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BOND MARKET COMMENTARY: FEBRUARY 2023

COMMENDABLE FISCAL CONSOLIDATION EFFORT, BUT...

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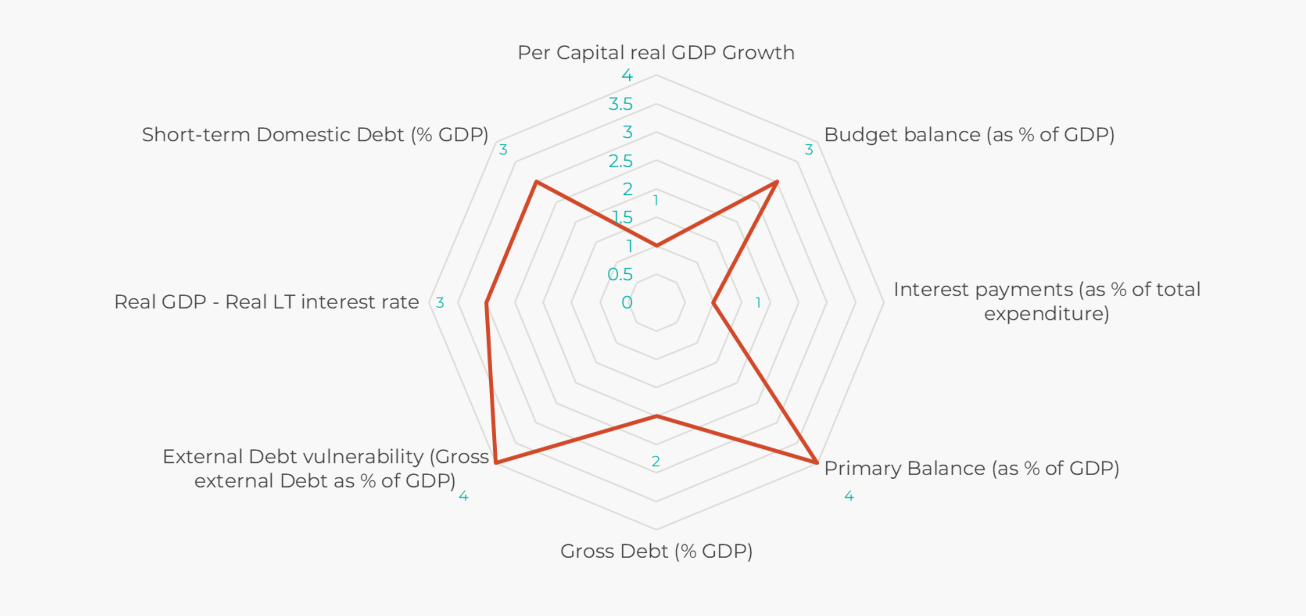
Confirmation of intent to return government finances to a more sustainable path

The annual delivery of the National Budget by the Minister of Finance remains a critical event on the economic calendar, more so for the local bond market, which remains the primary funding source for the South African government. The latest estimates for the 2022/23 fiscal year confirmed broad-based expectations of a stronger outcome relative to the estimates tabled in February last year. The combination of buoyant corporate tax receipts and efficiency gains at the South African Revenue Services, which propelled tax revenue gains to an historic peak of 25.8% of GDP, were the main contributors to the revised main budget deficit estimate of 4.5% of GDP, well below the initial estimate of 6.0% a year ago.

While the outcome for the current fiscal year is commendable, investor focus has already turned to the forthcoming fiscal years. This year, the main challenge had been to strike a balance between maintaining a credible commitment to fiscal probity and finding a comprehensive solution to the huge Eskom debt overhang. Our first cautious take is that the Ministry of Finance managed to credibly deliver on committing to a primary surplus, despite freeing Eskom of an estimated 60% of its debt and interest payment obligations over the Medium-term Expenditure Framework (MTEF) that stretches over a three-year period. Please see *here* for a comprehensive note on our thoughts on the Eskom debt relief proposal.

Of course, many hurdles are scattered across this fiscal path. An exceptionally weak economic backdrop, worsened by an intensifying energy crisis and a weakening terms of trade, pose downside risk to tax revenue estimates. Additional pressure on expenditure, including challenging wage negotiations and ongoing support to poorly managed state-owned enterprises, also remains a challenge. While we acknowledge the commitment to continued fiscal consolidation, our base-case view for now remains one of “good intentions, but with significant execution risk”. The impact on bond market sentiment and activity had been muted since the outcome was broadly in line with expectations. Please see *here* for a more comprehensive note on our thoughts on the latest budget.

Figure 1: Weak economic growth, a large and rising public sector debt load and consequently high debt service costs give rise to a fragile fiscal situation

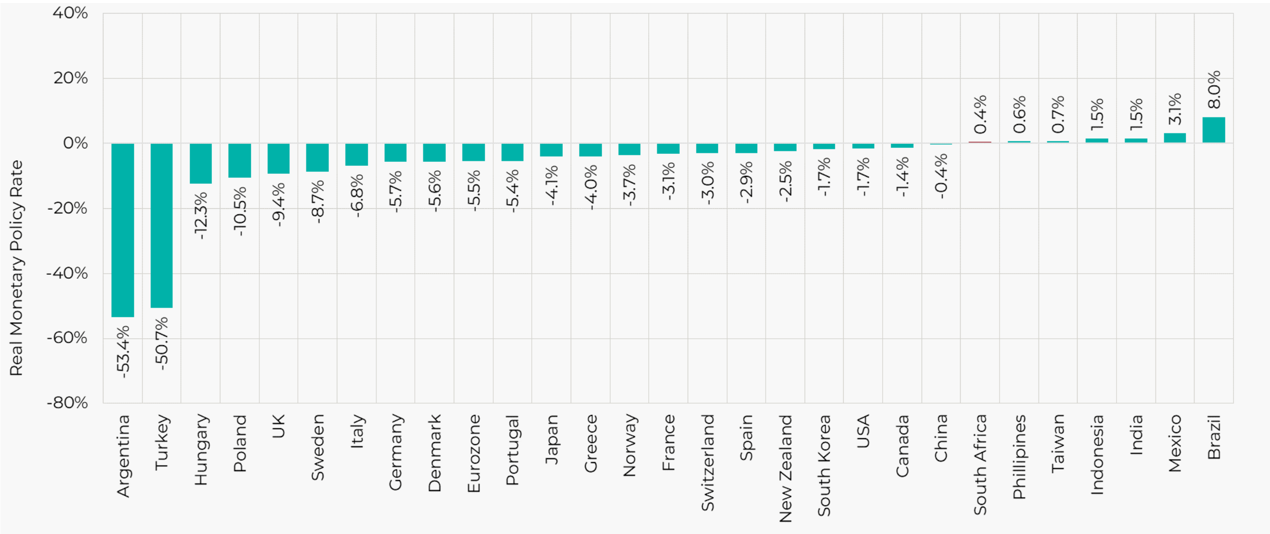


Source: Futuregrowth

The local disinflation trend maintains its momentum

The headline Consumer Price Index (CPI) slowed to a year-on-year rate of increase of 6.9% in January from 7.2 % the previous month. As broadly expected, the disinflation trend is progressing well, as last year's high base lends a helping hand to year-on-year CPI moderation from the 7.8% peak reached in July last year. However, on a more concerning note are disturbing renewed price pressures related to food (load shedding related?) and the more rand-sensitive components of the CPI basket. On the production side of the economy, the January Producer Price Index (PPI) data release also confirmed the disinflation trend. While still at a high level compared to CPI, the rate of increase for final manufactured goods eased to 12.7% year-on-year from 13.5% in December. The deceleration in the rate of increase was across a broad range of products, including intermediate manufactured goods (5.6%) and agriculture inflation (11.7%).

Figure 2: The South African inflation-adjusted repo rate back into positive territory and comparing well with the rest of the world



Source: Bloomberg, Futuregrowth

External trade account balance rolls over more decisively

The January external trade balance plunged to deficit of R23.1 billion, a significant swing from December's R5.4bn surplus. This was the largest monthly trade deficit since April 2020 and the latest in a weakening trend. The January trade deficit was mainly the result of a 14% month-on-month (m-on-m) decrease in exports, as imports only rose by around 3% m-on-m. While seasonal factors explain some of the weak export performance, the sharp drop in exports had been worse than expected and may also point to logistical constraints and inefficiencies at Transnet and South African ports. While a worsening terms of trade and its impact on the external trade account do not come as a surprise, the faster-than-expected acceleration in the pace of current account deterioration adds to a growing list of South African macro-economic challenges.

As feared, South Africa got grey listed

The Financial Action Task Force (FATF) evaluated South Africa in October 2021 and found several deficiencies in the country's policies and efforts to combat money laundering and terrorism financing. Although the FATF, at its February plenary meeting, acknowledged that the country had made significant progress towards addressing most of the deficiencies, eight areas were highlighted as problematic. This forced it to add South Africa to the grey list. While National Treasury and the South African Reserve Bank (SARB) have committed to addressing these urgently, our view remains that a turnaround from a law enforcement implementation perspective will take some time. While this outcome adds to the already dented confidence deficit in the country, we maintain that the direct market impact will be limited as none of this comes as a surprise.

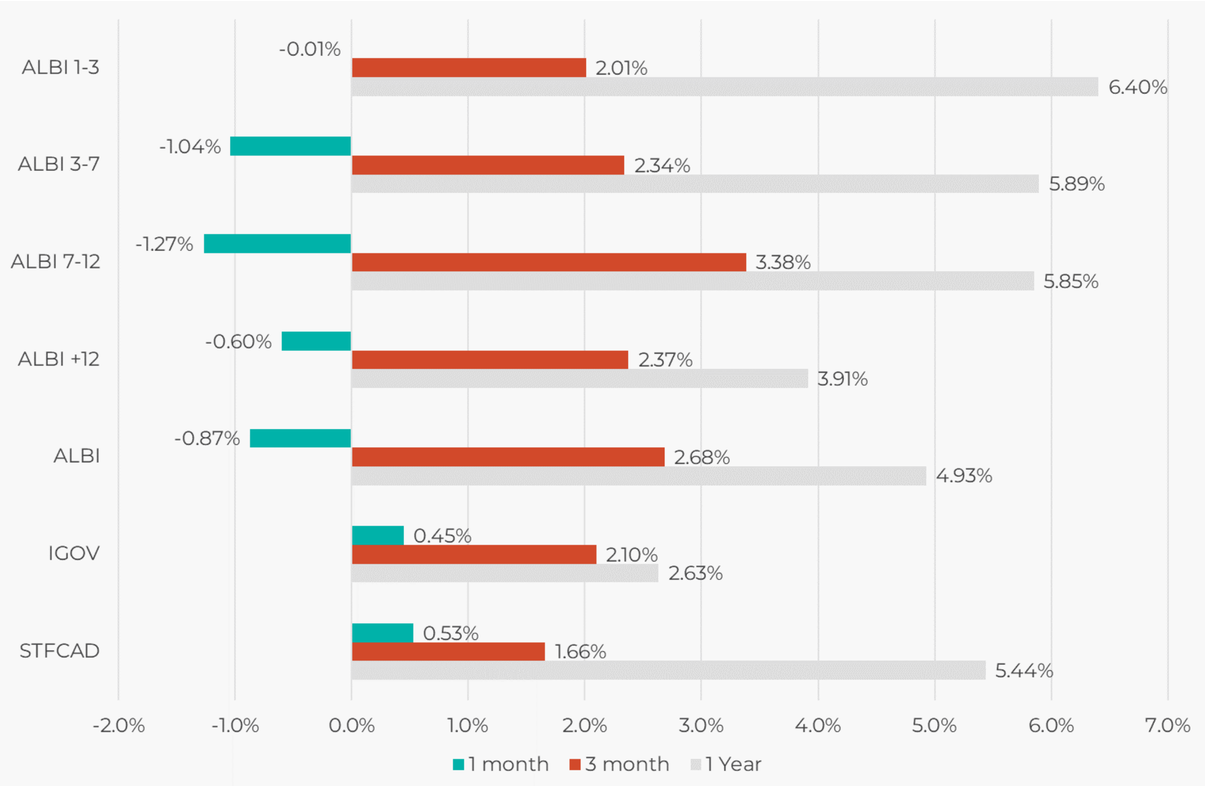
Global developments dent local currency and bond performance

Some of the more prominent global bond markets, including the US Treasury market, had to contend with a more challenging backdrop, which exerted upward pressure on bond yields. In the US, the combination of slower-than-expected disinflation, and more evidence that earlier recession risk had faded somewhat, lured interest rate bears back. In turn, expectations of policy easing as early as later this year had to pared back. The tweak in rate expectations contributed to a stronger US dollar and higher US Treasury yields, which in turn contributed to renewed rand weakness and some upward pressure on local bond yields.

A weak month follows the strong start for the year

The nominal bond market got out of the 2023 starting blocks at pace. However, the net effect of the above events forced bond yields back to slightly higher levels in February and, in the process, detracted from the exceptionally strong performance earlier this year. The FTSE JSE All Bond Index (ALBI) rendered a return of -0.87% for the month, with bonds in the 7- to 12-year maturity band performing the worst. In contrast, the inflation-linked bond market (ILB) managed to recover some lost ground as real yields grinded lower despite a lower inflation carry. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) returned +0.45%, a significant swing from the -1.05% recorded in January. Cash rendered a return of 0.53%, well above that of nominal bonds and still slightly better than the returns offered by ILBs. However, nominal bonds retained podium position for the first two months of 2023, with a return of 2.04%, followed by cash (+1.10%) and inflation-linked bonds (-0.61%).

Figure 3: Bond market index returns (periods ending 28 February 2023)



Source: IRESS, Futuregrowth

THE TAKEOUT: The Ministry of Finance managed to strike a commendable balance between an ongoing commitment to fiscal consolidation and addressing the Eskom debacle. While the South African disinflation trend still seems on track, food prices and more rand-sensitive components of the Consumer Price Inflation Index raise some concerns. A much larger than expected monthly trade account deficit adds to downside pressure on the balance of payments. To add insult to injury, South Africa also got grey-listed by the Financial Action Task Force. The combination of sticker inflation and reduced risks of global recession forced global bond yields higher as earlier expectations of a peak in policy rates and even policy easing had to be curtailed. Against this backdrop, nominal bonds (ALBI) lost some ground in February following the strong start for the year, with a return of -0.87%, below the +0.45% rendered by inflation-linked bonds (IGOV) and cash (+0.53%).

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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 2.1% 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 the 4.9% in 2021. 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 South Africa's grey listing by the FATF, which will further discourage 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 ways 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 and 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 facing exporters. Apart from the volume effect, relative prices have also turned the wrong way from a 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 grey listing, 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 grey listing of the country will likely hamper foreign capital flows, but the exact impact is hard to estimate.

Our investment view and strategy

We believe that the peaks in both the inflation and interest rate cycle have 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 a weak fiscal position. Even though the government is showing intent to stabilise the pace at which the public sector debt burden is rising, we remain cautious on the 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. The impact of the Eskom debt relief package should not be ignored. The bottom line is that the debt obligation of the state will increase and, with that, a higher debt-servicing cost.

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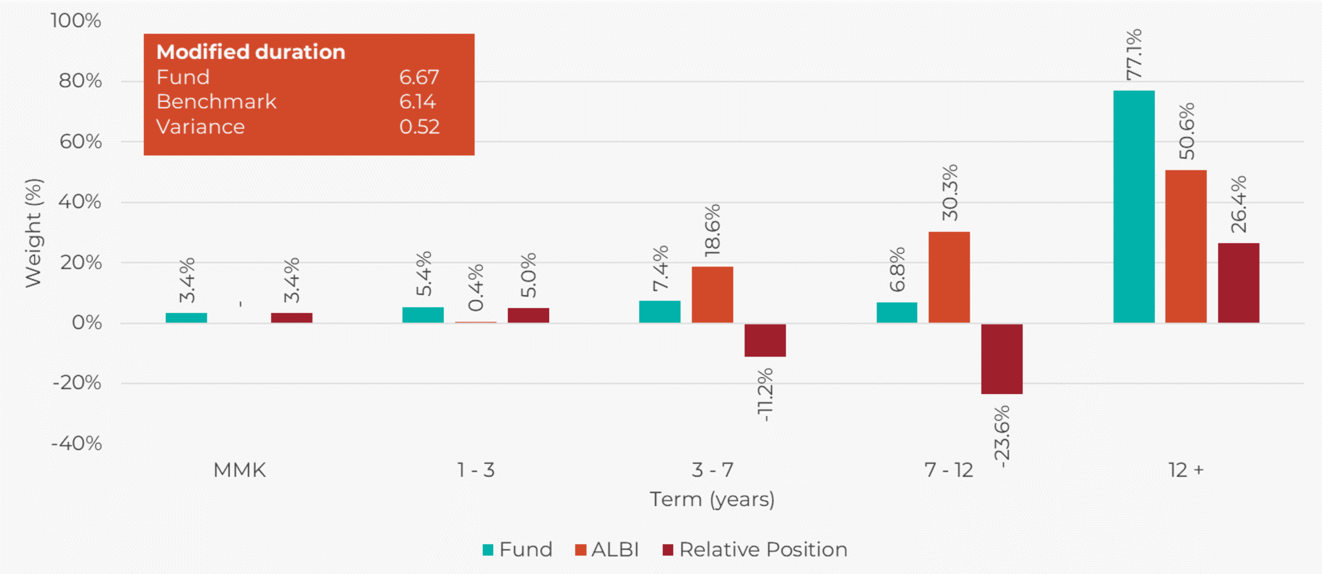
However, it is also acknowledged that some of the poor fiscal theme is reflected in current market valuations, specifically the steeply-sloped yield curve and the high level of yields on an inflation-adjusted basis. The challenge remains to find the optimal balance between managing potential capital 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 ILBs, 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 between 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 of limiting capital loss but also seeking 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 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 ILBs, 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 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%	2.1%	2.0%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.0%	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%

Source: Old Mutual Investment Group