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Are we there yet?

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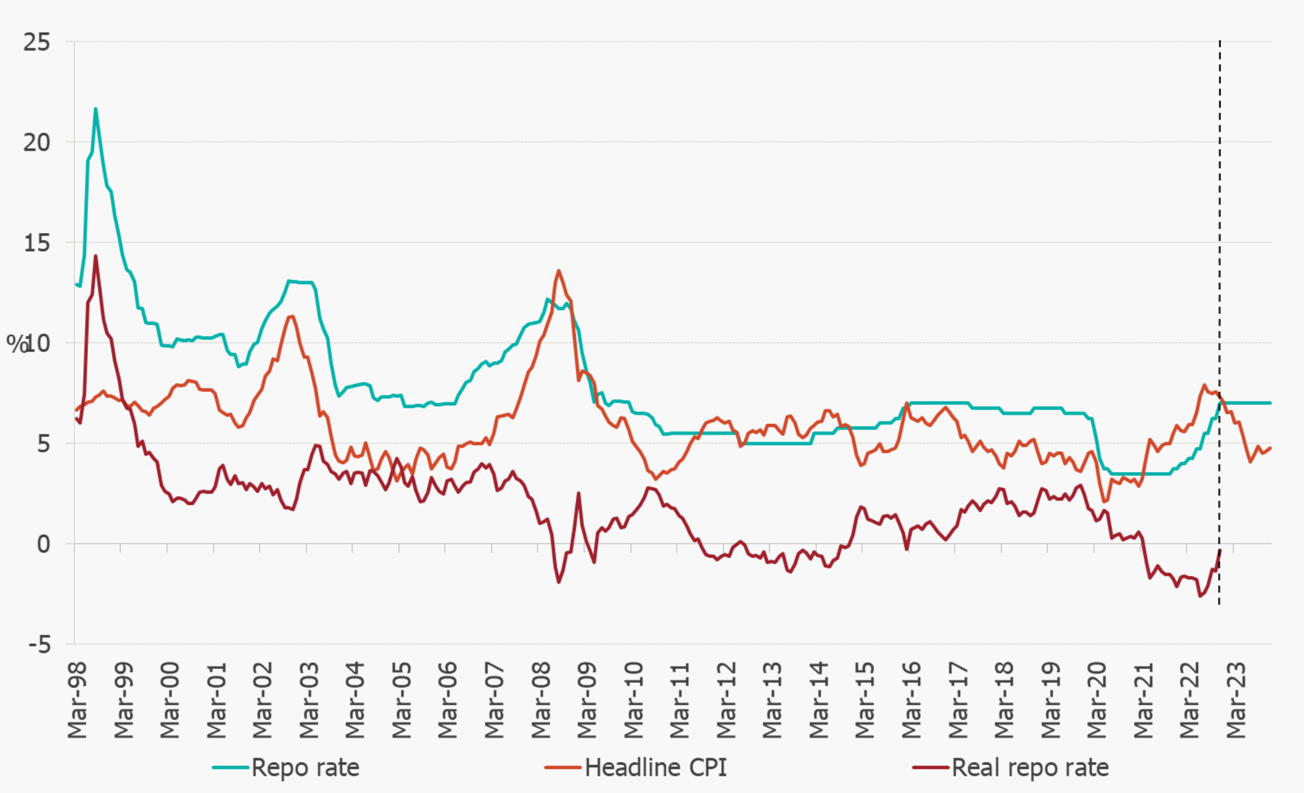
Markets hunt for signs of an ease in the pace of monetary policy tightening

Unsurprisingly, most central banks kept to their relentless policy tightening script in response to the worst inflation episode in decades (for advanced economies). In many cases, policy rates are currently at their highest level since 2008. For now, the hawks are still firmly in control, with phrases like “should continue normalising and tightening policy”, “inflation risks are still to the upside” or “inflation is still elevated” abounding. Even so, the cautious mention of carefully selected words like “slowing”, “pause” and “cut” have started to surface more recently as policy makers acknowledge the rising risk of prolonged and deeper recessionary conditions. For instance, the US November Federal Open Market Committee meeting minutes revealed a growing, if fragile, consensus among committee members on a potential slowdown in the pace of future tightening. This is linked to an increasingly weaker growth outlook and the fact that inflation is rising at a slightly slower pace, even though this is mainly due to favourable base effects. As one would expect, financial markets tend to look beyond short-term noise. In the case of the US, the recent decline in longer-dated treasury yields (and consequent yield curve bull flattening) signalled rising investor expectations of a near-term peak in both inflation and policy rates. Of course, this is not the case across all economic regions. In the UK and Euro zone, where monetary policy response has ambled somewhat to the worst inflation experience in four decades (partly due to the Ukraine/Russia conflict) the peak is still obscured by a dark inflation cloud. Data and events of the past two months or so are increasingly pointing to the start of a possible decoupling across economic regions, specifically regarding inflation and monetary policy dynamics.

The South African Reserve Bank sticks to hawkish action and messaging

Like its more hawkish monetary policy counterparts, the South African Reserve Bank (SARB) increased the repo rate by a widely expected 75 basis points (bps) at the November Monetary Policy Committee Meeting. While the committee and, in particular, the governor of the SARB went the extra mile to emphasise what would be needed for a pause, the fact that two of the five voting members opted for a 50bps rate increase could be interpreted by bulls as an early sign of a potential ease in the pace of future tightening. That said, one of the pre-conditions for an ease or pause is confirmation that the rate of inflation has decelerated to levels closer to 4.5% (the mid-point of the inflation target range). This is clearly still some way off. While we view a repo rate of 7.0% as the peak in the cycle, it is important to acknowledge the risk of one more hike of between 25bps to 50bps, possibly at the January MPC meeting. The governor’s remark “the cost of hiking too much is lower than the cost of hiking too little” should not be ignored. In the end, the SARB needs to be convinced that inflation expectations will remain contained.

Figure 1: Inflation to dip below the nominal repo rate next year



Source: Bloomberg, Futuregrowth

Local inflation keeps heading lower, but this is not smooth sailing

The South African Headline Consumer Price Index (CPI) accelerated by 7.6% year-on-year in October from 7.5% the previous month, disappointing market consensus which was looking for a more pronounced slowdown in the rate of increase. More concerning was the acceleration of Core CPI by 5.0% from 4.7% the previous month, with evidence that price pressure is broadening. This inevitably boosted the case of a 75bps repo rate hike at the November MPC meeting. On a more positive and forward-looking note, the year-on-year increase in the Producer Price Index (PPI) for final manufactured goods slowed to 16.0% from 16.3% in September and is now well below the PPI cycle peak of 18.0%. A potentially more appropriate indicator of future consumer inflation is easing price pressure for a broad basket of producer goods down the value chain, including the agriculture, forestry and fishing sectors. We believe that this will filter down and support the expected disinflation trend in coming months.

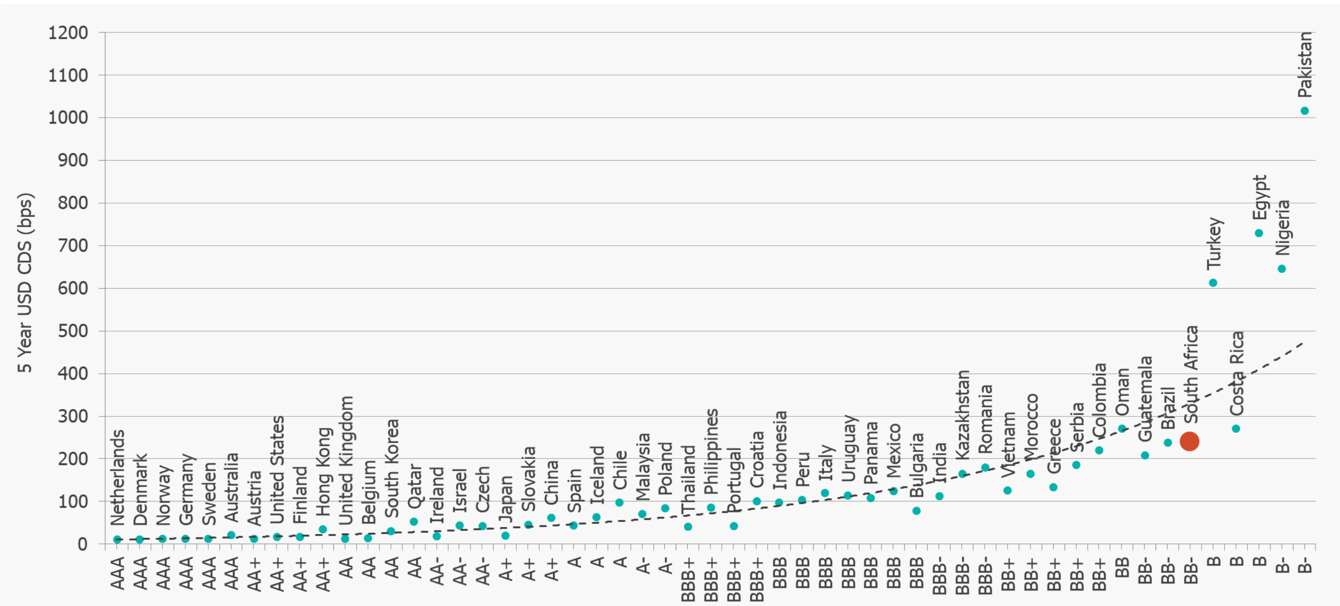
The merchandise trade account surplus swings into a deficit

It had always been expected that the very significant terms of trade gains that reached a peak earlier this year (partly as a result of the Ukraine/Russia conflict) are not sustainable. Apart from the recent negative impact on the terms of trade caused by the retracement in earlier high coal prices, export volumes are increasingly hampered by a number of factors. This includes weakening global economic activity, frequent COIVID-related interruptions in China and localised drivers such as intensified load shedding and poor service delivery by Transnet. Even so, the large swing in the merchandise trade balance from an upwardly revised R26 billion in September to a R4 billion deficit in October (the first since April 2020) surprised even the bears. This large swing was largely the result of a massive 17% month-on-month decline in exports. While the factors mentioned all contributed, the extent of the monthly change suggests that this mainly reflects the devastating impact of the Transnet strike that ended in October. While it could be assumed that the November data may show some rebound in exports as backlogs are cleared, the broader weakening trend remains entrenched.

South Africa's sovereign credit rating and outlook is confirmed

International rating agencies S&P and Fitch Ratings affirmed South Africa's foreign and local currency ratings at BB- with a positive outlook. Although it did not issue a statement, Moody's effectively followed the same action at its biannual review date. The affirmation was largely expected, which explains a muted if not a complete lack of market response. While the rating agencies kept the ratings and outlook unchanged, South Africa's low economic growth potential, slow progress with growth boosting reforms and significant risks to sustained fiscal consolidation were once again flagged as risks. These concerns are aligned with our long-held scepticism about the ability to lift the country's potential growth rate to a sustainable higher level in the absence of significant and bold structural changes and, in turn, to create an improved environment for quicker, much-needed fiscal consolidation.

Figure 2: South Africa is better priced than its official credit rating profile implies (Five-year credit default swap spread relative to S&P foreign currency ratings)



Source: Bloomberg, Futuregrowth

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The political backdrop enters troubled waters

The announcement by a special parliamentary panel that President Ramaphosa had a case to answer for with respect to a possible violation of anti-corruption laws complicates his campaign for re-election at the December ANC Elective Conference. The president also faces the possibility of impeachment by Parliament, which would require a two-thirds majority of members to support it. More importantly, the developments of late complicate progress with much-required improved macroeconomic policy certainty and structural reforms. This undoubtably will add a layer of uncertainty to general market sentiment, in turn contributing to higher return volatility.

Both nominal and inflation-linked bonds delivered cash-beating returns in November

November turned out to be less volatile for the local bond market compared to previous months, at least partly due to newfound strength and a higher degree of stability in most global bond markets. Stronger global bond markets, a recovery in the rand (at least in part due to some US-dollar weakness) and a hawkish SARB combined to allow room for lower nominal bond yields. As a result, the FTSE JSE All Bond Index (ALBI) managed to deliver a strong 3.9%. Following a brief period of significant weakness, ultra-long-dated inflation-linked bonds managed to recover some lost ground during November. The decline in real yields, partly boosted by a slightly higher than expected October CPI reading and improved valuation following the poor run in October, allowed the FTSE JSE Government Inflation-linked Bond Index (IGOV) to return a stronger 0.8% in November. For the year ending November, the IGOV returned 1.5%, lagging both nominal bonds (3.6%) and cash (4.4%) over this period.

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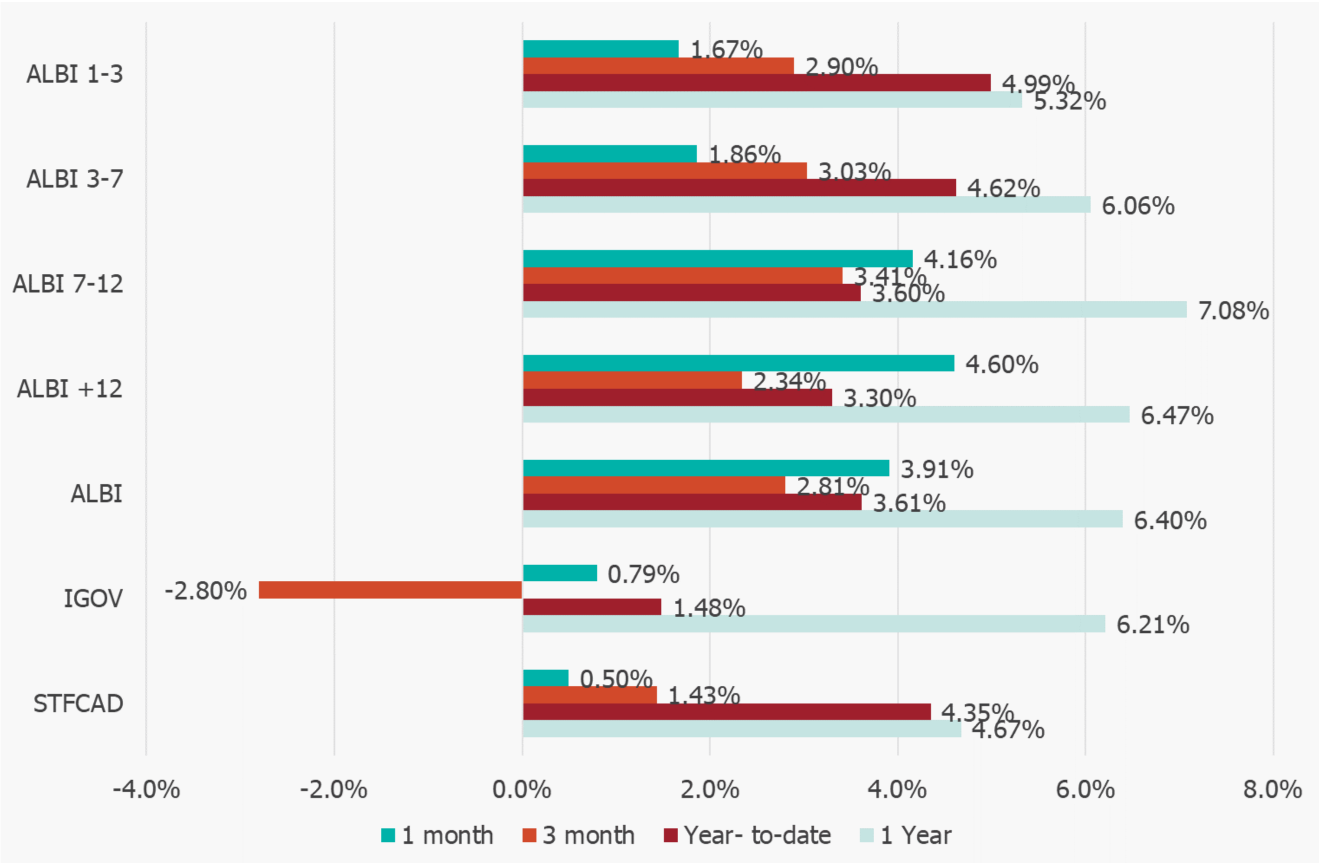
Figure 3: Bond market index returns (periods ending 30 November 2022)



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 continued to enjoy some reprieve during November as attention shifted increasingly to weaker economic data, evidence that inflation pressure is slowly easing in some regions. This increasingly dampened market expectations of policy tightening going into the new year. The SARB raised the repo rate by an expected 75bps, taking the repo rate to our estimate of the peak in this cycle. Locally, both CPI and PPI data prints confirmed the start of the disinflation trend, even though the former disappointed expectations with a higher year-on-year increase. Against this background, the nominal bond market performed relatively well despite some intra-month volatility. The inflation-linked bond market managed to recover some of the previous month's losses as real yields drifted lower from elevated levels. As a result, the ALBI rendered a recent return of 3.9%, outperforming both cash (0.5%) and the IGOV (0.8%) in November.

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AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 2.8% in 2022 to 2.0% in 2023 and 2.2% in 2024. Although the impact of COVID-related lockdowns on supply chains and the economic fallout from the conflict in Ukraine are fading, it remains a potential hurdle to economic activity. While earlier stubborn inflationary pressure is showing signs of some easing, several central banks are still tightening monetary policy, which, in turn, will dampen demand and keep recessionary fears elevated. Soggy PMIs in many advanced and emerging economies also clearly point to weaker economic growth prospects. Domestically, our latest GDP forecasts for 2022 and 2023 are 2.1% and 2.2% respectively, compared to last year's 4.9%. From a cyclical perspective, a small open economy like ours with strong links to the commodity cycle 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, poorly skilled, and 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 further inhibit much-needed foreign investment. Much needs to be done, especially when it comes to the actual implementation of the reform and recovery plans. The heightened uncertainty is reflected in low confidence among both consumers and the business sector, which in turn inhibits much-needed capital formation. **THE TAKEOUT** Global economic activity will remain weaker compared to the high post-COVID base as headwinds to economic growth persist. These headwinds include monetary and fiscal policy normalisation which contribute to tighter financial conditions, as well as high levels of inflation and energy disruptions, partly due to the Ukraine/Russia 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.

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INFLATION	The commodity fallout from the conflict in Ukraine and the effects of earlier significant supply-side bottlenecks have started to fade. Worryingly, strong wage increases and higher services inflation in some advanced economies are adding to underlying price pressures. Another development worth monitoring is the combined impact of some inventory recovery and weaker demand on some supply chains, reducing cost pressures. Moreover, crude oil and grain prices are showing signs of rolling over from exceptionally high levels. On the technical side, the recent surge in domestic and global price indices has created 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 and uncertainty around the global energy and food crisis and other supply constraints poses a risk to the pace of disinflation. 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 believe that the recent acceleration in the rate of inflation has built a higher base for 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. Another dynamic worth considering is the fact that idiosyncratic drivers, such as the tight labour market in the US or surge in energy prices in the EU, will increasingly lead to inflation variance among an increasing number of countries.

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BALANCE OF PAYMENTS	Although South Africa's merchandise trade account remains relatively buoyant relative to history and when compared to its peers, our long-held concern about the sustainability of the large surplus has turned into reality. Softer growth in key export markets (specifically China and the rest of Africa) and stronger import growth caused the current account surplus to moderate sharply in a relatively short space of time. Following the 3.7% current account balance (expressed as a ratio to GDP) recorded last year, the surplus is expected to dwindle to 1.3% of GDP this year and a small deficit next year. The capital account will bear the brunt of potential capital outflows given South Africa's probable grey listing early next year, although we remain of the view that the initial direct impact will either be limited or short lived. We are more concerned about the lingering long-term impact on the ease of doing business and much-needed foreign capital flows. **THE TAKEOUT** South Africa's current account moderation this year and next is mainly the result of reduced support from the country's terms of trade and weaker global economic growth. The probable grey listing of the country will hamper foreign capital flow, but the exact impact is hard to estimate.

MONETARY POLICY	Monetary policy tightening remains the dominant global trend as inflation remains elevated. However, elevated policy rates, weakening economic growth and evidence that inflation is starting to peak, has served as a spark for market speculation that the pace of policy normalisation may slow from here. Even so, the Federal Reserve and other major central banks remain determined to address inflation risks, even if this implies lower economic growth. Our view is that although more tightening will follow in the major economies, the pace of tightening will vary across regions and may even have peaked in some cases. This is mainly due to growing divergence with regards to economic activity and inflationary pressure. At its last eight MPC meetings, the South African Reserve Bank (SARB) responded to higher inflation by adjusting the repo rate upwards by a cumulative 350 basis points to 7.0%. While the recent upward adjustment breached our expected cycle peak of 6.75%, we did caution against some upside risk to this target. Our view is that the cycle peak had been reached, but that the repo rate will remain at the elevated level for a considerable period. **THE TAKEOUT** Monetary policy tightening remains the dominating global trend, but the pace will start to vary between economic regions. Locally, the most recent 0.75% increase took the nominal repo rate of 7.0%, which we believe to be the peak in the current interest rate cycle. The repo rate is expected to remain at his level for some time.

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 current primary balance position, 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. We believe that the peak in both the inflation and interest rate cycle had been reached, with a stronger disinflation trend to gather momentum from early next year. However, we concede that the SARB may opt to err on the side of caution by raising the repo rate by another 25bps to 50bps in January in an effort to manage inflation expectations.

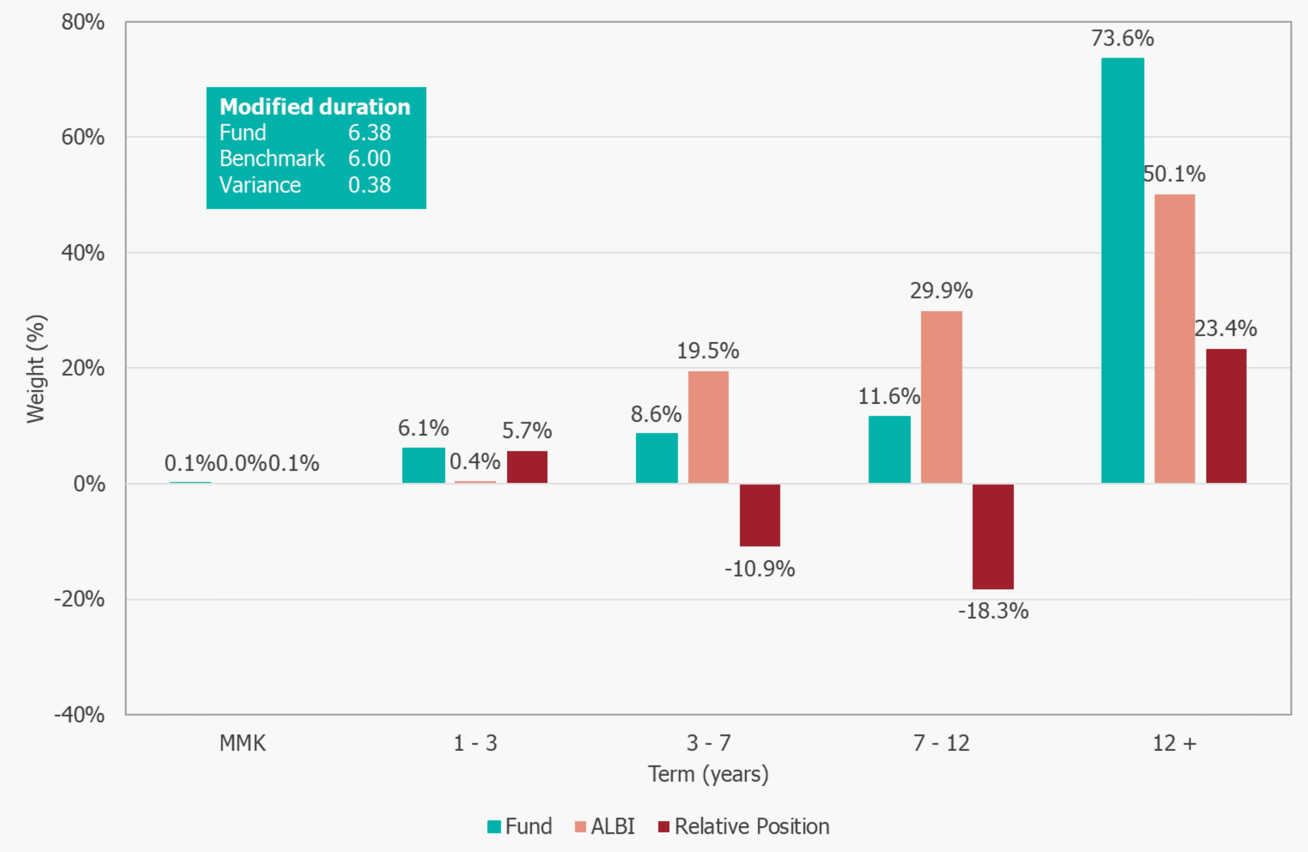
The progression of the tightening cycle (and the absolute levels at which shorter-dated bond yields are offered) implies that the impact of tighter monetary policy and a possible (last) hike is wearing off significantly. In turn, the earlier negating impact of rising short-term rates on potential yield curve roll-down gains will lessen from here on. Further out on the yield curve, market gyrations caused by varying global risk sentiment, global bond yield changes and the 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 lower yielding cash while maintaining an underweight exposure to short-dated fixed-rate bonds.

Considering the combination of stable or at worst limited potential monetary policy tightening, stable-to-downward 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. Within this framework, we shall continue to consider and implement more tactical investment opportunities in response to market/valuation swings, with increased political uncertainty one possible catalyst. 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 early next year.

THE TAKEOUT: Our investment strategy aims to strike a balance of: 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 gained more traction early next year, the outperformance of inflation-linked bonds in the past twelve months, and the current attractive inflation-adjusted yields offered by nominal bonds. Of course, political developments of late potentially increases uncertainty and may contribute to significant swings in investor sentiment.

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	2024
Global GDP	3.5%	3.2%	2.6%	-3.6%	5.9%	2.8%	2.0%	2.2%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.1%	2.0%	2.4%
SA Headline CPI	5.3%	4.6%	4.1%	3.3%	4.5%	6.8%	5.2%	4.5%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	1.3%	0.0%	-1.5%