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Global monetary policy mantra morphs to “interest rates higher for longer”

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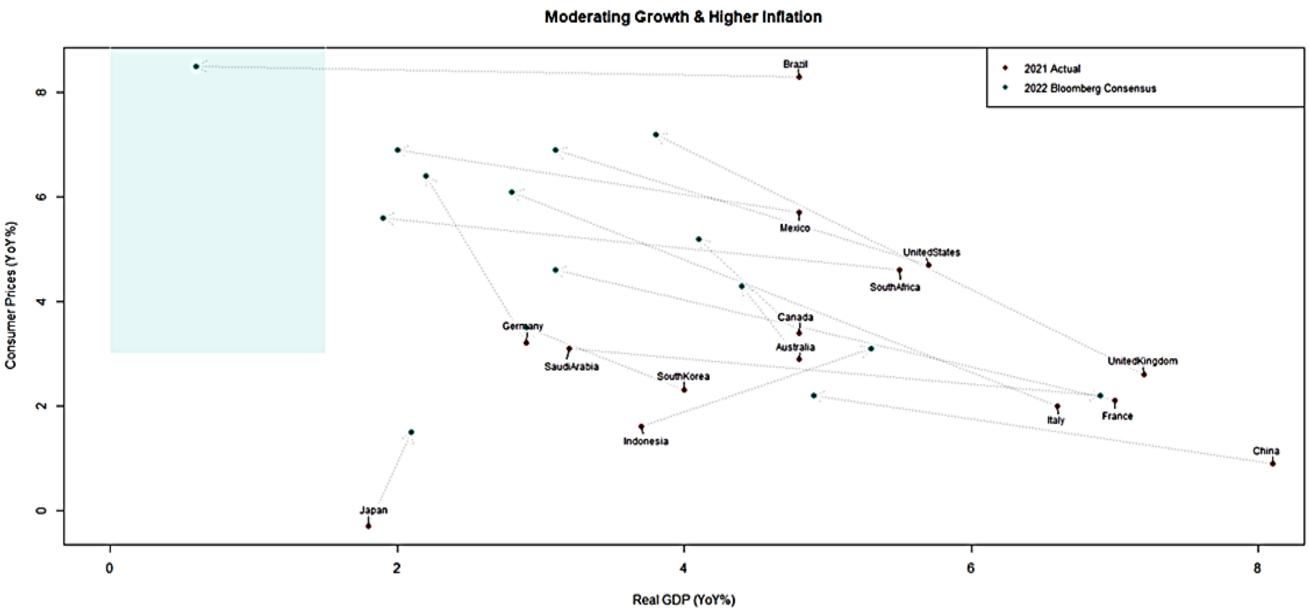
Hawkish central bank rhetoric feeds recession fear and market weakness

The word “happiness” and the phrase “higher sacrifice ratio” received a new meaning in financial markets in August. As should have been expected, central bankers, specifically policy makers from the US Federal Reserve (Fed) and the European Central Bank (ECB), used as much airtime as possible at the Kansas City Fed symposium in Jackson Hole to reiterate a strong commitment to force inflation back into the genie-bottle. While none of this belated central bank resolve should have been a surprise to markets because global inflation had been hovering well above 10-year averages for a while, investors nonetheless rushed for the exit as recession anxiety reached new highs.

The extent of the newfound commitment by central bank hawks was best demonstrated when Neel Kashkari, one of the Fed officials expressed “happiness” with how financial markets sold off in response to Fed chair Jerome Powell’s speech. Similarly, ECB officials made their intentions clear, while some used the opportunity to highlight the complexity of the current global inflation cycle. Isabel Schnabel, an ECB executive board member, was quoted as saying that central banks “face a higher sacrifice ratio (the loss in economic growth and employment to bring inflation under control) compared to the 1980s given that the globalisation of inflation makes it more difficult for central banks to control price pressure.”

The inflation issue boils down to potential higher future volatility around a higher underlying trend. Moreover, policy makers are dealing with shifting risks, including developments beyond their control. The message could hardly be clearer: expect policy rates to be higher for longer and do not expect rates to be cut at the first sign of economic slowdown. This is in stark contrast to the “lower for longer” mantra that, until not too long ago, dominated financial market airwaves for a long time.

Figure 1: More economies are drifting ever so slowly into to the stagflation zone



Source: Bloomberg, Futuregrowth

Central bank rhetoric is hawkish despite some evidence that underlying inflation is moderating

The fact that global inflation is still hovering at sky-high levels and well above central bank target levels is undisputed. However, one should not lose sight of evidence of a moderation in the rate of increase across several economies. In the US, just as the hawks have become noisier, a telling indicator of this moderation is the seasonally adjusted rolling 3-month annualised rate of change for both the Headline and Core PCE (Personal Consumption Expenditure) deflator data series. This is supported by the fact that crude oil prices, grain prices and the CRB (Commodity Research Bureau) Food Price index are all off their more recent peaks. This recent trend is also reflected in the recent sharp drop in the Prices Paid sub-component of the USA Producer Manager Index (PMI). Similarly, the combined effect of slower economic activity, the continued unwinding of supply chain bottlenecks and the slow normalisation of shipping activity and the cost thereof are also contributing to some pipeline price pressure relief. Of course, this excludes the Euro area and UK as they are still in the midst of a pre-winter energy crisis, a clear upside risk to inflation.

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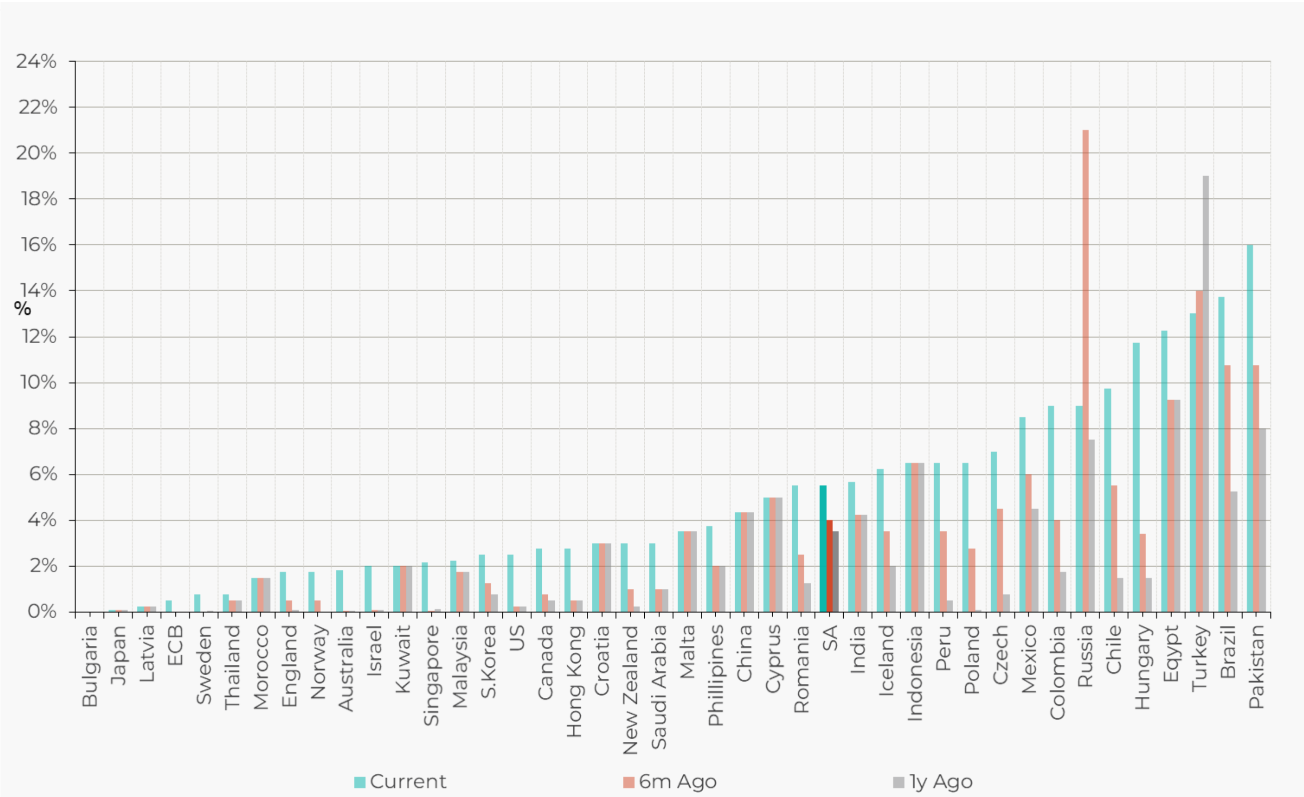
Figure 2: Central bank policy rates in most markets are above the lows of a year ago

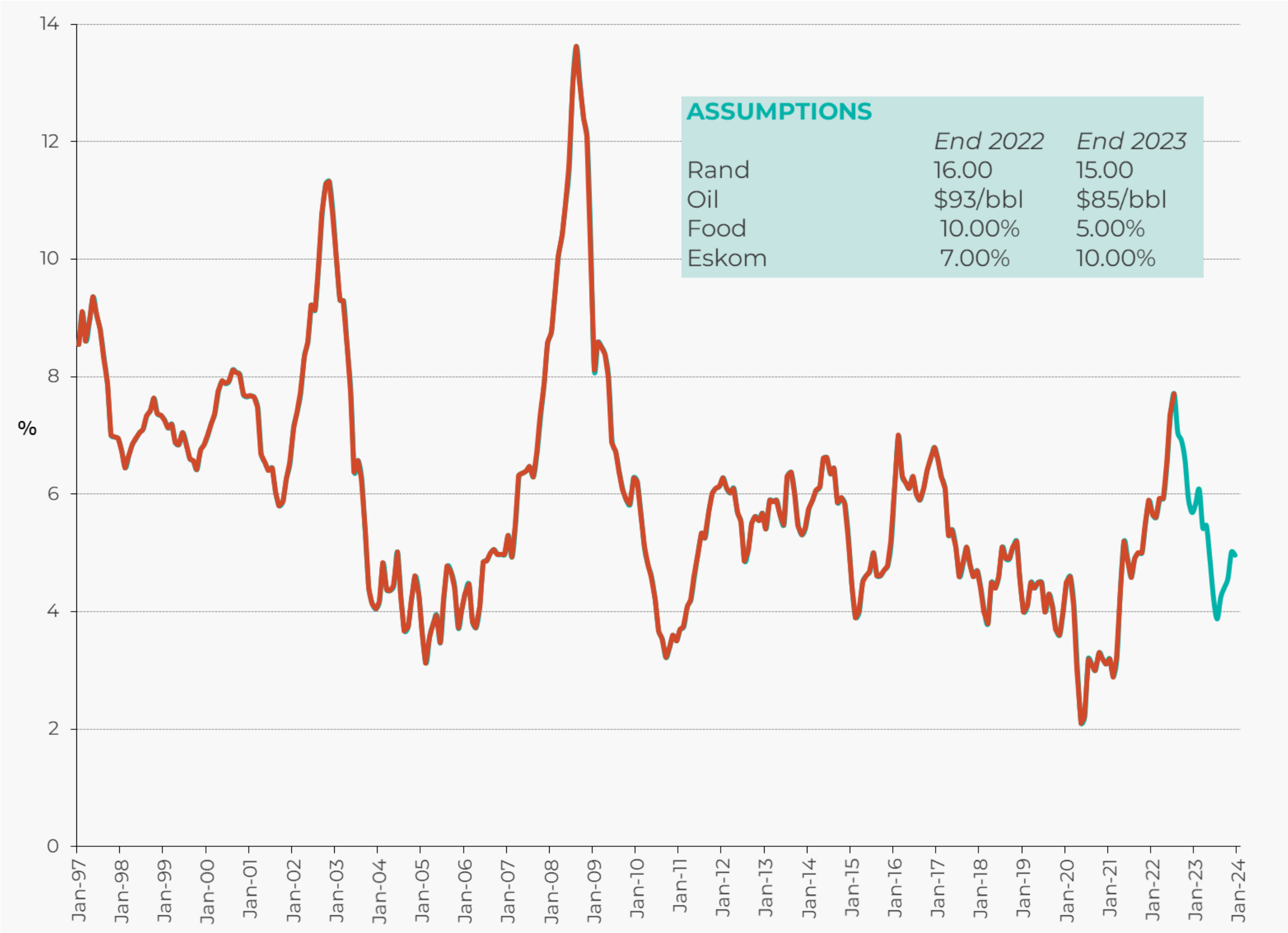


Source: Bloomberg, Futuregrowth

South African inflation probably peaked in July

The South African Headline Consumer Price Index (CPI) accelerated by 7.8% year-on-year in July from 7.4% the previous month. This was broadly in line with market expectations. Unsurprisingly, the food and transport components of the index remained prominent contributors to the higher rate of increase. Core CPI rose by a more subdued 4.6% from 4.4%, while (worryingly) services inflation accelerated from 3.9% to 4.3%. Even so, the July Headline CPI data point is deemed to be the peak in this cycle, in light of sizeable petrol price decreases in August and September which are expected to offset a further increase of food prices. In July the Producer Price Index (PPI) for final manufactured goods accelerated to 18.0% from 16.2% in June on a year-on-year basis, with the sharp rise in fuel prices once again a significant contributor. While producer inflation rose in seven of the nine categories, easing trends in the Intermediate Manufactured Goods and Agriculture sub-components of the index are noteworthy. Moreover, crude oil prices, global grain/food indices and SAFEX futures prices for key grain crops continued to ease 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. All in all, these developments point to a possible peak in PPI for final manufactured goods in July.

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



Source: OMIG, Futuregrowth

Strong first fiscal quarter is followed by a larger than expected deficit in July

For the first three months of the current fiscal year, sustained higher-than-expected tax revenue collection and contained expenditure resulted in a small budget surplus of R12 billion - the first in 16 years. The promising start was followed by worse than expected main budget data for July. While provisional financing data for July pointed to a large monthly deficit of around R83 billion, the actual data print turned out to be worse at R130 billion. While the large monthly deficit could be explained by seasonal factors, mainly the timing of large coupon payments and a sharp decline in corporate income tax receipts, the larger-than-expected deficit turned out to be the result of a worrying 4% year-on-year decrease in Personal Income Tax receipts. On the positive side, total expenditure growth remained subdued, with a modest 1.2% year-on-year rate of increase. All considered, actual data for the first four months of the fiscal year continue to support our expectation of a markedly smaller budget deficit compared to the official estimate.

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The merchandise trade surplus is still sizeable despite strengthening headwinds

The country's merchandise trade surplus is holding up relatively well despite global weakening demand and local intensified electricity loadshedding and rail network issues. The July surplus of R24.8 billion turned out to be marginally higher than the R24.2 billion recorded in June. The monthly decrease in total imports of 5% exceeded the 4% drop in total exports. While the export of metals and precious stones decreased sharply by 17% in July, this was offset by a strong increase by other major export products. A sharp drop in the import of mineral products was also noteworthy. While the trade surplus is still sizeable, our view of a gradual narrowing of the current account surplus, especially against the background of weakening global demand, is unchanged.

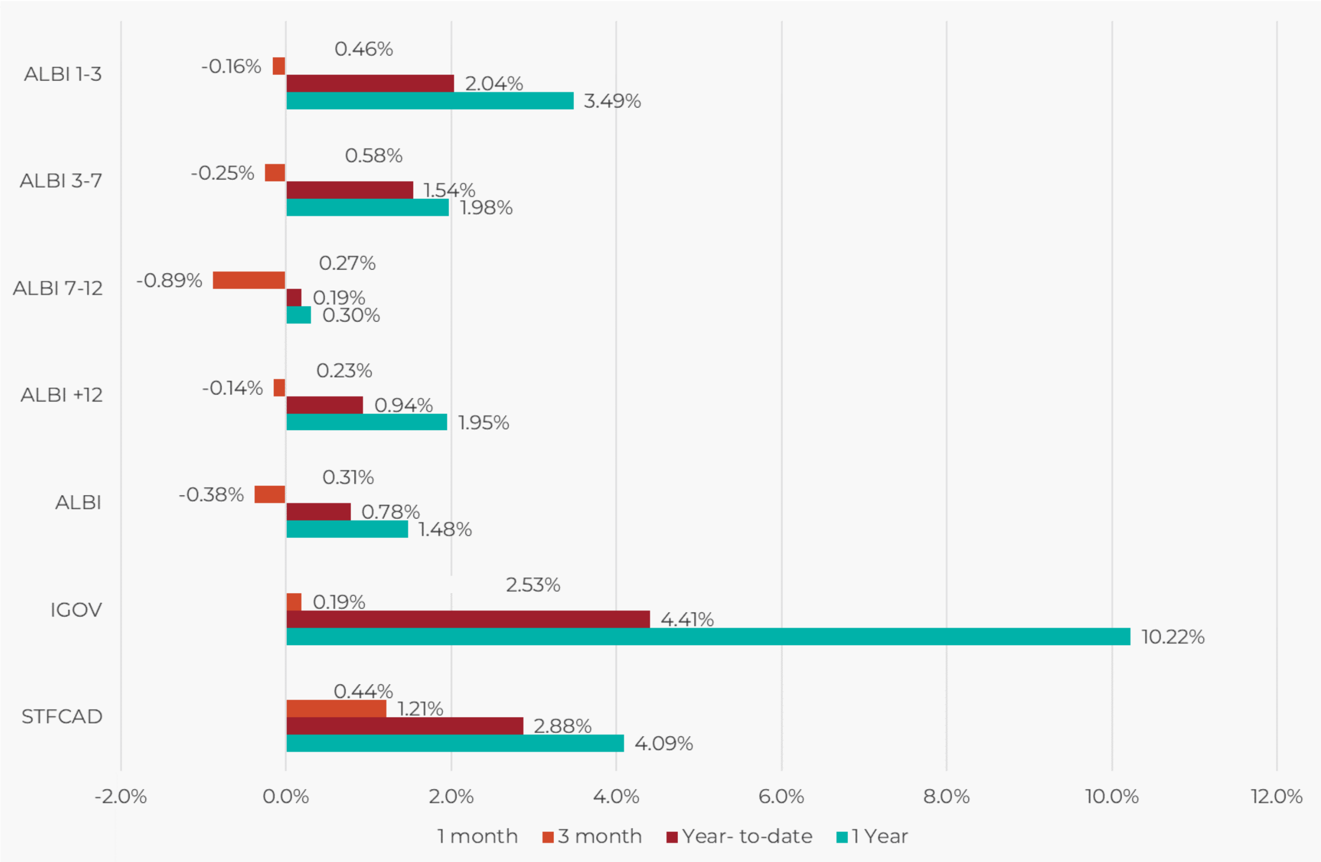
Potential grey listing becoming a more prominent risk

The Financial Action task Force (FAFT) evaluated South Africa in October last year and found several deficiencies in the country's policies and efforts to combat money laundering and terrorism financing. Although significant progress has been made in terms of addressing the deficiencies pointed out by the FATF, much of this has been on the legislative side. The FATF is due to review South Africa in October this year to gauge if enough progress has been made to combat money laundering and terrorism financing, and to assess whether the country has a credible plan to deal with areas of concern. The FATF will then have a plenary meeting February 2023 where it will be decided whether or not to add South Africa to the grey list. Our view is that, although the legislative changes are a positive step, a turnaround from a law enforcement implementation perspective will take some time. As a result, we see it as probable that South Africa will be added to the grey list. Please see *here* for a more comprehensive analysis. Suffice to state that grey listing is more than likely to inhibit much-needed foreign capital flows.

SA nominal bonds lost some ground in August

Following very strong performance in July when the FTSE JSE All Bond Index (ALBI) returned a heady 2.44%, nominal bond returns lost some momentum in August. The combination of rising global bond yields in response to hawkish central bank rhetoric, heightened concern about weaker global growth which in turn dampened risk appetite and by extension demand for SA bonds and rand weakness caused local yields to drift higher. As a result, the FTSE JSE All Bond Index (ALBI) returned 0.31% in August, with bonds in the 12+ year maturity band rendering the lowest return of 0.23%. Cash marginally outperformed bonds over the period by rendering a return of 0.45%. In contrast, real yields ground lower as demand continued to be boosted by an attractive inflation carry in the short term. The combination of a higher inflation carry and capital gains from falling real yields caused the FTSE JSE Government Inflation-linked Bond Index (IGOV) to render a strong return of 2.53%, a significant swing from the -1.30% in July. As a result, the return from nominal bonds still lags behind that of inflation-linked bonds (and even cash) for the eight-month period ending August.

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



Source: IRESS, Futuregrowth

THE TAKEOUT: Globally, monetary policy tightening has kept gaining momentum, with central banks focused on getting the inflation genie back into the proverbial bottle. This new-found resolve has raised lingering concerns about economic growth prospects and, in contrast to July, caused sovereign global bond yields to drift higher as focus has shifted to the risk of higher policy rates for longer. Locally, both CPI and PPI data prints for July probably represent the peak in the current inflation cycle. On the fiscal front, main budget data for July disappointed with a larger than expected deficit although seasonal factors played a role in this. The combination of the above factors forced local nominal bond yields higher, while inflation-linked bonds benefitted from inflation-hedging demand, in turn backed by an attractive inflation carry for the next three months. As a result, inflation-linked bonds outperformed, with the IGOV rendering a return of 2.53%, well in excess of ALBI and cash, which returned 0.31% and 0.45%. respectively.

AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 2.7% in 2022 to 2.0% 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. Moreover, stubborn inflationary pressure is forcing the hands of several central banks to engage in more aggressive monetary policy action, which, in turn, 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. In contrast, and on a more positive note regarding economic activity, the Chinese authorities have announced significant stimulatory measures during August which may at least partly offset some of the headwinds referred to above. 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, and 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 and higher services inflation in some advanced economies like the US are now also adding to underlying price pressures. 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. Another development worth monitoring is the combined impact of some inventory recovery and weaker demand on supply chain problems, possibly reducing cost pressures. Moreover, crude oil and grain prices are showing signs of rolling over from exceptionally high levels. 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. 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 relatively low corporate profit margins in South Africa. **THE TAKEOUT** 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, while the rate of headline inflation is expected to decelerate from here on, more broad-based price pressures could prevent inflation from reaching central bank target levels. 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 from here on.

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 even if this implies lower economic growth. 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 yield changes, some inflation uncertainty, 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.

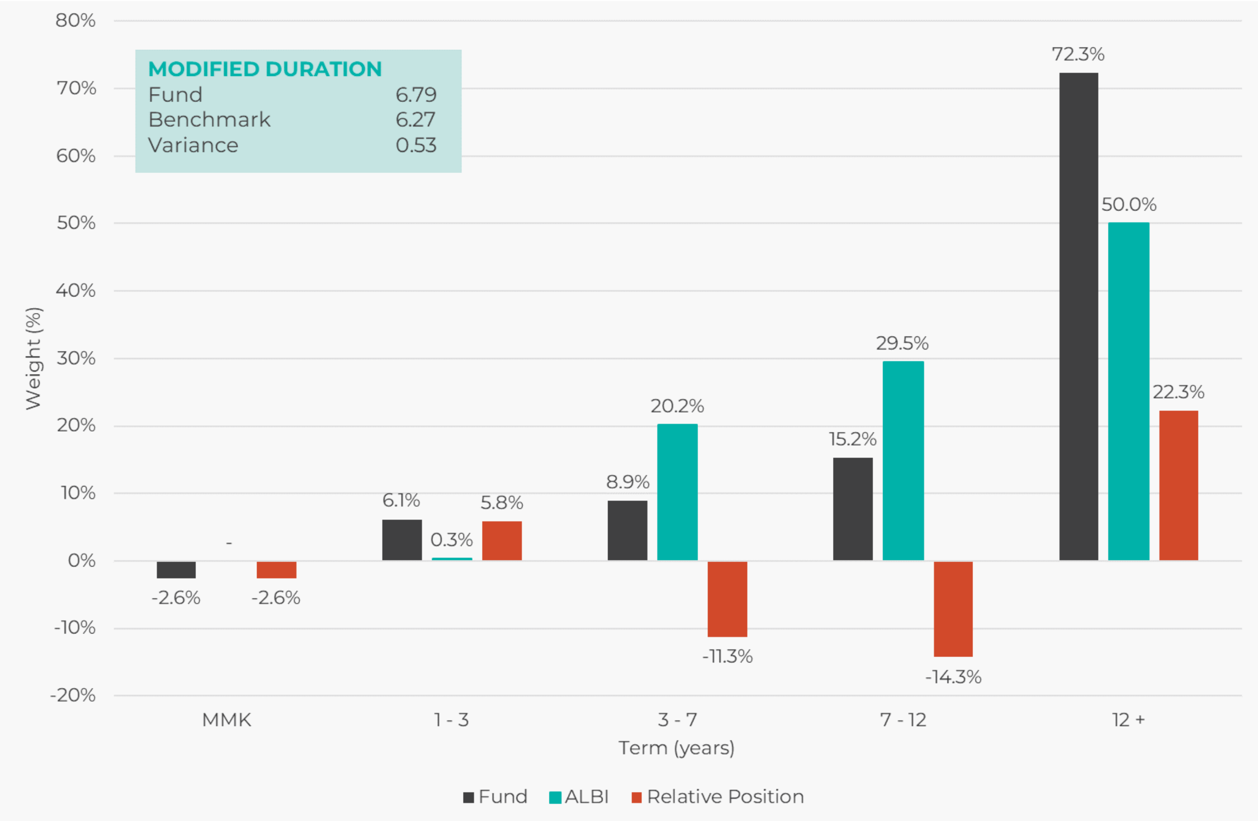
Considering the combination of monetary policy tightening, upward pressure on global bond yields and the challenging fiscal backdrop, the most appropriate risk-adjusted area of the yield curve (at a strategic level) remains the 12- to 20-year maturity band. However, within this framework, we shall continue 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 down the yield curve from the 19- to 22-year maturity band to shorter-dated bonds, thus reducing modified duration relative to benchmarks. This was in response to falling bond yields and bullish yield curve flattening which eroded market valuation and allowed our funds to lock in some capital gains following earlier buying of bonds at more attractive levels.

We continue to favour medium to longer-dated nominal bonds over inflation-linked bonds. We view the July CPI and PPI prints as the peak in the current cycle, with disinflation to gain momentum from here on. In addition, the strong relative inflation-linked bond performance of the past twelve months 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 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. We continue to favour longer-dated nominal bonds over inflation-linked bonds considering the high probability of strong disinflation next year, the outperformance of inflation-linked bonds 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

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%