FUTUREGROWTH ECONOMIC & BOND MARKET REVIEW

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BOND MARKET COMMENTARY: MAY 2023

Our Investment Theme Keeps Darkening

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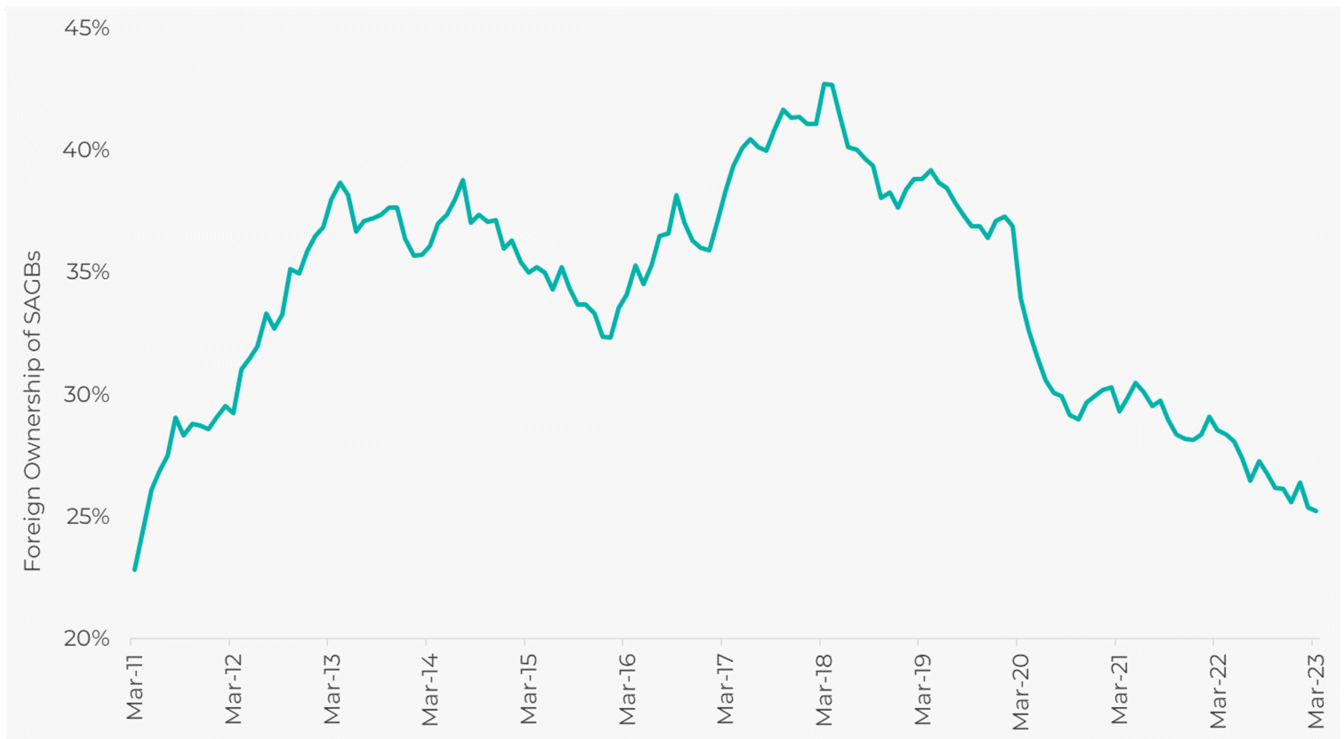
Investor sentiment dips to new lows

Intensified loadshedding has been ongoing for several months. While this arduous experience has become part of the average South African's daily routine, investor concerns about the negative impact on economic growth prospects and inflation continued to increase over the period. Amongst foreign investors in particular, the disturbing possibility of a grid collapse and its devastating consequences finally proved too much to stomach. This was evident in an accelerated reduction of exposure to South African financial assets, including government bonds. Foreign shareholding of SA government bonds has now reached the lowest levels in more than twelve years.

Not only did net foreign selling impact bond valuation directly as sellers outnumbered willing buyers, but bond yields across the yield curve moved in tandem with the weakening rand as it reached a new weakest level of R19.86 against the US-dollar. Even more concerning from an inflation point of view is the broad-based weakening of the local currency against a trade-weighted basket of currencies. Diplomatic own-goals like the alleged supply of weapons to Russia and the potential fall-out from an international trade perspective reduced confidence further.

While unsettling offshore developments such as the US debt ceiling soap opera and sustained policy tightening by some of the developed world's major central banks added to general risk aversion, the core driver of local discontent remained the impact of the developments described above on an already fragile fiscal situation. Please see here for our detailed view on the devastating impact that loadshedding has on an already fragile South African fiscal position and bond market pricing.

Figure 1: Foreign investor shareholding of SA government bonds continues to trend lower



Source: National Treasury, Futuregrowth

The South African Reserve Bank (SARB) keeps a firm foot on the tightening pedal

The combination of sticky inflation at elevated levels (specifically relative to the official target band, growing unease about rising and sustained costs associated with intensified loadshedding) and the latest bout of significant rand depreciation convinced all five members of the SARB Monetary Policy Committee to vote for a 50 basis points (bps) repo rate increase at the May meeting. The latest increase took the repo rate to 8.25%, the highest since 2009. This increase, in combination with the deceleration of the rate of inflation to 6.8% from 7.0% the previous month, allowed the real repo rate to shift further into positive and thus restrictive territory. The repo rate is now well past the 7% peak we predicted earlier this year.

Figure 2: The South African inflation-adjusted repo rate crept further into positive territory and is still expected to rise sharply to pre-COVID levels

Source: Bloomberg, Futuregrowth

Producer price inflation continues to decelerate from a high base

Understandably, significant focus remains on the speed of consumer price increases. Encouragingly, Headline CPI data for April slowed to 6.8% year-on-year from 7.1% the previous month. While Core CPI disappointed with a marginal acceleration from 5.2% year-on-year in March to 5.3% in April, the latest developments at the producer level continue to support our view of a more prominent disinflation trend in the next few months. The April PPI data release showed that final manufactured goods prices at the producer level had increased at a rate of 8.6% year-on-year from 10.6% the previous month. An even more pronounced price deceleration was recorded for intermediate goods and agriculture, which slowed to 4.6% and 3.7% year-on-year, respectively. The latter represents the lowest rate of increase since mid-2020. While producer food prices at 11.1% for April are still very high, base effects are expected to support the continuation of the recent sharp deceleration in the rate of increase.

Figure 3: The continued slowdown in food price increases at producer level bodes well for consumer inflation

Source: IRESS, Futuregrowth

We have a discouraging start to fiscal year 2023/24

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 by National Treasury. Even though this is still the smallest budget deficit since 2019, upward 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.

The slightly worse than expected end to the 2022/23 fiscal year was followed by a particularly poor start to the new fiscal year. Data for the month of April confirmed our long-held and rising concerns about the knock-on effect of intensifying structural hurdles to economic activity, falling commodity prices and weaker global growth on tax revenue collections, with specific reference to corporate taxes. National Treasury reported a main budget deficit of R67.5 billion for the first month of the new fiscal year, which is significantly larger than the R45 billion for the same month last year. The wider deficit was the result of an 8.8% year-on-year shrinkage in tax revenue receipts, which included a 10.1% decrease in VAT receipts. While one should refrain from drawing longer-term conclusions from one month of data, the exceptionally weak start to the fiscal year is particularly worrying and unfortunately serves as a timely reminder of the risks that weak economic growth pose to domestic fiscal sustainability.

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The external trade account continues to weaken

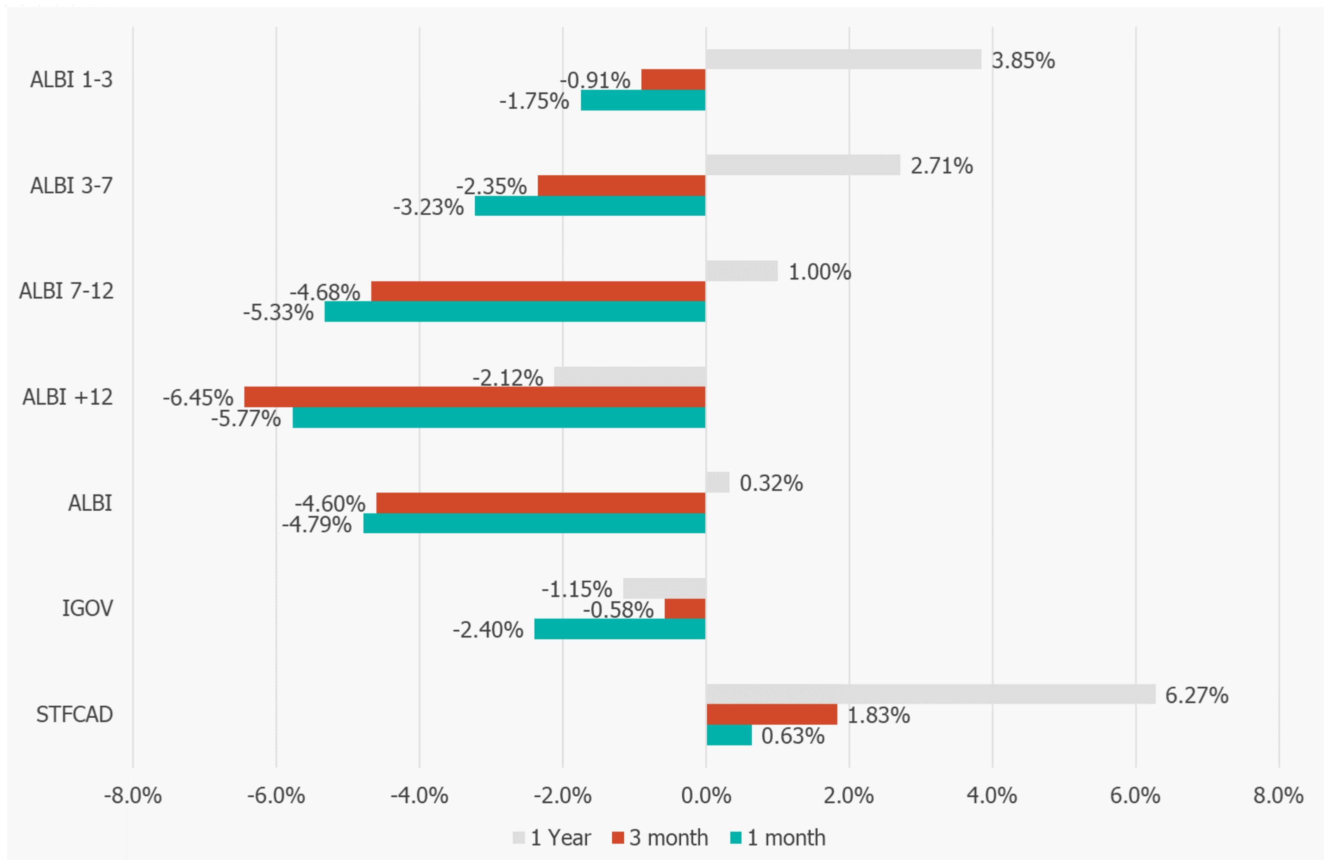
Like most market analysts, we never expected the large surplus on the external trade account that South Africa has enjoyed in recent times (partly due to the fall-out from the Russia/Ukraine conflict that started more than a year ago) to be maintained indefinitely. However, the April data release was the latest data point to confirm the view of a narrowing surplus and thus an overall weaker balance of payments position. The smaller April trade surplus of R3.5 billion, from R6.3 billion the previous month, was partly the result of a sharp drop in merchandise exports, mainly due to lower gold and platinum exports.

While the blow-out in bond yields is abysmal, cash comes to the fore

Higher developed-market bond yields, sustained and significant rand weakness, aggressive monetary policy tightening by the SARB and growing evidence of a very vulnerable fiscal backdrop led to a mini exodus by foreign market participants in both the nominal and inflation-linked bond markets. We sense that the weakness experienced in the past two months is an indication of a confidence loss in the credibility of the South African government. In May, bonds in the 7- to 12- and 12+ maturity bands rendered the weakest returns of 5.33% and 5.77% respectively, as the yield curve bear steepened. The FTSE JSE All Bond Index (ALBI) rendered an overall return of -4.79%, significantly worse than the -1.11% recorded the previous month. The inflation-linked bond market (ILB) did not manage to completely escape the investor flight out of RSA Government bonds, despite sticky consumer inflation data. The negative capital impact of rising real yields more than offset the buffer from a decent inflation carry, causing the FTSE JSE Government Inflation-linked Bond Index (IGOV) to render a return of -2.40%. As a result, cash managed to handsomely outperform both nominal and inflation-linked bonds with a return of 0.63%.

The market weakness since April had been significant enough to drag both the ALBI and IGOV down to levels well below those of cash for the first five months of this year. The former returned a dismal -2.65%, followed by the IGOV return of -1.18%. In contrast, cash managed to return 2.95%. While yielding a significant positive return relative to both nominal and inflation-linked bonds, the return offered by cash still lagged consumer inflation over the period.

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



Source: IRESS, Futuregrowth

THE TAKEOUT: While the rate of inflation (both at consumer and producer levels) slowly subsided, investors turned their focus to the devastating impact of power infrastructure decay on South African economic growth, price pressures, the weakening balance of payments and the impact on an increasingly vulnerable fiscal situation. Apart from the continued weakening of the structural backdrop, at least in part due to poor macroeconomic management, the political fall-out from the South African/Russian romance also contributed to a sharply weakening currency. Concern about the impact of sustained intensified loadshedding on costs and a sharply weaker rand forced the SARB to increase the repo rate by another 50bps to 8.25%. While the US deficit ceiling saga played a role, sharply worsened investor appetite for all South African financial assets caused a significant jump in both nominal and inflation-linked bond yields. As a result, the ALBI returned a disappointing -4.79% in April, followed by the -2.40% rendered by the IGOV.

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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 2.0% next year. The risk to these estimates is on the downside. While earlier stubborn inflationary pressure is generally showing signs of easing, developed market central banks are generally 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. Our latest domestic 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 primarily due to 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 arising from efforts 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 have rolled 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 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 of the current bout of intensified loadshedding on industry, and, particularly, the agricultural sector, which 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. 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.

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 balance: 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 slightly 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 offer the best risk-adjusted return profile across the nominal bond curve. 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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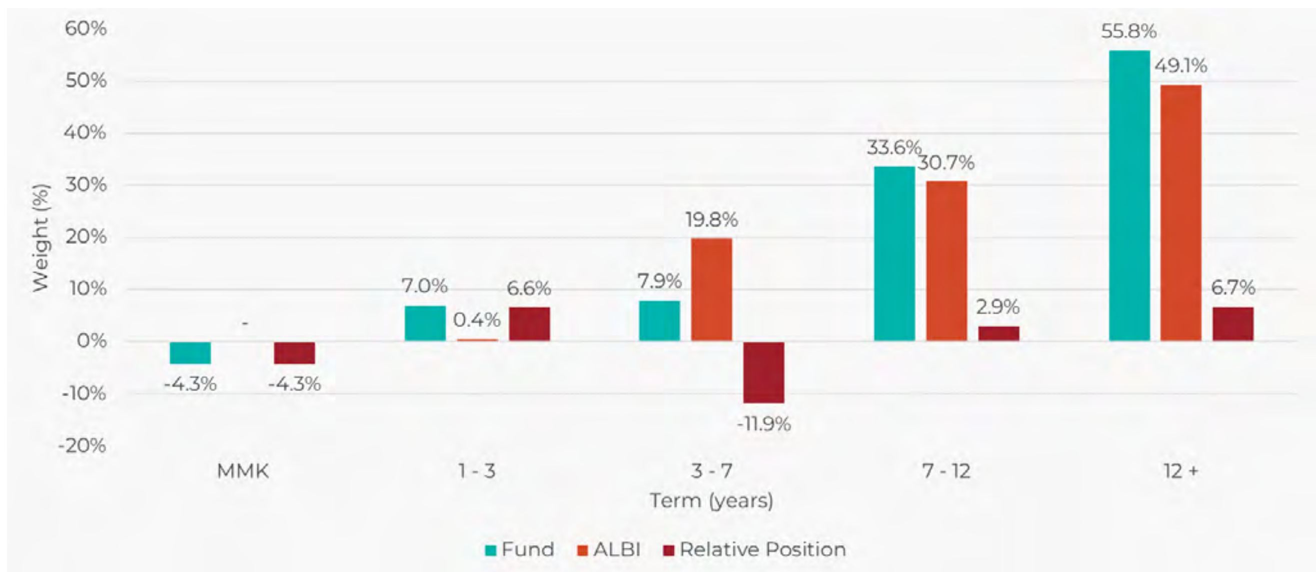
In the case of our Listed Yield Enhanced Bond Composite, our view is expressed as follows:

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%	2.0%
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

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