

FUTUREGROWTH

/ ASSET MANAGEMENT



Monthly Review

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The Futuregrowth story: Past and future

A vision unfolding

In the wake of South Africa's democratic transition, Futuregrowth was founded in 1994, with a small suite of investment funds focused on social development and empowerment, and with the vision of creating a sustainable channel for pension funds to invest in disadvantaged communities and national development.

Fast forward more than 20 years: Today, Futuregrowth manages around R185 billion (+/- US\$13 billion) of clients' assets, across the full range of fixed interest and development funds, and plays a leadership role in the asset management industry in South Africa. During this time we have not wavered from our purpose: to protect and grow investors' savings through skill and diligence, while being a force for good in the markets and environment in which we operate.

This sense of purpose is based on our belief that investors can make a positive difference in society while earning sound investment performance for pension fund members. That has inspired us to pioneer development funds in sectors such as infrastructure, rural and township retail property, agriculture and renewable energy, providing finance to innovative deals including low-income housing construction, a church in Soweto, urban regeneration projects, taxi finance, and alternative energy, to name a few.

As a responsible investor we engage with our industry and investee companies privately, and sometimes publicly, on sustainability issues. As examples: We have been working steadfastly to improve South Africa's debt capital market standards. In 2013, we identified unfair, unsustainable and prejudicial practices within the consumer lending industry. We chose to stop lending to such businesses in our developmental funds and publicly called for industry reform. And in 2016, we announced that we could no longer in good conscience invest pension fund members' assets in certain State Owned Enterprises (SOEs) until we had concluded detailed governance reviews.

The original concept of Futuregrowth is still alive and thriving in the Futuregrowth of today. Even though the company has developed into a successful asset management business, the philosophical belief on which the business was founded back in 1994 is still at the core of everything we do.

Market review

Economic and market overview

Market flip-flop... so what's new?

The fleeting nature of market sentiment never fails to amaze us. A few short weeks ago, global markets were trading as if the end was nigh. But that changed at the drop of the proverbial hat with the arrival of the New Year. Admittedly, the carnage of the fourth quarter was followed by significantly improved valuations across many asset classes, which played an important role in luring hesitant bulls back into the ring. Nonetheless, it's hard not to roll one's eyes over some of the more subjective catalysts of the latest swing in sentiment - most notably "hope" of a lasting resolution between the US and China.

Let's take a look at some of these sentiment shifters in more detail.

Catalyst one: The role the US Federal Reserve has played in the current trade stand-off. Guidance provided by the world's leading central bank changed significantly in a short space of time, from expecting more policy tightening as recently as December to a considerably more dovish rhetoric at the January policy rate-setting meeting. There, it omitted "some further gradual increases". This change in statement prompted the US interest rate forward market to price policy rate cuts for later this year, causing a notable diversion from the December Fed Dot Plot. To us this seems an unlikely outcome, as we're expecting a US growth slowdown, as opposed to a more broad-based collapse.

Catalyst two: Rising hopes of a lasting ease in the US/China trade rift. Sadly, stability on the international trade front cannot be guaranteed for as long as a populist remains in the White House.

Demand for South African assets

A significant improvement in global investor sentiment fed through to global bond markets and the majority of emerging market currencies. Closest to the action was the US Treasury market, where the US's 10-year Treasury bond yield declined sharply, from 3.25% in October last year to 2.63% at the end of January, in response to fears of a US hard landing.

The significant appreciation of emerging market currencies joined hands with a broad-based bond bull rally. In South Africa, the rand recorded significant gains. At the end of January, the rand-dollar exchange rate of R13.3 was a far cry from last year's weakest level of R15.4. This strong currency performance was partly driven by net foreign portfolio inflows, most notably net purchases

of SA government bonds, to the value of R10.5bn. The more than 40% drop in crude oil prices during the last quarter of last year finally filtered into local data releases. On the inflation front, both the Consumer and Production Price indices for the month of December recorded a sharp deceleration in the year-on-year rate of increase. In the case of CPI, the December reading was an impressive 4.5%. The December PPI reading showed a very sharp drop, from 6.8% to 5.2%. In both cases, the sharp year-on-year deceleration in the rate of increase mainly resulted from sharply lower petroleum prices. The impact of the earlier crude oil collapse also found its way into the external trade account for December, when the biggest trade account surplus (R17.2bn) since May 2016 was recorded. This big positive surprise came predominantly on the back of significant import compression, as opposed to export strength, with the sharp drop in mineral imports, mostly crude oil, making a notable contribution. The above-mentioned developments allowed the South African Reserve Bank some leeway and it aptly opted to leave the repo rate unchanged at its recent policy meeting.

Our very own albatross

The news on the fiscal front was at best neutral, at worst disappointing. With Eskom around our necks, as well as many smaller state-owned corporates breathing heavily down the collar of National Treasury (read: the tax payer), a tighter budget deficit becomes even more desirable than ever.

Unfortunately, monthly government finance data for December - which is normally a significant month for revenue collections - failed to ease concern over the possibility of engineering significant fiscal consolidation. The surplus of R13bn fell short of the preceding five-year average of R25bn by a substantial margin.

On the revenue side, both personal income and corporate income tax receipts continued to disappoint, relative to the revised October budget estimates: under collection of the latter was more stark than the former. Fortunately, the negative impact on the consolidated budget was mostly offset by improved VAT receipts. But the low growth environment that we continue to experience suggests revenue growth will continue to stutter.

Government expenditure has been lagging the budget for the period April to December, with FYTD year-on-year departmental expenditure growth being 2.5%, in comparison to a budgeted growth of 6.0%.

In short, the latest fiscal data failed to materially sway any positive momentum created by improved market sentiment. Considering these developments, the path of least resistance came in the form of sharply declining local bonds. With the short end of the yield curve anchored by stable monetary policy, the yield curve flattened in a significant way. The yield of the benchmark government bond (R186, maturity 2026) closed at 8.58%, a drop of 30 basis points from the previous month.

This bull rally was not limited to nominal bonds. Following a horrific 2018, demand for inflation-linked bonds at the higher real yields exceeded supply, despite a particularly benign inflation outlook. Under

normal circumstances, this would dampen demand for inflation protection. The yield of the benchmark R197 (maturity 2023) declined to a level of 2.85% at month end: significantly lower than the weakest level of 3.05% recorded in November of last year. From a total index return perspective, the JSE ASSA All Bond Index returned a very strong 2.9%, followed by a decent 1.7% by the JSE ASSA Government Inflation-linked Index (IGOV). Both nominal and inflation-linked bond indices outperformed the cash return of 0.6% by a significant margin.

Market summary

Key macroeconomic themes

Economic growth

The global economic recovery we've seen over the last few years started losing momentum in the latter half of 2018, with fears of recession significantly impacting investor sentiment. We still don't foresee a broad-based collapse, partly due to late-cycle fiscal expansion in global growth engines like the US and China. Central banks remain sensitive to growth signals - especially in light of sustained low inflationary pressures in developed markets in particular. That said, the risk to our base case is skewed to the downside by two notable potential catalysts, namely a sustained weak euro area growth and continued global trade friction as a result of intensifying protectionism.

Locally, the biggest impediment to higher growth remains structural. The low growth trap is largely due to policy uncertainty; weak policy implementation; low levels of fixed capital investment and a rigid labour market.

While acknowledging the positive steps towards improved governance, marked by the reconfiguration of the boards of Eskom and Transnet and the finalisation of the mining charter, the perilous state of most of South Africa's state-owned enterprises remains a negative risk to the fiscus and, as a consequence, to domestic economic growth.

For now, a failed economic recovery continues to be the biggest threat to our current investment theme. Should it culminate in a global growth slowdown, the local growth outlook will be significantly affected.

Inflation

Slow rising global inflation over the course of the last few years has been the result of a combination of firmer total demand; tighter production capacity; higher commodity prices and rising employment costs, brought on primarily by accommodative monetary conditions.

But despite an environment of ultra-accommodating monetary conditions, none of the drivers has been strong enough to overshoot target levels. In light of the current moderation in global economic growth, we predict inflation will remain relatively benign in most cases.

Locally, the telegraphed drop in food inflation and a broadly neutral currency view has resulted in our 2019 annual average inflation forecast of 4.6%.

More importantly, there is strong evidence that the pass-through of rand weakness to inflation will remain exceptionally weak, reflecting weak economic growth and an inability on the part of producers and retailers to pass on price increases to the end consumer in a significant way.

Responsible Investing in 2019: Some Tipping Points... and Some Not

There are some meaningful changes in the world's thinking about responsible investing (RI). Read Andrew Canter's in-depth view of RI for 2019.

To read Andrew Canter's in-depth view of RI for 2019, visit:

www.futuregrowth.co.za/newsroom



Key macroeconomic themes continue

Inflation continue

This model continues to support the view that the near-term acceleration in the rate of inflation is expected to be relatively benign. The targeted inflation rate is expected to remain within the SARB's 3% to 6% target range - although still above the more desirable mid-point of 4.5%.

Balance of payments

We expect the negative current account balance widened to 3.5% of GDP last year, remaining at similar levels over the following two years. Even with the significant 125bn cumulative net foreign selling of rand-denominated bonds and equities in the 2018 calendar year, the unfavourable income account deficit (primarily due to the large net dividend and interest payments to foreigners) remains a considerable drag on a sustained and meaningful balance of payments correction.

An escalation in international trade tensions still represents the biggest risk to adversely impacting the balance of payments position, especially for a small open economy like South Africa and its strong Eurozone and Chinese trade links.

Monetary policy

With the unemployment rate in the US stuck around a historically low 4%, and growth moderation more likely than a recession, we believe that the Federal Reserve should not simply abandon its interest rate normalisation process. Instead, it should rather pause for appropriate periods of time bearing cognisance of the risks to US and global economic growth.

We therefore disagree with the current market view of a possible rate reduction by the US Federal Reserve this year.

The SARB is expected to maintain its more cautious stance, which we fully support.

The factors contributing to our stance include:

Pressure on the balance of payments; the fact that actual inflation is back above the mid-point of the target range (which the SARB has consistently telegraphed as the desired target point); inflation expectations remaining stubbornly close to the top end of the target band and waning support from a decade of ultra-loose global monetary policy.

This is all at least partly balanced by the fact that the central bank is not completely ignorant of how weak underlying economic activity remains. All in all, the risk to our stable repo rate outlook is still skewed to the upside, mostly due to embedded high inflation expectations. Despite this and, barring a significant financial crisis, a stable to weak monetary policy tightening cycle remains our base case.

Fiscal policy

Although fiscal year-to-date revenue performance up until the 2018 Medium Term Budget Policy Statement (MTBPS) proved to be resilient in guiding expectations of a positive result, the actual outcome was disappointing. National Treasury is still confronted by a very challenging fiscal path and continues to balance the need for fiscal consolidation and economic stimulus very carefully.

As we have previously highlighted, structurally weak domestic growth is primarily responsible for severely impeding the consolidation of SA's budget balance. Although likely positive in the longer term, SARS efforts to address legacy issues around Value Added Tax refunds have also notably contributed to the slowing down of fiscal consolidation. All eyes are now on the actual delivery of fiscal and wide-ranging state-owned enterprise reform, to reinvigorate consumer and business confidence.

Our investment view and strategy

At a global level, a weaker growth outlook has stalled the shift from quantitative easing to quantitative tightening. Even so, we are of the view that authorities are prepared to adjust relatively quickly, having already avoided a broad-based collapse in economic growth. This implies that global bond yields - more specifically the US Treasury market - may have already peaked. They may hover in a tight, slightly lower range in the near term as a result.

Locally, our main concern with the bond market remains the strong link between lacklustre economic growth and fiscal consolidation. This points to the state's rising debt burden, which arises from a lack of fiscal consolidation and therefore continues to threaten the country's sovereign risk profile, in addition to the pressure it places on domestic funding costs.

The risk of a failed economic recovery has certainly not dissipated. Even when accounting for the strong third quarter rebound in GDP of 2.2%, the underlying economy remains structurally weak. This makes us question the quality of tax revenue collections - and consequently the state of health of the tax base, which in turn keeps the risk of a budget deficit overrun at elevated levels.

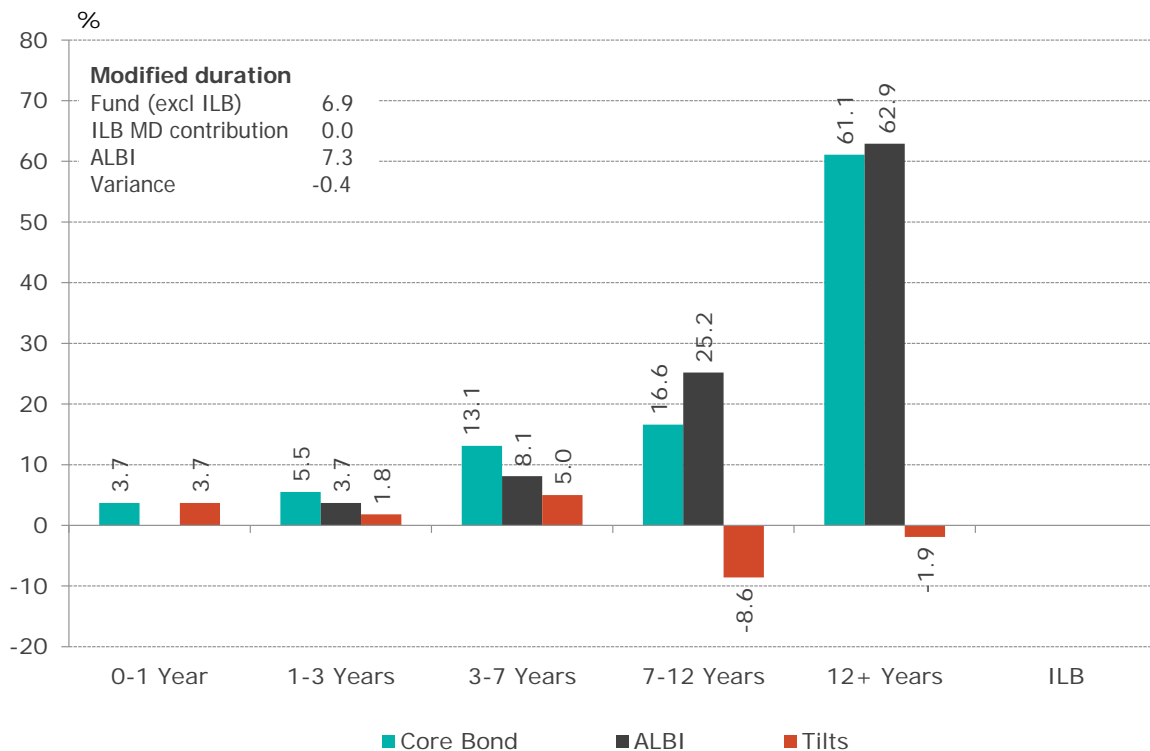
The financial burden on state finances of poorly managed state-owned enterprises has now reached a turning point: the delivery of a credible national budget is nearly impossible in the absence of solutions to remedy an unfolding financial disaster. The proverbial chickens, mainly in the form of Eskom,

are coming home to roost every time the lights go out - and this requires more than the usual liquidity provision. The issue of solvency must be addressed.

Following the repo rate increase in November, we maintain our view on the monetary policy front, that the central bank will remain hostage to the opposite forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of our strong disinflationary environment. For now, this suggests to us a stable policy path, combined with a central bank that will keep warning us of the threat of higher inflation outcomes.

The current underlying domestic disinflationary trend and its risk to the global growth outlook should not be ignored. On balance, the risk to a stable repo rate outlook is still skewed to the upside - our base case remains for stable rates for longer.

The bull rally we've been experiencing of late, combined with renewed concerns over the state of the fiscus, (after taking into account the very significant financial burden left by the SOEs), has convinced us to reduce risk into bouts of market strength. In doing that, we endeavour to strike a balance between avoiding capital loss (in the case of either a market sell-off or of losing out on the accrual offered by a steeply sloped yield curve). As a result, our broad interest rate investment strategy remains defensive. In the case of our Core Bond Composite (benchmarked against the All Bond Index), this is expressed below.



Key economic indicators and forecasts (annual averages)

	2015	2016	2017	2018	2019	2020
Global GDP	2.9%	2.5%	3.3%	3.2%	2.9%	2.7%
SA GDP	1.3%	0.3%	1.3%	0.8%	1.8%	2.5%
SA Headline CPI	4.6%	6.3%	5.3%	4.6%	4.6%	5.0%
SA Current Account (% of GDP)	-4.4%	-3.3%	-2.0%	-3.5%	-3.5%	-3.8%

Source: Old Mutual Investment Group

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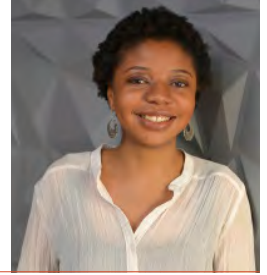
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