Monthly Review

November 2019

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Market review

Economic and market overview

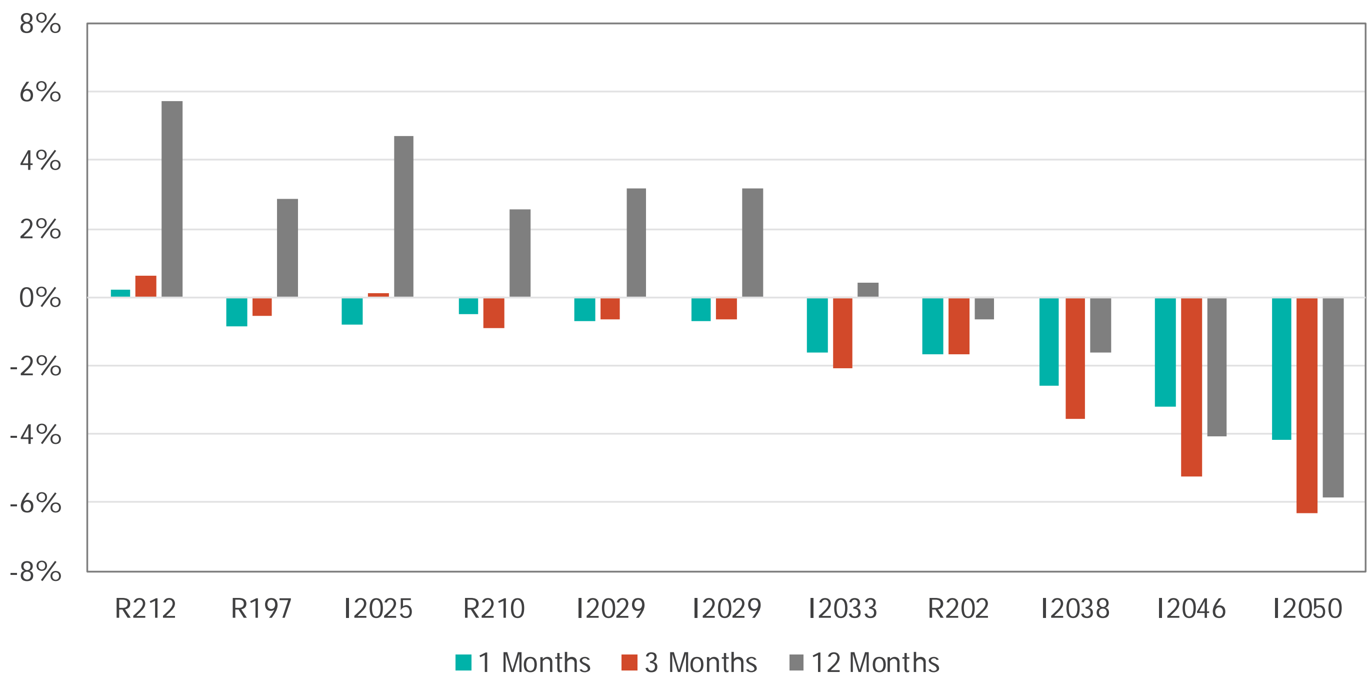
November bond market returns reflect diverging forces

The terrible fiscal news delivered in the 2019 Medium Term Budget Policy Statement (MTBPS) is still fresh in the minds of investors. To make matter worse, rating agency Standard & Poor's changed the country's sovereign rating outlook from stable to negative, which opened the door for further downgrades deeper into sub-investment grade territory. The market reaction to government's inability to arrest fiscal slippage - and rising concern about the response by rating agencies (particularly Moody's) - led to renewed bearish yield curve steepening. At the back end of the yield curve, the yield of the R2048 (maturity 2048) government bond drifted 16 basis points (bps) higher to close the month at 10.235%. This is the highest level since October 2018. In contrast, the yield of the shorter-dated R2030 (maturity 2030) closed the month 2.5bps below the October close of 9.205%.

The bearish yield curve steepening is better illustrated by the individual JSE All Bond Index (ALBI) sector returns. Due to the increase in long-dated bond yields, the 12+ year maturity band rendered a total return of -0.2%. In contrast, the remaining sectors all managed a positive return ranging between +0.5% and +0.9%. The combination of the relatively poor 12+ year return and its substantial index weight of 55.3% limited the ALBI total return to +0.2% for the month. Although slightly lower than the 0.5% offered by cash, this was significantly better than the return offered by inflation-linked bonds.

Inflation-linked bonds continued to lag behind in the race and once again ended in the last place, as the JSE Inflation-linked Government Bond Index (IGOV) returned a disappointing -1.5% for the month. The poor return is the result of a low inflation adjustment (inflation carry) as well as the significant negative marked-to-market impact resulting from rising real yields. With respect to the latter, the yield of the I2029 (maturity 2029) closed the month at 3.7%, 14bps higher than the October close and well above the 2019 best level of 2.9% recorded in May. At the back end, the yield of the longest-dated I2050 (maturity 2050) closed the month at 4.0%, its weakest level since being issued for the first time in 2012.

Figure 1: Inflation-linked bonds: Stock returns for periods ending November 2019



Source: JSE, Futuregrowth

Bond market remains trapped in the "twilight" zone

The bearish yield curve steepening described above is a classic response to the difficult combination of low growth/low inflation on the one hand, and worrying fiscal slippage with significant risk to the country's sovereign risk profile on the other. More specifically, short-dated nominal bond yield yields remain anchored by the benign inflationary environment, weak economic growth and stable monetary policy. In terms of inflation, the October releases of both the consumer and producer price indices, once again surprised on the downside, with year-on-year increases of 3.7% and 3.0% respectively. If anything, this supports the case for more monetary policy easing. This was resisted by the Central Bank at its November Monetary Policy Committee meeting, in light of concerns about potential net capital outflows - should Moody's rating agency decide on a sovereign credit rating downgrade at their ratings review in March next year.

While current disinflationary forces are undeniably positive for nominal bonds, the impact is significantly diluted for longer-dated nominal bonds. This is due to fiscal slippage and the risk thereof on the country's sovereign credit rating, as well as the anticipated burden of additional funding due to a widening fiscal deficit.

Similarly, the inflation-linked bond market is facing the same two-headed monster as the nominal bond market; that is, disinflation and ever-rising fiscal risk. Not only would sustained disinflation reduce the return of this asset class via a lower inflation adjustment, but the reduced requirement for inflation protection also worsens the demand/supply balance.

Mad world - The ongoing "Japanification" of the global bond market - and my ice cream tub

As the author mulled through reams of research notes on disinflation, deflation, and policy rates, he thought of one of his all-time favourite songs, Mad World by Tears for Fears, released in 1983. Reflecting on negative bond yields, and rates that had been stuck at rock-bottom levels for years, the song attained a financial market meaning.

Read more:
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 tentative positive steps towards improved governance. However, the perilous state of a number of 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 to be 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 4.1%. 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% inflation target 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 while disinflationary forces remain particularly strong. 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. Barring a significant financial crisis, from here on, a stable monetary policy cycle with an easing bias remains our base case. Although future policy easing remains a risk, monetary policy tightening is not expected in the near term. 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	The headline numbers presented in the 2019 MTBPS deviated substantially from the national budget presented in February. The path charted by the latest MTBPS turned out to be significantly worse than even our long-held bearish estimates. An adjustment to more realistic macroeconomic assumptions and tax buoyancy rates by National Treasury garners much-needed credibility. Since 2009, National Treasury persisted with unrealistically high nominal GDP estimates, thus banking on higher economic growth (and higher inflation) to do some of the hard work. Disappointing growth and steady disinflation have contributed to tax revenue underperformance over time. The inability to match this shortfall by expenditure reductions lead to a sustained rise in the gross debt to GDP ratio, which is now estimated to reach 71.3% by 2022/23. Government has no choice but to start cutting back on current expenditure in order to arrest the fiscal slippage that continues to gather momentum.

Our investment view and strategy

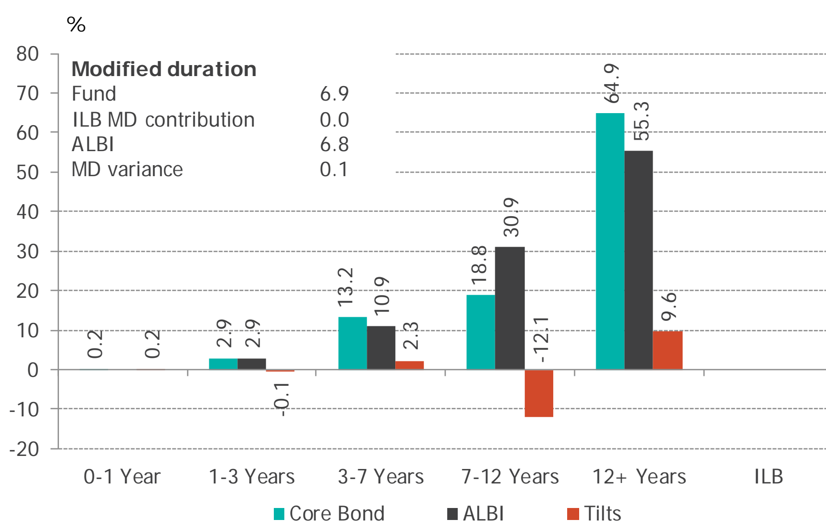
At a global level, the shift from quantitative easing to tightening has stalled, and in some cases even reversed, due to a heightened fear of a global growth slowdown - or even recession. Even so, we are of the view that authorities are prepared to adjust relatively quickly, and some are already responding, 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 a weak fiscal position. 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 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. The presentation of the 2019 MTBPS in October confirmed our bearish views. That said, we also noted slow progress in rehabilitating institutions

like the South African Revenue Services. In the midst of all the economic despair, as a responsible investor, we are continuously on the look-out for any green shoots, such as efforts to fix broken public institutions.

Following the Monetary Policy Committee's decision to keep the repo rate on hold at the September and November meetings, we maintain our view of a stable policy path from here on. That said, we acknowledge the risk of future policy 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 no reason to expect 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% to 6%, depending on what point on the yield curve is used as reference. Therefore, while our broad interest rate investment strategy remains defensive, the neutral modified duration position acknowledges reasonable valuation, which partly compensates for the relatively poor investment theme. For this reason, 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%	2.7%
SA GDP	1.5%	1.3%	0.3%	1.3%	0.8%	0.9%	1.6%
SA Headline CPI	6.1%	4.6%	6.3%	5.3%	4.6%	4.3%	4.5%
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.

AUM as at 31 December 2018

FUTUREGROWTH
/ ASSET MANAGEMENT

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