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AS GOOD AS IT GETS

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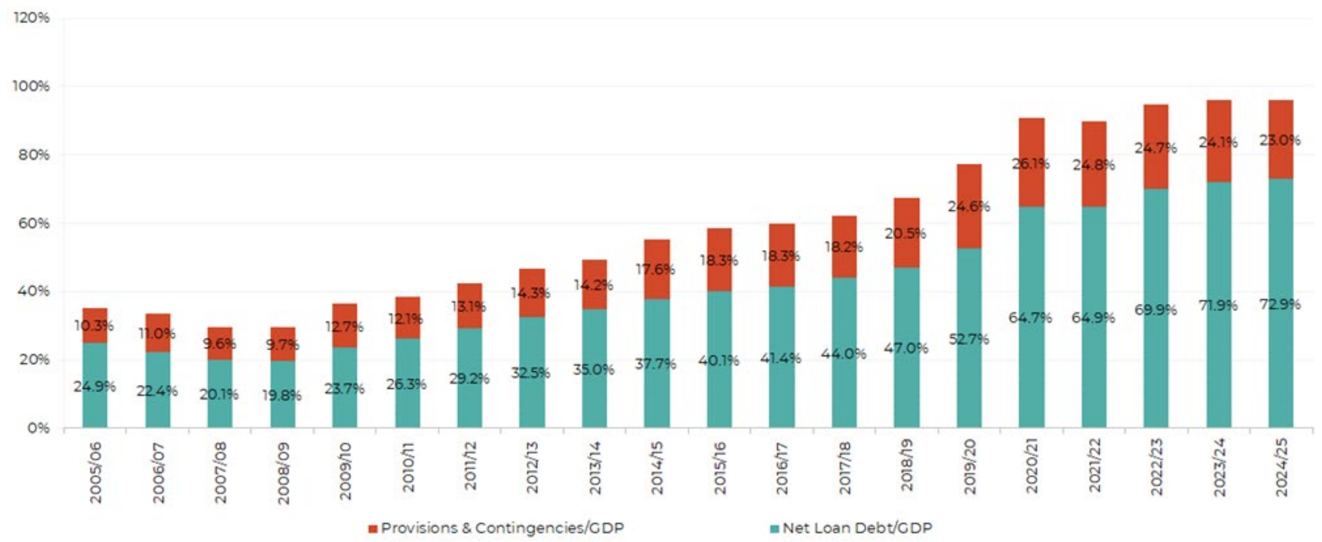
Mid-year fiscal update confirms fiscal consolidation

The tabling of the Medium Term Budget Policy Statement (MTBPS) on 26 October confirmed general market expectations of stronger fiscal consolidation for the current fiscal year. More specifically, tax revenue collection continued to steam ahead of initial conservative budget estimates. This - together with an adjustment to macro-economic assumptions, real GDP lower by 0.5% to 1.4% with inflation significantly higher at 6.8% from 4.5% for a higher nominal GDP estimate - contributed to a significant adjustment of the budget deficit to 4.9% from 6.0% for the current fiscal year. Expenditure was revised higher, but the net effect of the adjustments allowed for a decline of the gross loan debt to GDP ratio from 72.8% to 71.4%. However, disappointingly, no details were provided regarding the long-awaited transfer of a portion of Eskom debt onto the sovereign balance sheet. This will instead be furnished when the budget is tabled next year. Estimates for the forthcoming fiscal years are particularly optimistic, with the first primary surplus in fifteen years expected for the fiscal year 2023/24 and the consolidated budget deficit to narrow to 3.2% in 2025/26. This is mainly the result of expected sustained strong tax revenue collection and relatively contained expenditure. As a consequence, the gross debt to GDP ratio is expected to narrow to 70% in the outer years. The clear intention to accelerate fiscal consolidation is commendable and, at face value, good news for financial markets in general and the bond market in particular.

However, sustained fiscal improvement faces many hurdles

While the improved outlook (as envisioned by National Treasury) for the forthcoming years is welcomed, several factors unfortunately cast a dark shadow over prospects for the expected sustained fiscal consolidation. Firstly, more state-owned enterprises are knocking on National Treasury's door for financial assistance, most concerning being Transnet. Secondly, the tax revenue boon of the past two fiscal years is unlikely to be repeated to the extent reflected in the latest budget estimates, especially in the outer years. At the macro level, local economic growth continues to face structural and increasingly cyclical headwinds. Structurally, the intensified negative impact of loadshedding and increasingly poor service delivery by Transnet with respect to the railway network and ports are obvious and very significant hurdles to economic activity. Slowing global economic growth and the resultant negative implication for global commodity demand and prices has also not been sufficiently considered. Moreover, the expenditure assumptions for the forthcoming fiscal years seem unrealistically low (even if opportunistic). Current expenditure pressure remains an ominous risk, specifically with regards to public sector wage bill growth and an ever-increasing burden of rising social spending pressure. It is also glaringly obvious that the full impact of the proposed Eskom debt take-on has not been incorporated in the forecast.

Figure 1: Despite recent progress, the total level of outstanding debt is still too high, with contingent liabilities still looming large



Source: National Treasury, Futuregrowth

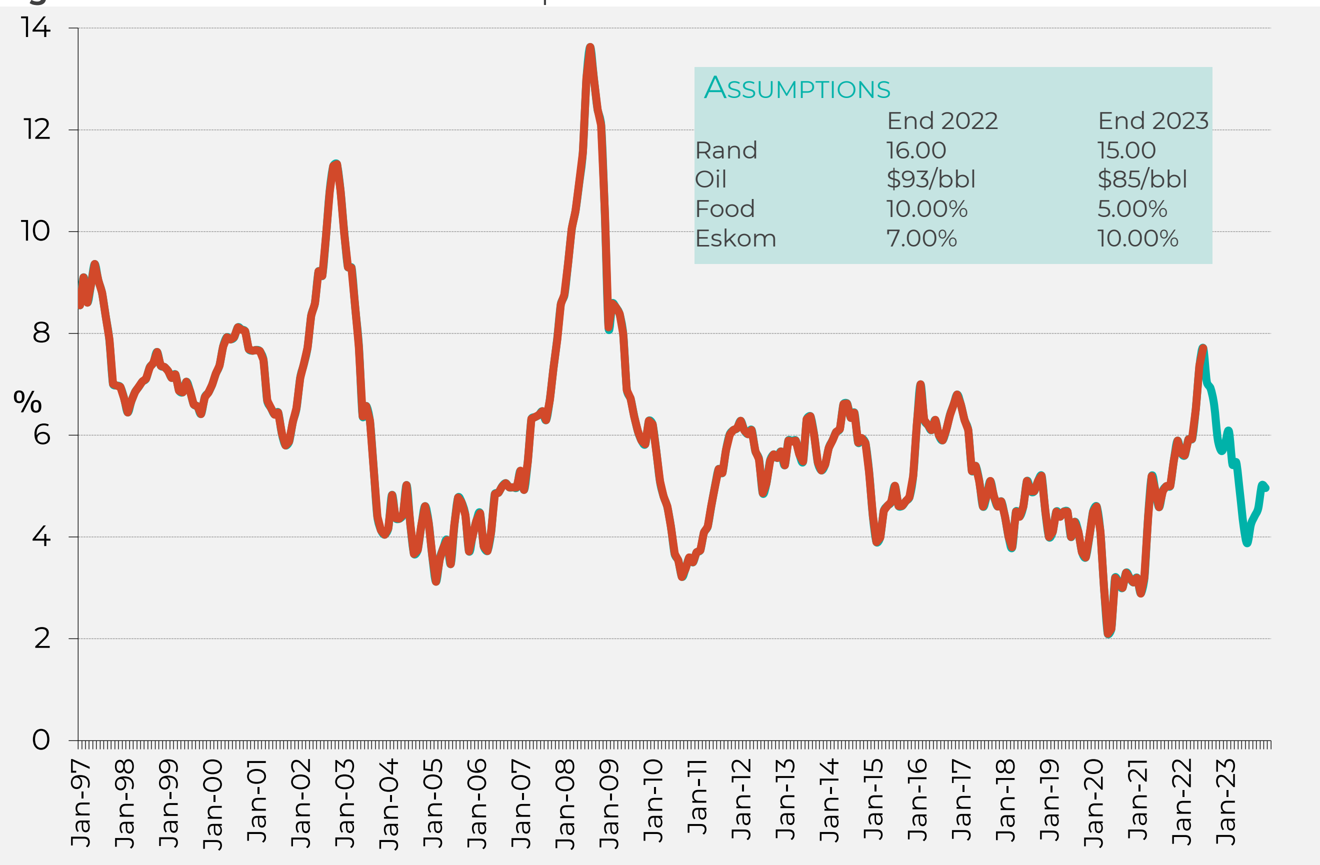
Global bond markets recovered somewhat following a bout of significant weakness

The local bond market got swept up by a significant global bond sell-off, especially in the early part of the month. The rise in global yields gained momentum during October, mainly due to the same concerns about the speed and extent of global monetary policy tightening and, particularly, by the leader of the central bank pack, the US Federal Reserve (Fed). Against the general backdrop of persistent high inflation, hawkish central bank response, weakening fiscal positions and lower economic growth (more specific country dynamics) amplified pressure on bond markets. In the UK, the botched attempt by the Truss administration to address the unfolding economic crisis in that country served as a catalyst for a spike in UK government bond yields. The initial sell-off that caused long-dated gilt yields to trade at levels north of 5.0% forced the Bank of England to intervene in order in order to introduce some stability. Towards month end, global bond markets found some reprieve as weaker economic data served as a catalyst for newfound investor anticipation that central banks, particularly the Fed, may potentially dial down their current aggressive policy stance in the short term. This somewhat opportunistic expectation received some backing from central banks like the Bank of Canada, which recently increased its policy rate by 50 basis points (bps) instead of an expected 75 bps, in response to slowing economic growth.

We have more confirmation that South African inflation peaked in July

The South African Headline Consumer Price Index (CPI) accelerated by 7.5% year-on-year in September from 7.6% the previous month, for the second consecutive month of marginal and tentative slowing. Even so, this confirmed the probable peak of 7.8% in July. In contrast, Core CPI accelerated by 4.7% from 4.4% the previous month, primarily driven by higher food inflation. The year-on-year increase in Producer Price Index (PPI) for final manufactured goods also slowed by 16.3% in September from 16.6% the previous month. Although the deceleration was slower than market expectations, the most recent data release is well below the PPI cycle peak of 18.0%. So far, both CPI and PPI data confirm the disinflation trend.

Figure 2: South African inflation is expected to head lower from here on



Source: OMIG, Futuregrowth

The South African Reserve Bank is likely to remain vigilant

While the slowdown in the rate of inflation at consumer and producer level is encouraging, the South African Reserve Bank (SARB) is unlikely to stand back yet on policy tightening. As clearly communicated, the SARB remains concerned about the possible impact of high actual inflation on inflation expectations, which, in turn, may cause cost-push pressure to morph into demand-led inflation. While most inflation expectation surveys are still at levels below the top end of the 3% - 6% inflation target range, they are heading higher, and, most concerning, particularly so in the case of labour unions. Our estimate of the terminal nominal repo rate suggests that the SARB should raise rates by at least another 50 bps. That said, we acknowledge that the risk remains for a slightly higher increase in the short term, especially should the majority of central banks keep raising rates. This should also be seen against the background of a weakening South African balance of payments situation and the grey listing red flag, which, in turn, will inhibit foreign capital flows.

Grey listing has become our base case

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, most of this has been merely on the legislative side. The FATF reviewed 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 action plan to deal with areas of concern. The FATF will have a plenary meeting in 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 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 say that grey listing is more than likely to inhibit much-needed foreign capital flows.

The SA Inflation-linked bond market suffered a brutal set-back

October turned out to be another volatile month for local bond markets, at least partly due to the global bond sell-off. On the nominal side, a month-end recovery - following an initial yield spike to levels north of 12% for longer-dated bonds - saved the day. The FTSE JSE All Bond Index (ALBI) returned a respectable 1.07%. Following exceptionally strong performance for an extended period since the end of last year, inflation-linked bond yields rose sharply during the last week in October. Earlier support from high inflation accrual and strong demand for inflation protection suddenly waned, leaving a notoriously illiquid market vulnerable. The increase in real yields more than offset any support from the inflation accrual. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) returned -1.27%, underperforming both nominal bonds and cash (+0.49%) by a significant margin. The IGOV returned 0.68% for the year ending October, a sizeable decrease from the 1.98% it returned for the first nine months of the year.

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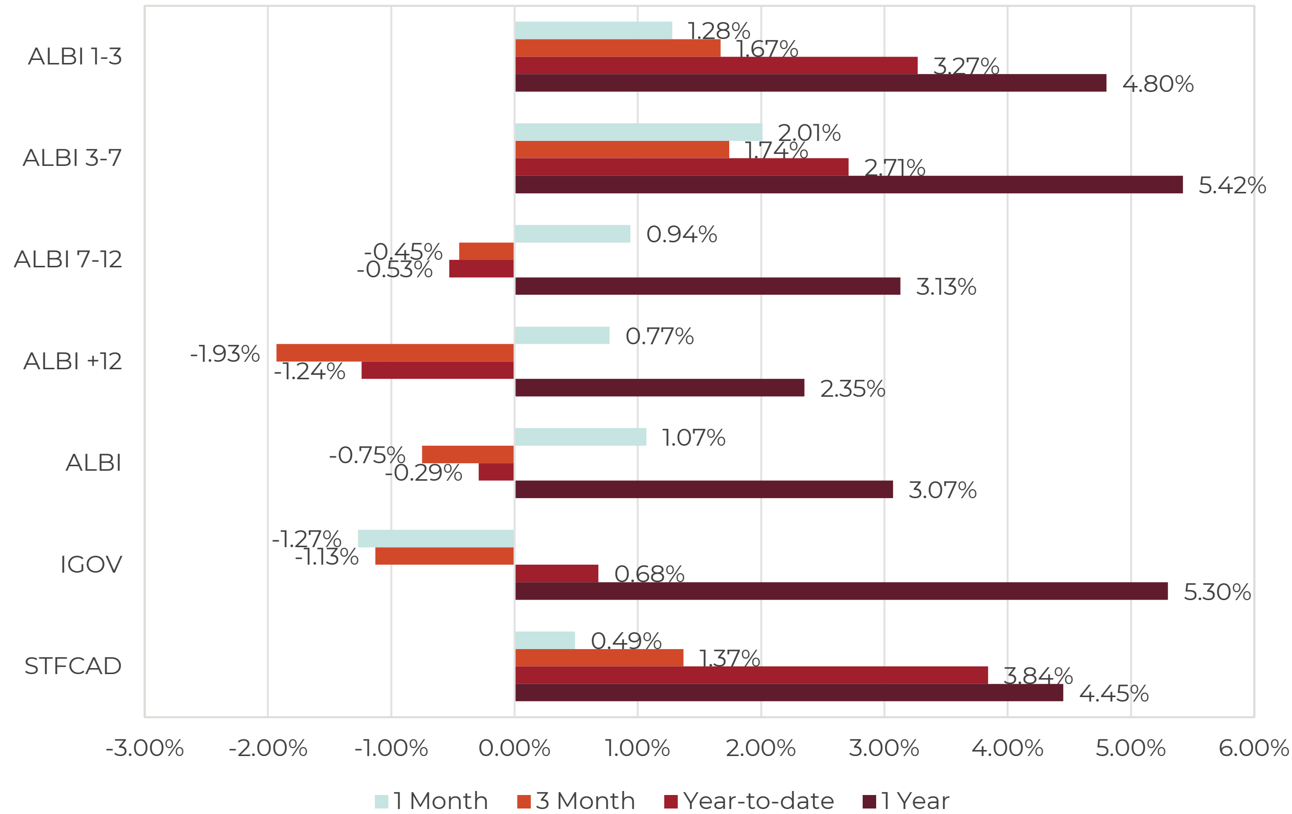
Figure 3: Bond market index returns (periods ending 31 October 2022)



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. Global bond markets experienced significant volatility, with an initial yield spike followed by some reprieve as weak economic data dampened policy tightening expectations. Locally, both CPI and PPI data prints confirmed the start of the disinflation trend. On the fiscal front, the release of the Medium Term Budget Policy Statement confirmed market expectations of a smaller budget deficit for the current fiscal year. National Treasury released more upbeat estimates for the forthcoming fiscal years compared to the February budget estimates. The impact on market sentiment has been muted, as the market, like us, questions the reasonability of the assumptions, both in terms of revenue and expenditure. Even so, the nominal bond market performed relatively well as yields managed to drift lower at month end. In contrast, the inflation-linked bond market suffered a setback during the last week of October as aggressive selling caused long-dated bond yields to spike. As a result, the ALBI rendered a recent return of 1.07%, outperforming both cash (+0.49%) and the IGOV (-1.27%) in October.

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AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 2.6% 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, will dampen demand and raise recessionary fears. Soggy PMIs in many advanced and emerging economies clearly 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 recently announced significant stimulatory measures which may at least partly offset some of the headwinds referred to above. Domestically, our latest GDP forecasts for 2022 and 2023 are 2.2% for each year, compared to 4.9% for 2021, but with significant downside risk. From a cyclical perspective, a small open economy with a heavy dependance on commodity exports like ours 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; inadequate and unreliable power generation; and an underdeveloped, rigid labour market. Of particular concern is prolonged and intensified loadshedding and its impact on economic activity. Another risk is the potential grey listing of South Africa by the FATF, which will inhibit 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 pick up. These headwinds include monetary and fiscal policy normalisation in response to significant and stubborn upward price pressure, and

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	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 some supply chains, 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 here on. The persistence of the global energy and food crisis and other supply constraints poses a risk to the pace of disinflation in the short term. Another negative price 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 reflects the inability of producers and retailers to pass large price increases on to the end consumer. 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 and continued aftereffects of COVID-related supply chain disruptions. 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 1.3% current account surplus, following the 3.7% recorded the previous year. Softer growth in key export markets (specifically China and the rest of Africa) and stronger import growth will see the current account surplus moderate going forward, with a balanced current account balance of 0.0% expected for 2023. The risk is for the surplus to turn into a deficit, due to the same factors or hurdles that hamper local economic growth prospects. The capital account will bear the brunt of South Africa's probable grey listing early next year. **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 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. However, this surplus is expected to shrink dramatically into next year, while the country's grey listing will most likely hamper foreign capital flow.
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 and other major central banks remain determined to accelerate their pace of tightening and address elevated inflation risks, even if this implies lower economic growth. At its last six 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 275 basis points to 6.25%. We have adjusted our expected cycle peak from 6.50% to 6.75% and are therefore still expecting an increase of 50 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 2.75% since the start of the cycle, which has taken the repo rate to 6.25%. We retain our repo rate forecast, targeting a terminal nominal repo rate of around 6.75% by the middle of next year.
FISCAL POLICY	While National Treasury based its most recent budget estimates on conservative macroeconomic assumptions, 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 considering the primary balance position and the implications of the high level of outstanding debt, and specifically the risks associated with the government's future ability to service it. The proposed transfer of a significant portion of Eskom's debt into the government's balance sheet and, in doing so, crystalising contingent liability risk, only adds to fiscal pressure. On the revenue side, we maintain that the strong corporate income tax performance of late is not sustainable, considering downside risk to global growth, commodity prices and local economic activity. **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 in the medium-term.

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.

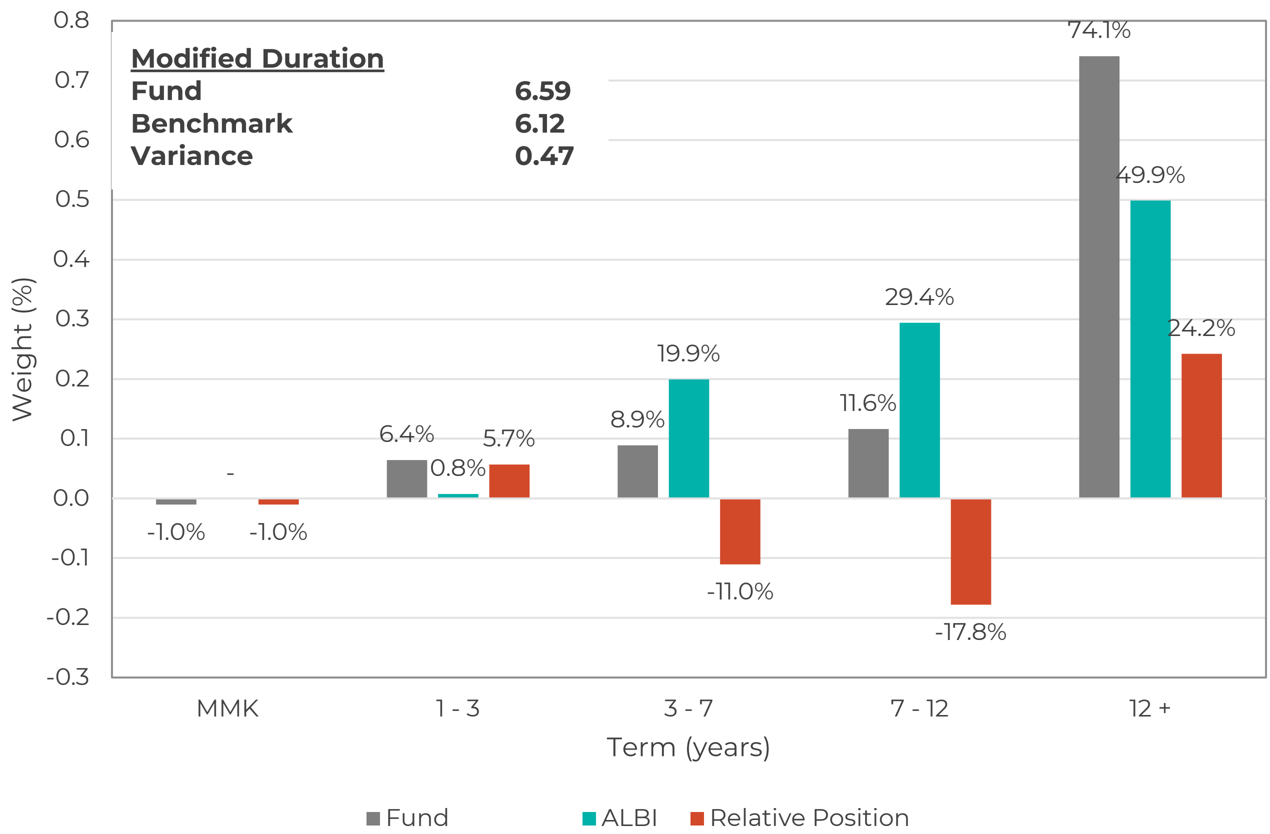
While the front end of the yield curve still remains most at risk to the monetary policy tightening cycle, the progression of the tightening cycle (and the absolute levels at which shorter-dated bond yields are offered) implies that the impact is wearing off. Similarly, while rising short-term rates 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. 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 medium-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 4: 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%	2.8%	2.0%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.1%	2.2%
SA Headline CPI	5.3%	4.6%	4.1%	3.3%	4.5%	6.7%	4.7%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	1.3%	0.0%