Global central bank policy divergence becomes more pronounced
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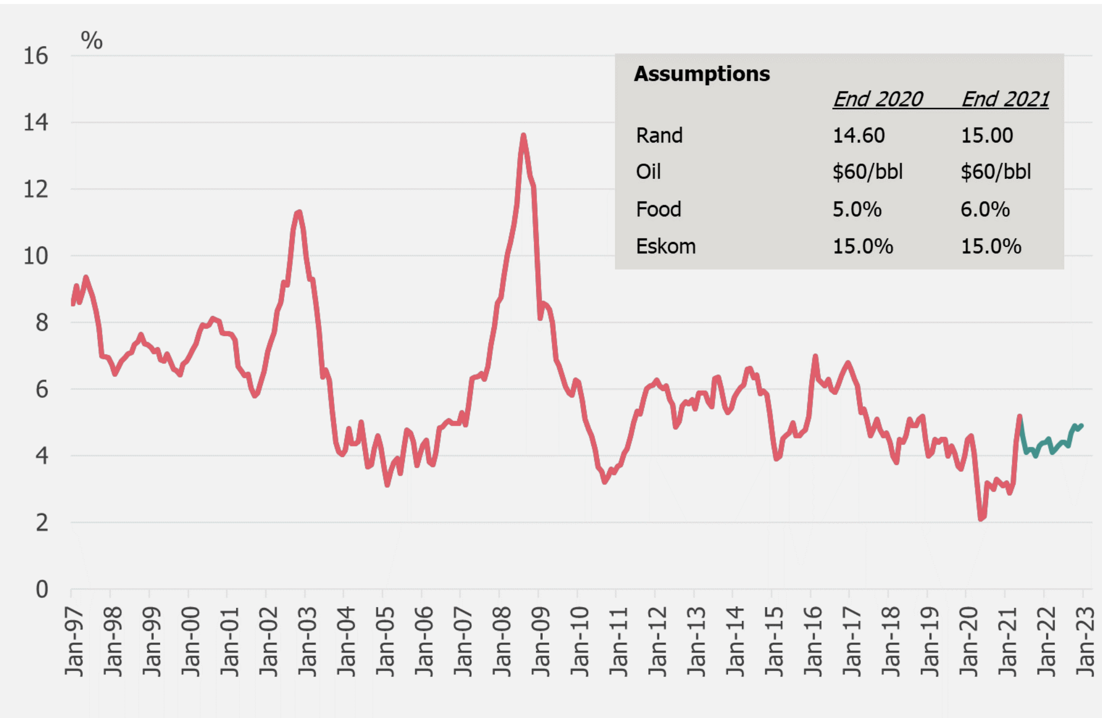
Inflation approached peak territory

Without exception, developed and emerging economies around the globe had to process the significance of inflation spikes over the past few months. In South Africa, the May year-on-year rate of increase for the Headline Consumer Price Index (CPI) and Producer Price Index (PPI) for final manufactured goods surged by 5.2% and 7.4% respectively. In our view, these are the likely peaks in the current inflation cycle. Price increases are still not broad based, with large year-on-year increases limited to individual categories such as “Oils and fats”, “Vehicles” and “Petrol”.

As widely expected, a common denominator across the globe is the influence of base effects one year after a dramatic crude oil price collapse, accentuated by the strong crude oil and general commodity price rebound since then. A similar trend played out in food prices, with pandemic-induced supply-bottleneck price increases added to the mix. While the inflation surge in recent months was well telegraphed and thus widely expected, headline inflation data generally still managed to surprise on the upside. This tested the nerves of investors and central bankers alike. In contrast, measures of core inflation remained relatively well contained in the majority of cases, supporting the view that headline data distortions caused by the pandemic in the past twelve months are most likely transitory. In the case of South-Africa, the transitory view is supported by the small 0.1% month-on-month Headline CPI increase in May.

Figure 1: SA Headline CPI has likely peaked and is expected to stabilise at lower levels in the months ahead



Source: OMIG, Futuregrowth

Economic growth surprised on the upside

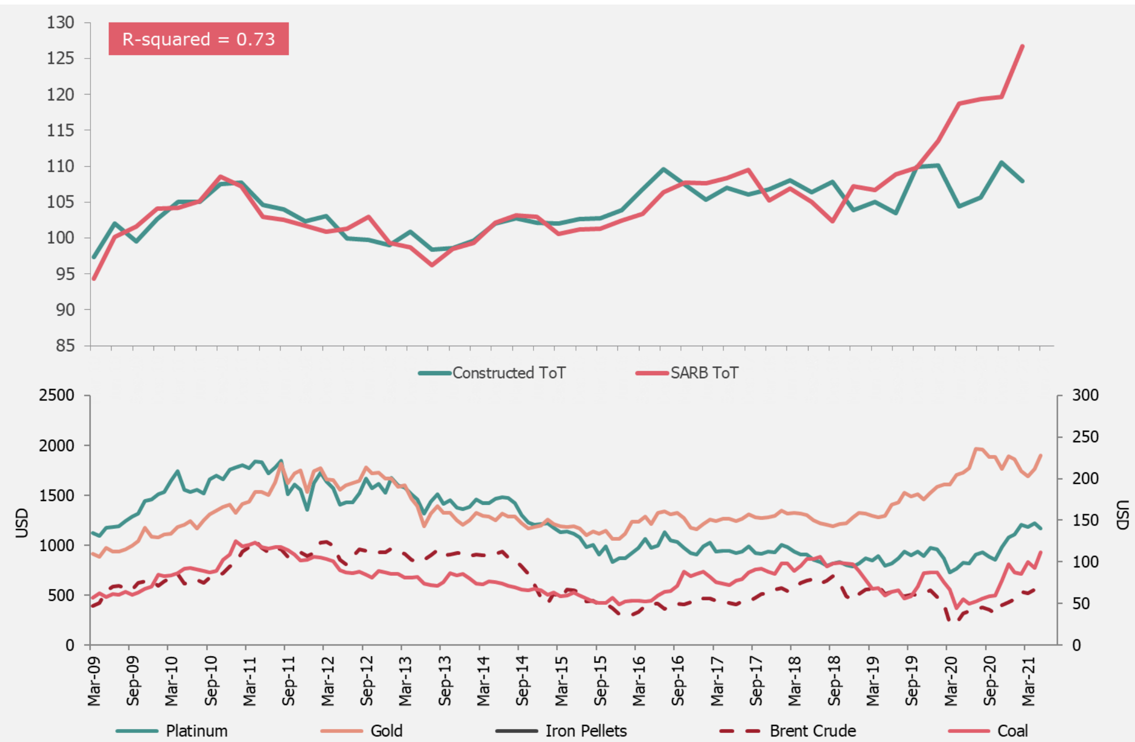
Global economic activity continued to broadly gain traction, even though progress remains uneven across regions. In the case of South Africa, the economy grew at a quarter-on-quarter seasonally-adjusted and annualised rate (SAAR) of 4.6% in the first quarter of this year, beating the consensus estimate of 3.2% by a significant margin. On the production side, the mining sector recorded a mammoth 18.1% growth (quarter-on-quarter, SAAR), reflecting the direct benefit of a strong global commodity cycle on our largely resource-based economy. While the latest data release confirms our expectation for a strong growth rebound this year, the economy still contracted by 3.2% year-on-year following the 2020 pandemic-induced growth collapse. The recent shift to adjusted Level 4 countrywide restrictions in an attempt to control the spread of the surge in COVID-19 cases does pose a risk should it be extended for longer than the anticipated two weeks.

Central banks become increasingly cautious

The improvement in economic activity combined with higher (albeit transitory) inflation brought about a stronger monetary policy response divergence among global central banks. While several central banks have started expressing more caution about the path of future monetary policy measures, some emerging market central banks have actually started hiking policy rates. The most prominent central bank in the world, the US Federal Reserve, indicated that it has officially started talk about the possible near-term tapering of its current USD120 billion monthly bond purchase programme. This is despite its firmly held view that the current inflation surge is merely transitory. A growing number of its Monetary Policy Committee members have also brought forward their rate increase expectations, but with the first hike at earliest still only forecast in 2022.

Locally, the South African Reserve Bank (SARB) repeatedly expressed the view that the recent surge in inflation was widely expected and can be mainly attributed to technical causes. More specifically, the SARB maintains the view that the current surge is not a threat to longer-term inflation stability (especially considering the persistent wide negative output gap) even though it did acknowledge upside risks to the short-term outlook. The announcement of a two-week escalation in lockdown restrictions as COVID-19 infections continued to rise is more than likely to support policy inaction for now.

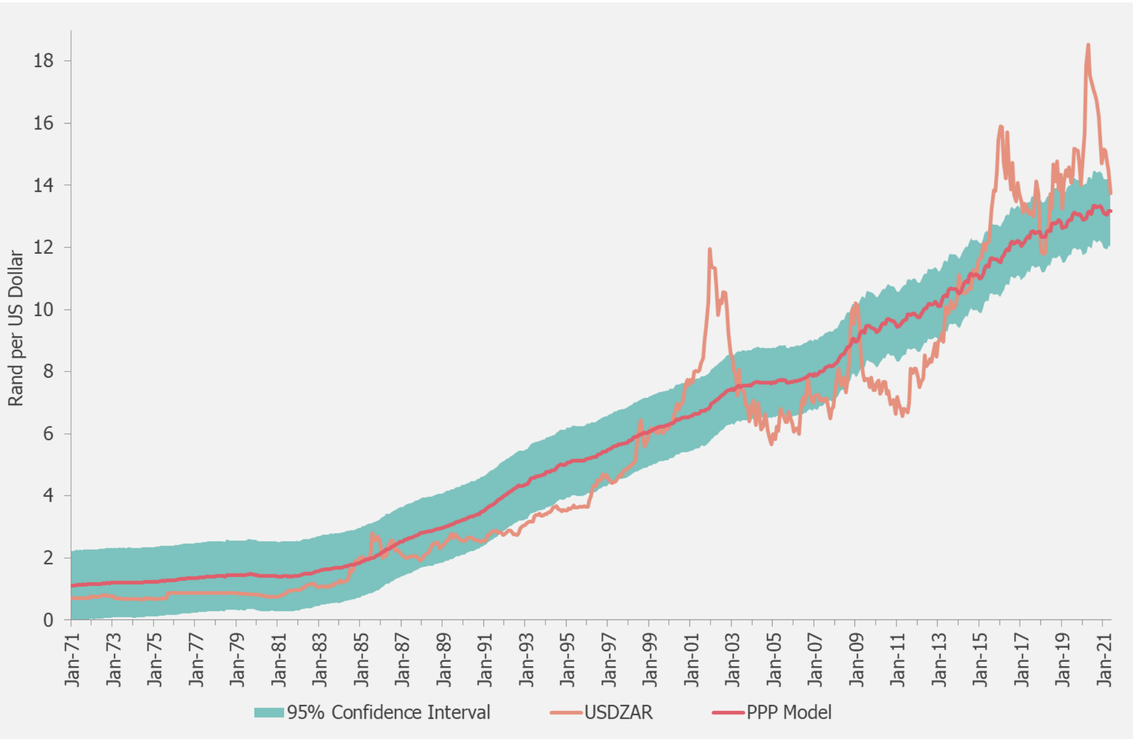
Figure 2: SA terms of trade are still strong, but expected to roll over in the second half of this year



Source: Bloomberg, Futuregrowth

Surging metal prices continue to provide broad based macroeconomic relief
One of the main developments in the past few months has been the positive impact of the strong global commodity cycle on the South African economy. On the external side, a much-improved terms of trade (where the prices of our main exports rose faster than the prices of those imported) bolstered the current account balance to its largest surplus in decades. This contributed to a more resilient currency, allowing the rand to gain more ground in the quarter, admittedly also with some assistance from a weaker US dollar. Moreover, the significant direct impact on economic activity via the very strong mining sector performance continued to bolster tax revenue receipts, which in turn supported fiscal consolidation efforts.

Figure 3: The Rand is better aligned with our estimate of fair value following recent strong appreciation
(USD/ZAR exchange rate versus its estimated purchasing power parity)



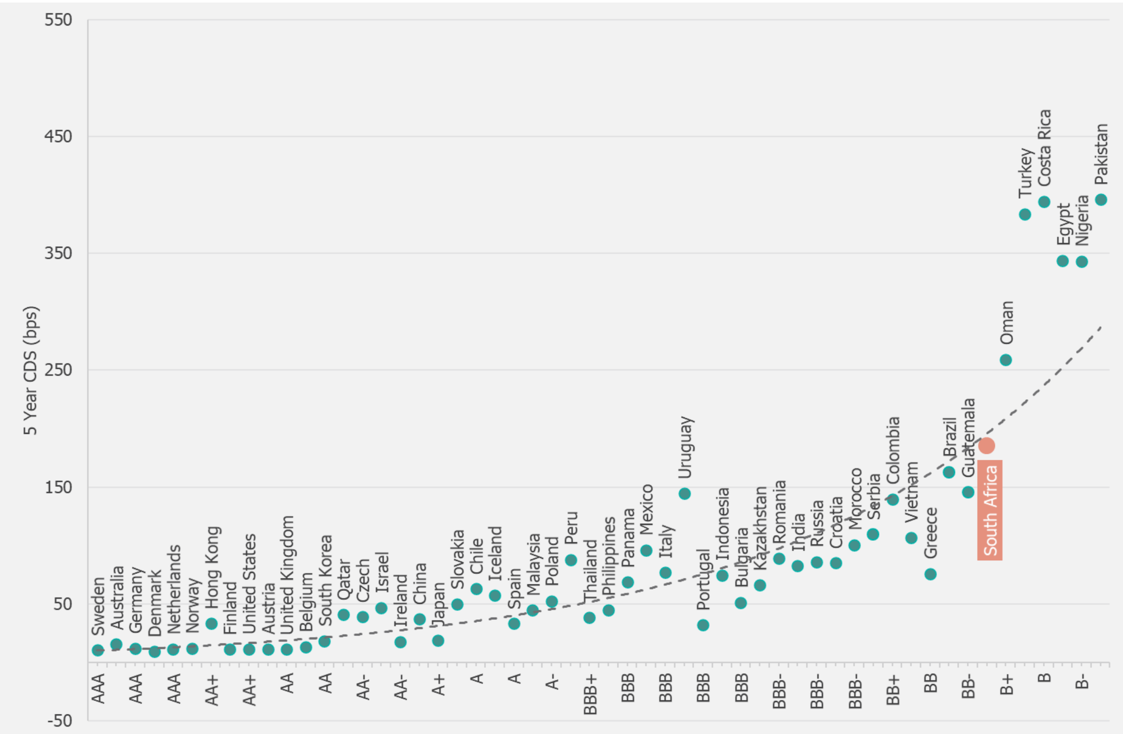
Source: Bloomberg, Futuregrowth

Recent developments may have bought SA Inc some time
In addition to the good news regarding the improvement in economic growth, the balance of payments, and of course the fiscal situation, government came to the proverbial party with long-awaited announcements. In an effort to resolve the persistent dire energy generation dilemma, a significant increase in the independent energy producer limit from 1MW to 100MW was proposed. At a more structural level, more detail regarding the planned unbundling of Eskom and Transnet were announced. The Department of Public Enterprises also announced a possible South African Airways privatisation deal, the details of which were still lacking at the time of writing. Even so, the intention to enhance growth-enabling conditions and address the level of contingency risk to the fiscus is welcomed.

Even so, we are not out of the woods yet
Prior to these announcements, international rating agencies Moody's, Fitch, and Standard & Poor released their latest South African sovereign credit rating reviews. The central message was largely aligned. In summary, the broad-based benefits from higher commodity prices as discussed above contributed to staving off further negative rating action for now. The agencies nonetheless expressed concern about our ability to return to a higher, sustainable economic growth path in light of structural hurdles and to continue on our fiscal consolidation path. Unsurprisingly, execution risk related to the

intention to reduce the size of the bloated public sector wage bill was, once again, specifically flagged, given the recent strong stance by organised labour regarding the expectation of above-inflation increases. The alarming state of local government finances - where only 27 of the country's 257 municipalities recorded clean audits - remains one of a number of concerns. In essence, the jury is still out on the outlook in the longer term, with attention already nervously turning to the next scheduled round of rating reviews in November this year. Another round of rating downgrades will take South Africa into the B-band (speculative rating band), something the market is not priced for at current yields.

Figure 4: South Africa is not priced for another round of rating downgrades
(Sovereign credit default spreads versus Standard and Poor's sovereign ratings)

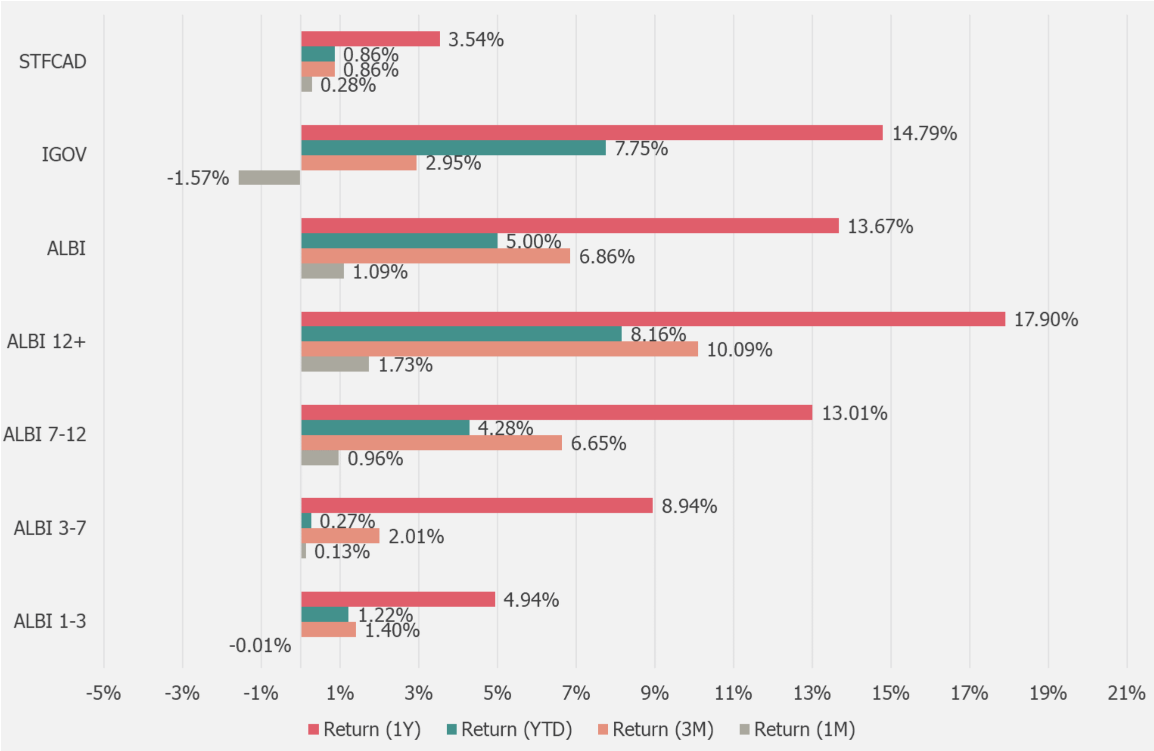


Source: Bloomberg, Futuregrowth

The nominal bond market regained some lost ground following a weak start to 2021
The developments described above, as well as the reduction in the size of primary government bond issuance at the weekly auctions by National Treasury, created room for nominal bond yields to drift lower, more so at the back end of the yield curve. In the process, the market regained some of the lost ground caused by the global mini-taper tantrum earlier this year. As a result, the FTSE JSE All Bond Index (ALBI) rendered a strong return of 6.86% during the quarter. The biggest positive contribution of 10.09% was from the 12+ year maturity band, as a result of bullish yield curve flattening.

Inflation-linked bond yields also ended the quarter lower, although inflation-hedging demand faded significantly towards the back end of the quarter. Even so, the FTSE JSE Government Inflation-linked Index (IGOV) still rendered a reasonable return of 2.95%. The performances rendered by both nominal and inflation-linked bonds were well above the 0.86% offered by cash during this period.

Figure 5: Bond market index returns (periods ending 30 June 2021)



Source: JSE, Futuregrowth

THE TAKEOUT: The sharp yield increase in major global bond markets in the first quarter was backed by improved economic growth prospects, fears of higher inflation, and, by implication, future monetary policy tightening. The sharp upward correction in developed market bond yields lost momentum in the second quarter as inflation concerns were played down by monetary policymakers, including the US Federal Reserve. Locally, bearish rate expectations were tempered by a strong consistent message by the SARB, insisting that the inflation surge is deemed transitory, which, together with a negative output gap, implies no immediate implication for monetary policy. Some improvements in economic growth, the external account, and particularly the fiscal situation, convinced international rating agencies to hold back on rating action even though all expressed concern about the longer-term outlook. The above developments contributed to improved risk appetite which, in turn, underpinned local markets during the second quarter. As a result, both nominal and inflation-linked bond markets rendered returns that exceeded the cash return by a significant margin.

AN OVERVIEW: Macroeconomic outlook, market view and investment strategy

Economic growth	The speed at which a wide range of direct and indirect monetary and fiscal measures have been announced and applied in the aftermath of the COVID-19 pandemic has been commendable. While this policy response and the vaccine rollout in mainly advanced economies contributed to the rebound in global economic growth, the recovery is still uneven across regions. Risks to the recovery remain, as many emerging markets are lagging with vaccinations programmes, while the issue of vaccine efficacy has become concerning as newer and more infectious COVID-19 strains develop. Even so, the economic rebound is broadly gaining

	momentum and, with that, the need for extraordinary monetary and fiscal support is slowly fading. Locally, the release of recent GDP data surprised on the upside, which is partly linked to the very strong commodity cycle. This supports our view of a 2021 estimated economic growth rebound of 5.5%, following the -7.0% collapse last year. Even so, the focus should turn to the forthcoming years, where the growth rate is still expected to be pedestrian at around 2%. To address this, structural weaknesses - namely, macro-policy uncertainty, weak policy implementation, low levels of fixed capital investment, reliable power generation, and a rigid labour market -need to be addressed. While we acknowledge recent progress, much still needs to be done, especially when it comes to actual delivery. **THE TAKEOUT:** The need for the pandemic-induced extraordinary direct and indirect monetary and fiscal stimulus is slowly fading in advanced economies. This allows for a move towards slow policy normalisation, although the pace and policy responses will differ across regions. Locally, any short-term policy response, which is likely to lag that of advanced and some emerging market economies, must be accompanied by more sustainable solutions to the many structural hurdles.
Inflation	Our base case of an inflation surge, mainly due to a combination of extraordinary base and supply bottle-neck effects, has largely played out. Even though this is widely deemed to be transitory, financial markets and central banks alike will continue to monitor developments closely. For now, we maintain a view that underlying inflation is expected to remain relatively benign in most developed economies as the drivers of stable core inflation are still largely entrenched. This includes inflation expectations, a key variable, which until now has not changed in a meaningful way. Locally, the release of May inflation data confirmed the expectation of a significant surge in the year-on-year rate of change, for reasons similar to those in most other advanced and emerging economies. This is expected to represent the peak in the current cycle. The passing of unfavourable base effects and the sustained sharp decline in housing rental inflation and very muted services inflation are expected to contribute to an ease in

	the rate of headline CPI in months ahead. More importantly, the muted core CPI reading continues to reflect the subdued structural pricing power already evident in the past two years. This includes 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 sustained large price increases on to the end consumer. On balance, we anticipate that headline inflation will average 4.1% in 2021 and 4.5% the following year. **THE TAKEOUT:** Locally, inflation has reached our expected peak in this cycle, mostly as a result of extraordinarily strong base effects and deemed transitory. The rate of inflation is now expected to stabilise and settle around the mid-point of the inflation target range well into next year.
Balance of payments	The improvement in the merchandise trade account that started in the second half of 2020 gained significant momentum during the first five months of this year. This bodes well for a positive current account balance in 2021, the second consecutive one following the 2.2% surplus recorded last year. This will go a long way to alleviate the drag created from a persistent negative income account deficit, given the structurally large dividend and interest payments to foreign investors, and will in turn lend some support to the currency. **THE TAKEOUT:** While South Africa’s terms of trade remain relatively favourable, the significant improvement in the past few quarters is not sustainable. Firstly, the sustainability of the strong commodity price increases should be questioned. Secondly, and in addition to recent rand strength, the anticipated recovery in the economy and crude oil price is likely to lead to some resurgence in imports over the course of this year, leaving the country with a smaller current account surplus of around 2.0%, compared to last year’s 2.2%.
Monetary policy	Broadly speaking, the tide for monetary policy stimulus has turned. While divergence with respect to the timing of the start of the tightening cycle among both advanced and emerging markets may persist for a while, stronger economic growth and tentative signs of higher inflation support the gradual normalisation of extraordinarily low policy rates. The strength of the tightening cycle is still expected to be relatively weak, considering the transitory nature of the short-term inflation surge.

	Locally, the SARB made it clear that it would retain its current policy stance, although with a hint of concern about upside risk to its latest inflation forecast. We agree with this stance and retain our view that the repo rate will remain unchanged until early next year. This is based on the fragile economic recovery and a relatively muted underlying inflation outlook despite the expected surge in headline inflation during the second quarter of this year. The risk to this view is an earlier start to the tightening cycle. **THE TAKEOUT:** Market focus has shifted to the potential inflationary consequences of a stronger economic recovery and its implication for monetary policy. In our view, the next big change is monetary policy tightening although the timing thereof is highly dependent on the circumstances of individual countries and regions. Locally, the SARB is expected to only start raising rates in the first half of 2022, and in a measured way. 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 2021.
Fiscal policy	While National Treasury based its 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 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-blown fiscal crisis. Improved tax revenue collection and reduced expenditure are admittedly pointing in the desired direction of deficit reduction, but this is still insufficient when considering the size of the primary deficit and the implications for the high level of outstanding debt - and the risks associated with the future ability to service it. The inability to turn the fiscal ship around has dire implications for the country's sovereign credit ratings and specifically for bond valuations. While SA is priced as a BB-rated issuer, a downgrade to the B-rated tranche will serve as a catalyst for significant negative repricing. **THE TAKEOUT:** A combination of stronger economic growth, better tax revenue collection, and limited expenditure reduction has allowed for some fiscal consolidation. However, in the wake of longer-term subdued and sub-par economic growth, the risk

remains that government may not be able to deliver on its ambitious stated intentions. We remain concerned about execution risk, specifically with regards to the size of the public sector wage bill and contingent liabilities which, in turn, may lead to weaker-than-expected consolidation. Therefore, the risk of more sovereign credit rating downgrades in the medium term cannot be dismissed.

Our investment view and strategy

Our main concern about the local bond market remains the strong link between the lacklustre economic growth (ignoring the quarter-on-quarter volatility in growth rates) and the weakest fiscal position in decades. Even though the government is showing intent to stabilise the pace at which the public sector debt burden is rising, we remain nervous about execution risk, the level of debt, and the threat to the country's sovereign risk profile. The weaker economic recovery beyond this year's rebound from last year's extremely low base, a strong balance of payments position, and the relatively benign inflation outlook for the remainder of this year will allow the SARB to normalise policy in a measured way, with the first hike expected sometime in the first half of next year.

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 are therefore maintaining our strategy to 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 still believe that the best risk-adjusted area of the yield curve remains the 10- to 15-year maturity band.

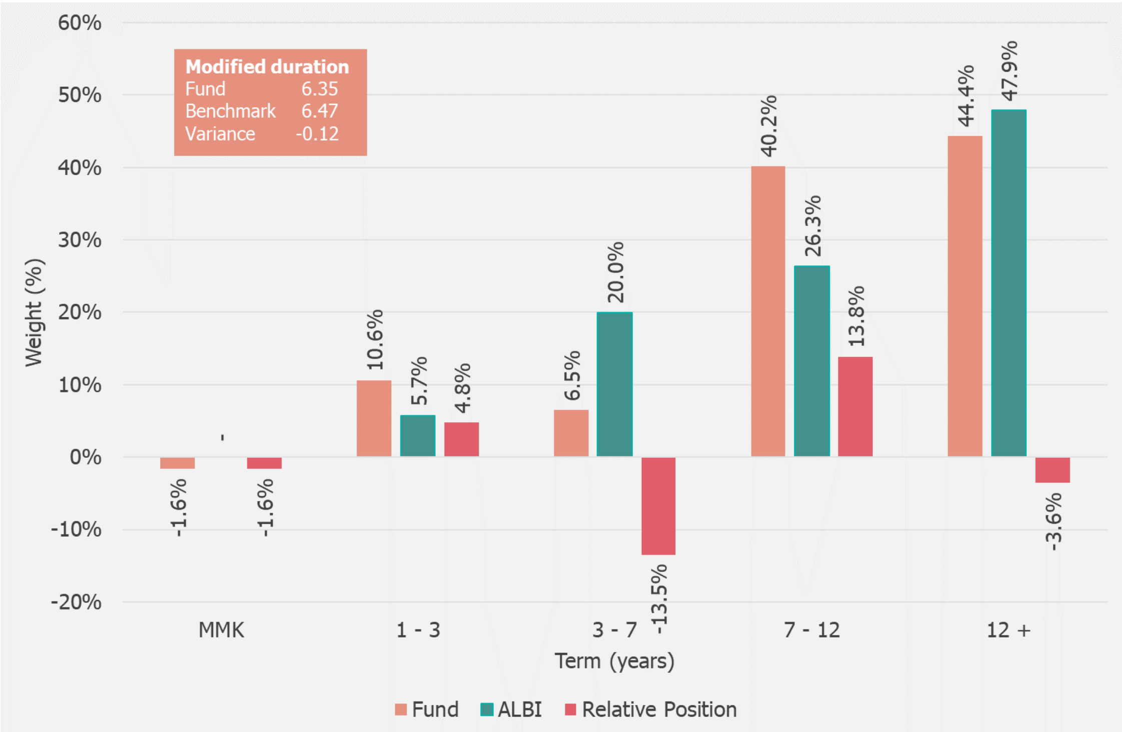
We continue to favour medium-dated nominal bonds over inflation-linked bonds. While we acknowledge that the latter have repriced to levels more reflective of fair value compared to a year ago, the strong inflation-linked bond rally since the end of 2020 has already diluted prospective future returns in a significant way. The attractiveness of this asset class (compared to nominal bonds) is undermined by the combination of a relatively benign inflation outlook, the dire fiscal backdrop, and the better inflation-adjusted yields currently offered by medium-dated nominal bonds.

While we still deem the above the most appropriate strategy, for now, it is important to consider the start of the local monetary policy tightening cycle. Even though our view on the likely start date and the pace of repo rate increases is not as aggressive as the expectation of the Forward Rate Agreement market, some level of caution is appropriate at this early stage, since this will impact the slope of the yield curve and thus one of our strategy pillars, that is, yield curve roll-down potential.

THE TAKEOUT: Our investment strategy aims to strike a balance between 1) capitalising on the extraordinarily high roll-down potential and base accrual (carry) on offer and 2) 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. However, we do acknowledge that the prominence of roll-down potential will start to fade in the medium term as pressure builds for the SARB to start normalising policy. Even so, 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 when considering a higher rate of inflation in the short 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%	6.7%	4.6%
SA GDP	0.4%	1.4%	0.8%	0.4%	-7.00%	5.5%	2.0%
SA Headline CPI	6.3%	5.3%	4.6%	4.1%	3.3%	4.1%	4.5%
SA Current Account (% of GDP)	-2.9%	-2.5%	-3.5%	-3.2%	2.2%	2.0%	-0.5%

Source: Old Mutual Investment Group