

“Inflation around the globe continued to accelerate at a relentless pace and, in the process, recorded new multi-decade highs in several advanced economies.”

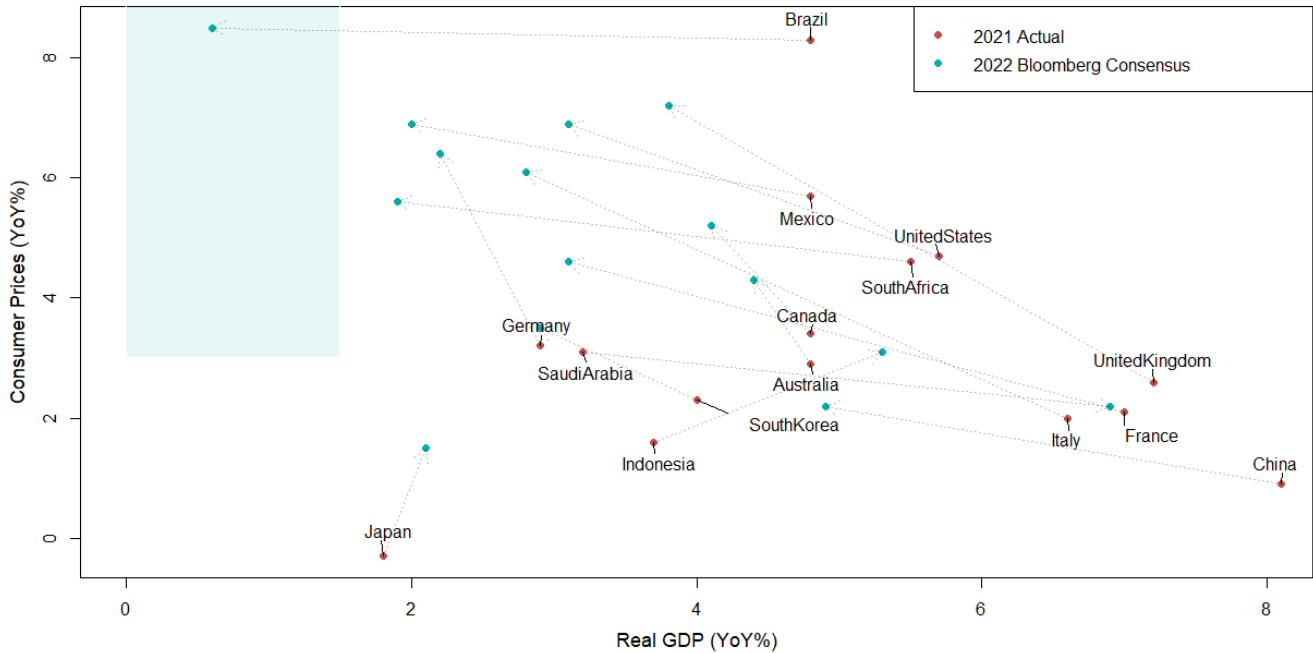
**Global market anxiety reached a new level****Author: Futuregrowth Interest Rate team****Published: May 2022****Price increases were relentless and monetary policy response slow**

Inflation around the globe continued to accelerate at a relentless pace and, in the process, recorded new multi-decade highs in several advanced economies. In the case of the United States (US), headline consumer price inflation reached a year-on-year rate of increase of 8.5% in March, reflecting the broad trend in most advanced and emerging economies. What is striking is the awkward similarity to the monetary policy debacle of the 1970's, of the pro-economic growth bias and inflation denialism of advanced market central banks over the past year. Thankfully, more and more of these central banks have become increasingly hawkish lately (and belatedly). In the case of the US Federal Reserve (Fed), official hints of an acceleration of the hiking cycle and the size of the incremental upward rate adjustments, have added to the recent spike in market nervousness. These hawkish hints turned into reality in early May as the Fed hiked its policy rate by 50 basis points (bps) for a total of 75bps in this tightening cycle. The Fed also announced much-anticipated balance sheet runoff which is to commence on 1 June as part of a more focused approach to fight inflation. Other advanced economy central banks, like the Bank of England, also tightened their policy rates, albeit in a less aggressive manner. In contrast, the politically constrained Central Bank of the Republic of Turkey could only watch with their monetary hands tied, as consumer inflation accelerated at an annual rate of 61%.

**Risks to economic growth remained a concern**

Recent market anxiety partly reflected rising investor concern about the ability of central banks to strike the right balance in an environment where high and rising inflation is accompanied by weaker economic activity. These stagflation concerns have reached a new level with inflation not only surprising on the upside, but downside risks to global economic activity building. In turn, this chain of events is fed by sustained supply chain disruptions, worsened by the latest round of COVID-related lockdown restrictions in China and the impact of the terrible conflict in Ukraine with no clear end in sight. At a more structural level, stagflation concerns are also fuelled by the negative consequences of a possible shift away from globalisation, which has for decades positively contributed to lower production costs while boosting economic activity across borders. It is glaringly obvious that there is only so much central banks can do to address developments beyond their sphere of influence. For this reason, markets across the different asset classes, except for some commodities, have become increasingly itchy about an increasingly difficult central bank balancing act. This was reflected by poor investment returns across global markets and a sharp kick higher in more general market indicators like the VIX volatility index in the past month. Bond yields in most advanced economies have also crept higher, with the 10-year US Treasury yield briefly breaching the 3% level.

**Figure 1: Stagflation risks are rising**

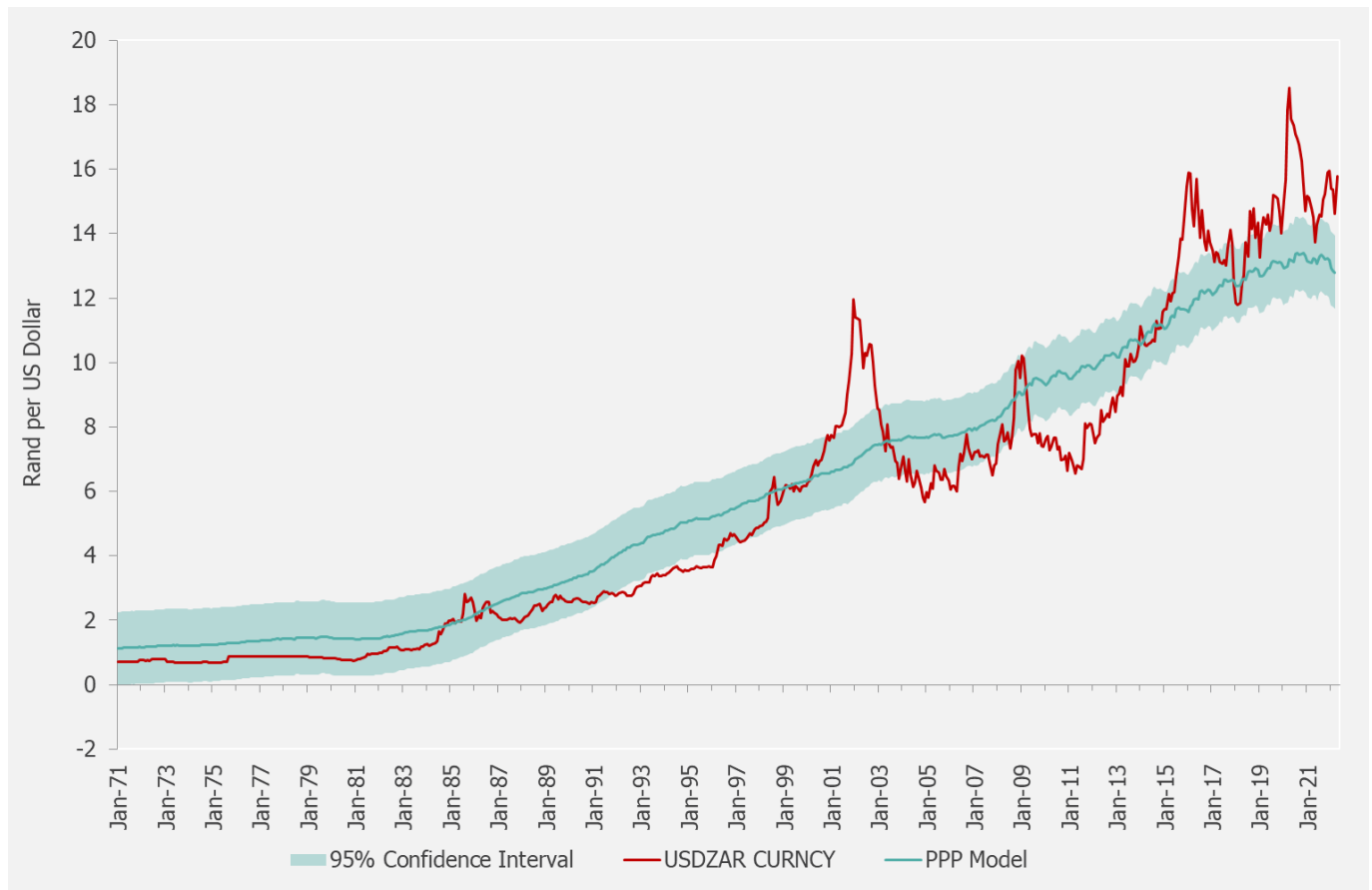


Source: Bloomberg, Futuregrowth

### The South African rand budged in the wake of global risk aversion

In stark contrast to the first quarter of this year, the local currency lost significant ground during April. A myriad of developments combined to let the rand bears out. Sharply lower global economic activity and rising inflation accompanied by monetary policy tightening usually bodes ill for emerging markets, particularly commodity producers like SA. While SA initially benefitted from relative commodity price movements during the initial phase of the Ukraine conflict, price changes of late, including a strengthening US-dollar, point to a possible partial reversal of the earlier boost to the country's terms of trade. This forced SA back onto the familiar path of a currency meltdown and rising bond yields in the latter half of April.

**Figure 2:** Rand undervalued relative to the US-dollar on an inflation-adjusted basis



Source: IRESS, Futuregrowth

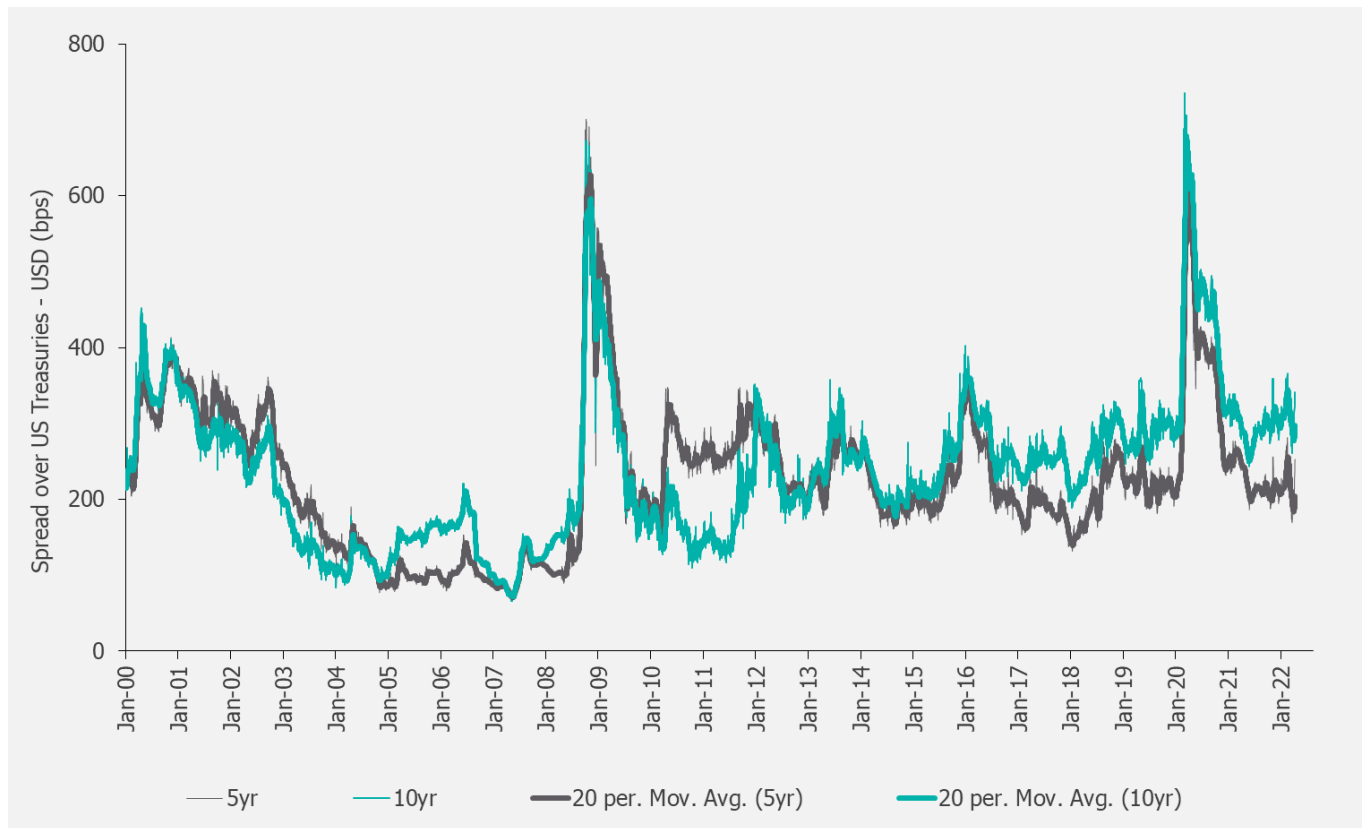
### Domestic economic activity faced a set-back, while inflation pressures intensified

While several leading indicators for March pointed to a reasonable outcome for economy activity, the terrible floods in KwaZulu-Natal and intensified load shedding by Eskom in April caused a short-term set-back. On the inflation front, the year-on-year rate of change of the headline Consumer Price Inflation index in March was reported at 5.9%, a tad higher than the 5.7% recorded the previous month and matching the highest reading in just over four years. Core CPI also ticked higher to 3.8% from 3.7%. More concerning is the surge in PPI for final manufactured goods by 11.9%, mainly due to the recent food and crude oil price spikes. This mirrors global developments in terms of pipeline price pressure and kept market expectations of aggressive future monetary policy tightening on the cards. With regards to the balance of payments, the merchandise trade balance widened to a whopping R46 billion in March, but with a limited impact on market sentiment due to the unfolding events described above.

### SA received a sovereign ratings reprieve as the fiscal situation continued to improve

On the positive side, Moody's changed the country's sovereign rating outlook from negative to stable in response to an improving fiscal situation. The rating action is supported by the recent confirmation of the R326 billion fiscal shortfall for the 2021/22 fiscal year, 5.2% of GDP. The deficit was R21 billion smaller than the February budget estimate and a marked improvement on the 2020/21 budget shortfall of R550 billion or 9.9% of GDP. This improvement continued to be the combined result of stronger tax revenue collections and subdued non-interest expenditure. The South African government managed to successfully raise USD3 billion in international markets by issuing 10- and a 30-year US dollar denominated bonds. The two bonds were issued at spreads of 309bps and 447bps over the US Treasury curve respectively, which are deemed reasonable levels considering global market conditions.

**Figure 3:** RSA Government USD-denominated bond (spreads over US Treasury curve)

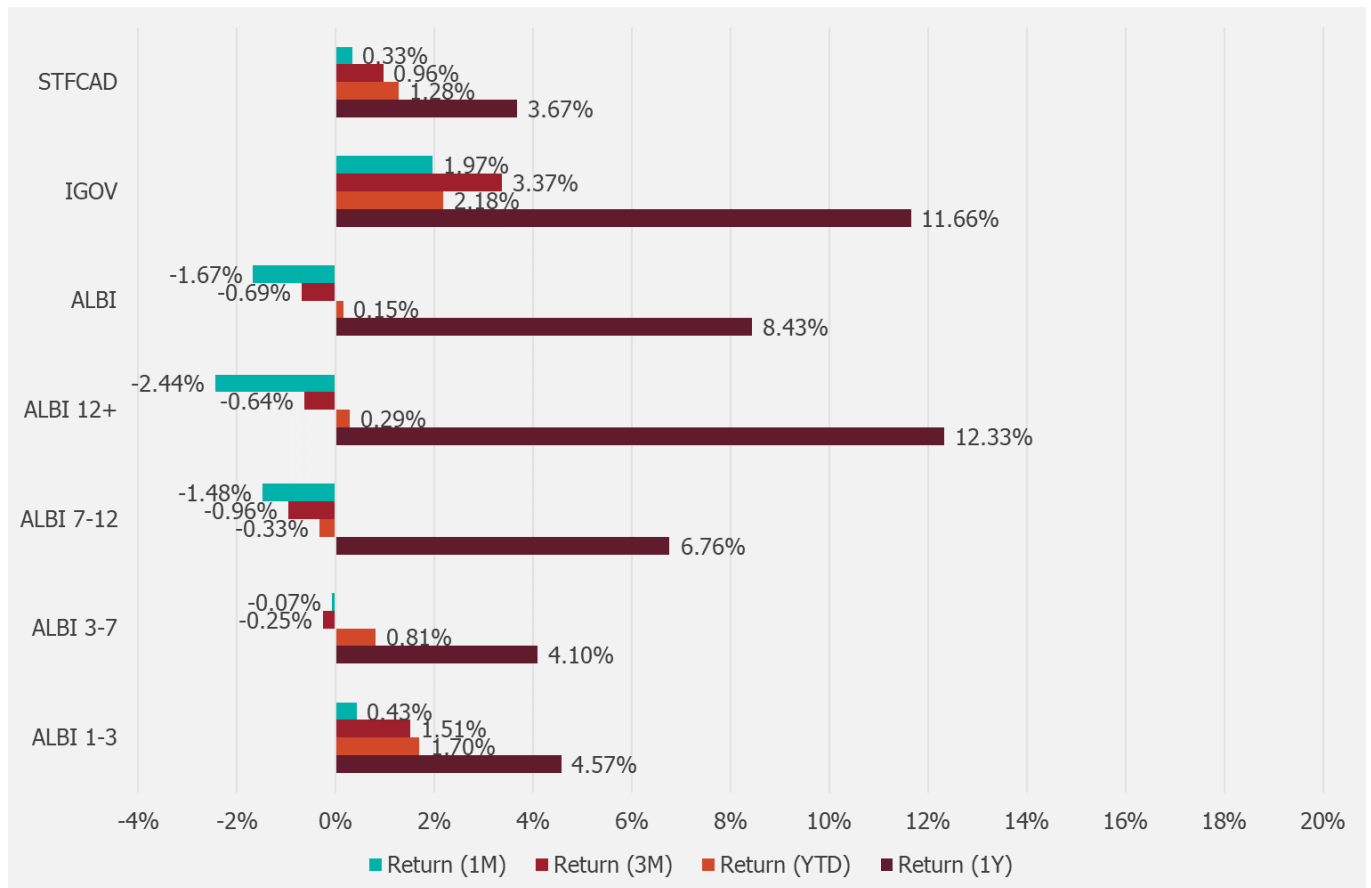


Source: Bloomberg, Futuregrowth

**SA nominal bonds lost ground in April, while inflation-linked bonds shone**

Against the backdrop described above, and in line with the adjustment of valuations in most global financial markets, local nominal bond yields headed higher. Moreover, the yield curve bear steepened as the yields of longer-dated bonds increased by more than those of shorter-dated bonds. As a result, the FTSE JSE All Bond Index (ALBI) returned -1.67% in April, with bonds in the 12+ year maturity band rendering a return of -2.44%. In contrast, the combination of rising inflation concerns, reasonable inflation accrual and limited net negative market activity rendered support to the inflation-linked bond market. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) rendered a strong return of 1.97%, outperforming nominal bonds and cash (+0.33%) by a wide margin.

**Figure 4:** Bond market index returns (periods ending 30 April 2022)



Source: IRESS, Futuregrowth

**THE TAKEOUT:** Most global financial markets lost significant ground during April. Heightened fears about stagflation are mainly to be blamed. In turn, these fears are fed by sustained upward pressure on inflation, the influence of COVID-related lockdowns in China, the ongoing conflict in Ukraine, and concern about the impact of tightening monetary and fiscal policy on growth prospects. Broader macroeconomic developments, specifically rising concerns about the reversal of gains from globalisation, are more fundamental in nature. This continued to keep global bond yields at elevated levels. Locally, the bout of global risk aversion led to an increase in bond market volatility which led to nominal bonds rendering negative returns. In contrast to March when the South African rand managed to hold its own, the pressure from global risk aversion and a very strong US-dollar proved too much and caused the currency to be swept along by the weakening global trend.

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

<p><b>Economic growth</b></p>	<p>Global growth is expected to slow from 3.3% in 2022 to 2.9% 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 lingers, the fallout from the conflict in Ukraine has added an additional layer of complexity.</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 economic growth impact of the recent flooding in KwaZulu-Natal is expected to be short lived. More importantly, lacklustre 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> Global economic activity is expected to slow from the high post-COVID base as headwinds to economic growth have picked up. These headwinds include monetary and fiscal policy normalisation in response to significant and stubborn upward price pressure, the direct and indirect impact of the Ukraine conflict and COVID-related lockdowns in China. Locally, economic growth is expected to ease back to pre-COVID levels, partly in response to weaker global growth, but also because of the many structural hurdles South Africa still faces.</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 earlier extraordinary easy monetary policy measures and stubborn supply-sided bottle-neck effects. More worryingly, strong wage increases in some advanced economies like the USA are now also adding to underlying price pressures. Therefore, we remain concerned about the short-term outlook for inflation. Even so, a balanced approach requires us to also consider potential positive drivers, such as strong corporate profit margins which allow producers to absorb some of the supply side pressures. On the technical side, the latest surge in price indices is creating a higher statistical base for a lower rate of change further down the line, while inflation expectations have not yet 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, in turn 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 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 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. The sustainability of</p>

	<p>this dynamic remains a risk, considering low corporate profit margins in South Africa. The large variance between CPI and PPI does suggest some risk to this dynamic.</p> <p><b>THE TAKEOUT:</b> The expected peak in inflation was, again, pushed out by a few months, mainly because of sustained pressure from energy and food price increases, in turn a direct consequence of the Ukraine-conflict. 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. That said, risks to more subdued underlying inflation are building, especially considering the stubborn nature of supply side pressures and rising wages. In the case of South Africa, the large and widening variance between the CPI and PPI measures of inflation, together with low corporate profit margins, requires careful monitoring and poses a risk to relatively subdued underlying inflation.</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 2022 with a 2.0% current account surplus, following the 3.7% 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 1.0% expected for 2023.</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. In the case of the Fed, it is determined to accelerate the pace of tightening.</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 anaemic 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</p>



	<p>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 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 non-interest 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.</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 the extremely low base set in 2020, 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

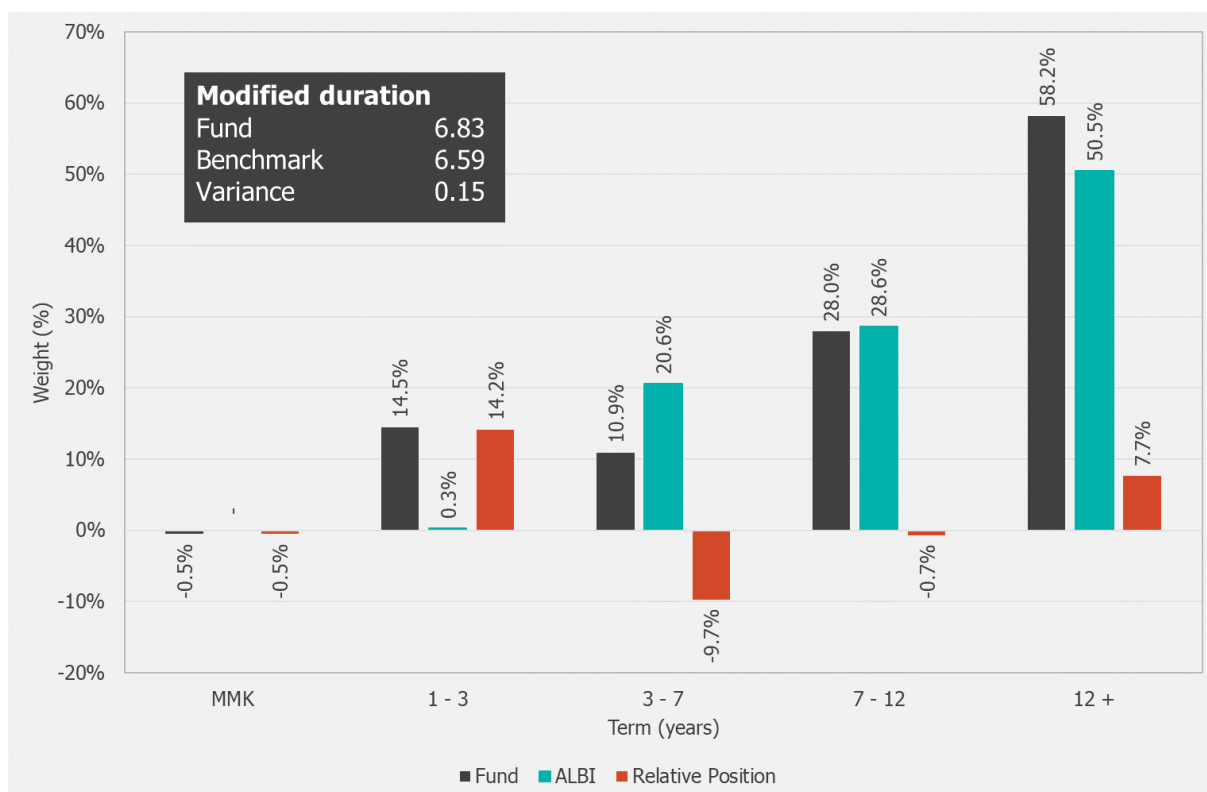
yields and the challenging fiscal backdrop, the most appropriate risk-adjusted area of the yield curve (on a strategic level) remains the 10- to 18-year maturity band. However, within this framework, we shall continue to consider and implement more tactical investment opportunities in response to market/valuation swings.

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 considering 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 5:** 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%	3.3%	2.9%
<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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