CENTRAL BANKS ARE FIRMLY SET ON TAMING INFLATION

This new-found resolve to tame inflation has raised concerns about economic growth prospects, in particular, the risk of broad-based recession.

FUTUREGROWTH

/ ASSET MANAGEMENT

FUTUREGROWTH
/ASSET MANAGEMENT

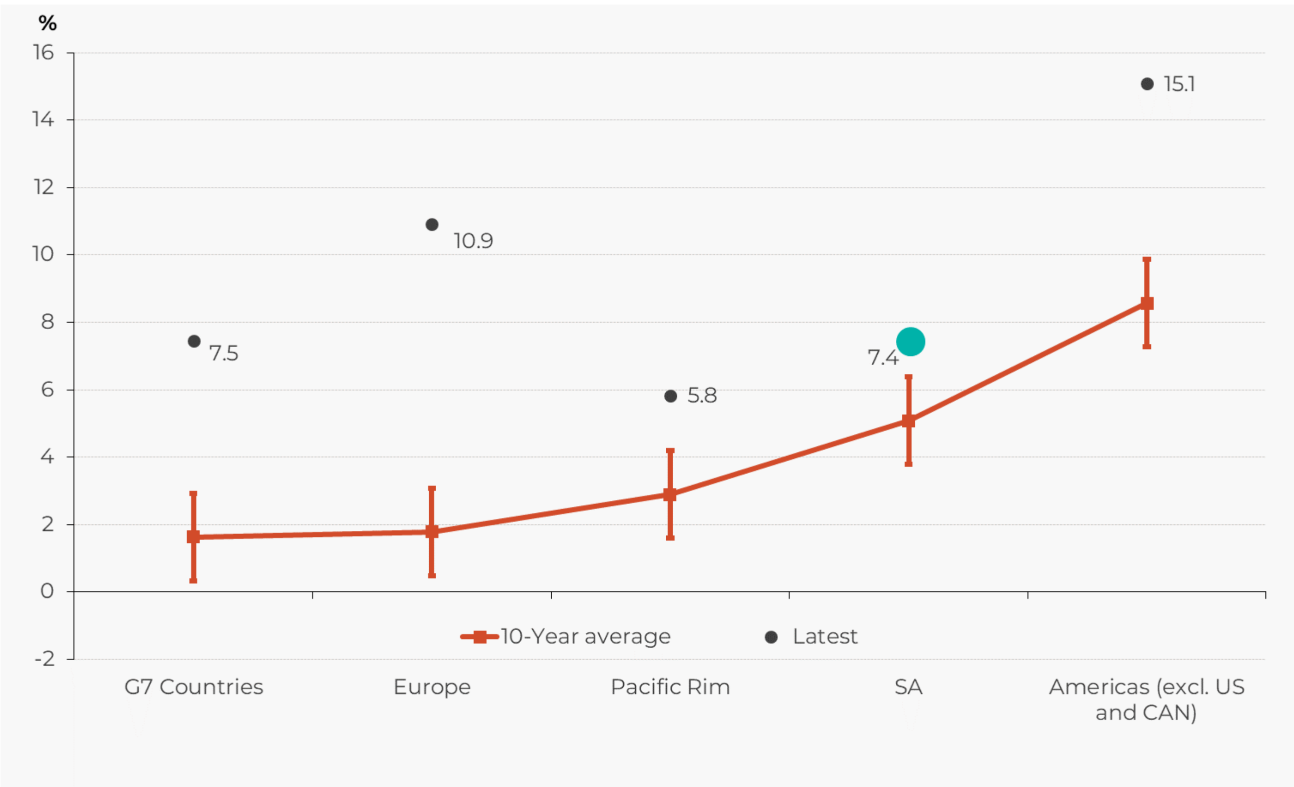
BELATED AGGRESSIVE GLOBAL MONETARY POLICY TIGHTENING FEEDS RECESSION FEARS

Author: Futuregrowth's Interest Rate team
Published: August 2022

Central banks are firmly set on taming inflation

Globally, central banks (with the exception of the central bank of Turkey, where political meddling blocks sensible macro policy management) continued to up the ante with an increasingly aggressive policy response to sustained broad-based inflation pressure. In stark contrast to their earlier tendency to underestimate the pervasiveness of inflation, the belated central bank hawkishness seems to increasingly supersede sensitivity to the impact of higher rates on economic activity. In the largest economy in the world, the US Federal Reserve lifted its policy rate by 75 basis points, the largest single increase since the 2008 global financial crisis Similarly, the South African Reserve Bank continued on the policy normalisation path by raising the repo rate by 75 basis points, with one of the five voting members calling for a 100 basis points increase. At 5.5%, the repo rate has now been increased by a cumulative 2.0% from the post-COVID low.

Figure 1: Global inflation is well above the 10-year average

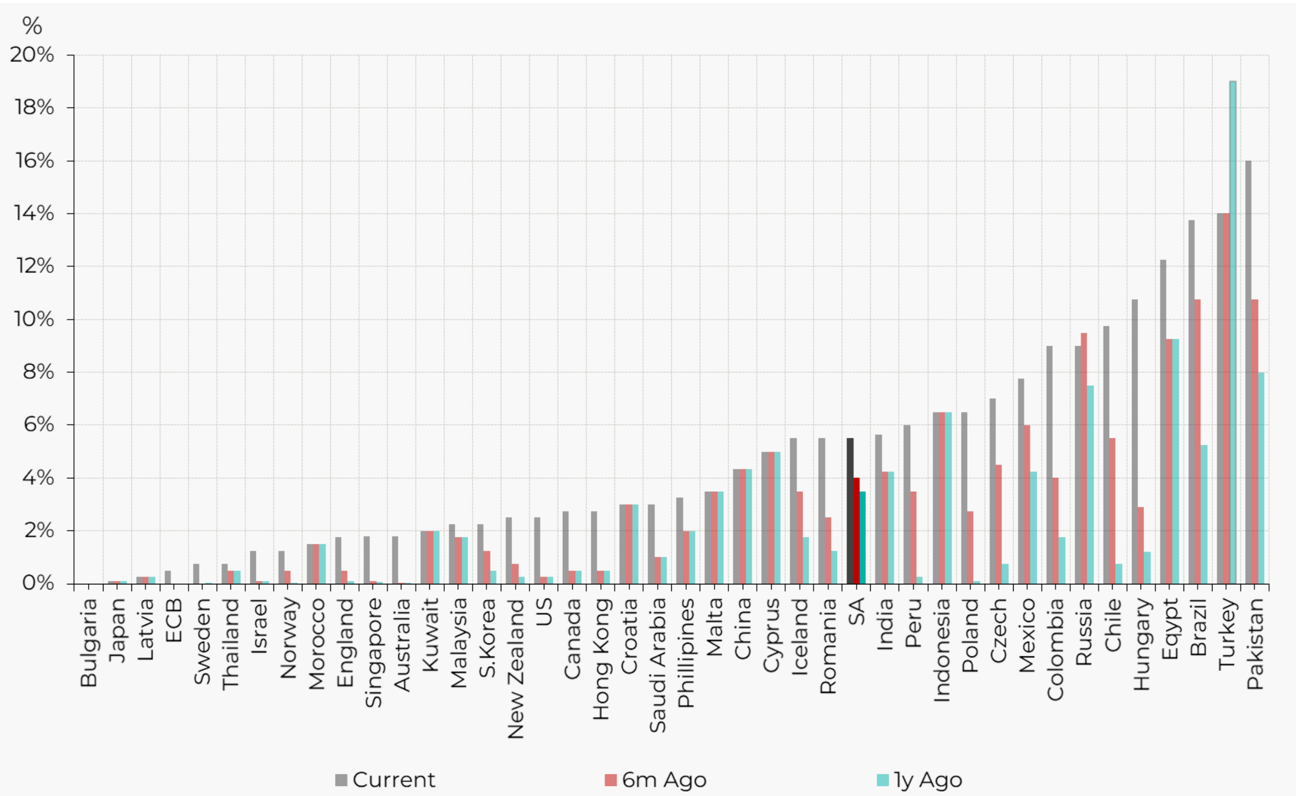


Source: Bloomberg, Futuregrowth

Sovereign bond yields drifted lower from overextended levels

Softer economic data releases (including a host of weak PMIs and US GDP data) and rising investor concerns about the added negative impact of fast rising policy rates on economic activity exerted downward pressure on sovereign bond yields. The lower bond yields imply market expectations of disinflation and weaker economic growth by next year, which in turn would force central banks to start unwinding the current bout of monetary policy tightening. This also ignited some risk appetite, with investors dipping into various financial markets now offered at more enticing valuation following the broad-based market correction in recent months.

Figure 2: Central bank policy rates in most markets are above the lows of a year ago

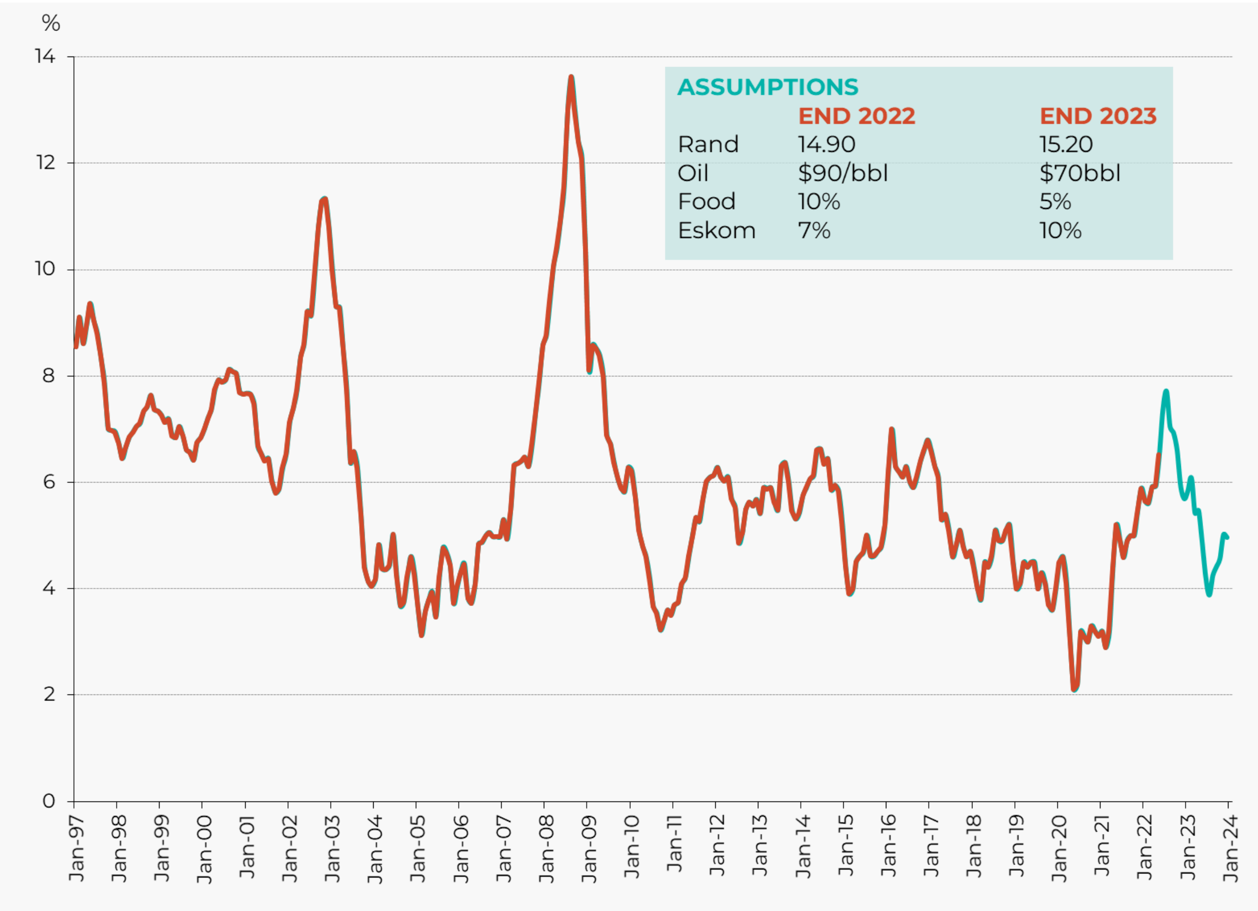


Source: Bloomberg, Futuregrowth

South African inflation keeps heading higher, along with the global trend

Being a small open economy and a net importer of oil, South Africa is not escaping the global turmoil unscathed. On the inflation front, the country's Headline Consumer Price Index (CPI) accelerated by 7.4% year-on-year in June from 6.5% the previous month. Unsurprisingly, a marked annual jump of 45.3% in fuel prices, and a 9.0% increase in year-on-year food inflation continue to be the primary drivers of this sharp acceleration, the highest in 13 years. While Core CPI rose by a more subdued 4.1% in May, from 3.8% the previous month, the acceleration was broad based and included the previously wellbehaved rental and services components. Also concerning, and closely aligned with global developments, is the continued sharp acceleration of prices at the producer level, with some risk of spillover to consumers. In June, the Producer Price Index (PPI) for final manufactured goods accelerated from 14.7% in May to 16.2% on a year-on-year basis, the highest since 1989 (even though the calculation methodology has changed over time). While once again broad based, with prices in six out of nine categories rising, it was nonetheless slightly better compared to the May data set when seven out of nine categories rose. On a forward-looking and more positive note, it is worth noting that crude oil prices, global grain/food indices and SAFEX futures prices for key grain crops have started easing from exceptionally elevated levels. In addition, the Prices Paid subindex of the ABSA PMI decreased to 87.5 in July, its lowest level in eight months. While still exceptionally high, the lower reading does, at least anecdotally, point to some deceleration in the rate of price increases at the production level. It is also noteworthy that subdued global economic activity has allowed for earlier extreme supply chain pressures to start easing.

Figure 3: Higher South African inflation is creating a high base for significant disinflation next year



Source: OMIG, Futuregrowth

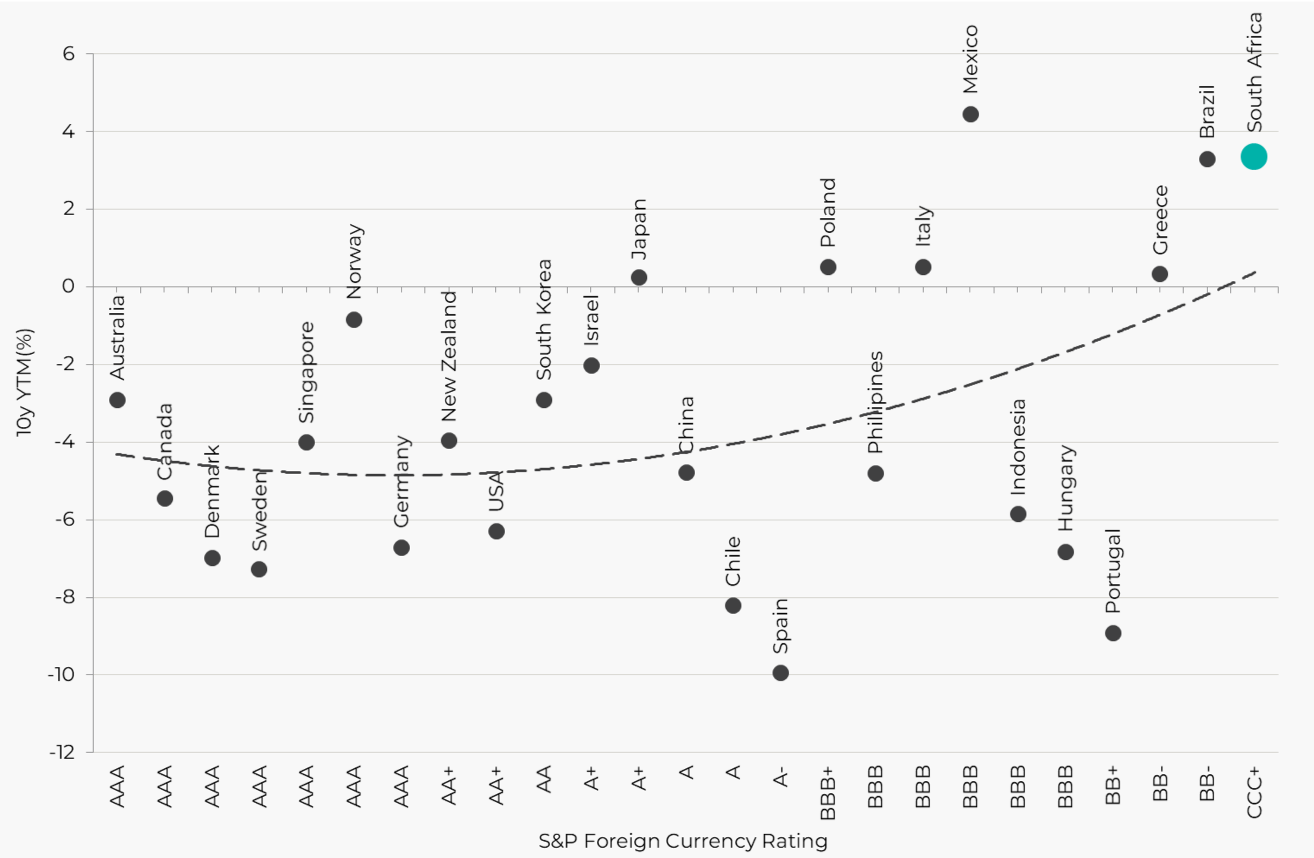
This has been the strongest first fiscal quarter for South Africa in 16 years

The promising start to the 2022/23 fiscal year received another significant boost in June. Data released by National Treasury revealed a main budget surplus of R73.8 billion for June, mainly due to a significant jump in corporate income tax (CIT) receipts. The year-on-year increase of 13.7% in CIT is particularly noteworthy considering last year's bumper collection which created a high base, together with the fact that commodity prices have started rolling over since then. While personal income tax receipts slowed, these were offset by higher VAT receipts and a surge in customs duties. It is also encouraging to note that total expenditure rose by a muted 6.5% year-on-year. The impact of sustained higher-than-expected tax revenue collection and contained expenditure during the first three months of the current fiscal year resulted in a small budget surplus of R12 billion - the first in 16 years. While provisional financing data for July points to a large monthly deficit of around R83 billion, this is broadly in line with seasonal trends, and significantly smaller than the deficit recorded for the corresponding month last year. All considered, the combination of actual data for the first three months and provisional data for July continue to support our expectation of a markedly smaller budget deficit for the current fiscal year, compared to the latest official estimate.

The merchandise trade surplus is still sizeable despite strengthening headwinds

The country's merchandise trade surplus narrowed from R30.9 billion in May to R24.2 billion in June as imports rose by more than 6%, mainly boosted by mineral products as the loss of domestic refinery capacity is believed to have forced the purchase of more expensive refined oil. The jump in imports outpaced the 1.6% rise in exports by a significant margin. While the surplus is still sizeable, the recent trend is aligned with our view of a gradual narrowing of the current account surplus.

Figure 4: South African bonds offer good value on a global scale (10-Year inflation-adjusted nominal government bond yields: local currency)



Source: Bloomberg, Futuregrowth

Government has a belated response to the ongoing and intensifying power crisis

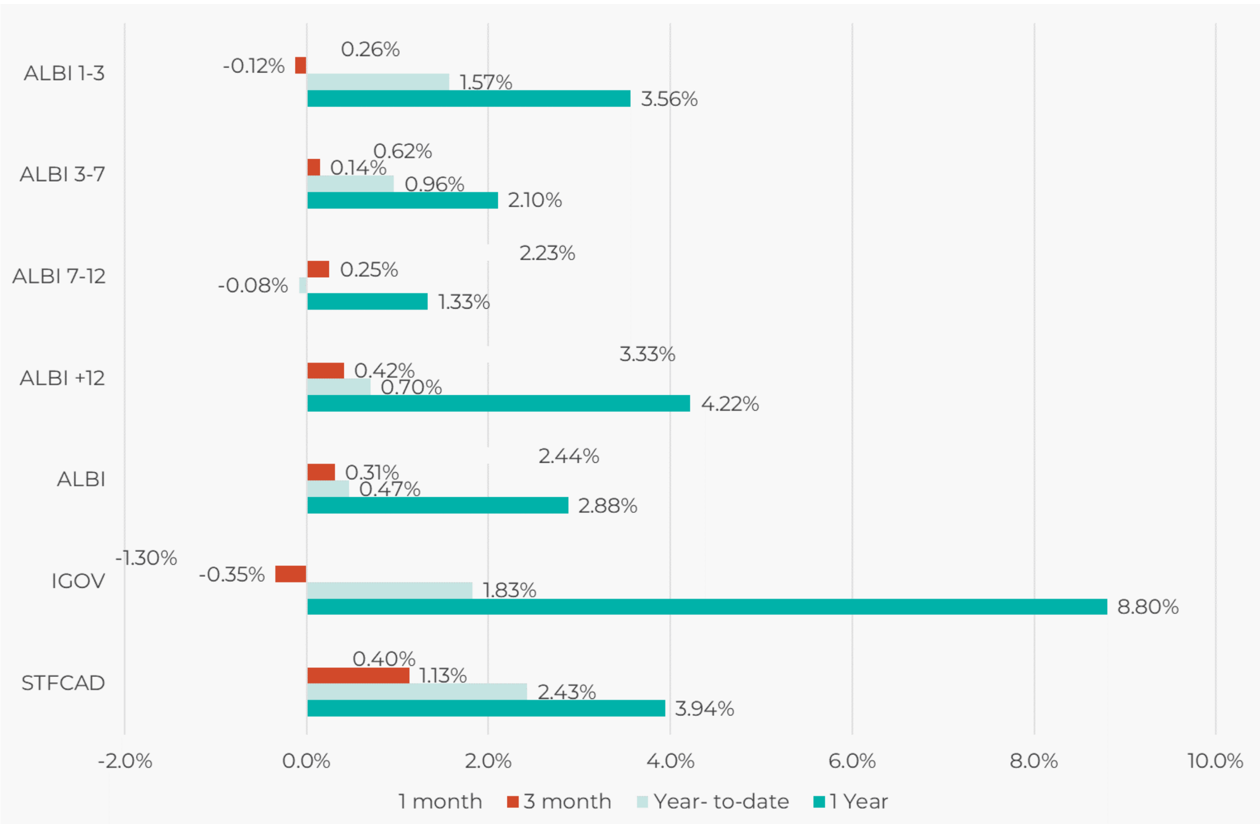
The recent intensified bouts of electricity loadshedding forced government to finally respond with a set of more meaningful electricity reforms. The 100 megawatt ceiling for private embedded electricity generation was scrapped while independent power producers (IPPs) will be allowed to feed/sell surplus power to the grid. The doubling of electricity procurement from these IPPs through bid window 6 will add more renewable energy to the grid. Eskom's balance sheet will also be strengthened by the proposed transfer of some of the entity's outstanding debt to the sovereign balance sheet. While this belated/slow response to the long running energy crisis is broadly welcomed, the beleaguered South African manufacturing sector (like most other sectors) continues to be hampered in a significant way by the constrained energy supply. For instance, the seasonally-adjusted business activity of the ABSA PMI decreased sharply to 39.8 in July from 46.0 the previous month. While power shortages should not bear all the blame, the fact that load shedding was implemented for an astonishing 22 days in the month - and at an elevated intensity - would surely have had a major impact.

FUTUREGROWTH
ASSET MANAGEMENT

SA nominal bonds regained lost ground towards month end

Following a period of significant market weakness during the second quarter of the year and the first few weeks in July, longer-dated bond yields decreased sharply towards the end of the month, resulting in significant bullish yield curve flattening. The recent relief rally reflects investor endorsement of the South African Reserve Bank (SARB)'s decision to accelerate the pace of policy tightening, improved fiscal performance and, of course, lower global bond yields. The reinvestment of sizeable coupon receipts at the end of July would have boosted demand for bonds from a technical perspective. As a result, the FTSE JSE All Bond Index (ALBI) returned a heady +2.44% in July, with bonds in the 12+ year maturity band rendering an impressive 3.33%. In contrast, real yields ground higher, despite supportive inflation data prints. The increase in real yields (and consequent drop in prices) was large enough to offset the benefits of a high inflation carry. Consequently, the FTSE JSE Government Inflation-linked Bond Index (IGOV) rendered a return of -1.30%, underperforming nominal bonds by a significant margin. Even so, the return from nominal bonds still lags that of inflation-linked bonds (and even cash) for the seven-month period ending July.

Figure 5: Bond market index returns (periods ending 31 July 2022)



Source: IRESS, Futuregrowth

FUTUREGROWTH
/ASSET MANAGEMENT

THE TAKEOUT: Globally, monetary policy tightening kept gaining momentum, with central banks focused on getting the inflation genie back into the bottle. This new-found resolve has raised concerns about economic growth prospects and, in particular, the risk of broad-based recession, which in turn caused sovereign global bond yields to drift lower. Locally, the SARB kept to the monetary policy tightening script by increasing the repo rate by 75 basis points in response to broadening inflation pressures. On the fiscal front, the first three months of the 2022/23 fiscal year turned out to be the best in 16 years, as sustained strong tax revenue collection gains and subdued expenditure delivered a small budget surplus. Following 22 days of intensified loadshedding during July, the government finally managed to put forward a plan to address one of the many structural hurdles to a sustainably higher level of economic growth. A combination of the above contributed to some market gains, with nominal bonds rendering the highest return, as bond yields decreased and the yield curve bull flattened.

AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 2.7% in 2022 to 2.3% 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 chains still lingers, the intensifying economic fallout from the conflict in Ukraine has added an extra layer of complexity. Stubborn inflationary pressure is forcing the hands of several central banks to engage in more aggressive monetary policy action, which, in turn, dampens the global economic growth outlook and raises recessionary fears. Soggy PMIs in many advanced and emerging economies indeed point to weaker economic growth prospects, while the largest economy in the world is already in a technical recession. Domestically, our latest GDP forecasts for 2022 and 2023 are 2.4% and 2.5%, respectively, compared to 4.9% for 2021. From a cyclical perspective, a small open economy with a heavy dependance on commodity exports cannot escape the downside to lower global growth, while higher inflation and interest rates will also negatively impact economic activity. Moreover, 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. Another risk is the potential grey-listing of South Africa, which will complicate matters regarding much-needed foreign investment. 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. This uncertainty is reflected in low confidence among both consumers and the business sector.

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. 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 meaningfully resolved.

INFLATION

The commodity fallout from the conflict in Ukraine added upside risk to a global inflation surge initiated by a combination of earlier extraordinary easy monetary policy measures and the effects of stubborn supply-side bottlenecks. 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 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 are actually adjusting upwards in response to persistent higher inflation. Another development worth monitoring is the easing impact of weaker demand on supply chain problems, possibly reducing cost pressures.

Domestically, a higher base, in turn due to the upside surprise to headline CPI over the past few months, 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 poses 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 the 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 sustained inflation pressure 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 our expectations of relatively subdued underlying inflation.
BALANCE OF PAYMENTS	South Africa's merchandise trade account remains buoyant, following the sharp price increase in the country's commodity export basket during the second half of last year and the beginning of this year as a result of the ongoing conflict in Ukraine. However, the sustainability of this calls for caution, considering the reason for the recent boost and the 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, mainly as a result of reduced support from the terms of trade and weaker global economic growth.
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 five 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 200 basis points. We did not adjust our expected cycle peak of

	6.50% and are therefore still expecting an increase of 100 basis points, admittedly with some upside risk. Even so, 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 2.0% since the start of the cycle, which has taken the repo rate to 5.5%. We retain our repo rate forecast, targeting a terminal nominal repo rate of around 6.50% by the middle of next year.
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 announced proposal by the president to transfer a portion of Eskom's debt into the government's balance sheet and, in doing so, crystalising contingent liability risk, only adds to fiscal pressure. The positive surprise in corporate income tax receipts is also unlikely to be sustained, 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, and additional current expenditure pressures. 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.

While the front end of the yield curve still remains most at risk to the monetary policy tightening cycle, the progression of the tightening cycle (and the absolute levels at which shorter-dated bond yields are offered) implies that the impact is wearing off. Similarly, while rising short-term rates undermine potential yield curve roll-down gains from shorter-dated fixed-rate bonds, the impact will lessen from here on. Further out on the yield curve, market gyrations caused by varying global risk sentiment, 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 sloped yield curve and the 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 20-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 8- and 10-year bonds to the 19- to 22-year maturity band, thus adding excess modified duration relative to benchmarks. This was in response to rising yields and bearish yield curve steepening which improved market valuation and thus the higher probability of capital gains.

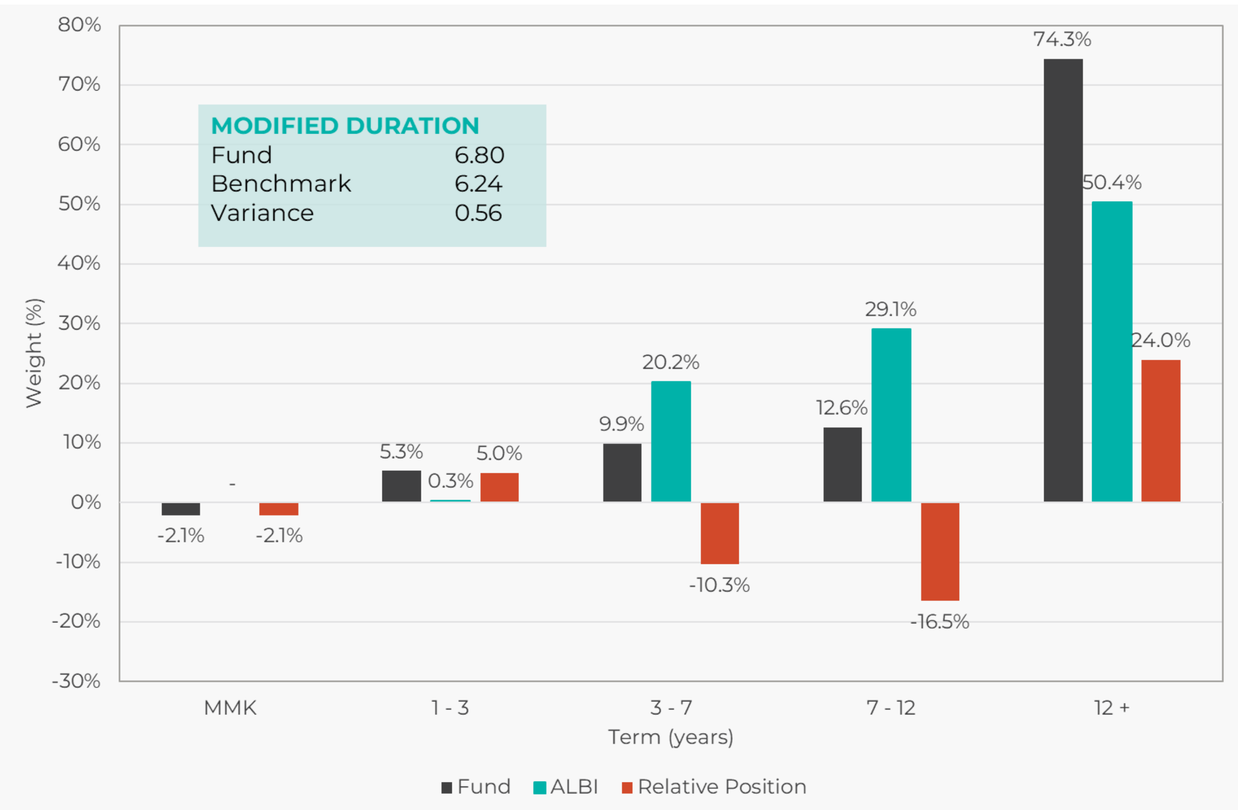
We continue to favour medium to longer-dated nominal bonds over inflation-linked bonds. While we acknowledge that inflation will remain under upside pressure in the short term, the probability of disinflation going into 2023 is high. In addition, the strong relative inflation-linked bond performance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

FUTUREGROWTH
/ASSET MANAGEMENT

THE TAKEOUT: Our investment strategy aims to strike a balance among 1) capitalising on the extraordinarily high base accrual (carry) on offer, especially relative to cash and short-dated bonds; 2) participating in the roll down potential offered by longer-dated bonds; and 3) active modified duration management with the objective to limit capital loss but also seek capital gain opportunities. The base accrual and (to a lesser extent) roll down are a function of the steeply sloped yield curve. 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 vulnerable (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 strategic alternative. 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 anticipation of capital gains. We continue to favour longer-dated nominal bonds over inflation-linked bonds considering the probability of strong disinflation next year, the outperformance of inflation-linked bond in the past 12 months and the current attractive inflation-adjusted yields offered by nominal bonds.

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

FUTUREGROWTH
/ASSET MANAGEMENT

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%

Published on www.futuregrowth.co.za/insights.
Futuregrowth Asset Management (Pty) Ltd ("Futuregrowth") is a licensed discretionary financial services provider, FSP 520, approved by the Registrar of the Financial Sector Conduct Authority to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. The fund values may be market linked or policy based. Market fluctuations and changes in exchange rates may have an impact on fund values, prices and income and these are therefore not guaranteed. Past performance is not necessarily a guide to future performance. Futuregrowth has comprehensive crime and professional indemnity in place. Performance figures are sourced from Futuregrowth and IRESS.