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Global risk appetite dips on growth concerns - while our beloved country had to deal with a devastating event

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Unrest and looting add to South Africa's list of challenges

The global spike in COVID-19 infections and emergence of the Delta strain compelled investors to question the sustainability of the global growth recovery (especially in low-vaccination countries) and the impact of this on asset prices in general.

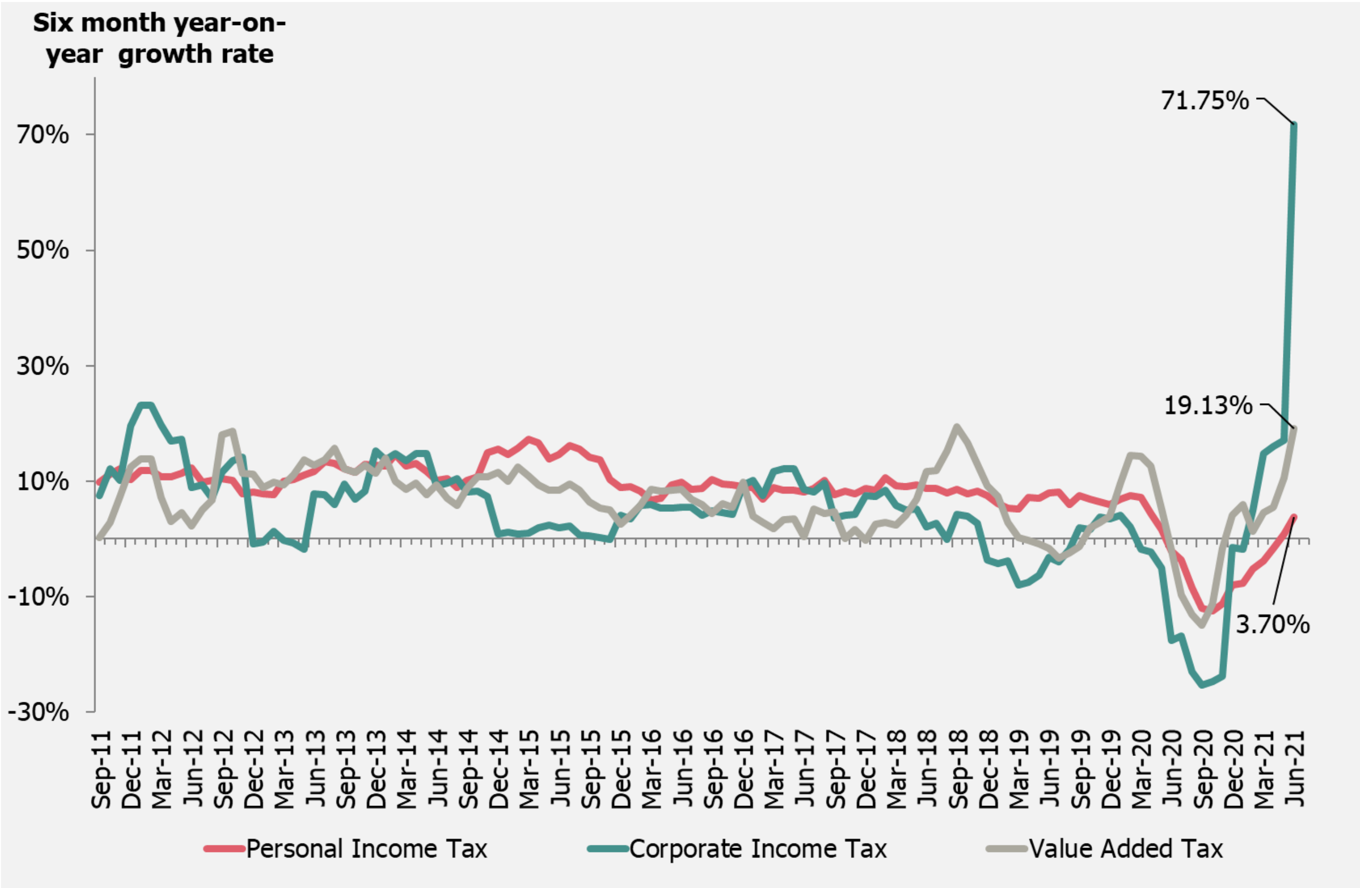
In the case of South Africa, the drop in global risk appetite was overshadowed by social unrest in the country's two biggest provinces. Not only did this result in the tragic loss of life, but also large-scale destruction of infrastructure and the disruption to distribution channels. While the immediate cost of the destruction is still being tallied, the longer-term negative impact on investor sentiment and much-needed fixed capital investment spending raises a concern. Moreover, both the cause and consequence of this event carry the risk of negatively impacting the country's sovereign creditworthiness and credit ratings – and further eroding the country's economic growth potential.

The event arguably forced the hand of President Ramaphosa to finally unveil a long-anticipated cabinet reshuffle. The most significant change, from a fiscal and market perspective, is the appointment of Mr Enoch Godongwana to replace Mr Tito Mboweni as Minister of Finance. Suffice it to say, this development fails to cause us to make any changes to our cautious investment theme and the relatively defensive market stance that flows from this. Our concern remains in place regarding the lacklustre policy efforts to lift economic growth to a sustainable higher level, as well as the execution risk to urgent fiscal consolidation.

The unrest resulted in unplanned additional government expenditure

Government responded by announcing a support package for the victims of the unrest. This includes tax breaks for businesses and the reintroduction of the social relief grant that was terminated in April. While the estimated outlay of R39 billion (comprising R34 billion in additional expenditure and R5 billion in additional tax breaks) will be funded by robust revenue collections, and thus will not reverse the fiscal consolidation, it will slow down progress. The tax revenue collection overshoot might offer a short-term reprieve, it implies a lost opportunity to reduce the speed at which government is accumulating expensive debt. A more long-term consideration is the fact that high unemployment and its devastating impact on the most vulnerable will increase pressure for the introduction of a basic income grant. The reintroduction of the social relief grant is thus likely to morph into a permanent expenditure item.

Figure 1: Firm commodity prices continue to boost corporate income tax revenue collection



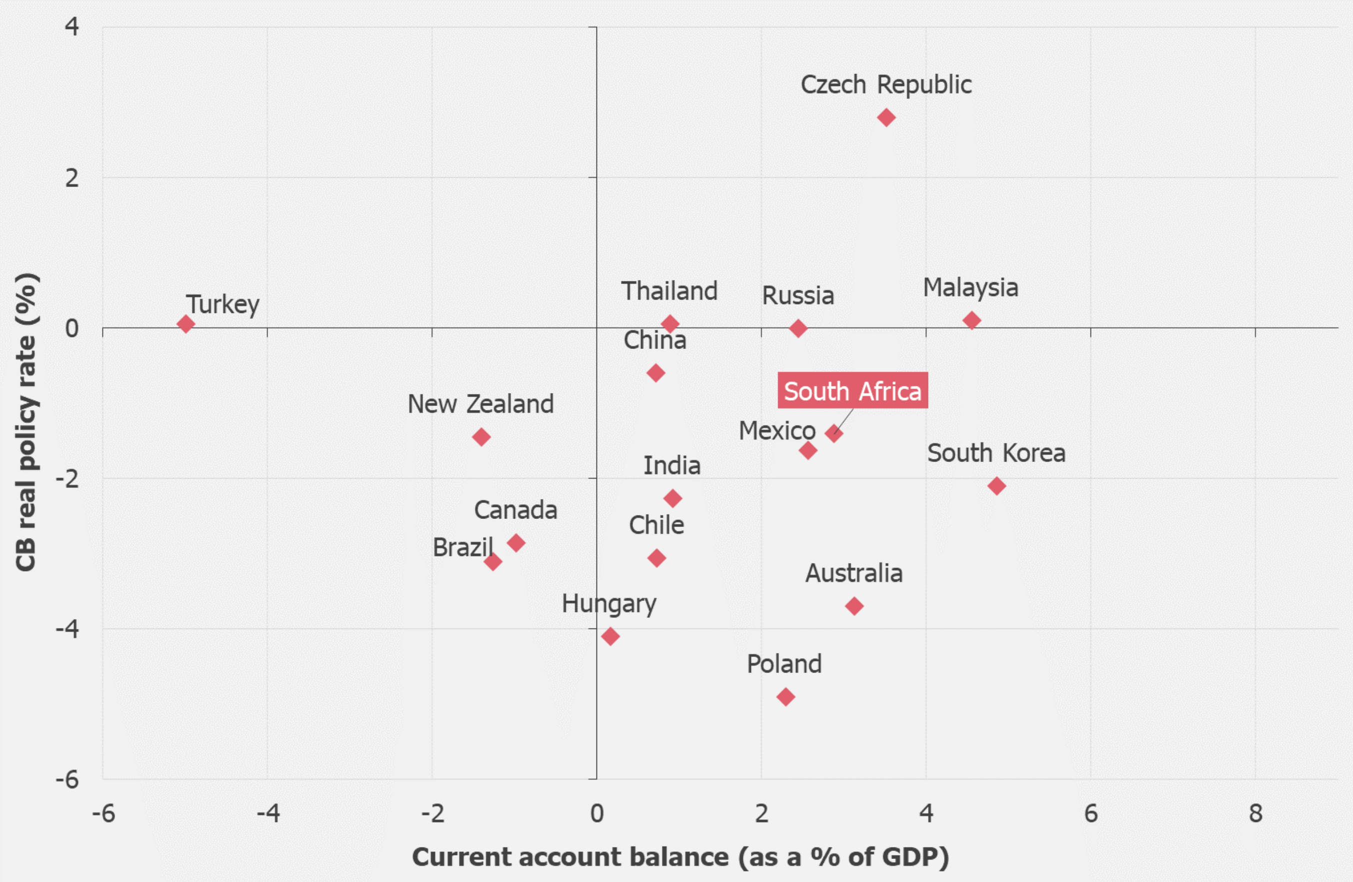
Source: Bloomberg, Futuregrowth

Firm commodity prices continue to support fiscal and external trade balances
Fortunately, the strong global commodity cycle continues to offer a reprieve, both for the country's public finances and the balance of payments. In the case of the former, the bulk of the tax revenue overshoot of the first three months of the current fiscal year is still mainly due to higher corporate income tax collection, mainly as a result of improved mining sector profitability. This specifically applies to the June data set where corporate income tax reached a record level of nearly R98 billion, representing fiscal year-to-date growth of 140% and 74% for 2020 and 2019 respectively.

The country recorded another strong external trade surplus in June with an increase to a new record of R58 billion from R54 billion in May. This bodes well for the current account which is now heading for the biggest surplus in decades and, in turn, offers significant support for the South African currency. However, we have to consider the sustainability of the strength of the global commodity cycle and thus the lasting positive impact this may or may not have. Prices already seem to have lost upward momentum, which is to be expected in light of the exceptional recovery since last year. This calls for caution, especially on the reliance of this windfall in plugging increasing government expenditure.

June inflation data confirmed that May represented the cycle peak
The June Headline Consumer Price Index (CPI) recorded a year-on-year increase of 4.9%, a touch lower than the cycle peak of 5.2% in May. While Core CPI accelerated slightly faster at 3.2% compared to 3.1% in May, it clearly remained relatively subdued. In contrast to CPI and general market expectations, the Producer Price Inflation Index (PPI) for final manufactured goods rose from a year-on-year increase of 7.4% in May to 7.7% in June. Worryingly, this was fairly broad based. Even so, the relationship between CPI and PPI has weakened significantly over the past few years and we continue to believe that weak consumer demand will limit the extent to which price increases at producer level will filter through to retail prices.

Figure 2: South Africa is in a better position, considering its relatively higher real policy rate and improved currency account position



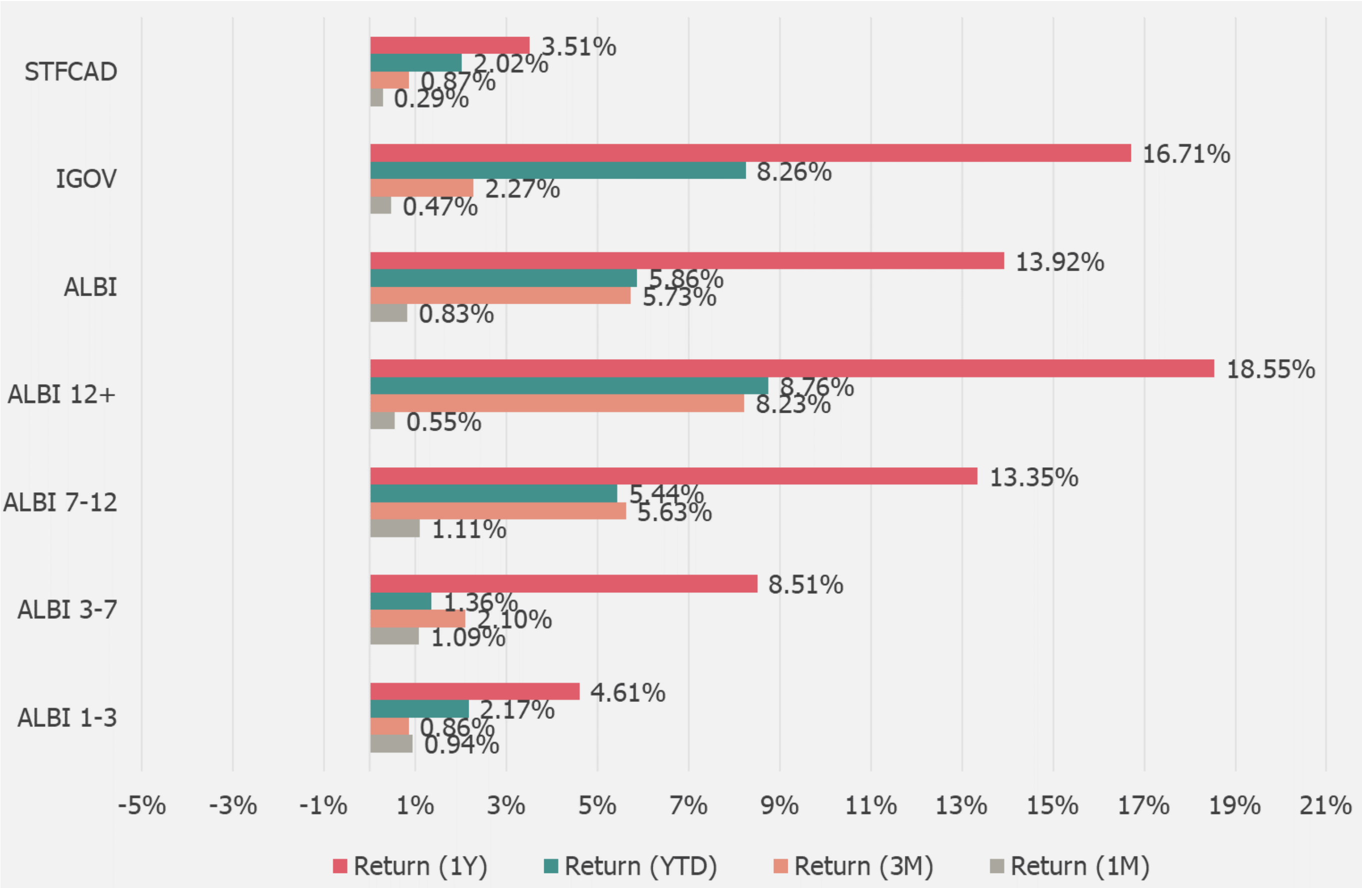
Source: Bloomberg, Futuregrowth

The South African Reserve Bank left rates unchanged
The unanimous decision to leave the repo rate unchanged at 3.5% at the July meeting of the Monetary Policy Committee (MPC) was widely expected. While the bank left its economic growth forecast unchanged, it did express the view that the recent unrest-related events could dent investor confidence. Although its inflation forecast was adjusted upwards, the mention of better anchored inflation expectations around the mid-point of the inflation target range, together with a fragile economic recovery and a relatively stable exchange rate, enticed the MPC to state that interest rates could be kept lower for longer. The Committee once again stressed that its Quarterly Projection Model (QPM), that continues to point to an earlier start and a more prominent tightening path, merely serves as guide. Unsurprisingly, this outcome forced the Forward Rate Agreement (FRA) market to reign in its persistently bearish rate expectations.

The nominal bond market regained some lost ground following a weak start to 2021
Following some earlier intra-month volatility, the market managed to recover earlier losses, and yields retreated to better levels. As a result, the FTSE JSE All Bond Index (ALBI) rendered a decent performance of 0.83%, with the biggest positive contribution coming from bonds in the 7- to 12-year maturity band.

While inflation-linked bond yields also edged lower, this asset class again underperformed nominal bonds, as the demand for inflation hedging continued to fade in light of a more benign medium-term inflation outlook. Even so, the FTSE JSE Government Inflation-linked Index (IGOV) rendered a reasonable return of 0.47%. Both nominal and inflation-linked bonds again outperformed cash, which rendered a return of 0.29% in July.

Figure 3: Bond market index returns (periods ending 31 July 2021)



Source: JSE, Futuregrowth

THE TAKEOUT: Early in July, the local bond market was negatively impacted by a decrease in global risk appetite and, to a lesser extent, local unrest, looting and the destruction of infrastructure. However, the market managed to regain some footing in response to multiple positive developments. The decision by the South African Reserve Bank to maintain its current supportive policy stance was widely anticipated. Nonetheless, the unanimous decision by the Monetary Policy Committee to leave the repo rate unchanged and its insistence that the market is putting too much emphasis on the Quarterly Projection Model did force interest rate bears to adjust their rate expectations lower. Confirmation that consumer price inflation has peaked and more evidence of the continued support from the global commodity cycle is lending support to both public finances and the balance of payments. As a result, both nominal and inflation-linked bonds managed to outperform cash.

AN OVERVIEW: Macroeconomic outlook, market view and investment strategy

Economic growth	The speed at which a wide range of direct and indirect monetary and fiscal measures have been announced and applied in the aftermath of the COVID-19 pandemic has been commendable. While this policy response and the vaccine rollout in mainly advanced economies contributed to the rebound in global economic growth, the recovery is still uneven across regions. Risks to the recovery remain, as many emerging markets are lagging with vaccinations programmes, and the issue of vaccine efficacy has become concerning as newer and more infectious COVID-19 strains develop. Even so, the economic rebound is broadly gaining momentum and, with that, the need for extraordinary monetary and fiscal support is slowly fading. Locally, the release of Q1 GDP data and leading economic indicators for the second quarter, supported our view of a strong economic growth rebound this year. The tragic and economically disruptive events in July did force us to scale down the GDP growth rate from 5.5% to 4.9%. Even so, the impact of the unrest is not entirely clear, especially on longer-term investment sentiment. More importantly, the unrest served as another stark reminder of the consequences of the widening income gap and the hardships faced by the unemployed. To address this, structural weaknesses (namely, macro-policy uncertainty, weak policy implementation, low levels of fixed capital investment, unreliable power generation, and a rigid labour market) need to be addressed. While we acknowledge recent progress, much still needs to be done, especially when it comes to the actual implementation of the reform plans. **THE TAKEOUT:** The need for the pandemic-induced extraordinary direct and indirect monetary and fiscal stimulus is slowly fading in advanced economies. This allows for a move towards policy normalisation, although the pace and policy responses will differ across regions. Locally, any short-term policy response, which is likely to lag that of advanced and some emerging market economies, must be accompanied by more sustainable solutions to the many structural hurdles. Although we acknowledge some progress, it remains too slow and tepid.
Inflation	Our base case of an inflation surge, mainly due to a combination of extraordinary base and supply bottle-neck effects, has largely played out. Even though this is widely deemed to be transitory, financial markets and central banks alike will continue to monitor developments closely. For now, we maintain our view that underlying inflation is expected to remain relatively benign in most developed economies as the drivers of stable core inflation are still largely entrenched. This includes inflation expectations, a key variable which, until now, has not changed in a meaningful way.

	Locally, the release of June inflation data confirmed the expectation that the peak in the current cycle was reached in May. The passing of unfavourable base effects and the sustained sharp decline in housing rental inflation and very muted services inflation are expected to contribute to an ease in the rate of headline CPI in the months ahead. More importantly, the muted core CPI reading continues to reflect the subdued structural pricing power already evident in the past two years. This includes strong evidence that the pass-through of rand weakness to inflation remains exceptionally weak, which, in turn, is reflective of the inability of producers and retailers to pass sustained large price increases on to the end consumer. We considered the impact of the July unrest on prices and responded by tweaking our headline inflation forecast slightly higher, by lifting the 2021 average from 4.1% to 4.2%. The forecast to next year remains largely unchanged at 4.5%. **THE TAKEOUT:** Locally, inflation has reached our expected peak in this cycle, mostly as a result of extraordinarily strong base effects, making it largely transitory. The rate of inflation is now expected to stabilise and settle around the mid-point of the inflation target range well into next year.
Balance of payments	The improvement in the merchandise trade account that started in the second half of 2020 gained significant momentum during the first six months of this year. This bodes well for a positive current account balance in 2021, the second consecutive one following the 2.2% surplus recorded last year. This will go a long way to alleviate the drag created from a persistent negative income account deficit, given the structurally large dividend and interest payments to foreign investors, and will, in turn, lend some support to the currency. **THE TAKEOUT:** While South Africa's terms of trade remain relatively favourable, the significant improvement in the past few quarters is not sustainable. Firstly, the sustainability of the strong commodity price increases should be interrogated. Secondly, and in addition to recent rand strength, the anticipated recovery in the economy and crude oil price is likely to lead to some resurgence in imports over the course of this year, leaving the country with a current account surplus of around 2.2%.
Monetary policy	Broadly speaking, the tide for monetary policy stimulus has turned. While divergence with respect to the timing of the start of the tightening cycle among both advanced and emerging markets may persist for a while, stronger economic growth and tentative signs of higher inflation support the gradual normalisation of extraordinarily low policy rates. The speed of policy normalisation is still expected to be very gradual, considering the transitory nature of the short-term inflation surge.

	Locally, the SARB made it clear that it would retain its current policy stance, although with a hint of concern about upside risk to its latest inflation forecast. We agree with this stance and retain our view that the repo rate will remain unchanged until early next year. This is based on the fragile economic recovery and a relatively muted underlying inflation outlook for the remainder of this year. The risk to this view is an earlier than expected start to the tightening cycle. **THE TAKEOUT:** Market focus has shifted to the potential inflationary consequences of a stronger economic recovery and the implication for monetary policy. In our view, the next big change is monetary policy tightening, although the timing thereof is highly dependent on the circumstances of individual countries and regions. Locally, the SARB is expected to only start raising rates in the first half of 2022, and in a measured way. We are therefore in strong disagreement with the local FRA market that is pricing a higher repo rate as early as the third quarter of 2021.
Fiscal policy	While National Treasury based its most recent budget estimates on more realistic macroeconomic assumptions than previously (which lent more credibility to the budget), the proposed implementation of reforms - and significant expenditure reductions over the next three years - carries significant execution risk. It has also become clear that, without significant expenditure cuts and structural reforms, the South African economy could eventually devolve into a full-blown fiscal crisis. Improved tax revenue collection and reduced expenditure are admittedly pointing in the desired direction of deficit reduction, but this is still insufficient when considering the size of the primary deficit and the implications for the high level of outstanding debt (and the risks associated with the future ability to service it). The unplanned additional pressure on expenditure as a direct consequence of the July unrest does mean one step backwards, although the impact is expected to be relatively small. An inability to turn the fiscal ship around will have dire implications for the country’s sovereign credit ratings and specifically for bond valuations. While SA is priced as a BB-rated issuer, a downgrade to the B-rated tranche will serve as a catalyst for significant negative repricing. **THE TAKEOUT:** A combination of stronger economic growth, better tax revenue collection, and marginal expenditure reduction has allowed for some fiscal consolidation. However, in the wake of longer-term subdued and sub-par economic growth, the risk remains that government may not be able to deliver on its ambitious stated intentions. We remain concerned about execution risk, specifically with regards to the size of the public sector wage bill and contingent liabilities which, in turn, may lead to weaker-than-expected consolidation. The additional expenditure pressure following the public sector wage deal agreement and the July unrest forced the country to take one step backwards. Therefore, the risk of more sovereign credit rating downgrades in the medium term cannot be dismissed.

Our investment view and strategy
Our main concern about the local bond market remains the strong link between the lacklustre underlying economic growth (ignoring the quarter-on-quarter volatility in growth rates) and the weakest fiscal position in decades. Even though the government is showing intent to stabilise the pace at which the public sector debt burden is rising, we remain nervous about execution risk, the level of debt, and the threat to the country's sovereign risk profile. The weaker economic recovery beyond this year's rebound from last year's extremely low base, a strong balance of payments position, and the relatively benign inflation outlook for the remainder of this year will allow the SARB to normalise policy in a measured way, with the first hike expected sometime in the first half of next year.

In terms of the yield curve, we continue to favour an anchored front end, while gyrations around global risk sentiment and continued uncertainty about the dire local fiscal situation will potentially contribute to back-end volatility. However, with the positive yield curve slope already quite steep (from a portfolio positioning perspective) the challenge remains to find a better balance between managing potential capital loss and benefitting from holding higher-yielding longer-dated bonds that offer an attractive carry or base accrual relative to cash and short-term instruments. We are therefore maintaining our strategy to avoid holding cash (in light of its low return potential). We have also tempered our holding of ultra-long-dated nominal bonds, with the risk of sustained fiscal slippage in mind. We therefore still believe that the best risk-adjusted area of the yield curve remains the 10- to 15-year maturity band.

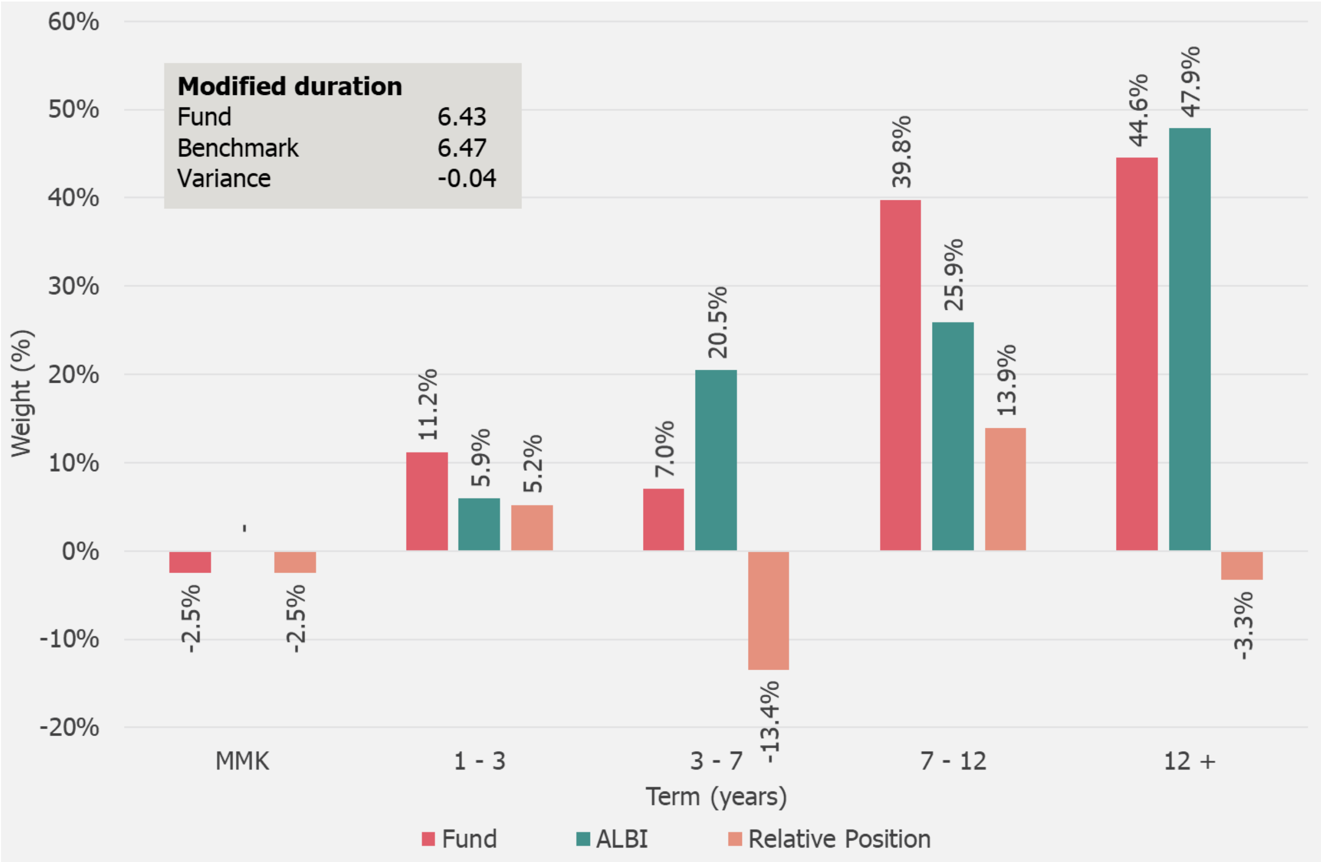
We continue to favour medium-dated nominal bonds over inflation-linked bonds. While we acknowledge that the latter have repriced to levels more reflective of fair value compared to a year ago, the strong inflation-linked bond rally since the end of 2020 has already diluted prospective future returns in a significant way. The attractiveness of this asset class (compared to nominal bonds) is undermined by the combination of a relatively benign inflation outlook, the dire fiscal backdrop, and the better inflation-adjusted yields currently offered by medium-dated nominal bonds.

While we still deem the above the most appropriate strategy, for now, it is important to consider the start of the local monetary policy tightening cycle. Even though our view on the likely start date and the pace of repo rate increases is not as aggressive as the expectation of the FRA market, some level of caution is appropriate at this early stage. Monetary policy tightening down the line will impact the slope of the yield curve and thus one of our strategy pillars: yield curve roll-down potential.

THE TAKEOUT: Our investment strategy aims to strike a balance between 1) capitalising on the extraordinarily high roll-down potential and base accrual (carry) on offer and 2) limiting potential capital loss. The high roll-down potential and carry are a function of the steep yield curve slope, especially at the front end. This, in turn, is due to the combination of a multi-decade low anchored repo rate, a relatively benign inflation outlook, and the weakest fiscal backdrop in recent history. However, we do acknowledge that the prominence of roll-down potential will start to fade in the medium term as pressure builds for the SARB to start normalising policy. Even so, with potential returns at the short end approaching sub-inflation levels, and the dire fiscal position putting ultra-long-dated bonds most at risk of capital loss, we believe that medium-dated nominal bonds offer the best risk-adjusted alternative. In our view, these bonds are also better priced than inflation-linked bonds, even when considering a higher rate of inflation and thus inflation carry on a forward-looking basis.

In the case of our Listed Yield Enhanced Bond Composite, our view is expressed as follows:

Figure 4: Futuregrowth Listed Yield Enhanced Bond Composite Fund Structure



Source: Futuregrowth

Table 1: Key economic indicators and forecasts (annual averages)

	2016	2017	2018	2019	2020	2021	2022
Global GDP	2.5%	3.4%	3.3%	2.6%	-3.6%	6.5%	4.5%
SA GDP	0.4%	1.4%	0.8%	0.4%	-7.0%	4.9%	2.3%
SA Headline CPI	6.3%	5.3%	4.6%	4.1%	3.3%	4.2%	4.5%
SA Current Account (% of GDP)	-2.9%	-2.5%	-3.5%	-3.2%	2.2%	2.2%	-0.5%

Source: Old Mutual Investment Group

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