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The hawks continue to rule the roost

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Global central banks doggedly stick to the task

With consumer price inflation at multi-decade highs in the past quarter, central banks across a swathe of developed markets doggedly stuck to the task of quelling this, with monetary policy rates at levels last seen prior to the global financial crisis of 2008.

While the monetary policy hawks continue to rule the roost, contributing to policy tightening intended to contain broad and stubborn inflation pressures, the forward guidance provided by some central bankers – with the incorporation of words like "slowing", "pause" and "cut" in their commentary – indicates acknowledgement of the growing risk to macroeconomic growth in the coming years. In the case of the US, the deceleration in the pace of monetary policy tightening to 50 basis points (bps) in December by the Federal Open Market Committee (FOMC) relative to the 75bps increments preferred throughout 2022 speaks to the increasingly fine balance that will need to be struck between fending off inflation pressure and not unduly choking the economy of its growth potential.

As one would expect, financial markets tend to look beyond short-term dynamics. In the case of the US, the recent decline in longer-dated treasury yields, and consequently yield curve bull flattening, signals investor expectations of a near-term peak in both inflation and policy rates. Of course, this is not the case across all developed economies, with increasing evidence of an imminent decoupling in inflation dynamics and the consequent monetary policy response. In the UK and Eurozone, the delayed monetary policy response to the severest episode of inflation in four decades, partly due to the ongoing Russia/Ukraine military conflict, has resulted in peak inflation and monetary policy rates that remain clouded from view even as recessionary economic conditions begin to take root across the region. An ironic exhibit of Europe's stagflation bind is the rejection of a 4% pay increase by European Central Bank staffers – and the suggested strike action in protest.

Policy determination will test economic resilience

After a more resilient than anticipated Q3 of 2022 from a global growth perspective, high-frequency economic activity indicators in Europe in the fourth quarter point to a pending downturn. The clearest signals have come from global Purchasing Managers Indices (PMIs). The forward-looking components within the manufacturing subsectors of these indices require particular attention, with weak new orders and inventory levels suggesting that the worst is yet to come from an economic growth perspective, due to weakening demand for manufactured goods.

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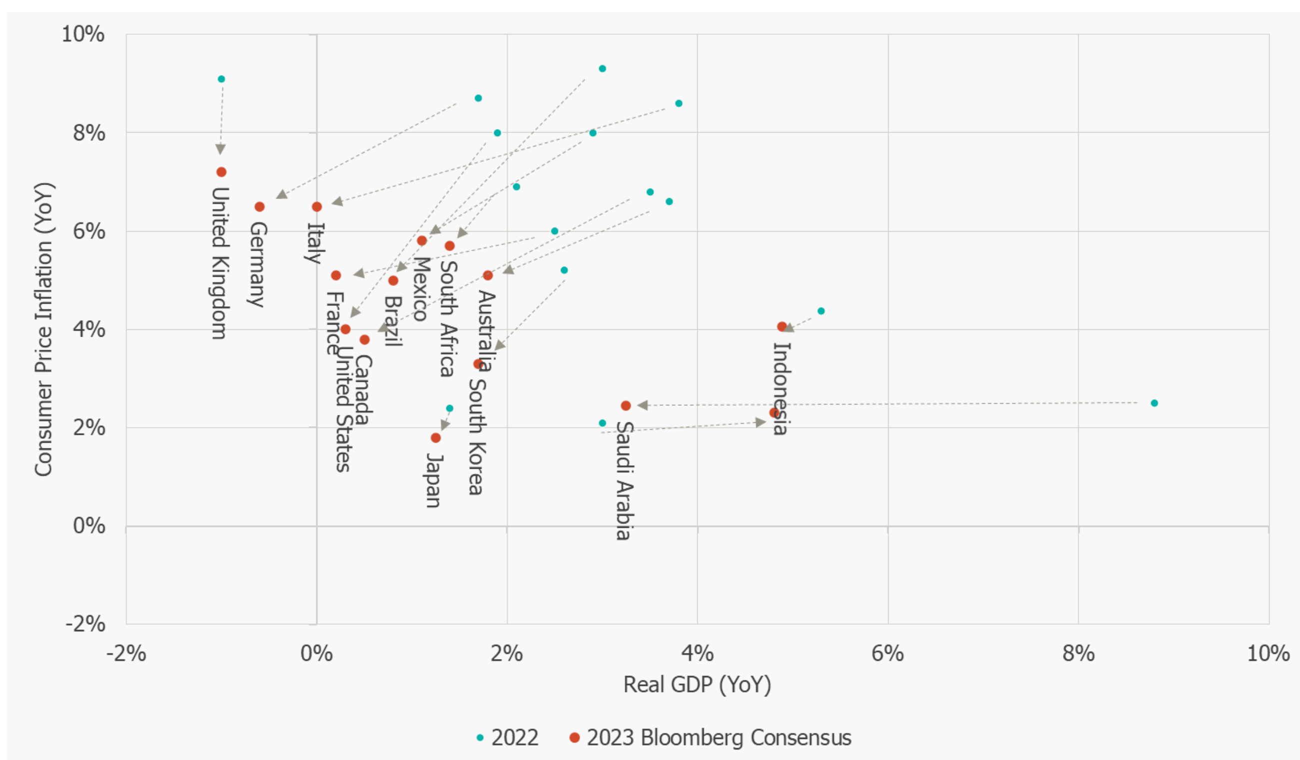
Read as a barometer for recession risk, the aggressive yield curve bull flattening (and consequent curve inversion) in the US highlights market expectations of an impending recession. Although musings of a hard landing have lingered for some time, these risks are not reflected in default expectations or valuations.

In mainland China, the easing of stringent lockdown restrictions will aid the easing of supply-side constraints and moderately buffer global economic growth downside in 2023. However, the lesson from the awakening of the rest of the world to a post-COVID reality highlights the risk that China could initially see a jump in infection and transmission rates that could impair the mobility of its citizenry before a more sustained rebound in economic activity in the latter part of 2023.

Figure 1: Developed economies are increasingly drifting towards the stagflation zone



Source: Bloomberg, Futuregrowth

"Higher for longer" is the new order of the day

Consumer inflation remained significantly above central bank targets across the developed world in the past quarter, as we expect to be the case for the year ahead. "Higher for longer" would seem a suitable mantra for global monetary policy rates in the foreseeable future, as central banks contend with a higher sacrifice ratio (the loss in economic growth and employment required to rein in inflation) compared to the 1980s, given the globalised nature of the current inflation bout. However, it is important to not lose sight of the increasing evidence of a moderation in the rate of inflation across several economies. In the US, a telling indicator of the moderation in the rate of inflation 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.

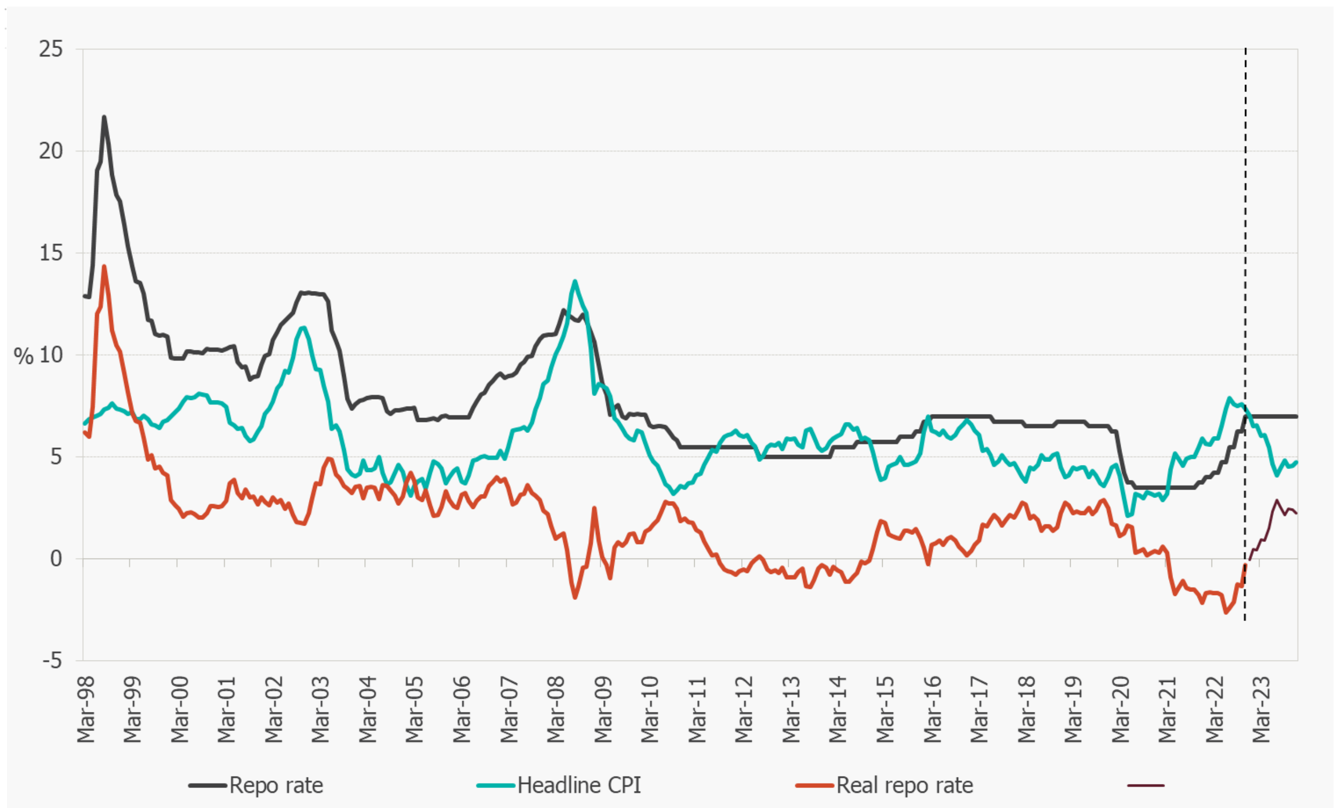
Further to this, the combined effect of significant dollar strength, slower economic activity, the continued unwinding of supply chain bottlenecks, the slow normalisation of shipping activity and the cost thereof are also contributing to some pipeline price pressure relief.

The slow grind back to the inflation target band continues

South Africa's Headline Consumer Price Index (CPI) accelerated by 7.4% year-on-year in November from 7.6% the previous month. This confirms the peak at 7.8% in the third quarter of the year and we expect a further moderate receding of inflation pressures in the coming months. In contrast to the turn in domestic headline consumer inflation, albeit very slowly, Core CPI remained sticky at its recent peak of 5.0% in November.

Hot on the heels of this inflation print, the South African Reserve Bank (SARB) hiked the repo rate by 75bps at its final Monetary Policy Committee (MPC) meeting of 2022, delivering a cumulative 325bps of hikes for the year and a consequent year-end repo rate of 7.0%. While the 3:2 vote split by the five-person MPC in favour of a 75bps policy hike relative to 50bps increments points to the nearing peak in the cycle, Governor Kganyago's highlighting of the committee's bias to over-tighten in the post MPC Q&A serves as a warning of the SARB's hawkish bias in the current interest rate cycle – and its intent to unequivocally rein in inflation risk.

Figure 2: South Africa Headline Consumer Price Inflation (CPI)



Source: OMIG, Futuregrowth

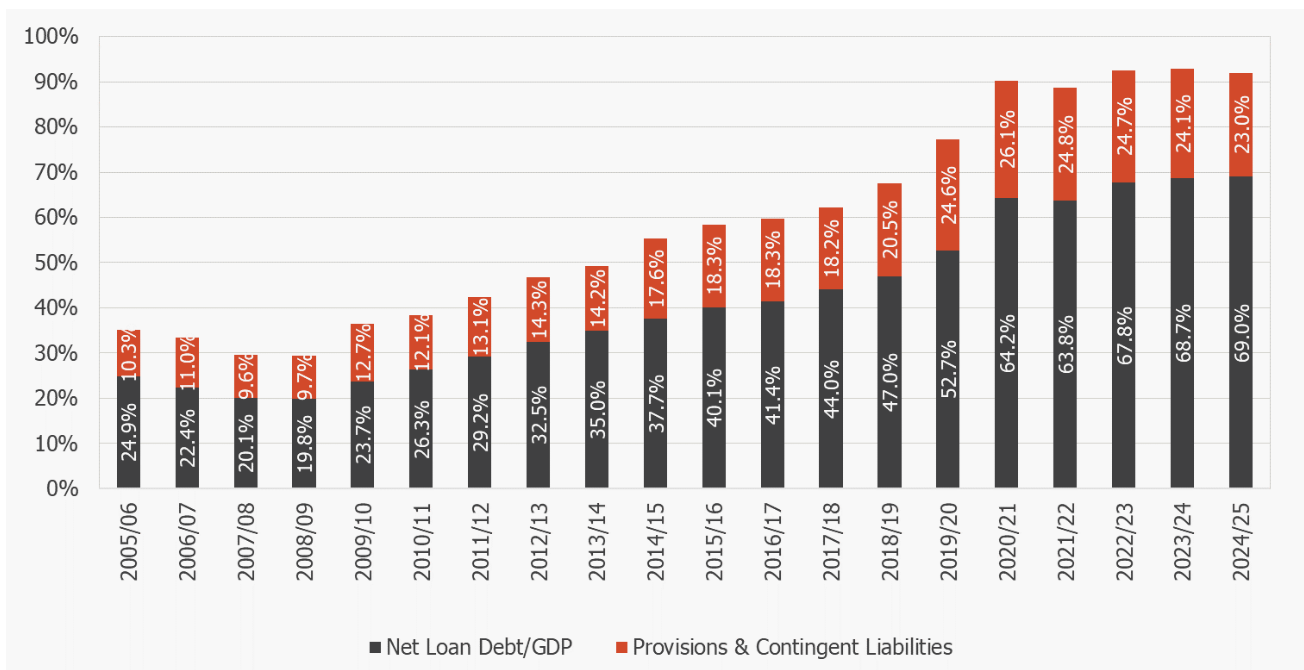
The Medium-Term Budget Policy Statement is ambitious but flawed

The tabling of the Medium-Term Budget Policy Statement (MTBPS) on 26 October 2022 confirmed general market expectations of stronger fiscal consolidation for the current fiscal year. Primarily due to corporate income tax revenue collection continuing to steam ahead of conservative budget estimates, the budget deficit for the 2022/23 fiscal year is now estimated to contract to 4.9% from a previous estimate of 6.0%. While expenditure was adjusted higher and real gross domestic product continues to undershoot budgeted expectations, the net effect of National Treasury's adjustments allows for a decline of the gross loan debt to GDP ratio from 72.8% to 71.4% in its estimates. However, disappointingly, no details were provided regarding the long-awaited transfer of a portion of Eskom debt onto the sovereign balance sheet. National Treasury has now committed to furnishing this detail in the tabling of the Budget in 2023. Estimates for the forthcoming fiscal years are particularly optimistic, with the first primary surplus in fifteen years expected for the 2023/24 fiscal year and the consolidated budget deficit to narrow to 3.2% of GDP in 2025/26. This is mainly the result of expected sustained strong tax revenue collection and relatively contained expenditure. Consequently, the gross debt to GDP ratio is expected to narrow to 70% in the outer years of the medium-term

expenditure framework. The clear intention to accelerate fiscal consolidation is commendable and was trumpeted by market participants.

However, given South Africa's structural economic growth constraints and elevated expenditure pressure, we continue to caution against the significant fiscal execution risk in the medium term. Moreover, while Eskom's dark shadow continues to blight economic growth and fiscal consolidation prospects, Transnet has now worryingly joined the ranks of the beleaguered state-owned enterprises clambering for fiscal support – only further impinging on fruitful, growth-enhancing fiscal expenditure in the medium term.

Figure 3: Despite recent progress, the level of outstanding sovereign debt and contingencies remains too high



Source: National Treasury, Futuregrowth

Potential grey listing remains a prominent risk

The Financial Action Task Force (FAFT) evaluated South Africa in October 2021 and found several deficiencies in the country's policies and efforts to combat money laundering and terrorism financing. The FATF reviewed South Africa again in October 2022 to gauge if enough progress had 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.

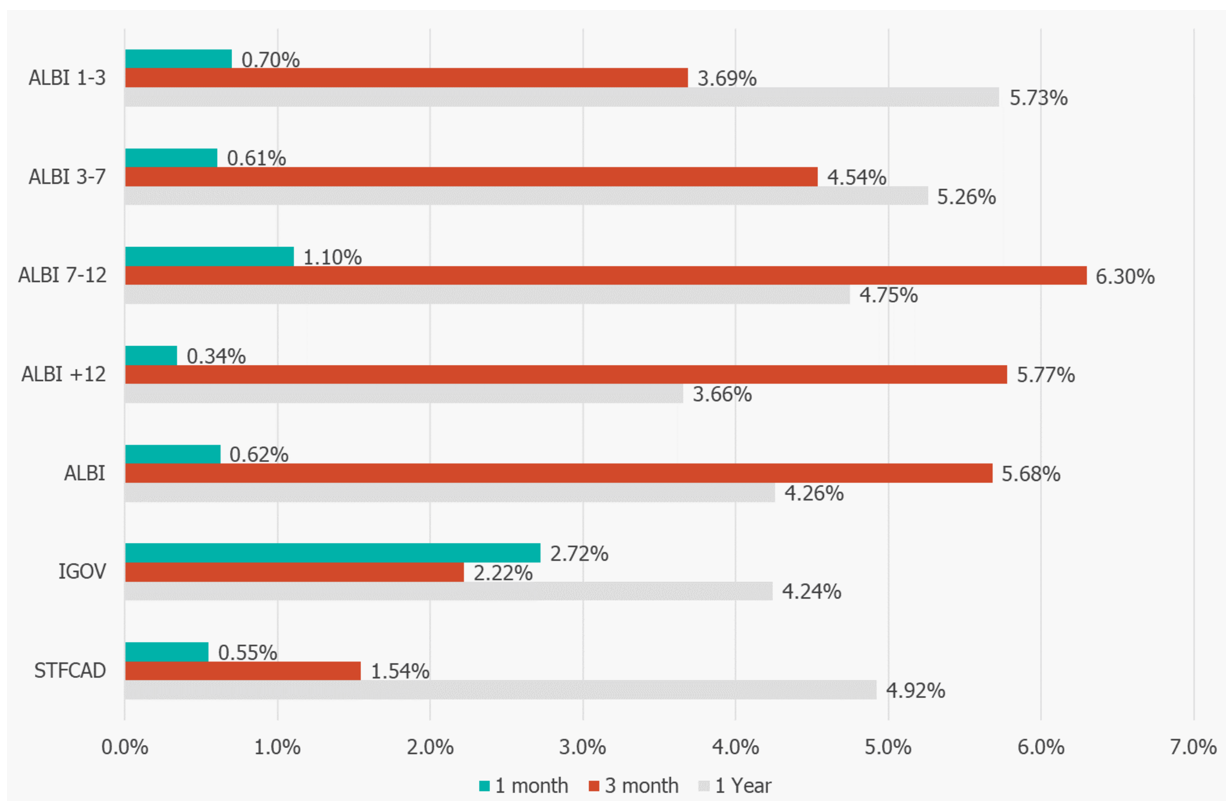
Although significant progress has been made in terms of addressing the deficiencies pointed out by the FATF in 2021, much of this has been on the legislative side. The FATF is due to have a plenary meeting in February 2023 where it will be decided whether to add South Africa to the grey list. While the legislative changes are progressive, our view remains that 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, inhibiting much-needed foreign direct investment (FDI). Please see *here* for a more comprehensive analysis.

Amidst the volatility, nominal bonds significantly outperform

Following a rather uneventful October for the domestic nominal bond market, where the FTSE JSE All Bond Index (ALBI) returned 1.07% for the month, the following two months of the quarter were marked by a heightened degree of return volatility owing to a combination of stronger global bond markets and a recovery in the rand in November, together with heightened local political uncertainly in December brought on by the Section 89 Parliamentary Panel findings against President Ramaphosa related to the theft at his Phala farm. Against this backdrop, the ALBI returned a heady 5.68% for the quarter, led by the 6.30% return for the 7- to 12-year maturity segment. Indicative of the market volatility in the quarter, the benchmark 10-year maturity R2032 government bond traded within a wide range of 10.67% to 11.52% over the period. The FTSE JSE Government Inflation-linked Bond Index (IGOV) returned a comparatively modest 2.22% for the quarter, as the benefit of the exceptionally strong inflation accruals enjoyed by the asset class in the past year starts to wane. Cash was the laggard from a return perspective across the interest-bearing asset class for the quarter, rendering a return of 1.54%.

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



Source: IRESS, Futuregrowth

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THE TAKEOUT: Global central banks doggedly stuck to the task of reining in consumer price inflation which had been at multi-decade highs in the quarter. This resolve has raised nascent concerns for economic growth downside in 2023. Locally, CPI data prints in the quarter have confirmed that we are beyond the peak in the current inflation cycle, and are slowly trudging back to the upper bound of the inflation target band. On the fiscal front, notwithstanding downward growth revisions in the medium-term, the recent corporate income tax windfall has confirmed our expectations of stronger fiscal consolidation for the current fiscal year. We, however, remain alert to the still significant fiscal execution risk in the medium-term. Even so, amidst heightened return volatility in the quarter, the ALBI returned a heady 6.41% for the fourth quarter of the year. The IGOV returned a comparatively modest 2.47%, and cash was the laggard in the interest-bearing asset class, returning 1.64%

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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 is 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 2.0% 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 expected 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 discourage 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.

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 pose 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 a 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, with 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 predicted 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.

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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 sceptical 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 has been reached, with a stronger disinflation trend to gather momentum from 2023. 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 as 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 2023.

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. With the vulnerable (albeit improved) fiscal position still posing a risk to ultra-long-dated bonds, and short-dated yields anchored by monetary policy expectations, 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 as they arise. We continue to favour longer-dated nominal bonds over inflation-linked bonds considering the high probability of strong disinflation in 2023 and the current attractive inflation-adjusted yields offered by nominal bonds.

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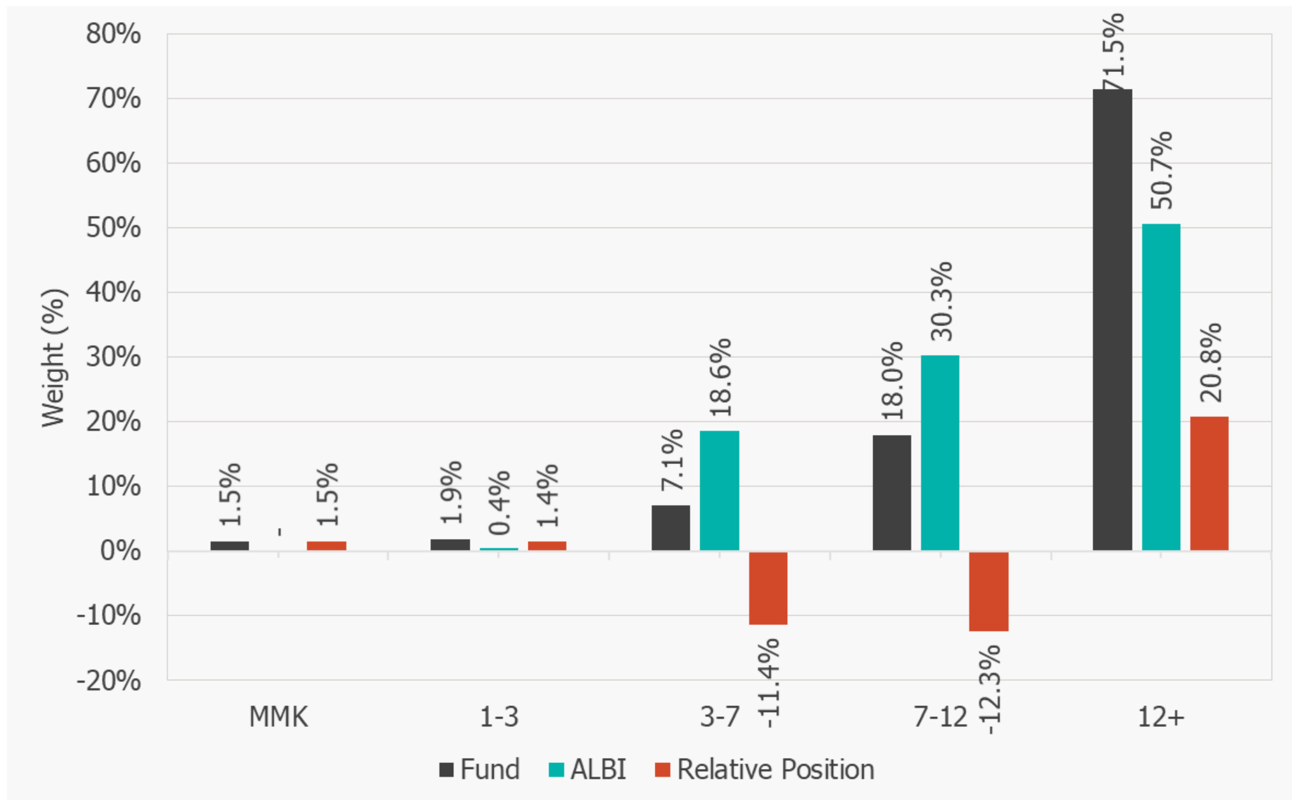
In the case of our Listed Yield Enhanced Bond Composite, our view is expressed as follows:

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%

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