"Stagflation fears are rising, fed by sustained upward pressure on inflation, the influence of COVID-related lockdowns in China, the economic fall-out from the ongoing conflict in Ukraine, and concern about the impact of tightening monetary and fiscal policy on growth prospects."

FUTUREGROWTH

/ ASSET MANAGEMENT

**Escalating inflation pressure and other economic headwinds**
**Author: Futuregrowth Interest Rate team**
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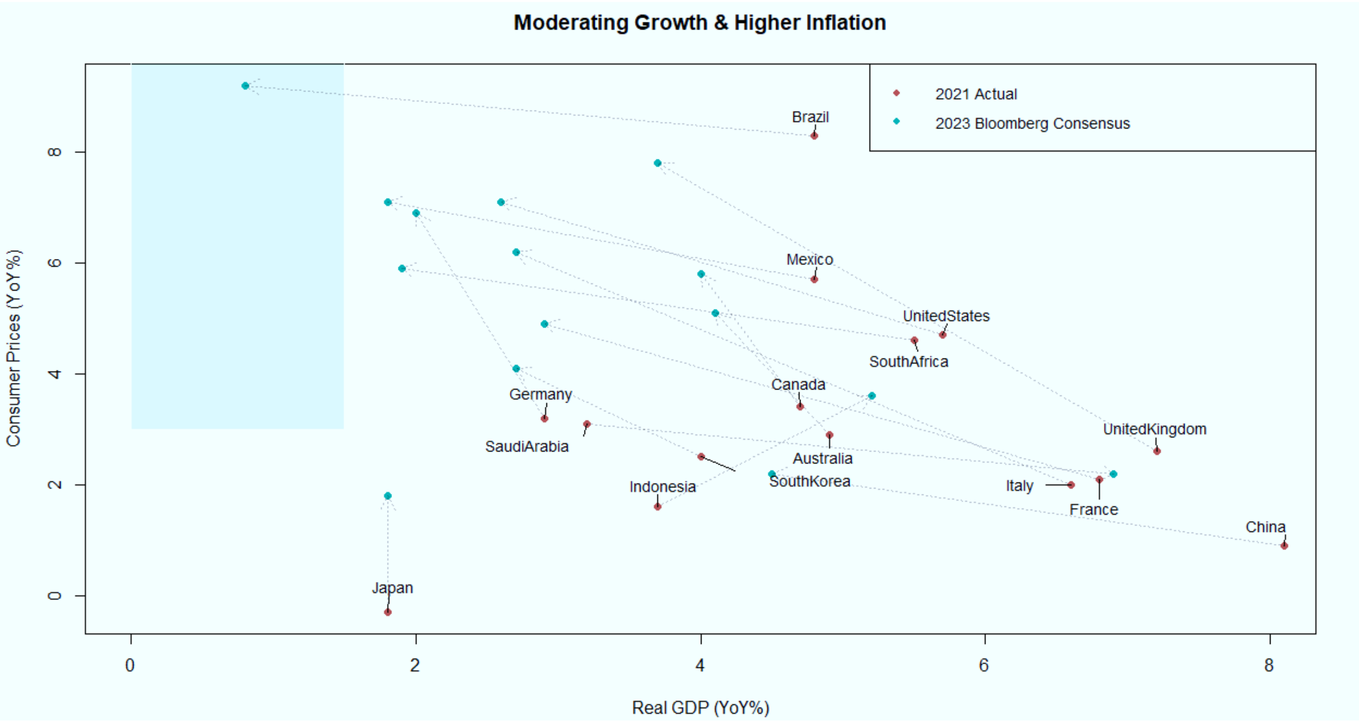
### Inflation remains elevated...and still exceeding expectations

Inflation rates continued to reach new highs around the globe. The march higher in crude oil prices because of the escalation of the economic fall-out between the West and Russia is still the main catalyst. This is in addition to rising food prices, also linked to the Ukraine war, and stubborn supply bottlenecks and constraints worsened by recent COVID-related hard lockdowns in China. More concerning is the fact that inflation keeps surprising expectations on the upside, especially in advanced markets that have managed to maintain price stability successfully for decades. One noticeable possible exception is US headline consumer expenditure inflation, or the PCE deflator, which shows tentative signs of a possible peak, with both the year-on-year and month-on-month rates of change down from the previous month.

### Headwinds to economic growth are picking up, but no collapse - yet

Latest real activity data releases, including Production Managers Indices (PMIs) for the US and the Euro area, are holding up relatively well in the face of supply constraints, commodity price spikes and monetary policy tightening. However, this contrasts with some sectors, like the US housing market, where the recent spike in mortgage rates has dragged down activity. This also coincides with the sustained weakening in US consumer sentiment, as real income growth remains negative. In fact, the latest US Federal Reserve (Fed) Beige Book release points to slowing economic activity, with surging inflation. Elsewhere, emerging economy manufacturing PMIs were broadly weaker, with only South Africa and Russia holding some ground. Compared to a year ago, activity is down across the board.

**Figure 1:** Stagflation risks are rising



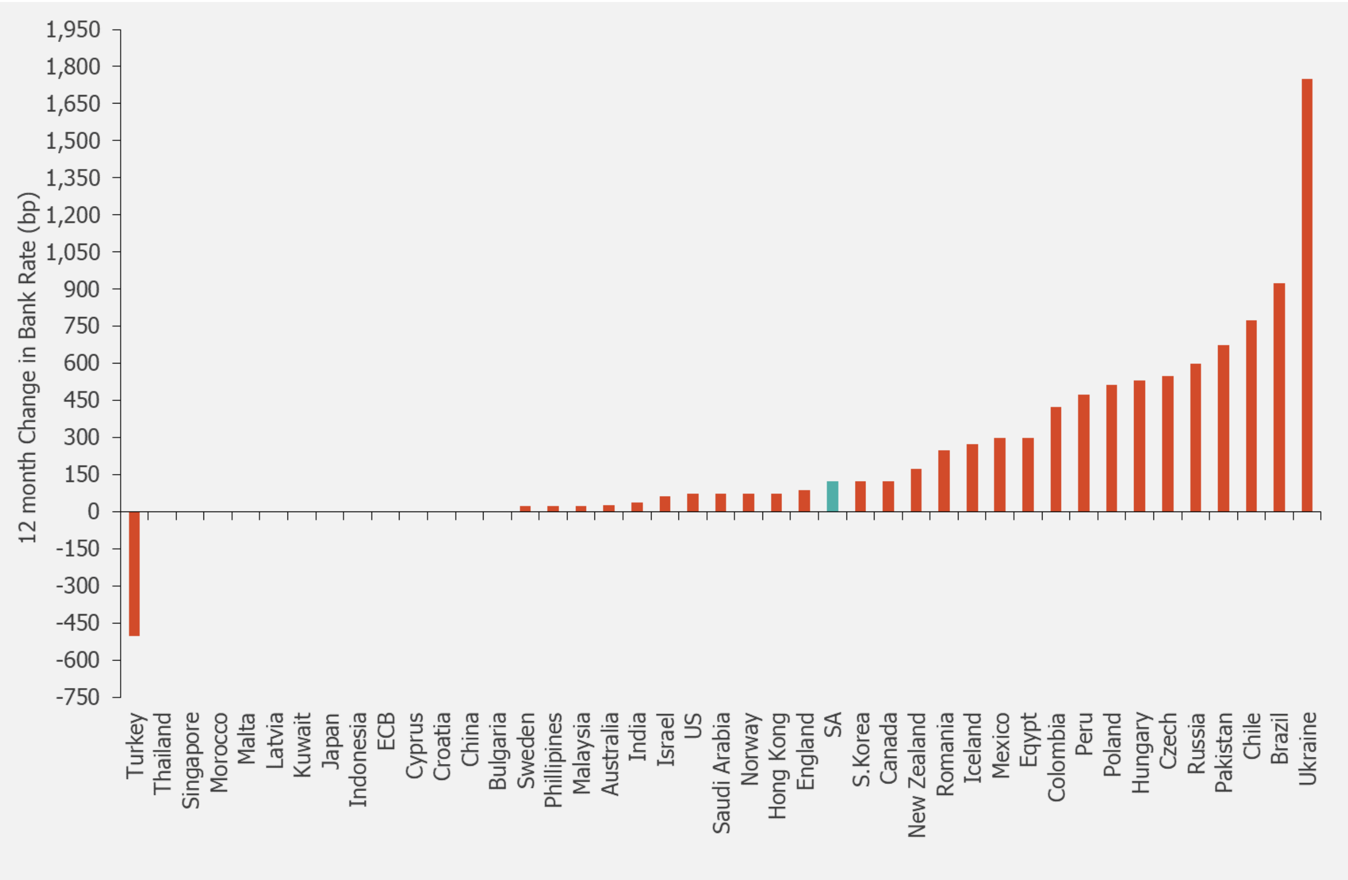

*Source: Bloomberg, Futuregrowth*

### Central banks are eagerly tightening the monetary screws

Actual policy action and expectations of a more aggressive monetary policy response are contributing to rising recession fears, especially in advanced economies. Central banks have become increasingly hawkish in response to inflation developments, which, in turn, is feeding concerns that indecisive policy action risks the credibility of inflation targets and its potential negative impact on inflation expectations.

The belated central bank hawkishness seems to increasingly supersede sensitivity to the impact of higher rates on economic activity. In the US, the minutes of the Federal Reserve's May Monetary Policy Committee meeting revealed that it agreed that the current inflation rate and risks to inflation support a faster tightening pace. Elsewhere, one of the policy laggards, the European Central Bank (ECB), is finally preparing the market for the start of its policy tightening process as it aims to reach positive rates by the end of this year. Like most other economies, the main driving force behind the ECB's change of tack has been persistent rising inflation in the Euro-area that continues to exceed expectations. For instance, in Germany, consumer price inflation accelerated to a multi-decade high of 8.7% in April due to soaring energy and food prices.

**Figure 2:** Central bank policy rates: 12-month change




*Source: IRESS, Futuregrowth*

**Global bond market sell-off took a breather, while the US dollar weakened**

The US Treasury market and other more prominent bond markets recovered some lost ground in May following the strong sell-off across the board in April. The US dollar also lost some steam, in turn allowing the rand to take a breather. While crude oil prices continued to head higher, the industrial metal complex was negatively impacted by concerns about global economic activity in general and lower manufacturing activity in China as a result of COVID-related lockdowns in particular.

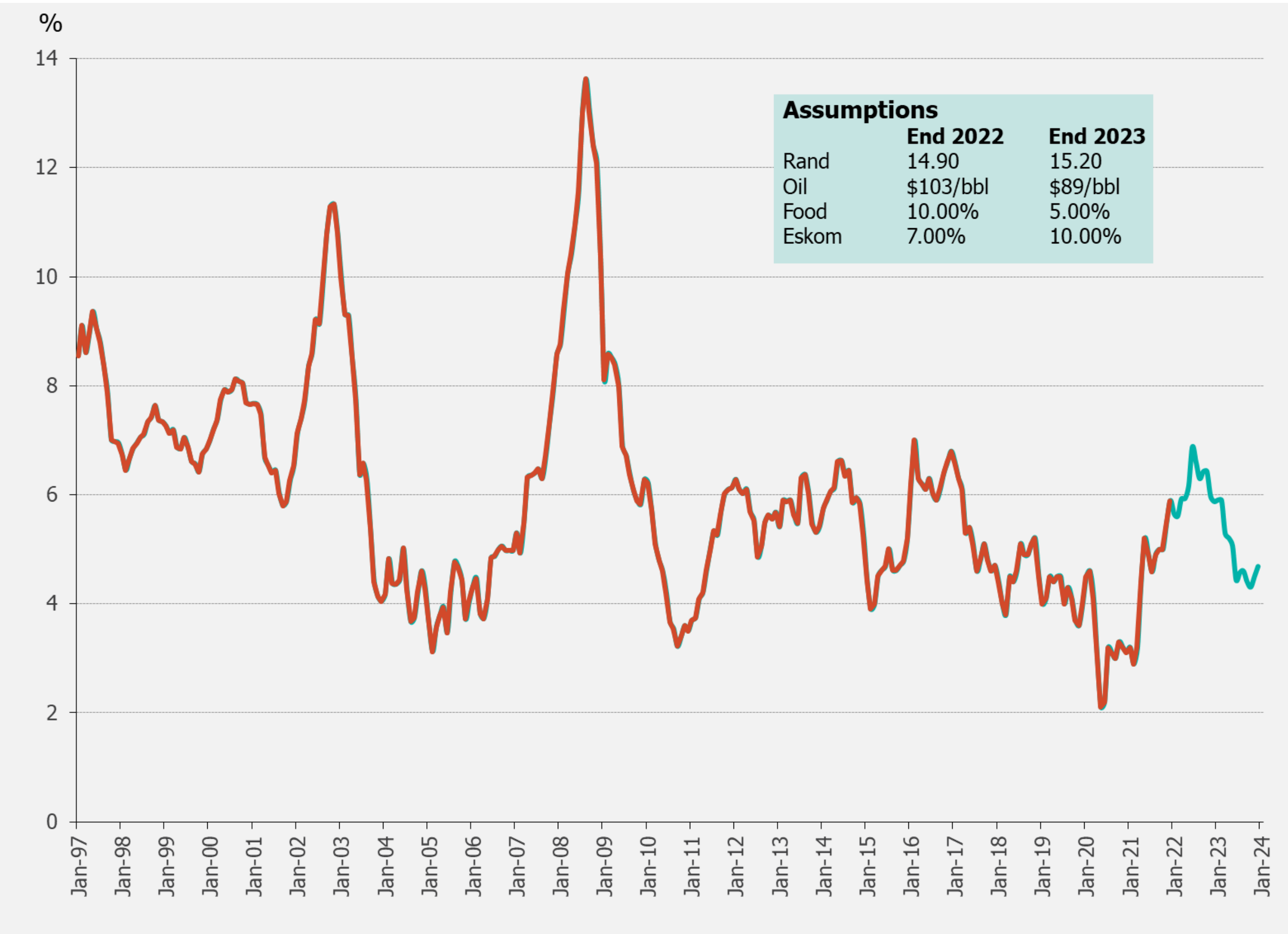
**Domestic economic news is a mixed bag**

While consumer price inflation is still reasonably well contained at a year-on-year increase of 5.9%, especially against the global backdrop, wholesale prices are reflecting price pressures more acutely. Headline Producer Price Inflation (PPI) recorded a year-on-year increase of 13.1% in April. While the spike in petroleum product prices and, to some extent, food prices are mainly to be blamed, increases north of 10% have also been recorded for broader categories, such as Final Manufactured Goods and PPI excluding petroleum products.

The April public sector main budget balance recorded a deficit of R45.2bn, slightly higher than the deficit of R37.2bn in March. Although wider than a month ago, the April budget deficit represents a 44% improvement over the 12-month period. The improvement is the result of a 17% decline in total expenditure, while total revenue increased by 9%. A strong 12-month increase of 13% in personal income tax is particularly encouraging. The strong tax revenue collection performance outweighed a decrease in fuel levy receipts, a direct result of the temporary reduction in the fuel levy to ease the burden of sharply rising petrol and diesel prices. Looking forward, the recently announced two-month extension of the temporary fuel levy reduction will result in foregone tax revenue of R4.5bn, which is not an insignificant amount.

The country's merchandise trade surplus narrowed sharply from R47.2bn in March to R15.5bn in April. Substantial swings in the exchange rate of the rand and commodity prices negatively impacted the country's terms of trade. Moreover, disruptions to road, rail and port handling operations at the Durban port caused by the recent flooding and more intense load shedding also hampered export traffic flow.

**Figure 3:** SA Headline CPI: Expected peak keeps creeping higher

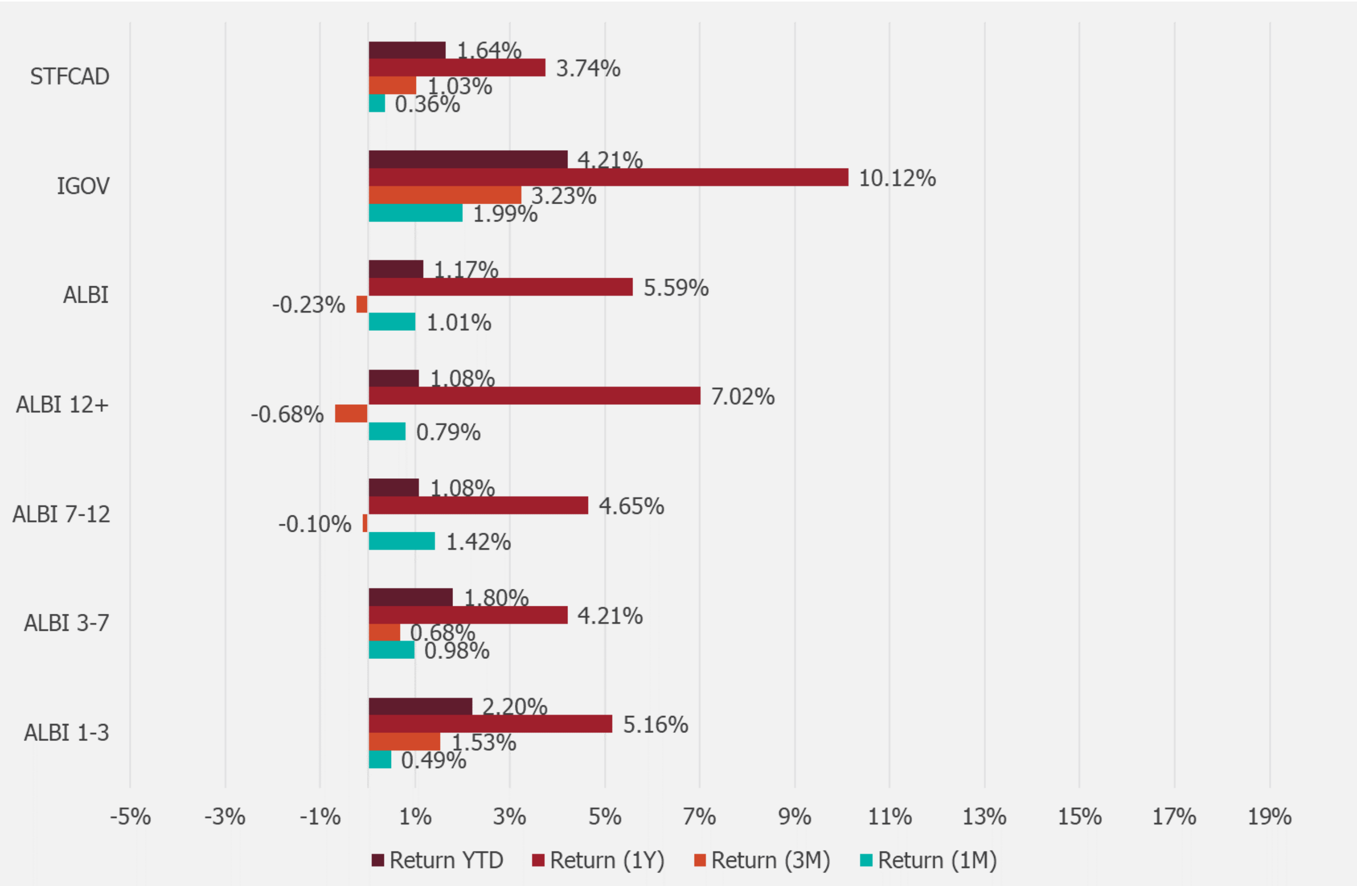



*Source: OMIG, Futuregrowth*

**SA nominal bonds regained some lost ground, with inflation-linked bonds in pole position**
Against the backdrop described above, the FTSE JSE All Bond Index (ALBI) returned 1.01% in May, a significant turnaround from the -1.67% in April, with bonds in the 7- to 12-year maturity band rendering the highest return of 1.42%. The combination of rising inflation concerns and reasonable inflation accrual continued to lend support to the inflation-linked bond market. As a result, the FTSE JSE

Government Inflation-linked Bond Index (IGOV) rendered a strong return of 1.99%, marginally bettering the April return of 1.97% and outperforming nominal bonds and cash (+0.36%) by a decent margin.

**Figure 4:** Bond market index returns (periods ending 31 May 2022)




*Source: IRESS, Futuregrowth*

**THE TAKEOUT:** Stagflation fears are rising, fed by sustained upward pressure on inflation, the influence of COVID-related lockdowns in China, the economic fall-out from 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 the gains from globalisation, are more fundamental in nature. While global bond yields remained at elevated levels, locally, bond market volatility subsided somewhat in May while the rand regained some lost ground. Both nominal and inflation-linked bond markets rendered cash-beating returns, with inflation-linked bonds delivering a stellar performance for the second consecutive month.

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

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| **Economic growth** | Global growth is expected to slow from 3.0% 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 intensifying economic fallout from the conflict in Ukraine has added an additional layer of complexity. Stubborn inflationary pressure is forcing the hands of several central banks to engage in more aggressive monetary policy responses, which, in turn, is dampening the economic growth outlook.<br><br>Domestically, our latest GDP forecasts for 2022 and 2023 are 2.2% 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: 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.<br><br>**THE TAKEOUT:** 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 recent COVID-related hard 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 faces that are still some ways from being resolved in a meaningful way. |
| **Inflation** | 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-side bottleneck effects. More worryingly, strong wage increases in some advanced economies like the US are now also adding to underlying price pressures. Therefore, we remain concerned about the short-term outlook for inflation. Even so, a balanced approach also requires us to 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 backwards-looking - and are therefore an unreliable indicator of structural changes to inflation dynamics.<br><br>Domestically, a higher base, in turn due to the upside surprise to headline CPI over the past few months, and relatively muted services inflation, is expected to contribute to an easing in headline CPI in the months ahead. However, the persistence of the global energy crisis |

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| | (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 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.<br><br>**THE TAKEOUT:** The expected peak in inflation was, again, pushed out by a few months, mainly because of sustained pressure from energy and food price increases as 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 expectations of relatively subdued underlying inflation. |
| **Balance of payments** | 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, the sustainability of this calls for caution, considering the reason for the recent boost and the rising probability of a global growth slowdown. For now, the country is expected to end 2022 with a 2.2% current account surplus, following the 3.7% recorded the previous year. Despite the recently 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.<br><br>**THE TAKEOUT:** While South Africa's terms of trade regained some positive momentum as a result of 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. |
| **Monetary policy** | 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 its pace of tightening.<br><br>At its last four consecutive MPC meetings, the South African Reserve Bank (SARB) responded to higher inflation and rising risks to the outlook by adjusting the repo rate upwards by a cumulative 125 basis points (bps). We revisited our outlook and opted to adjust our |

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| | expectation for this year by an additional 50bps, which would take the repo rate to 5.5% by year-end. We did not change the outlook for next year, still expecting an increase of 100bps, which would leave the repo rate at an expected cycle peak of 6.50%. This is mainly due to the outlook for input prices and resulting risks to higher inflation in the medium term. However, we continue to disagree with the aggressive pricing of the forward market in terms of the magnitude and pace of the tightening cycle.<br><br>**THE TAKEOUT:** 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 will be 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 potentially disruptive impact of the eastern European conflict, as this could potentially raise the risk of stagflation. Locally, the SA Reserve Bank (SARB) has tightened monetary policy by a cumulative 1.25% since the start of the cycle, which has taken the repo rate to 4.75%. We have adjusted our repo rate forecast, targeting a terminal nominal repo rate of around 6.50% by the end of next year, considering upside risks to inflation in the medium term. |
| **Fiscal policy** | 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 expenditure reductions over the next three years) is subject to 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 government's future ability to service it). The positive surprise in 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.<br><br>**THE TAKEOUT:** 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. |

**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 in 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.

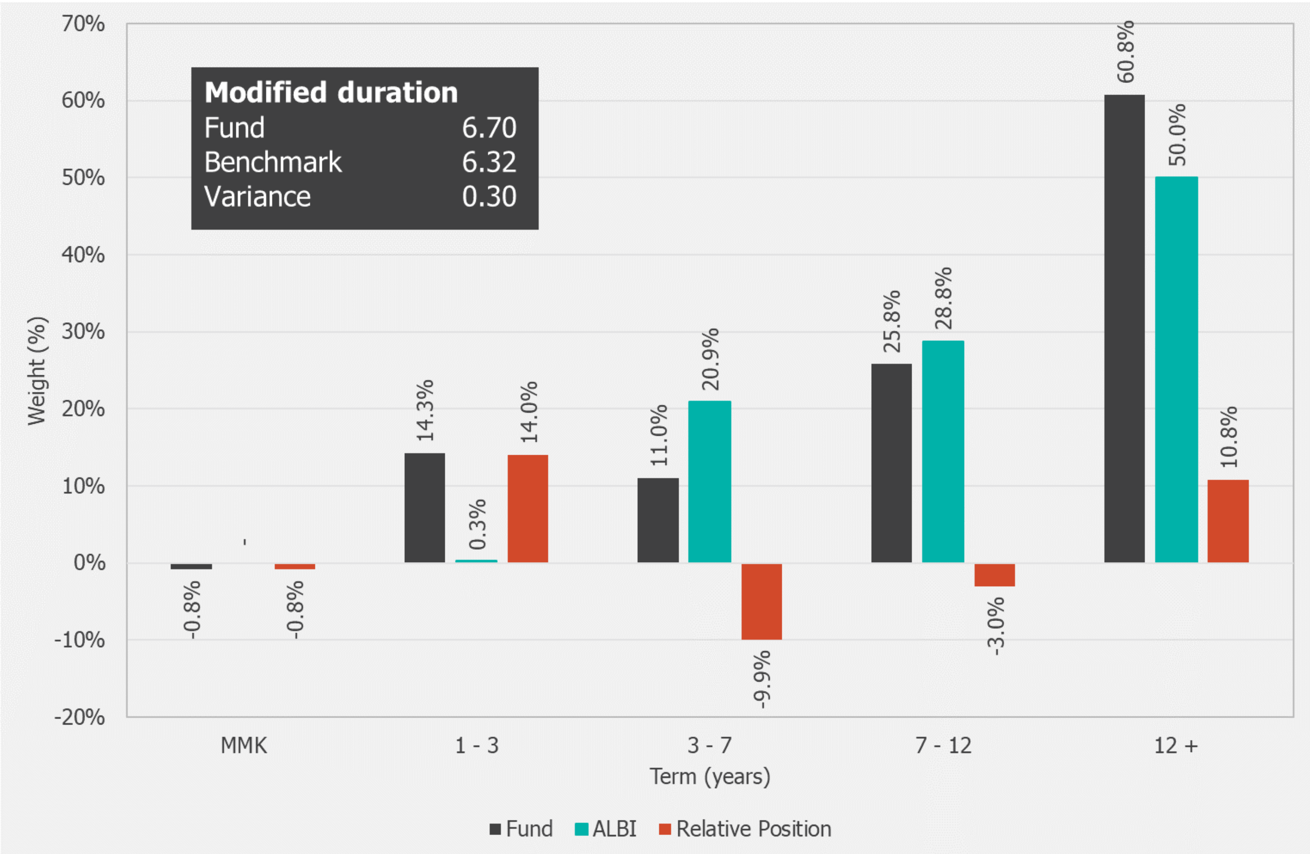
In terms of the yield curve, the front end remains most at risk to the monetary policy tightening cycle even though it is expected to happen at a moderate pace. Rising short-term rates also undermine potential yield curve roll-down gains from shorter-dated fixed-rate bonds. Further out on the yield curve, 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 steeply positive yield curve slope and the reasonably 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 considering 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 (at 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 than a year ago, the strong inflation-linked bond rally over the past few months has diluted prospective future returns significantly. 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 between 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 are 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 |
|---|---|---|---|---|---|---|---|
| **Global GDP** | 3.5% | 3.2% | 2.6% | -3.6% | 5.9% | 3.1% | 2.9% |
| **SA GDP** | 1.2% | 1.5% | 0.1% | -6.4% | 4.9% | 2.2% | 2.5% |
| **SA Headline CPI** | 5.3% | 4.6% | 4.1% | 3.3% | 4.5% | 6.0% | 4.7% |
| **SA Current Account** (% of GDP) | -2.4% | -3.0% | -2.6% | 2.0% | 3.7% | 2.2% | 1.0% |

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