

FUTUREGROWTH

/ ASSET MANAGEMENT



Monthly Review

May 2019

Cur Pr	Chg on Day	Pct Chg on Day	Chg Y
131.1281	-0.0121	+0.09%	+4
16.8885	-0.0497	+3.30%	+
104.0575	-0.0369	+2.26%	+2
10.0700	-0.0018	-1.16%	+1
100.124	-0.18	+1.16%	+7
111.1449	+0.0114	-1.11%	+1
1200.159	+1.69	+1.13%	+11
1076.95	-2.22	-0.21%	+8
152.95	-0.01	-0.11%	-
1478.00	+16.00	+1.10%	+2
1754.00	-144.00	-8.21%	-
130772.00	+93.00	+0.07%	-
149.00	-2.00	-1.34%	-1
10713.00	-119.00	-1.11%	+1

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Market review

Economic and market overview

The US tariff-gun is once again wreaking havoc on global sentiment

The escalation in the trade dispute between the two largest global economies continued to add to rising investor concern about a further slowing of global economic growth. With China unlikely to simply back down, risk aversion increased as investors braced for more of the same. To worsen matters, the President of the US also thought it wise to threaten other trading partners like Mexico with higher tariffs, albeit for different reasons. The tit-for-tat exchange partly explains persistent downward pressure on government bond yields in large parts of the developed world as investors continue to flee to so-called safe-haven assets. In the US, the yield of the benchmark 10-year Treasury bond decreased to 2.12%, the lowest in more than two years and well below the recent weakest level of 3.21%. A similar trend unfolded in the UK and Eurozone, even though yields in those markets are already significantly lower for idiosyncratic reasons.

Central banks generally remain cautious doves

Central bank caution in the face of the current economic growth slowdown, risks to growth and a stable inflation backdrop has been another critical driver of the bond rally. Even though this is not a new development, explicit messages by major central banks, such as the US Federal Reserve (Fed) expressing patience about interest rates, received more than their fair share of interest from risk averse investors. That said, short-term data releases are showing tentative signs of some lift, at least relative to generally more bearish expectations. In the US, consumer confidence seems to be on the wallop again, backed by a strong labour market.

Local election outcome overshadowed by global events

The local bond market got caught up between the global risk-off trade and onshore developments. It was no surprise that the outcome of the national elections and the all-important and much anticipated announcement of the new cabinet took centre stage. At face value, the outcome offers a good start to the process of re-building trust and addressing the many structural impediments capping growth potential. Although the jury is still out with respect to delivery by the newly assembled executive, the importance of global events was clearly illustrated by the fact that developments in the global market overshadowed the important local political event, to some extent.

Local data continues to reflect soft economic conditions

The release of the latest local data pertaining to labour market conditions, economic activity and consumer inflation pointed to very subdued conditions. In terms of economic growth, all indications are that the first quarter had been very weak. Against this backdrop, two of the five South African Reserve Bank (SARB)'s Monetary Policy Committee members voted for a 25 basis points repo rate reduction at the May meeting. Moreover, the SARB informed the market that it lowered its growth forecast in light of unsupportive global and local conditions. Positively, inflation at the consumer levels remains well behaved, with the April Core Consumer Price Inflation data point printing at 4.4%, back to the mid-point of the 3%-6% target range - this despite a weaker currency, higher crude oil prices and other administered price increases. In contrast, the rate of producer inflation for final manufactured goods accelerated at 6.5% year-on-year in April. The uptick was mostly as a result of metals, machinery and equipment, but also live animals, meat and meat products. The latter signals the most likely end to CPI meat deflation.

Fiscal conditions remain on a slippery path

Following the breach of the 2018/19 fiscal target, mostly as a result of tax revenue underperformance, the first month of fiscal 2019/20 was also not the best of starts. Against a backdrop of continued weak tax revenue collections, but also an expenditure spike mainly due to an R13.5bn emergency payment to Eskom, the main budget deficit for April came to R63.5bn. This is considerably larger than the R43.7bn recorded in April last year. Even so, we would caution against reading too much in one month's data in light of the following two factors. Firstly, the sharp VAT net collection drop was the result of a sharp 40% year-on-year rise as the South African Revenue Service (SARS) is still addressing the backlog accumulated in the past. Secondly, seasonality, especially with respect to expenditure, which appeared to be markedly higher, calls for caution when interpreting one month's data. That said, we remain concerned about the fiscal situation, especially with an eye on the state-owned enterprise (SOE) fiasco. The fact that the CEO's of both Eskom and South African Airways resigned recently, raised more red flags with regards to the risk some of these SOE's hold for the sovereign balance sheet.

Yield curve slope steepened...on the back of a variety of reasons

Weak economic data, expectations of more weakness and the more dovish central bank policy tone supported the demand for nominal bonds at the short end of the yield curve. In contrast, net foreign selling during the month and fear of sustained fiscal slippage more than offset the impact of the more positive drivers. As a result, the month of May saw some upward drift to long-dated bond yields, causing shorter-dated bonds to outperform longer-dated bonds.

Nominal bonds rendered the highest returns...but only just

The local nominal bond market was trapped in a relatively narrow trading range despite a very eventful month. The yield of the R186 (maturity 2026) closed the month of May only six basis points lower at 8.48% after reaching an intra-month low of 8.32%. The All Bond Index returned 0.7% in May, marginally higher than the 0.6% cash return. The JSE Inflation-linked Government Bond Index underperformed with a return of -0.9% as real yields retraced some of April's significant gains.

Market summary

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.

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%.

A young boy with a serious expression is holding a small green seedling with soil in his hands. He is standing in a field of tree stumps, suggesting a reforestation project. The background shows a line of trees under a clear sky.

Metrics and the multiplier effect of impact investing

There is a growing interest in impact investments by institutional investors who wish to invest profitably but at the same time align their investments with their values. In addition, we are seeing an increase in the number of frameworks used to measure and report on impact, which provides investors with more options and opportunities to create more robust processes.

To read more, visit:

www.futuregrowth.co.za/newsroom

Key macroeconomic themes (continue)

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.

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 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, and especially the role that international trade friction plays, developed market government bond yields may be trapped at the lower levels for a while.

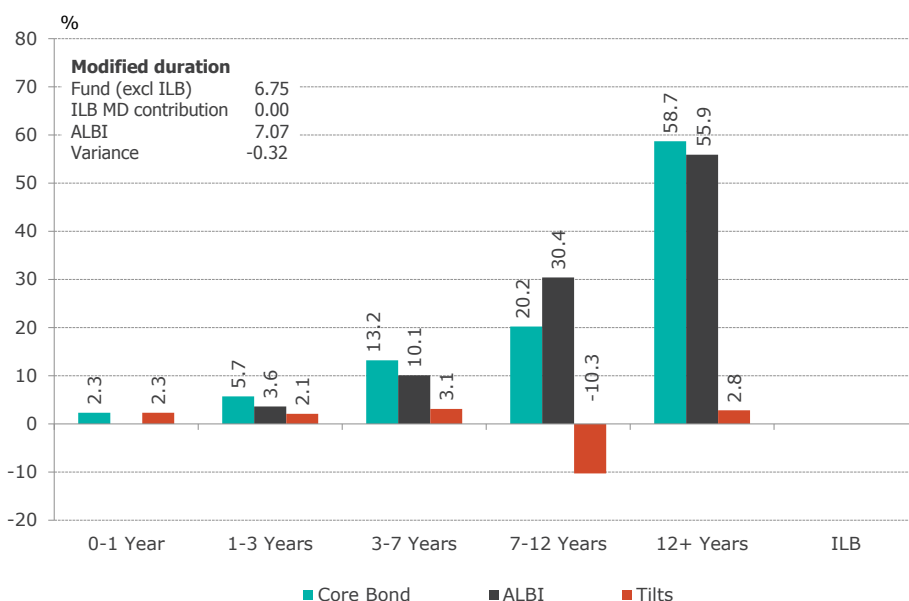
Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth and the lack of fiscal consolidation. More specifically, this points to the rising debt burden of the state, which arises as a consequence of the lack of fiscal consolidation. This continues 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 nearly 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 May 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. This is best reflected by the recent split decision by the MPC members with two members voting for a rate cut. Although this implies a higher probability of a rate cut in the near term, we are sticking to a stable policy path for now, but acknowledging that the risk is to the downside, in light of weak economic growth and strong disinflationary forces.

With the above in mind, we continue to endeavour 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 long-dated 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 -0.3 is some way off the maximum allowed position of -1.0. This acknowledges reasonable valuation which partly offsets the relatively poor 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)

	2014	2015	2016	2017	2018	2019	2020
Global GDP	2.8%	2.9%	2.5%	3.3%	3.2%	2.9%	2.8%
SA GDP	1.5%	1.3%	0.3%	1.3%	0.8%	1.5%	2.0%
SA Headline CPI	6.1%	4.6%	6.3%	5.3%	4.6%	4.4%	4.7%
SA Current Account (% of GDP)	-5.4%	-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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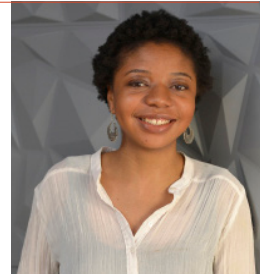
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The Futuregrowth story: Past and future

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.

FUTUREGROWTH

/ ASSET MANAGEMENT

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