FUTUREGROWTH ECONOMIC & BOND MARKET REVIEW

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Scaling the peak in local rates

Authors: Futuregrowth Interest Rate team
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South African Reserve Bank is among the first of the central banks to scale the peak in policy rates

Until late last year, central banks across a swathe of developed markets doggedly stuck to the task of quelling multi-decade high inflation. This lingering response pushed policy rates to 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, policy action and forward guidance provided by some central bankers increasingly 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 and 25bps in February 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's growth potential. In contrast to this step-down in tightening pace by the US Federal Reserve, the Bank of England and the European Central Bank are still frantically fighting decades-high inflation after being relatively slow to get out of the proverbial blocks last year.

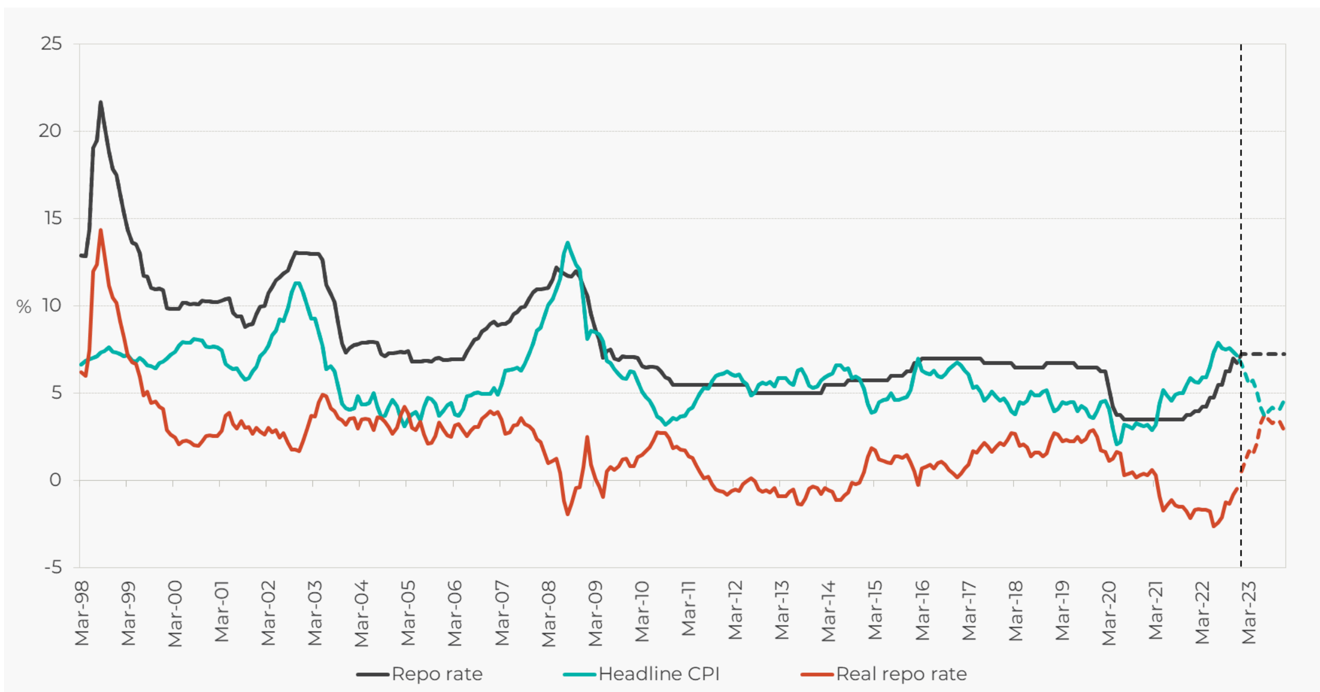
In contrast, to this belated response, the South African Reserve Bank (SARB) responded earlier and in a more focused manner. The 25bps increase at the January Monetary Policy Committee meeting (MPC), a step down from the earlier larger incremental increases, lifted the repo rate to 7.25%. This increase took the policy rate to a neutral real level for the first time since the first quarter of 2021. The combination of lower inflation, weaker economic growth prospects and the slowdown in global policy tightening forms the base of our view that South Africa has reached the peak in the current interest rate cycle.

The local disinflation trend continues to gain momentum

Apart from worsening economic growth prospects, the SARB's monetary policy management has been guided by the sustained downward trend in local inflation at both consumer and producer levels. Headline Consumer Price Index (CPI) slowed to a year-on-year rate of increase of 7.2% in December from 7.4 % the previous month. CPI is now well below the peak of 7.8% reached in July last year. While the more volatile components like food showed signs of peaking, more pleasing is the fact that Core CPI eased to a year-on-year rate of increase of 4.9% from 5.0%, even though mainly due to a slowdown in the rental component. On a month-on-month basis, Core CPI accelerated by 0.2% against a much quicker pace of 0.5% in the three months prior. Even though there are pockets of faster rising prices, for instance more rand-sensitive products such as appliances and vehicles, the disinflation trend seems to be gaining momentum for now.

On the production side of the economy, the December Producer Price Index (PPI) data release also served to confirm the disinflation trend. While still at a high level compared to CPI, the rate of increase for final manufactured goods eased to 13.5% year-on-year in December from 15.0% the previous month. The deceleration in the rate of increase was across a broad range of products.

Figure 1: South African inflation-adjusted repo rate back at a neutral level, and expected to rise from here on as inflation gradually moderates



Source: OMIG, Futuregrowth

Pricing the start of policy easing: curb your enthusiasm

Markets are forward looking for obvious reasons. So, it comes as no surprise that the market has started pricing a likelihood that the SARB may be convinced or forced to start reducing the repo rate towards the end of this year. While we accept that the next major move would be monetary policy easing, for now it would be prudent to keep one eye on rising inflation expectations, which, although backward looking, have been steadily creeping higher in the past few months. This would have caught the attention of policy hawks at the SARB. While this situation may not imply more rate increases unless it starts feeding into higher prices on a more sustained basis, it does call for caution and make us hesitant to share the more optimistic market expectation. This is in a similar vein to our push against more bearish rate expectations during 2022. For now, we feel comfortable with a higher repo rate for a longer period until the rate of inflation has decelerated to the mid-point of the target band (4.5%) on a more sustainable basis.

We remain sceptical about the fiscal outlook

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. Subsequent monthly data continues to support this outlook, primarily due to buoyant corporate income tax receipts which continue to exceed budgeted targets. We now expect a marginal improvement on National Treasury's main budget balance target of -4.9% relative to GDP for the 2022/23 fiscal year. Such an outcome could open the door to the attainment of the first primary surplus in the post Global Financial Crisis (GFC) period, and a decline in of the gross load debt to GDP ratio below the 71.4% that was estimated in the MTBPS for the current fiscal year.

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. Against a constrained global growth backdrop and its negative implications for the domestic economy, Eskom's dark shadow continues to blight economic growth and fiscal consolidation prospects. Moreover, 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.

Accounting for sharp, downward economic growth revisions, given the severity of the domestic electricity shortfall as well as persistent expenditure pressure to address the myriad of social and economic challenges, we are of the view that National Treasury's fiscal estimates for the forthcoming fiscal years are particularly optimistic. Relative to National Treasury's expectations for the consolidated budget deficit to narrow to 3.2% of GDP in 2025/26, our estimates, accounting for growth downside and expenditure upside, suggest these estimates are well off the mark – with the budget deficit remaining anchored towards -4.5% relative to GDP in the medium-term. In our view, without significant improvement in domestic energy availability and the successful implementation of other structural reforms, the domestic economy will continue to fall short of its growth potential and fiscal consolidation targets.

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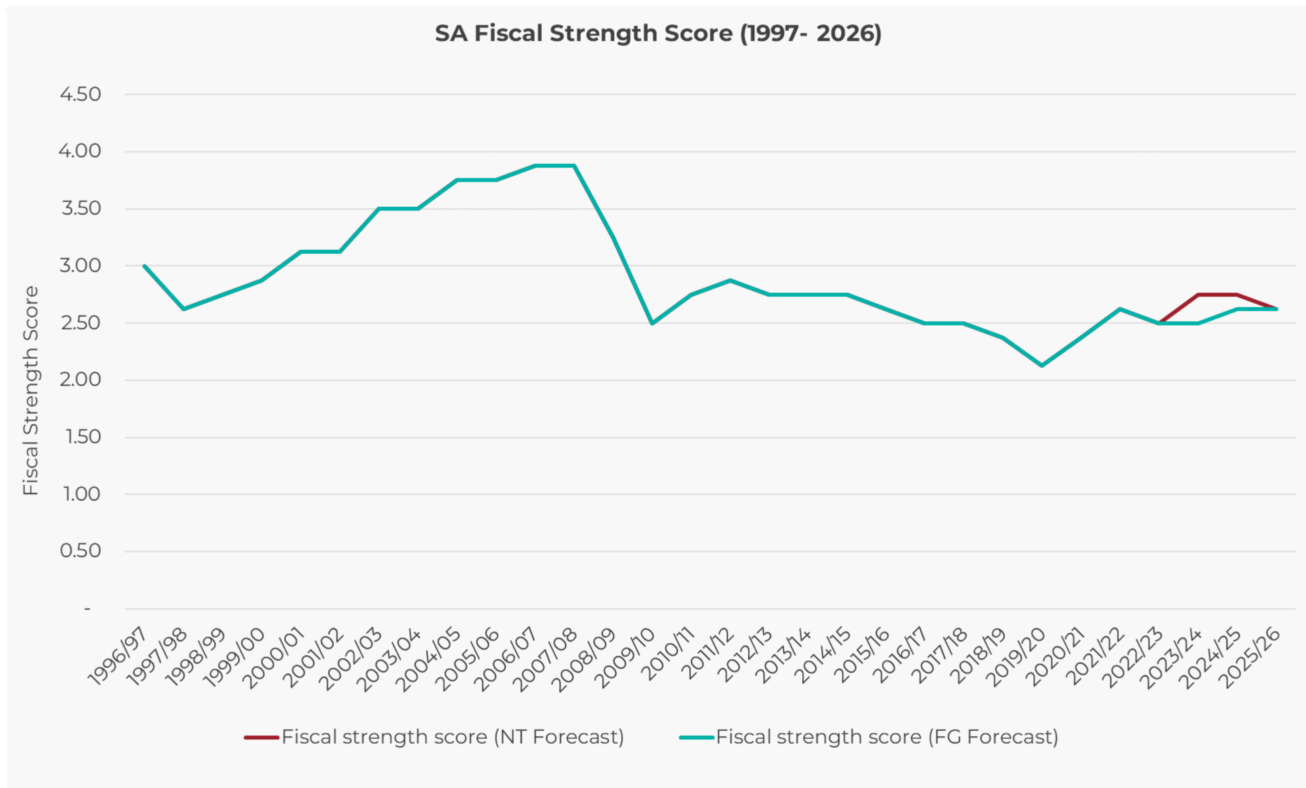
Figure 2: We remain less positive on continued fiscal consolidation

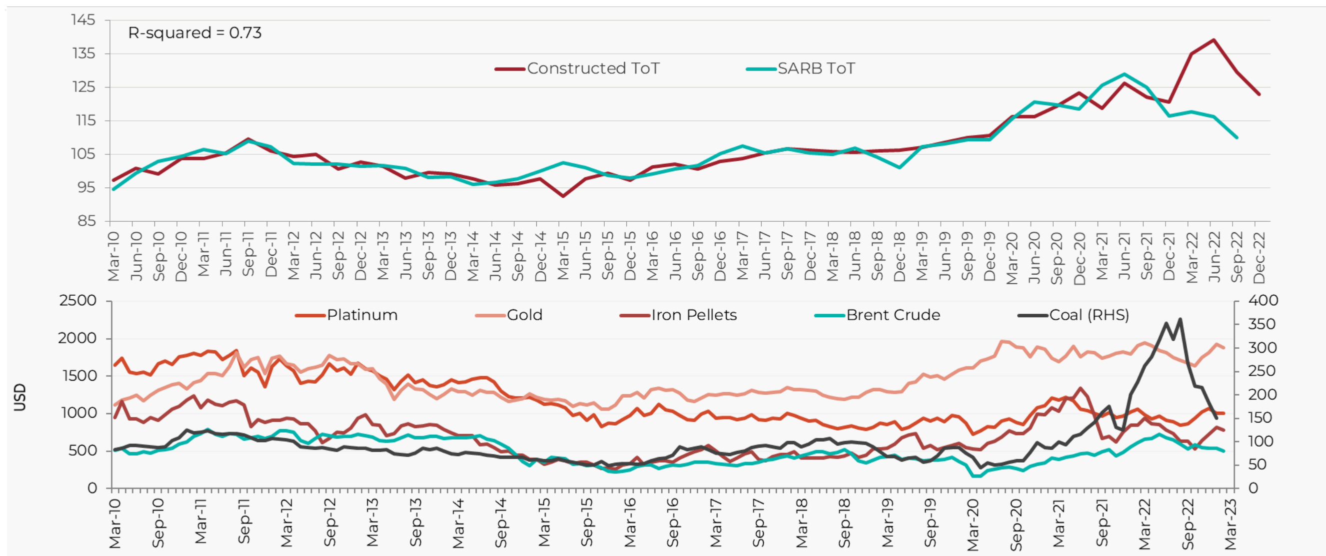


Source: National Treasury, Futuregrowth

External trade account balance continues to roll from last year's much better levels

The December external trade balance recorded a deficit of R4 billion. This was the largest monthly trade deficit since April 2020 and the latest in the more recent weakening trend, due to a combination of higher import volumes as well as sharply reduced terms of trade support. The reduced terms of trade support was in turn mainly driven by lower export prices, concentrated in the dramatic drop in coal prices following the spike caused by Russia's invasion of Ukraine last year. While this weakening had been anticipated, the worsening external trade position nonetheless adds to a growing list of South African macro-economic challenges.

Figure 3: Significant weakening of the South African terms of trade

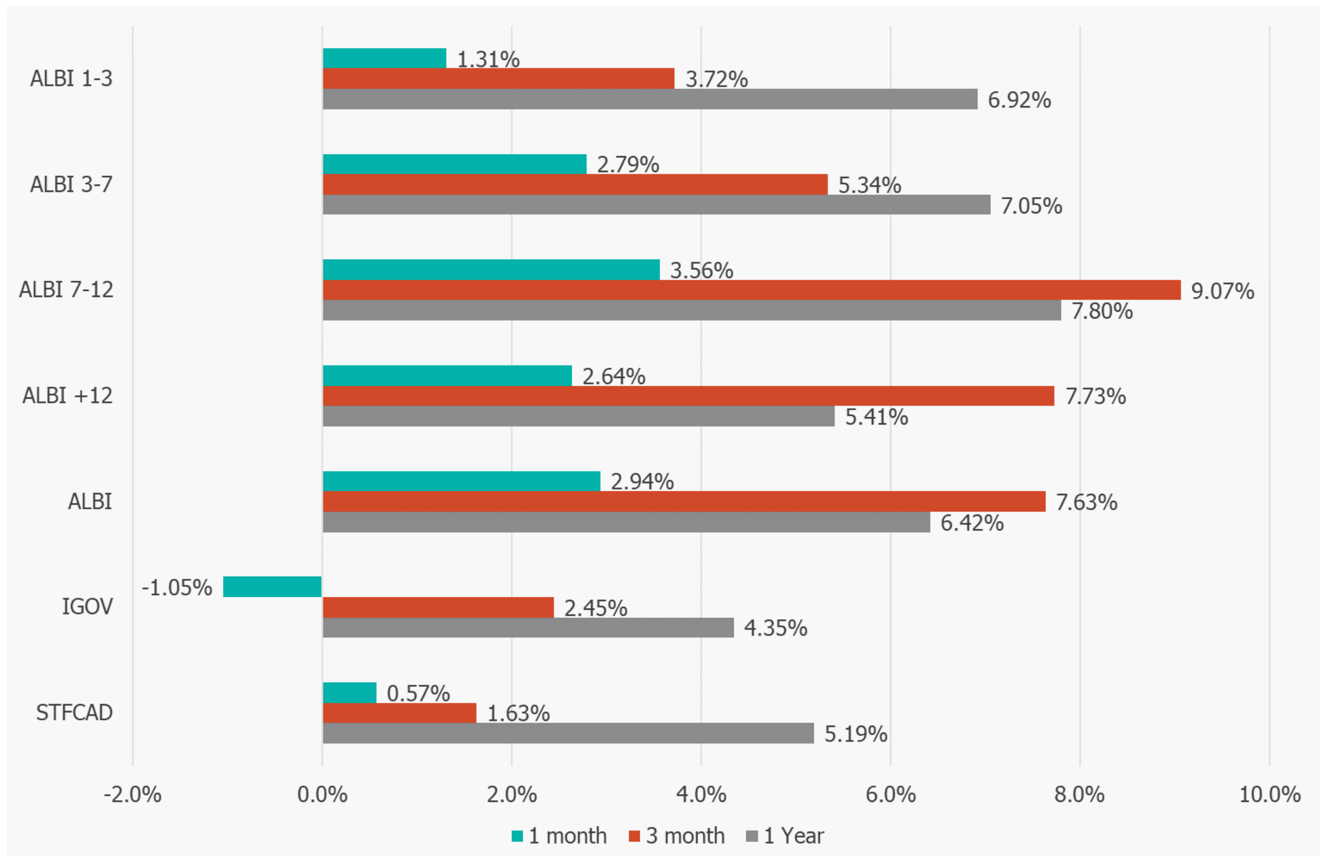


Source: Bloomberg, Futuregrowth

A strong start for the year for nominal bonds

The nominal bond market got out of the 2023 starting blocks at pace. Bond yields decreased to lower levels across the yield curve and, despite giving back some of the gains at month-end, the FTSE JSE All Bond Index (ALBI) still rendered a remarkably strong return of 2.94% for the month. Against the backdrop of the sustained slowdown in the rate of inflation, the inflation-linked bond market (ILB) continued to be negatively impacted by the reduced inflation carry and weaker inflation-hedging demand. This combined to exert upward pressure on longer-dated real yields. In fact, relative to the more liquid nominal bond market with much better price discovery dynamics, the ILB market demonstrated even more price volatility than usual. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) returned a weak -1.05% in January, underperforming both nominal bonds and cash. Cash rendered a return of 0.57%, well below that of nominal bonds despite the very significant rise in the level of the policy rate since the end of 2021. This is partly a reflection of the steep positive slope of the nominal bond yield curve, with longer-dated nominal bonds still offered at attractive inflation adjusted yields.

Figure 4: Bond market index returns (periods ending 31 January 2023)



Source: IRESS, 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 progressing, 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.

THE TAKEOUT: Global central banks doggedly stuck to the task of reining in consumer price inflation which had been at multi-decade highs for most of the past year. This resolve has raised nascent concerns for economic growth downside in 2023. Locally, CPI and PPI data prints continued to serve as confirmation that the disinflation trend is gaining momentum. This positive development, as well as rising concern about the potential devastating impact of ongoing intensified loadshedding on a fragile economic environment, convinced the SARB to reduce the pace of policy tightening to 25bps at the January MPC meeting. This, we believe, took us to the peak in the current interest rate cycle. On the fiscal front, notwithstanding downward growth revisions in the medium-term, strong tax revenue performance relative to budget estimates has confirmed our expectations of stronger fiscal consolidation for the current fiscal year. We, however, remain alert to the significant fiscal execution risk in the medium to longer term. Against this backdrop, nominal bonds (ALBI) managed to return an excellent +2.94%, well in excess of the -1.05% rendered by inflation-linked bonds (IGOV) and cash (+0.57%).

AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH

Global growth is expected to slow from 2.8% in 2022 to 2.1% in 2023 and 2.0% next year. The risk to these estimates is on the downside. 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 easing, several central banks are still tightening monetary policy, which, in turn, has become the primary driver of weakened consumer demand and fear of widespread recessionary conditions. However, this concern should be weighed against more recent events, which include the re-opening of the Chinese economy and the possible slowing of monetary policy tightening in larger economies like the US in response to easing inflationary pressure and weaker economic growth.

Domestically, our latest GDP forecasts for 2022 and 2023 are 2.3% and 2.0% respectively, compared to last year's 4.9%. However, we believe that these forecasts are exposed to significant downside risk. 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 even after considering China's economic re-opening. Additionally, higher interest rates will also dampen cyclical consumer demand, which, after all, is the intention of policy tightening. More importantly, expected lackluster economic growth underscores 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 at the macro policy level, especially when it comes to the actual implementation of the nicely-worded 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. Without capital formation, no economy can make headway in terms of growth and employment on a sustained basis.

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). The re-opening of the Chinese economy may offset some of this downside risk. 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. The current bout of intensified load shedding cannot be swept aside as it impacts most industries in a very significant way.

INFLATION

The commodity fallout from the conflict in Ukraine and the effects of earlier significant supply-side bottlenecks have started to fade. 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 surge in domestic and global price indices last year has created a higher statistical base for a lower rate of change this year even though some broader price pressures may still linger for a while.

Domestically, a higher base (in turn due to the upside surprise to headline CPI over the past year or so) will continue to contribute to an easing in headline CPI. While the direction of the rate of inflation is clearly downward, we are now focused on the pace of that deceleration and the level of the lower turning point in this cycle. With one eye fixed on global energy and food price developments, evidence of the pass-through of rand weakness to inflation has been flagged as a risk. We are also increasingly concerned about the negative impact the current bout of intensified loadshedding on industry, and particularly the agricultural sector, which in turn may prompt higher prices due to either shortages or rising input costs. 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 as well as the potential rise in input costs.

THE TAKEOUT

Disinflation globally, and particularly in South Africa, is gaining momentum. That said, while the rate of headline inflation is expected to continue 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. We are also increasingly concerned about the negative impact the current intensified bout of loadshedding is having on the manufacturing industry, the agricultural sector and eventually input costs.

BALANCE OF PAYMENTS

Although South Africa's merchandise trade account remains 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. The ever-increasing challenges at Transnet are adding to a growing list of hurdles to exporters. Apart from the volume effect, relative prices have also turned the wrong way from the South African perspective. Following the 3.7% current account balance (expressed as a ratio to GDP) recorded in 2021, the surplus is expected to have dwindled to 0.4%of GDP in 2022, with a balanced current account expected this year. The capital account will bear the brunt of potential capital outflows given South Africa's probable grey listing early this 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 in 2022 and 2023 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.

Our investment view and strategy

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 onwards. The combination of weak economic growth, disinflation and the repo rate peak lend strong support to local nominal bonds from a pure inflation/interest rate cycle point of view.

However, the positive implications of the inflation and interest rate cycle should not be considered in isolation. Our main concern about the local bond market remains the strong link between lacklustre underlying economic growth 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 unsustainable high level of outstanding sovereign debt, the rising risk inherent in significant contingent liabilities, and sustained current expenditure pressures. The challenging local fiscal situation will continue to serve as the main catalyst for back-end volatility.

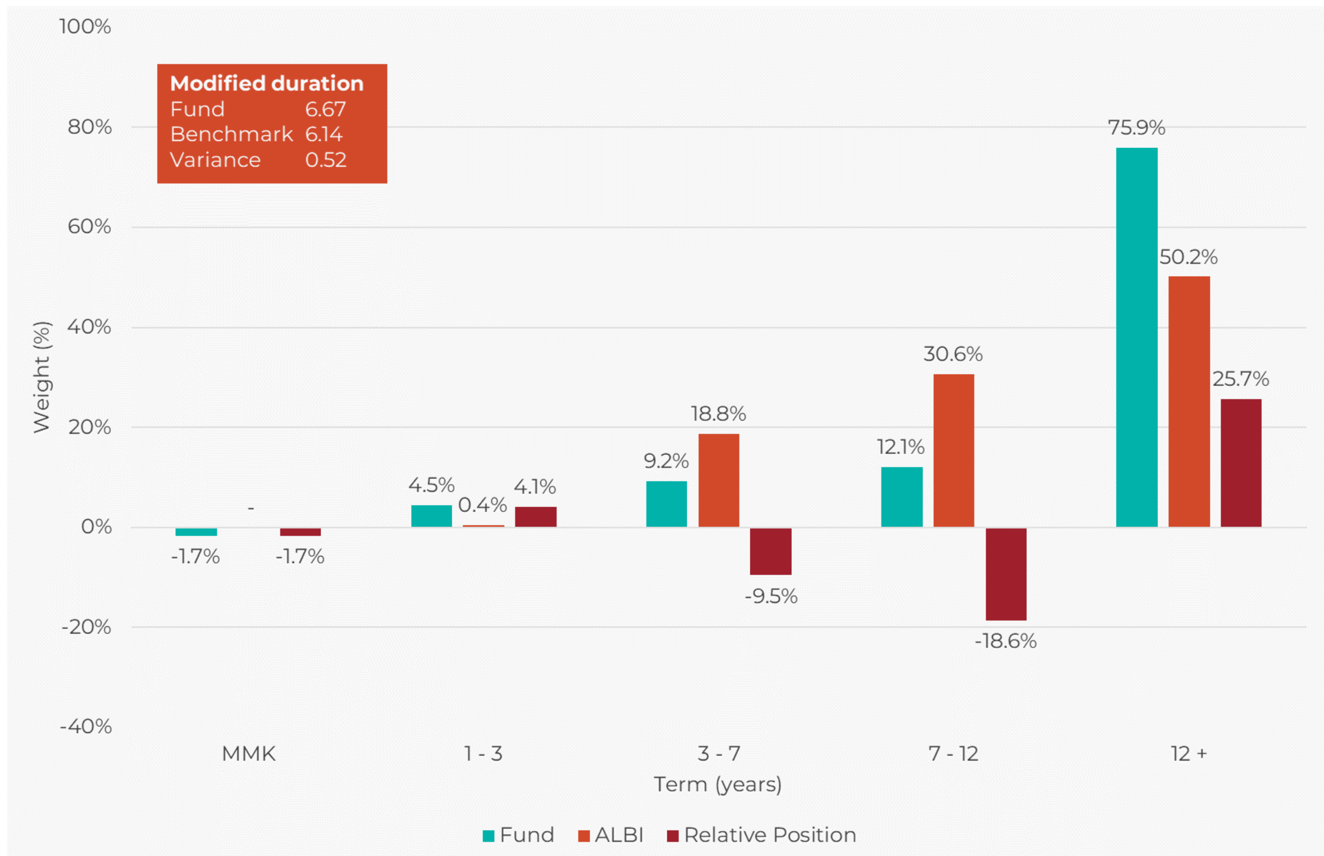
However, it is also acknowledged that some of the poor fiscal theme is reflected by current market valuation, specifically the steeply-sloped yield curve and the high level of yields on an inflation-adjusted basis. The challenge remains to find the optimal balance between managing potential capital loss 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 remains the 12- to 20-year maturity band. Within this strategic 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, considering the current disinflation phase. This position will be carefully considered on an ongoing basis, given the growing potential upside risks to inflation further down the line.

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 and the interest rate cycle peak, 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.

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	2024
Global GDP	3.5%	3.2%	2.6%	-3.6%	5.9%	2.8%	2.1%	2.0%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.3%	2.0%	2.4%
SA Headline CPI	5.3%	4.6%	4.1%	3.3%	4.5%	7.2%	4.5%	4.8%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	0.4%	-0.8%	-1.5%

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3rd Floor, Great Westerford
240 Main Road, Rondebosch
7700, South Africa
Private Bag X6, Newlands, 7725, South Africa
Tel: +27 21 659 5300 Fax: +27 21 659 5400
www.futuregrowth.co.za

Directors
GL Gobodo (Chairman) PE Rackstraw (Managing Director)
AC Canter* H Beets** P Moodley S Mabaso-Koyana
*American **Netherlands
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