Q2 | May 2021

STAND POINT

STANLIB

THE TURNING OF THE TIDE

CONTENTS

FROM OUR STANDPOINT

INSIGHTS FOR IMPACT

PERFORMANCE AT A GLANCE

FROM OUR STANDPOINT

A note from our Head of Institutional Distribution,

Tracy Coetzer

We are now treading the slow path to recovery and our conversations around lockdowns have been replaced with those around hopes of vaccination and a return to normality. The focus on investments has shifted from managing short-term crises to critically reviewing longer-term plans, as we grapple with fundamental shifts in market behaviour and perhaps our own financial needs.

As we face this unknown journey through recovery, I am reminded of the word 'hardiness'. I recently had the privilege of listening to Stephen McGowan, a young South African traveller who, while travelling through Africa, was captured in Mali in 2013 and held captive for nearly six years. His ability to stay hardy and adapt to an extreme situation enabled him to thrive, not just survive.

His actions are an example of behaviour described by well-known author and US psychologist, Salvatore Maddi. People who thrive are not those that try to bounce back, but those who take a step forward, exhibiting what Maddi calls, 'existential courage'. The key is to look forward for opportunities, rather than try to get back to what you had, or try to understand why things have changed. This gives us food for thought as we continue to reshape and adapt to how we live and work during 2021.

Equity markets this year are recovering well, delivering healthy returns across many sectors. If you had been invested in South African equity (JSE All-Share Index) from 1 January to 31 May, you would have gained 14.4% in just five months. The S&P 500 Index would have delivered 11.9% over the same period, in dollars. However, we clearly need to question the sustainability of this performance.

In this edition

As we focus on recovery and staying hardy, our Chief Economist, Kevin Lings, shares an interesting analysis of world trade's remarkable recovery in the first few months of 2021. This is good news for SA, as we stand to benefit from an upturn in the commodity cycle and the resulting export revenue and tax receipts. On the topic of commodities, Warren Buhai, Senior Portfolio Manager in our Multi-Strategy team, provides an insightful view on commodity super cycles. Could we be in the midst of one?

For those who have ventured through commercial areas recently, one change you could not have missed is eerily vacant office space. Nesi Chetty, Senior Portfolio Manager in our Listed Property team, looks at how office owners will need to adapt to changing needs – the office world as we knew it, is unlikely to return. Lastly, Tarryn Sankar, Head of Credit in our Fixed Income team shares an interesting perspective on adapting to new dynamics in the credit market and how we react to a crisis, but respond with deep consideration for a slow recovery.

We hope STANDPOINT continues to provide you with some useful investing perspectives. Please share your feedback with us on stanlibinstitutional@stanlib.com

Stay warm, stay safe and enjoy the read! I look forward to the next edition when we will welcome the return of spring.

Kind regards,
Tracy

CHARTICLE:

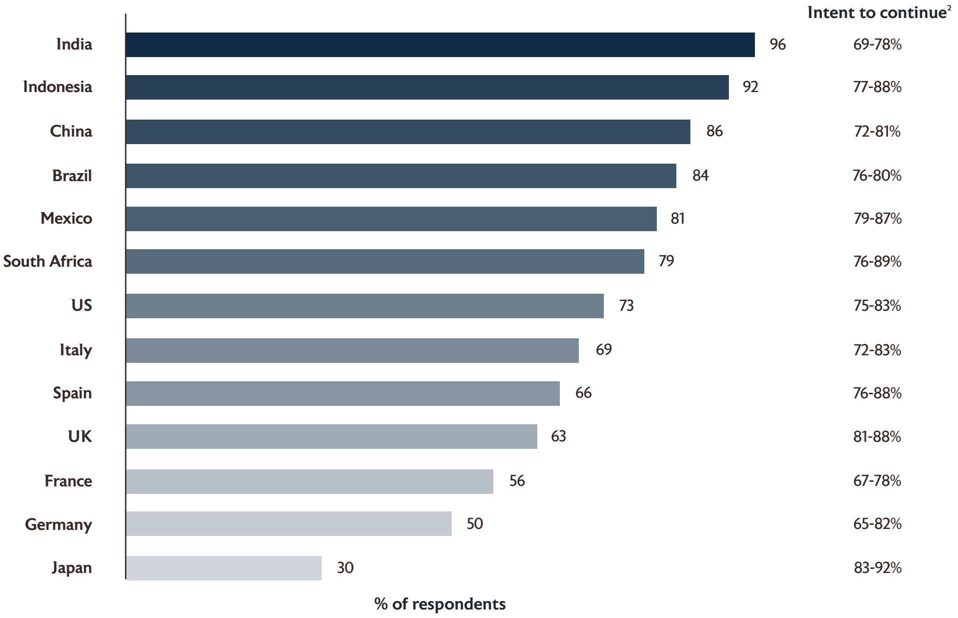
CHANGING CONSUMER BEHAVIOUR

ARE WE CREATURES OF HABIT?

The sudden outbreak of a pandemic provided a catalyst for consumers to try something new. Does this mean they'll slip back to previous shopping behaviours when the world recovers, or could some new trends be here to stay?

McKinsey's consumer survey in the last quarter of 2020 indicated many consumers worldwide have tried new shopping behaviours such as online shopping since COVID-19. In SA, 79% of survey respondents have tried new shopping routines and most said they intended to continue.

Figure 1: Customers who have tried new shopping behaviours since COVID-19[1]



[1]Q: "Since the coronavirus (COVID-19) situation started (i.e., in the past - 3 months), which of the following have you done?" The chart excludes % of consumers selected "none of these."

[2]Q: "Which best describes whether or not you plan to continue with these shopping changes once the coronavirus (COVID-19) situation has subsided?" Possible answers: "will go back to what I did before coronavirus"; "will keep doing both this and what I did before coronavirus"; "will keep doing this and NOT go back to what I did before coronavirus", Intent to continue includes respondents who selected "will keep doing both this and that I did before coronavirus" and "will keep doing this and NOT go back to what I did before coronavirus."

Source: McKinsey & Company COVID-19 Consumer Pulse Surveys, conducted globally September 18-30, 2020

McKinsey's study indicated that, given consumers' price sensitivity, value remains the primary reason for trying new brands and new places to shop. Convenience and availability are most often cited as the top motivators for consumers' decisions about where to shop, while quality and purpose (desire to support local businesses, for example) are more important considerations when choosing new brands.

Retailers are likely to be reflecting these short-term shifts (positive or negative) in their revenue lines. It remains to be seen whether consumer behaviour changes really persist through and after a recovery. Are we creatures of habit, or can we truly embrace change?

GLOBAL TRADE'S REMARKABLE RECOVERY

AT A GLANCE

Global trade and industrial production are back at a record high, despite the slow roll-out of vaccines in many major economies.

Export volumes and industrial production were down significantly across the world in 2020, leading to global recession.

Overall, the rebound in international trade since the middle of 2020 has been broad-based and has far exceeded the expectations of most analysts.

By ***KEVIN LINGS***, Chief Economist

Global trade represents approximately 30% of global GDP. The world's economic performance, especially global industrial production, is closely linked to the performance of global trade. The emergence and rapid spread of COVID-19 in the first half of 2020, and the consequential significant economic lockdowns, pushed world trade from a phase of stagnation into a severe recession, contributing significantly to the worst global economic recession in decades.

2020: Economic lockdowns lead to major global trade slowdowns

In the first five months of 2020, the volume of world exports declined by an incredible 17.5%, easily surpassing the fall-off in global trade that occurred during the global financial market crisis in 2008-2009. Understandably, in this period there was also a very noticeable fall-off in global shipping activity and a recession in global industrial production, which fell by 12.9% between end-2019 and May 2020.

Figure 1: Declining export volumes and industrial production across major economies

	Export volumes	Industrial production
United States	-30.7%	-16%
Euro area	-22.1%	-17.4%
Japan	-22.1%	-18.6%
China	-5.9%	-1.7%

China's modest decline in exports was helped by the fact that the COVID-19 crisis was quickly brought under control, certainly relative to most other major economies. China's industrial production also outperformed on a relative basis, with the Chinese government providing the sector with significant support, including a sizeable further increase in infrastructural activity.

There is also a strong and important relationship between global trade (industrial production) and industrial commodity prices. Unsurprisingly, industrial commodity prices fell by 7.3% in dollars in the first five months of 2020, although there was a wide dispersion in performance between energy prices, which were down almost 50% in dollars, and the index of precious metal prices, which rose by roughly 12.5% over the same period.

The collapse of global trade in early 2020 had a severe impact on SA's export performance, which fell by just over 23% year-on-year in dollars during the first five months, despite the rise in precious metal prices. This, in turn, substantially weakened mining (more than 50% of the country's exports are commodities) and manufacturing output, contributing substantially to SA's worst economic performance in more than 60 years. Although the fiscal and monetary authorities provided some support to the economy during this phase of the COVID-19 crisis, including through lower interest rates, increased social payments and credit support for the business sector, these measures did very little to compensate for the severity of the COVID-19 lockdown restrictions that were applied in most major economies.

Early 2021: Global trade revival, despite slow vaccine roll-out

Remarkably, while the speed and magnitude of the collapse in global trade in early 2020 was devastating, the subsequent recovery has been even more impressive. Monthly data provided by the Netherlands Bureau for Economic Policy Analysis (CPB) highlights that **both global trade and industrial production has recovered sharply, reaching a record high, in volume terms, during January 2021.** This recovery, which began in June 2020, has seen world export volumes increase by a total of 26.4% in the eight months from June 2020 to January 2021. At the same time, global industrial production has rebounded by 17.3%, also in volume terms. Unsurprisingly, during this period, world shipping activity has rebounded and global industrial commodity prices have risen by a spectacular 71% (in dollars), helped by a 57% increase in metal and mineral prices, as well as a 104% rise in energy (oil) prices.

From SA's perspective, while the rise in energy (oil) prices is unfortunate, pushing the domestic petrol price to a record high in April 2021, **it is encouraging that every other major commodity price index has also risen convincingly, providing a very welcome uplift to export performance.**

Most major economies have experienced a very rapid rebound in international trade since the middle of 2020, suggesting that the recovery in global trade has broadened out considerably in recent months. There is now a **global revival in international trade,** which has been helped by the easing of the more severe COVID-19 lockdown restrictions around the world. This is despite many countries still struggling to make significant progress with the distribution of the COVID-19 vaccine, including SA.

It is heartening to see that the Global Trade Uncertainty Index has fallen back down to historical lows. This suggests that the extreme anxiety about trade tensions between the US and China that characterised much of President Trump's term in office has dissipated, together with concerns surrounding the impact of Brexit on Europe and the UK. This does not mean that international trade relationships are back to 'normal', but it does suggest that the extreme uncertainty regarding the world's most important trade links, especially between the US and China, have eased considerably. This should lead to a further and ongoing improvement in international trade.

Trade rebound benefits DM and EM

It is also worth highlighting that the rebound in global trade and industrial production over the past eight months has benefitted both developed and emerging economies, although China has experienced a particularly large pick-up in both industrial production and exports. For example, since the middle of 2020, China's export volumes have risen by 38.1%, allowing it to easily surpass its previous peak level of exports, as well as reach a record level of manufacturing output. Industrial production and international trade remain a vital component of China's economic success, although the government is trying to boost consumer activity to ensure that the economy achieves a more balanced set of key economic drivers.

The US has also experienced a strong rebound in exports, which have grown by 38.4% since the middle of 2020, but its industrial output remains below the peak that prevailed prior to the onset of COVID-19. This is partly because the US has become more import-intensive, recording a 24.9% increase in the volume of imports since the middle of 2020. The euro area has also experienced an impressive gain in exports – up 27.5% since mid-2020 – but has struggled to fully revitalise industrial production due to weaker domestic economic activity. Japan's exports have risen by 36.2% over the same period, but its industrial production remains moderately below the 2019 level of activity.

Unfortunately, the pick-up in exports out of Africa since June 2020 has been disappointing, rising by only 5.3%. Equally, the rebound in industrial production within the African continent has also lagged most of the other economic regions. This partly reflects the fact that the COVID-19 pandemic impacted this region later than most other parts of the world. In addition, the region lacks the financial resources to aggressively procure and distribute the COVID-19 vaccine.

Overall, the rebound in international trade since the middle of 2020 has been broad-based and has far exceeded the expectations of most analysts. Given the latest round of fiscal stimulus in the US, as well as persistently low interest rates within most major economies and relatively low levels of inventories throughout the global supply chain, the current revival in international trade and industrial production is likely to continue throughout 2021 and into 2022.

Critically, from SA's perspective, the revitalisation of international trade should continue to support the global commodity price cycle, providing the country with vital export revenue as well as a welcome boost to tax receipts. Hopefully, the policy authorities can use this windfall as a catalyst to urgently start to revitalise rail and port infrastructure, which is critical to the sustained success of SA's international trade. ■

HAS THE PANDEMIC INDUCED A NEW COMMODITY SUPER CYCLE?

AT A GLANCE

Supply chain bottlenecks have increased given global lockdowns, affecting the extraction and refined supply of many commodities.

Inflationary fears have risen on realisation that excessive money printing could cause excess demand for goods and services above available supply. Also, hedging inflation risk using commodities, further squeezes tight markets.

Decarbonisation efforts and related energy transmission infrastructure changes may trigger super cycle conditions for certain commodities, but are unlikely to do so for the asset class as a whole.

By ***WARREN BUHAI,***
Senior Portfolio Manager, STANLIB Multi-Strategy

Since COVID-19-related lockdowns became widespread globally in Q1 2020, bottlenecks have developed in various supply chains, including most commodity markets, to varying degrees. This, together with rising concern around inflationary risks driven by the combination of highly stimulative monetary and fiscal policies working together for the first time since the 1970s, has raised the question whether we have entered a new commodity super cycle.

The high degree of uncertainty around both supply and, more importantly, medium- to longer-term demand for most major commodities, makes it very difficult to conclude with high conviction that we have entered a new commodity super cycle. However, it is clear that the world has reached an inflexion point in combating climate change. Long-term stringent carbon emission reduction targets set by the world's largest governments will have a material impact on many industries, making it highly probable that certain commodities will experience super cycle conditions over the next decade or two.

Commodity super cycles are generally demand-driven

It is generally accepted that commodity price super cycle bull markets are extended periods during which commodity prices are well above their long-run trend. The main drivers of super cycle bull markets since the late 1800s included:

- US industrialisation in the early 1900s.
- Reindustrialisation and reconstruction of Europe and Japan, following the Second World War, drove the 1950s and 1960s cycle.
- China's acceleration of both industrialisation and urbanisation beginning in the early 2000s.

This illustrates that a commodity super cycle is likely to need a specific medium-term demand driver that distinguishes it from normal demand growth. Today, we potentially have two key recent developments that could generate a potential super cycle:

1. Decarbonisation brought on by increasing climate change. Governments have set long-term carbon emissions reduction targets, which help to grow the supply of renewable energy sources like wind and solar (and therefore materially adjust energy infrastructure). There are also consumer-driven behaviour changes such as the choice of electric vehicles (EVs) over internal combustion engine (ICE) vehicles. This shift is often incentivised by governments, such as through tax credits for buying EVs or penalties for auto manufacturers that do not improve the oil consumption efficiency of their new models.
2. Globally, central banks are using monetary policy to effectively fund fiscal policy, which includes the previously discussed increase in renewable investments, as well as direct stimulus payments to both corporates and households. These payments may change the disinflationary forces of the past 40 years, as governments and central banks understand the necessity of generating inflation to assist in paying down record-high debt levels.

Decarbonisation is a potential game changer for some major commodities

Given its excessive carbon emissions, the transition of the energy sector is likely to include:

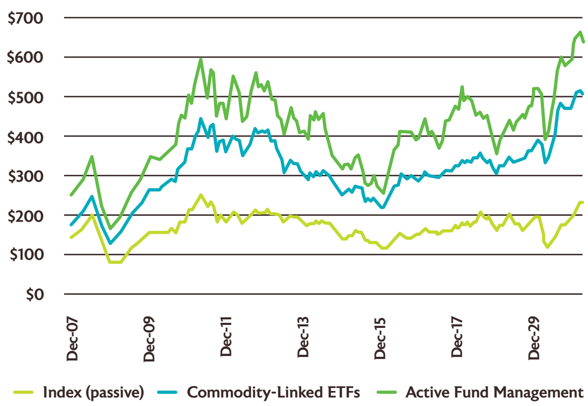
- For primary energy consumption, moving away from fossil fuels, such as coal and oil, towards renewables like wind and solar.
- For transportation, moving away from oil used in ICE vehicles to EVs, which includes the need for lithium-ion batteries and significantly more copper, including for increased EV charging stations.
- While the global ICE vehicle fleet is likely to decline gradually in the long run, platinum group metals (PGMs) will remain in high demand, as a key input for the autocatalytic converters that reduce ICE vehicle carbon emissions.
- The expanded transmission infrastructure linked to less carbon-intensive, renewable energy sources. Batteries and copper will also be needed in energy storage, which will play an important role in the deployment of renewable sources like wind and solar that only supply energy at certain times of the day.

Inflation risk is highest in decades

A fundamental change was made by the US Federal Reserve last year in the way it tackles its key mandate of price stability and full employment. Changing to average inflation targeting and focusing on the low end of the employment spectrum has effectively changed the way it tries to pre-empt overheating in the US economy. This means that going forward, it will allow the economy and, by design, inflation, to run much hotter than any time since the 1970s.

Global investors concerned about the rising inflation risk often hedge by buying commodities. The chart below clearly shows that commodity investment is currently even higher than the peak reached in the China-driven super cycle. However, relative to the trillions of US dollars of COVID-19 monetary and fiscal stimulus and the size of other risk asset classes, total commodity investment of less than $700 billion is small and could increase materially if inflation risks continue to rise.

Figure 1: Institutional and retail commodity investments ($'billions)



Source: Citigroup Global Markets Inc. (data to Q1 2021)

Another important issue related to inflation expectations is their close correlation to the oil price. This is unsurprising, given its direct and indirect impact on most industry supply chain costs. Linked to this, is the question whether new renewable power generation sources and infrastructure can rise at the appropriate rate to replace the falling supply of fossil fuels, like oil and coal. Mismatches in this transition could potentially cause shortages and price spikes in years to come, despite a declining demand profile for fossil fuels. Such energy price spikes are likely to stoke inflation fears, thereby continuing to support hedging demand.

Challenges to a broader commodity super cycle

While decarbonisation and average inflation targeting are compelling tailwinds for certain commodities, it is difficult to envisage a broad-based commodity super cycle, because of various long-term headwinds, including:

- Carbon emission targets are not set in stone: China's plans, which drive a significant global portion, lack firm commitment.
- The US dollar may not be destined for extinction: While the US dollar is an easy target at the moment, given the extent of America's rising twin deficits (fiscal and trade), relative demographic profiles and potential growth rates do not place the US at a major disadvantage to other large currencies in the medium term.
- Uncertain global growth after the 2021 unlock rebound: Record annual growth rate numbers in many countries in 2021, will mostly be driven by the base effect of the fall during 2020's lockdown-induced recessions and the associated large monetary and fiscal response. Many factors impact longer-term growth trends.
- China's high level of global commodity consumption is set to wane as its GDP growth mix evolves.

Conclusion

A potential commodity super cycle generally requires a meaningful and sustainable above-trend growth driver. While the supply chain problems and short-term growth rebound linked to the COVID-19 lockdowns globally have pushed certain prices above marginal costs and some into super cycle territory, these are unlikely to drive a sustainable, longer-term, broad-based commodity super cycle.

We do, however, believe that it is plausible to have 'super cycles' in specific commodities that encounter above-trend demand growth conditions. Uncertainties around inflation driven by the continued combination of novel and aggressive monetary and fiscal policies in the US and other major economies, will underpin significant investment demand in commodities. Such tailwinds, together with impending decarbonisation policies in all the world's major economies, can drive supply deficits in commodities such as copper, lithium, PGMs and perhaps ironically, oil. The extent and persistence of these deficits will depend on government commitment, speed of adoption and continuity of decarbonisation policy initiatives.

THE RISE OF THE VIRTUAL OFFICE:

WHAT DOES THIS MEAN FOR SA PROPERTY?

AT A GLANCE

The pandemic-led disruption to the traditional office business model has resulted in lasting changes.

Demand for office space has fallen as people embrace the cost-efficient and time-saving benefits of a flexible work model.

Short-term trends for the office sector include rising vacancies, falling rentals, increasing asset disposals and lower valuations.

The South African office market, like many office markets across the world, needs to embrace these shifting market dynamics to stay relevant.

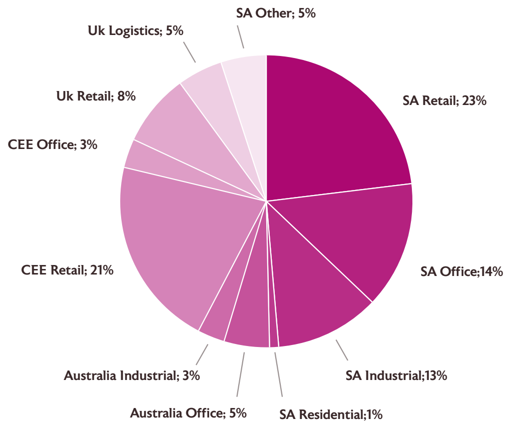
By ***NESI CHETTY***, Listed Property Senior Portfolio Manager

The impact of the sudden pandemic-led disruption to the traditional office model is clear. Many companies took the opportunity to embrace work-from-home models and review their real estate footprint, leaving once-vibrant commercial centres eerily quiet in 2021.

Even before the COVID-19 outbreak, SA's office sector was feeling the pressure of a weakening economy coupled with an oversupply of space. Investors in the R220 billion SA-listed property sector[1] have cut their exposure to the South African office sector from 18% three years ago to 14% in April 2021. Their total office exposure, including to Australia and Central and Eastern Europe, is currently 22%. The decline is as a result of listed companies selling office assets to private companies and individuals, and the sector's relative underperformance. With further asset sales expected, we anticipate the total office exposure will fall to approximately 10% in the next three years.

[1] *All Property Index market capitalisation at April 2021*

Figure 1: SA listed property sector exposure (ALPI)

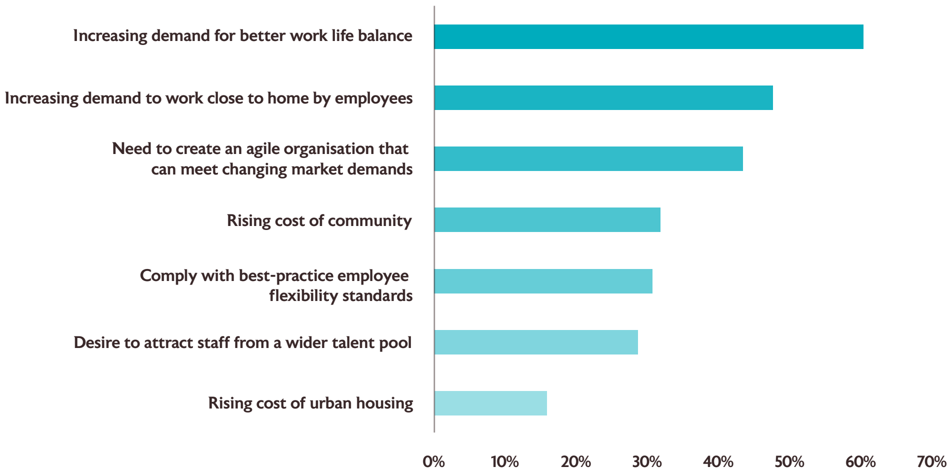


Source: STANLIB Property April 2021

Rising trends to watch as market dynamics shift

The success of remote working since the start of lockdown suggests a permanent shift in behaviour. According to a survey by Regus, this shift is driven by the following factors:

Figure 2: Reasons for the shift to flexible working



Source: Regus

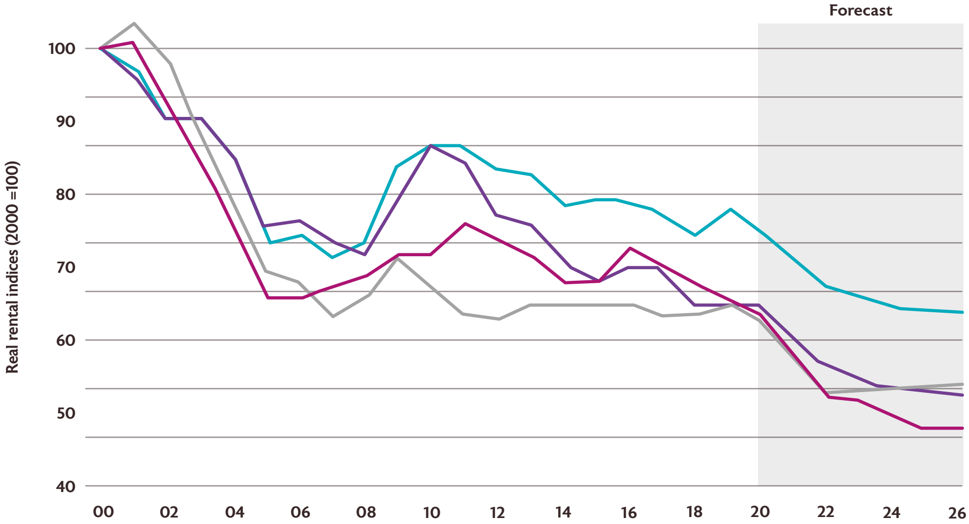
The challenges within the SA office sector are expected to increase in the medium term. This will impact current and future dynamics in the sector in the following ways:

1. Declining rentals

An increase in supply over the last few years, coupled with corporates adopting work-from-home models, has given tenants the upper hand in lease negotiations. As a result, tenants are enjoying benefits such as tenant installation, generous rent-free periods, cash payments and much lower rentals. For example, we have seen rentals for Grade A office assets decrease by 5% in the first quarter of 2021 alone.

Rentals in key office nodes like Pretoria, Johannesburg, Durban and Cape Town, have all shown a negative real trend. Based on economic growth projections, we expect rentals will only begin increasing again in real terms from 2025 onwards.

Figure 3: Real decentralised office rentals

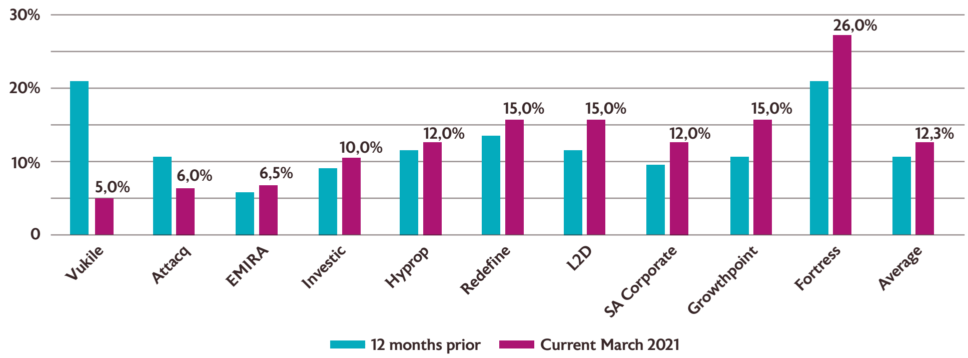


Source: Rode, BER

2. Rising vacancies

Over the last four years, vacancies in the office sector have risen. Since the start of SA's lockdown, vacancies on average have increased by 2%. Large office property landlords, like Growthpoint, have seen a 5% increase in vacancies over the 12 months to March 2021. Unfortunately, low economic growth, combined with oversupply in the medium term, are likely to cause vacancies to increase before excess supply is absorbed.

Figure 4: SA listed property vacancy rates



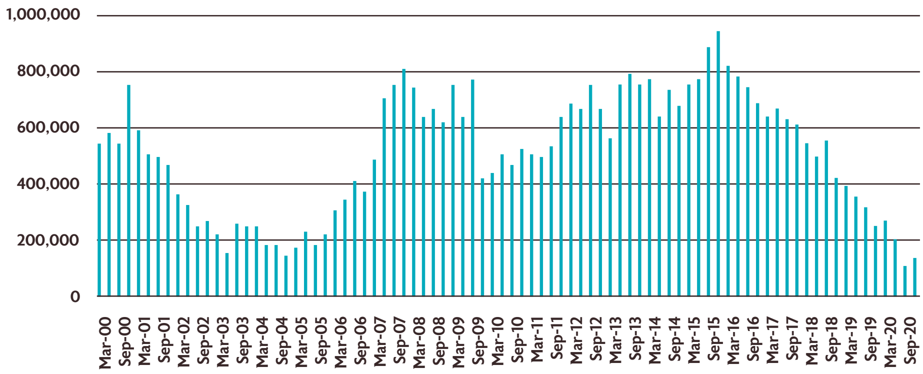
Source: STANLIB Property

Vacancies are under further pressure as some of the major corporates are looking to sublet part of their existing space. Additionally, as leases expire, there is likely to be less take-up of that space. This situation is exacerbated by the behaviour of many smaller business enterprises, who are embracing working from home and meet in public spaces, like coffee shops, to save on rental costs.

The negative impact will be felt more in the B to C grade buildings, since they are older and do not have the longer leases found in many of the newer P and A grade buildings. Given the oversupply of offices, tenants are negotiating better quality space in P and A grade buildings at discounted levels.

On a positive note, SA has seen considerably less office development since 2016. This will be favourable for a recovery in office vacancy rates when the market finally stabilises. Speculative office development has been curtailed for most listed property companies.

Figure 5: Office space under construction in SA (square metres)

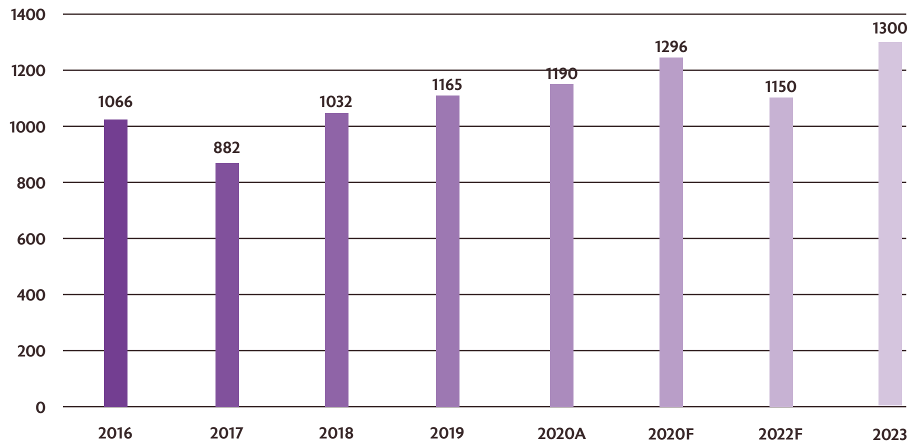


Source: Rode, BER

3. Accelerating asset disposals

Asset disposals have been concentrated mainly in the retail and office sectors, with buyers being predominately private companies or individuals. Listed property funds sold office assets with a range of vacancy profiles in 2020 and will continue to do so in the year ahead.

Figure 6: SA listed property – office sector disposal (R millions)



Source: STANLIB Property

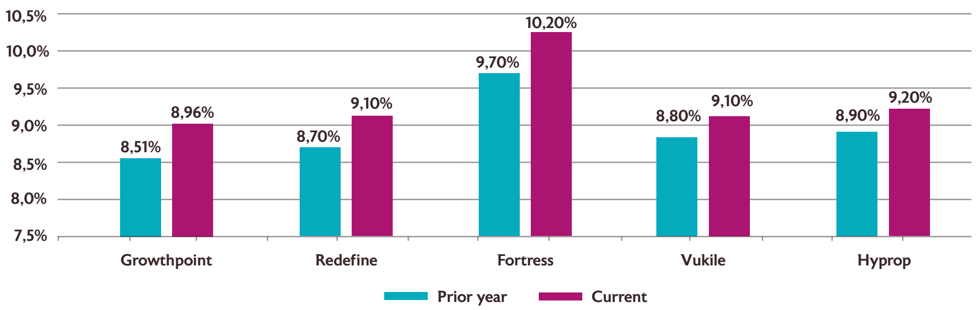
The sale of office assets will reduce the strain on the balance sheets of South Africa's listed property companies, as many companies will use the sale proceeds to pay off debt. This will have a positive impact on these companies, making them more sustainable over the longer term.

Large funds, like Growthpoint and Redefine, have concrete disposal plans for some of their assets.

4. Lower SA office property valuations reflect some of these risks already

Given lower rentals and net operating income now being generated by office assets, most listed property companies have also written down the long-term value of these assets. On average, this has meant an increase in the capitalisation rate (cap rate) – the ratio of income required relative to asset value, or price paid for the property – of between 0.3% and 0.5% a year. These rising cap rates, all else been equal, means companies show lower property asset values on their balance sheets. In this way, the South African office property book values have already begun to reflect the risks of the sector.

Figure 7: SA listed fund office exit cap rate estimates



Source: STANLIB Property April 2021

We expect office cap rates will rise by another 0.3% in 2021. As the market recovers from 2023 onwards, we expect cap rates will stabilise.

The office market is not dead – its role is evolving to meet tenant needs

As flexible office working becomes a growing part of the South African office landscape and the relevance of suburban offices increases, corporates need to re-think their office strategy. We expect most corporates will embrace flexible working arrangements, reduce rental costs and improve employee work-life balance.

We do not expect that work-from-home will completely replace the traditional office market yet, as offices will remain a place to conduct meetings, establish corporate culture and train staff.

South African office market capex requirements will actually increase, as will property asset management intensity, given changing demands from tenants. Property landlords will need to retro-fit and develop offices to meet tenants' new needs.

The pandemic has rapidly accelerated the rental and vacancy trends that were already in place, and property companies most prepared for these trends will continue to outperform in both the short- and long term. The office sector will see an operating model recalibration, with some conversion to residential, reconfiguration and sub-letting.

Critically, office property owners' ability to adapt their business models to changing dynamics, will be key for their success.

REACTING TO A CRISIS, RESPONDING TO A RECOVERY:

ADAPTING TO NEW DYNAMICS IN MANAGING CREDIT RISK AS WE MOVE THROUGH A RECOVERY

AT A GLANCE

Investing in credit assets provides an additional source of low-volatility income when both individual credit selection and portfolio construction decisions are effective.

The credit market reacted immediately to the Covid-19 crisis, with asset quality and demand falling and spreads between corporate and bank instruments widening, due to higher perceived risks for corporate paper.

Current market dynamics are stabilising against the backdrop of a slow economic recovery.

By ***TARRYN SANKAR***, Head of Credit, STANLIB Fixed Income

The gradual lifting of Covid-19-related restrictions has shifted the focus to economic recovery in all its forms. This ranges from the pace at which recovery might be expected to continue, to whether the early signs of recovery we are seeing are sustainable in the long term.

As active fixed income managers, we are watching the changing dynamics in the listed credit market and evolving our risk management and portfolio construction processes to optimise return outcomes for our clients as a result of the Covid-19-induced economic shock.

The role of credit in a fixed income portfolio

It is important to remember why we invest in credit assets. Investors in these assets are effectively providing a company with a loan to grow the business in return for regular interest payments and the ultimate repayment of this loan. An investment in credit assets provides an additional source of low-volatility income compared with investments in listed equity or listed property. Companies can defer or materially reduce dividends to shareholders during periods of market stress, but the interest paid to debt holders on credit assets is a contractual commitment.

However, the volatility of income and returns generated by credit assets is only low if:

1. Effective credit selection has appropriately mitigated (as oppose to eliminated) the risk of corporates defaulting on interest and capital payments; and

2. Portfolios are constructed in such a way that the diversity of credit issuers and instruments serves to reduce the volatility of returns, even if defaults were to occur.

Investing in credit assets provides investors with an opportunity to support corporate growth. Although there are still risks, investors' legal claim to interest and principal due on credit instruments ranks higher than the claims of equity investors. While upside gains may be limited compared with equity, there is a level of downside risk protection.

Current dynamics in listed credit markets

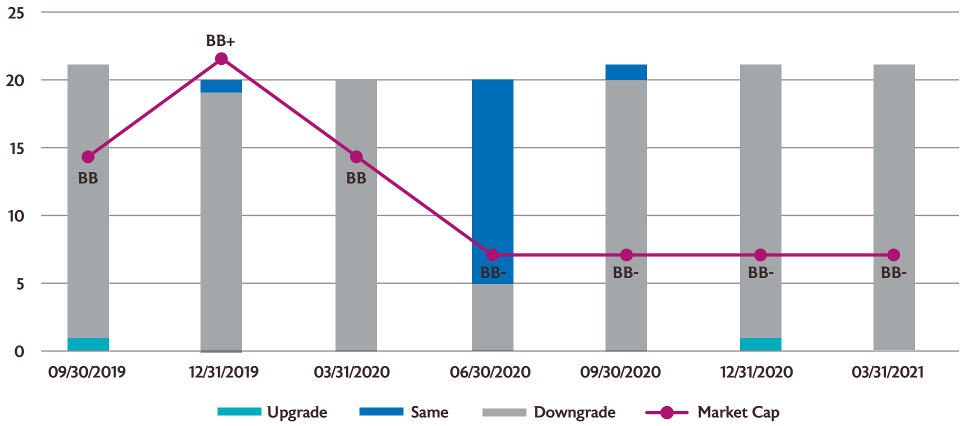
Market cycles vary and it is important to consider the current dynamics and what may lead to long-term fundamental shifts, rather than short-term reactions to market news. The current dynamics of the listed credit market can be explained by four elements:

- the quality of instruments in the market (the credit risk)
- the supply of instruments to the markets
- the demand from local and international investors for credit instruments
- valuations.

Quality

The chart below shows a number of downgrades / upgrades for official S&P Global Ratings in South Africa. Of 20 South African issuers, 15 were downgraded by at least by one notch in Q2 2020, which changed the average global scale ratings from BB to BB-. The chart also illustrates that, so far in 2021, **credit quality can be best characterised as stabilising rather than improving.**

Figure 1: The evolution of S&P global ratings in SA



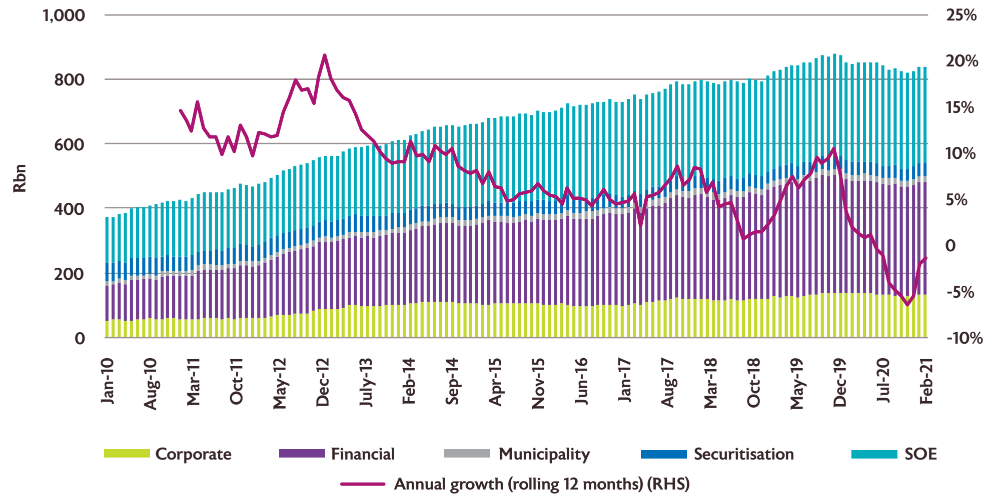
Source: S&P Global Market Intelligence

Supply

The net monthly outstanding issuance shows how much listed debt issued by banks, corporates and SOEs is outstanding. It takes into account new debt issuances as well as debt that has been repaid. The graph below shows that the **net monthly outstanding issuance across all sectors is still lower than in comparative periods, but the rate of decline is slowing down.**

Total issuance volumes are not yet growing in positive terms – it is merely that the rate of deceleration is slowing down. This further exacerbates demand and supply imbalances and may partly explain why bid cover ratios (an indicator of demand for instruments up for sale at auctions) have been increasing so significantly.

Figure 2: Net monthly outstanding issuance (supply) per sector

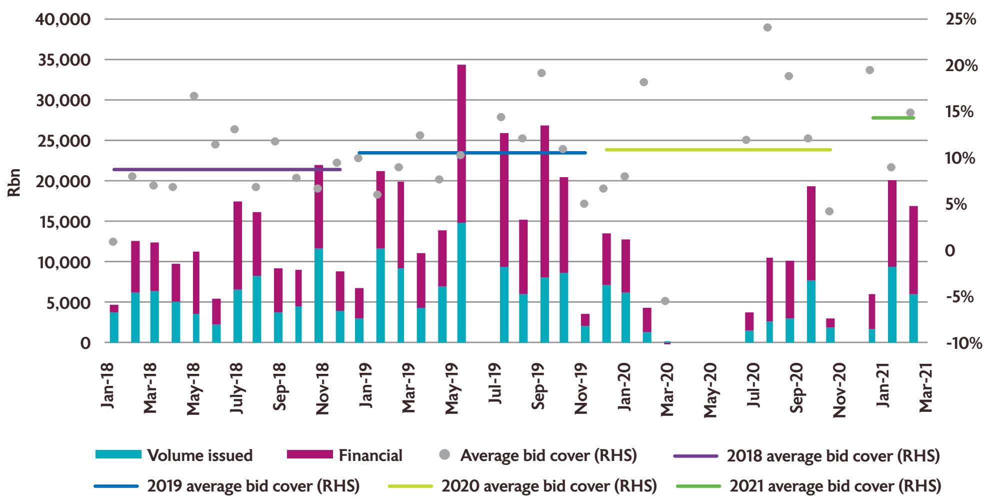


Source: Standard Bank Research, JSE, data as at 30 April 2021

Demand

There has been a resurgence in demand for listed credit instruments as bid cover ratios increased. In April 2021, average bid cover ratios[1] were higher than in the previous four years. This means that the extent to which demand for listed credit outstrips the available supply at auctions is at its highest since 2017. On average, auctions were between 2.5 and three times oversubscribed compared with 2018, 2019 and 2020, when bid coverage ratios were between two and 2.5 times, on average.

Figure 3: Primary market auctions: monthly volumes issued vs bids



Source: Standard Bank Research analysis; auction results; JSE

[1]*A measure of demand for listed credit relative to available supply of credit at listed credit auctions*

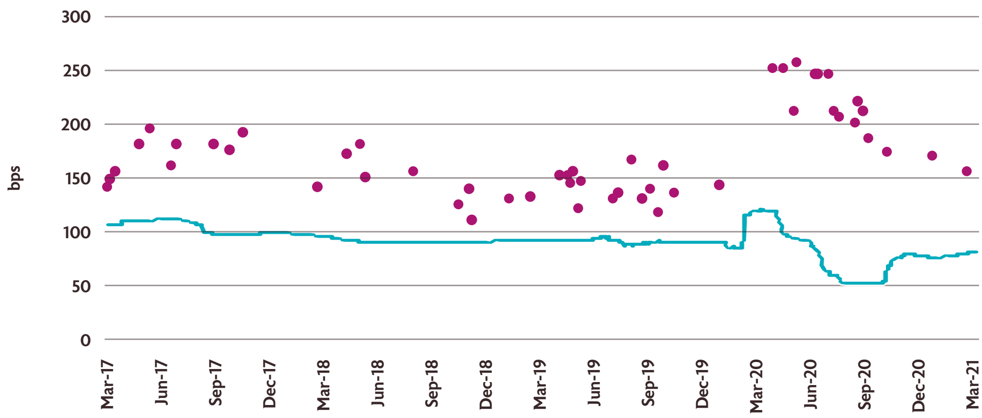
Valuation

The graph below shows one view of spread dynamics in the listed credit market by comparing the spread on corporate debt with the spread on bank debt. We clearly see how credit spread widening in 2020, following the Covid-19-induced economic shock, has been replaced by a relatively sustained trend of corporate spread narrowing, although at a slower pace in 2021 than at the end of 2020.

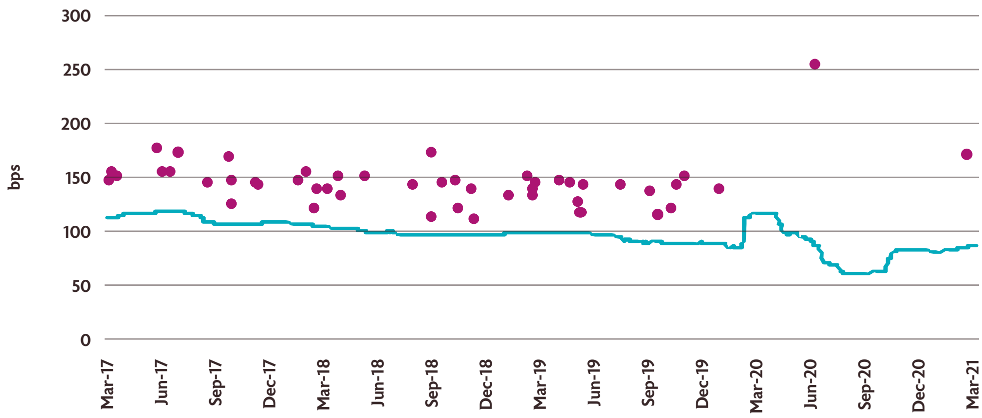
Within corporates, a distinct differential in spread trajectory and pace is emerging for higher-quality corporates. SOE spreads remain elevated and refinance risks continue in this sector, as many SOEs need to restructure their balance sheets to sustain their businesses.

Figure 4: Comparing corporate spreads (Floating Rate Notes) with bank debt spreads (NCDs)

3-year corporate FRN spreads vs 36-month NCD spreads



5- to 6-year corporate FRN spreads vs 60-month NCD spreads



Source: Standard Bank Research; JSE. Note only AA/A rated corporates

How do we think about credit in an economic recovery?

Attention has now shifted to economic recovery. Asset class returns from equities and listed property stand to benefit meaningfully from improved prospects for economic recovery, with higher share prices, the resumption of dividends and the ability to realise gains on positions that have recovered from crisis lows.

Credit assets, on the other hand, are primarily exposed to downside risk: namely the risk that borrowers will not repay interest and principal in full and in a timely manner. The relative illiquidity of South African listed credit assets (as opposed to listed equities and listed property) means that the timely realisation or monetization of sizeable gains on credit positions is not always possible.

It is this asymmetric risk profile that underscores the importance of analytically sound and robust credit risk management processes **that can take a through-the-cycle view of credit quality in positioning the appropriate long-term response to the economic recovery for client funds.**

Individual credit selection remains important when constructing credit portfolios. In the present crisis, changes in creditworthiness differ by sector and subsector to a greater degree than they arguably did in previous recessions, which further underscores the importance of bottom up, fundamental research. However, understanding how these individual credit selection decisions come together in a portfolio context matters just as much as exposures to individual counterparties.

What are we doing in client funds?

The initial **credit reaction to the Covid-19 induced economic shock** was swift and immediate credit rating and market pricing adjustments to take into account heightened credit and liquidity risk. We believe the **credit response to the nascent signs of economic recovery** requires a disciplined adherence to our investment philosophy of considered evaluation of through-the-cycle credit quality and selectively raising our exposure to credit assets at the right price.

We are active managers and continue to be selective in adding credit assets to funds managed on behalf of clients. We have heightened our focus on identifying counterparties within sectors that are well-positioned to benefit from the recovery.

Our approach to position sizing and exposure management has been enhanced to consider appropriate medium- to long-term exposure targets for certain sectors. We are actively using tools available to us (concentrated exposure management, maturity management and, to a lesser extent, secondary market trading) to right-size exposures to funds based on our assessment of through-the-cycle credit quality.

Difficult economic cycles call for more, rather than less, diversification. A key focus area for the team is actively expanding our credit coverage universe to ensure that we can identify diverse counterparties that pass our credit quality screening, whether on financial or non-financial (including Environmental, Social and Governance) risks.

Whenever we participate in primary credit auction markets, we bid where we see value, and as a result may not receive our full demand. We are comfortable with this outcome, as it demonstrates consistency with our internal credit process.

PERFORMANCE AT A GLANCE

MARKET INDICATORS

For the period ending May 2021

Index	1 Year Return (%)	3 Years* Return (%)	5 Years* Return (%)	10 Years * Return (%)
SA markets				
SWIX (J403T)	35,44	6,96	5,66	10,53
All share (J203T)	38,11	9,98	7,98	10,97
Top 40 (J200T)	36,12	10,79	8,33	11,01
Resource 10	49,26	24,60	21,07	5,70
Financial 15	41,34	-2,42	2,24	9,52
Property (J253T)	37,69	-12,40	-9,28	3,97
All bond index (ALBI)	11,11	8,42	9,79	8,43
Cash (STeFI)	4,15	6,14	6,69	6,28
Inflation (CPI)	4,43	3,92	4,32	5,03
Offshore markets (ZAR)				
MSCI AC World	9,95	18,11	11,75	18,94
MSCI ACWI	10,88	17,53	11,67	18,12
Barclays Global Aggregate	-18,70	7,20	0,33	9,54
Global Property**	6,20	10,19	2,44	14,08

Source: Morningstar, STANLIB Fund Research
** annualised*
*** FTSE EPRA Nareit Developed Rental Index*

PERFORMANCE AT A GLANCE

CORE FUND PERFORMANCE

For the period ending May 2021

		1 Year		3 Years		5 Years		10 Years		Highest or lowest annual returns over the last 10 years (%)	
	Fund	Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Highest	Lowest
INCOME	STANLIB Income Fund	5,95	2	7,22	2	7,88	1	7,30	2	9,63	4,85
	STANLIB Flexible Income Fund	9,37	1	7,59	2	7,58	2	7,43	2	11,86	1,84
STABLE GROWTH	STANLIB Balanced Cautious Fund	13,05	2	9,08	1	6,20	2	8,43	2	21,03	-1,31
	STANLIB Absolute Plus Fund	14,40	3	7,58	2	6,39	1	8,14	2	19,64	-3,86
GROWTH	STANLIB Balanced Fund	18,24	3	8,82	2	5,34	3	9,17	2	29,84	-7,46
	STANLIB Equity Fund	22,53	4	7,73	2	4,07	3	10,05	1	37,74	-12,78
	STANLIB Property Income Fund	31,89	4	-11,51	3	-8,17	4	4,20	3	46,75	-51,80
OFFSHORE (ZAR)	STANLIB Global Equity Fund	6,19	4	18,32	1	11,55	1	16,13	2	56,44	-12,62
	STANLIB Global Balanced Fund	-1,62	4	13,92	1	7,20	1	13,66	1	37,05	-12,93
	STANLIB Global Property Fund	-2,69	4	7,04	4	-0,28	4	11,81	1	43,48	-19,27

Source: Morningstar

DISCLAIMER

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Portfolio performance figures are calculated for the relevant class of the portfolio, for a lump sum investment, on a NAV-NAV basis, with income reinvested on the ex-dividend date. Individual investor performance may differ due to initial fees, actual investment date, date of reinvestment of income and dividend withholding tax. Portfolio performance accounts for all costs that contribute to the calculation of the cost ratios quoted so all returns quoted are after these costs have been accounted for. Any forecasts or commentary included in this document are not guaranteed to occur. Annualised return figures are the compound annualised growth rate (CAGR) calculated from the cumulative return for the period being measured. These annualised returns provide an indication of the annual return achieved over the period had an investment been held for the entire period. A portfolio that derives its income primarily from interest-bearing instruments calculates its yield daily and is a current effective yield.

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