



FUTUREGROWTH

/ ASSET MANAGEMENT

Monthly Review

July 2019

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Contact our client relationship team

Steffen Josephs

T +27 21 659 5466

C +27 83 327 3543

sjosephs@futuregrowth.co.za

Ziyanda Tshaka

T +27 21 659 5460

C +27 83 666 0392

ziyandat@futuregrowth.co.za

Marilyn Gates-Garner

T +27 21 659 5453

C +27 82 466 0868

marilyng@futuregrowth.co.za

Ayanda Zondi

T +27 21 659 5454

C +27 72 483 4090

azondi@futuregrowth.co.za



Market review

Economic and market overview

Fiscal chickens come home to roost

A strong start to bond market performance in July was derailed in a significant way in the latter part of the month. Market participants had a rude awakening from the Minister of Finance and senior National Treasury officials who confirmed the dire state of South Africa's fiscal situation. The impact of weak economic growth on lagging tax revenue receipts and the burden of financial support to state-owned enterprises, particularly Eskom, are anything but new. Yet, this served as a catalyst for Fitch rating agency to change the country's outlook from stable to negative, implying a higher risk of a sovereign rating cut deeper into non-investment grade territory at some point. At the same time, Moody's rating agency released a less than constructive opinion about the country, pointing to the increased probability of a ratings outlook downgrade from stable to negative before the end of this year.

National Treasury reluctantly increased primary auction issuance

Both the local currency and bond markets responded negatively to the events above, even though little of it should come as a significant surprise. The impact on the bond market was more direct since National Treasury was forced to announce an increase in the amount of debt on offer at the weekly primary auctions, in order to fund the widening budget deficit caused by lower tax revenue collection and increased financial support to Eskom. In the case of the nominal bond market, weekly issuance will increase from R3.3 billion to R4.5 billion, while the amount of inflation-linked bonds on offer will increase from R0.8 billion to just over R1 billion.

Nominal bond yields rose sharply

Bond yields retraced higher as a result. The sell-off was partly fuelled by non-resident net sales, which hit the R11 billion mark in July. The yield of the R2030 closed the month 14 basis points (bps) higher at 8.98%, which masks the more significant increase from the intra-month low of 8.60%. With the short end of the yield curve anchored by expectations of either another repo rate reduction or, at worst, a stable near-term path, longer-dated bond yields faced the brunt of renewed investor risk aversion. As a result, the back-end of the yield curve produced the weakest returns, offsetting some of the gains the market had managed to garner

since the beginning of the year. Real yields also rose despite the fact that the inflation outlook remained fairly static compared to a month ago. In contrast to the nominal market, foreign participation in this market is limited, implying that it was local investors who thought it wise to reduce exposure to this asset class in anticipation of higher supply. Even so, the yield of the I2029 still closed the month 16bps higher at 3.33%.

Little else mattered as local fiscal concerns took centre stage

Globally, interest rate doves are still out in force as they await more policy easing by some of the major central banks. These expectations are backed by subdued inflation, weaker general economic activity and, in some cases, even misplaced political pressure. The US Federal Reserve was the latest central bank to cut its lending rate. However, the 25bps cut was accompanied by a stern warning that it did not necessarily signal the start of a prolonged easing cycle. This, in our view, is the only reasonable assessment. The low level of bond yields in many developed markets kept the demand for yield enhancement alive and well. This is in stark contrast to the risk aversion expressed by foreign investors in the local market over the same period, a clear signal that they are not completely insensitive to the implication of continued fiscal slippage. The worrying fiscal backdrop also diluted the impact of the much anticipated 25bps repo rate reduction by the South African Reserve Bank around mid-July

A strong first six months for nominal bonds ended in tears

Following a strong first six months, nominal bond returns took a turn for the worse in July. During the month, the JSE All Bond Index (ALBI) returned -0.7%, with the worst performing 12+year maturity band detracting 1.1%. Following a rather shaky end, the JSE Government Inflation-linked Bond Index (IGOV) produced a zero return, well below the cash return of +0.6%. Returns for the first seven months of the year remain a decent 6.9% for the ALBI, followed by cash (4.2%) and, in last place, 3.3% for the IGOV.



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Key macroeconomic themes

Economic growth

The global economic recovery of the past 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 a number of 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. This was clearly evidenced by the deterioration of fiscal metrics as a result of additional support to Eskom in the magnitude of R26 billion and R33 billion for the 2019/20 and 2020/21 fiscal years respectively. 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 weak state of the economy and a broadly neutral currency view result in our 2019 annual average inflation forecast of 4.3%. More importantly, there is strong evidence that the pass-through of rand weakness to inflation remains exceptionally weak, reflective of 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 comfortably remain within the SARB's 3% to 6% range, although inflation expectations still remain above the more desirable mid-point of 4.5%.

Key macroeconomic themes (continued)

Balance of payments

We expect the negative current account balance to widen to 3.2% of GDP in 2019 and to increase further to 3.6% 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 its strong Eurozone and Chinese trade links. .

Monetary policy

Unemployment in the US appears to be strongly anchored below 4.0% and we continue to believe that a moderate growth rate is still more likely than a recession. That said, the broader market remains priced for US monetary policy easing. Should this fail to materialise, US bond yields will head upwards from current low levels.

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 ignorant of persistently weak underlying economic activity. This was well demonstrated by the most recent policy action that saw the repo rate lowered by 25bps. Barring a significant financial crisis, from here on, a stable to weak monetary policy tightening cycle remains our base case. Similar to market expectations in the US, the local market is priced for rate cuts and is thus at risk should these fail to materialise.

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. This view has been confirmed by recent announcements relating to more financial support to the ailing entity. Recent official warnings about the worsening fiscal situation also served to confirm our long-held bearish assessment of government finances. 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.

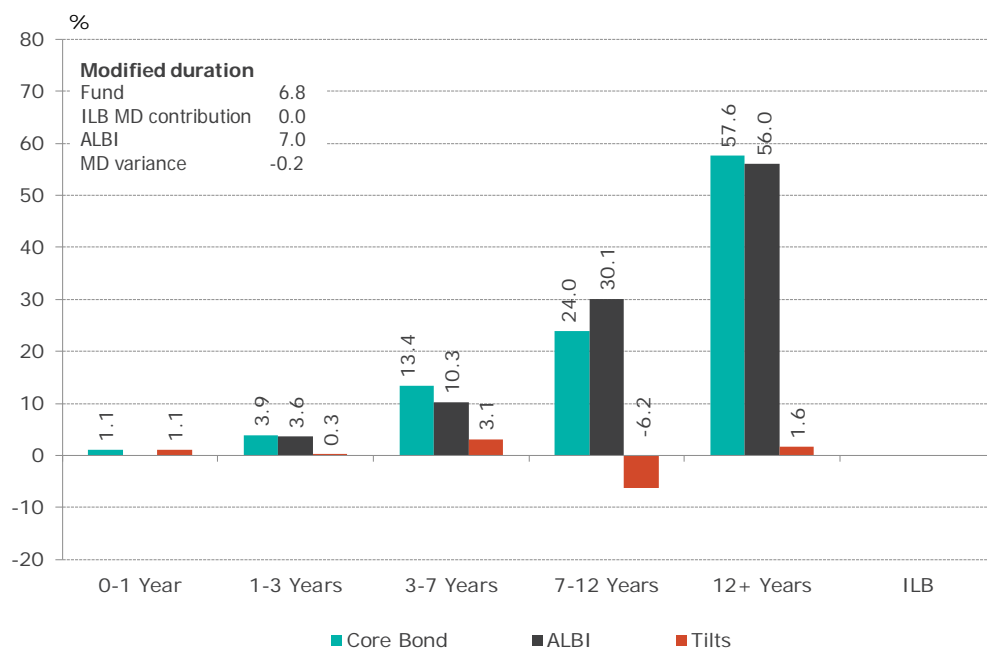
Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth and the lack of fiscal consolidation. More specifically, this points to the rising debt burden of the state, which arises as a consequence of the lack of fiscal consolidation. This continues 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, with this firmly supported by disappointing first quarter GDP data. 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 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.

Following the Monetary Policy Committee's decision to reduce the repo rate by 25bps at the July meeting, we maintain our view of a stable policy path from here on. That said, we acknowledge the risk of more easing in light of weak economic growth and strong disinflationary forces. From a yield curve perspective, the important point is that the short end remains well anchored, with a negligible possibility of monetary policy tightening in the near term. This remains a crucial pointer to our investment strategy, specifically with regards to sector allocation.

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 not losing out on the accrual offered by a steeply sloped yield curve. We also consider 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 -0.2 is some way off the maximum allowed position of -1.0. This acknowledges reasonable valuation, which partly offsets the relatively poor investment theme. Therefore our investment strategy remains one where we would utilise bouts of market weakness to add to those stocks that offer the best balance in terms of base accrual and limiting capital loss.

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%	2.6%	2.8%
SA GDP	1.5%	1.3%	0.3%	1.3%	0.8%	0.9%	1.8%
SA Headline CPI	6.1%	4.6%	6.3%	5.3%	4.6%	4.3%	4.6%
SA Current Account (% of GDP)	-5.4%	-4.4%	-3.3%	-2.0%	-3.5%	-3.2%	-3.3%

Source: Old Mutual Investment Group

Produced by the Interest Rate Team



Rhandzo Mukansi
Portfolio Manager



Wikus Furstenberg
Portfolio Manager &
Head: Interest Rate
Process



Daphne Botha
Portfolio Manager &
Head: Risk
Management



Yunus January
Interest Rate
Market Analyst



Refilwe Rakale
Research
Analyst

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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3rd Floor, Great Westerford
240 Main Road, Rondebosch
7700, South Africa
Private Bag X6, Newlands, 7725, South Africa
Tel: +27 21 659 5300 Fax: +27 21 659 5400
www.futuregrowth.co.za

A MEMBER OF  **OLDMUTUAL** INVESTMENT GROUP