Bond bears show their face after an extended absence
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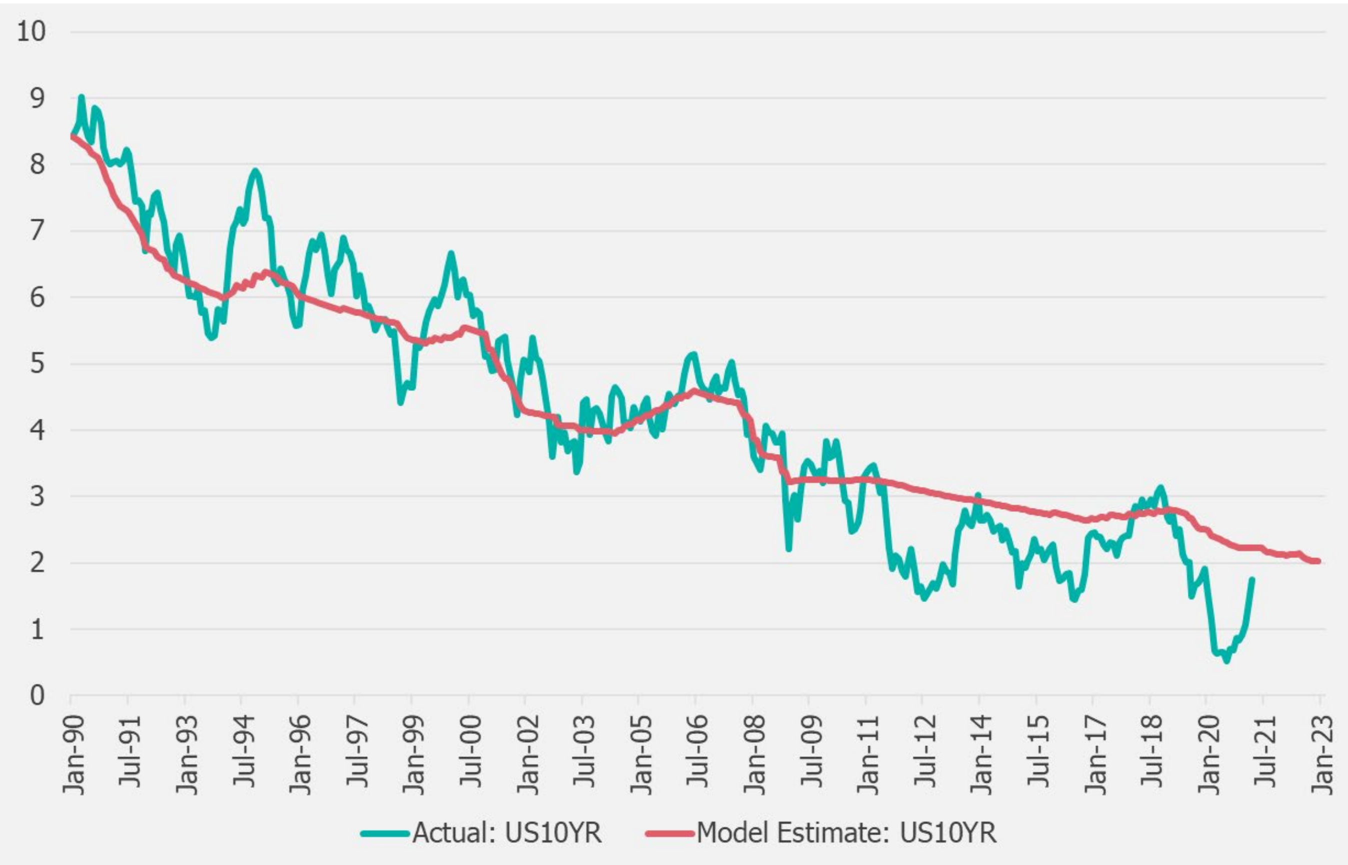
Global bond market meltdown gained momentum

A spectacular meltdown took centre stage during February and March as rising inflation fears and expectations of monetary policy tightening took a firm hold amongst global bond market investors. The combination of improved general economic activity, a lull in COVID-19 infection rates, some progress with vaccination rollout programmes in a number of developed markets, and the approval of a massive US fiscal stimulus package fed growing concerns of higher future inflation and monetary policy tightening. Opinions expressed by the Federal Reserve and several other developed market central banks stressed that sustained elevated levels of inflation (and thus aggressive policy tightening) are not imminent, were drowned out by market noise. The tsunami of sellers caused the US 10-year Treasury yield to reach a high of 1.74% (a notable jump compared to the twelve-month low of 0.5%) dragging the entire global bond market with it in the process. This upward global bond yield correction, specifically in those markets where economic growth is gaining some traction and yields were hovering at unsustainably low levels like the USA, should be anything but a surprise. It could be argued that the US Treasury market correction still has some legs even in the absence of a significant inflation shock or a dramatic rise in official interest rates (Figure 1 refers).

Figure 1: The US Treasury sell-off was long in the making (Market yield versus Futuregrowth fair value estimate)

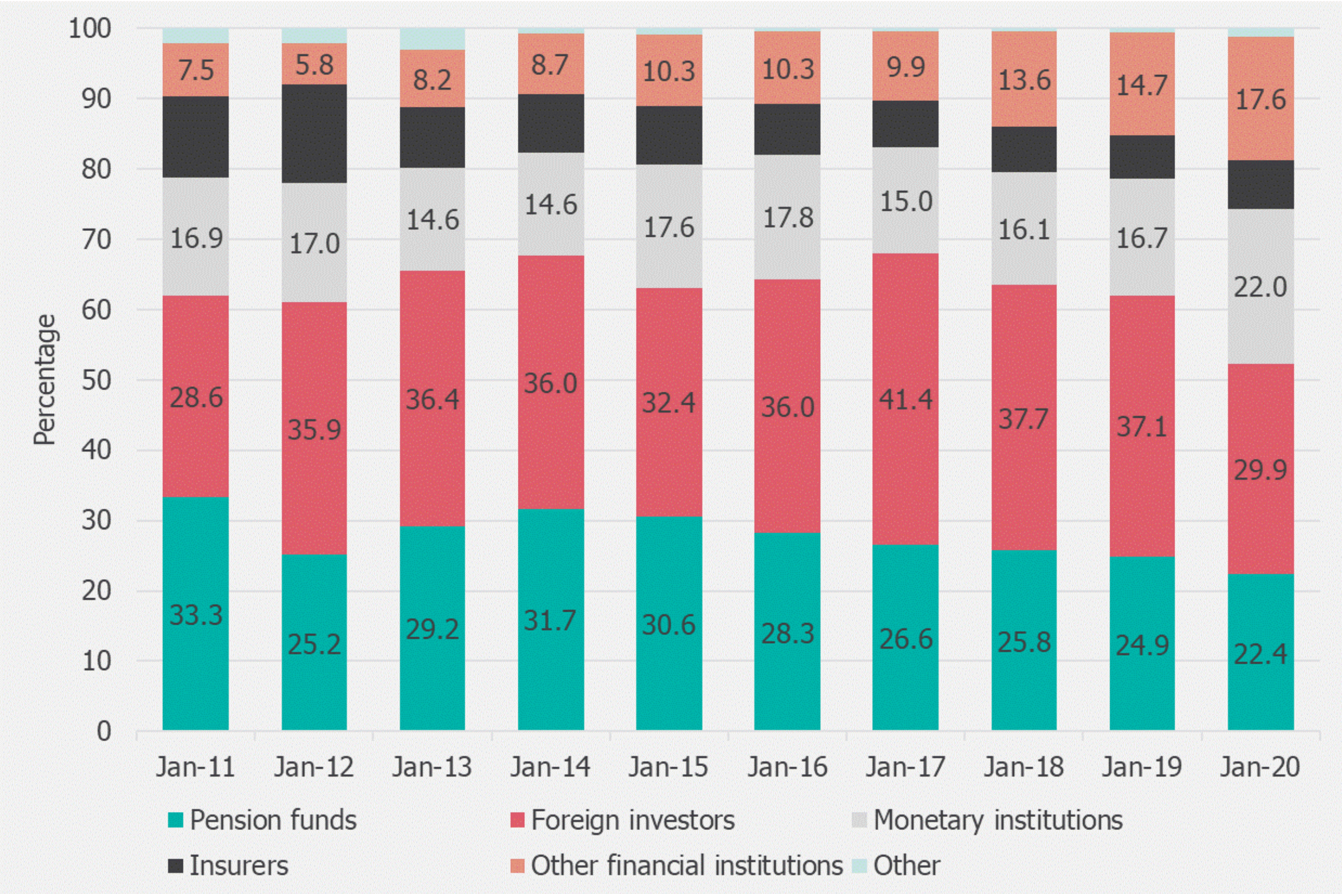


Source: National Treasury, Futuregrowth

Local market succumbed to the global bond sell-off

As is usually the case, the local market did not escape global developments unscathed. Even though the share of foreign investor exposure to South African rand-dominated government bonds dropped sharply after the peak of 41.4% in 2017 to 30.3% in February 2021, they remain the single largest investor group. This carries a significant risk to the local market, which once again was clearly demonstrated during the first quarter of this year. According to JSE trading statistics, indiscriminate foreign selling of rand-denominated government bonds, mainly in response to global events, totalled a whopping R38 billion during the quarter. Moreover, about 85% of total foreign selling was concentrated in the 3- to 10-year maturity band. This had a profound impact on market pricing despite that fact that local investors who, in contrast to foreign participants, were more constructive and accumulated bonds into market weakness.

Figure 2: Shareholding of RSA rand-denominated government bonds



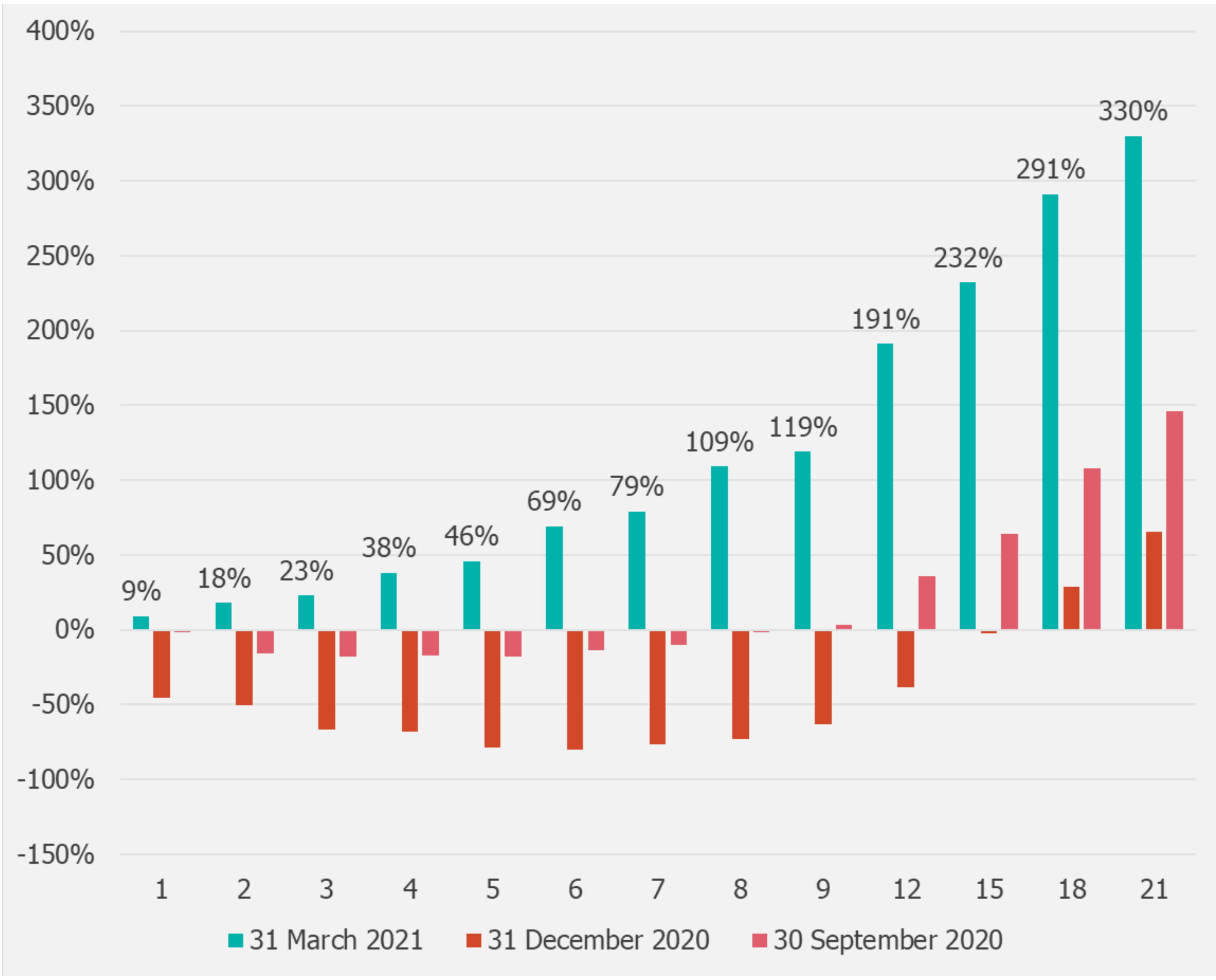
Source: National Treasury, Futuregrowth

Market better priced for local monetary policy tightening

The spill over from the global reflation trade was not limited to the local bond market. Concern about elevated future inflation and its negative implication for monetary policy also found its way into more bearish short-term interest rate pricing. The steep upward slope of the local forward rate agreement (FRA) market curve clearly reflects this. At the time of writing, the FRA market reflected expectations of significant monetary policy tightening by the South African Reserve Bank (SARB) later this year and into 2022. As with the stand-off between monetary authorities and nervous market participants in the US, local investors opted to err on the side of caution by ignoring the consistent dovish message from the South African Reserve Bank (SARB). We also suspect that market participants are putting too much emphasis on global market developments, the potential direct and indirect impact on South Africa, and projections by the SARB's own Quarterly Projection Model (QPM). The QPM projects no fewer than two repo rate hikes of 25 basis points each this year, followed by four more next year and again in 2023. However, it is very important to note that the SARB does not slavishly follow the interest rate path predicted by its QPM and has in fact deviated substantially from it in the past. It merely serves as one of many possible guides; a fact that is conveniently ignored by a jittery market and an issue that should probably be better communicated by the Bank.

In fact, the SARB reiterated its more neutral/dovish stance at the March Monetary Policy Committee (MPC) meeting by unanimously keeping the repo rate unchanged at 3.5%. The relatively benign longer-term inflation outlook, a fragile economic recovery and the rising risk of a third COVID-19 infection wave, convinced the MPC to refrain from prematurely sounding the proverbial hawkish horn. These considerations are expected to offset risks posed by the widely expected year-on-year inflation spike in the second quarter of this year, mainly the result of a low statistical base and the dramatic recent spike in crude oil prices following the spectacular collapse in the same period last year.

Figure 3: Forward Rate Agreement Market (Probability of a 0.5% change in short term interest rates)



Source: National Treasury, Futuregrowth

Economic data releases broadly supportive of stable monetary policy path – for now
Latest actual inflation data continued to point to relatively benign underlying inflationary, specifically with respect to demand-pull forces. In February, both Headline and Core consumer inflation surprised on the downside with year-on-year rates of change of 2.9% and 2.6% respectively. While low to no medical aid insurance price increases represented the lion's share, lower food price inflation and several other consumption items also contributed in a positive way. On the production side, the rate of inflation for final manufactured goods accelerated from 3.5% in January to 4.0% in February. The bulk of this

increase was due to a widely expected lift in fuel prices following the sharp increase in crude oil prices. Encouragingly, like developments at the consumer level, food producer inflation also slowed, in turn pointing to a fading in the upward momentum of food prices, in general. That said, all eyes are now set on the widely expected jump in the rate of inflation in the next few months.

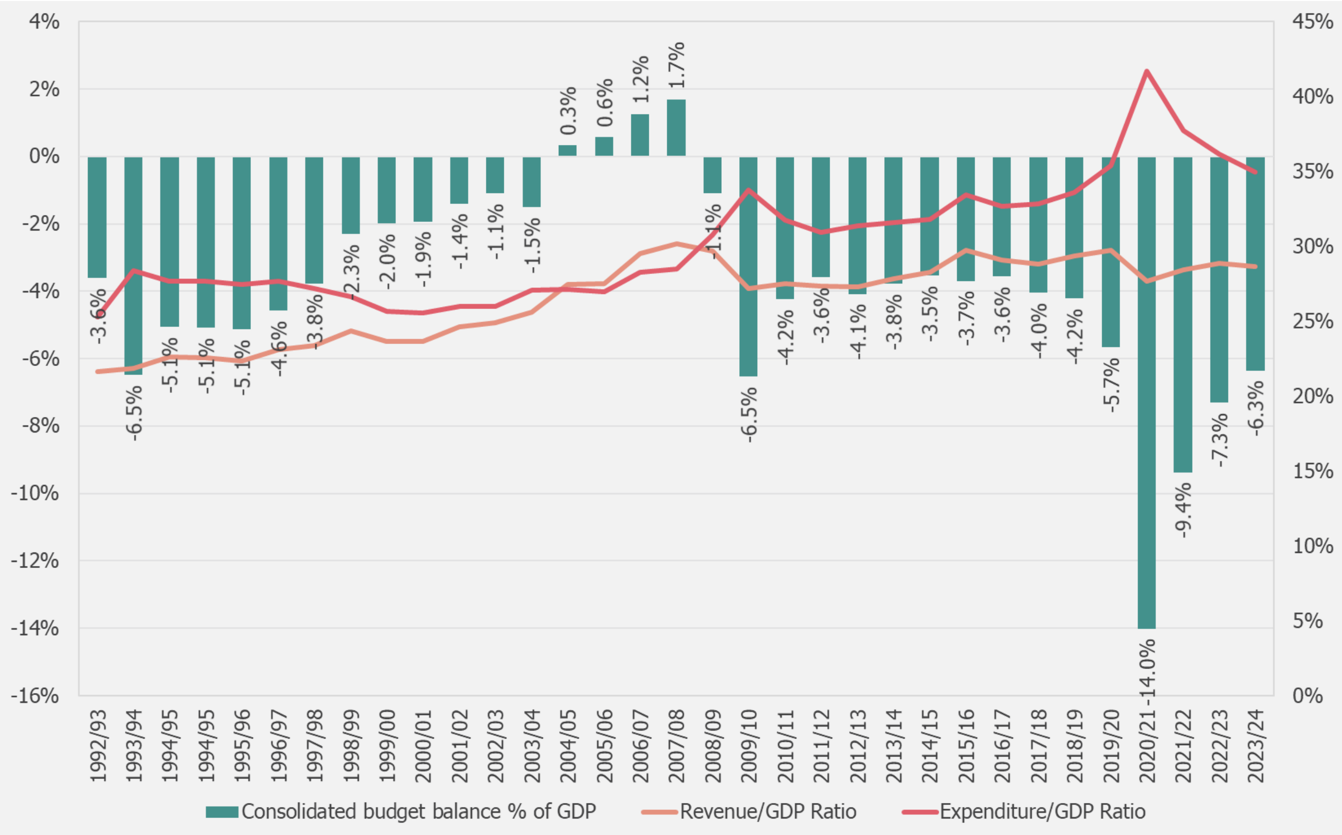
Total private sector credit extension remains weak with a 2.6% year-on-year increase in February, and the total loans and advances sub-component now at 1.7% (from a recent trough of 0.6% in the third quarter of last year). While slowly accelerating, this rate of increase is too weak to feed relative price changes into sustained price increases across the board.

The external account continued to deliver good news, with a large trade surplus for the first two months on this year - the combined result of strong export performance while imports remain relatively subdued. The difference between the pre- and post-pandemic periods is striking. In the first two months of this year compared to last year, goods exports were 14% higher year on year, in contrast to the 1% decline in goods imports. This resulted in a R41 billion trade surplus for the first two months of this year, compared to a R10 billion surplus for the same period last year.

Fiscal authorities strike the right chord, but implementation risk looms large
In his 2021 budget speech, the Minister of Finance confirmed that this administration is serious about its intention to turn the fiscal ship away from the proverbial cliff. The deceleration of debt accumulation by means of higher-than-expected tax revenue collection and focus on expenditure reduction rather than simply raising taxes is encouraging. This improvement, together with its intention to tap into cash balances, enabled National Treasury to announce the reduction in the size of the weekly primary bond auctions with effect 1 April 2021.

However, the planned fiscal consolidation carries significant execution risk, particularly when it comes to the intended reduction of the enormous wage bill. Although the debt to Gross Domestic Product (GDP) ratio is now estimated to peak at a lower level of 88.9% in 2025/26 (vs the medium-term estimate of 95.1%), it is still extremely high and unsustainable for a number of reasons, especially in light of our (and National Treasury's) economic growth outlook. We also remain concerned about the more bullish revenue estimates in the fiscal years beyond 2020/21, given that these are not backed by significantly higher real GDP growth, improved tax buoyancy or any additional tax measures. For more detail on our take on the recently tabled budget please read *Is the ailing fiscal position finally receiving a lifeline?.*

Figure 4: Planned fiscal improvement faces significant execution risk



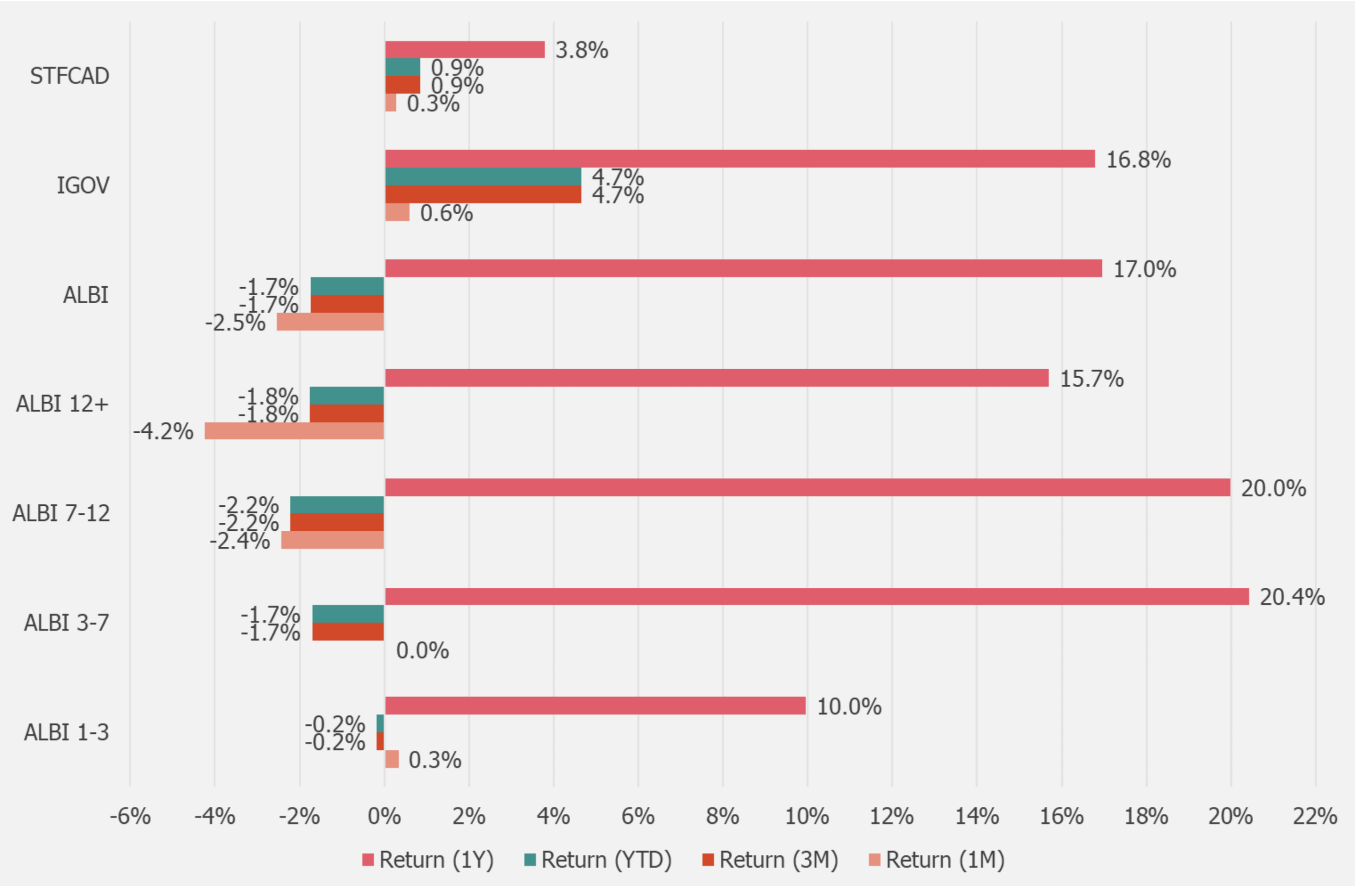
Source: National Treasury, Futuregrowth

Nominal bond returns took a turn for the worse, while inflation-linked bonds put in a star performance

In stark contrast to the previous three quarters, rising bond yields caused a significant underperformance of nominal bonds relative to inflation-linked bonds and even cash. On a net basis, the FTSE JSE All Bond Index (ALBI) rendered a return of -1.74% for the first quarter of this year. The biggest negative contribution was from bonds in the 7- to 12-year maturity band, which returned -2.22%.

Conversely, inflation-linked bonds rallied across the real yield curve, owing to inflation-hedging demand. As a result, the FTSE JSE Government Inflation-linked Index (IGOV) rendered a very strong return of 4.66%. The combination of reasonable valuation and expectations of higher inflation in the near term (which will boost the inflation carry offered by these bonds) served as catalysts for renewed interest in this asset class. This performance was well in excess of the 0.85% rendered by cash during this period.

Figure 5: Bond market returns (periods ending 31 March 2021)



Source: JSE, Futuregrowth

THE TAKEOUT: The sharp increase of yields in some of the major global bond markets (particularly the US) backed by improved economic growth prospects, fears of higher inflation and by implication future monetary policy tightening, turned foreign investors into aggressive net sellers of South African nominal government bonds. This contributed to significant bond market weakness as bond yields across the curve increased. In stark contrast, inflation-linked bond yields traded lower, leading to strong returns for the quarter. Local monetary policy rate expectations, as reflected by the forward rate market, turned even more bearish. This is in stark contrast to a cautious yet neutral policy message from the central bank at its latest MPC meeting in March. On the local fiscal front, government reiterated its intended fiscal consolidation with the tabling of the latest national budget. However, the well-laid-out plan is still fraught with challenges and thus execution risk. As a result, it failed to offset the impact of jittery global sentiment.

AN OVERVIEW: Macroeconomic outlook, market view and investment strategy

Economic growth	The worst fears regarding 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, including the recently announced massive US fiscal stimulus package. While the jury is still out on the strength and sustainability of the economic recovery, most leading indicators point in the right direction - for now. Locally, the timing of the COVID-19-induced crisis could not have been worse, as the country was already 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. While business confidence (evidenced in the BER Business Confidence Index) has recovered from its all-time low at the height of the COVID-19 induced lockdown, it remains below the neutral 50 point mark at 35, signalling a dim path to much-needed new capital formation, despite the lowest borrowing rates in decades. **THE TAKEOUT:** Direct and indirect monetary and fiscal action has been implemented in an effort to offset some of the fallout from the pandemic. Locally, however, this short-term policy response has to be accompanied by more sustainable solutions to the many structural hurdles that forced the country into a low growth trap preceding the COVID-19 crisis for any chance of a secure, sustainable and strong economic recovery.
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 have yet been strong enough to cause an overshoot of inflation target levels. Considering the pandemic-related moderation in global economic growth, our base case continues to be for inflation to remain relatively benign in most developed economies. Locally, the recessionary impact on domestic pricing power was evidenced in the 2020 annual average inflation rate of 3.3%. This is significantly lower than the already sub-target 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. That said, we do anticipate a strong acceleration in the rate of inflation in the second quarter of 2021 to levels around 4.5%, mainly due to strong base effects, especially those linked to the exceptionally sharp fuel price decrease in the second quarter of 2020 followed by the spike a year later. Higher food prices, the recently announced electricity tariff

	increase and the sharp crude oil price increase will add to the short-term spike. On the other hand, the sustained sharp decline in housing rental inflation and very muted services inflation will partly offset some of these relative price changes. On balance, we anticipate that inflation will average 4.1% in 2021. **THE TAKEOUT:** In the short term, inflation is expected to spike to levels around the 4.5% mid-point SARB target, mostly due to base effects. However, beyond the short-term spike, the rate of inflation will remain relatively contained.
Balance of payments	The South African current account surplus narrowed to 3.7% of GDP in the fourth quarter of 2020 from 5.9% in the previous period. The deterioration was mainly driven by a reduction in the income and goods balances and a widening of the income account deficit. We expect the latter to remain a drag on the balance of payments, given the large dividend and interest payments to foreigners. The full-year surplus finalised at 2.2%, a significant upswing from the previous year's deficit of -3.2% of GDP. **THE TAKEOUT:** While South Africa's terms of trade remains relatively favourable, the significant improvement in the last few quarters is not sustainable. The economic recovery expected for the year and the spike in crude oil prices are expected to lead to some resurgence in imports over the course of this year, leaving the country with a smaller current account surplus of around 1% compared to last year's 2.2%.
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. Some central banks like the Bank of England and the Federal Reserve continue to indicate a higher inflation tolerance and a willingness to respond to actual data as opposed to forecasts. Locally, the relatively more cautious South African Reserve Bank (SARB) is expected to retain its current stance, which is in stark contrast to current market expectations of a higher repo rate by year end. We retain our view of an unchanged repo rate until early next year, considering the sustained weak economic conditions and a relatively muted inflation outlook, notwithstanding the expected acceleration in the rate of inflation during the second quarter of 2021. **THE TAKEOUT:** Market focus has shifted to the higher possibility of rising inflation, the economic recovery and consequent monetary policy tightening. This, in our view, is some way off, considering an excessively high unemployment rate and a relatively subdued inflation and weak economic growth outlook. We are therefore in

	strong disagreement with the local forward rate market that is pricing a higher repo rate as early as the third quarter of this year.
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 remain fragile. While National Treasury based the most recent budget estimates on more realistic macroeconomic assumptions than previously (which 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, the South African economy could eventually devolve into a full-on fiscal crisis. While the latest budget estimates and monthly public financing data lifted sentiment somewhat, this is insignificant when considering the size of the primary deficit and the implications for the high level of outstanding debt and risks associated with the future ability to service it. **THE TAKEOUT:** In the wake of subdued and sub-par economic growth, it seems unlikely that the government will be able to cut current expenditure as much as hoped and thus deliver in a meaningful way on its ambitious stated intentions. We therefore remain concerned about execution risk and thus weaker-than-expected consolidation.

Our investment view and strategy

Our main concern about the local bond market remains the strong link between lacklustre economic growth (ignoring the quarter-on-quarter volatility in growth rates) and the weakest fiscal position in decades. Even though government is showing intent to stabilise the pace at which the public sector debt burden is rising, we remain very concerned about execution risk, the level of debt and the threat to the country's sovereign risk profile. The benign economic recovery, an improved balance of payments situation, and ultra-low global interest rates will allow the SARB to stay on hold, despite an expected year-on-year acceleration in the rate of inflation during the second quarter due to well-telegraphed base effects.

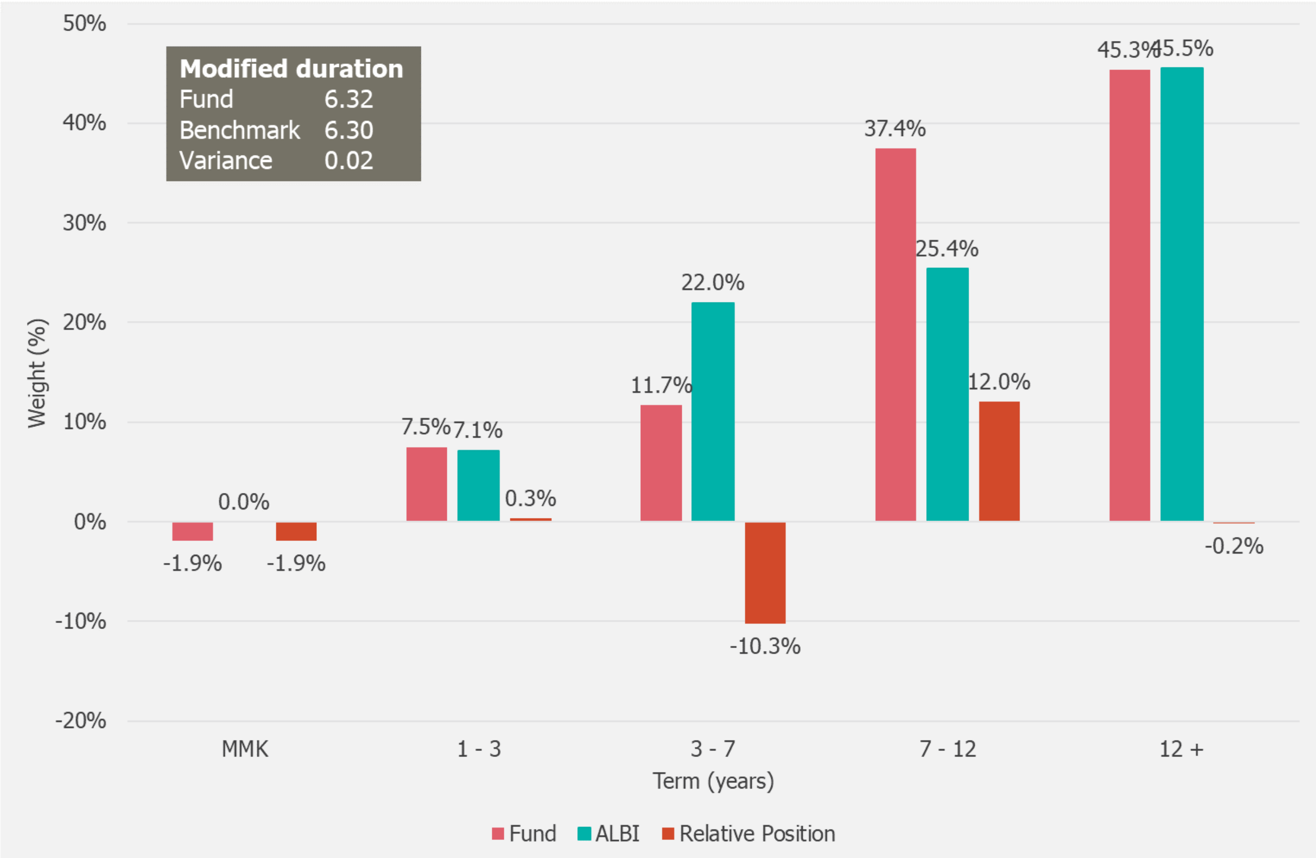
In terms of the yield curve, we continue to favour an anchored front end, while gyrations around global risk sentiment and continued uncertainty around the dire local fiscal situation will potentially contribute to back-end volatility. However, with the positive yield curve slope already quite steep, from a portfolio positioning perspective the challenge remains to find 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. We therefore avoid holding cash in light of its low return potential and our neutral view on monetary policy. We have also tempered our holding of ultra-long-dated nominal bonds, with the risk of sustained fiscal slippage in mind. We still 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, the strong inflation-linked bond rally since the end of 2020 has already diluted prospective future returns. The attractiveness of this asset class relative to nominal bonds is undermined by the combination of a relatively benign inflation outlook - even after considering the expected higher inflation carry in a few months' time, the dire fiscal backdrop, and the better inflation-adjusted yields currently offered by medium-dated nominal bonds.

THE TAKEOUT: Our investment strategy aims to strike a balance between the extraordinarily high roll-down potential and base accrual (carry) on offer, while limiting potential capital loss. The high roll-down potential and carry are a function of the steep yield curve slope, especially at the front end. This in turn is due to the combination of a multi-decade low anchored repo rate, a relatively benign inflation outlook and the weakest fiscal backdrop in recent history. With potential returns at the short end approaching sub-inflation levels and the dire fiscal position putting ultra-long-dated bonds most at risk of capital loss, we believe that medium-dated nominal bonds offer the best risk-adjusted alternative. In our view, these bonds are also better priced than inflation-linked bonds, even considering a higher rate of inflation in the near term.

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

Figure 6: Futuregrowth Listed Yield Enhanced Bond Composite Fund Structure



Source: Futuregrowth

Table 1: Key economic indicators and forecasts (annual averages)

	2016	2017	2018	2019	2020	2021	2022
Global GDP	2.5%	3.4%	3.3%	2.6%	-3.6%	6.6%	4.5%
SA GDP	0.4%	1.4%	0.8%	0.4%	-7.0%	5.0%	2.0%
SA Headline CPI	6.3%	5.3%	4.6%	4.1%	3.3%	4.0%	4.5%
SA Current Account (% of GDP)	-2.9%	-2.5%	-3.5%	-3.2%	2.2%	1.0%	-1.0%

Source: Old Mutual Investment Group

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