

A person wearing a dark jacket and pants stands on a wooden pier, holding a bright red umbrella. The scene is set during a heavy rainstorm, with rain streaks visible against a dark, overcast sky. The pier has a wooden railing and extends into the distance. The overall mood is somber and contemplative.

# FUTUREGROWTH

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The spike in commodity prices in response to the military conflict in Ukraine raised already elevated global inflation concerns to even higher levels. In turn, this added urgency to the earlier shift towards monetary policy tightening by the majority of global central banks.”

## Bond market commentary: Weathering the latest global firestorm

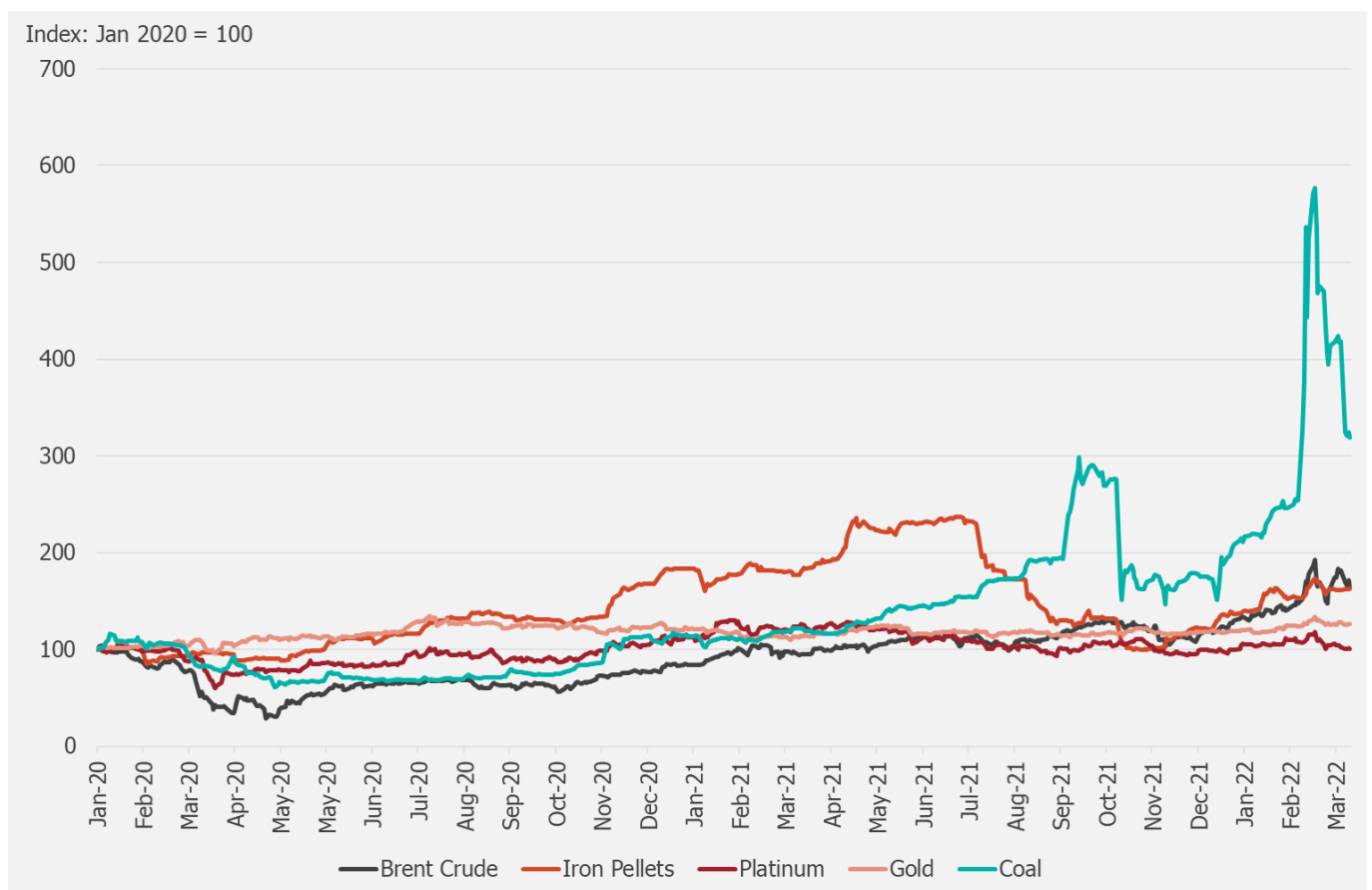
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### Eastern European conflict adds complexity to an already muddy global backdrop

At the time of writing, markets were still on tenterhooks and digesting the ongoing impact of the escalation of the terrible Russia-Ukraine full-scale military conflict, with spill-overs materialising in all financial markets. While the direct effects on global growth are likely to be limited, as both countries only represent around 2% of global GDP, the indirect impact matters more for now. That said, investors and policy makers alike are already concerned about the longer-term effects should the conflict escalate or be prolonged. The immediate indirect effect had been evident in commodity market turmoil and the tightening of global financial conditions. During March, commodity markets (specifically energy, food, and metals) have experienced the biggest price adjustments since the 1973 oil crisis. For instance, the price of brent crude oil increased from \$95 per barrel to \$127 per barrel two weeks into the conflict - fed by concerns about supply - before it dipped back to lower levels. The upward price changes for coal and grain products were even more dramatic. From a global monetary policy management perspective, the conflict adds another level of complexity, with the risk of higher inflation and weaker economic growth (stagflation) to be considered by both monetary and fiscal authorities. This comes at a time when many central banks are already grappling with stubbornly high levels of inflation - one of the legacies of the COVID pandemic.

**Figure 1:** Commodity price changes (Jan 2020 = 100)



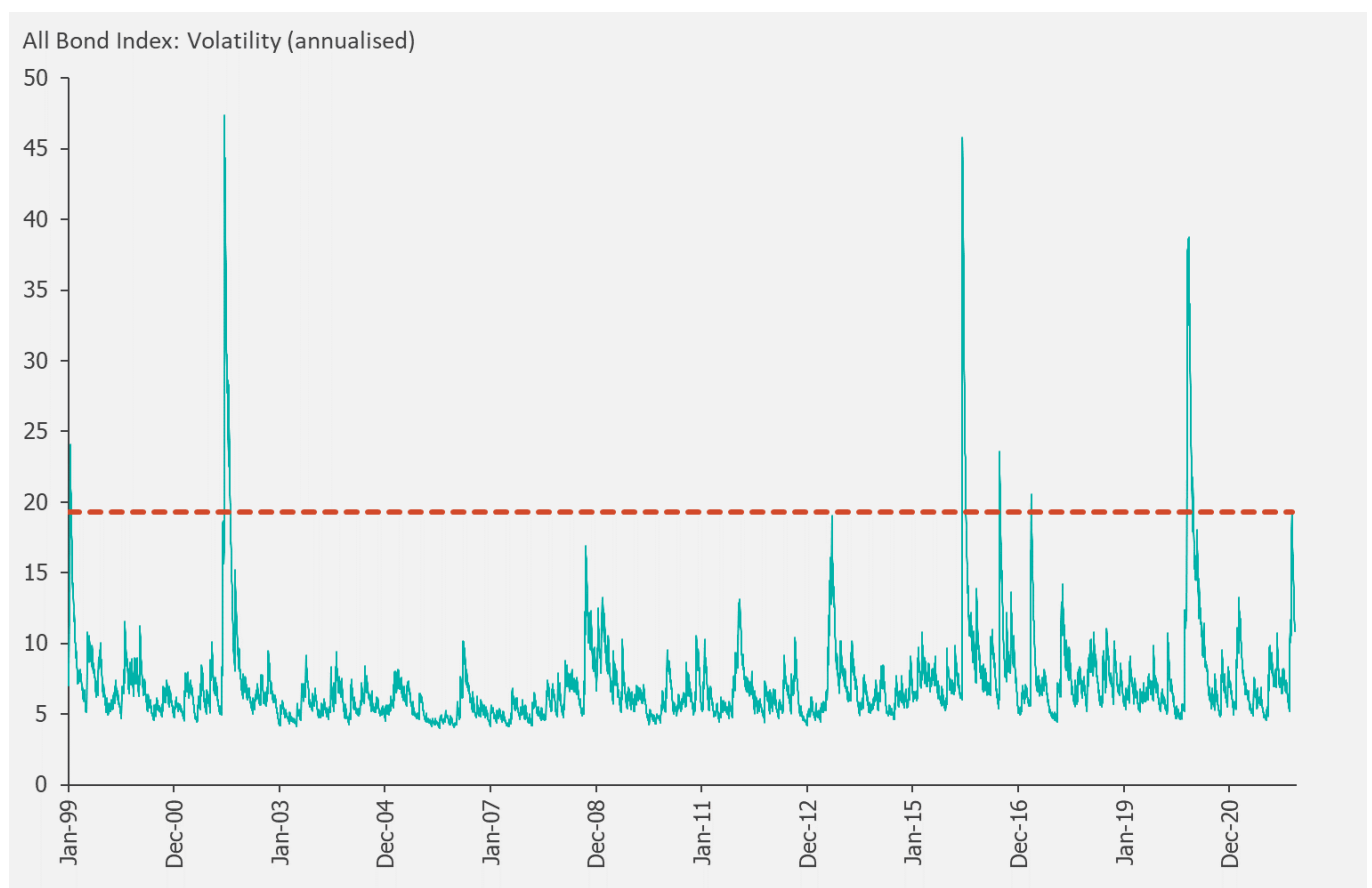
Source: Bloomberg, Futuregrowth

### Elevated inflation and pipeline price pressure forced the hand of central banks

Rising uncertainty about stagflation aside, many prominent central banks stuck to their telegraphed intention to tighten monetary policy in response to the stubbornly high rates of inflation. In the case of

the US Federal Reserve (the Fed), which finally joined a growing number of hawkish central banks, the 25 basis points (bps) increase at the March policy meeting was the first since 2018 and a direct response to heightened inflation concerns. Most concerning is the fact that the global economy faces another significant broad-based supply shock (and thus upward price pressure) to add to the supply-side constraints caused by the COVID pandemic. In fact, the resurgence of COVID cases and regional lockdowns of important ports and manufacturing hubs in parts of North Asia raised another red flag. The one prominent exception is the European Central Bank (ECB), which, despite cautious communication about high and rising inflation, opted to remain on hold while it is more concerned about the impact of the conflict on real economic activity in the region. Locally, the South African Reserve Bank (SARB) raised the repo rate by another 25bps to 4.25% at the March Monetary Policy Committee Meeting, the third consecutive repo rate increase. More telling, though, is the fact that two of the five committee members voted for a 50bps hike at the recent meeting, signaling a more hawkish pivot compared to the previous two meetings. Unlike previous crisis periods, relative rand strength did not contribute directly to the decision. Instead, the policy response was completely focused on broader macro-economic fundamentals, specifically an acceleration in the rate of inflation and the expected narrowing of the negative output gap. This required a pre-emptive response from the central bank to manage possible lasting second round effects from the latest energy and food price fallout.

**Figure 2:** Global risk aversion leads to a sizeable volatility spike in the SA bond market



Source: IRESS, Futuregrowth

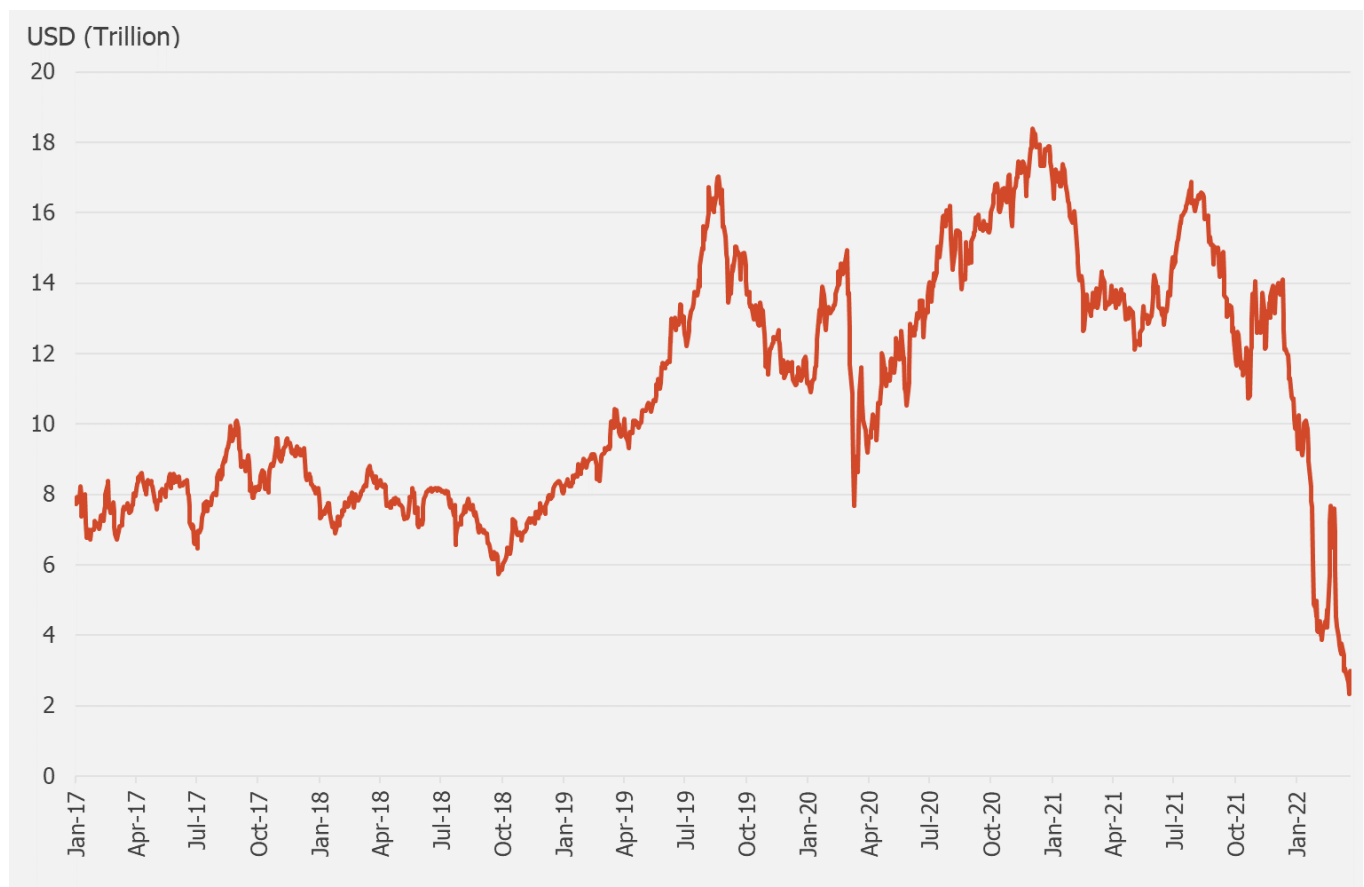
### De-risking drags global bond market yields higher

Global bond markets did not escape the wrath of opportunistic speculators and panicky investors. Rising inflation concerns (from an already high base), increasingly more hawkish central bank messaging and action, the sudden and sharp ratings downgrade of Russian government bonds and the inability to exit Russian financial markets forced broad-based de-risking across advanced and emerging bond markets. While the pace of net outflows in both developed and emerging bond markets slowed towards quarter



end, the broad de-risking trend remains, in light of rising inflation fears and the accompanying policy response. The selloff in bonds has resulted in the amount of negative yielding securities falling to \$3 trillion globally, the lowest since 2015 - a slump of almost 85% since the 2020 peak. In the US, the yield of the 10-year US Treasury bond jumped from 1.5% at the end of December 2021 to around 2.30% at the end of March 2022. This yield movement from such a low base caused a significant capital drawdown of around 10% over this period. In the case of South Africa, foreign investor net selling on the back of general global risk-off sentiment initially led to a significant increase in bond yields before the country's relatively favourable position allowed for differentiation and the return of some sanity.

**Figure 3:** Amount of negative yielding global debt decreased sharply

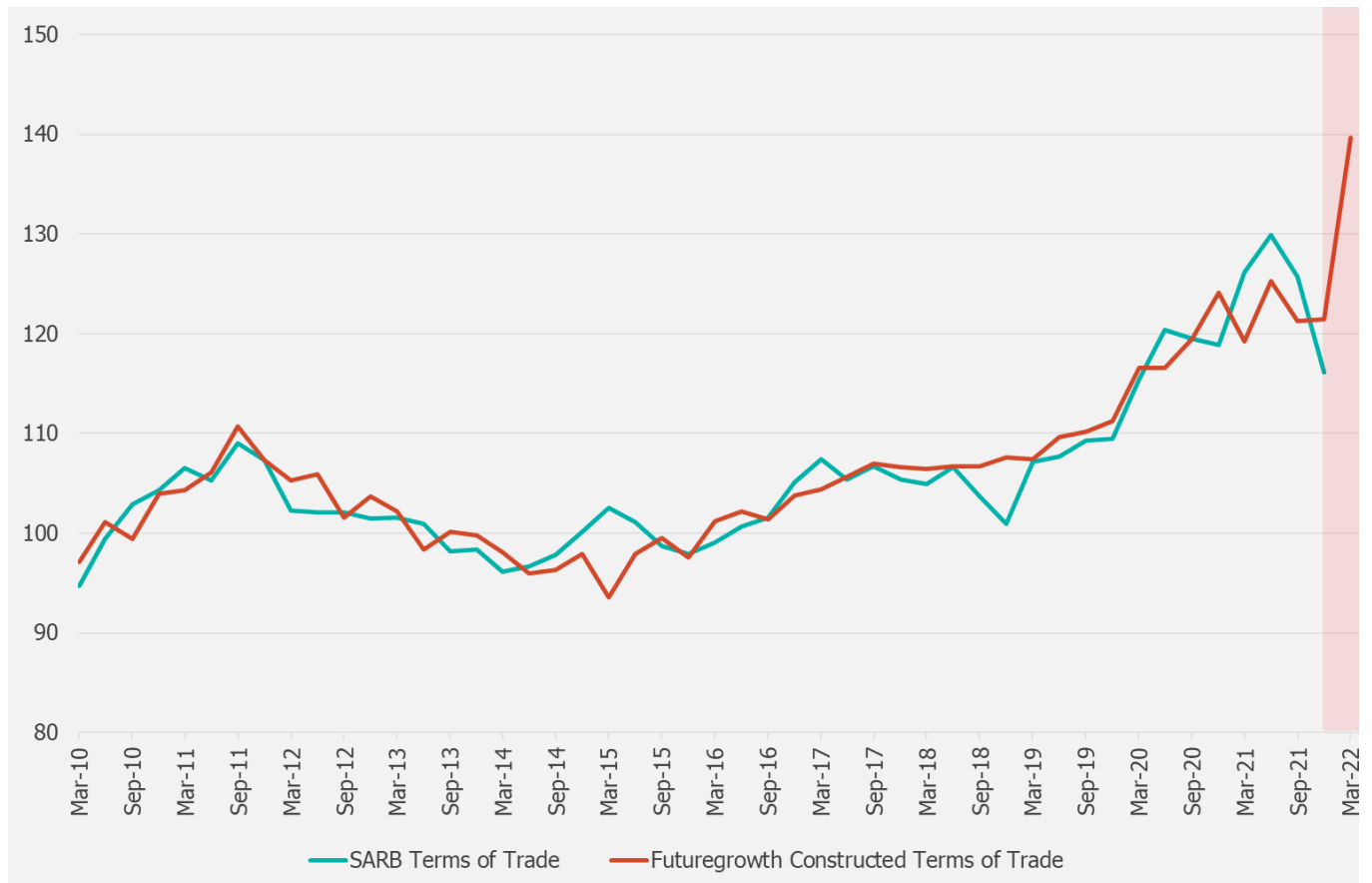


Source: Bloomberg, Futuregrowth

### The fallout from the eastern European conflict is not all bad news for SA

While near-term inflationary pressures will intensify due to the spike in oil and grain prices, the external account impact is more than offset by the sharp increase in coal, iron ore, and precious metal prices. The resultant jump in SA's export price index thus far is expected to more than offset the negative impact of higher oil prices on the country's terms of trade. This, in combination with SA's negligible direct trade and commercial links with Russia, it's geographical distance from the conflict, and an already relatively strong current account base, enabled the rand to weather the fallout from the eastern European firestorm very well. Moreover, higher export earnings may limit the downward pressure on economic activity.

**Figure 4:** SA's term of trade were boosted as the Ukraine conflict intensified



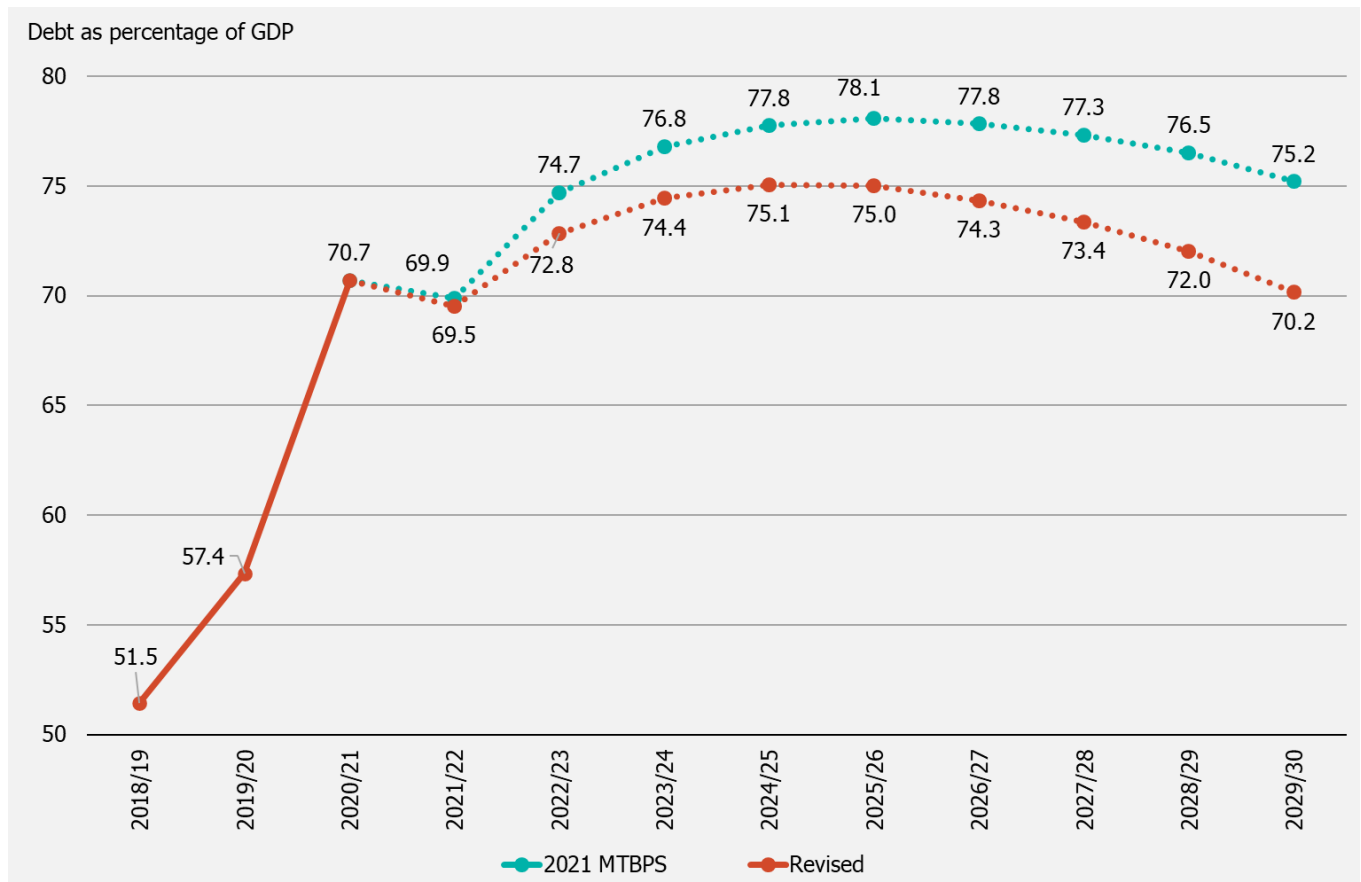
Source: Bloomberg, IRESS, Futuregrowth

## Recent global events overshadowed a reasonable national budget outcome

The tabling of the 2022/23 national budget took a back seat to the disturbing developments in eastern Europe, but the South African government managed to stick to its consolidation plans. In fact, the Minister of Finance managed to strike a delicate balance across debt containment, bolstering public infrastructure expenditure, and securing the social welfare net. The positive outcome of the 2021/22 budget (and the forthcoming fiscal projections) reflects a concerted effort to accelerate the pace of fiscal consolidation. In the short term, it is worth noting that the most recent boost to South Africa's main commodity exports due to the Russia-Ukraine conflict could potentially filter down to stronger-than-expected corporate tax revenue receipts, which, in turn, will assist with efforts to consolidate fiscal finances.

On another positive note, the South African Constitutional Court ruled unanimously in favour of the government in its decision not to implement the third year of the 2018 public sector wage deal. A ruling in favour of organised labour would have had a significant negative impact on fiscal consolidation efforts. Even so, we remain concerned about the underlying tenuous fiscal situation, mainly as a result of the country's sub-par economic growth path and sustained current expenditure pressures, which, in turn, give rise to significant execution risk in the years ahead.

**Figure 5:** The level of outstanding government debt is expected to stabilise, albeit still at elevated levels



Source: National Treasury, Futuregrowth

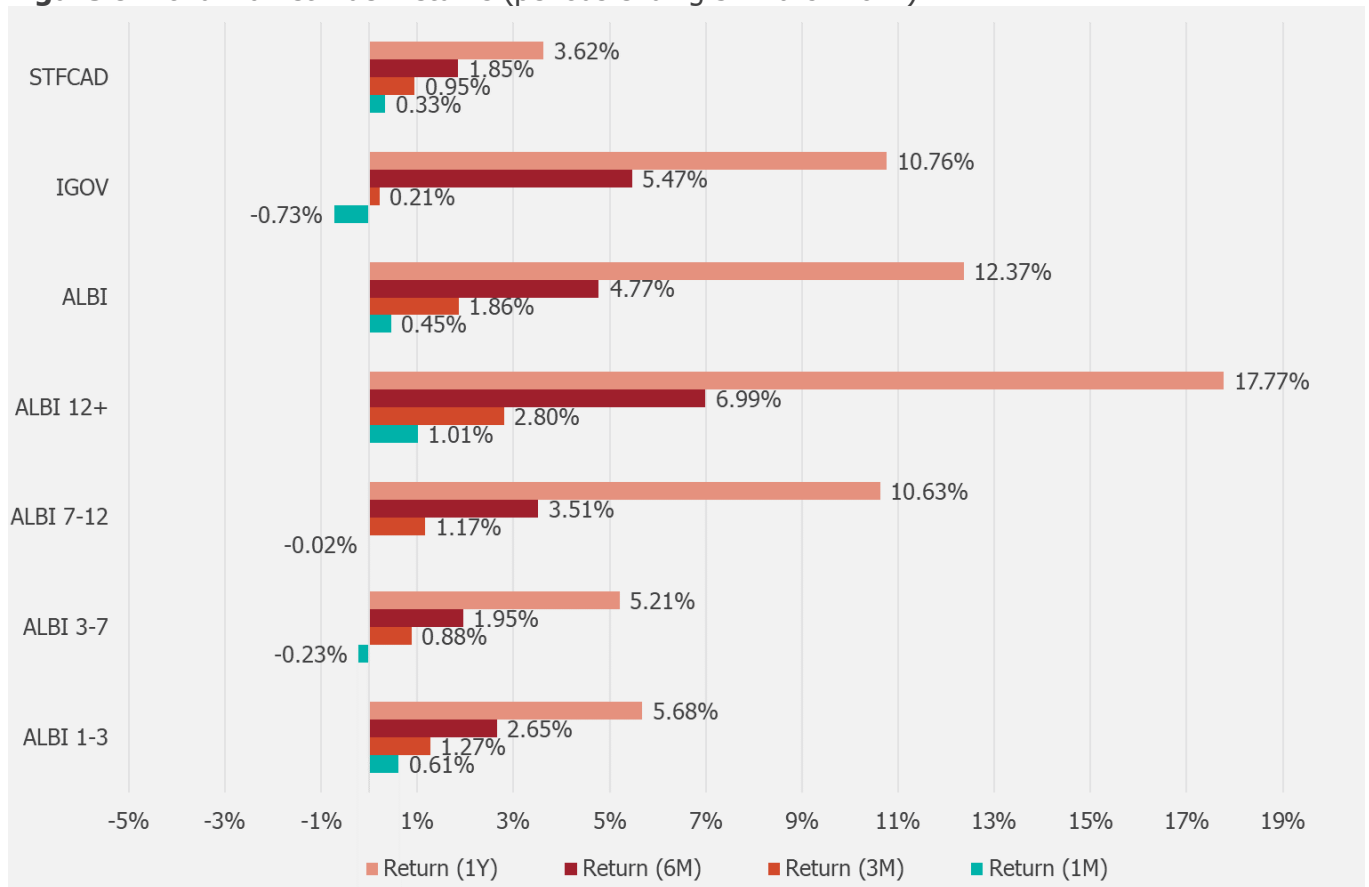
### Local inflation eased back a little before a widely expected acceleration

The year-on-year rate of change of the headline Consumer Price Inflation index in February had been reported at 5.7%, a tad lower than the 5.9% recorded in December, which in turn had been the highest reading in just over four years. Overall, the transport category remains primarily responsible for the strong pickup in inflation, which was recorded as 3.5% in February. This helps explain the variance between headline and core inflation. Although inflationary pressures persist in the form of supply-side-induced price increases, underlying demand-driven inflation continues to remain soft, in light of the sky-high unemployment rate and as a consequence a constrained consumer.

### The SA bond market managed to eke out cash-beating returns despite the troubled global backdrop

While the South African bond market had to deal with lower global risk appetite (mainly in response to the developments described above) it nonetheless still managed to deliver cash-beating returns in the first three months of the year. The FTSE JSE All Bond Index (ALBI) rendered a return of 2.80%, with bonds in the 12+ year maturity band once again outperforming shorter-dated bonds by more than 150 basis points. This was in excess of the cash return of 0.95%. Despite sustained upside inflation pressure and strong technical demand for ultra-long-dated instruments, inflation-linked bond yields drifted slightly higher. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) rendered a relatively weak return of 0.21%.

**Figure 6:** Bond market index returns (periods ending 31 March 2022)



Source: IRESS, Futuregrowth

**THE TAKEOUT:** The spike in commodity prices in response to the military conflict in Ukraine raised already elevated global inflation concerns to even higher levels. In turn, this added urgency to the earlier shift towards monetary policy tightening by the majority of global central banks. The step-up in inflation concerns and monetary policy response served as a catalyst for a significant spike in global bond yields. Locally, the bout of global risk aversion led to an increase in bond market volatility and weakness, which subsided towards month-end. In contrast to previous crisis periods, the South African rand managed to hold its own. This is mainly ascribed to net commodity price movements which benefitted the country's terms of trade. Limited direct trade and investment links to Russia and South Africa's geographical location away from the flash point also assisted. The fallout from the eastern European conflict overshadowed the outcome of the latest South African national budget, which turned out to be mildly positive from an investment perspective as fiscal consolidation retained prominence.

## AN OVERVIEW: Macroeconomic outlook, market view and investment strategy

<p><b>Economic growth</b></p>	<p>Global growth is expected to slow from 3.6% in 2022 to 3.0% in 2023, following a strong post-COVID V-shaped recovery and as risks to the recovery persist. While the impact of earlier COVID-related lockdowns on supply pipelines still linger the fallout from the conflict in Ukraine has added an additional layer of complexity. This may also contribute to a further rise in food and energy prices, considering the importance of Russia and Ukraine to global food, gas, and crude oil supply. Despite this, several central banks have started to unwind their extraordinary monetary support, in light of improved economic conditions, and specifically sustained higher inflation. In the case of the Fed, the recent 25bps rate increase was the first such move since 2018.</p> <p>Domestically, our latest GDP forecasts for 2022 and 2023 are 2.3% and 2.5% respectively, compared to 4.9% for 2021. The lackluster growth rates from 2022 onwards underscore long-standing and persistent structural weaknesses, namely: macro-policy uncertainty; weak policy implementation; low levels of fixed capital investment; unreliable power generation; and an underdeveloped, rigid labour market. While we acknowledge recent progress in addressing some of these issues, much still needs to be done, especially when it comes to the actual implementation of the recovery plans.</p> <p><b>THE TAKEOUT:</b> The need for the pandemic-induced extraordinary direct and indirect monetary and fiscal stimulus in advanced economies has faded fast as inflation stubbornly kept surprising on the upside. Unsurprisingly, monetary policy normalisation has started in earnest, although the pace will vary across regions, specifically those like the ECB with a closer link to eastern Europe. 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 South Africa faces. Although we acknowledge some progress with initiatives to address some of the structural issues, policy response and implementation remain too slow and tepid.</p>
<p><b>Inflation</b></p>	<p>The commodity fallout from the conflict in Ukraine added upside risk to a global inflation surge that already surprised on the upside due to a combination of extraordinary base and stubborn supply-sided bottle-neck effects. While we are concerned about the short-term impact of the most recent commodity price spike, we maintain our medium-term view that inflation is expected to slow as the drivers of core inflation are still largely entrenched. This includes inflation expectations which, until now, have not changed in a meaningful way. That said, we are reminded that inflation expectations are backward looking - and are therefore an unreliable indicator of structural changes to inflation dynamics.</p> <p>Domestically, a higher base (due to the upside surprise to headline CPI over the past few months) and relatively muted services inflation are expected to contribute to an easing in the rate of local headline CPI in the months ahead. However, the persistence of the global energy crisis (that gave rise to higher crude oil prices) and general supply constraints pose a risk to this view in the short term. On the positive side, a relatively muted core CPI reading continues to reflect the subdued structural pricing power evident over the past two years. This includes strong evidence that the pass-through of rand</p>



	<p>weakness to headline inflation remains relatively weak. In turn, this is reflective of the inability of producers and retailers to pass large price increases on to the end consumer on a sustained basis.</p> <p><b>THE TAKEOUT:</b> The expected peak in inflation was, again, pushed out by a few months, this time mainly the result of sustained pressure from energy prices. Lately, stronger food price increases (due to global events) were added to the list of short-term concerns. We continue to believe that the accelerating rate of inflation in the short term is building a higher base for some disinflation in the medium term.</p>
<p><b>Balance of payments</b></p>	<p>The weakening of the merchandise trade account following the sharp price drop in South Africa’s commodity export basket during the second half of last year and the beginning of this year, regained significant positive momentum because of the conflict in Ukraine. However, it is still early days, and the sustainability of this improvement calls for caution. For now, the country is expected to end 2021 with a 3.7% current account surplus, following the 2.0% recorded the previous year. Despite the recent improved terms of trade, softer growth in key export markets (specifically China and the rest of Africa) could still see the current account surplus moderate going forward, with a marginally smaller, but still significant, surplus of 2.2% expected for 2022.</p> <p><b>THE TAKEOUT:</b> While South Africa’s terms of trade regained some positive momentum considering the fallout from the Ukraine conflict, the sustainability of the recent improvement should be questioned. For now, we still expect some current account moderation over the course of 2022, even though from a higher base.</p>
<p><b>Monetary policy</b></p>	<p>Monetary policy tightening has been established as the broad global trend as inflation pressures mount. However, the outlook in terms of the rate of policy normalisation is somewhat clouded, as the fallout from the conflict in Ukraine has raised the risk of stagflation. Elevated concerns about sustained inflation pressure and a more aggressive monetary policy response forced global bond yields closer to fair value levels.</p> <p>The South African Reserve Bank (SARB) responded at the last three MPC meetings to higher inflation risks by adjusting the repo rate upwards by a cumulative 75bps. We deem this an appropriate response, both in terms of the pace and timing of the policy adjustment. However, we continue to disagree with the aggressive pricing of the forward market in terms of the magnitude and pace of the tightening cycle. Our view remains based on anemic economic growth and a relatively muted underlying inflation outlook. Currently, we are sticking to an estimated repo rate increase of between 50bps and 75bps for the remainder of 2022.</p> <p><b>THE TAKEOUT:</b> Market focus has shifted to the potential inflationary consequences of a stronger economic recovery, the fallout from the Ukraine conflict, and what this implies for the speed at which monetary policy is tightened. While the global trend has shifted decisively to more broad-based monetary policy tightening, the timing and pace of this will be highly dependent on the circumstances of individual countries and regions. It is also prudent to consider the potential disruptive impact of the eastern European conflict, as this could potentially raise the risk of stagflation. Locally, the SARB kick-started its policy tightening cycle by raising the repo rate by a</p>

	<p>cumulative 0.75%, to 4.25%. We retain our long-held view that tightening will proceed in a measured way, and we currently expect another 0.50% to 0.75% rise in the repo rate this year. This is supported by sub-trend economic growth from next year, while core inflation is expected to remain relatively subdued.</p>
<p><b>Fiscal policy</b></p>	<p>While National Treasury based its most recent budget estimates on conservative (and arguably more realistic) macroeconomic assumptions (lending more credibility to the process), the proposed implementation of reforms (and significant expenditure reductions over the next three years) carries significant execution risk. 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 continued deficit in the primary balance and the implications of the high level of outstanding debt (and the risks associated with the future ability to service it). The positive surprise in tax revenue collection (specifically corporate income tax) is also likely to be unsustainable, given that it has been a function of cyclically elevated commodity prices, which translated into strong mining sector profits. An inability to turn the fiscal ship around, despite the recent boon of excess revenue collection, will have dire implications for the country's sovereign credit ratings, and for bond valuations. With SA being priced as a BB-rated borrower, a downgrade to the B-rated tranche will serve as a catalyst for significant negative bond market repricing.</p> <p><b>THE TAKEOUT:</b> A combination of stronger economic growth, improved 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.</p>

## 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 outstanding sovereign debt, the risk inherent to significant contingent liabilities, potential additional current expenditure pressures, and the threat to the country's sovereign risk profile. The weaker economic recovery beyond 2021's rebound from 2020's extremely low base, a stronger balance of payments position, and the relatively benign inflation outlook will allow the SARB to normalise policy in a measured way. For now, we do not expect the fallout from the conflict in Ukraine to change this in a significant way.

In terms of the yield curve, the front end remains most at risk to the monetary policy tightening cycle even though it is expected to happen at a moderate pace. Rising short-term rates also undermine potential yield curve roll-down gains from shorter-dated fixed rate bonds. Further out on the yield curve, market gyrations caused by varying global risk sentiment, rising global bond yields, upside risk to inflation in the short term and the still challenging local fiscal situation will serve as combined catalysts for back-end volatility. However, with the steep positive yield curve slope and the reasonable high level of yields on an inflation-adjusted basis, the challenge remains to find the optimal balance between managing potential capital loss from rising yields and benefitting from holding bonds that offer an attractive carry or base accrual. We therefore continue to avoid holding low-yielding cash, while maintaining an underweight exposure to short-dated fixed rate bonds in light of the potential negative market impact of a rising repo rate. Considering the combination of monetary policy tightening, upward pressure on global bond

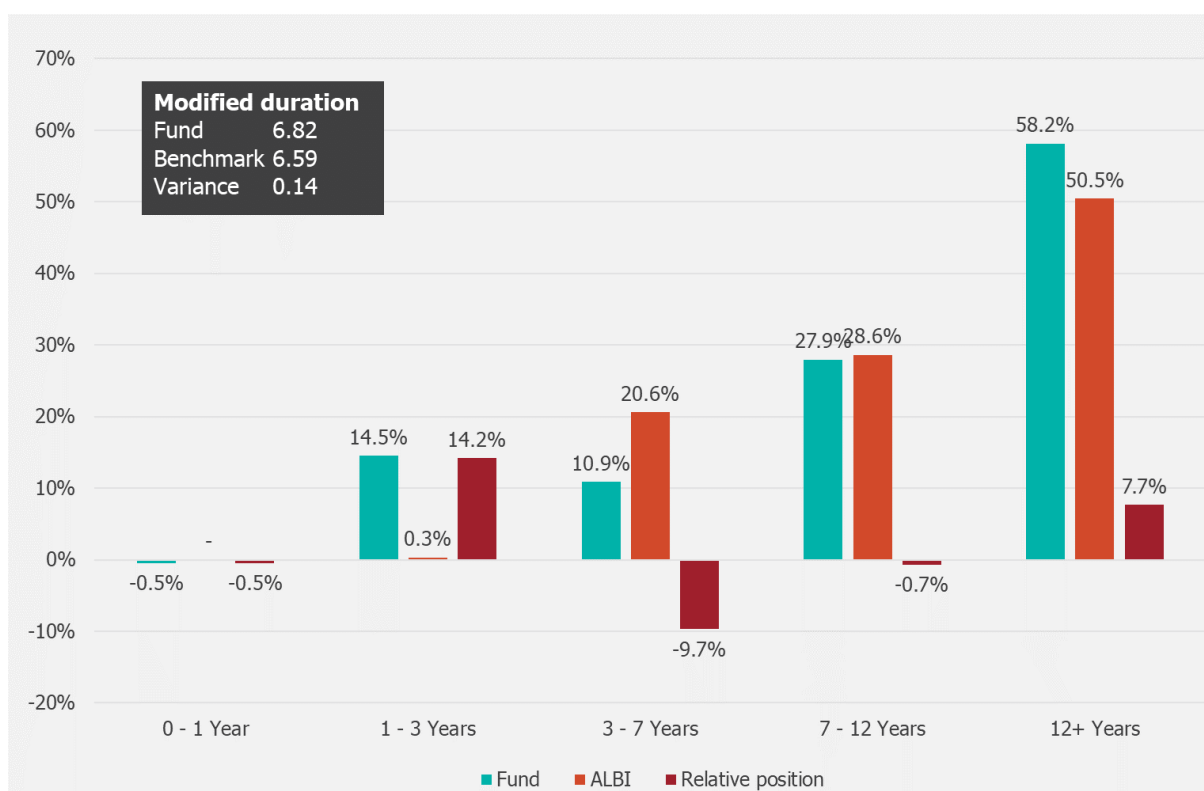
yields and the challenging fiscal backdrop, the most appropriate risk-adjusted area of the yield curve (on a strategic level) remains the 10- to 15-year maturity band. However, within this framework, we shall continue to consider and implement more tactical investment opportunities in response to market/valuation swings, like the adjustments during March.

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 over the past few months has diluted prospective future returns in a significant way. The attractiveness of this asset class relative to nominal bonds is undermined by the better inflation-adjusted yields currently offered by medium-dated fixed rate nominal bonds.

**THE TAKEOUT:** Our investment strategy aims to strike a balance among 1) capitalising on the extraordinarily high base accrual (carry) on offer; 2) participating in the (reduced) roll-down offered by medium-dated bonds; and 3) limiting potential capital loss. The base accrual and, to a lesser extent, roll-down are a function of the steep positive yield curve slope. We do acknowledge that the prominence of roll-down potential has faded as the SARB proceeds with monetary policy normalisation, even though this is expected to be at a gradual pace, especially relative to more bearish market expectations. With potential returns at the short end approaching sub-inflation levels, and the weak, albeit improved, fiscal position still posing a risk to ultra-long-dated bonds, we continue to believe that (at a strategic level) medium-dated nominal bonds offer the best risk-adjusted alternative. In our view, these bonds are also better priced than inflation-linked bonds at this point, even after the consideration of more short-term upward pressure on inflation. However, within this strategic framework we shall continue to respond to more tactical opportunities that may present themselves.

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

**Figure 7:** Futuregrowth Listed Yield Enhanced Bond Composite fund structure



Source: Futuregrowth

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

	2017	2018	2019	2020	2021	2022	2023
<b>Global GDP</b>	3.5%	3.2%	2.6%	-3.6%	5.9%	3.6%	3.0%
<b>SA GDP</b>	1.2%	1.5%	0.1%	-6.4%	4.9%	2.3%	2.5%
<b>SA Headline CPI</b>	5.3%	4.6%	4.1%	3.3%	4.5%	5.9%	4.7%
<b>SA Current Account</b> (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	2.2%	1.0%

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