



FUTUREGROWTH

/ ASSET MANAGEMENT

Monthly Review

September 2019

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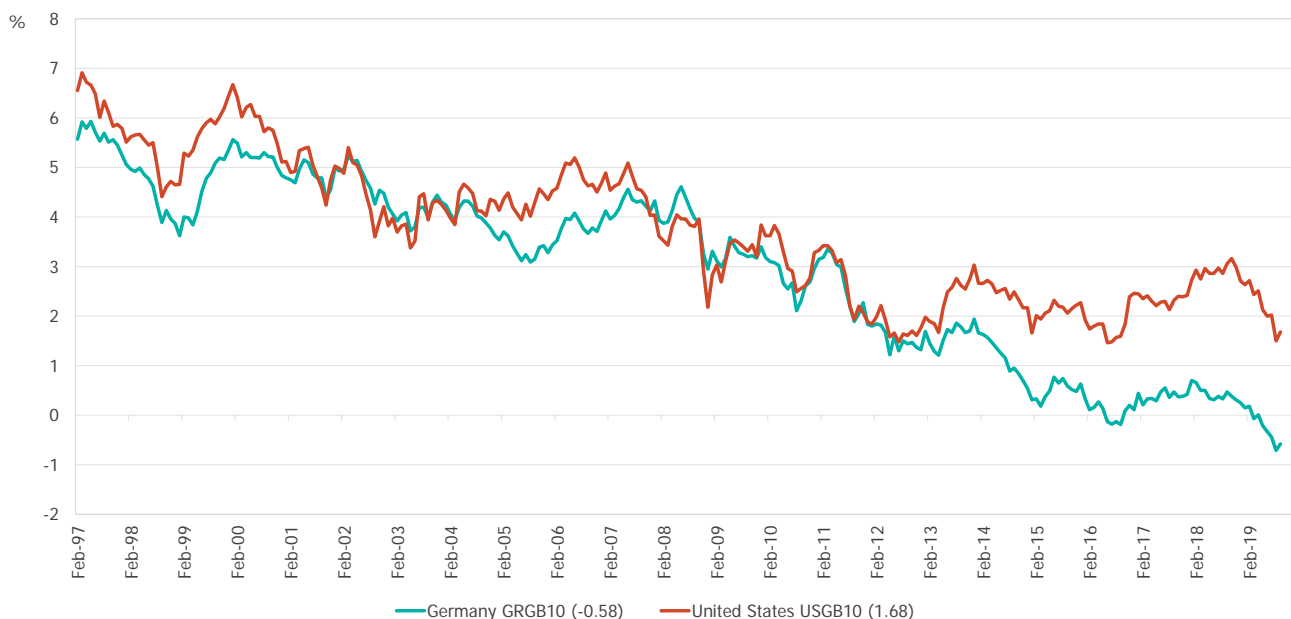
Market review

Economic and market overview

Rising global risk aversion pushed global bond yields lower and weaken emerging market currencies

During the first two months of the third quarter, global bond yields, particularly in developed economies, continued the strong downward trend that commenced in the latter part of 2018. 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 the 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 56 basis points (bps) to 1.47% from the end of June to the first week of September - the lowest level in three years. Elsewhere, German Bund yields were initially forced deeper into negative territory, with the entire yield curve trading at sub-zero levels. In the process, some corporate bonds were also dragged into the abyss of negative yields. Although yields retraced somewhat higher from these lows towards the end of September, levels are still well below those recorded a year ago. In a number of developed markets, yield curves even inverted, with long-dated bond yields now trading at levels lower than those of short and medium-dated bonds - a reflection of market expectations of further monetary policy easing. The drivers of the lower bond yields also served as a catalyst for renewed emerging market currency weakness. Against this backdrop, the South African Rand depreciated by almost 8% against the US dollar earlier in the quarter, before recovering some lost ground in September.

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 search for yield, non-resident investors have actually reduced SA exposure in the past few months. This time around, the extent of sustained fiscal slippage and its negative implication for sovereign creditworthiness made it much harder to alleviate non-resident investor fears. It also reflects expectations of a possible 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. During the quarter, net sales by these investors were recorded as R30bn, taking the year-to-date net sales number to R11bn. 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.

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

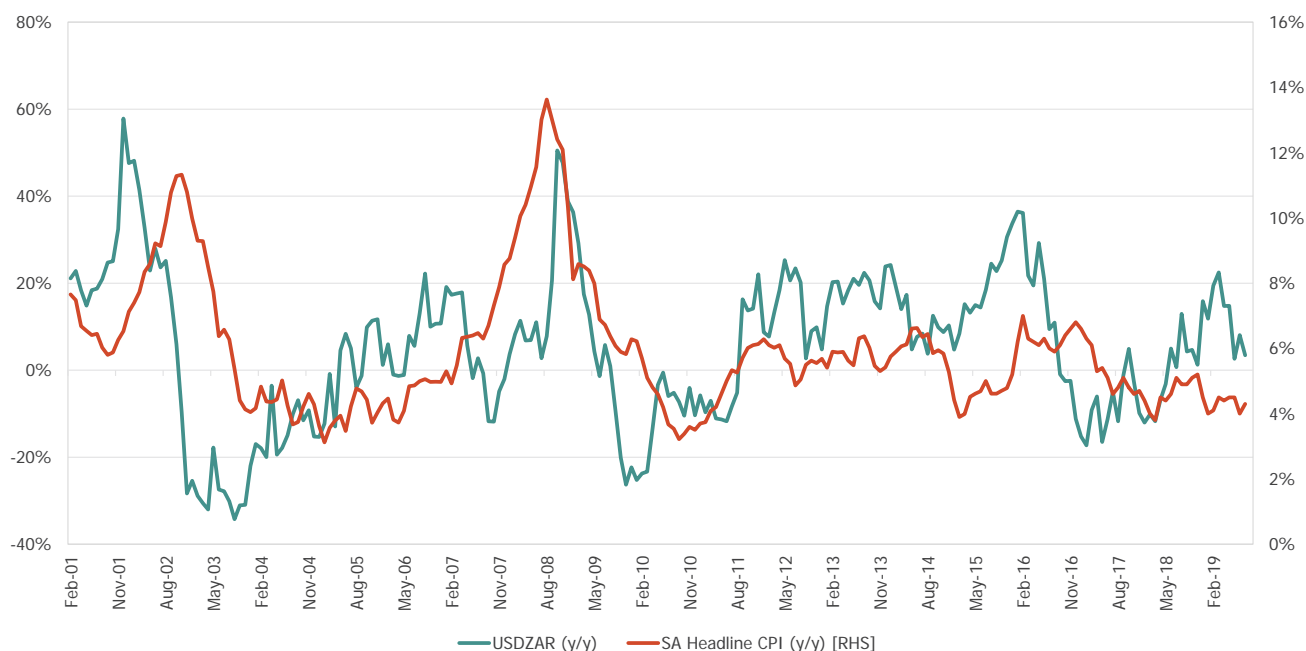


Source: National Treasury, INET, Futuregrowth as at 30 September 2019

Local inflationary pressures remain relatively subdued, while the economic growth outlook remains deeply depressing

While the third quarter 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 August Headline Consumer Price Index (CPI) accelerated at a relatively benign annual rate of 4.5%. A similar dynamic is playing out on the production side of the economy. In the same month, the Producer Price Index (PPI) slowed sharply to a year-on-year rate of increase of 4.5% from 5.8% a mere two months earlier. On the growth front, the quarter generally delivered disappointing SARB Leading Indicator prints and monthly activity data releases. This supports our long-held view that economic growth will remain suppressed. Not even the 6.9% year-on-year growth in private sector credit extension in August, which was a tad lower than the 7.2% year-on-year growth from the previous month, managed to excite the market. Despite this backdrop, the South African Reserve Bank opted to keep rates unchanged at its most recent monetary policy meeting. The risk of recent currency weakness to the inflation outlook and concerns around the fiscal backdrop both played a role as the Committee opted to stay the course of stable rates following the 25 basis point reduction in July.

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

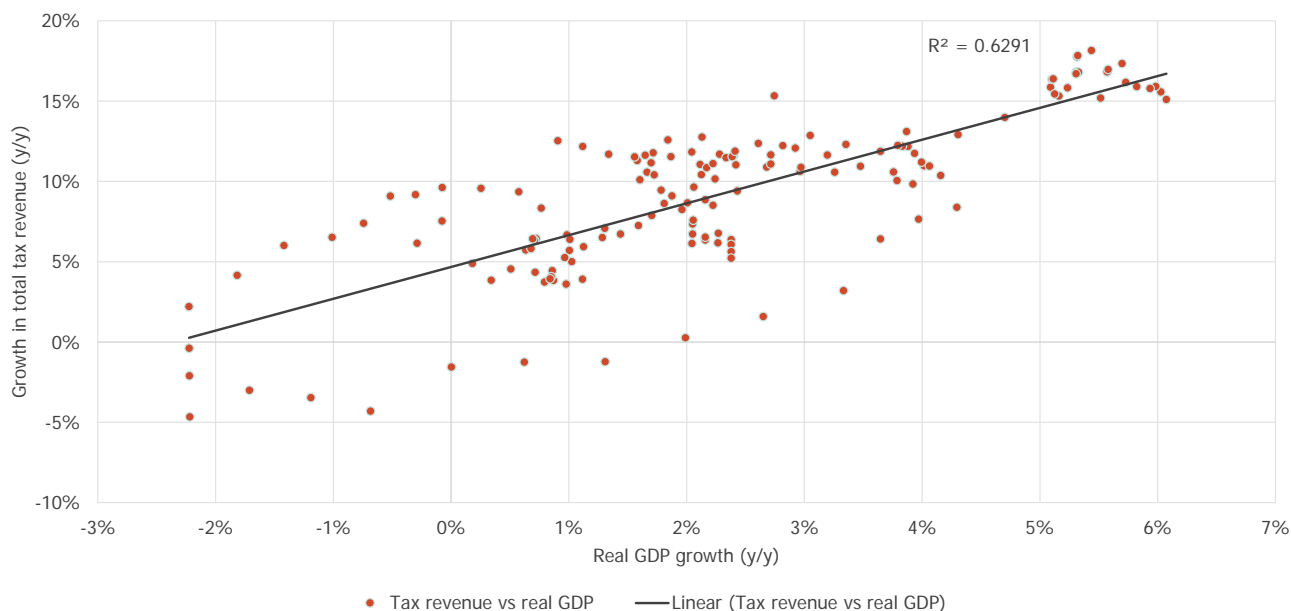


Source: Bloomberg, Futuregrowth

The dark, stormy fiscal clouds keep rolling in

The combination of lower than expected inflation and sustained 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), National Treasury recently felt the urge to issue a stern warning about a potential significant tax revenue shortfall for the current fiscal year. On the expenditure side, it also requested the various state departments to consider cutting their respective budgets by 5% for the 2020/21 fiscal year, 6% for the 2021/22 year and 7% for 2022/23%. 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 negative fiscal view. Unfortunately, the long-held concern about the fiscal situation was affirmed by another disappointing round of monthly national budget data. In August, a deficit of R32.8bn was posted, significantly wider than the average of R10.5bn over the prior five fiscal years. While elevated VAT refunds are still partly to blame, the sharp deterioration of total tax revenue keeps our fiscal concerns at a heightened level. This particularly applies to personal income tax which has only increased by 6.9% year-to-date –significantly lower than the budgeted 11.1% target for the current fiscal year. While corporate income tax collection has registered a slight improvement of 1.9% thus far, it is still well below budget estimates. On a positive note, the August merchandise trade balance registered a swing to a robust surplus of R6.8bn from the deficit of R3.7bn recorded in July, pointing to the possible improvement of the current account balance in the third quarter.

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



Source: Bloomberg, National Treasury, 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 alarm in the media about the possibility of the country being forced to approach the International Monetary Fund (IMF) for financial assistance. While we do not contest the seriousness of the extent of fiscal slippage (our grave concerns on SA's fiscal position have been well articulated in recent years), we believe that the commentators by and large ignore the conditions required for such an eventuality. In short, a number of critical conditions are missing. These include an imminent balance of payments crisis, an inability to service state debt (particularly the portion denominated in foreign currency) and an inability to access financial markets. None of these apply to South Africa at the moment and we do not foresee them applying 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.

If anything, the recent successful placement by National Treasury of a USD5bn Eurobond issue at reasonable, market-related levels serves to demonstrate our point. What impressed was the ability to issue USD2bn of 10-year and USD3bn of 30-year bonds, which cleared at 4.85% (spread of 313bps) and 5.75% (359bps) respectively.

Opportunistic politicians push the panic button to pave the way for a repeat of the prescribed asset disaster of yesteryear

That said, not only well-meaning alarmists 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 feverish 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 prescription, 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](#).

Both nominal and inflation-linked bonds underperformed cash during the third quarter

Market activity during the period under review is best described as a roller coaster ride with a decent positive correlation between local bonds and the rand exchange rate to the US-dollar. Not even the brief spike in crude oil prices in mid-September managed to disrupt it in a significant way. The 56 basis point intra-quarter trading range of the benchmark 10-year RSA government bond (R2030) best illustrates the extent of the market volatility. After reaching a best level of 8.6% in mid-July, the R2030 yield retraced sharply to 9.2% around a month later, the weakest level during the period under review. This was followed by a second significant bull rally of 35bps before another retracement forced the market to close weaker at 9.0%. This was 20bps higher than the closing level at the end of the second quarter.

The nominal bond yield curve slope steepened during this period. The combination of the July repo rate reduction, a benign inflation backdrop and rising concern about the worsening fiscal backdrop caused longer-dated bond yields to increase relative to shorter-dated bond yields. The bearish yield curve steepening is well-illustrated by the maturity band return divergence, with the 3 to 7-year sector rendering the highest return of 1.3%, and the 12+ year sector the lowest of 0.5%. The JSE All Bond Index (ALBI) delivered a 0.7% return over this period, well short of the cash return of 1.6%.

In contrast, inflation-linked bond yields retraced to higher levels in an almost straight line. The yield of the 10-year RSA Government Inflation-linked bond increased sharply by 26bps to close the third quarter at 3.4%. This is also well above the low of 2.6% that was recorded in May 2018. As a result, the JSE Government Inflation-linked Bond Index (IGOV) rendered a disappointing 0.1% return, which was also well below the cash return over the same period.

Despite the poor quarter, nominal bonds still managed a relatively stellar performance for the first nine months of the year. The JSE All Bond Index (ALBI) returned 8.4%, with bonds in the 7 to 12-year maturity band taking the first podium position with a 9.5% return. The JSE Government Inflation-linked Bond Index (IGOV) only managed to eke out a return of 3.4% over the same period, not only underperforming nominal bonds and cash (5.0%), but also headline CPI.

Shedding light on money market fallacies

Money market funds are generally considered to be safe investment vehicles with no investment risk. While it is true that money market funds exhibit the lowest risk compared to other asset classes, it is dangerous to accept that such investments are completely risk free.

Learn more:
www.futuregrowth.co.za/newsroom

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 take root, 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 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 any time 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 additional 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 (which has been evidenced to be extremely weak for the fiscal year to date) 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

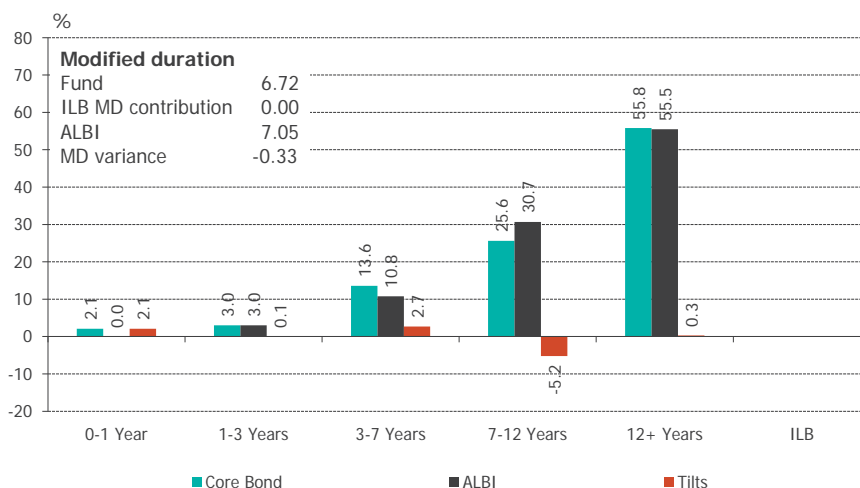
impossible in the absence of substantial remedial action for the unfolding financial disaster. The proverbial chickens, mainly in the form of Eskom, have come home to roost, and this requires more than the usual liquidity provision. Addressing solvency is an entirely different matter, requiring more than simply kicking the can down the road via more liquidity bail-outs.

Following the Monetary Policy Committee's decision to keep the repo rate on hold at the September 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 -0.3 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

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The Futuregrowth story: Past and future

A vision unfolding

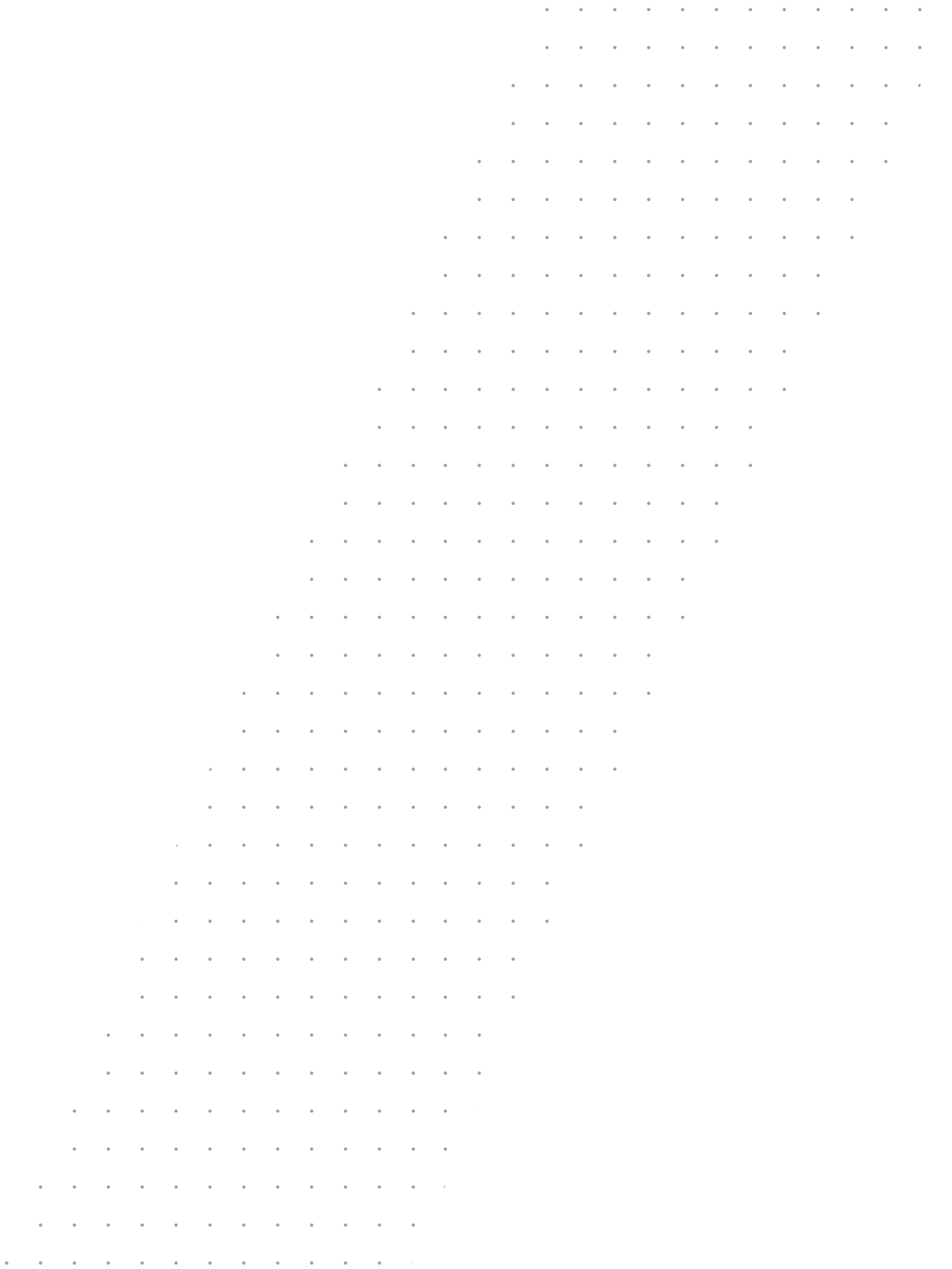
In the wake of South Africa's democratic transition, Futuregrowth was founded in 1994, with a small suite of investment funds focused on social development and empowerment, and with the vision of creating a sustainable channel for pension funds to invest in disadvantaged communities and national development.

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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