FUTUREGROWTH
/ ASSET MANAGEMENT

Monthly Review

October 2019

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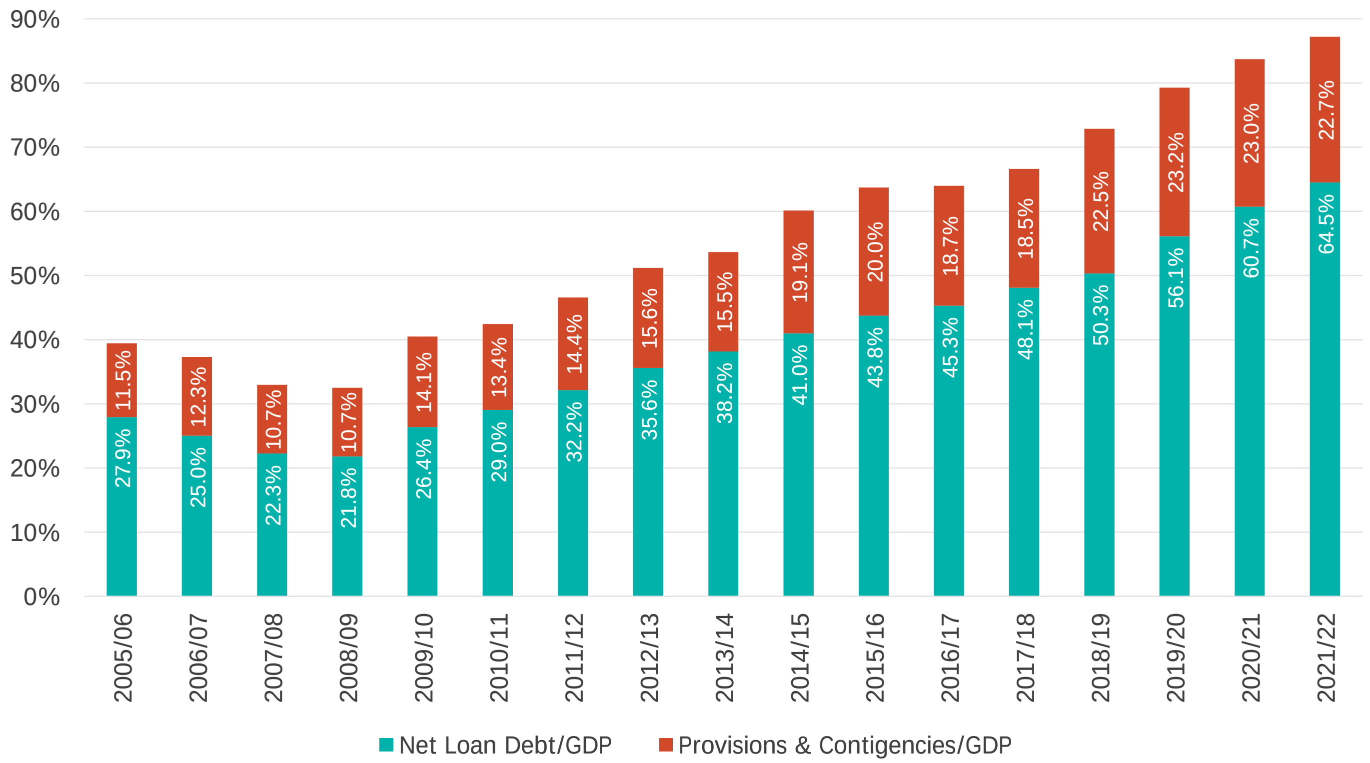
Market review

Economic and market overview

More oil dumped onto the slippery fiscal slope
In a similar vein to the shocking 2017 Medium Term Budget Policy Statement (MTBPS), this year's presentation spooked financial markets. In fact, the latest medium-term budget estimates turned out to be even worse than our relatively bearish outlook. Against a much weaker macroeconomic backdrop, tax revenue collections are expected to keep underperforming, while an earlier call for mandatory expenditure cuts was abandoned. Underperforming state-owned enterprises (SOEs) once again took a bigger slice of the budget cake than earmarked earlier this year. As a result, the main budget deficit for fiscal 2019/20 is now estimated to widen to 6.2% of GDP, compared to the original target of 4.7% of GDP set in February this year. With nowhere to hide, government is once again forced to turn to financial markets with a higher borrowing requirement. In turn, this makes it impossible for the debt-to-GDP ratio to stabilise over the forecast horizon.

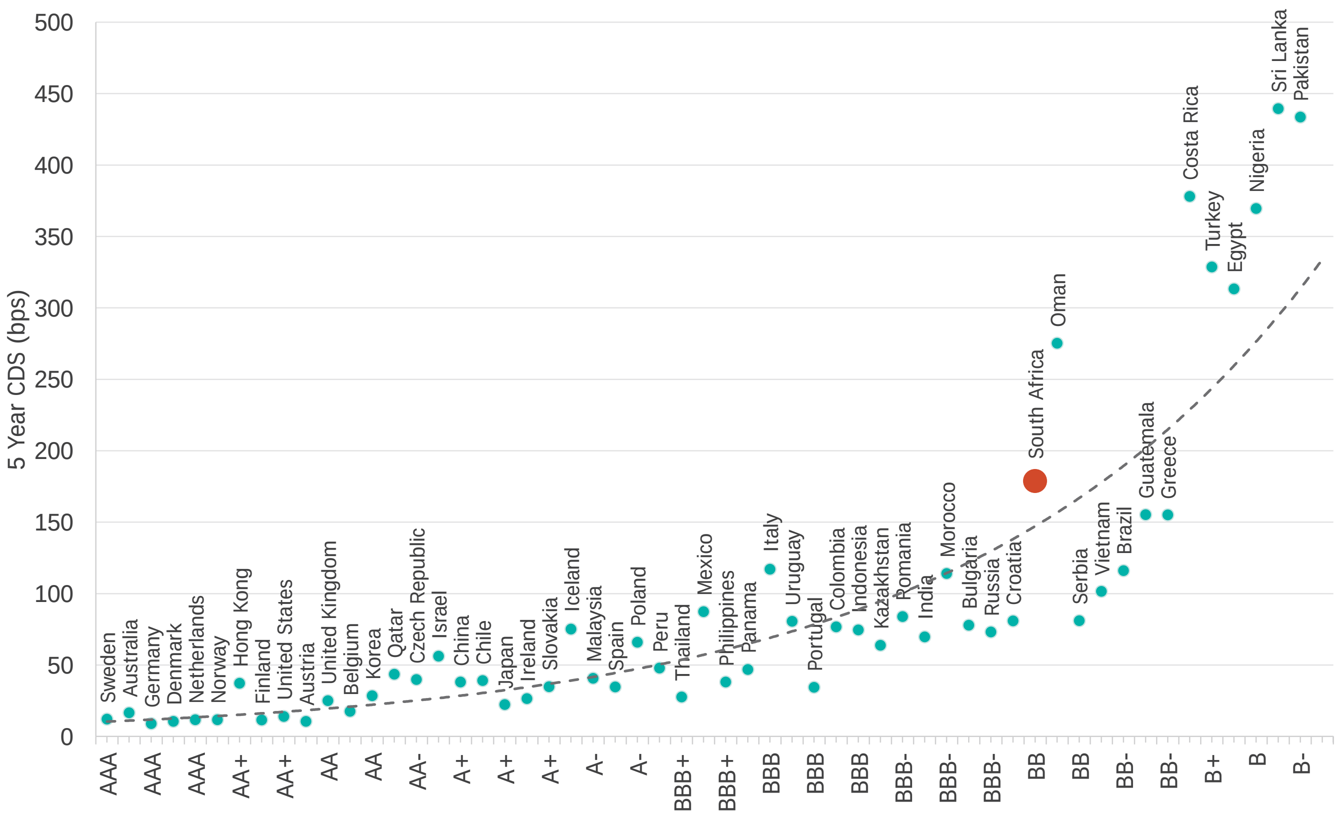
Figure 1: Debt-to GDP ratio: Heading higher...and at an accelerating pace



Source: National Treasury, Futuregrowth

Moody's rating agency painted into a corner
The very significant worsening of the fiscal outlook immediately raised concerns about the response of Moody's rating agency, the only agency still prepared to give the country the benefit of the doubt. However, the 2019 MTBPS left the agency with no choice but to change the sovereign rating outlook from stable to negative. This opens the door for a rating downgrade to sub-investment next year. In our minds, this a long overdue decision by Moody's, who is the only rating agency to still consider the South African government as an investment grade borrower.

Figure 2: Moody's is lagging the market…South Africa is already priced as a sub-investment sovereign borrower.



Source: Bloomberg, Futuregrowth

Positive developments elsewhere got drowned-out by the awful fiscal news
Inflation, both at consumer and producer levels, continued to reflect relatively subdued price pressure. With both headline and core annual inflation rates hovering around the mid-point of the central bank's 3% to 6% target range, stability at the front end of the yield curve still seems like a realistic outcome for the immediate future. Another snippet of positive news originated from the external trade account, where the monthly trade balance remained in positive territory, mainly as a result of a sharp drop in merchandise imports. Even news that the Federal Reserve cut its policy rate had little direct bearing on the local bond market, as investors got bogged down by the unfolding fiscal horror show.

Both nominal and inflation-linked bonds underperformed cash during the month
As would be expected, both nominal and inflation-linked bond yields spiked in response to the worse than expected 2019 MTBPS. With the short end of the yield curve anchored by a benign inflation outlook as well as a reasonable expectation of a stable repo rate path, it was up to the back end of the yield curve to adjust higher. This led to bearish yield curve steepening. In terms of the 10-year point, the yield of the R2030 increased from 8.86% to close the month at 9.20%. Similarly, the 30-year point (R2048) jumped by 30 basis points (bps) to close at a yield of 10.08%, the highest since December last year. Inflation-linked bonds were not spared as the real yields continued their march upwards. In the case of the 10-year point (I2029), the real yield closed at 3.56%, 15bps above the level at the end of September, and well above this year's low of 2.90% that was recorded early May.

As a result, the JSE Inflation-linked Government Bond Index (IGOV) and the All Bond Index (ALBI) returned -0.5% and -0.3% respectively, well below the cash return of +0.5%. Even so, the ALBI is still heading the leader board for the first ten months of the year with a total return of +8.1%, followed by cash (+5.5%), while inflation-linked bonds are still lagging both. Over this period, the IGOV rendered a return of +2.9% as a low inflation carry only partly offset the performance drag from rising real yields.

A bold step forward for SA's energy sector

The energy sector is at a cross road and actions taken now will have multi-generational social, economic and environmental implications for our country.

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 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 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 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	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 significantly worse than even our long-held bearish estimates. An adjustment to more realistic macroeconomic assumptions and tax buoyancy rates by National Treasury should be applauded. Since 2009, National Treasury persisted with unrealistic high nominal GDP estimates, thus banking on higher economic growth (and higher inflation) to do some of the hard work. Disappointing growth and a pinch of deflation contributed to tax revenue underperformance over time. The inability to match this shortfall by expenditure reductions combined to lead to a sustained rise in the gross debt to GDP ratio, which is now estimated to reach the level of 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

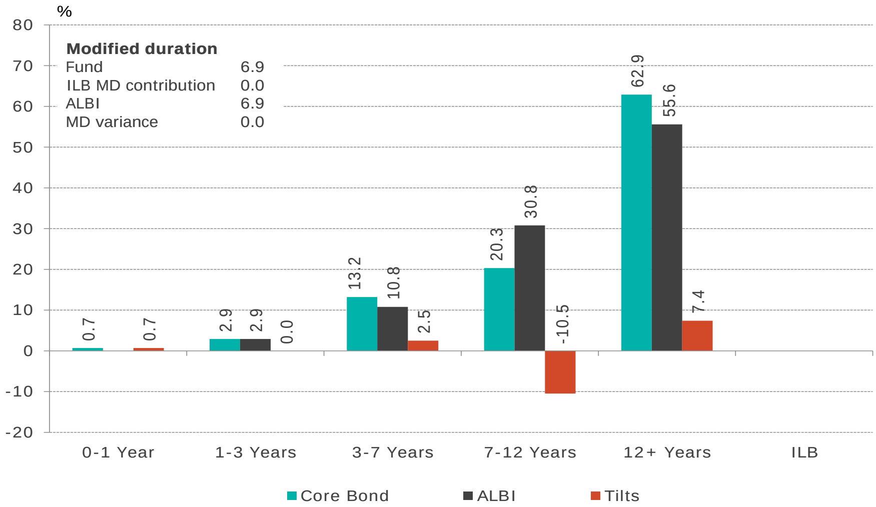
At a global level, the shift from quantitative easing to tightening has stalled, and in some cases even reversed, due to a heightened fear of a global growth slowdown - or even recession. Even so, we are of the view that authorities are prepared to adjust relatively quickly, and in some cases are already 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 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 worst fears. That said, we also noted slow progress at rehabilitating institutions like the South African Revenue Services. In the midst of despair, as a responsible investor, we are also keenly keeping on the look-out for any green shoots, specifically with regards to efforts to fix broken institutions.

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% to 6%, depending 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 offsets 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%	2.6%
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.

AUM as at 31 December 2018

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