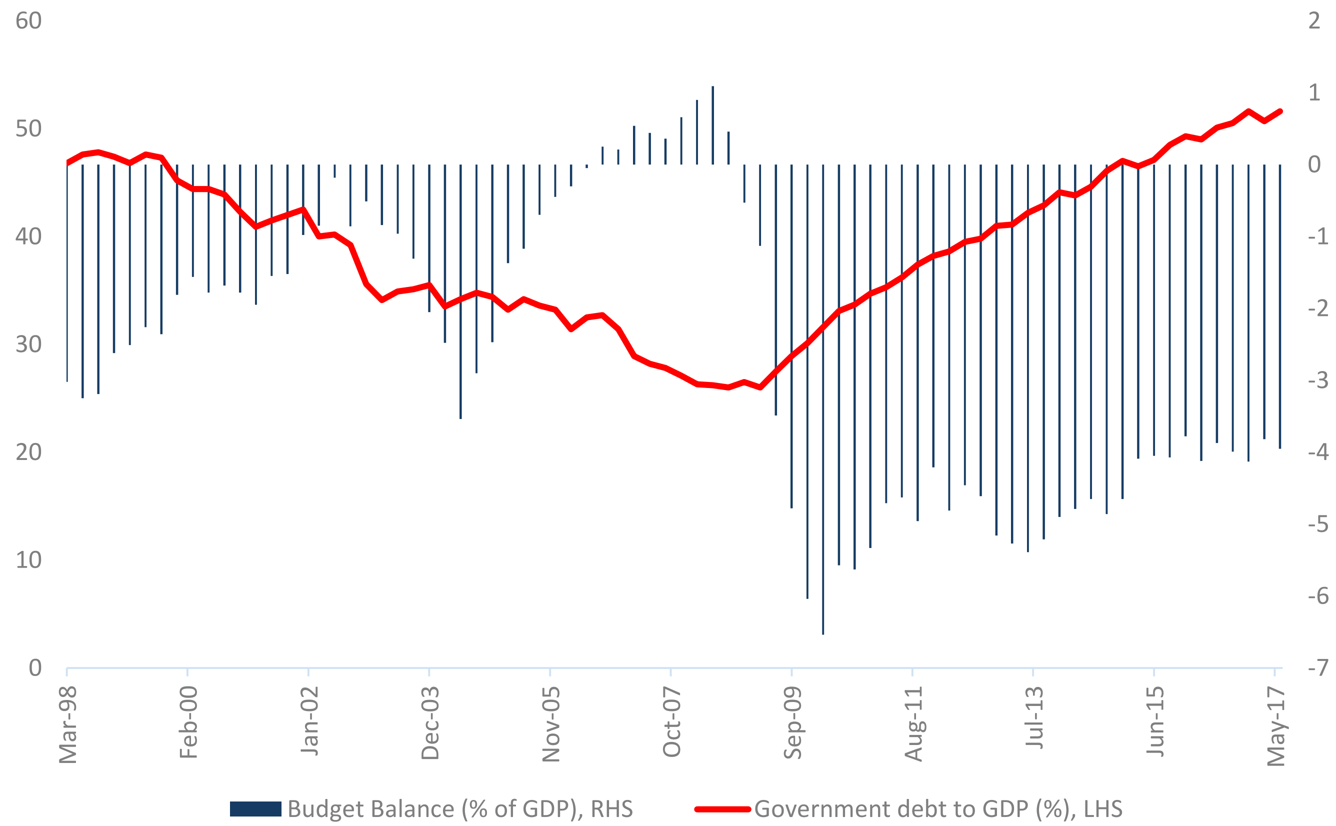
The first aspect of the debate is domestic politics. While the narrative has been overwhelmingly negative for some time, we believe there is an increasing likelihood of an ANC presidential candidate emerging in the December elective conference which could be seen to be more "pro-business" than what investors have had to deal with in the past number of years. The three front-runners appear to be Nkosazana Dlamini Zuma, Cyril Ramaphosa and Zweli Mkhize; we believe either of the latter two would be relatively well-received compared to the former, and we would ascribe roughly equal odds to all three.

Thus, one could say that the likelihood is that South Africa may well achieve a good outcome politically in December. The immediate reaction to a good outcome would likely be a risk-on trade for South African assets, specifically Retailers, Listed Property and Banks. The thinking here is that the vast majority of the current economic malaise is due to very low business and consumer confidence as a consequence of toxic politics, and a return of confidence in and of itself would lift economic activity and release "pent up" demand significantly. Whether or not a market-friendly regime would result in real structural reform down the line is almost a moot point – indeed, we do not hold out much hope in this regard.

We believe the key opposing debate is the fiscal situation in South Africa. For the fiscal year to date through August 2017, National Treasury data indicate that revenue has grown by 3%, while expenditure is tracking 7% higher. If we extrapolate these growth rates for the full year, the likelihood is that Treasury will be facing an approximately R75bn shortfall against budgeted revenue collections, while the deficit would have ballooned to 4.5% of GDP (from a budgeted 3.1%, and 3.4% achieved in FY16/17).

To be clear, South Africa's budget deficit has been worse before (see Figure 5.2 below), but the key difference is that the budget deficit is high and growing at the same time as government debt to GDP is at all-time high levels in post-democracy South Africa. This is what makes the present trajectory so dangerous – debt payments are crowding out room for necessary investment expenditure, making a return to sustainably higher GDP growth rates less likely. This is what ratings agencies will be focusing on.

Figure 5.2: South Africa budget balance as a % of GDP vs government debt to GDP



Source: Bloomberg, SARB

To be sure, the situation is not yet as dire as that of Brazil (10% budget deficit, 70% debt to GDP), but the direction of change is deeply concerning. Absent a significant lift in GDP growth, we are concerned that stickiness in government expenditure coupled with inflexibility on the revenue front (a very narrow taxpayer base relative to population and social-grant recipients) will result in the deficit steadily creeping higher. Furthermore, should tax rates be increased, the likelihood is that this would prove growth negative – especially if it involves a VAT hike (the only real needle-mover to generate more revenue). Ultimately, it is GDP growth which is required to extricate South Africa from this predicament.

Figure 5.3: South Africa's precarious fiscal situation

	2016/17	BUDGETED 2017/18	LIKELY 2017/18	% VS BUDGET	% CH YEAR ON YEAR
Revenue	1,297	1,414	1,336	-6%	3%
Expenditure	- 1,445	- 1,563	- 1,546	-1%	7%
Budget balance	- 148	- 149	- 210	41%	42%
% of GDP	**-3.4%**	**-3.1%**	**-4.4%**		

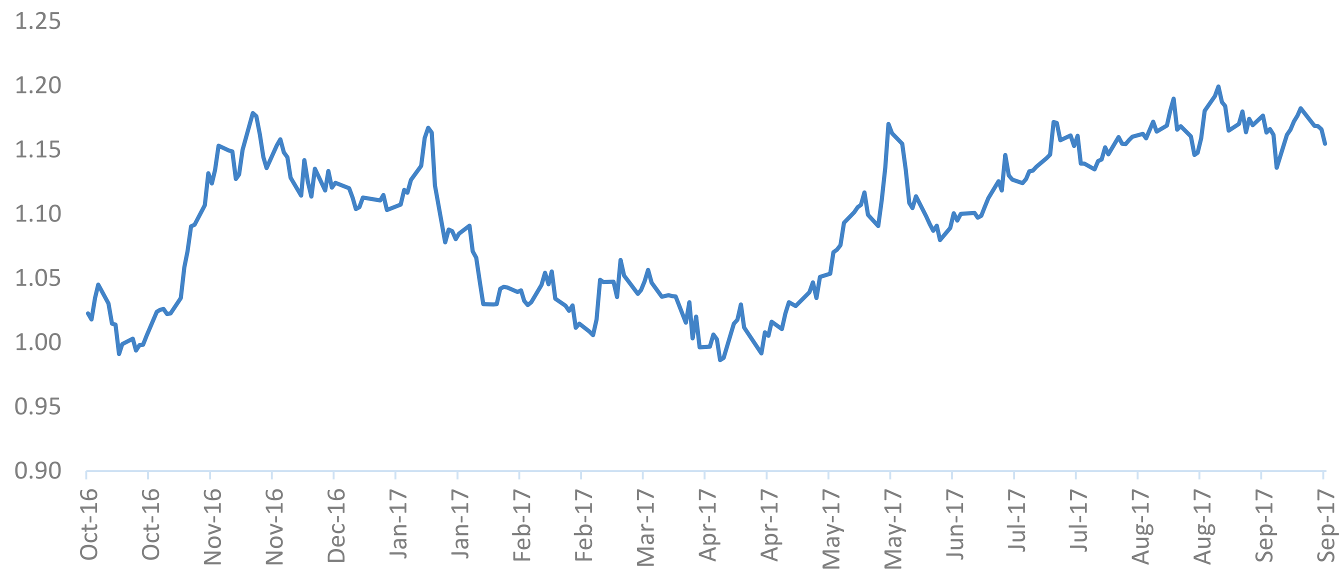
Source: National Treasury data; "likely" column represents Anchor Capital estimates

How does one resolve the fiscal situation? Tax hikes are highly likely in the upcoming budget, but even the most punitive measures in this regard are unlikely to resolve the present situation to anything remotely resembling a satisfactory level. Raising the top marginal income tax rate again to 50% would yield an extra R5bn, while a 1% move in VAT – the only tax type that can really move the needle if adjusted upwards – would yield an extra R22bn. This still yields a gaping hole against the likely shortfall. The expenditure side of the equation would also be a logical point of departure: simply eradicating all forms of corruption would probably yield R50bn-R100bn in savings without impacting service delivery, but this is an unlikely scenario – at least in the short-to medium-term.

We conclude that increasing tax rates will not solve the fiscal problems which South Africa faces: it is only a return of confidence on the part of business and consumers which will achieve this, and via a return of spending, growth and the resultant tax buoyancy which follows. For this, we need a decisively good outcome on the political front in December.

From the perspective of equity positioning, we retain broadly balanced currency positioning in domestic-only CIS mandates relative to the SWIX, while our equity mandates which allow for direct foreign investment are roughly 15% invested offshore. We have commented in the past that Banks were a safer way to play an improving SA environment given strong capital positions and less income statement sensitivity to an economy not growing in real terms. Since end-1Q17, Banks have outperformed General Retailers by 15% with the trend continuing in 3Q17.

Figure 5.4: Banks relative to General Retailers



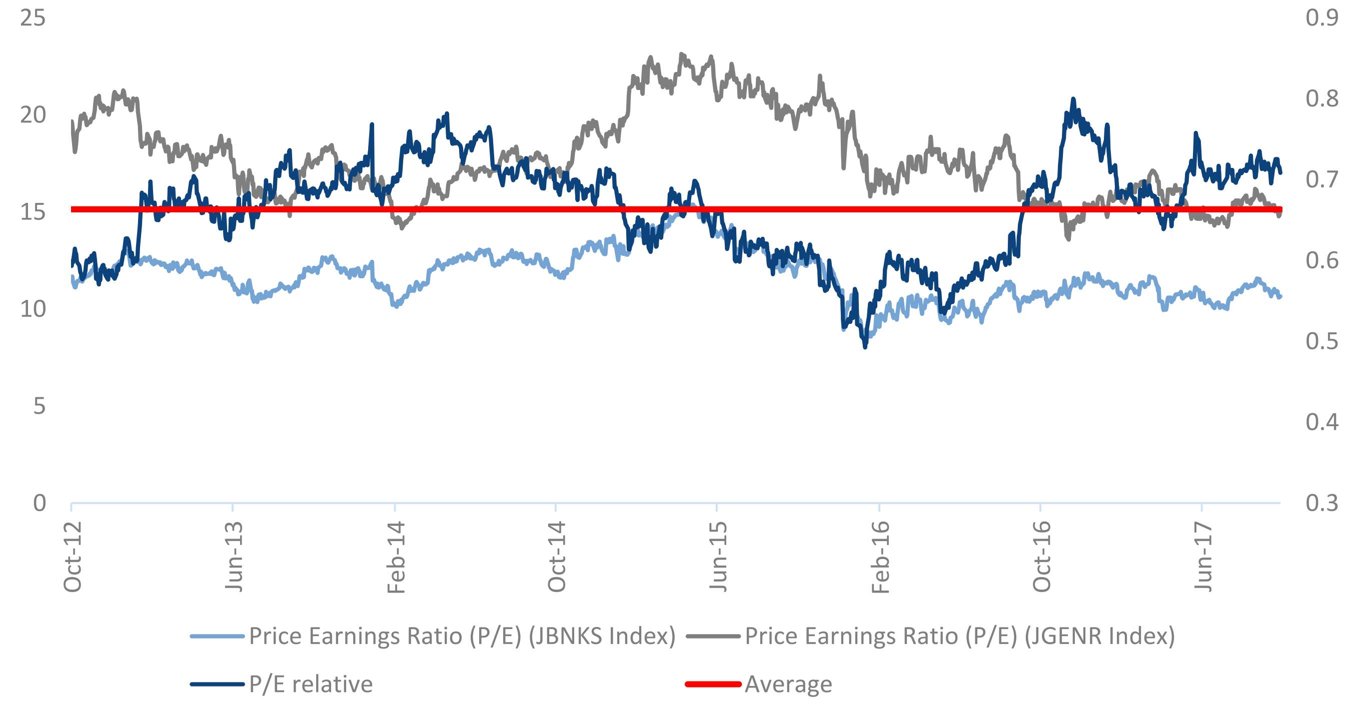
Source: Bloomberg

From a valuation perspective, we regarded Banks as offering better relative value vs General Retailers (they do tend to, however, always trade at a discount) earlier this year.

However, given the persistent recent outperformance we believe this opportunity has largely passed. We have reduced our exposure to Banks in favour of an allocation to discretionary retail (Mr Price, Foschini and more recently a small weighting in Steinhoff Africa Retail), but at a sector level our combined weighting in Banks, Retailers and Food Producers (proxies for South African consumer exposure) remains well below benchmark, highlighting our concerns about South Africa's fiscal position and the potential knock-on effects to consumer demand and growth.

Our main stock-specific overweight positions include Steinhoff, Old Mutual, RMI Holdings, Reinet and Exxaro in the resources sector.

Figure 5.5: Banks P/E relative to General Retailers: no longer undervalued on a relative basis



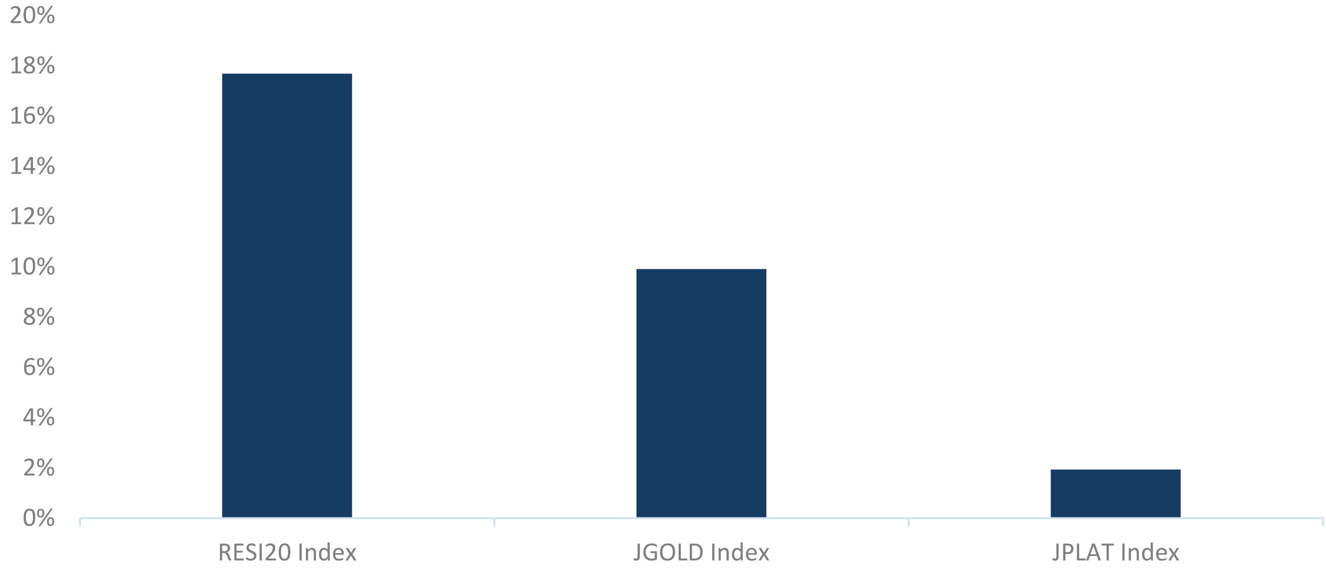
Source: Bloomberg, Anchor Capital

Diversified Miners continue to lead the Resources sector

3Q17 was buoyant for the resources sector on several fronts. Share price performance was strong across the board, driven by generally higher commodity prices. This was particularly true for the Diversified Miners, once again leading the sector (see Figure 5.6). Precious metals miners continued to lag the bulks and base-metal producers.

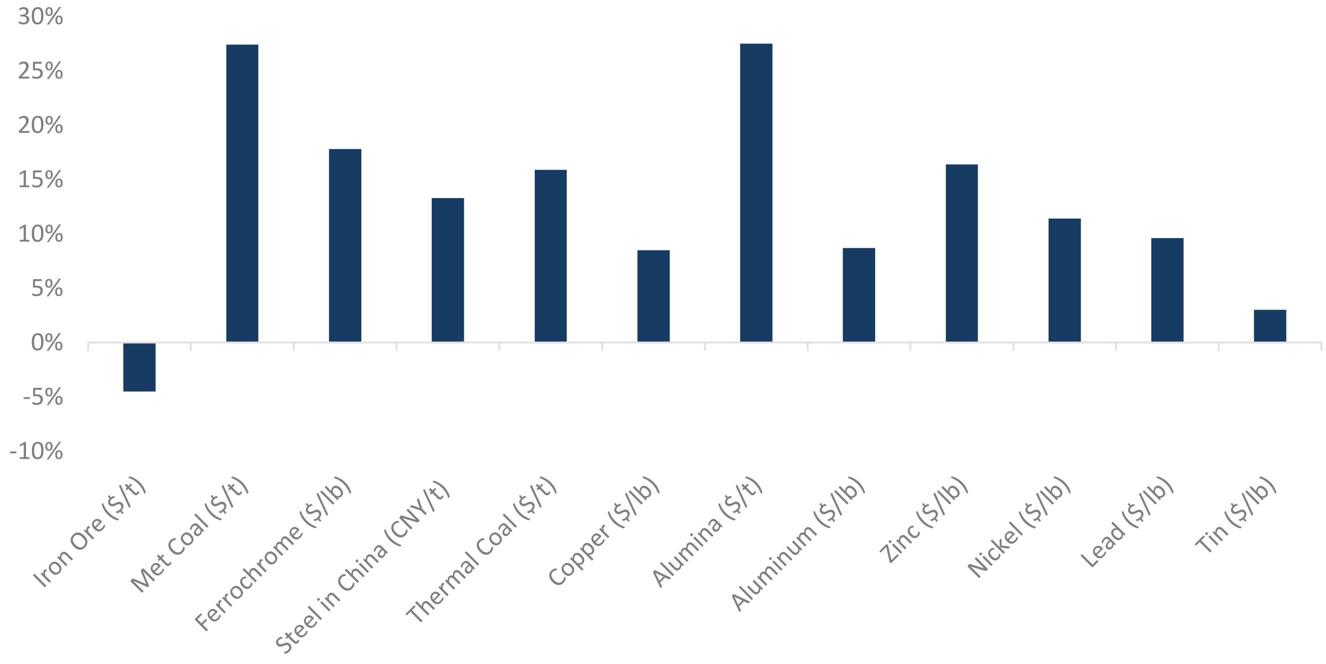
The quarter was also a resumption of the recovery in commodity prices that began in 2016. Most major metals were higher with iron ore the laggard in the bulks and base metals space for the quarter.

Figure 5.6: 3Q17 Resources total return by sub-sector



Source: Bloomberg

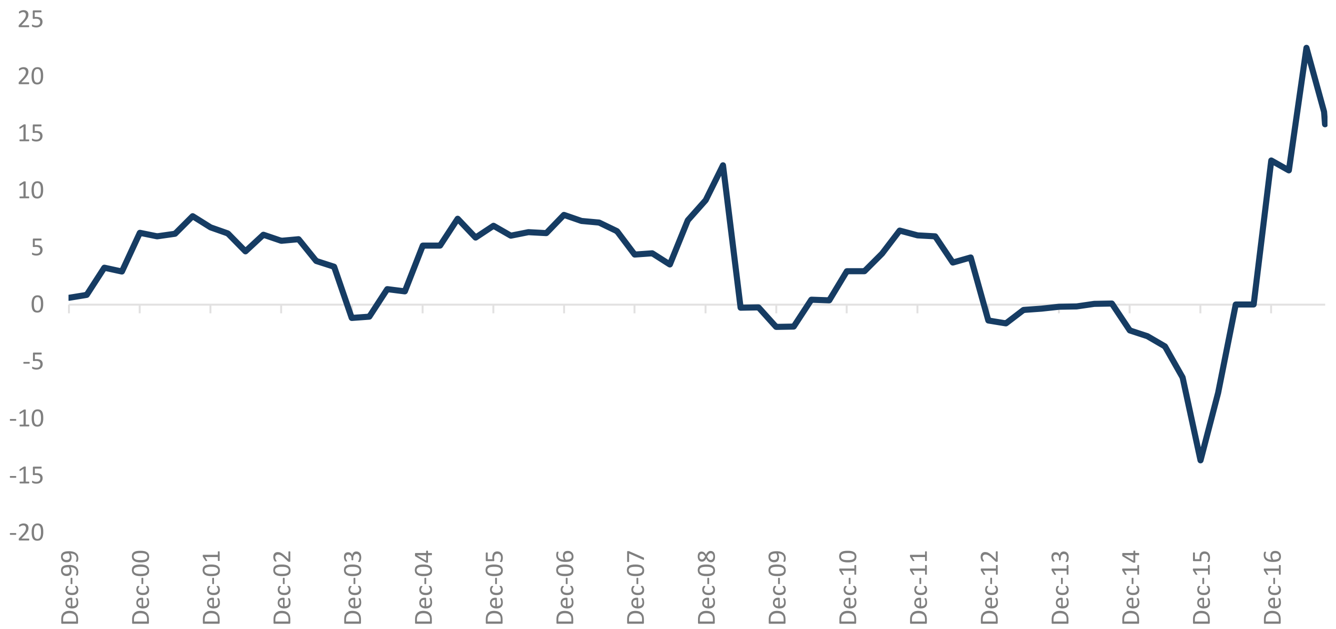
Figure 5.7: Bulks and base metal performance



Source: Bloomberg

At face value, this appears ironic given that it was the shares most exposed to iron ore that had the strongest appreciation. This apparent disconnect is explained by the high level at which iron ore began 3Q17. The average iron ore price over the quarter was $72/t, still well above the estimated 90th percentile price of $60/t. While we have not felt that mid-$70/t iron ore prices were sustainable, it has been important to note the level of free cash flow being generated by the diversified miners at these iron ore prices. We estimate that Anglo American, for example, is currently trading at a 17% free cash flow yield. When viewed in comparison to its history, this looks particularly attractive (see Figure 5.8).

Figure 5.8: Anglo American free cash flow yield (2000 – 2017)



Source: Bloomberg

The thesis for the diversified miners is one of enhanced cash returns to shareholders in the short-to medium-term rather than further commodity price appreciation. Considering Anglo American from this perspective is instructive. At Anglo's current level of debt reduction, net debt will reach c. $1.6bn by June 2018 (from $6.2bn at June 2017). The EV/FCFF ratio would unwind from 7.4x as at June 2017 to 6.3x at June 2018 (while also paying 40% of earnings through dividends). This calculation is necessarily an approximation as it requires many implicit assumptions (commodity prices persisting at near current levels, capital expenditure remaining stable, etc.).

Nevertheless, the exercise is informative. Iron ore prices are currently just above $60/t. This price appears more reasonable as it is at the estimated 90th percentile of the cost curve. Furthermore, the four major iron ore producers (Rio Tinto, BHP Billiton, Fortescue Metals Group and Vale) have not grown production significantly as of yet. Whilst forecasting commodity prices is always perilous at best, these factors give us more comfort in iron ore prices at these levels in comparison to the higher levels seen earlier this year.

Platinum holding back the PGM Basket for PGM miners

Platinum shares continued to lag the wider sector. The relative performances of platinum and palladium (the key platinum group metals [PGM]) over the quarter are illustrative of each metal's 2017 performance: platinum continued to lag palladium materially. PGM prices, with the exception of platinum, have moved higher strongly in US dollar terms YTD. Palladium, rhodium, ruthenium and iridium are 37%, 54%, 75% and 44% higher, respectively YTD, to the end of September. The problem for the platinum miners is that platinum is the largest constituent in the PGM basket – approximately 65%, depending on the company.

In September, palladium's price exceeded platinum's for the first time since 2001 (see Figure 5.10). In addition to the fundamental issues of supply and demand, platinum has been plagued by continual negative sentiment. The persistent negative narratives this year have been centered around diesel's decline in Europe and the threat of electric vehicles (EVs).

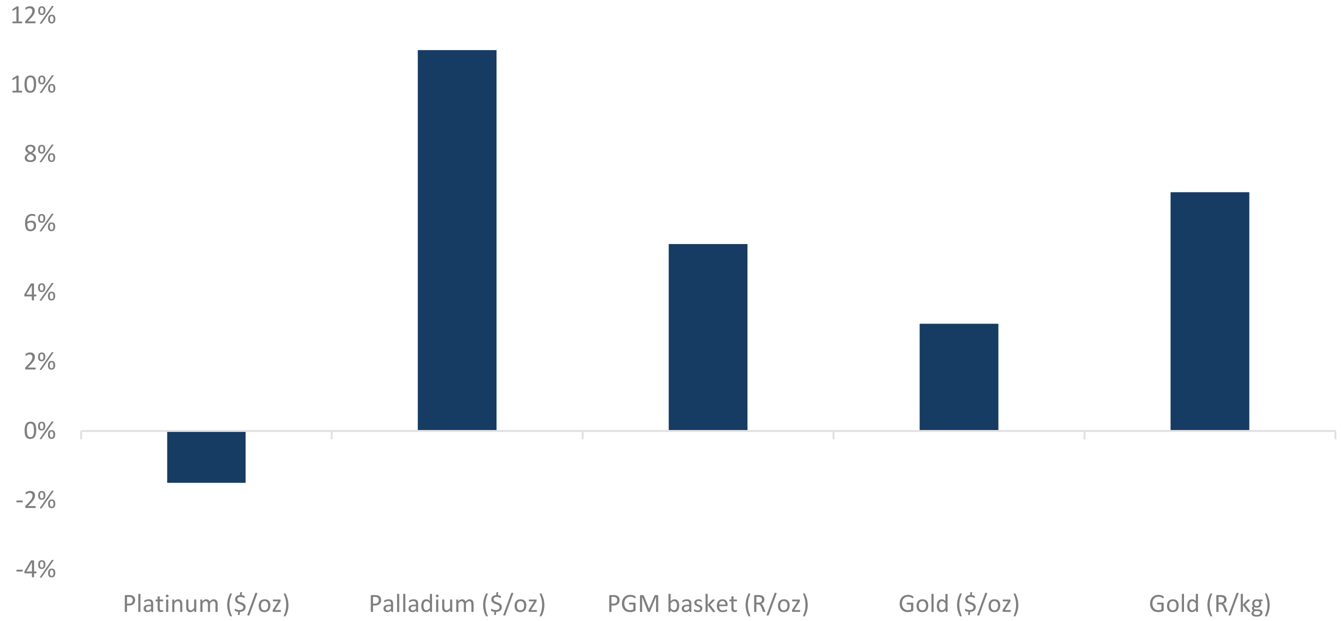
Figure 5.9: Platinum vs. Palladium ($/oz.) (2000 – 2017)

Source: Bloomberg

The platinum price has been much more subdued than other PGM prices, down 2% for the quarter and only 1% higher YTD. It is that lethargic performance of platinum that explains the muted 8% increase in the rand PGM basket YTD, despite the significantly higher moves for PGM metals outside of platinum.

All of the major platinum miners, with the exception of Anglo American Platinum, continue to be free cash flow negative at spot. The industry's current cash burn rate makes the 5% move in the rand PGM basket over the quarter insufficient for profitability and suggests that the Platinum Mining Index's (JPLAT) underperformance vs the RESI-20 Index is not surprising.

Figure 5.10: 3Q17 Precious metal price performance

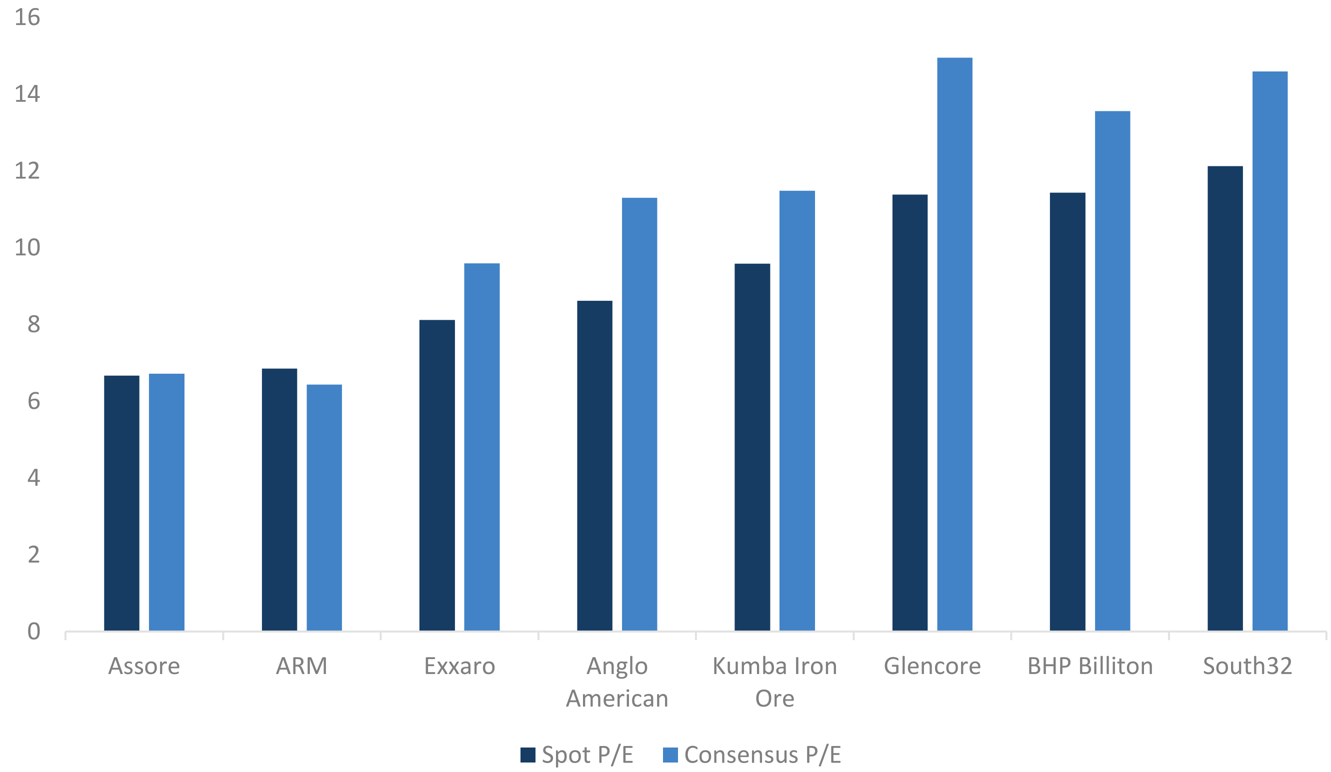


Source: Bloomberg

Whilst we continue to have little to no exposure to platinum in our mandates, we believe the strong moves in PGMs outside of platinum are noteworthy. We view the platinum shares as call options on PGM prices and will continue to monitor the degree of optionality priced into the shares.

The thesis for the diversified miners remains largely unchanged – miners should return material amounts of cash to shareholders given the high levels of free cash flow being generated. The difference between spot and consensus earnings (and thus multiples) is not as large as it has been in the past, which is reflective of the major share-price appreciation across the sector over the quarter. We continue to be overweight the sector through our equity positioning in Anglo American, BHP Billiton and Exxaro.

Figure 5.11: Spot vs. consensus earnings multiples for Diversified Miners



Source: Bloomberg, Anchor Capital

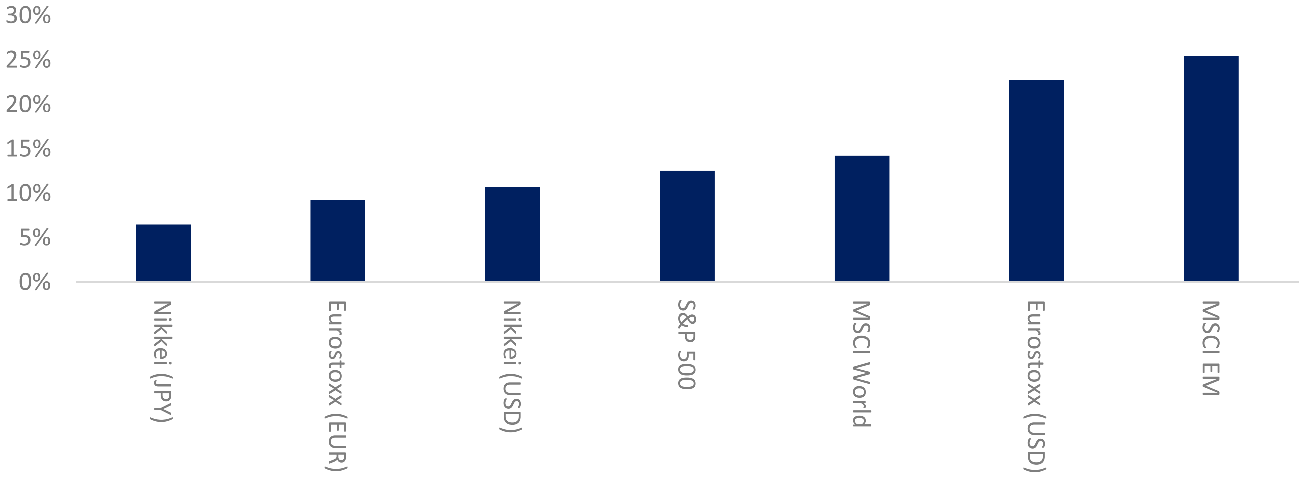
06 OFFSHORE EQUITY

Global equities have clocked yet another quarter of strong returns: the S&P 500 gained 4% during the quarter, while European equities doubled this performance, delivering a very strong 8% price gain, when measured in US dollar terms. YTD, EMs have undoubtedly been the star performer in the equity space, with indices up 25% in US dollar terms, while European equities are up over 20% for the period. In an environment in which an acceptable risk-adjusted return for global equities is 7% p.a., these numbers are truly breathtaking (Figure 6.1).

The sizeable return differentials between regional markets reflect the major macroeconomic developments that have been unfolding over the year: the growing momentum of the economic recovery in Europe, which has reflected in euro strength against the US dollar, is also displayed in the region's equity market performance. Similarly, improvements in the EM credit cycles and strong commodity prices buoyed the resources and financial sectors which dominate EM equity indices.

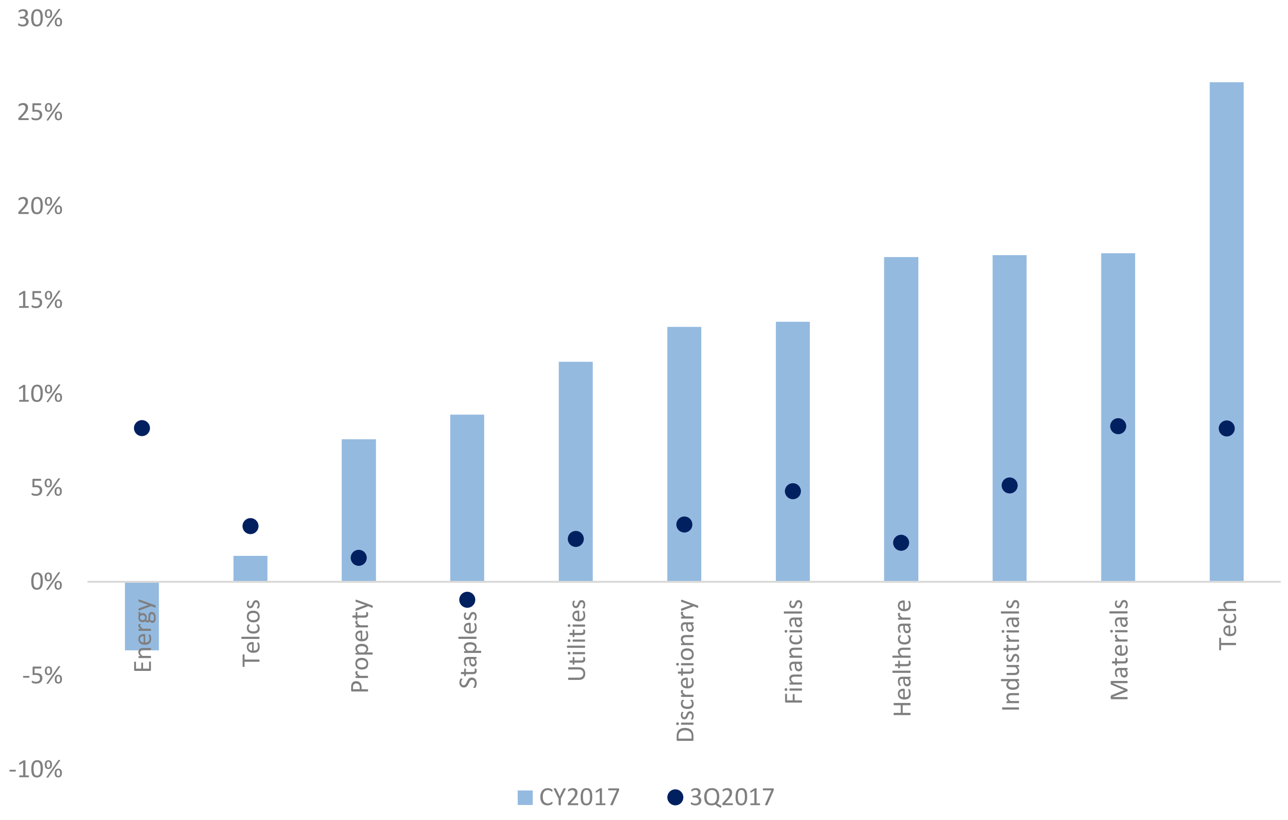
Our portfolios have benefited from our overweight allocation to equity during the quarter. Although we have reallocated capital to European and EM equities over the year, these are still relatively small in comparison to our holdings of US corporates. Similarly, our recent allocation to Energy has served us well during the past quarter, but we nevertheless remained underweight Materials and Energy, which were the star sectoral performers during the recent quarter. The latter reflects a generally conservative posture towards these highly cyclical sectors. From the perspective of the YTD, however, our sector allocation has worked very well, partly due to our large allocation to Technology, comfortably the top performer (Figure 6.2).

Figure 6.1: Stunning equity returns 2017 YTD



Source: Bloomberg; Anchor estimates

Figure 6.2: Equity sector performance for 3Q17 and CY2017 to date



Source: Bloomberg; Anchor estimates

Chinese Banks, in particular, form a very large proportion of the EM Equity Index. Although EM Banks have been strong across most jurisdictions this year, they hardly represent a homogenous asset class: the fortunes of Brazilian and Russian banks are tied largely to the commodity markets which drive these economies, while Chinese banks have been driven by concerns attached to rapid debt accumulation and the preponderance of state-owned enterprises (SOEs) in this market. The risk being that many such SOEs may well be 'Zombie' corporations, associated with the 'Old China', and being kept on financial life-support by state-owned banks.

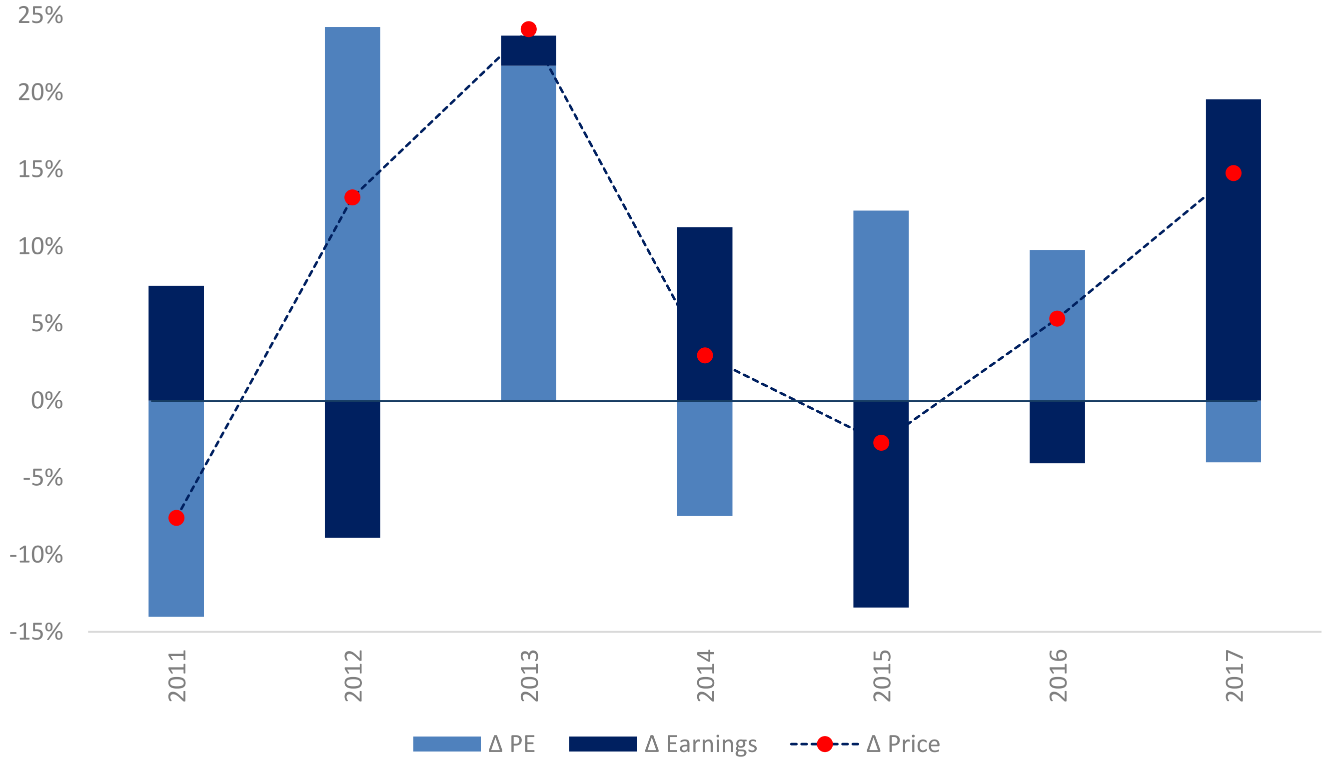
In the past year, however, a number of developments have taken place in Chinese banking which bode well for the sector and therefore also the broader economy. First, a degree of liquidity restriction was aimed at addressing the problems of excess debt accumulation and, potentially, the amassing of poor-quality assets. This was reflected in a rise in the Chinese interbank rate. Second, reporting by the major Chinese banks have indicated a clear improvement in the credit cycle: credit losses seem to have turned the corner, and banks have redirected lending away from sectors in structural decline. Perhaps in recognition of this progress, The People's Bank of China (PBoC) announced that it will cut the reserve ratio (RRR) in 2018 for certain large banks. This should both boost the profitability of banks, and reverse the foregoing (albeit modest) restriction on credit growth.

There are very many dimensions to the complex question of Chinese credit. Somewhat simplistically, however, one could say that recent developments involve a successfully navigated period of monetary tightening, associated with a general improvement in credit quality in the banking system, which has recently been followed by signs of renewed easing. The bullish consequences of these developments are already becoming apparent: Chinese GDP has actually surprised on the upside in the 2017 YTD, pushing many major global banks to raise their forecasts of Chinese GDP growth (as we too have done). Similarly, the share prices of Chinese banks have registered the improvement: the largest Chinese Bank, Industrial and Commercial Bank of China (ICBC), is up about 40% in US dollar terms YTD. This represents, one could say, the Chinese leg of the global reflation trade.

The importance of these developments for global markets cannot be overstated. China continues to be the largest contributor to global GDP growth, and the world's largest consumer of commodities. As such, a large proportion of the country's growth derives from debt-funded investment spending - developments in the Chinese credit cycle will have an effect on the entire world's growth dynamics. This improvement in China is also pointedly significant for the EM complex in general, for whom China is the major export destination.

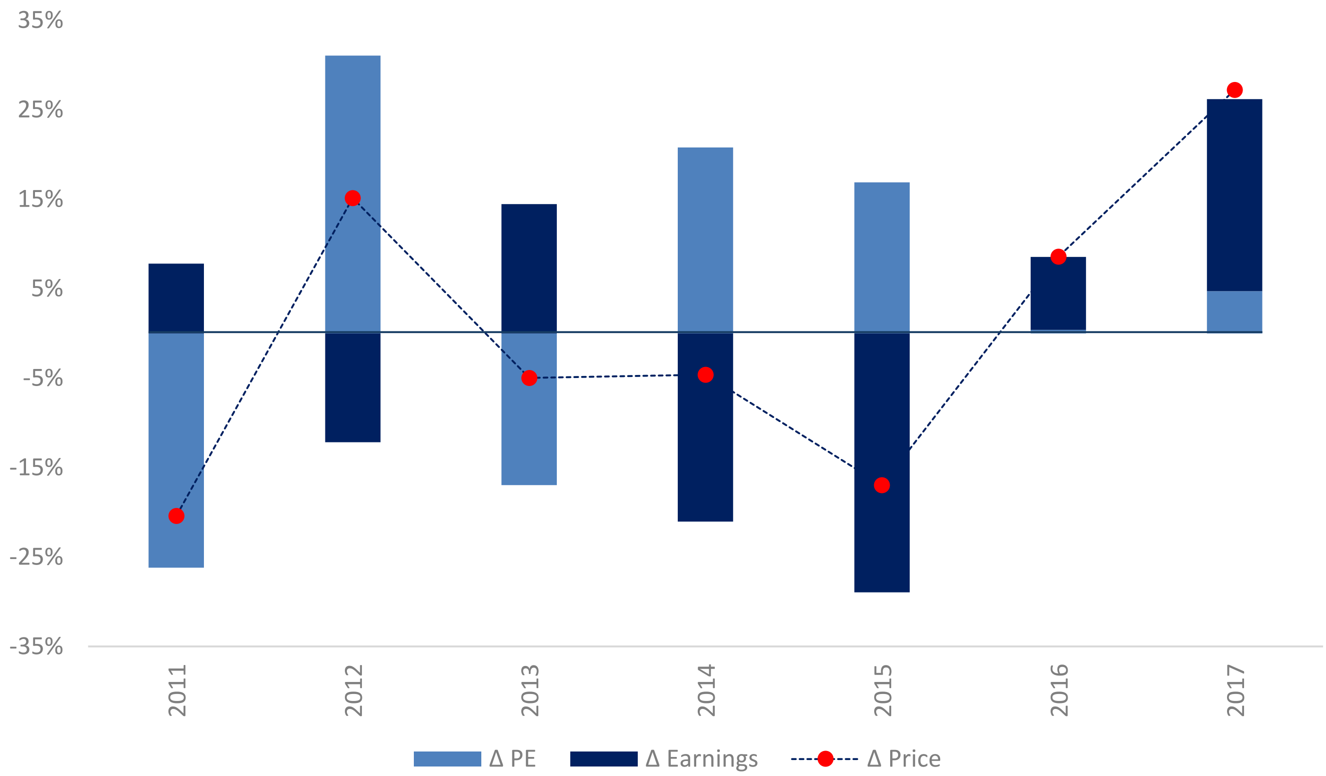
From a more general perspective, a truly singular feature of this year's equity market rally is that it has been driven entirely by earnings growth (Figure 6.3 and 6.4). This contrasts notably with the period after 2010 (the year of the post-recession earnings rebound), in which most years of strong performance have been driven by PE multiple expansion (e.g. 2012, 2013, 2016 in Figure 6.3). The pattern in EMs is somewhat different, but shares with DM equities a recent rally that is convincingly underwritten by strong earnings growth. This rally has also been associated with a remarkably stable forward earnings yield, for the past 3 years, in spite of an oscillating bond yield (Figure 6.5).

Figure 6.3: MSCI World – Earnings and PE components of price changes, by calendar year



Source: Bloomberg; Anchor estimates

Figure 6.4: MSCI EM – Earnings and PE components of price changes, by calendar year



Source: Bloomberg; Anchor estimates

Figure 6.5: MSCI World forward earnings yield – stable around 6-7% for the past three years

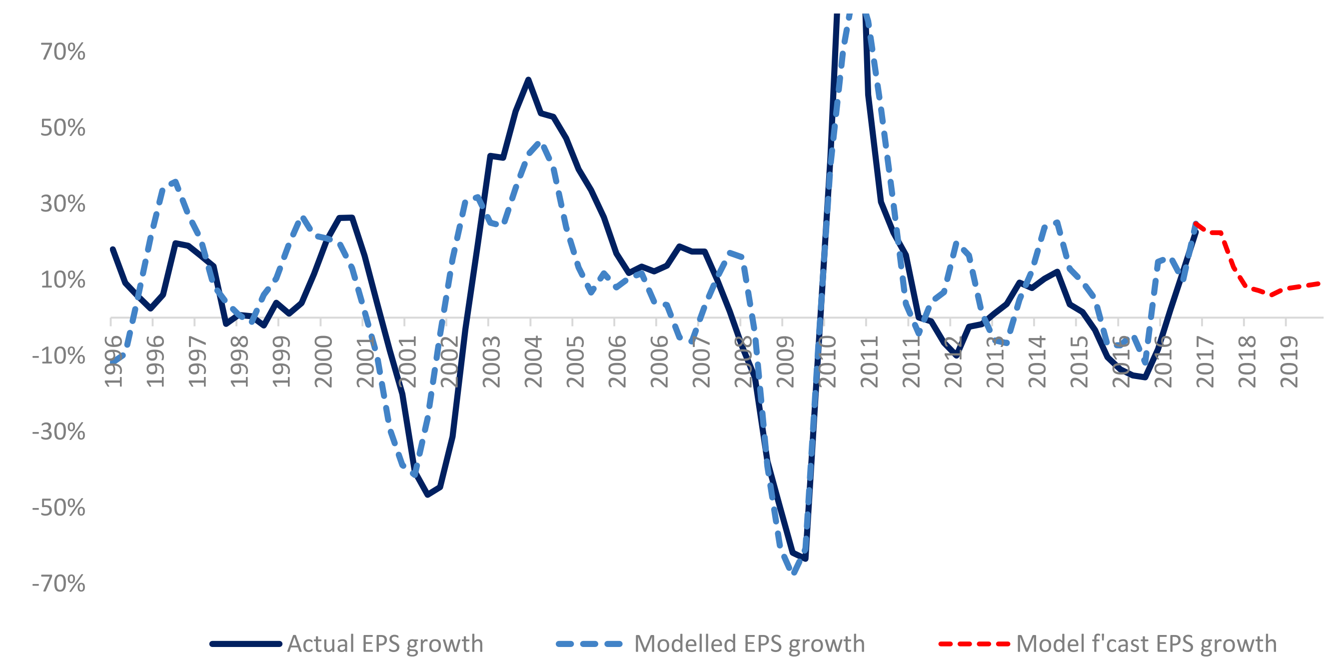
Source: Bloomberg; Anchor estimates

We shall now shift gears from a largely backward-looking analysis to a discussion of our expectations for future returns. Global equities, in our view, should deliver about 7% in US dollar terms over the next 12 months. This estimate of market upside is driven entirely by expected corporate earnings growth with no anticipation of a market rerating. Bottom-up analysts' earnings expectations are for MSCI World earnings to grow by c. 10% in CY2018. Our top-down estimate of corporate earnings, which is based on our forecasts of macroeconomic variables (GDP growth, the US dollar, the oil price, etc.), is for 8% earnings growth in CY2018 and CY2019, respectively. Our forecasts have stuck with the more conservative two-year forward earnings growth number of 8% (Figure 6.6).

In an environment of monetary normalisation, rising rates could put pressure on PE multiples that appear to have been inflated by ultra-low rates. In a 'normal' world, one in which markets have not been distorted by quantitative easing (QE), it is more normal for equity prices and bond yields to be positively correlated (e.g. rising bond yields and rising equity prices are both associated with a growth environment). Worrying about the converse case – that rising bond yields may cause falling equity prices, or at least a PE compression – is a reflection of the new era into which we now appear to be heading: normalisation of such unprecedented monetary stimulus has never happened before, and the consequences are not well understood.

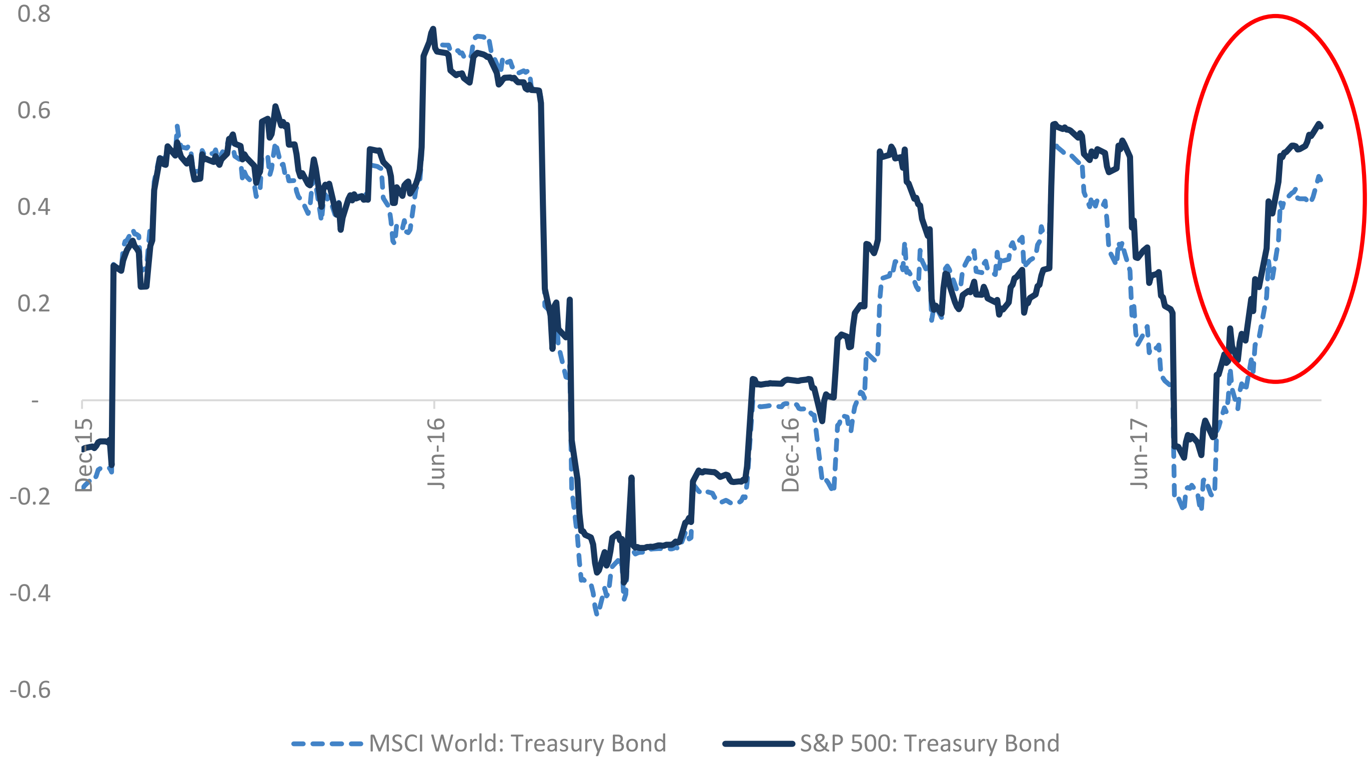
With this concern in mind, it is particularly encouraging that we are currently in an environment of a 'normal' correlation between bond yields and equity prices: that is, equity prices are rising with rising rates (Figure 6.7). This validates the view that rates are still low enough, and economic growth strong enough, for rising rates to remain a bullish signal for equities. Although this variable has been quite volatile, its current levels suggest that tactically, if not strategically, the reflation trade is again the basic thesis driving global markets.

Figure 6.6: Top-down MSCI World earnings growth estimate



Source: Bloomberg; Anchor estimates (model adjusted R square is 0.66)

Figure 6.7: Rising correlations between equity prices and bond yields



Source: Bloomberg; Anchor estimates

We have, nevertheless, assumed a modest derating (minus 3%) of global equities over the coming year. This is in order to reflect our view that certain key markets are moving into a late stage of their business cycle. Historically, such a stage has been associated with lacklustre equity returns. The corollary of the preceding analysis of business cycles (see Section 3: Global Macroeconomics) is a consideration of the classic bear-market indicators for equity markets. This involves a consideration of the fundamental tension which animates this report, that between the "beautiful normalisation" and the flashing orange lights of the US business cycle. Six classic bear-market indicators are:

1. *Very low unemployment*. This typically marks the end of the business cycle, and a 'choke point' at which further GDP growth feeds into spiralling wage pressures (rising unemployment is more likely to coincide with a bear market, and is therefore less useful to investors who require a leading indicator). As is well known, the US economy is currently at full employment and consequently this signal could be interpreted as a flashing red light. It is also the case, however, that the US labour force participation rate is quite low (Figure 6.8), hence actual unemployment may be higher than the headline number suggests. This is reinforced by the lack of wage pressures at present.

2. *Yield curve flattening into negative territory*. It is indeed true that the US yield curve has been flattening during the current year (Figure 6.9). While we heed this signal, we note that curve flatness appears to be, to a significant degree, the result of QE; further, the curve has not dipped into negative territory.

3. *Tightening monetary policy*. This is usually brought about by a late-cycle spike in inflation, or the forebodings thereof. While there is not even a hint of either, at present, global central banks are normalising rates from entirely abnormal levels; similarly, the early stages of the end of a decade of QE are now upon us. Higher rates do carry the risk of stifling growth, as a reversal of QE comes with the risk of draining the liquidity, which may have been the dominant driver of asset returns for much of the past decade. Our view, however, is that rate hikes will not exceed modest levels for some time.

4. *High Manufacturing PMI*. As with low unemployment, this apparently counterintuitive signal can flag an economy operating at full capacity, from which the natural path is downwards. ISMs are most bullish when they are recovering from low levels. In the case of the US, a very strong manufacturing PMI may be a cause for concern, suggesting a peak in the manufacturing cycle.

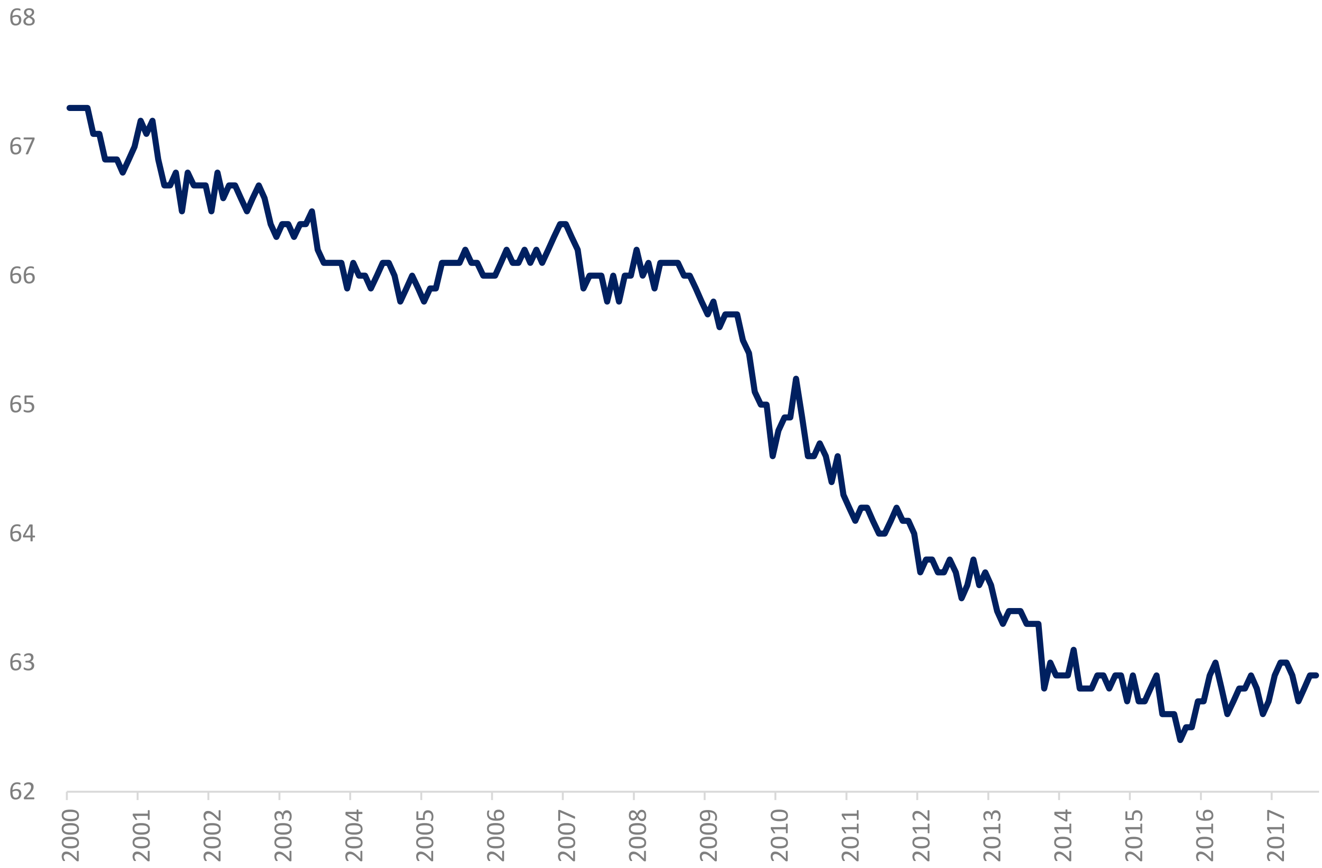
5. *An ageing expansion*. The current US expansion has lasted about 8 years, in-line with the average expansion since the 1970s. While we agree that the US is entering a late stage of its business cycle, we believe it will last for an abnormally long period. We note, further, that were a recession to arrive, the likely fiscal response would be sufficiently dramatic (the memory of the GFC still haunts policymakers) that the equity market may have a fiscal, if not a monetary, put option.

6. *Demanding valuations*. Our judgement is that global equities are fully valued, but not expensive. This squares with our overweight position in equities because we allocate capital in terms of the relative attractiveness of asset classes. We view equities as marginally more attractive than bonds and cash, while conceding that the value proposition is less compelling than it was in January of this year.

While none of these indicators are flashing a red light, they do all appear to be flashing an ambiguous orange. Although the bull market in US equities is entering a mature phase, commensurate with the maturing of the US business cycle, we believe it to be entering a period of 'lacklustre' performance rather than one characterised by negative returns. The economy has not yet reached any choke-points that could precipitate a recession, and there is, as yet, little sign in the data that the status quo of gradual expansion is under threat. In such an environment, particularly given the synchronicity of global growth, it would be excessively prudent to take money off the table and cut our global equities allocation from its longstanding overweight position.

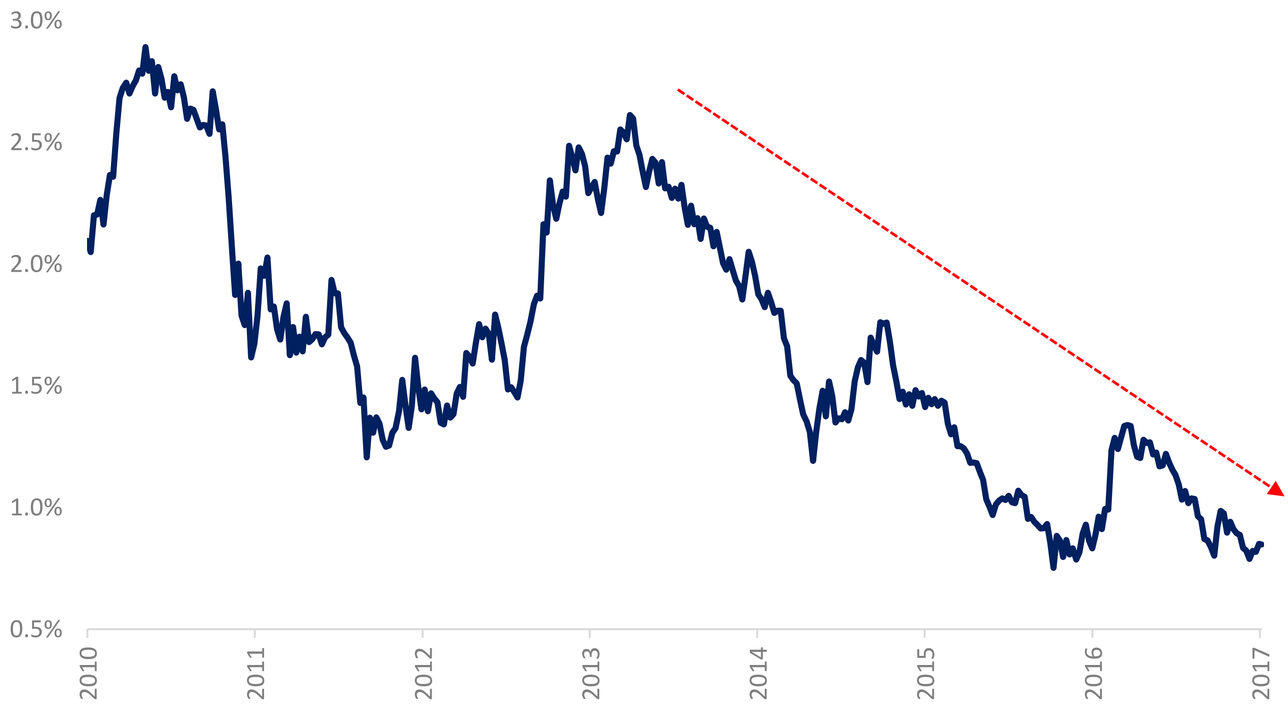
In summary, global equity markets are in a phase in which strong price performance is being validated by similarly strong earnings growth, global GDP growth appears to be in a synchronised and self-reinforcing period of resilience, and equity prices are moving in their 'normal' positive correlation with bond yields. This is a reflection of what has come to be called the "beautiful normalisation". Although business-cycle analysis suggests that some of the world's major economies may be moving into late-stage cycles, we argued that this will most likely be abnormally long. Similarly, although a consideration of classic bear-market indicators would advise a degree of caution at present, they are not, in our view, sending a strong enough signal to warrant the downgrading of our overweight call in offshore equities. Rather, when taken together, these various strands of analysis suggest a period of positive but lacklustre returns from offshore equities.

Figure 6.8: US labour participation rate



Source: Federal Reserve Bank of St Louis

Figure 6.9: A flattening US yield curve (10 year – 2 year treasury differential)



Source: Bloomberg; Anchor estimates

07 DOMESTIC BONDS

We expect a total return of 8.30% on the South African 10-year benchmark bond for the next twelve months. This comprises of 8.60% interest income, with a capital loss of 0.30% as yields move towards our target of 8.65%.

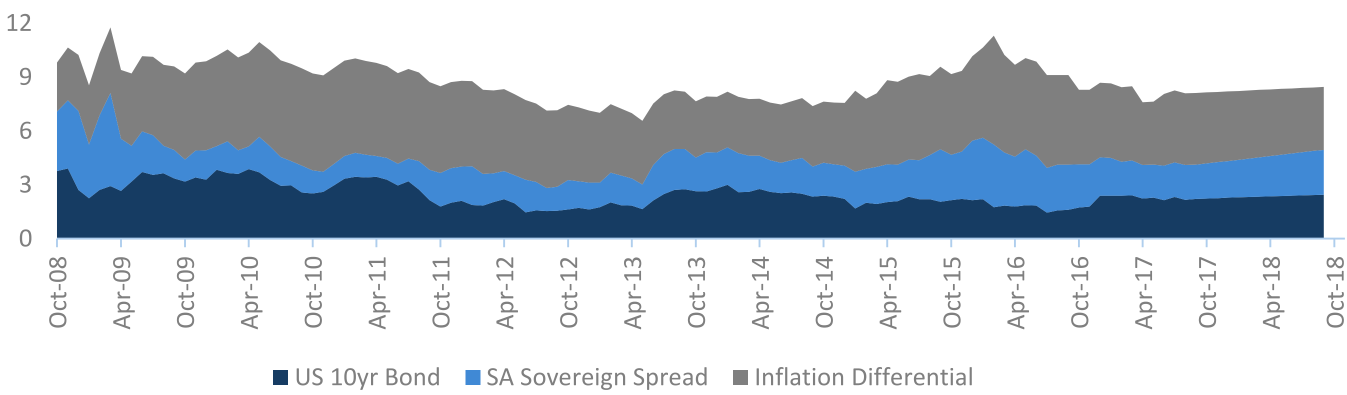
Yields over the last quarter rallied towards 8.35%, which was slightly stronger than our target yield of 8.45%. The global macro environment has remained more forgiving than we had expected and the market has been interpreting that the events will hasten the removal of the corrupt faction from the South African government.

We expect South African inflation will begin to trend higher again towards the second half of 2018. This will begin to weigh on the attractiveness of bonds. As a result, we have marginally increased our target yield towards 8.65%. This is also pricing in one further ratings downgrade from Standard & Poor's, whilst we expect South Africa to retain its current rating at Moody's.

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 South African credit-risk premium (based on credit default swaps), and the inflation differential between South Africa and the US. In looking forward, we have already stated that we see the US 10-year bond yield at 2.45% at the end of the period, with US inflation pushing towards 1.9% over our 12-month time horizon.

The stronger rand for the past 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. However, it will push up in the direction of 5.4% towards the end of the next twelve months. This gives us a target inflation differential of 3.5 % next year.

Figure 7.1: Modelled fair yield of the South African 10-year bond over time



Source: Thomson Reuters

We see the South African credit default swaps (CDS) as fair at 2.50%. It is worth noting that we anticipate South Africa 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 1.65% towards 2.50%.

Aggregating the US 10-year bond at 2.45%, the inflation differential at 3.50% and the CDS at 2.50%, we get to a fair yield for the South African 10-year bond of 8.45%. We sense that a cautious view towards risk might see the market trade slightly higher than fair value in the near term. Therefore, we think that a target yield of 8.65% is reasonable.

On a longer-term basis, we think that South African inflation will trend back towards the 6.0% level with which we are more familiar. Therefore, whilst there is an underpin for bonds at 8.65% currently, this will dissipate during late-2018 and we expect that the long-term fair yield for South African bonds will be in the 9.00%-9.50% range. Over the next 12 months, we expect low inflation and expectations of interest rate cuts to keep our bonds anchored at around the 8.65% level.

It is perhaps more interesting to the consumer, that on the back of the weak economic growth, we expect two further rate cuts over the next year.

We see two distinct risks to our forecast. The political situation in South Africa 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 US economic growth accelerate, then our domestic interest rates will see upward pressure.

Domestic credit spreads

This year has been marked by a dramatic slowdown in the issuance of South African corporate bonds with only a handful of issuers returning to the market. The slowdown of the South Africa 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 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. Banks have also been accumulating bonds for their high-quality liquid assets portfolio. Again, keeping credit spreads for quality credit tighter than we believe is justified by fundamentals.

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.

08 OFFSHORE BONDS

We are expecting a gain of 1.6% on US 10-year treasury bonds over the next twelve months. This is comprised of interest income of 2.4%, being offset by capital losses of 0.8%. Over the period, we also expect yields on US treasury bonds to increase from 2.37% to 2.45%.

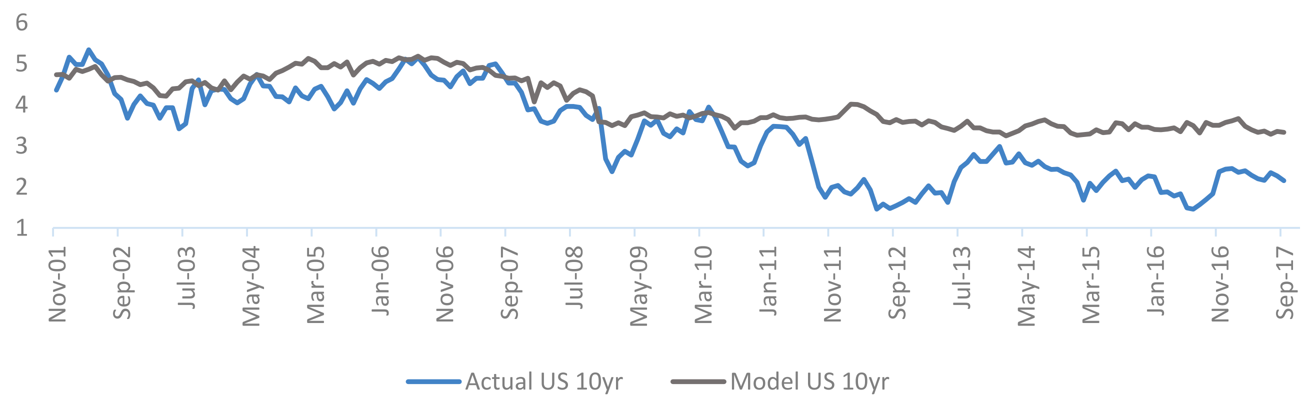
Our regression of US bond yields against a combination of short-term rates, core inflation, the manufacturing index and curve steepness, continues to show that US bonds are unattractive, with an implied fair yield of 3.33% being significantly more than the 2.37% that is on offer in the market.

Our estimate of the long-term fair yield for US bonds of 3.33% is in-line with that of 3.31% last quarter. US economic data that have been released have not lived up to the expectations of a growth acceleration, whilst inflation has continued to disappoint at levels below the Fed's 2.0% target. We also believe that the recent hurricanes in the US will extend the softness of these data to at least the beginning of 2018.

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 artificially low bond yield in the markets.

The US Fed recently announced that it will start reducing its holding of fixed-income instruments, effectively unwinding the QE that took place in the aftermath of the GFC of 2008. This will begin with a negligible reduction in the balance sheet holding of bonds. The quantum of the balance-sheet reduction will increase over time until about three years from now when the Fed's balance sheet is normalised for the size of the US economy.

Figure 8.1: Modelling US 10-year bond using macro fundamentals



Source: Thomson Reuters

We have stated before that we expect this to have a negligible impact on bond yields in the near term, owing to the insignificance of the amounts by which the balance sheet is being reduced.

The European Central Bank (ECB) has continued to support the market by buying bonds onto its balance sheet. We anticipate that the ECB will announce a slowdown of these purchases during the first half of 2018. We would expect that these events will remove some of the support for bonds from the market and will also narrow the gap between our modelled fair yield and that on offer in the market. We don't expect the ECB to cease buying bonds, rather we anticipate that the pace of purchases will slow down from the current EUR60bn per month towards EUR40bn. In our view this will cause moderate upward pressure on global bond yields.

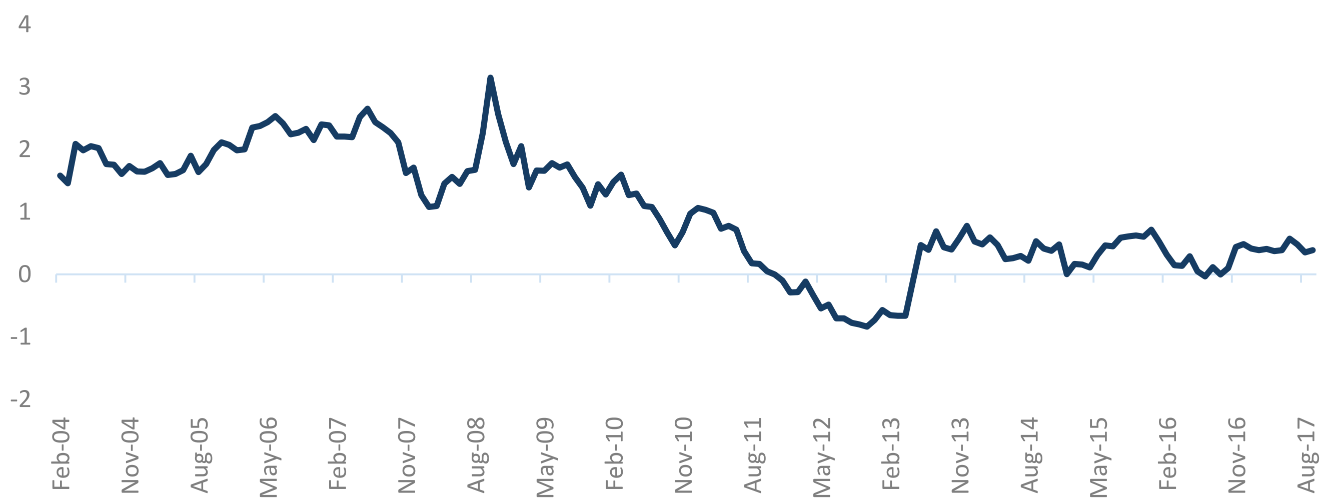
We look at the real yields (yields above inflation) as priced-in by the US 10-year inflation-linked bonds. We highlight that real yields compressed from an average of 2% before the 2008 GFC to a level of -0.50% at the height of QE. The Fed's announcement that it would stop buying bonds in 2013 resulted in a 1% increase in real yields. These are currently at 0.38%. We anticipate that the reduction in stimulus in Europe will have a smaller impact than we saw with the US tapering and we have modelled for an increase of 0.40% in real yields towards 0.75% for a complete termination of EU QE. In-line with our expectation that European QE is only reduced by about a third, we expect that real yields will rise by c. 0.15% resulting in a real yield of approximately 0.55%. This is supportive of our target US 10-year bond yield of 2.45%.

Our yield estimate has declined from 2.55% at the end of 2Q to the projected 2.45%. This reflects the lacklustre performance of the US economy, along with the dearth of inflation. Whilst we believe that some economic acceleration is to be expected, it appears that this is likely to be less than we had originally been hoping for. Inflation is also likely to remain subdued for the near term.

The risks to our view are of a political nature in that the ability of US President Donald Trump's administration to deliver on its fiscal stimulus remains to be seen. The market has been sorely disappointed and the uncertainty from Trump's administration has weighed down the economy without a counterbalancing stimulus. We think that some positive surprises are due and 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 - 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 acknowledge that, as the US economy moves into the late stage of its economic cycle, the number of risk factors to our forecast is particularly high. This is likely to be the year where active management of risk will be of the greatest importance to your investments.

Figure 8.2: US 10-year TIPS real yields over time



Source: Thomson Reuters

09 PROPERTY: DOMESTIC & OFFSHORE

This section first considers local and thereafter offshore property.

There are some concerning signals about the near-term prospects for South Africa:

- Standard & Poor's and Moody's executives speaking late in September painted a picture where it was unlikely we could avoid a downgrade for too much longer.
- The news that SAA received another bail out of R3bn to enable it to repay its debts is illustrative of just how deep the rot is within SOEs.
- The mid-term budget speech on 25 October looms large as an important event with all eyes on tax revenue collection given acute growth concerns. With income growing at 3% p.a., while expenses rise by 7%, we fear the undershoot may be as much as R75bn.
- As we move into the 4Q17 the ANC elective conference dominates the headlines and adds to uncertainty. It is unlikely, until there is clarity on this front, that asset markets will move strongly one way or the other, although volatility during the period is a near certainty.

All of these factors are driving both investment decisions by asset allocators, as well as capital-allocation decisions by property companies. The market is now noticeably bifurcated between local property portfolios and operators who are looking offshore, particularly in Eastern Europe.

Locally, the most striking feature is a difficult operating environment for property owners. All recently reported corporate results and updates point to this, and forecast growth rates in earnings and distributions are now c. 5.5%-6.5% - down from 7%-9% and even higher in some instances. The local property companies have de-rated, however, and yield is now a reasonable underpin to these share prices in the main.

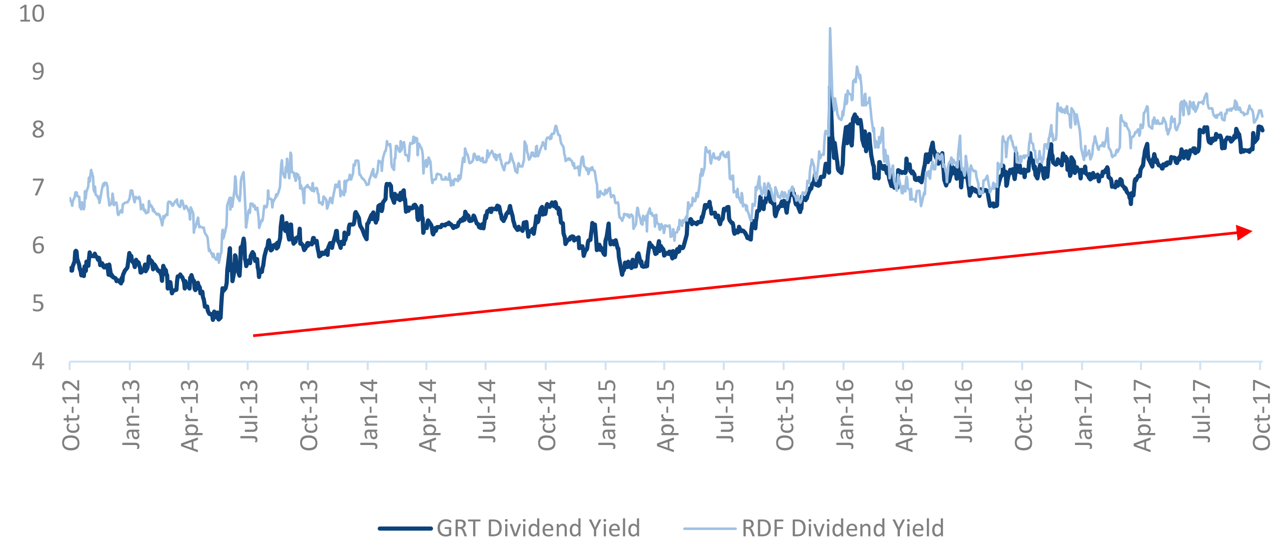
However, the appetite for investment into the Property sector for proven business models and operators, especially in geographies that are able to demonstrate improved growth prospects, remains robust. During the course of the last quarter:

- Resilient raised R2.5bn in August (and returned 6.4% in September).
- MAS Real Estate came to market to raise R500mn initially, but ended up tapping the market for R2bn, some 15% of its market cap. The share ended up 12.7% for the month of September even after this!
- Index heavyweight and Eastern European specialist, NepiRockcastle raised R5bn, again upsizing from initial indications.

The balancing act between the local component of the index and the offshore portion (some 40% now) remains key in reading the tea leaves. The seesaw seems perfectly balanced at the moment. Offshore stocks are expensive on a fundamental valuation basis and the Eastern European property sector, as priced by South African investors, is a global anomaly. The other side of the equation is currency and the prospect of far superior growth, not evident in South Africa, which local investors are willing to pay-up handsomely for at this point.

Currently, the sector overall is at a clean one-year forward yield of 7.15%, growing at 8.3%. All things equal this would mean a return of >15%. However, we see some marginal upside in bond yields, as well as some further de-rating of property yield relative to the bond yield. Our 12M-return projection is therefore 10.5% and, consequently, we remain at equal weight.

Figure 9.1: Growthpoint , Redefine trailing yield - Gradual de-rating of index heavyweights over the last 5 years



Source: Bloomberg, Anchor Capital

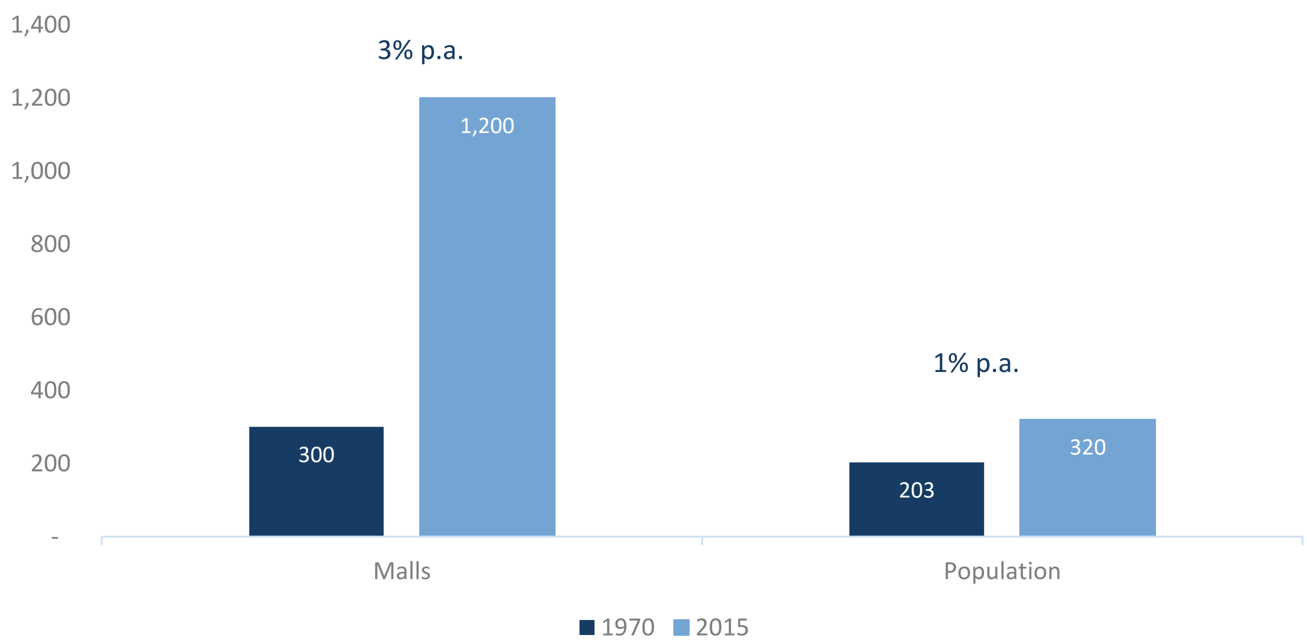
Offshore Property

Over the last three years, global developed market real estate investment trusts (REITs) have delivered about 7% p.a. in US dollar terms, with c. 25% of the return coming from growth, 10% from re-rating and the rest from income.

Within that industry there are two distinct stories playing out, predominantly around the market-share gains of online retailing. Retail REITs are comfortably the biggest sector of the REIT market, making up about 25% of global REITs' market cap and it's become fairly apparent that there is a vast glut of oversupply (predominantly in the US) around the same time as the demand for offline/mall shopping is being eroded by online shopping. Over the last 45 years the number of malls in the US grew three times faster than the number of people.

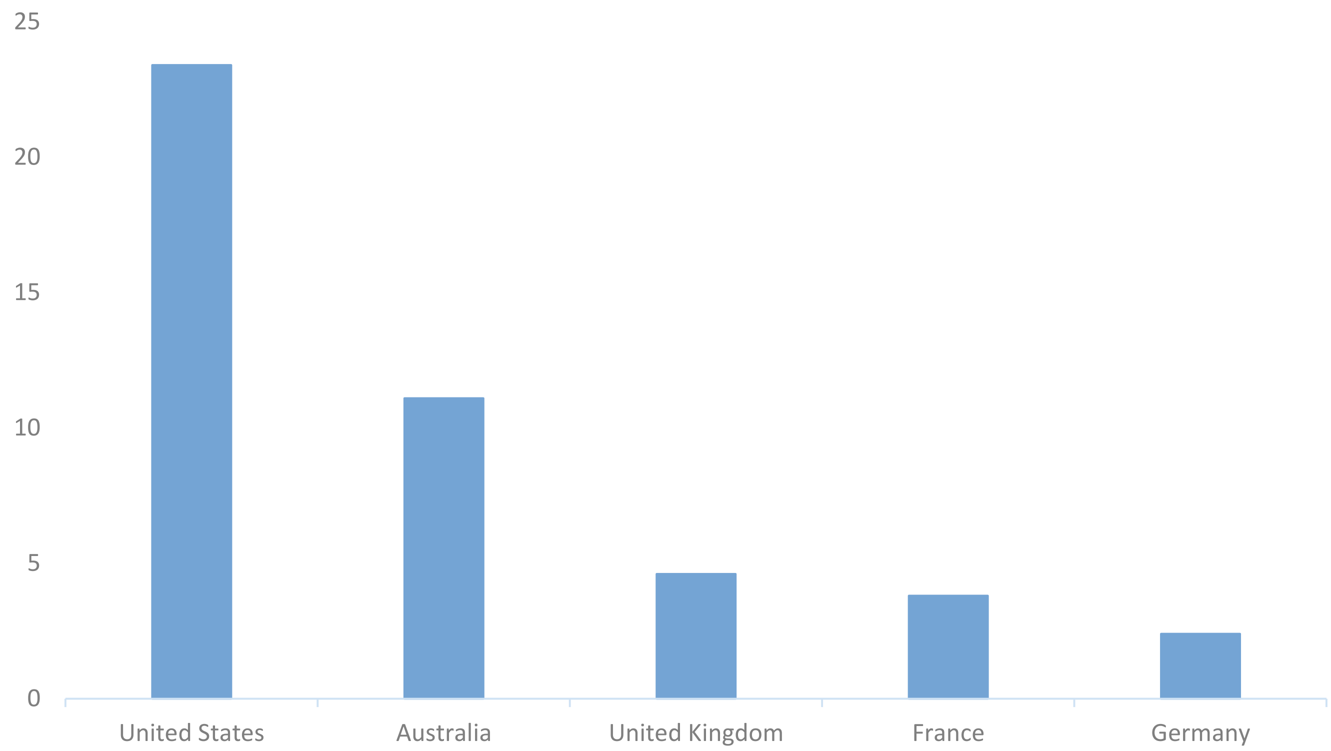
This has left the US with way too much mall space at a time when shoppers are switching to do some of their shopping online.

Figure: 9.2: Growth in the number of US malls vs. population growth



Source: ICSC, Bloomberg, Anchor Capital

Figure: 9.3 Retail floor space per person, 2016 (square foot)

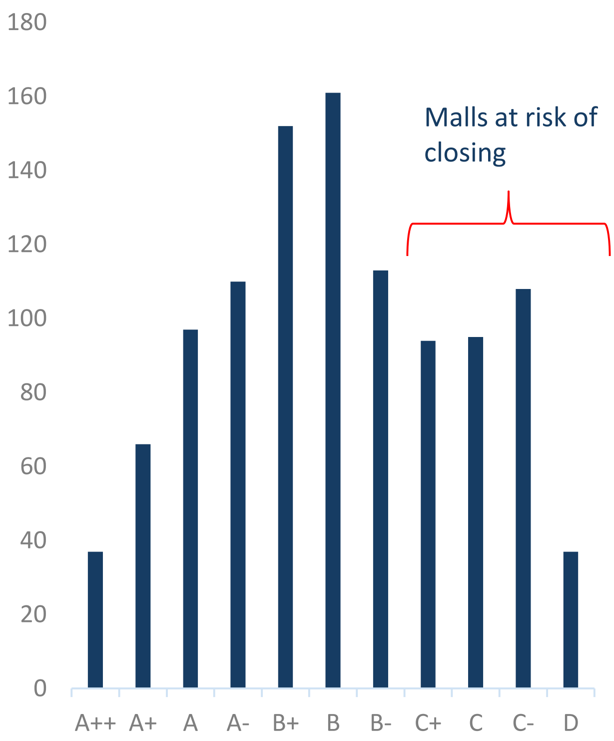


Source: Cowen and Company, Anchor Capital

Some estimates suggest that a quarter of US malls will need to close to bring supply and demand back in line.

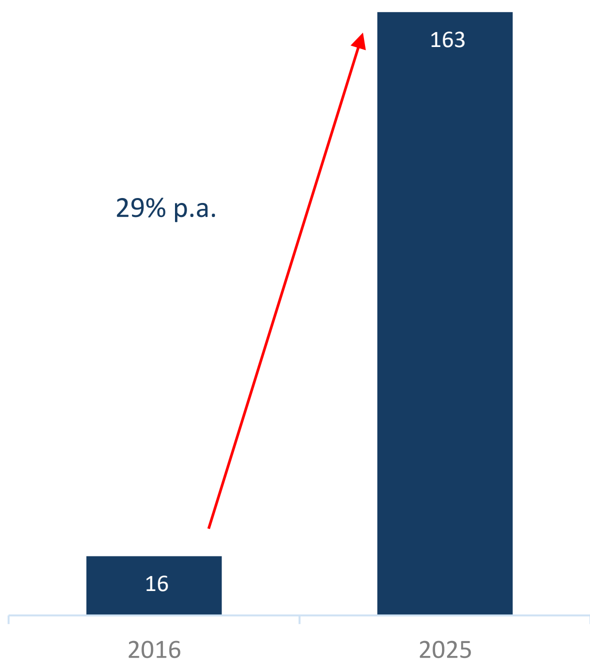
On the other end of the spectrum, the warehouses and data centres needed to service the rapidly growing online ecosystem are experiencing stellar demand growth. A study commissioned by Seagate suggests that the amount of data that requires storage will grow at 29% p.a. over the next 10 years.

Figure 9.4: Number of US malls by quality



Source: Green Street Advisors

Figure 9.5: Size of global datasphere in zettabytes



Source: Seagate, IDS, Anchor Capital

The question now is whether REIT market pricing has already accurately factored in all this information. Retail REITs now trade at a price/FFO multiple of about 15% below the industry average, having de-rated by c. 10% in the last three years. They now trade at a 5% forward dividend yield, which seems attractive, but could be quickly eroded if vacancies increase and defaults continue in this space. There is also pressure on rental rates in anything but the premium malls.

On the flipside, industrial and specialised REITs have been growing their FFO at around 15% p.a. over the last 3 years and still trade at a forward dividend yield of c. 3.5% (industrials) and 4.2% (specialised). However, with price/FFO multiples at a premium they also run the risk of overshooting on supply, losing their pricing power and disappointing on growth. There are already some signs that data centre tenants are gaining more leverage in their negotiations for space. The balance seems delicately poised at this point and it's probably too early tell how far we are through the shift from online to offline. Supply in retail is starting to adjust and that will also prove helpful. Competition is increasing in the warehouse and datacentre market and that will start to become a headwind.

At the industry level, it seems to us that there is probably still some derating that needs to happen to reflect a slightly lower demand for yield as global rates start to edge higher. It's unlikely that we're going to see earnings growth significantly above inflation at the industry level, with growth in industrial and specialised REITs earnings being largely offset by shrinking Retail REITs earnings. So, the expectations for returns in the industry are going to be largely a function of current yields plus inflation. By our calculations this should give investors in global DMs listed property a total return of around 6% in US dollar terms over the next twelve months.

10 CASH AND RAND EXPECTATIONS

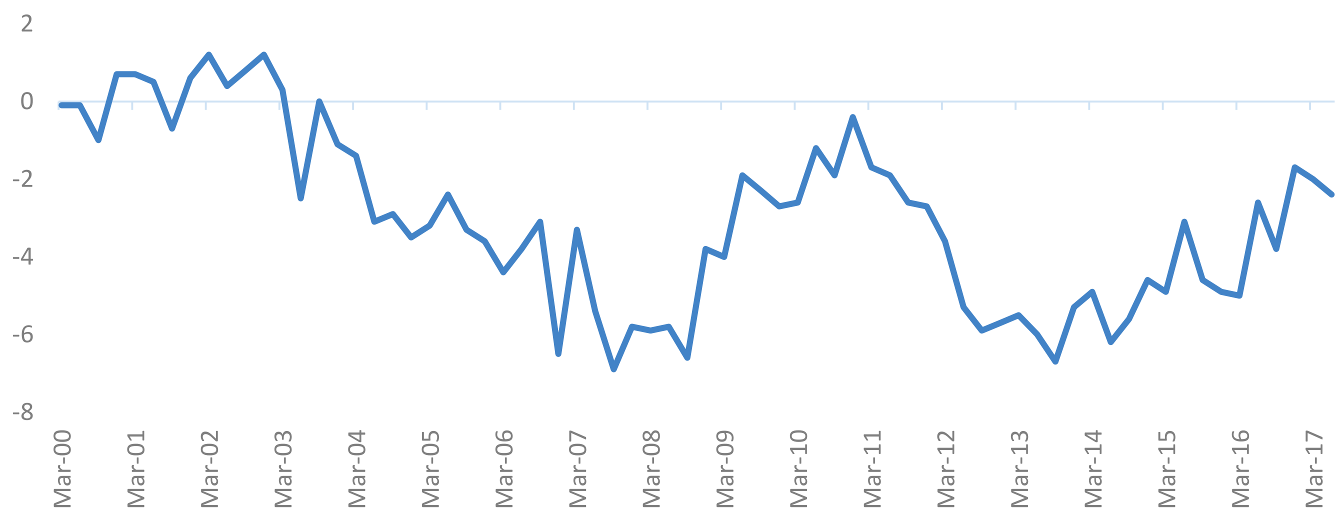
We are projecting a rand vs US dollar exchange rate in the range of R13.50/$1-R15.00/$1 in twelve months' time. The mid-point of our range is R14.25/$1, which is our base-case forecast. The South African exchange rate is notoriously difficult to forecast, hence, we acknowledge that there is a large degree of possible variance between our forecast and the realised outcome.

We had previously been projecting the rand at R14.00/$1 to reflect the supportive global environment, notwithstanding deteriorating domestic fundamentals. The South African terms of trade have swung massively in our favour with gold and platinum prices holding up well when considered against the huge drop in oil prices. This has meant that the current account deficit has shrunk from 6% to the present 2.4%. In short, this means that South Africa needs to raise far less from inflows into our bonds and equities in order to support the rand than we previously did.

This will keep a lid on the rand for now, although the fallout from politics and loose fiscal management are likely to come home to roost.

We expect that the inability of the government to meet its fiscal targets, the pressures for social spending and the shrinking tax base (as a result of a poor economy and emigration) will result in South Africa needing to further raise its expected debt/ GDP target. This will likely be met by a further ratings downgrade from Standard & Poor's. We believe that by this time next year South Africa will be teetering in the edge of being kicked out of the World Government Bond Index. The market will be on edge and will likely be cautious in pricing both South African bonds and the rand. We are perhaps erring on the side of optimism in that we do not think Moody's will downgrade South Africa in the next twelve months and this will give us a little more runway before making the inevitable move.

Figure 10.1: Modelling US 10-year bond using macro fundamentals



Source: Thomson Reuters

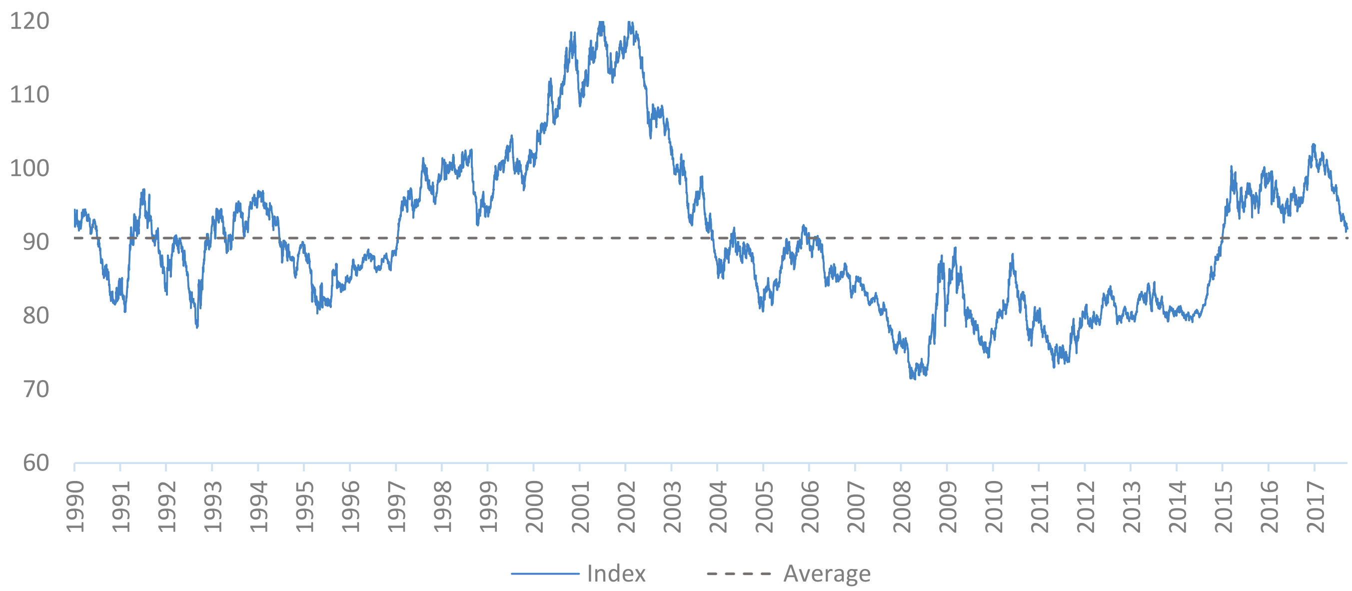
We also believe that the rand will be a victim of the desperate politics within the ANC itself. We should fully expect poorly thought-out populist policies to be the order of the day in the run-up to the ANC elective conference in December. In the race to sound more radical, the economy and the rand will suffer the most, in our view.

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 portends for a reduction in the benefits that the search for yield provided for the rand.

We include a chart 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. As can be seen from Figure 10.2 below the US dollar is tracking towards its long-term average. We think that a scenario with growth in the US battling to sustainably exceed 2.5%, coupled with global policy normalisation (European tapering) would see the US dollar moving broadly sideways from here. This is in-line with our view of the carry trade slowly reversing. In short, we are of the view that the US dollar will stabilise at around current levels (possibly a little stronger), with EM currencies also coming under pressure.

Based on the idiosyncratic difficulties that South Africa faces, and the less supportive global environment, we are expecting the rand to weaken to R14.25/$1.

Figure 10.2: The US dollar index



Source: Thomson Reuters

11 PERFORMANCE SUMMARY

		FUND PERFORMANCE						BENCHMARK PERFORMANCE					Performance vs Benchmark
	Start date	Annualised p.a.	Since inception	12 Month	6 Month	3 Month	Sep 2017	Since inception	12 Month	6 Month	3 Month	Sep 2017	
UNIT TRUSTS (Rands)													
Anchor BCI Equity	Apr-13	16.1%	95.4%	4.57%	6.3%	5.3%	-0.6%	69.1%	7.0%	7.0%	7.0%	-1.7%	26.3%
Anchor BCI SA Equity	Jan-15	3.7%	10.2%	0.3%	4.4%	5.1%	-1.3%	17.9%	7.0%	7.0%	7.0%	-1.7%	-7.7%
Anchor BCI Flexible Income	Jun-15	8.3%	20.6%	7.7%	4.7%	2.8%	1.1%	20.3%	8.6%	4.2%	2.1%	0.6%	0.2%
Anchor BCI Managed	Jan-15	6.1%	17.2%	8.0%	7.0%	5.4%	1.4%	31.3%	9.8%	4.0%	1.8%	0.5%	-14.1%
Anchor BCI Worldwide Flexible	May-13	13.3%	73.1%	9.17%	4.7%	4.2%	5.3%	47.8%	8.8%	3.5%	1.6%	0.4%	25.3%
Anchor BCI Property Fund	Nov-15	2.2%	4.2%	8.7%	6.6%	5.0%	2.8%	11.3%	9.5%	6.7%	5.7%	1.2%	-7.1%
Anchor BCI Global Capital Feeder	Nov-15	-1.8%	-3.4%	-1.94%	1.5%	2.5%	2.9%	3.5%	1.7%	2.6%	4.5%	4.4%	-6.9%
Anchor BCI Global Equity Feeder	Nov-15	7.0%	13.8%	12.1%	9.5%	4.0%	3.9%	20.6%	17.0%	10.8%	9.1%	6.0%	-6.8%
Anchor BCI Bond Fund	Feb-16	12.0%	20.6%	9.7%	5.9%	3.9%	1.1%	19.0%	8.2%	5.2%	3.7%	1.1%	1.6%
Anchor BCI Diversified Stable Fund	Feb-16	7.8%	13.3%	7.5%	4.7%	3.5%	1.0%	11.5%	6.5%	4.6%	3.7%	1.1%	1.8%
Anchor BCI Diversified Moderate Fund	Feb-16	6.7%	11.5%	7.1%	5.3%	4.2%	0.7%	11.0%	6.0%	5.0%	4.5%	0.9%	0.5%
Anchor BCI Diversified Growth Fund	Feb-16	5.7%	9.6%	6.4%	5.9%	5.2%	0.5%	11.6%	6.0%	5.0%	5.1%	0.8%	-2.0%
Anchor BCI Africa Flexible Income	Mar-16	5.5%	8.7%	3.2%	6.3%	4.7%	1.7%	15.6%	9.6%	4.7%	2.3%	0.7%	-6.8%
HEDGE FUNDS (Rands)													
Long Short Equity	Mar-13	9.9%	52.8%	4.8%	3.8%	2.4%	-0.1%	40.7%	9.2%	4.5%	2.2%	0.7%	12.1%
Property Long Short	Jan-14	13.8%	62.3%	12.6%	7.0%	5.6%	3.4%	37.7%	9.8%	4.7%	2.2%	0.7%	24.6%
OFFSHORE (Dollars)													
High Street Equity	Jun-12	13.6%	95.0%	19.9%	10.1%	2.2%	0.9%	85.1%	18.8%	9.4%	5.0%	2.3%	9.9%
High Street Equity – Rands	Jun-12	24.8%	220.2%	17.7%	10.9%	5.2%	4.6%	206.0%	17.1%	10.5%	8.8%	6.4%	14.1%
Offshore Balanced	Jun-12	11.5%	77.0%	15.3%	8.8%	1.9%	0.7%	52.6%	10.3%	7.1%	3.6%	1.1%	24.5%
Offshore Balanced – Rands	Jun-12	22.6%	191.3%	13.2%	9.6%	4.8%	4.4%	152.7%	8.7%	8.2%	7.4%	5.1%	38.6%
Global Dividend	Jan-14	9.9%	41.3%	19.5%	10.5%	3.7%	2.3%	37.6%	18.8%	9.4%	5.0%	2.3%	3.7%
Global Dividend – Rands	Jan-14	15.8%	71.3%	17.2%	11.3%	6.7%	6.0%	67.5%	17.1%	10.5%	8.8%	6.4%	3.8%
Anchor Global Equity Fund	Mar-15	7.7%	21.0%	16.9%	9.0%	2.5%	0.3%	22.6%	18.6%	9.7%	5.2%	1.9%	-1.7%
Anchor Global Capital Plus Fund	Mar-15	-1.0%	-2.4%	1.6%	1.2%	0.2%	-0.2%	7.4%	2.9%	1.5%	0.7%	0.2%	-9.8%