

FUTUREGROWTH

/ ASSET MANAGEMENT



Monthly Review

April 2019

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Market review

Economic and market overview

Global bond markets stabilised post the strong first quarter rally

In contrast to previous months, global data releases started surprising on the upside during April. Among the developed markets, this was most noticeable in the Euro Zone. In light of its relative importance, the extent of Chinese positive data surprises is particularly encouraging from a global perspective. The tentative signs of some growth acceleration, persistent low inflation and a neutral monetary policy stance among the majority of central banks were the main contributors to bringing about some stabilisation to global bond markets following the sharp drop in yields until recently. As a result, the US Treasury market entered a tight trading phase, pivoting around the 2.5% mark during the month of April.

Local data mixed, with the first signs of some inflationary pressure

Locally, the latest consumer inflation data release simply confirmed the relatively low inflation trajectory of the past few months. However, this was in contrast to price changes at the producer level where the recent strong increase in crude oil prices caused an uptick in the more volatile Coal and Petroleum Products category. Even though most other categories are still reflective of subdued price pressure, sustained rising oil prices and rand weakness are worth flagging as a potential short-term risk.

Fiscal slippage remains the key risk

National Treasury confirmed that the main budget deficit for the 2018/19 fiscal year was R14 billion wider than projected in the February Budget. The slippage was primarily due to tax revenue underperformance, which was mainly driven by Corporate Income Tax under-collection of -2.7%, which more than offset the lower-than-budgeted expenditure. Although this slippage is only about 0.3% of GDP, it nonetheless clearly illustrates the challenge with respect to fiscal consolidation and the strong link to sustained weak economic conditions, in addition to operational challenges.

Local nominal bond yields drifted slightly higher

The strong bond bull rally that had its origin in October last year finally lost momentum in April this year, with yields of medium- and longer- dated nominal bonds drifting slightly higher. The yield of the R186 (maturity 2026) closed the month 6 basis points higher at 8.54%. This can be tied to global bond market stability, some rand weakness, concern about the worsening fiscal situation and perhaps some pre-election jitters.

In contrast, real yield decreased sharply

This was in stark contrast to market movements in the inflation-linked bond market. A combination of a significant valuation correction that lasted for almost a year, improved inflation accrual, and expectations of some acceleration in the rate of inflation in the medium term created excess demand for the asset class. As a result, real yields declined across the yield curve, with the front end rallying more significantly.

Inflation-linked bonds take the podium

The inflation-linked bond bull rally propelled the Johannesburg Stock Exchange (JSE) Inflation-linked Government Bond Index (IGOV) into first place for the month of April. The index's return of 3.4% exceeded the 0.7% and 0.5% rendered by the JSE All Bond Index (ALBI) and cash, respectively. The strong April performance also pushed the IGOV into a much stronger second position for the first four months of the year. For this period, the IGOV return of 3.9% is comparable to the 4.6% rendered by the ALBI, with cash in third position with a return of 2.2%.

Key macroeconomic theme

Economic growth

The global economic recovery of the last few years started losing momentum in the latter half of 2018, and recent fears of recession have impacted investor sentiment in a significant way. We still do not foresee a broad-based collapse, partly due to late-cycle fiscal expansion in global growth engines such as the US and China. Central banks also remain sensitive to growth signals, especially in light of sustained low inflationary pressures, particularly in developed markets. That said, the risk to our base case is skewed to the downside. The two notable potential catalysts to this downside risk are sustained weak Euro area growth and continued global trade friction, as a result of intensifying protectionism.

Locally, the biggest impediment to higher local growth remains of a structural nature. The low-growth trap is largely due to policy uncertainty, weak policy implementation, low levels of fixed capital investment and a rigid labour market. There have been positive steps towards improved governance, such as the reconfiguration of the Eskom and Transnet boards, the appointment of a new SARS commissioner and the finalisation of the mining charter. However, the perilous state of most state-owned enterprises (SOEs) remains a negative risk to the fiscus, and therefore to domestic economic growth. This includes the negative impact of the acute operational challenges at Eskom. For now, the risk of a failed economic recovery continues to be the biggest threat to our current investment theme. Should a global growth slowdown culminate, it will worsen the local growth outlook in a significant way.

Inflation

Slow rising global inflation over the past 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. However, despite an environment of ultra-accommodative monetary conditions, none of the drivers were strong enough to cause an overshoot of target levels. Considering the current moderation in global economic growth, our base case continues for inflation to remain relatively benign in most economies.

Locally, the telegraphed drop in food inflation, and a broadly neutral currency view, results in our 2019 annual average inflation forecast of 4.4%. More importantly, there is strong evidence that the pass-through of rand weakness to inflation remains exceptionally weak, reflective of the weak economic growth and the inability of producers and retailers to pass on price increases to the end consumer. This 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 should remain within the South African Reserve Bank (SARB)'s 3% to 6% range, although inflation expectations still remain above the more desirable mid-point of 4.5%.

Balance of payments

We expect the negative current account balance to have widened to 3.3% of GDP in 2019 and to have increased to 4% by 2021. 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 of international trade tensions still represents the biggest risk to the balance of payments position, especially for a small open economy like South Africa, with strong Eurozone and Chinese trade links.



Venture Capital – South Africa’s saviour in the waiting

Institutional investors, like Futuregrowth, are starting to play a bigger role in the Private Equity/Venture Capital ecosystem. Read a full write-up of how investors are making strategic investments into these types of deals.

Visit: www.futuregrowth.co.za/newsroom

Key macroeconomic themes continue

Monetary policy

With unemployment in the US anchored around a historically low 3.6%, and moderate growth still seen as more likely than a recession, we believe that the US Federal Reserve (Fed) should not simply abandon its interest rate normalisation process, but rather opt to 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 Fed this year.

The SARB is expected to maintain its more cautious stance, which we fully support. Factors contributing to this stance include sustained pressure on the balance of payments, the fact that inflation expectations remain above the mid-point of the target range, and the possibility that inflation has bottomed, for now. This is at least partly balanced by the fact that the central bank is not completely ignorant of persistently weak underlying economic activity. Barring a significant financial crisis, a stable to weak monetary policy tightening cycle remains our base case.

Fiscal policy

Our reading of the February budget would have been kinder if we were convinced that the extraordinary support to Eskom would be enough to negate the fiscal and economic risk the entity poses over the medium term. This seems to be where we differed from the market in our reading of the budget. While over-delivering in its support of Eskom, relative to prior market expectations, we are of the view that government support still falls short of what is required to keep Eskom solvent over the medium term.

The bottom line: without improved domestic growth, South Africa's debt burden looks increasingly unsustainable – particularly in light of the abandonment of two critical fiscal consolidation anchors, namely, the expenditure ceiling and deficit-neutral SOE funding.

Our investment view and strategy

At a global level, the shift from quantitative easing to tightening has stalled, and in some cases even reversed, due to fear of a global growth slowdown. Even so, we are of the view that authorities are prepared to adjust relatively quickly, and in some cases are already responding, to avoid a broad-based collapse in economic growth. This implies that global bond yields, and more specifically the US Treasury market, have already responded as if an easing cycle has commenced. Our view is somewhat different in the sense that although we agree with a global growth slowdown, the risk of a collapse is small enough to argue in favour of higher bond yields and steeper curves than current levels. However, given the level of uncertainty about the growth outlook, yields may be trapped at the lower levels for a while.

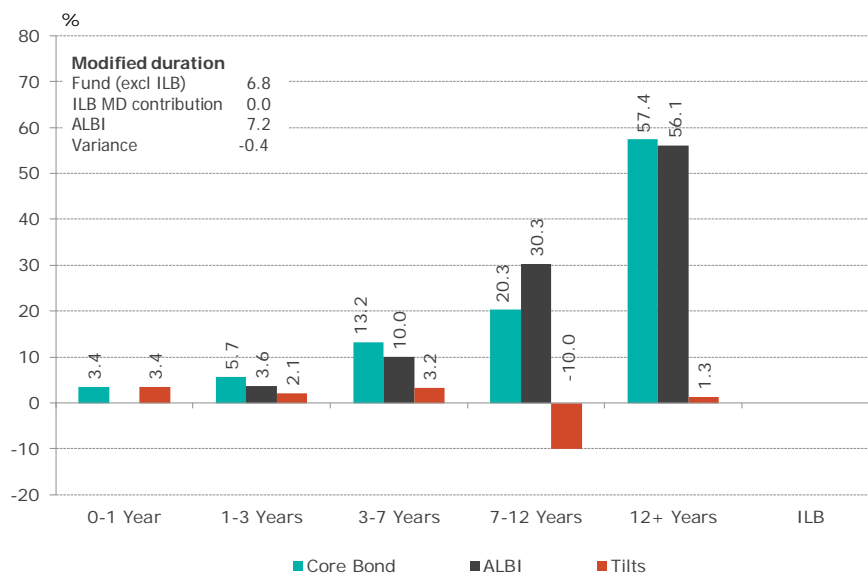
Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth and the lack of fiscal consolidation. More specifically, this points to the rising debt burden of the state, which arises as a consequence of the lack of fiscal consolidation. This continues to threaten the

country's sovereign risk profile and places pressure on domestic funding costs. The risk of a failed economic recovery has certainly not dissipated. Even when accounting for the strong second half rebound in 2018 GDP of 2.6%, and 1.4% in the third and fourth quarters respectively, the underlying economy remains structurally weak, with growth for the 2018 calendar year an uninspiring 0.8%. 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 of poorly managed SOEs on state finances has reached a point where the delivery of a credible national budget is near impossible in the absence of a substantial remedial action for the unfolding financial disaster. The proverbial chickens, mainly in the form of Eskom, have come home to roost and this requires more than the usual liquidity provision. Addressing solvency is an entirely different matter, requiring more than simply kicking the can down the road via more liquidity bail-outs.

On the monetary policy front, we maintain our view, following the Monetary Policy Committee's decision to keep the repo rate stable in February 2019, that the central bank will remain hostage to the opposing forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of the strong disinflationary environment. For now, this suggests a stable policy path combined with a central bank that will keep warning of their response function to the threat of higher inflation outcomes. The underlying domestic disinflationary trend and the risk to the global growth outlook should not be ignored. On balance, the risk to the stable repo rate outlook is still skewed to the upside, but our base case remains for a stable repo rate.

The bull rally of late, combined with renewed concerns about the fiscal state, convinced us to reduce risk into bouts of market strength. In doing that, we endeavoured to strike a balance between avoiding capital loss in the case of a market sell-off and losing out on the accrual offered by a steeply sloped yield curve. We have also considered the fact that nominal bonds are currently trading at an attractive real yield of around 4%. So, while our broad interest rate investment strategy remains defensive, the modified duration variance of -0.4 is still some way off the maximum allowed position of -1.0. This acknowledges reasonable valuation which partly offsets the poorer investment theme.

In the case of our Core Bond Composite (benchmarked against the All Bond Index), our view is expressed as follows:



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%	2.8%
SA GDP	1.3%	0.3%	1.3%	0.8%	1.5%	2.0%
SA Headline CPI	4.6%	6.3%	5.3%	4.6%	4.4%	4.7%
SA Current Account (% of GDP)	-4.4%	-3.3%	-2.0%	-3.5%	-3.3%	-3.5%

Source: Old Mutual Investment Group

Produced by the Interest Rate Team



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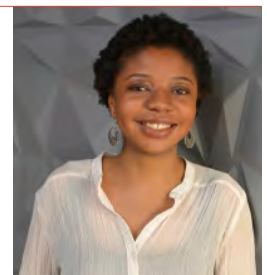
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The Futuregrowth story: Past and future

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.

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