FUTUREGROWTH
ASSET MANAGEMENT

Economic and bond market review

November 2020

Contents

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Sliding down the sovereign credit rating scale

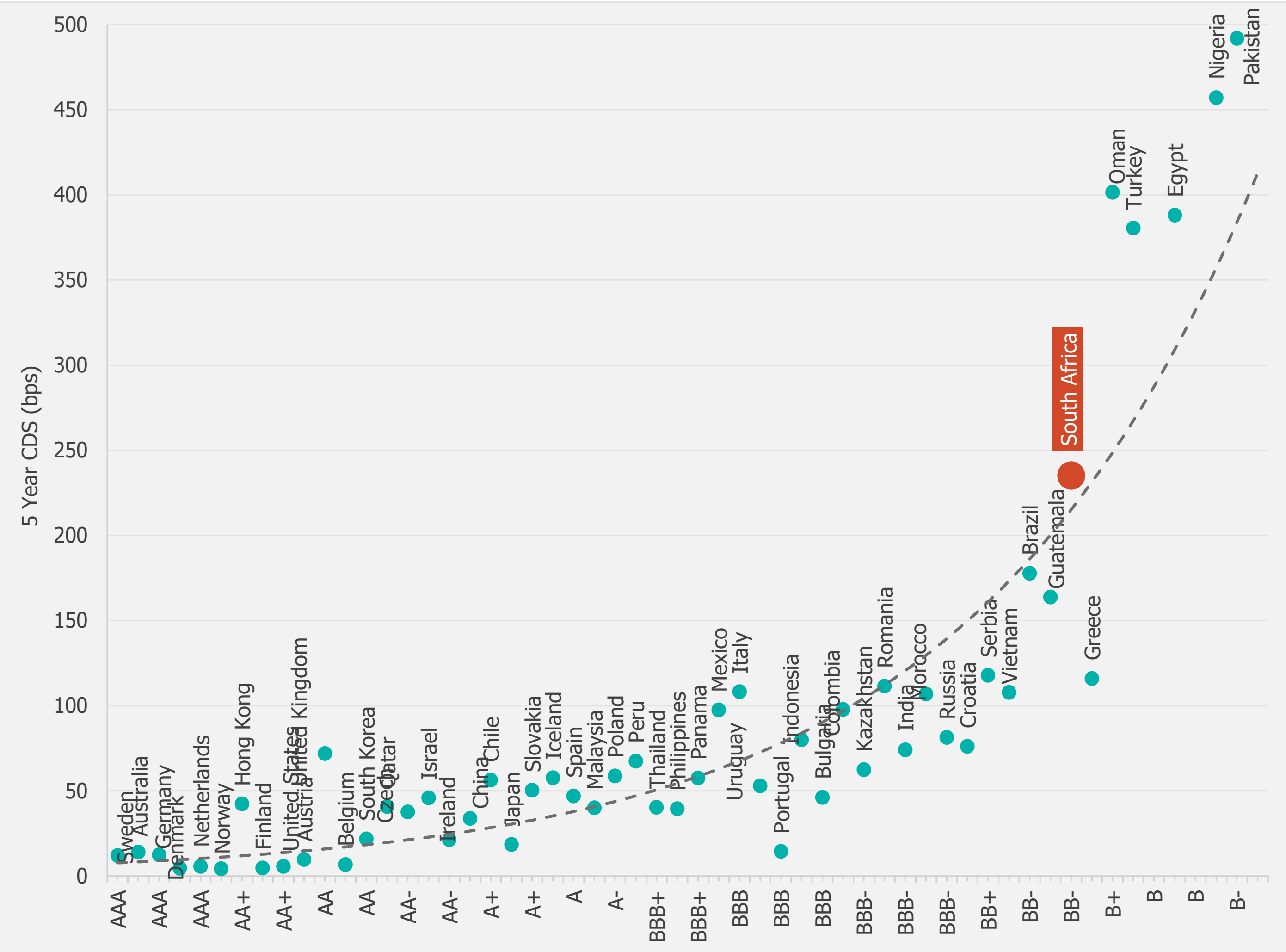
Rating agencies catching-up with reality

On 20 November 2020 Fitch and Moody's rating agencies downgraded the South African sovereign credit rating by one notch to BB- and Ba2 respectively. Both agencies retained a negative outlook. Unsurprisingly, none of the reasons backing the downgrades were newsworthy. Sustained low trend growth, exacerbated by the COVID-19 pandemic, significant implementation risk around fiscal consolidation and structural reform plans, the fast-rising debt burden and more specifically the unaffordability thereof, are all well telegraphed. Rigid labour market conditions - especially in light of plans to reduce the unsustainable size of the public sector wage bill - received specific mention, and for good reason. In contrast, Standard & Poor's (S&P), which had already downgraded the country to BB- in April, opted to affirm its rating, but with a stable outlook.

Rating action had very little, if any, impact on market yields

Even though few market analysts expected actual downgrades by any of the rating agencies in November, the more important matter is that the downgrades are already baked into market pricing. This is demonstrated by basic market valuation indicators, of which the level of credit default swap spreads relative to the S&P sovereign credit rating is but one. As demonstrated by Figure 1 below, the market once again seems to be streets ahead of rating agencies.

Figure 1: Credit Default Swap spreads: Downgrades to BB- are priced in



Source: Bloomberg, Futuregrowth

Renewed bout of risk-seeking by unconstrained foreign bond investors

In contrast to October, when local investors stepped up to the plate, it was up to foreign investors to absorb excess supply during November. The combination of a USA presidential victory for Biden and promising news on a number of COVID-19 vaccines served as catalyst for a broad-based relief rally. The jump in global risk appetite spilled over to the South African bond market as those foreign bond investors who are indifferent to sovereign credit ratings took their cue from the relatively high level of local yields. Net foreign buying of nominal bonds totalled a hefty R13.5 billion during November, which resulted in a decline of the year-to-date net foreign sales figure to -R73 billion.

The central bank again opts to keep the repo rate unchanged

At the November Monetary Policy Committee meeting, the South African Reserve Bank opted to keep the repo rate unchanged, with two of the five committee members voting in favour of a 25 basis points rate cut. Concern about the poor fiscal backdrop once again played a role in the decision to keep monetary policy stimulus unchanged.

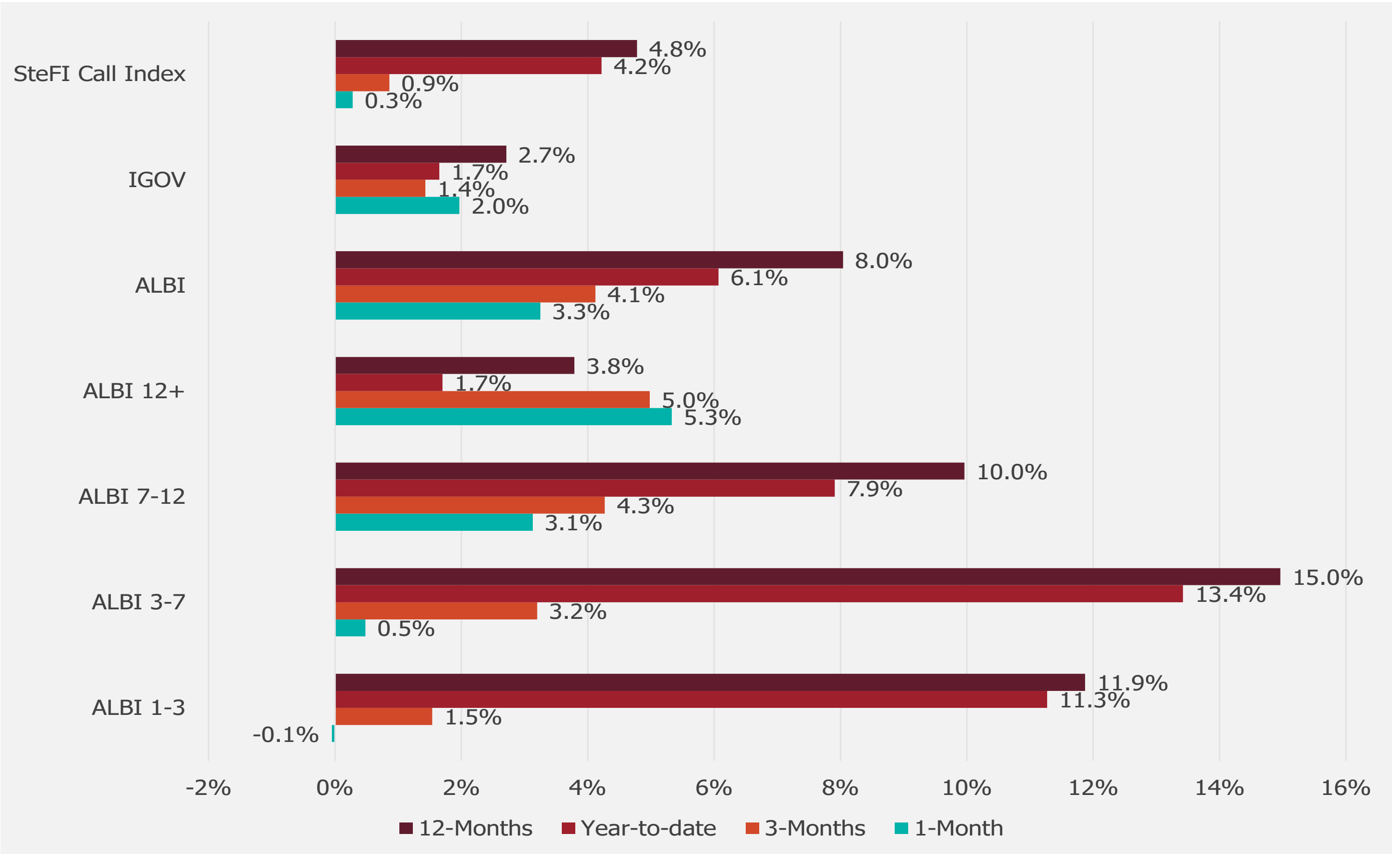
Despite some hefty monthly food price increases, broad inflationary pressure remains remarkably subdued

The Headline Consumer Price Index (CPI) for the month of October showed a slightly higher than expected year-on-year increase of 3.3% from 3.0% in the previous month, mainly due to higher food and non-alcoholic beverage prices. Core CPI edged up to 3.4%. Despite these positive surprises, the fact remains that both these inflation indicators are still well below the official central bank mid-point target of 4.5%, while underlying inflation remains well contained. A similar outcome unfolded at the producer level, where the year-on-year price increase for final manufactured goods accelerated by 2.7% from 2.5% in September, with much of the upward price pressure emanating from food, beverage and tobacco products.

Another strong month for nominal bonds

As a result of strong foreign demand, nominal bond yields decreased, with longer dated bonds gaining most from a capital gain perspective. On the nominal side, the FTSE JSE All Bond Index (ALBI) rendered a strong return of 3.25% for November with the ALBI 12+ year maturity band the star performer with a return of 5.33%, as the yield curve flattened from the back end. Inflation-linked bonds ended the month with a fourth straight month of positive returns. In November, the FTSE JSE Government Inflation-linked Index (IGOV) managed to eke out a return of 1.97%, well below that of the ALBI, but beating cash (0.28%) hands down. For the first eleven months of 2020, the ALBI is in first place with a return of 6.07%, well above the 4.22% return offered by cash. The IGOV remained in last place with a return of 1.65%.

Figure 2: Bond market returns (periods ending 30 November 2020)



Source: JSE, Futuregrowth

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 earlier this year 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 at its most fragile in many years, and unfortunately supports our scepticism about government's ambitious expenditure reduction plan. The recent bout of sovereign rating downgrades simply serves as confirmation. The combination of stable monetary policy and an increasingly slippery fiscal path implies an anchored short end, but upside risks to the yields of longer-dated fixed and inflation-linked instruments.

COVID-19 risks to staff wellbeing are real

Mindfulness practice has helped Futuregrowth staff stay grounded, nurture feelings of connectedness and reduce the risks of isolation during this time. Find out how mindfulness practice can help you.

Visit to read on: **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, the 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 the widespread resurgence of COVID-19 cases and selective lockdowns in many northern hemisphere countries. 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. This in turn is 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 has 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 a 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 sharp 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 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 3.2%. 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 2.7% in October, which 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 to longer term.

Outlook of macroeconomic themes cont.

Inflation cont.	**THE TAKEOUT:** In the short term, inflation is expected to dip below the lower point of the South African Reserve Bank (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. A significant improvement in the current account is expected in the third quarter, given very 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 is lending 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. Focus now should be on when policy will be tightened again. This, in our view, is still a long way off in light of very subdued inflation and economic growth.
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 and the Medium Term Budget Policy Statement in October. 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 carries 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 the government will be able to cut current expenditure as much as hoped for and thus deliver in a meaningful way on its 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 countries. However, since the outcome of the pandemic is still uncertain, especially concerning the occurrence of second and third waves across many countries in the northern hemisphere, we have no way of knowing if this will be sufficient to stem the tide.

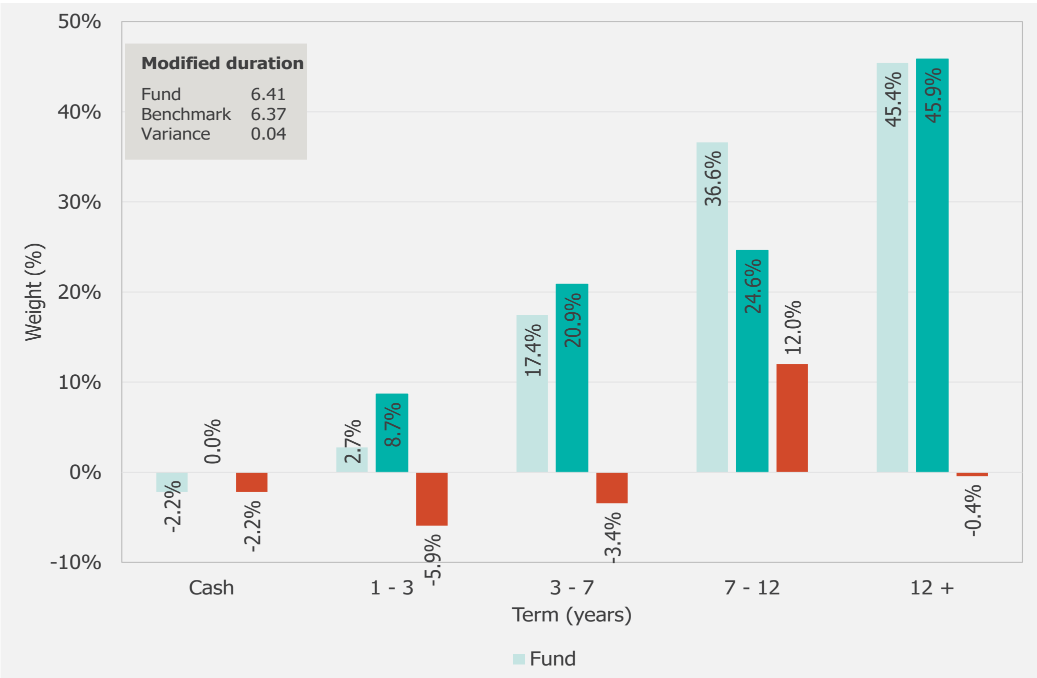
Locally, our main concern regarding the bond market remains the strong link between lacklustre economic growth (further hampered by the fall-out from the pandemic) and the weakest fiscal position in decades. The fast-rising debt burden of the state threatens the country's sovereign risk profile and places 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 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 have 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:



Key economic indicators and forecasts (annual averages)

	2016	2017	2018	2019	2020	2021
Global GDP	2.5%	3.4%	3.3%	2.6%	-3.7%	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%	3.2%	4.0%
SA Current Account (% of GDP)	-2.9%	-2.5%	-3.5%	-3.2%	0.8%	-1.0%

Source: Old Mutual Investment Group

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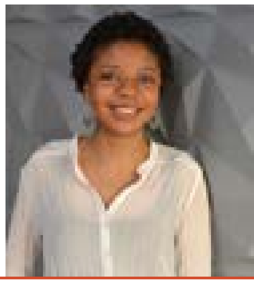

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The Futuregrowth story: Past and future

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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