

**FUTUREGROWTH**

/ ASSET MANAGEMENT



## **Monthly Review**

May 2017

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1996/018222/07

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# Market review

## Economic and market review

<p><b>Offshore investors still reaching for yield</b></p>	<p>Rand and bond bulls had the upper hand in May. With the US dollar on the back foot, emerging market currencies like the rand gained ground. Rand strength and the global reach for yield, also referred to as the carry trade, lent a helping hand to the local bond market. Net non-resident bond purchases now total around R45bn for the first five months of 2017. This is a large number and to add perspective: this would cover a third of the portion of the 2017/18 fiscal year's expected funding requirement which is to be financed via the issue of nominal bonds.</p>
<p><b>SARB on hold</b></p>	<p>Other positive sentiment drivers included falling US Treasury bond yields and better than expected local inflation data. The South African Reserve Bank's monetary policy committee's decision to leave the repo rate unchanged at its most recent meeting had little market impact as the outcome was widely anticipated.</p>
<p><b>Nominal bond return tops for the month</b></p>	<p>The drift of bond yields to lower levels resulted in an All Bond Index return of 1% for the month of May; well above the cash return of 0.6%. However, it should be noted that most of the ALBI return was sourced from the 3-12 year area of the curve, with the long end only contributing 0.9% despite strong foreign buying.</p>
<p><b>Poor run of inflation-linked bonds continue</b></p>	<p>Meanwhile, the inflation-linked bond market's re-pricing gained momentum on the back of lower inflation. Reduced demand for inflation protection and the ongoing weekly addition to the pool of inflation-linked bonds as part of the financing of the national budget deficit continue to push real yields higher. As bond yields rise, prices drop. This resulted in a -0.1% monthly return of the IGOV Index. In an environment of lower inflation and rising concern about a possible future higher national government financing requirement, the relative poor performance of this asset class makes perfect sense.</p>

## Market summary

### Key macroeconomic themes

<p><b>Economic growth</b></p>	<p>A mild, uneven global economic recovery remains our base case, with a relatively strong US economy still leading the way. The Trump presidential victory (together with a House and Senate Republican majority) boosted speculation that higher US fiscal spending will benefit the US growth trajectory. This remains to be seen and for now the risk is that markets may have to face disappointment with respect to both the timing and size of the much anticipated stimulus. We believe that the global recovery will be structurally lower than in previous cycles, mainly due to lower productivity growth, ongoing broad-based balance sheet repair (deleveraging) and shifting demographics (older populations tend to save more and spend less).</p> <p>Most emerging market economies are caught between an improved, but still mixed outlook for the developed world, the implication of structurally lower Chinese economic growth on commodity demand and the US Federal Reserve's well telegraphed intent to normalise monetary policy. Therefore, commodity producers with external imbalances, such as SA, remain vulnerable.</p>
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### Key macroeconomic themes continues

#### Economic growth continues

Locally, the biggest impediment to higher local growth remains of a more structural nature. The current technical recession South Africa finds itself in bears testament to the broad-based structural weakness we've seen over the past few quarters. Absent of urgent macroeconomic policy reform, any short term cyclical upswing from the primary and secondary sectors of the economy will prove inadequate in addressing South Africa's economic growth ills.

#### Inflation

The strong rise in energy and other raw material prices in the last few months has started showing in headline inflation numbers in many economies. Although reflation is welcomed with open arms, since this is what policy makers had aimed to achieve, the feed-through to underlying inflation is still not entirely convincing. Final demand is simply not yet strong enough.

Locally, the expected drop in food inflation and the stronger rand in the last few months has forced down our 2017 annual average inflation forecast to 5.6%. Recent rand weakness in response to the cabinet reshuffle and S&P's sovereign credit ratings downgrade do not yet pose a threat as a weaker rand assumption has been accounted for in our consumer price inflation forecasts.

#### Balance of payments

Significant rand depreciation until a few months ago, an improved terms of trade position and a pick-up in global economic activity are lending relief to the balance of payments position. As a result, we expect a narrowing of the current account deficit from an annual average of 3.3% in 2016 to 3.0% in 2017, followed by marginal widening to 3.5% in 2018. The surprisingly small deficit for the fourth quarter of 2016 is not sustainable. Our terms of trade are expected to weaken from current levels, while the unfavourable income account deficit (primarily comprised of net dividend and interest payments to foreigners), remains a significant drag on a sustained and meaningful balance of payments correction. A stronger currency may also limit a significant further narrowing of the current account deficit over the medium term.

#### Monetary policy

Having finally started the long awaited and well telegraphed monetary policy normalisation process, we agree with the Federal Reserve's intent to follow a slow and gradual process. With an unemployment rate seemingly stuck below 5%, slowly-rising wages and the more stable PCE core inflation rate now hovering at 1.6%, we believe that the Federal Reserve should continue with its interest rate normalisation process, but for obvious reasons at an appropriate pace. The recent pick-up in market chatter about the imminent shrinking of the Federal Reserve's large balance sheet (the largest since the Second World War following its response in the aftermath of the 2008 financial crisis) is premature to our minds. We have also taken the view that the Fed, when they commence with the process, will conduct this in an interest rate neutral manner.

The current trend of global monetary policy divergence is expected to continue over the next year or so. With more policy tightening in the US on the cards, the European Central Bank and Bank of Japan will retain their respective quantitative easing and negative interest rate policy programmes, with some tweaks. At the same time, some of the smaller advanced and commodity-driven economies may be forced to ease policy, mainly due to below-trend economic growth and a modest inflation backdrop. On the positive side, monetary policy divergence will act to soften the impact of higher US rates on global growth.

## Key macroeconomic themes *continued*

### Monetary policy

In the case of SA, we feel comfortable with the prospects of the South African Reserve Bank (SARB) being at the peak of the interest rate tightening cycle. A cautious monetary policy approach is supported by the weak economic growth backdrop, low levels of credit extension growth and limited evidence of demand-led inflation. However, considering the size of the balance of payments deficit (albeit improving) and the stickiness of inflation (still in the upper end of the target range), we deem a neutral policy stance (thus no cuts) as the most appropriate course for monetary policy right now. Recent market turmoil should also add to the list of reasons for the central bank to remain cautious about reducing the repo rate.

## Investment view and strategy

With the exception of the US, and more encouraging signs of some improvement in other G10 countries, the global growth recovery remains fragile. This sets the scene for a modest rise in inflation as well as continued monetary policy divergence. It also implies a steady tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should limit significant upside to global bond yields. Nonetheless, we are of the view that the US Treasury market is now underestimating the extent of monetary policy tightening by the Federal Reserve, leaving investors vulnerable to fast rising bond yields from current low levels. We remain of the view that the US 10-year Treasury bond yield should be closer to 3% as opposed to the current 2.2%.

Locally, the downward trend to inflation is entrenched, supported mostly by significantly lower food price increases. While the South African Reserve Bank has adopted a neutral bias, it is unlikely that they would consider interest rate cuts soon. The external imbalance, albeit improving, is still too big to allow for a lower real repo rate. Unpredictable currency swings also continue to pose a risk to the more benign inflation outlook.

Although the newly appointed Minister of Finance is doing his best to downplay risks to the previously carefully managed fiscal consolidation, it would take far more than a political undertaking to convince us that all is indeed well. While acknowledging the expected lift in economic growth this year, this is cyclical and in turn largely due to the agricultural sector recovery from a very low base. We remain particularly concerned about the inability to lift the underlying economic growth rate to the much higher levels required. Persistent sub-trend economic growth and macro policy uncertainty have negative implications for fiscal consolidation and eventually sovereign credit ratings.

Negative ratings momentum in the medium to longer term caused mainly by sustained sub-trend economic growth as well as uncertainty about the fiscal outlook does not match the continued aggressive accumulation of local currency bonds by foreign investors. This mismatch continues to present a potential lethal mix for the local bond market. Considering this, we shall continue to approach the market with extreme caution.

Our broad interest rate investment strategy for a core bond fund benchmarked against the ALBI is as follows:

- Modified duration - Underweight (70% of maximum allowable range)
- Cash - Overweight
- Nominal bonds (1-3 years) - Underweight
- Nominal bonds (3-7 years) - Overweight
- Nominal bonds (7-12 years) - Underweight
- Nominal bonds (12+ year) - Underweight
- Inflation-linked bonds - Zero holding

## Key economic indicators and forecasts (annual averages)

	2013	2014	2015	2016	2017	2018
Global GDP	2.6%	2.8%	2.9%	2.5%	3.0%	2.8%
USA	1.9%	2.4%	2.4%	1.6%	2.1%	1.8%
Euro area	-0.4%	0.9%	1.5%	1.7%	2.1%	1.7%
Japan	1.6%	-0.1%	0.5%	1.0%	1.7%	0.7%
China	7.7%	7.4%	6.9%	6.7%	6.6%	6.2%
SA GDP	2.2%	1.5%	1.3%	0.5%	1.5%	2.0%
SA Headline CPI	5.8%	6.1%	4.6%	6.3%	5.6%	5.5%
SA Current Account (% of GDP)	-5.8%	-5.4%	-4.4%	-3.3%	-3.0%	-3.5%

Source: Old Mutual Investment Group

Produced by



**Wikus Furstenberg**  
Portfolio Manager &  
Head: Interest Rate Process

## Product information and performance

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
<b>MONEY MARKET</b>											
Call Money Market	Average Call rate of four largest SA banks	Aims to provide maximum return on overnight cash investments.	Nazley Bardien	January 2000	Product Benchmark Outperformance	7.29% 6.91% 0.38%	6.45% 6.03% 0.42%	5.89% 5.45% 0.44%	5.81% 5.35% 0.46%	6.98% 6.50% 0.48%	7.08% 6.61% 0.47%
Core Money Market	STeFI 3-month Index	Targets high cash returns through a carefully balanced and actively managed mix of short-term interest-bearing investments. The weighted average duration for the Composite may not exceed 120 days.	Michael van Rensburg	July 2004	Product Benchmark Outperformance	8.45% 7.24% 1.21%	7.46% 6.52% 0.94%	6.78% 5.97% 0.81%	6.64% 5.90% 0.74%	7.82% 7.01% 0.81%	7.86% 7.13% 0.73%
180 day Enhanced Money Market	STeFI Composite Index	Targets high cash returns through a carefully balanced and actively managed mix of short- and medium-term interest-bearing investments with maturities ranging from 180 days to 2 years.	Michael van Rensburg	July 2004	Product Benchmark Outperformance	8.82% 7.62% 1.20%	7.75% 6.87% 0.88%	7.01% 6.26% 0.75%	6.88% 6.11% 0.77%	8.03% 7.16% 0.87%	8.09% 7.25% 0.84%
<b>STeFI PLUS</b>											
Yield Enhanced A STeFI+ Short Term	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of A-. Weighted average term to maturity less than 365 days.	Daphne Botha	October 2002	Product Benchmark Outperformance	8.99% 7.62% 1.37%	7.96% 6.87% 1.09%	7.78% 6.26% 1.52%	7.73% 6.18% 1.55%	8.66% 7.27% 1.39%	8.97% 7.79% 1.18%
Yield Enhanced A STeFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of A based on official ratings. Weighted average term to maturity less than five years.	Daphne Botha	January 2010	Product Benchmark Outperformance	10.22% 7.62% 2.60%	9.04% 6.87% 2.17%	8.70% 6.26% 2.44%	8.58% 6.18% 2.40%		8.65% 6.24% 2.41%
Yield Enhanced BBB STeFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB.	Daphne Botha	February 2010	Product Benchmark Outperformance	10.88% 7.62% 3.26%	10.75% 6.87% 3.88%	10.25% 6.26% 3.99%	10.22% 6.18% 4.04%		10.14% 6.23% 3.91%

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
<b>STEFI PLUS CONT.</b>											
Yield Enhanced BB SteFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BB.	Daphne Botha	January 2012	Product Benchmark Outperformance	9.15% 7.62% 1.53%	12.05% 6.87% 5.18%	11.51% 6.26% 5.25%			11.74% 6.21% 5.53%
Yield Enhanced Geared BB SteFI+	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement, as well as equity risk. The Composite's weighted average rated credit quality must be a minimum of BB-.	Daphne Botha	January 2008	Product Benchmark Outperformance	9.81% 7.62% 2.19%	12.20% 6.87% 5.33%	11.30% 6.26% 5.04%	11.62% 6.18% 5.44%		11.84% 7.11% 4.73%
Power Debt	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB. Investments in this product are limited to listed and unlisted assets in the power sector and supporting industries.	Paul Semple	May 2014	Product Benchmark Outperformance	11.82% 7.62% 4.20%	11.41% 6.87% 4.54%				11.49% 6.85% 4.64%
<b>INCOME</b>											
Core Income	50% SteFI Call Deposit Index; 50% 3-7 Years All Bond Index	Aims to deliver excess return by investing in money market and bond assets with a focus on yield enhancement while limiting interest rate risk to a maximum average duration of two years.	Wikus Furstenberg	November 2002	Product Benchmark Outperformance	10.20% 10.52% -0.32%	7.82% 7.82% 0.00%	6.96% 6.52% 0.44%	7.17% 6.70% 0.47%	8.14% 7.50% 0.64%	8.60% 8.02% 0.58%
Flexible Income	110% SteFI Call Index	Aims to deliver excess return by investing in money market, bonds, preference shares and listed property and taking advantage of yield enhancement and capital growth opportunities. The composite is not limited by duration constraints.	Wikus Furstenberg	July 2006	Product Benchmark Outperformance	9.81% 7.68% 2.13%	7.57% 6.91% 0.66%	7.58% 6.31% 1.27%	7.91% 6.37% 1.54%	8.74% 7.27% 1.47%	8.96% 7.30% 1.66%
Yield Enhanced Income	20% All Bond Index; 80% SteFI Composite Index	Aims to deliver excess returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted assets. Interest rate risk is constrained.	Wikus Furstenberg	May 2012	Product Benchmark Outperformance	10.17% 8.77% 1.40%	8.76% 7.11% 1.65%	8.63% 6.56% 2.07%			8.59% 6.53% 2.06%



Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
<b>INTEREST RATE ASSET ALLOCATION</b>											
Interest Rate Asset Allocation	ALBI (62.5%); JSE ILB IGOV Index (30%); STEFI Call Deposit Index (7.5%)	Aims to deliver excess return mainly through a combination of aggressive asset allocation within the various interest-bearing asset classes.	Wikus Furstenberg	July 2010	Product Benchmark Outperformance	10.11% 9.36% 0.75%	7.66% 6.91% 0.75%	8.70% 7.42% 1.28%			9.50% 8.45% 1.05%
<b>INFLATION-LINKED BONDS</b>											
Passive ILB Index	Barclays Capital/ Absa SAGILB	Aims to match the returns of the benchmark through passive interest rate and yield curve management.	Nazley Bardien	September 2005	Product Benchmark Outperformance	1.86% 1.87% -0.01%	5.00% 5.01% -0.01%	7.38% 7.42% -0.04%	8.53% 8.65% -0.12%	9.17% 9.24% -0.07%	9.29% 9.37% -0.08%
Core ILB	JSE ILB IGOV Index	Aims to deliver excess return through active interest rate risk management and limited yield enhancement.	Wikus Furstenberg	November 2005	Product Benchmark Outperformance	2.31% 1.91% 0.40%	5.19% 4.99% 0.20%	7.64% 7.41% 0.23%	9.00% 8.65% 0.35%	9.55% 9.24% 0.31%	9.46% 9.17% 0.29%
Yield Enhanced Long Duration ILB	Barclays SAGILB 15+ Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets.	Mei-Chi Liou	June 2011	Product Benchmark Outperformance	1.40% -0.71% 2.11%	6.56% 4.27% 2.29%	10.12% 7.77% 2.35%			10.31% 8.24% 2.07%
Power Inflation-linked***	RSA Inflation Linked Government Bond I2038 Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets in the power sector and supporting industries.	Mei-Chi Liou	January 2014	Product Benchmark Outperformance	3.88% 0.27% 3.61%	7.50% 4.43% 3.07%				8.31% 5.72% 2.59%
Infrastructure & Development ILB	Barclays BESA SAGILB 15+	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Mei-Chi Liou	Pending	Product Benchmark Outperformance	N/A					
<b>NOMINAL BONDS</b>											
Passive All Bond	All Bond Index	Aims to match the returns of the benchmark through passive interest rate and yield curve management.	Nazley Bardien	June 2000	Product Benchmark Outperformance	13.38% 13.35% 0.03%	7.80% 7.80% 0.00%	7.53% 7.52% 0.01%	8.56% 8.57% -0.01%	8.29% 8.28% 0.01%	10.83% 10.81% 0.02%
Core Bond	All Bond Index	Aims to deliver excess return through a combination of interest-bearing asset allocation, active duration management and yield enhancement.	Daphne Botha/ Wikus Furstenberg	January 2000	Product Benchmark Outperformance	13.82% 13.35% 0.47%	8.14% 7.80% 0.34%	8.27% 7.52% 0.75%	9.26% 8.57% 0.69%	9.02% 8.28% 0.74%	11.29% 10.69% 0.60%

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
<b>NOMINAL BONDS cont.</b>											
Long Duration Bond	All Bond Index 12+ Years	Aims to deliver excess return through active allocation between long-dated fixed rate and inflation-linked bonds, limited yield curve selection, duration management and yield enhancement.	Wikus Furstenberg	December 2006	Product Benchmark Outperformance	13.01% 13.89% -0.88%	7.29% 7.75% -0.46%	7.68% 7.94% -0.26%	8.51% 8.69% -0.18%	7.85% 7.54% 0.31%	7.75% 7.48% 0.27%
Yield Enhanced Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted assets.	Jason Lightfoot	December 2001	Product Benchmark Outperformance	14.46% 13.35% 1.11%	9.93% 7.80% 2.13%	9.99% 7.52% 2.47%	11.15% 8.57% 2.58%	10.67% 8.28% 2.39%	11.20% 9.28% 1.92%
Infrastructure & Development Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Jason Lightfoot	January 1995	Product Benchmark Outperformance	14.09% 13.35% 0.74%	9.74% 7.80% 1.94%	9.95% 7.52% 2.43%	11.17% 8.57% 2.60%	10.76% 8.28% 2.48%	12.62% 10.69% 1.93%
<b>SOCIALLY RESPONSIBLE INVESTMENTS</b>											
Infrastructure & Development Bond	All Bond Index	Targets high cash returns through a combination of active interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Jason Lightfoot	January 1995	Product Benchmark Outperformance	14.09% 13.35% 0.74%	9.74% 7.80% 1.94%	9.95% 7.52% 2.43%	11.17% 8.57% 2.60%	10.76% 8.28% 2.48%	12.62% 10.69% 1.93%
Development Equity	Consumer Price Index (CPI) + 10%	Targeting high returns by investing in equity and related assets that are socially responsible or developmental.	James Howard	September 2006	Product Benchmark	2.24% 15.36% -13.12%	12.84% 15.36% -2.52%	12.02% 15.62% -3.60%	12.14% 15.51% -3.37%	12.68% 16.27% -3.59%	16.77% 16.27% 0.50%
Community Property	Consumer Price Index (CPI) + 4%	A portfolio specialising in the finance and development of retail shopping centres catering to the needs of under-served communities throughout South Africa.	Smital Rambhai	June 1996	Product Benchmark	24.30% 9.36% 14.94%	17.06% 9.36% 7.70%	14.44% 9.61% 4.83%	12.55% 9.50% 3.05%	13.11% 10.26% 2.85%	13.78% 9.90% 3.88%
Agri	Consumer Price Index (CPI) + 10%	A portfolio specialising in equity investments in agricultural land, agribusinesses and farming infrastructure.	Smital Rambhai (Product Manager)	March 2010	Product Benchmark	N/A					

Product	Benchmark	Description	Portfolio manager	Inception date	Investment returns	1 Year	3 Years*	5 Years*	7 Years*	10 Years*	Since inception*
<b>SOCIALLY RESPONSIBLE INVESTMENTS cont.</b>											
Development Balanced**	A composite weighting of the underlying funds' benchmarks.	A balanced portfolio providing investors with social impact from a targeted and development perspective and exposure to listed equities that track the JSE's SRI Index.	James Howard	November 2004	Product Benchmark Outperformance	8.96% 6.14% 2.82%	6.48% 4.77% 1.71%	10.79% 9.11% 1.68%	10.93% 9.56% 1.37%	9.20% 8.20% 1.00%	12.89% 11.99% 0.90%
Power Debt	STeFI Composite Index	Targets high cash returns through active interest rate risk management and yield enhancement. The Composite's weighted average rated credit quality must be a minimum of BBB. Investments in this product are limited to listed and unlisted assets in the power sector and supporting industries.	Paul Semple	May 2014	Product Benchmark Outperformance	11.82% 7.62% 4.20%	11.41% 6.87% 4.54%				11.49% 6.85% 4.64%
Power Inflation-linked bond***	RSA Inflation Linked Government Bond I2038 Total Return Index	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted assets in the power sector and supporting industries.	Mei-Chi Liou	January 2014	Product Benchmark Outperformance	3.88% 0.27% 3.61%	7.50% 4.43% 3.07%				8.31% 5.72% 2.59%
Infrastructure & Development Inflation-linked bond	Barclays BESA SAGILB 15+	Targets high cash returns through a combination of active, real and nominal interest rate risk management and yield enhancement by investing in listed and unlisted socially responsible and developmental assets.	Mei-Chi Liou	Pending	Product Benchmark Outperformance	N/A					

Currency: ZAR/Gross of fees

\*Annualised

\*\*Currently investors are Futuregrowth staff who may elect to invest through their retirement funds.

\*\*\*Portfolio returns. Supplemental information.

# FUTUREGROWTH

/ ASSET MANAGEMENT

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