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BOND MARKET COMMENTARY: MARCH 2023

LOCAL FISCAL CONSOLIDATION AMIDST HAWKISH CENTRAL BANKS AND GLOBAL BANKING TURMOIL

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Global developments cause significant market volatility

During the first quarter of 2023 global financial markets were trapped by the monetary policy implications of stickier inflation on the one hand and concerns about the health of the global banking sector on the other. The latter, which was caused by the collapse of Silicon Valley Bank and Signature Bank in the USA, quickly raised contagion concerns about the financial health of Credit Suisse and several other major banks in Europe. These developments had opposing impacts on monetary policy expectations and thus market responses.

Earlier in the quarter, the more prominent global bond markets, including the US Treasury market, had to contend with a more challenging backdrop related to slower-than-expected disinflation, and more evidence that earlier recession risk had faded somewhat. This lured interest rate bears back as expectations of policy easing as early as later this year had to be 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.

During March, the unfolding banking crisis led to global risk aversion. This risk aversion turned out to be another factor allowing the US dollar to remain well bid. In the case of the US Treasury market, this short-lived flight to safety forced yields sharply lower and thus exposed investors in this market to significant volatility during the quarter. After reaching a peak of 4.06% earlier this year on the back of sticky inflation and monetary policy concerns, the yield of the 10-year US Treasury bond decreased sharply by around 50 basis points (bps) following the banking sector-induced safe-haven trade. Monetary policy expectations also caused the US Treasury curve to be particularly volatile and to end the quarter inverted. Concerns about the broader banking sector receded towards the end of March, in turn illustrated by the VIX (a measure of market fear), which pulled back from levels above 30 to 19. The return of some market calm also caused longer-dated US Treasury yields to retrace to higher levels as the earlier rush for relative safety lost momentum.

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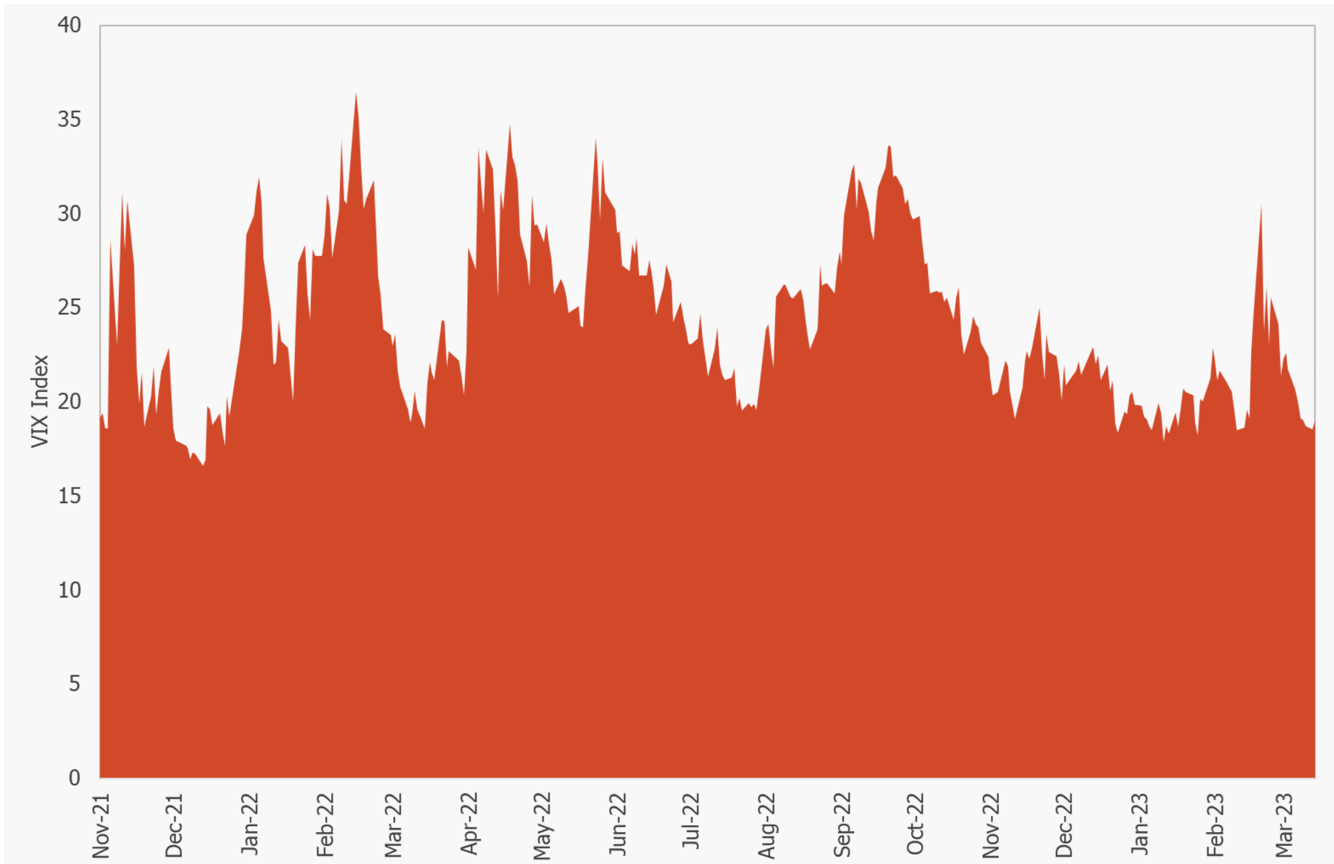
Figure 1: Volatility in the VIX index remains elevated with the latest flareup coming as a result of the banking sector crisis



Source: Bloomberg

Some of the risk aversion was taken off the table as both monetary authorities and the private banking sector stepped in to stabilise matters in the global banking sector. In addition, some of the major central banks went the extra mile to reiterate their main policy objective of taming the inflation monster by tightening monetary policy further, even in the face of weak economic growth and banking sector jitters. Among the major advanced economies, the US Federal Reserve and the European Central Bank raised their policy rates by 0.25% and 0.50% respectively, citing sticky inflation at unacceptable levels relative to their respective targets. In the case of the Fed, the latest, smaller increase also served as confirmation of a slowdown in the pace of policy tightening.

Intention confirmed 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

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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 2022/23 fiscal year is commendable, investor focus has already turned to the 2023/24 fiscal year and beyond. The main challenge for the 2022/23 fiscal year was 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 was 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.

From a funding perspective, National Treasury has sought to further develop the local currency nominal, inflation linked (ILB) and floating rate bond (FRN) curves with the issuance of new instruments in each of these markets. The 8-year maturity I2031 ILB was issued for the first time at the last ILB auction in March, with the first issuance of both the 30-year maturity R2053 nominal bond and 7-year maturity floating rate note scheduled for April.

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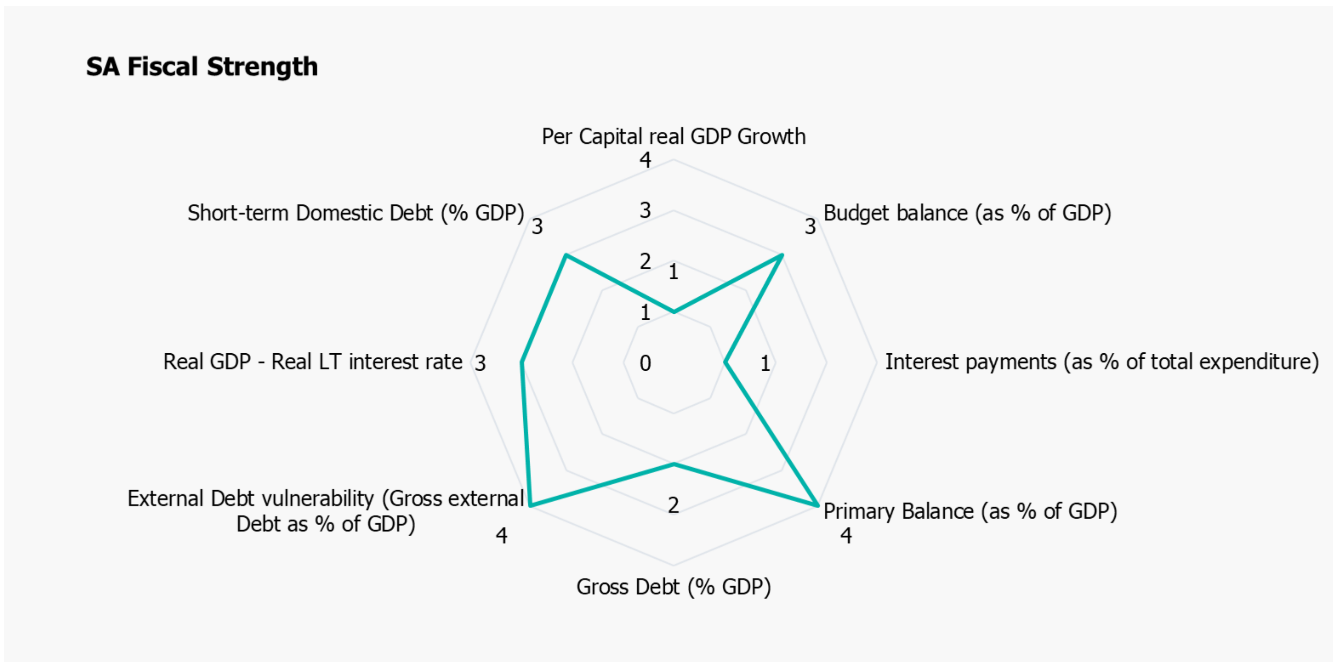
Figure 2: Weak economic growth, a large and rising public sector debt load and consequently high debt service costs give rise to a fragile fiscal situation



Source: Futuregrowth

The local disinflation trend maintains its momentum, despite a pick-up in February

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, this trend was disrupted by the year-on-year Headline Consumer Price Index reading of 7.0%, which was slightly higher than the previous month's reading of 6.9% and higher than market expectations at the time. Core CPI also remained sticky at 5.2%. Even so, the broader trend remains one of disinflation. This is confirmed by the latest data on the production side of the economy. While still at a high level compared to CPI, the rate of increase for final manufactured goods eased to 12.2% year-on-year in February from 13.5% in December. The deceleration in the rate of increase was across a broad range of products, including intermediate manufactured goods and agriculture inflation.

As feared, South Africa was grey listed

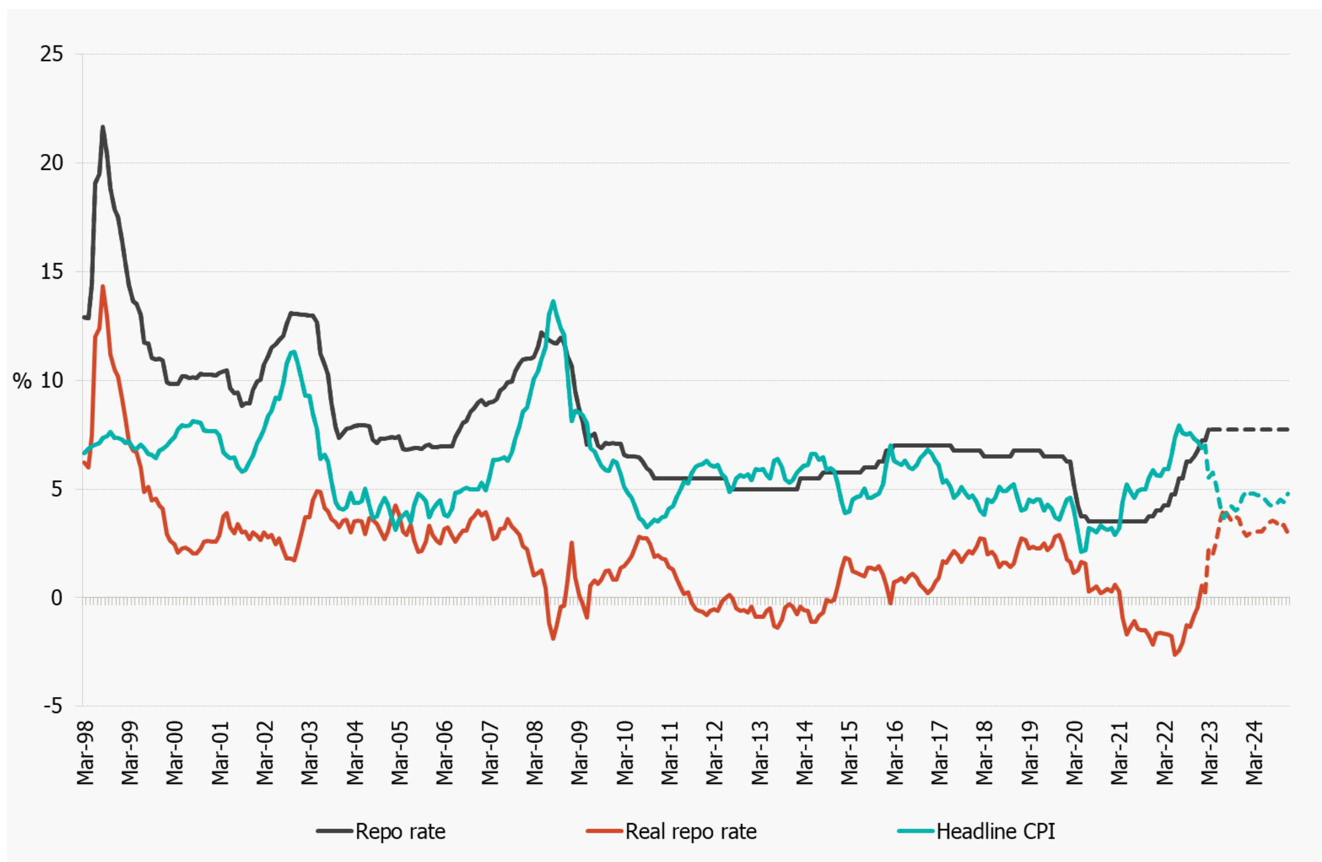
The Financial Action Task Force (FATF) evaluated South Africa in October 2021 and found several deficiencies in the country's policies and efforts to combat money laundering and terrorism financing. Although the FATF, at its February plenary meeting, acknowledged that the country had made significant 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 business confidence in the country, we maintain that the direct market impact will be limited as none of this comes as a surprise.

The SARB maintains a hawkish stance

The SARB proved the market (and us) wrong by lifting the repo rate by more than we anticipated in the first quarter of this year. The combination of sticky and high inflation in many advanced economies, the slow shift to local disinflation, perceived upside risks due to renewed currency weakness, intensified loadshedding and rising inflation expectations convinced three of the five monetary policy committee members to support a larger than expected 50bps at the March meeting. The concern about risks to the inflation outlook is striking considering its downward economic growth revision to 0.2% for this year. The SARB raised the repo rate by a cumulative 75bps during the first quarter of this year to 7.75% - 1.5% above its pre-COVID level. Considering the February Headline CPI reading of 7.0%, the real repo rate is at 0.75% and is expected to increase significantly in the next few months as we continue to expect disinflation to regain momentum.

Figure 3: The South African inflation-adjusted repo rate back in positive territory and expected to rise sharply to pre-COVID levels

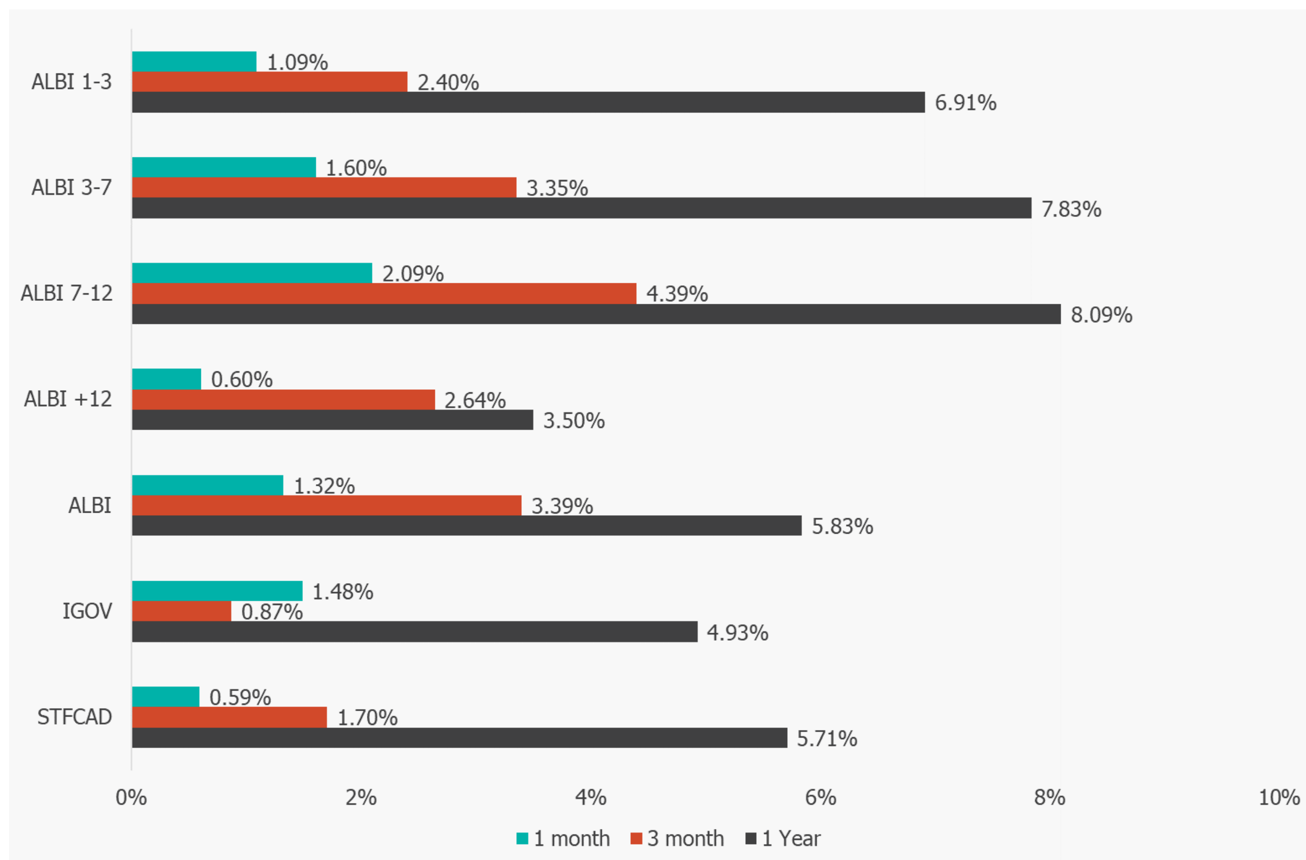


Source: Bloomberg, Futuregrowth

A strong quarter for nominal bonds despite recent market turmoil

The nominal bond market came 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 March and, in the process, detracted from the exceptionally strong performance earlier this year. Even so, the exceptionally strong January market performance allowed the FTSE JSE All Bond Index (ALBI) to render a return of 3.39% for the quarter, with bonds in the 7- to 12-year maturity band outperforming ultra-long-dated bonds as the yield curve bear steepened. In contrast, the inflation-linked bond market (ILB) managed to recover some lost ground in March following a very weak start to the year. As a result, the FTSE JSE Government Inflation-linked Bond Index (IGOV) returned 0.87% for the quarter, a significant swing from the -1.05% recorded in January. Cash rendered a return of 1.70%, slightly better than the returns offered by ILBs.

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



Source: IRESS, Futuregrowth

THE TAKEOUT: Globally, financial markets were exposed to a disruptive mixture of sticky inflation, hawkish central bank talk, a two-speed economic recovery and a banking sector scare. Intervention by central banks as well as the private banking sector brought about some sanity and calm, but only following significant market volatility, including the US Treasury considering its safe-haven status. Banking sector concerns failed to derail central bank focus on fighting sticking inflation. Locally, the Ministry of Finance managed to strike a commendable balance between an ongoing commitment to fiscal consolidation and addressing the Eskom debacle in the delivery of the annual national budget in February. While the South African disinflation trend still seems on track, the trend was disrupted by medical aid premium increases, sticky food prices and the more rand-sensitive components as the Consumer Price Index ticked slightly higher in February. A very hawkish South African Reserve Bank surprised all by adjusting the repo rate by 50bps at the March Monetary Policy Committee Meeting, for a cumulative increase of 75bps to 7.75% during the first quarter. To add insult to injury, South Africa was also grey listed by the Financial Action Task Force, although the market impact, as expected, was overshadowed by other global and local developments. Against this backdrop, nominal bonds (ALBI) lost some ground in February and the early part of March. However, the exceptionally strong start to the new year and the return of the bulls at quarter end enabled the ALBI to render a decent return of 3.4% for the first three months of 2023, outperforming both inflation-linked bonds (IGOV) and cash, which returned +0.9% and 1.7%, respectively.

AN OVERVIEW: MACROECONOMIC OUTLOOK, MARKET VIEW AND INVESTMENT STRATEGY

ECONOMIC GROWTH	Global growth is expected to slow from 2.9% in 2022 to 2.4% in 2023 and 2.1% next year. The risk to these estimates is on the downside. While earlier stubborn inflationary pressure is generally 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 forecast for 2023 is 2.0%, compared to the 2.0% and 4.9% in 2022 and 2021, respectively. However, we believe that the 2023 forecast is 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. Higher interest rates will also dampen cyclical consumer demand, which, after all, is the intention of policy tightening. More importantly, expected lacklustre 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 stated 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 contributes 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 loadshedding 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, ultimately, 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 current account recorded a 0.5% deficit in 2022. The deficit is expected to widen to 1.6% in 2023 and to 1.7% next year. The capital account will bear the brunt of potential capital outflows given South Africa's grey listing, although our view remains 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.

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.

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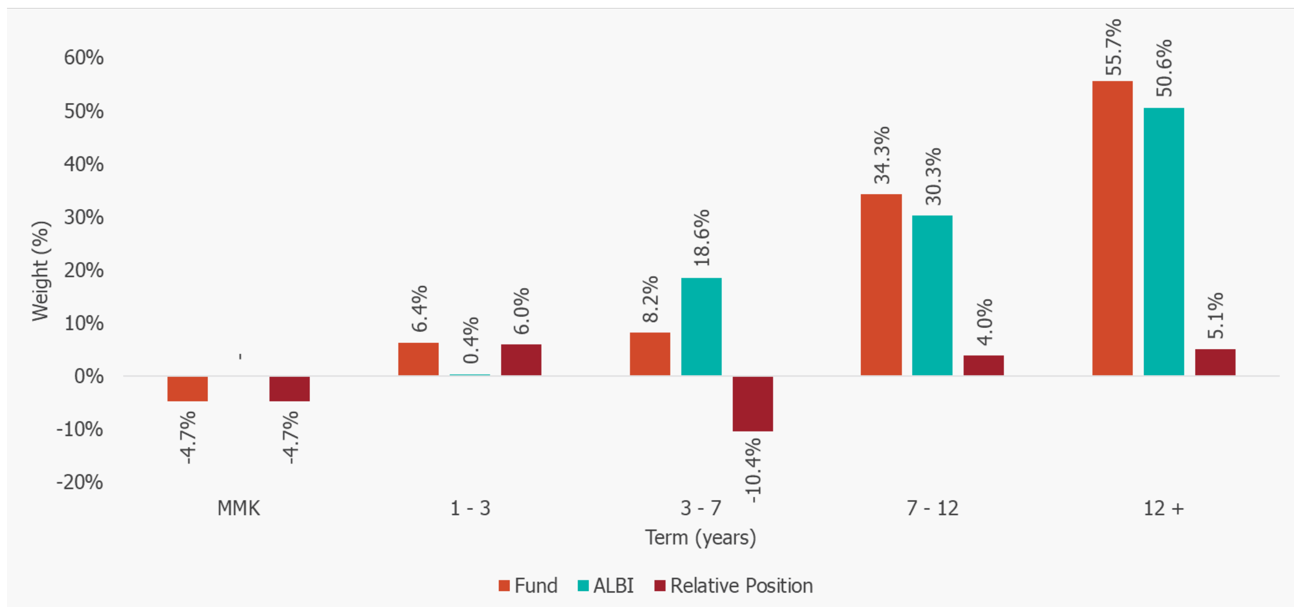
In the case of our Listed Yield Enhanced Bond Composite, our view is expressed as follows:

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	2024
Global GDP	3.5%	3.2%	2.6%	-3.6%	5.9%	2.9%	2.4%	2.1%
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%	6.9%	5.3%	4.6%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	-0.5%	-1.6%	-1.7%

Source: Old Mutual Investment Group

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