FUTUREGROWTH
/ ASSET MANAGEMENT

Monthly Review

August 2019

Contents

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

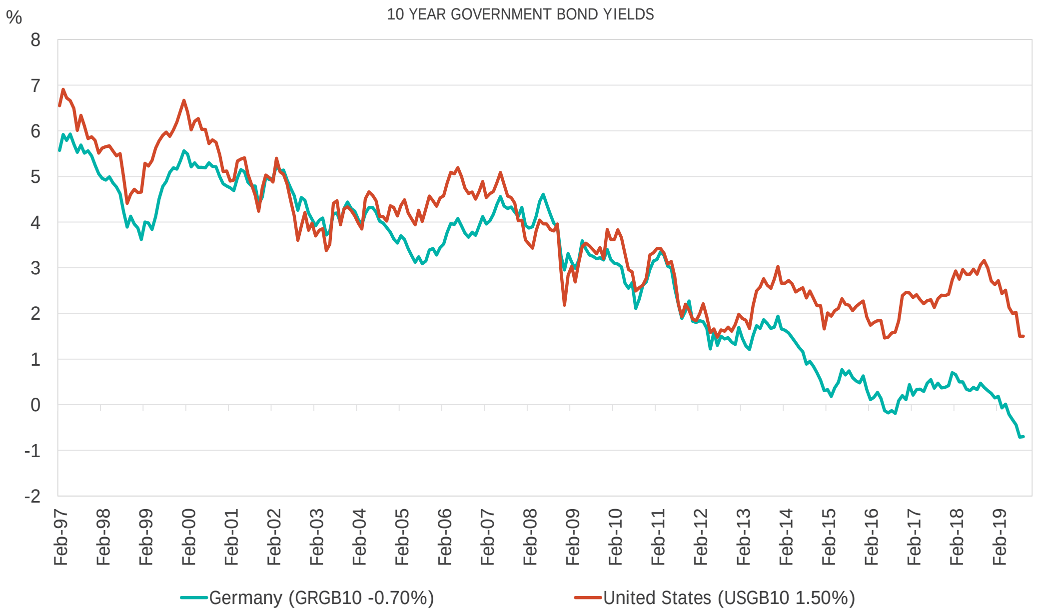
Ayanda Zondi
T +27 21 659 5454
C +27 72 483 4090
azondi@futuregrowth.co.za

Market review

Economic and market overview

Rising global risk aversion pushed global bond yields lower and weaken emerging market currencies
During August, global bond yields, particularly in developed economies, continued the strong downward trend of the past few months. The combination of strong disinflationary forces, heightened fears of a global recession and broad-based monetary policy easing are mainly to blame. The seemingly never-ending US-China trade spat fuelled these recession fears which, in turn, forced the majority of investors into risk aversion mode. In the largest global bond market, the yield of the 10-year US Treasury bond dropped a very significant 52 basis points to end the month at a yield of 1.50% - the lowest level since July 2016. Elsewhere, German Bund yields were forced deeper into negative territory, with yields across the curve now trading at negative levels. In the process, some corporate bonds also got dragged into the abyss of negative yields. In a number of the developed markets, yield curves started inverting, with long-dated bond yields now trading at levels lower than those of short- and medium-dated bonds. Moreover, the latest bout of global risk aversion also served as a catalyst for renewed emerging market currency weakness. Closer to home and against this backdrop, the South African Rand depreciated by almost 8% against the US dollar, before recovering some lost ground at month end.

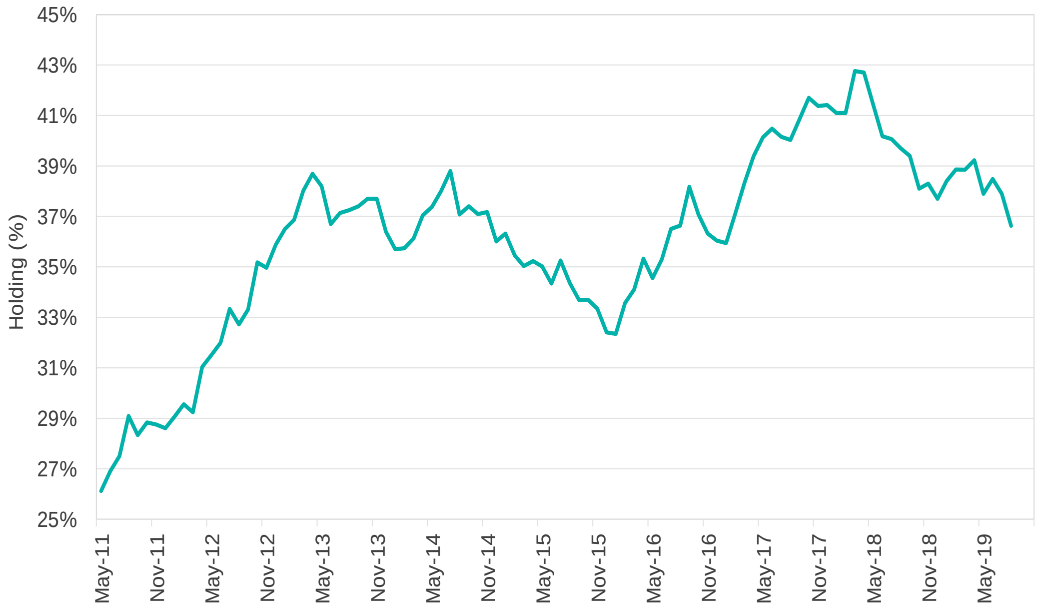
Figure 1: How low can developed market bond yields go...and for how long?



Source: INET, Futuregrowth

Foreign investors continue to trade out of SA bonds
In stark contrast to previous periods when all-time low developed market bond yields served as catalyst for a global reach for yield, non-resident investors have actually reduced SA exposure in past four months. This time around, the extent of sustained fiscal slippage and its negative implication for sovereign creditworthiness made it much harder to alleviate investor fears. This probably also reflected expectations of a change in the ratings outlook by Moody's rating agency from stable to negative by year end, to be followed by a possible ratings downgrade to non-investment grade in 2020. In August, net sales by these investors were recorded as R15bn, taking the year-to-date net sales number to R5bn. As illustrated below, although a significant drop, the foreign held share of the total outstanding rand-denominated government debt remains fairly high at just under 37%*. This points to either some resilience, possibly linked to a global search for yield, and/or a risk of further capitulation. The jury is out on this one.

Figure 2: The foreign investor share of total RSA government bonds is well below the historical high, as concerns about creditworthiness are rising

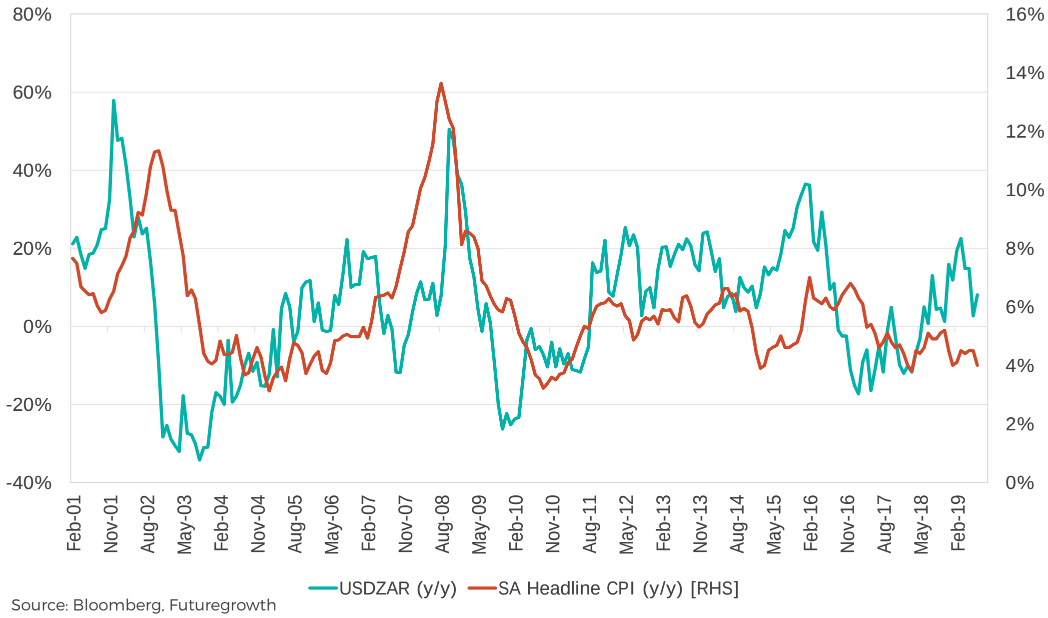


Source: National Treasury, JSE, Futuregrowth as at 31 August 2019

Local inflation surprised on the downside again, while the economic growth outlook remains deeply depressing

While the month turned out to be brutal with respect to the impact of global events on risk appetite, a benign local inflation backdrop remains one of the few sunny spots in an otherwise wintry local economic landscape. Latest inflation data releases point to weak inflation momentum, despite several negative relative price changes and sustained currency weakness in recent months. At the consumer level, the July Headline Consumer Price Index (CPI) slowed to an annual rate of 4.0%. This was mainly as a result of lower than expected food and electricity pricing. A similar dynamic is playing out on the production side of the economy. In the same month, the Producer Price Index slowed sharply to a year-on-year rate of increase of 4.9% from 5.8% in the previous month. On the growth front, the release of yet another weak leading indicator number supports our long-held view that economic growth will remain supressed. Not even the 7.2% year-on-year growth in private sector credit extension in July, which was higher than the 6.9% year-on-year, growth from the previous month managed to excite the market. This is somewhat understandable, given that low base effects had played a role in pushing these figures higher.

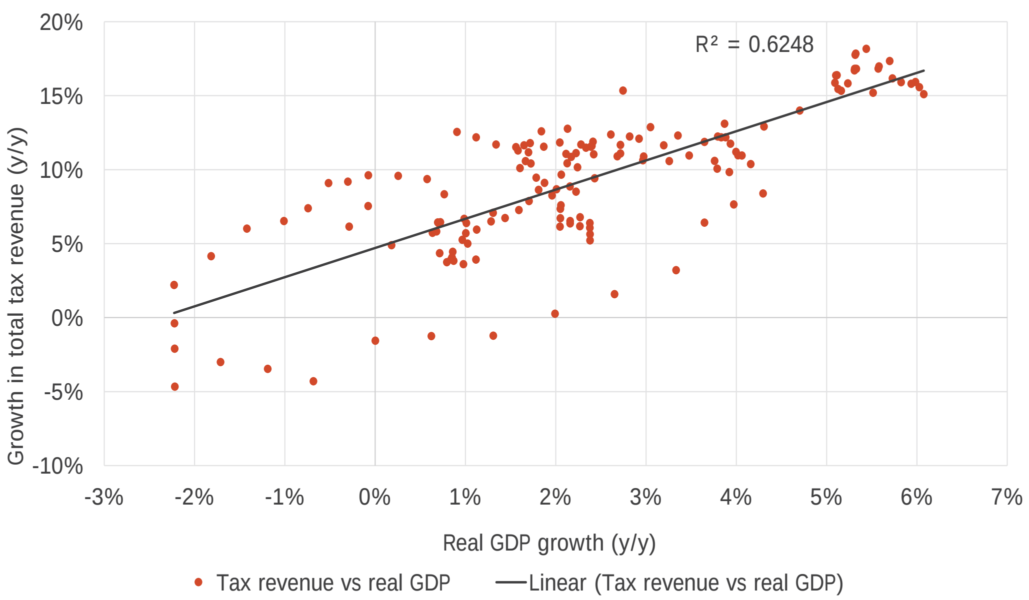
Figure 3: The historic strong positive correlation between rand depreciation and headline CPI started breaking down as far back as 2011



Source: Bloomberg, Futuregrowth

The dark, stormy fiscal clouds keep rolling in
The combination of disinflation and poor economic growth is not what the South African fiscal authorities ordered when the national budget was tabled earlier this year. With real GDP growth and tax revenue receipts strongly correlated (62% over the last 15 years), it comes as no surprise that National Treasury and the South African Revenue Services (SARS) more recently felt the urge to issue a stern warning about a potential significant tax revenue shortfall for the current fiscal year. This leaves us with ample reason to stick to our own significantly larger budget deficits, relative to official estimates for the current and outer fiscal years. In addition, the risk of more financial bailouts for a number of state-owned enterprises remains significant, with very little progress made over the last month or so to induce us to reconsider our current stance. The above long-held concerns about the fiscal situation were unfortunately affirmed by another disappointing round of monthly national budget data. In July, a deficit of R99.1bn was posted, significantly wider than the average of R74bn over the prior seven fiscal years. While elevated VAT refunds are still partly to blame, the sharp deterioration of total tax revenue, particularly corporate income tax, kept fiscal concerns at a heightened level. A worse than expected trade deficit of R2.9bn for July, was also disappointing. Although still reasonably small, and mainly due to a rise in capital goods imports, it served as a reminder that the country is facing an uphill battle to rid itself of the twin-deficit monster.

Figure 4: An undeniable strong correlation: If economic growth falters, then tax revenue collection falters



Source: Bloomberg, Futuregrowth

Worsening fiscal backdrop feeds IMF fear as well as political opportunists
The worsening macro backdrop in general, and the public finance situation in particular, raised the alarm about the possibility of the country being forced to approach the International Monetary Fund (IMF) for financial assistance. During the past month, seats on the IMF bailout bandwagon quickly filled with alarmists. While we do not contest the seriousness of the extent of fiscal slippage (in fact, this had been well telegraphed for well over a year), we believe that these opinions are based on a misplaced interpretation. More specifically, they by and large ignore the conditions required for such a possibility. In short, a number of critical conditions are missing. This includes an imminent balance of payments crisis, an inability to service state debt (particularly the portion denominated in hard currency) and an inability to access financial markets. None of these apply to South Africa at the moment and neither do we foresee them to apply in the medium term. Read our article on **Why IMF assistance to South Africa is not a realistic expectation in the near term**, for more detail about our stance on this important matter.

Opportunistic politicians push the panic button to pave the way for a repeat of the prescribed asset disaster of yesteryear
That said, it is not only well-meaning alarmists who got into the IMF act. Proponents of the re-introduction of prescribed assets also thought it wise to take up some seats on the IMF bailout bandwagon, albeit with a very different agenda. Calls for the re-introduction of prescribed assets, mostly by opportunistic politicians, reached more feverishly levels in August. In our minds, these calls should be regarded as more of a threat than the - for now - distant possibility of an IMF bailout. More concerning is the fact that one of the country's

biggest labour unions, COSATU, who initially strongly opposed it, recently seemed to have had a change of heart. We would strongly oppose this as set out in more detail in our write up, **Responsible investing and the issue of prescription**.

Nominal bonds, nonetheless, deliver stellar returns for the month of August

Initially, the nominal bond market extended the sell-off that started in earnest around mid-July. The yield of the 10-year benchmark (R2030) initially increased to an intra-month high of 9.12%, before a market recovery caused the yield to close the month at 8.90%, or 8bps below the previous month's 8.98%. During the month, the JSE All Bond Index (ALBI) returned 1.0%, with short-dated bonds in the 1- to 3-year maturity band rendering the lowest return. In contrast, the yields of inflation-linked bonds kept heading higher in response to a muted inflation outlook and an increase in primary issuance. The yield of the I2029 increased just over 10bps during the month to end August at 3.42%. As a result, the JSE Government Inflation-linked Bond Index (IGOV) rendered a disappointing -0.2%, well below the cash return of +0.5%. Returns for the first eight months of the year remain a very decent 7.9% for the ALBI, followed by cash (4.4%). The IGOV only managed a return of 3.0%, not only underperforming nominal bonds and cash, but also headline CPI.

A focus on whistleblowers and steps to combat corruption

In an era where corruption is on the rise, SA is clearly in need of leaders with integrity and transparency. Daily Maverick hosted a 'call to action' in the form of their recent Business Against Corruption event. The event provided a fresh perspective on the role of both business leaders and individuals in creating and reinforcing a corruption-free environment.

Read a write-up about the event, with a special focus on whistleblowing here: **www.futuregrowth.co.za/newsroom**

Market summary

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 in growth, 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. 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 4.2%. 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%.
Balance of payments	We expect the negative current account balance to widen to 3.2% of GDP in 2019 and to widen 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.

Key macroeconomic themes (continued)	
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. Do not expect this anytime soon, though. For now, the fear of a recession has the upper hand. 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

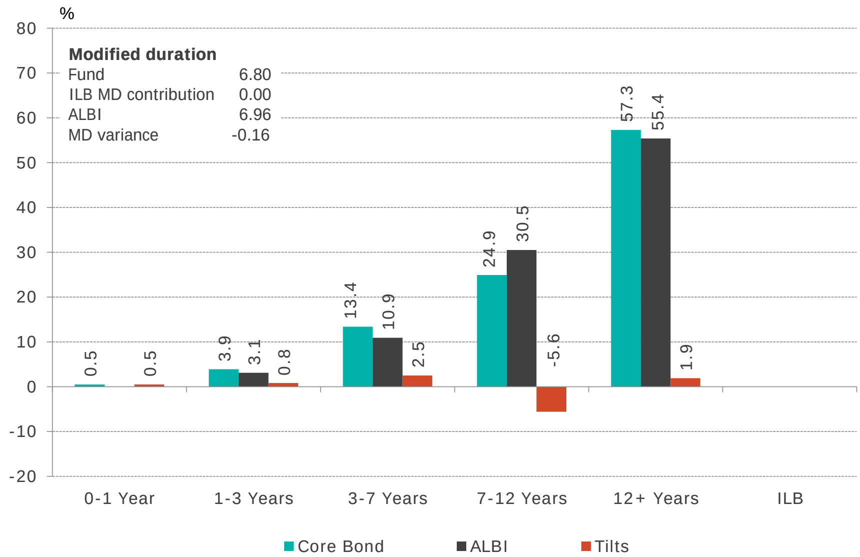
At a global level, the shift from quantitative easing to tightening has stalled, and in some cases even reversed, due to a heightened fear of a global growth slowdown, or even recession. Even so, we are of the view that authorities are prepared to adjust relatively quickly, and in some cases are already 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 5%. 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%	2.6%
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.

AUM as at 31 December 2018

FUTUREGROWTH
/ ASSET MANAGEMENT

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