FUTUREGROWTH BOND MARKET REVIEW

30 June 2022

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PERSISTENT INFLATION PRESSURE, BELATED POLICY TIGHTENING AND RECESSION CONCERNS

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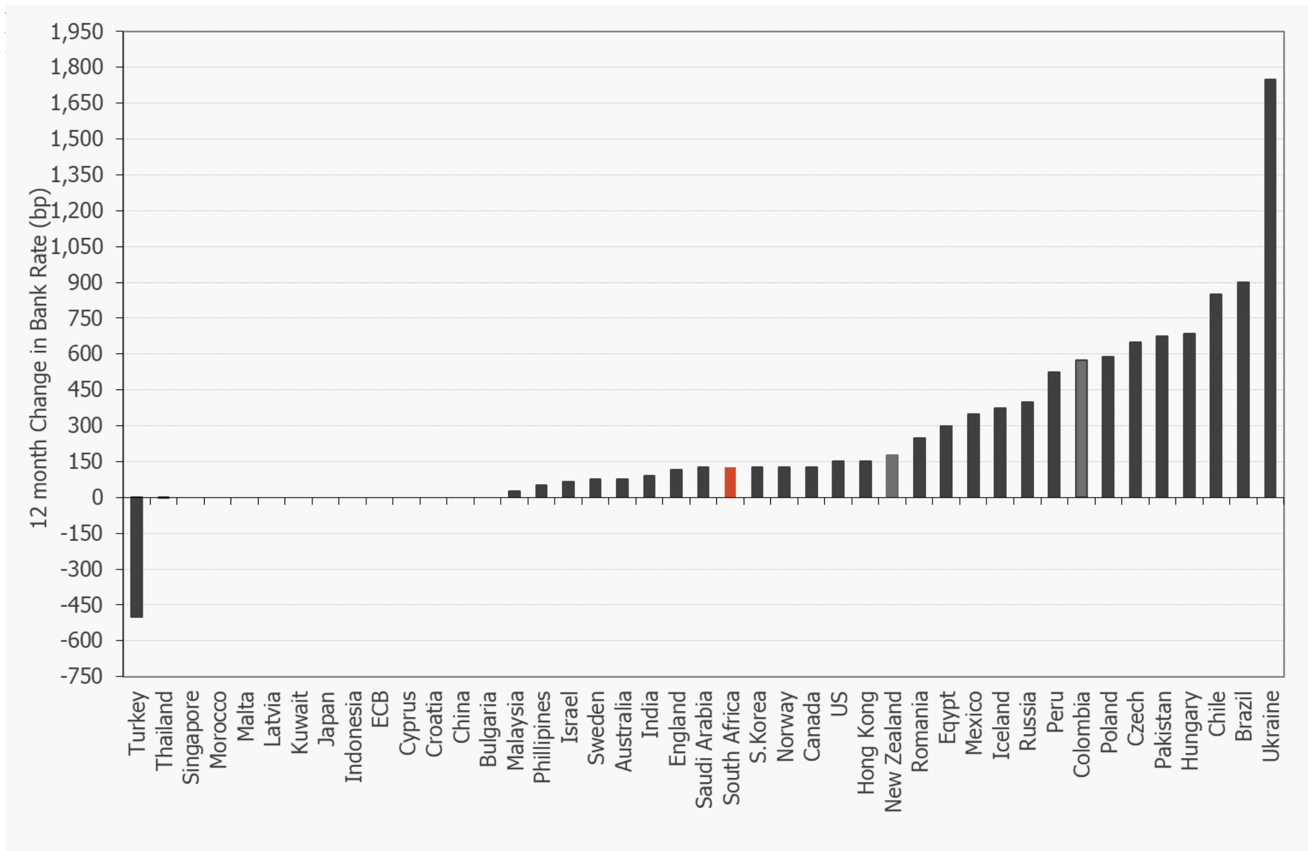
Globally, inflation remains elevated

Inflation rates continued to reach new highs around the globe. The march higher in crude oil prices due to the escalation of the economic fallout between the West and Russia is still the main catalyst. This is in addition to rising food prices, also linked to the war in Ukraine, 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 successfully maintain price stability for decades.

Central banks are belatedly 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 inflationary developments, which, in turn, feed concerns that indecisive policy action risks the credibility of inflation targets and their 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 most recent 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, which continues to exceed expectations.

Figure 1: Central bank policy rates: 12-month change

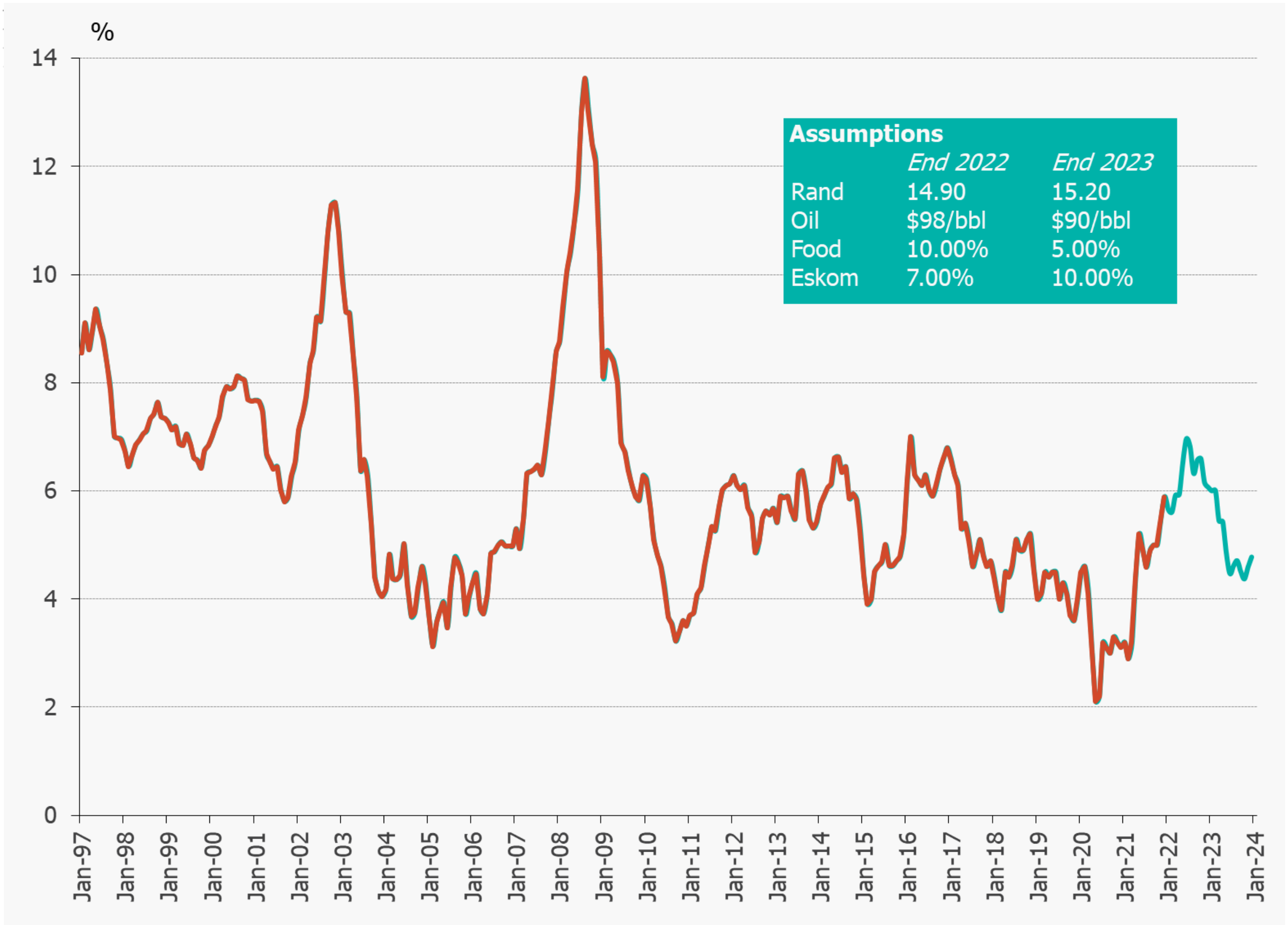


Source: Bloomberg, Futuregrowth

South African is dragged along the global inflation and monetary policy storm

Being a small open economy and a net importer of oil, South Africa is not escaping the global turmoil unharmed. On the inflation front, the country's Headline Consumer Prices Index (CPI) accelerated by 6.5% year-on-year in May and breached the top end of 3% to 6% inflation target band of the South African Reserve Bank (SARB) in the process. Unsurprisingly, a marked jump of 7.8% year-on-year in food inflation turned out to be the primary driver of this sharp acceleration. In contrast, Core CPI rose by a more subdued 4.1% in May, from 3.8% the previous month. More concerning, and closely aligned with global developments, is the continued sharp acceleration of prices at the producer level, with some risk of spill over to the consumer side. In May, the Producer Price Index (PPI) for final manufactured goods accelerated from 13.1% in April to 14.7%. This was broad based, with prices in seven out of nine categories rising. While it still appears that price pressures at both producer and consumer levels are mainly supply (and not demand) driven, the SARB wisely opted to stay the course with its tighter monetary policy. Following the 50 basis points (bps) increase in the repo rate to 4.75% at the May Monetary Policy Committee Meeting, for a total increase of 1.25% so far in this cycle, the central bank has clearly evidenced its commitment to containing second round effects before they become entrenched.

Figure 2: South African inflation heading higher in the short term



Source: OMIG, Futuregrowth

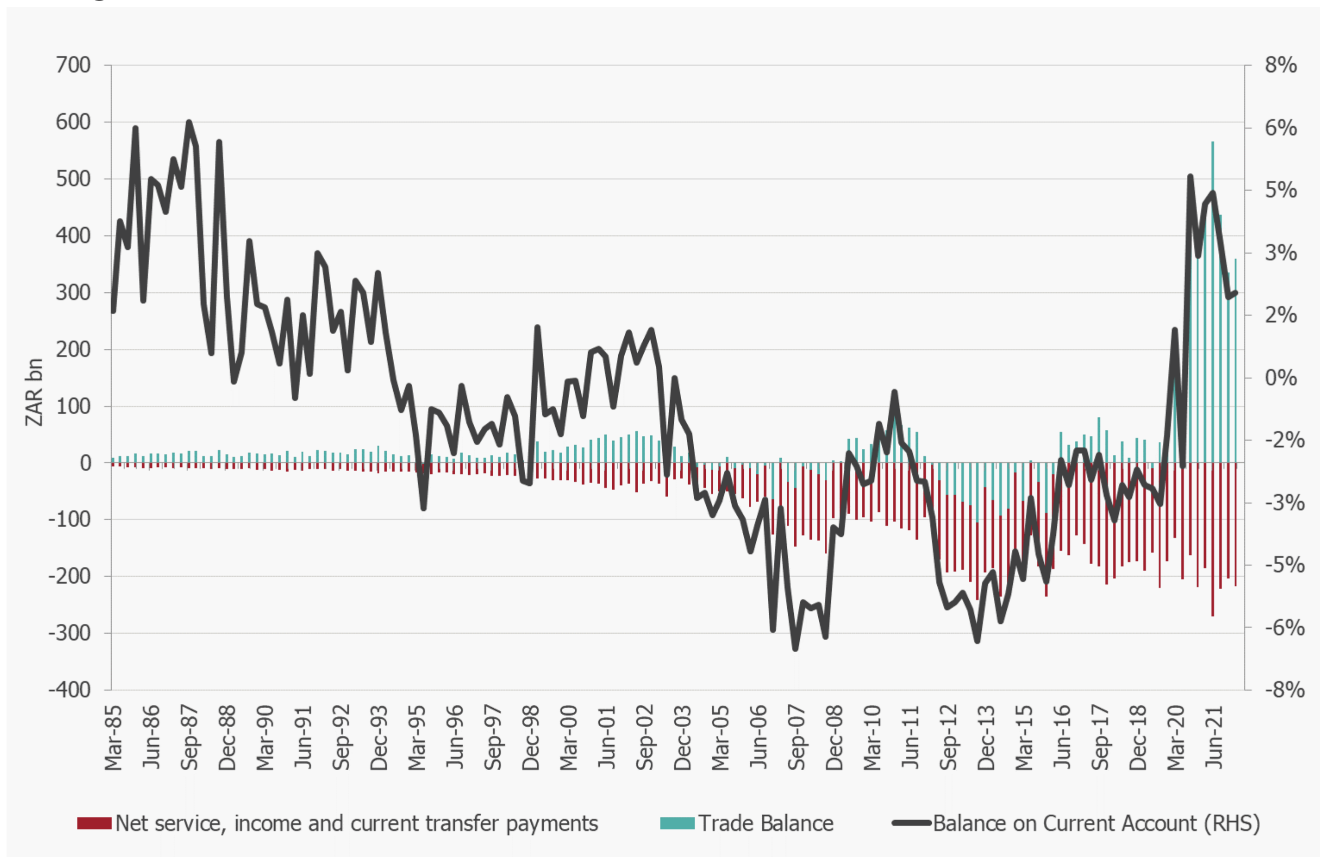
South African fiscal performance is off to a promising start

The May public sector main budget balance recorded a deficit of R17.1 billion; significantly smaller than the deficit of the first month of the 2022/23 fiscal year. It also represents an improvement over the 12-month period. Moreover, provisional financing data issued by National Treasury points to a main budget surplus in June 2022, which may be significantly larger than the surplus recorded for June 2021. Notably, tax revenue receipts continued their strong growth momentum, with both VAT and personal income tax showing promising performance despite a challenging macro-economic backdrop. 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. Similarly, the June 2022 provisional financing data suggests strong corporate tax receipts. On the negative side, the two-month extension of the temporary fuel levy reduction will result in foregone tax revenue of R4.5 billion, which is not an insignificant amount. Of course, it is still early days, especially considering the risk to local economic activity from global growth headwinds together with local developments such as intensified Eskom load shedding. On a positive note, high commodity prices (especially coal prices) continue to bode well for corporate tax receipts.

Merchandise trade surplus is still sizeable despite headwinds

While the country's merchandise trade surplus initially narrowed sharply from R47.2 billion in March 2022 to R16.0 billion in April, it regained some lost ground with a R28.3 billion surplus recorded in May. During the period under review, substantial swings in the exchange rate of the rand and commodity prices impacted the country's terms of trade. On the negative side, disruptions to road, rail and port handling operations at the Durban port (due to the Kwa-Zulu Natal flooding) and intensified electricity load shedding hampered export traffic flow. With crude oil prices kept hostage at elevated levels, 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 earlier COVID-related lockdowns.

Figure 3: SA current account: large merchandise trade surplus, but terms of trade are turning for the worse



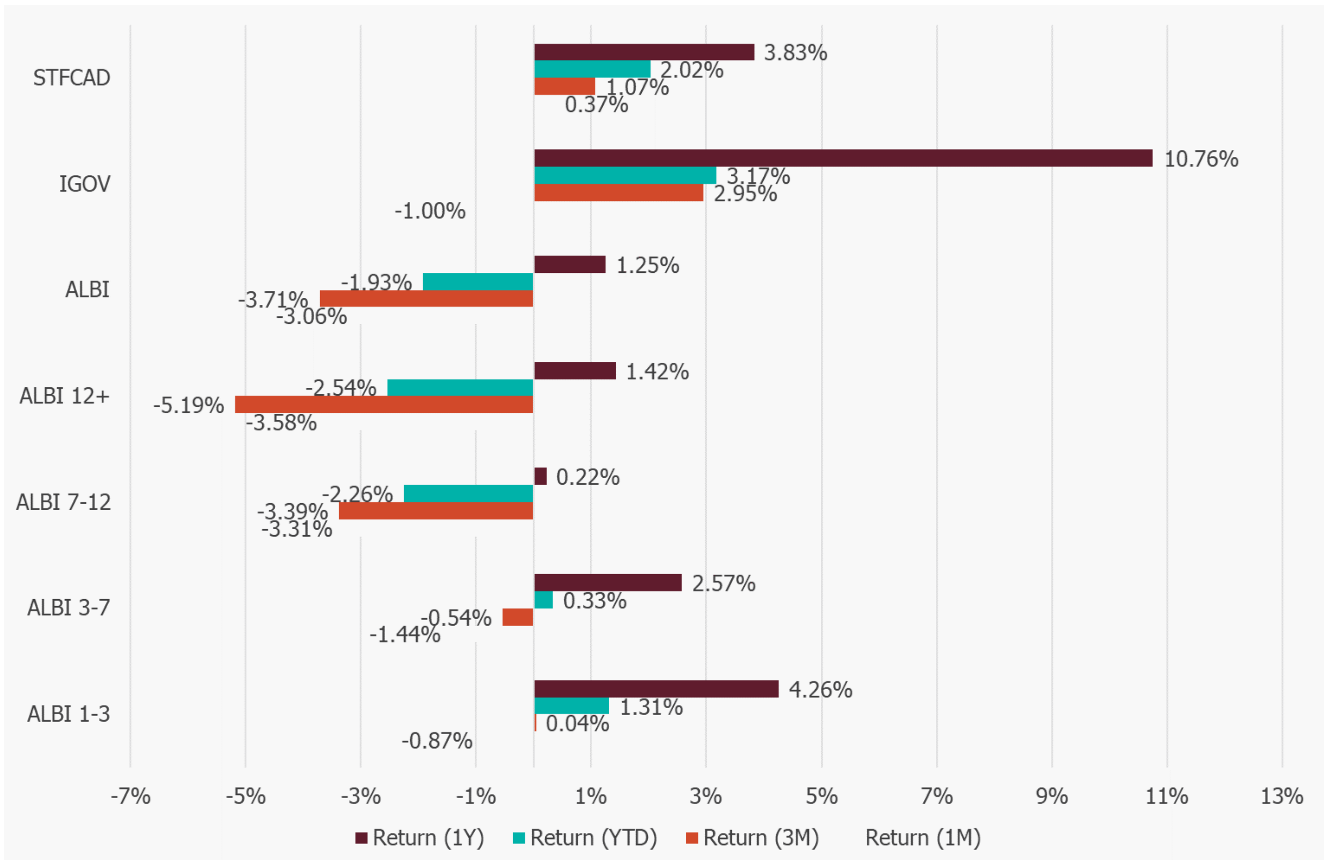
Source: Bloomberg, Futuregrowth

SA nominal bonds lost ground while inflation-linked bonds retained pole position

During the second quarter, the FTSE JSE All Bond Index (ALBI) returned -3.71%. Bonds in the 12+ year maturity band rendered the worst return as yields of the longest-dated bonds rose in excess of 100 basis points over the period. The sell-off was the combined result of the global economic fallout from the eastern Europe conflict, the feed into persistent rising inflation, tighter monetary conditions, global recession fears and local developments such as intensified load shedding, which added to an already clouded growth outlook. This fed

risk aversion, which was followed by significant sales of local bonds by foreign investors. In contrast, rising inflation concern and a higher inflation accrual lend support to the inflation-linked bond market. Consequently, the FTSE JSE Government Inflation-linked Bond Index (IGOV) rendered a relatively strong return of 2.95%, outperforming nominal bonds by a significant margin. Cash rendered a return of 1.07% over this period.

Figure 4: Bond market index returns (periods ending 30 June 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, the nominal bond market weakened sharply during the quarter, underperforming both inflation-linked bonds and cash. Rising inflation angst and an attractive inflation carry boosted inflation-linked bond performance significantly.

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AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 3.0% in 2022 to 2.8% in 2023, following a strong post-COVID V-shaped recovery, and as risks to the outlook 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, dampen the global economic growth outlook and raise recessionary fears. Domestically, our latest GDP forecasts for 2022 and 2023 are 2.4% 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 reform and recovery plans. 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 way 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 are actually adjusting upwards in response to persistent higher inflation. 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 from early next year. The persistence of the global energy and food crisis and other supply constraints pose a risk to this view in the short term. Another more recent development is evidence that the pass-through of rand weakness to inflation has picked up somewhat. On the positive side, a relatively muted core CPI reading continues to reflect the subdued structural pricing power evident over the past two years. 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 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 unsustainability 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) would see the current account surplus moderate going forward, with a marginally smaller but still significant surplus of 1.2% expected for 2023.

	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 this improvement should be questioned. For now, we still expect some current account moderation over the course of 2022, although 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. The Federal Reserve remains determined to accelerate its pace of tightening and address elevated inflation risks. 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 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, and are still expecting an increase of 100bps, which would leave the repo rate at an expected cyclical 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 unfolding tightening cycle. THE TAKEOUT: Market focus has shifted to the potential inflationary consequences of a stronger economic recovery and 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 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.

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 the 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 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 stable inflation outlook will allow the SARB to normalise policy in a measured way.

In terms of the yield curve, the front end remains most at risk to the monetary policy tightening cycle, even though this 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 12- 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. This is best illustrated by recent investment action whereby we rolled up the yield curve from

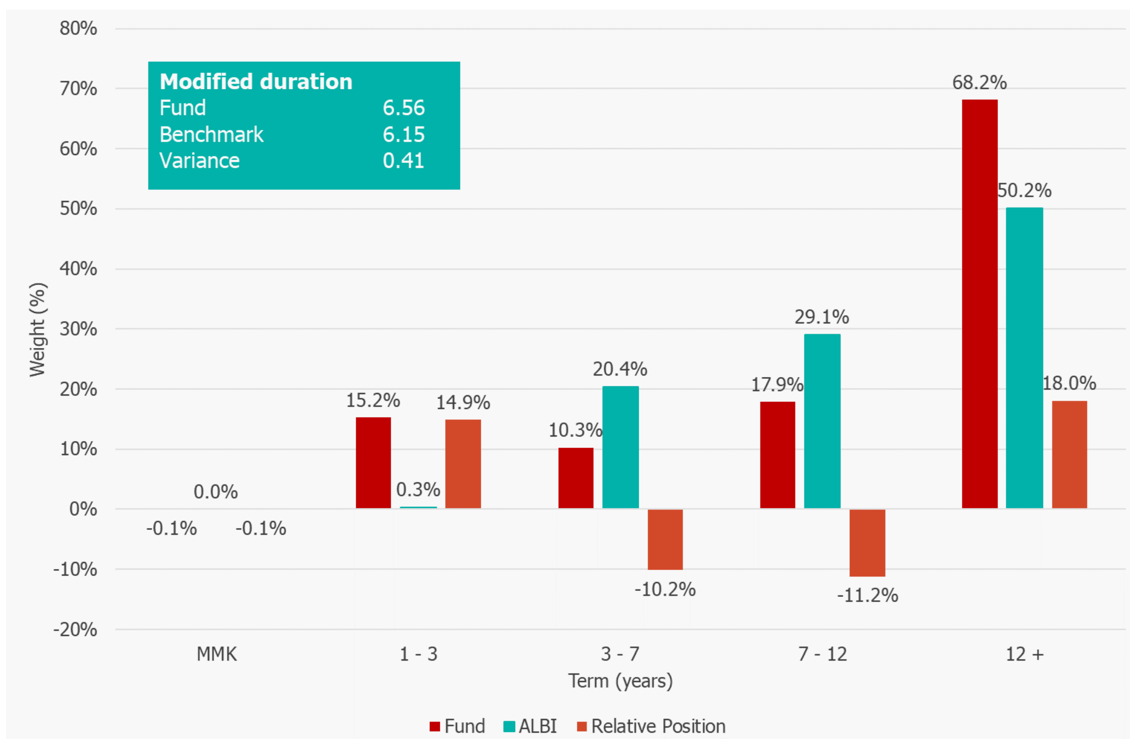
the 8- and 10-year bonds to the 19- to 22-year maturity band. This was in response to rising yields and bearish yield curve steepening which improved valuation.

We continue to favour medium to longer-dated nominal bonds over inflation-linked bonds. While we acknowledge that inflation will remain under upside pressure in the short term, the probability of some disinflation going into 2023 is rising. In addition, the strong relative inflation-linked bond performance of late has diluted prospective future returns from this asset class. Moreover, fixed-rate nominal bonds are currently offered at attractive inflation-adjusted levels.

THE TAKEOUT: Our investment strategy aims to strike a balance among 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. 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 short-term upward pressure on inflation. However, within this strategic framework, we shall also continue to respond to tactical opportunities that may present themselves, including adding modified duration by rolling up a steepening yield curve.

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

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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%	2.8%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.4%	2.5%
SA Headline CPI	5.3%	4.6%	4.1%	3.3%	4.5%	6.4%	4.7%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	2.2%	1.2%

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