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BOND MARKET COMMENTARY: APRIL 2023

STICKY INFLATION SETS THE TABLE FOR MORE TIGHTENING

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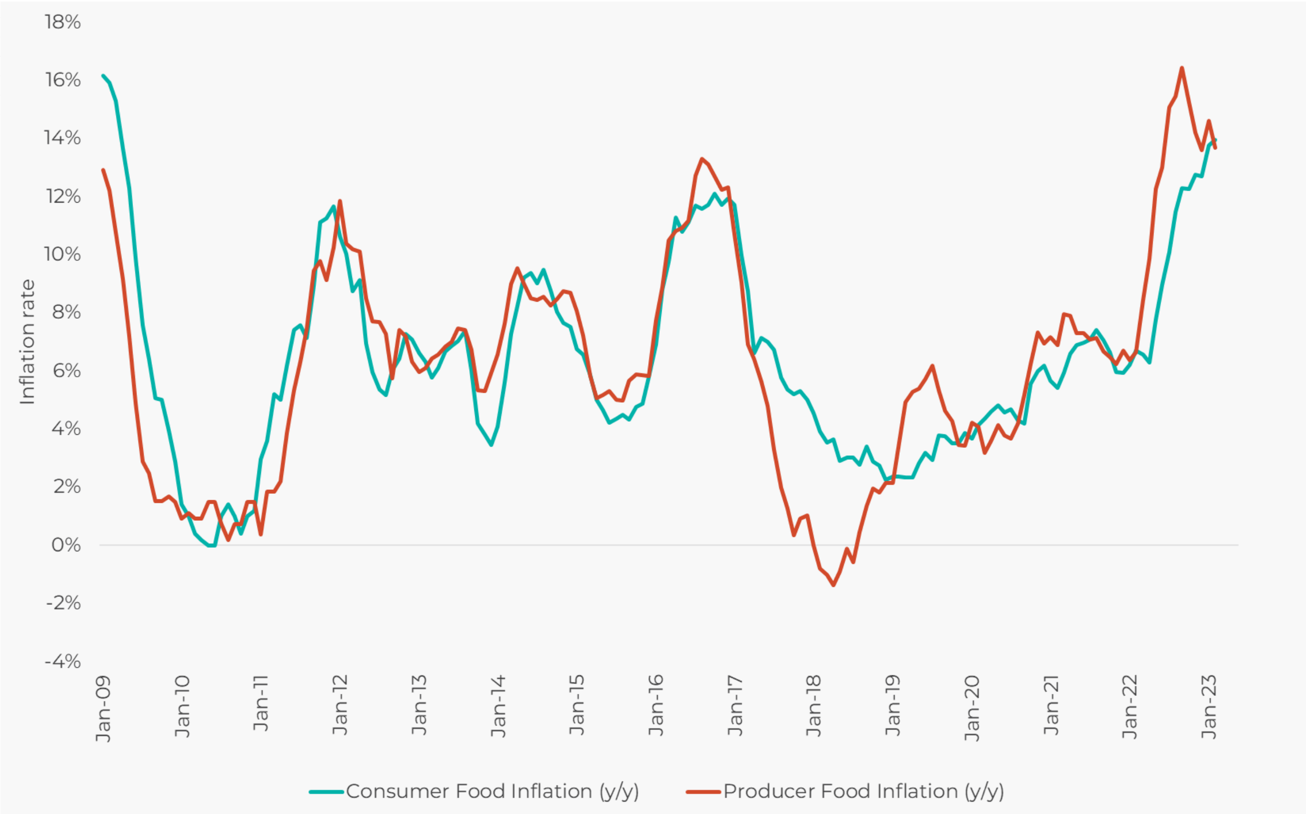
Published: May 2023

Local consumer inflation is still hovering at elevated levels

Headline Consumer Price Inflation (CPI) remained sticky in March as it edged up to a year-on-year increase of 7.1% from 7.0% the previous month. The main source of the short-term upward price pressure was the food component, with vegetable prices the biggest culprit with a very significant month-on-month spike of 3.8%. Core CPI, the less volatile inflation indicator, printed an unchanged 5.2% annual rate of increase from the previous release. While the slowdown in the pace of disinflation is disheartening, a more pronounced acceleration in disinflation had always been expected to start unfolding in the second quarter.

On a more positive note, the pace of disinflation at the producer level, albeit from a much higher base, was more pronounced. In the case of Producer Price Inflation (PPI) for final manufactured goods, the index increase slowed to 10.6% in March from 12.2% the previous month. This was the eighth consecutive year-on-year decrease. Encouragingly, producer food inflation, which has a strong correlation with food inflation at the consumer level, also eased significantly.

Figure 1: The slowdown of producer food inflation bodes well for consumer prices



Source: Futuregrowth, Bloomberg

Merchandise trade account surplus continues to shrink

The merchandised trade surplus narrowed to R6.9 billion in March, from a significantly downwardly revised R10.7 billion the previous month. Similar to recent months, this was due to a strong rise in imports, mainly from higher crude oil and petroleum products demand. The combination of a narrowing merchandise surplus and a large deficit on net income, service and current transfers supports our long-held view of a widening current account deficit.

Figure 2: Current account balance swinging back to pre-COVID levels

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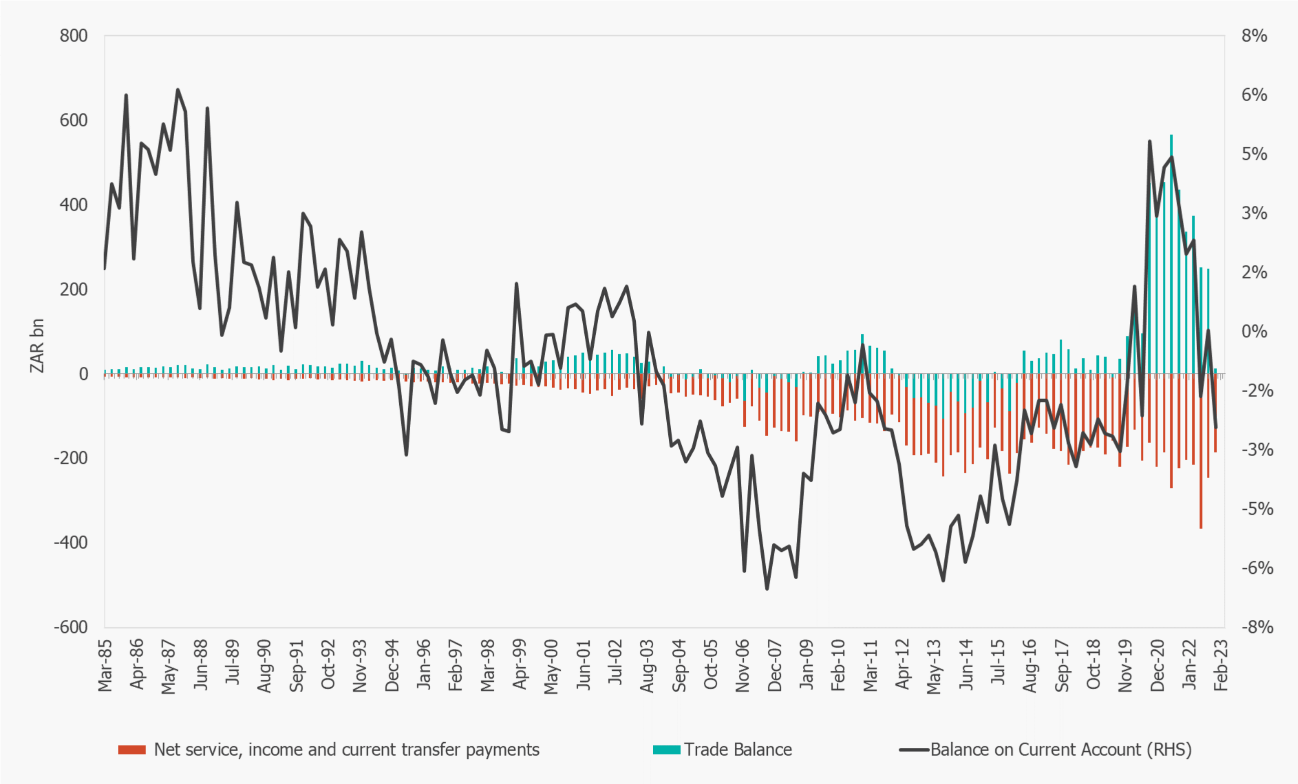
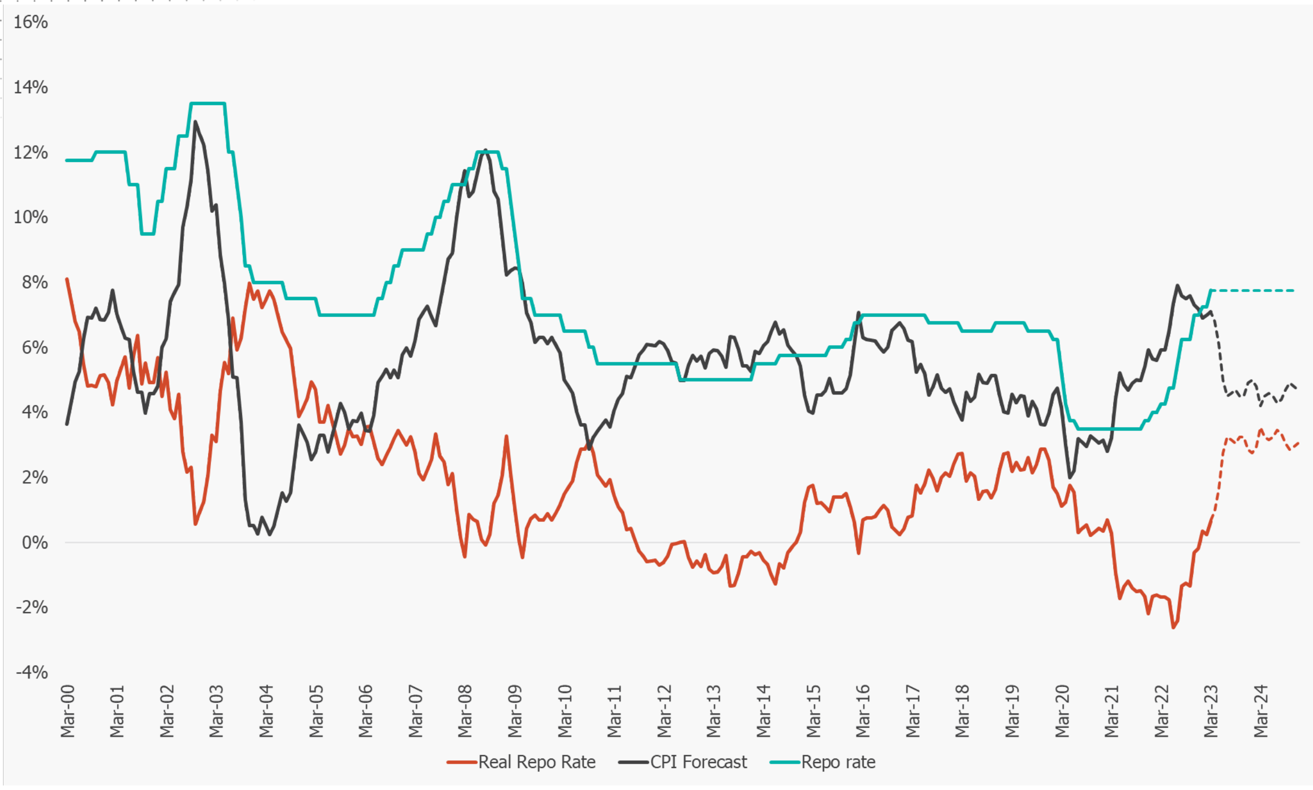


Source: Bloomberg

A hawkish SARB is most likely to over tighten monetary policy

The South African Reserve Bank (SARB) proved the market (and us) wrong by lifting the repo rate by more than 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 (MPC) members to support a larger than expected 50 basis points (bps) 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. Considering the hawkish monetary policy mindset, the recent stickiness to both Core and Headline CPI as well as the fact that it remains well above the inflation target band, most market participants expect the Bank to adjust the repo rate upwards by 25bps at the May MPC Meeting.

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



Source: Bloomberg, Futuregrowth

The fiscal 2022/23 budget deficit ends wider than budgeted

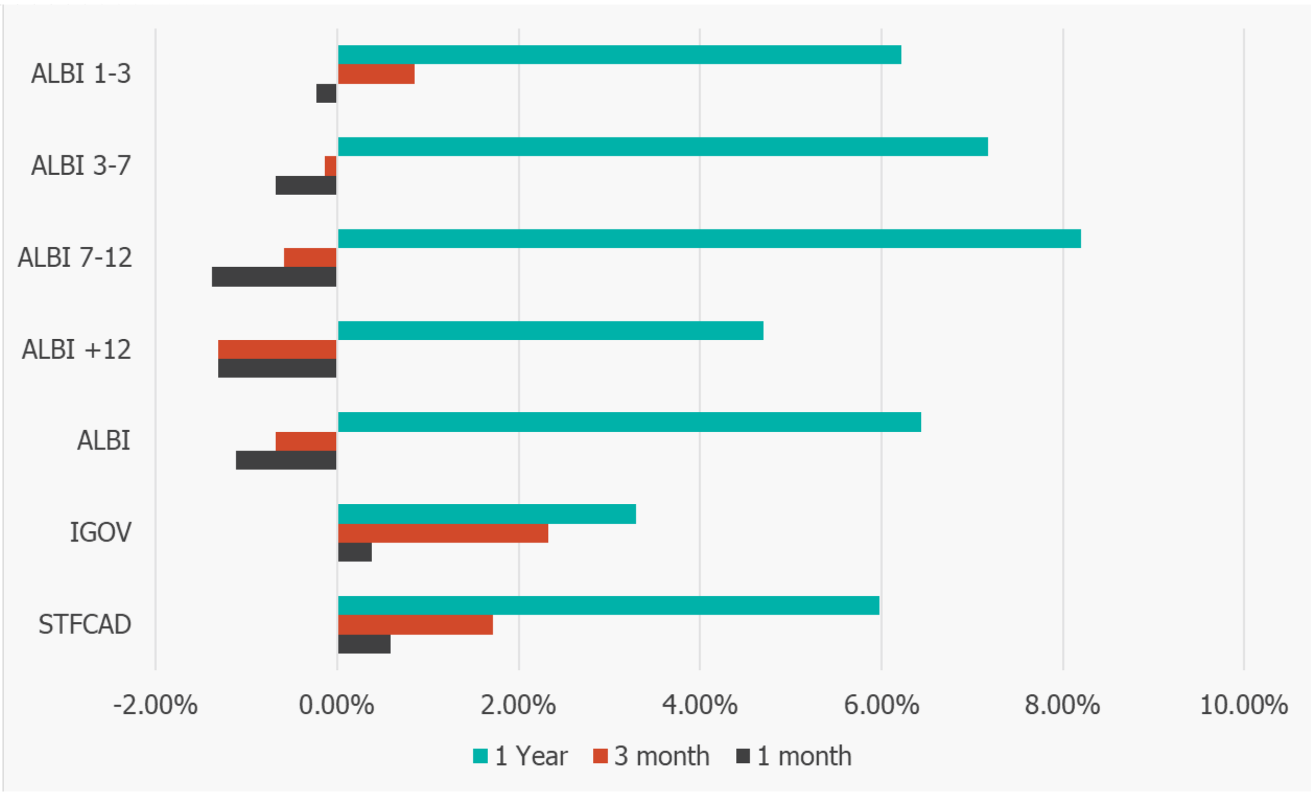
The budget deficit for the fiscal year ending March 2023 ended at 4.7% of Gross Domestic Product (GDP), slightly wider than the 4.5% formal estimate. While a late expenditure surge is mainly to be blamed, total revenue collection for the fiscal year also marginally underperformed relative to budget estimates. Even though this is still the smallest budget deficit since 2019, sustained expenditure pressure and waning tax revenue performance against a background of sustained weak economic growth continue to highlight our long-held concern about the state of the country's fiscal health.

Nominal bonds achieve some payback, while inflation-linked bonds benefit from sticky inflation

The combination of rising developed market bond yields, some rand weakness, the perceived implication of sticky local consumer inflation to the rising risk of more policy tightening at the May MPC meeting, reduced the demand for nominal bonds. Bonds in the 7-12 and 12+ maturity bands rendered the worst returns as the yield curve bear steepened. As a result, the FTSE JSE All Bond Index (ALBI) rendered a return of -1.11% for April. In contrast, the inflation-linked bond market (ILB) continued to recover lost ground in April as the FTSE JSE Government Inflation-linked Bond Index (IGOV) returned 0.38%. Even so, cash still managed to outperform the previous month as it rendered a return of 0.59%.

While the ALBI (2.24%) is still ahead of the IGOV (1.25%) for the first four months of 2023, cash (with a return of 2.30%) is now leading the pack with a marginal outperformance over nominal bonds.

Figure 4: Bond market index returns (periods ending 30 April 2023)



Source: IRESS, Futuregrowth

THE TAKEOUT: The South African disinflation trend experienced another disruption following the March year-on-year increase of 7.1%, mainly due to sustained food price pressure. Concerns about the higher print were partly offset by an easing of food prices at the producer level, which are expected to filter down to consumer prices with a short time lag. The combination of sticky consumer inflation at elevated levels relative to the inflation target band and a well-telegraphed hawkish SARB policy stance convinced most financial market participants to pencil in another round of policy tightening at the May MPC meeting. The latest external trade data, which confirmed weakening current account dynamics, added to the list of growing concerns. The budget deficit for the fiscal year 2022/23 was reported at 4.7% of GDP. The slightly worse outcome compared to the official budget estimate of 4.5%, was mainly the result of some overspending in March. Against this backdrop, nominal bond yields increased, causing the ALBI to lose ground with a return of -1.11%, with long-dated bonds rendering the worst performance as the yield curve bear steepened. In contrast, the combination of the decent inflation accrual and demand for inflation-linked bonds lifted the IGOV total return for the month to 0.38%. While still worse than the 0.55% rendered by cash, inflation-linked bonds managed to regain some lost ground relative to both nominal bonds and cash.

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 1.5%, 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 with 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, mainly through disruptions to the production process and margin pressure in an effort to find alternative and more reliable sources of energy.
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 in the medium term. 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 is 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 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.

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Our investment view and strategy

We believe that the peaks in both the inflation and interest rate cycles have been reached, with a stronger disinflation trend to gather momentum from mid-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 also not be ignored. The bottom line is that the debt obligation of the state will increase and, with that, a higher debt-servicing cost.

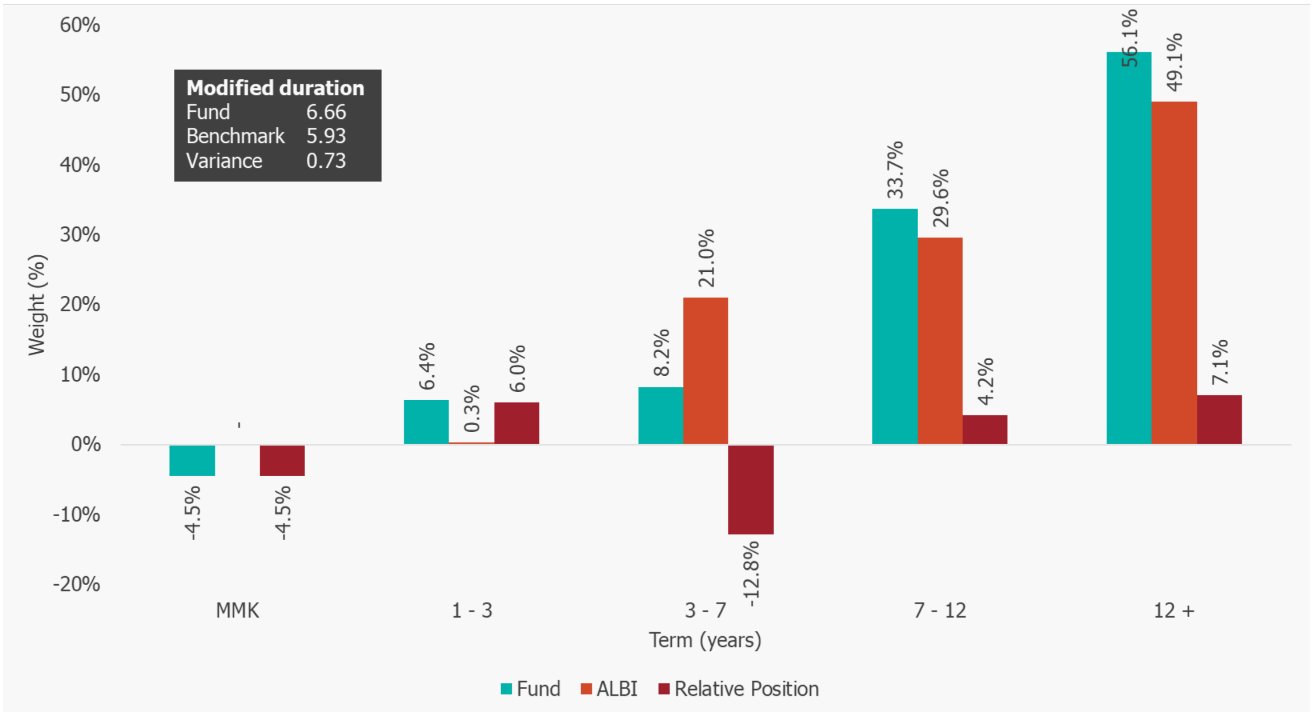
However, it is also acknowledged that some of the poor fiscal theme is reflected in current market valuations, specifically the steeply sloped yield curve and the high level of yields on an inflation-adjusted basis. The challenge remains to find the optimal balance between managing potential capital 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.

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%	2.0%
SA GDP	1.2%	1.5%	0.1%	-6.4%	4.9%	2.0%	1.5%	2.3%
SA Headline CPI	5.3%	4.6%	4.1%	3.3%	4.5%	6.9%	5.6%	4.6%
SA Current Account (% of GDP)	-2.4%	-3.0%	-2.6%	2.0%	3.7%	-0.5%	-2.1%	-2.5%

Source: Old Mutual Investment Group