FUTUREGROWTH
/ ASSET MANAGEMENT

Economic and bond market review

September 2020

Contents

Page 3
Throwing everything at getting out of the COVID-19 hole
Page 6
The use of Agile Enterprise Architecture to facilitate digital transformation
Page 7
Outlook of macroeconomic themes
Page 9
Our investment view and strategy
Inside back cover
The Futuregrowth story

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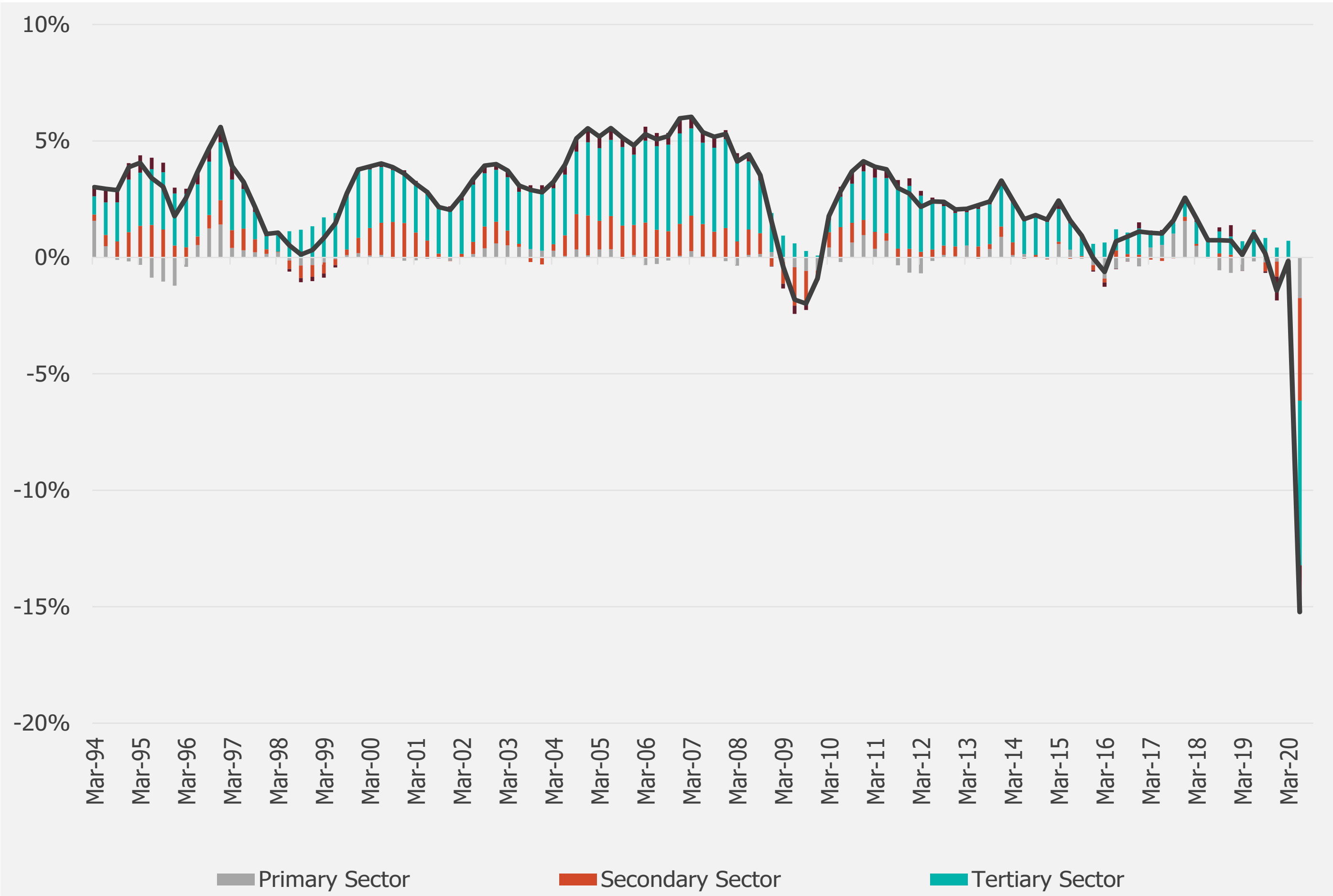
Throwing everything at getting out of the COVID-19 hole

Globally, most central banks are still pulling out all the stops
The global economic and financial crisis has forced central banks to remain on the back foot. In the case of the most recent monetary policy meetings, two developments deserve mention. In the United Kingdom, the Bank of England noted that it would begin formal talks with private sector financial institutions on the operational challenges regarding negative rates. On the other side of the Atlantic Ocean, the Federal Reserve, in stating its usual forward guidance, indicated that it would leave interest rates near zero for the foreseeable future. It also tweaked the reference to inflation by adding that this would be allowed to moderately exceed a rate of 2% for some time, in order to anchor inflation expectations at the 2% target. While both central banks left their policy rates unchanged, the respective messages about negative rates and reflation are worth flagging. These served to underline the strong intention to maintain an unprecedented accommodative monetary policy stance for as long as it takes to help engineer a more sustainable economic recovery.

The South African central bank adopted a more cautious stance
Back home, the South African Reserve Bank (SARB) opted to keep the repo rate unchanged at 3.50% at the September Monetary Policy Committee (MPC) meeting. The more conservative approach of the SARB is demonstrated by the fact that its own growth and inflation forecasts have been revised lower since the July MPC meeting when it cut the repo rate by 25 basis points. Moreover, a sharp drop in inflation expectations in the third quarter to a new 15-year low, including that of organised labour, points to inflation expectations being anchored lower. In another development, the Bank opted to halt its purchases of government securities in the secondary market in response to improved market conditions. This confirmed the clear intention not to use its balance sheet to assist, in a stealth manner, with the funding of the national budget deficit.

Figure 1: Impact of CV19-induced national lockdown worse than expected (SA Gross Domestic Product: year-on-year change)



Source: StatsSA, Futuregrowth

Confirmation of the economic carnage caused by the CV19-induced national lockdown

The release of Gross Domestic Production data for the second quarter of this year undoubtedly stole the limelight. The national lockdown was the main cause of the broad-based 15.2% (year-on-year) collapse in economic activity which, in turn, had a ripple effect elsewhere, including a large negative impact on tax revenue collection by the state. On the other side, the exceptionally weak economic growth backdrop lends a helping hand to a muted inflationary environment. While the July year-on-year rate of increase for both the Consumer and Producer Price Indices accelerated for the first time since the end of 2019, detailed analysis still points to very muted underlying inflationary pressure. In the case of the Consumer Price Index (CPI), the year-on-year rate of increase accelerated from 2.2% in June to 3.2% the next month, before dipping to 3.1% in August.

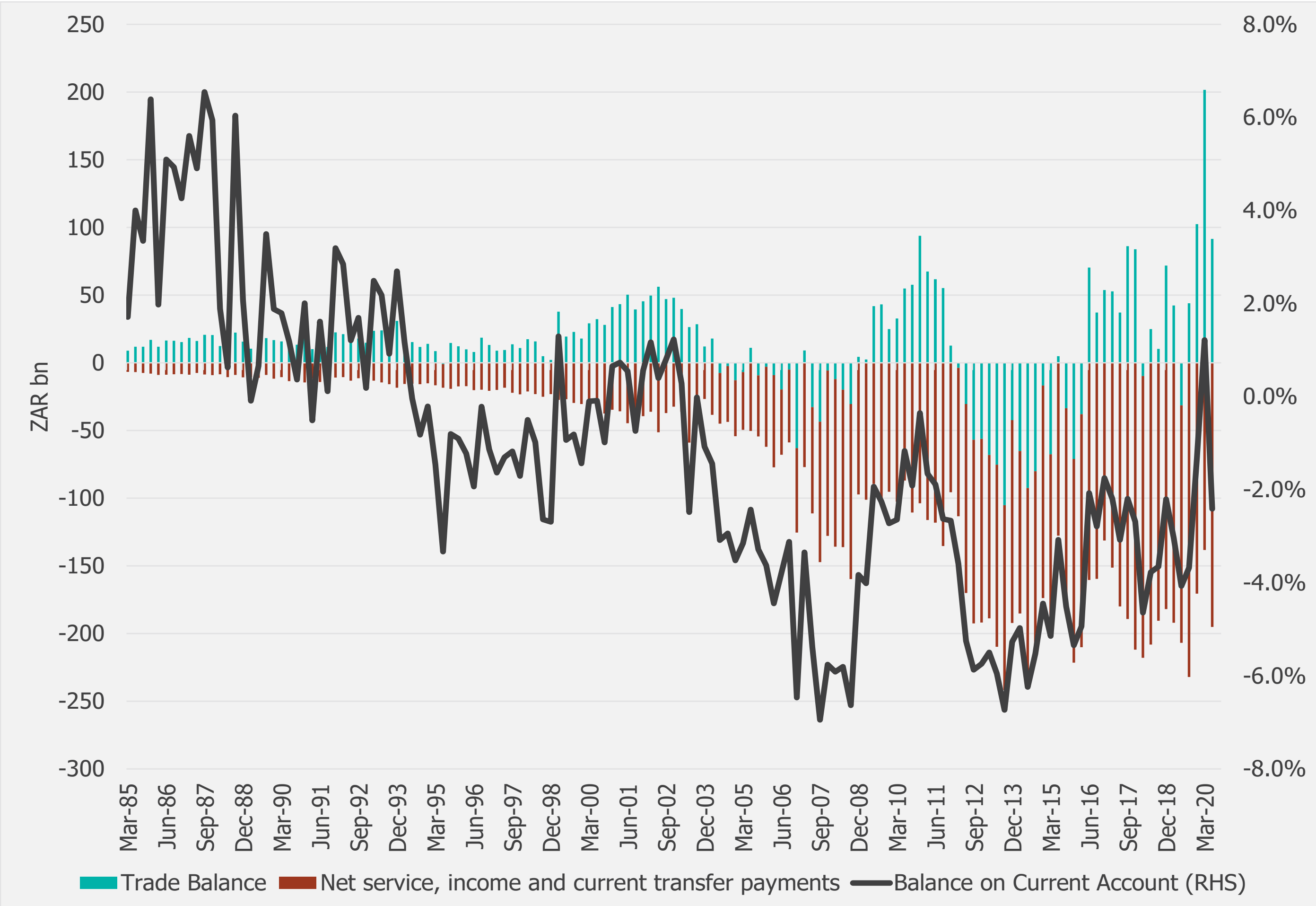
More recent improvement in economic activity points to a rebound, but South Africa is not out of the woods yet

Indicators such as electricity demand, new vehicle sales and manufacturing activity all rebounded from the collapsed levels in April. Even though this is welcome news, the sustainability of the rebound remains questionable. One indicator calling for caution is the continued sharp slowdown in underlying corporate and household credit extension, a clear signal that both sectors are under significant duress, while lenders have also become more risk averse. In the case of private sector credit extension growth, the year-on-year rate of increase continued to slow, with the August data down to 3.9%, dropping for the fifth consecutive month, after having peaked at 7.7% in March this year. Household credit extension remained particularly lacklustre at 3.0%.

Another large merchandise trade surplus

Data for the three months ending August showed impressive surpluses of R47- , R37- and R39- billion respectively. While imports rebounded in August by 7% month-on-month, this increase was coupled with an improvement in exports of 6.6%. In light of this, the continued strong performance of some of the export categories is particularly pleasing. This development continues to bode well for a current account surplus for this and next year and might, in combination with a weaker US-dollar, lend some support to the currency.

Figure 2: Current account position relapsed into negative territory in Q2 but the outlook for the remainder of 2020 looks more promising

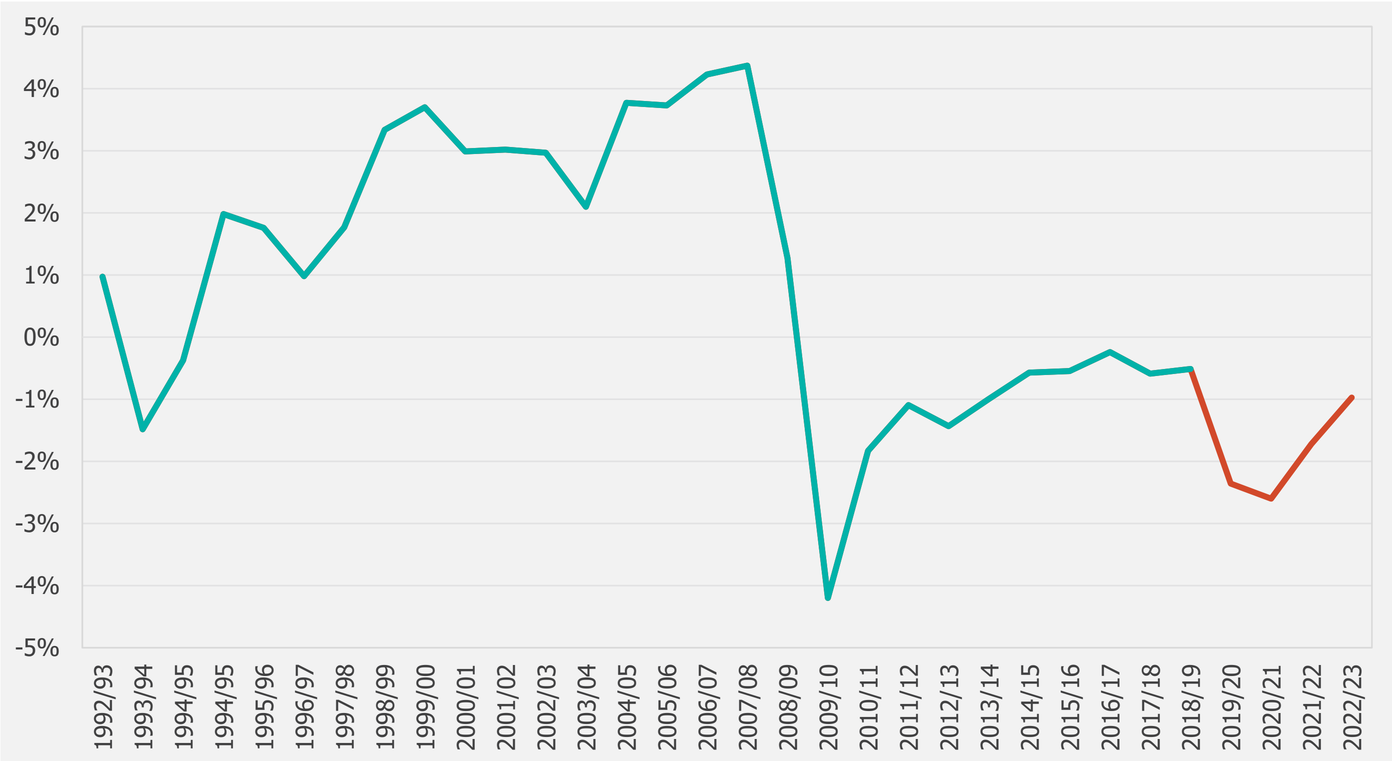


Source: South African Reserve Bank, Futuregrowth

Latest fiscal data release confirms the fiscal slide

July and August fiscal data continued to confirm the impact of the anaemic economic environment. Revenue collections remain in the red, with a cumulative year-on-year collapse of 20% in August continuing to reflect the dire economic consequences of the COVID-19-induced crisis. On the expenditure side, initial slow spending started to pick up in the third quarter with the relaxation of lockdown restrictions, with August year-on-year growth coming in higher than the budgeted growth of 7%, at 10%. Overall, fiscal data thus far suggests that the risks to debt sustainability remain elevated, highlighting the urgent need for significant expenditure cuts and structural reforms.

Figure 3: A primary deficit is an unsustainable situation (Consolidated national budget balance excluding interest payments on outstanding debt)



Source: National Treasury, Futuregrowth

A marginally better quarter for the South African government bond market

Although foreign net selling of rand-denominated government bonds reached R74 billion for the first nine months of this year, the pace of foreign selling slowed during the third quarter. This, combined with stronger local investor demand in response to more attractive market levels and steeper yield curve slopes, brought about some stability in both the nominal and inflation-linked bonds markets. On the nominal side, the FTSE JSE All Bond Index (ALBI) rendered a return of 1.45% for the quarter ending September. Better performance since August also helped inflation-linked bonds with a tentative comeback. The FTSE JSE Government Inflation-linked Index (IGOV) managed to eke out a return of 1.00%, marginally beating cash which returned 0.91% over this period. Returns for the first nine months of the year show cash still firmly in first position at 3.62%, followed by the ALBI (1.82%) and, in last place, the -1.45% rendered by the IGOV.

Table 1: Bond market returns (periods ending 30 September 2020)

	3 Months	Year-to-date	12 Months
FTSE JSE All Bond Index			
1-3 Years	2.40%	10.13%	11.85%
3-7 Years	4.19%	11.49%	14.45%
7-12 Years	1.09%	3.15%	5.55%
12+	0.25%	-3.81%	-2.58%
Overall Index	1.45%	1.82%	3.58%
FTSE JSE Inflation-linked Government Index	1.00%	-1.45%	-2.41%
STeFI Call Index	0.91%	3.62%	5.28%

THE TAKEOUT: Although inflation is slowly regaining positive momentum, strong disinflationary forces are undoubtedly still at play. Even so, a cautious central bank opted to keep the repo rate unchanged at the last MPC meeting, following a series of unprecedented cuts that left the repo rate at an all-time low of 3.50%. While economic activity appears to be picking up following the devastating impact of the national lockdown in the second quarter, it is still well below pre-lockdown levels. This does not bode well for a fiscal situation that is already the most fragile in many years, and unfortunately supports our scepticism about government's ambitious expenditure reduction plan. The combination of stable monetary policy and an increasingly slippery fiscal path imply an anchored short end, but upside risks to the yields of longer-dated fixed and inflation-linked instruments.

The use of Agile Enterprise Architecture to facilitate digital transformation

We expand on the concept of enterprise architecture, a powerful methodology that can be used to effect organisational change.

VISIT:
www.futuregrowth.co.za/newsroom

AN OVERVIEW: Macroeconomic outlook, market view and investment strategy

Outlook of macroeconomic themes	
Economic growth	The worst fears relating to the impact of COVID-19 on global economic activity have been realised. Economic activity has collapsed across most regions and industries. The speed at which a wide range of direct and indirect monetary and fiscal measures have been announced and applied is commendable. Thus far the impact has been mixed, with strong rebounds in the US housing market, US durable orders, Chinese composite PMI and the Euro Area confidence surveys. Even so, the jury is still out on the sustainability of these recoveries, especially in light of rising concern about a resurgence of COVID-19 cases. Locally, the timing of the COVID-19-induced crisis could not have been worse, as the country is grappling with the consequences of a low-growth trap, largely due to structural weaknesses, namely, macro policy uncertainty, weak policy implementation, low levels of fixed capital investment and a rigid labour market. Unreliable power supply adds to the list of economic growth constraints. As a result, business confidence remains in the doldrums, virtually blocking the path to much-needed new capital formation despite the lowest borrowing rates in decades. **THE TAKEOUT:** Although direct and indirect monetary and fiscal action have been implemented in an effort to offset some of the fallout from the pandemic, we suspect that this will fall short of what is required for a sustainable South African economic recovery. The short-term response has to be accompanied by more sustainable solutions to the many structural hurdles that forced the country into the low growth trap in the first place.
Inflation	Slow-rising global inflation over the past few years has resulted from a combination of firmer total demand, tighter production capacity, higher commodity prices and rising employment costs - brought on primarily by accommodative monetary conditions. However, despite an environment of ultra-accommodative monetary conditions, none of the drivers were strong enough to cause an overshoot of inflation target levels. Considering the current moderation in global economic growth, our base case continues to be for inflation to remain relatively benign in most developed economies. The COVID-19 crisis is likely to further undermine pricing power, at least in the near term. On the other hand, the uncertain extent of the decimation of production capacity and its impact on future supply capacity and pricing power must be considered as a long-term risk to the current strong global disinflationary environment. Locally, the recessionary impact on domestic pricing power has led us to revise our 2020 annual average inflation forecast to 3.1%. This is significantly lower than the average of 4.1% for 2019. More importantly, there is strong evidence that the pass-through of rand weakness to inflation remains exceptionally weak, which in turn is reflective of the inability of producers and retailers to pass price increases on to the end consumer. This is illustrated by the extent of disinflation at the producer level, where the most recent year-on-year rate of inflation printed at 2.4% in August, which, although slightly higher than the 1.9% printed in July, is significantly lower than the 4.6% we saw at the start of the year. This continues to support the view that the near-term acceleration in the rate of inflation is expected to be relatively benign. As with the global backdrop, a significant dislocation of the supply network (due to the recession) holds some risk to inflation in the medium term.

Outlook of macroeconomic themes (continued)

Inflation (continued)	**THE TAKEOUT:** In the short term, inflation is expected to dip below the lower point of the SARB's 3% to 6% range again. On a one-year view, the rate of inflation could revert to levels around 4.5%, mostly due to base effects and not because of underlying inflationary pressure. Even so, it is important to keep an eye on cost pressures, in case supply chains start disintegrating due to sustained subdued economic activity.
Balance of payments	Following the revised current account surplus of 1.2% of GDP in the first quarter, the current account deteriorated into a deficit of 2.4% of GDP in the second quarter. This was driven by a broad-based relapse in all components of the current account, with the biggest decline stemming from the merchandise trade balance almost halving as a percentage of GDP from 3.9% in the first quarter to 2.1% in the second quarter. This was largely a result of lockdown restrictions impacting exports more adversely than imports. Some improvement in the current account is likely in the third quarter, given favourable terms of trade and subdued domestic demand. **THE TAKEOUT:** Small, open emerging markets like South Africa will remain at risk if the global fallout is not arrested. While the earlier oil price collapse and subdued import demand lend some support, the positive contribution will be degraded if the recovery in net exports is not sustained.
Monetary policy	The focus remains on mitigating the impact of the COVID-19-induced collapse in market confidence. Globally, monetary authorities have reached the end of the road in terms of their ability to further reduce interest rates conventionally. We are back to quantitative easing and direct fiscal support until the global infection rate has peaked and economic activity starts accelerating at a reasonable rate. As a matter of fact, some central banks like the Bank of England and the Federal Reserve are diving deeper into the tool chest, looking at negative rates and indicating a higher inflation tolerance. In contrast, the relatively more cautious South African Reserve Bank (SARB) still has some scope, albeit more limited at current levels, to reduce the repo rate in light of the severity of the unfolding recession and, in particular, a very muted inflation outlook. **THE TAKEOUT:** Although the SARB has some scope to make small downward adjustments to the repo rate in coming months, the bulk of monetary policy easing is behind us.
Fiscal policy	With growth assumptions lowered significantly for 2020 on the back of the COVID-19 crisis, South Africa's ailing fiscal position is forecast to worsen quite markedly. This was confirmed with the tabling of the Supplementary Budget in June. While National Treasury based the most recent budget estimates on more realistic macroeconomic assumptions (which thus lent more credibility to the budget) the proposed implementation of reforms and significant expenditure reductions over the next three years carry significant execution risk. It has also become clear that, without significant expenditure cuts and structural reforms, South Africa's fiscal state of affairs could eventually devolve into a full-on fiscal crisis. **THE TAKEOUT:** In the wake of the current economic crisis, it seems unlikely that government will be able to cut current expenditure and thus deliver in a meaningful way on ambitious stated intentions. We therefore anticipate even further fiscal slippage in the medium term.

Our investment view and strategy

Central banks, fiscal authorities and multi-national organisations across the globe have announced a number of measures in a desperate effort to at least partly offset the negative impact of the COVID-19 pandemic on economic activity. Some of this is paying off, with leading indicators showing evidence of a sharp pick up of economic activity from a very low base in a number of important economic regions. However, since the outcome of the pandemic is still uncertain, especially concerning a second wave, we have no way of knowing if this will be sufficient to stem the tide.

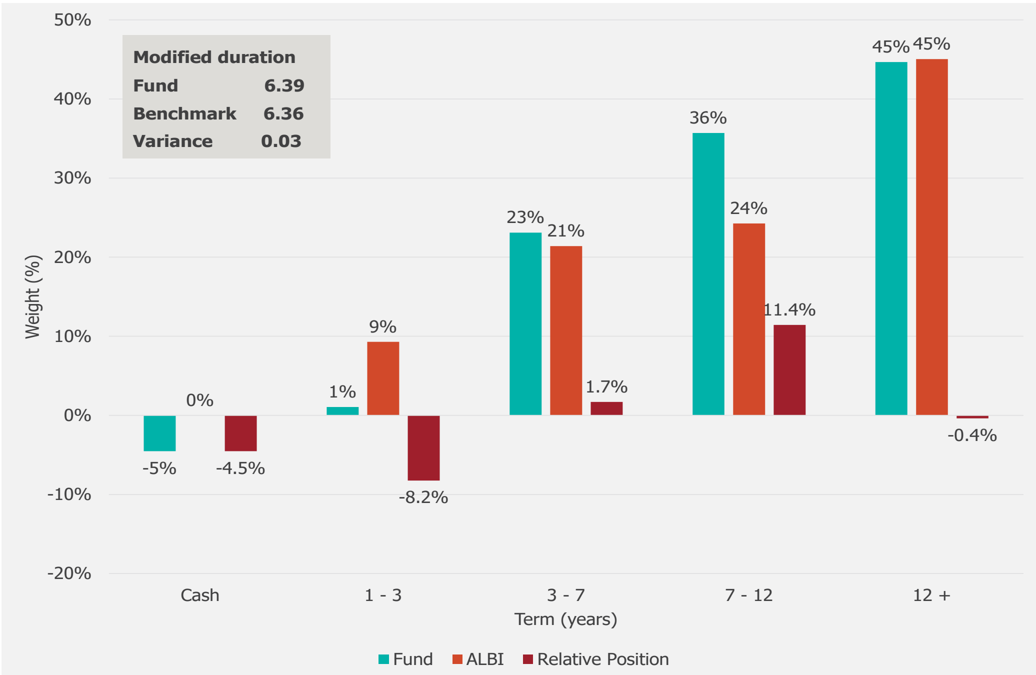
Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth, further hampered by the fall-out from the pandemic, and the weakest fiscal position in decades. The fast-rising debt burden of the state threatens the country's sovereign risk profile and places pressure on domestic funding costs. This will continue to keep the yields of long-dated bonds elevated, especially relative to cash and short-dated rates. Under current conditions, and in response to the unfolding crisis, the central bank is still in a position to marginally reduce the repo rate. Factors such as the slow economic recovery, a benign inflation path and low global interest rates remain supportive of limited monetary easing.

The above conditions continue to favour yield curve steepening, with the front end moving lower or at worst staying anchored, while the back end will remain hostage to a fast-deteriorating fiscal situation. However, with the yield curve slope already quite steep, the challenge from a portfolio positioning perspective, remains in finding a better balance between managing potential capital loss and benefitting from holding higher-yielding longer-dated bonds that offer an attractive carry or base accrual relative to cash and short-term instruments. With this in mind, we avoid holding cash, in light of its low return potential. We've also tempered our holding of ultra-long-dated nominal bonds, with the risk of sustained fiscal slippage in mind. We therefore continue to believe that the best risk-adjusted area of the yield curve remains the 10- to 15-year maturity band.

We continue to favour medium-dated nominal bonds over inflation-linked bonds. While we acknowledge that the latter have repriced to levels more reflective of fair value compared to a year ago, this is overshadowed by the combination of a benign inflation outlook, a dire fiscal backdrop and better inflation-adjusted rates offered by medium-dated nominal bonds

INVESTOR TAKEOUT: Our latest investment view supports a steepening yield curve slope. With returns at the short end approaching sub-inflation levels and the dire fiscal position putting ultra-long-dated bonds at risk of capital loss, we still believe that medium-dated nominal bonds offer the best risk-adjusted alternative. These bonds are also better priced than inflation-linked bonds.

In the case of our Core Bond Composite (benchmarked against the ALBI), our view is expressed as follows:



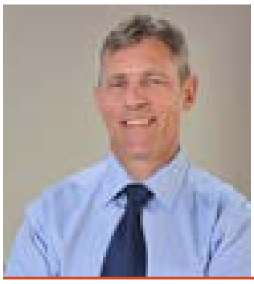
Source: Futuregrowth

Key economic indicators and forecasts (annual averages)

	2016	2017	2018	2019	2020	2021
Global GDP	2.5%	3.4%	3.3%	2.6%	-3.8%	5.0%
SA GDP	0.4%	1.4%	0.8%	0.4%	-8.1%	5.2%
SA Headline CPI	6.3%	5.3%	4.6%	4.1%	3.1%	4.0%
SA Current Account (% of GDP)	-2.9%	-2.5%	-3.5%	-3.2%	1.5%	-1.0%

Source: Old Mutual Investment Group

Produced by the Interest Rate Team



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The Futuregrowth story: Past and future

A vision unfolding

In the wake of South Africa's democratic transition, Futuregrowth was founded in 1994, with a small suite of investment funds focused on social development and empowerment, and with the vision of creating a sustainable channel for pension funds to invest in disadvantaged communities and national development.

Fast forward more than 20 years: Today, Futuregrowth manages around R194 billion (+/- US$14 billion) of clients' assets, across the full range of fixed interest and development funds, and plays a leadership role in the asset management industry in South Africa. During this time we have not wavered from our purpose: to protect and grow investors' savings through skill and diligence, while being a force for good in the markets and environment in which we operate.

This sense of purpose is based on our belief that investors can make a positive difference in society while earning sound investment performance for pension fund members. That has inspired us to pioneer development funds in sectors such as infrastructure, rural and township retail property, agriculture and renewable energy, providing finance to innovative deals including low-income housing construction, a church in Soweto, urban regeneration projects, taxi finance, and alternative energy, to name a few.

As a responsible investor we engage with our industry and investee companies privately, and sometimes publicly, on sustainability issues. As examples: We have been working steadfastly to improve South Africa's debt capital market standards. In 2013, we identified unfair, unsustainable and prejudicial practices within the consumer lending industry. We chose to stop lending to such businesses in our developmental funds and publicly called for industry reform. And in 2016, we announced that we could no longer in good conscience invest pension fund members' assets in certain State Owned Enterprises (SOEs) until we had concluded detailed governance reviews.

The original concept of Futuregrowth is still alive and thriving in the Futuregrowth of today. Even though the company has developed into a successful asset management business, the philosophical belief on which the business was founded back in 1994 is still at the core of everything we do.

AUM as at 31 December 2019

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