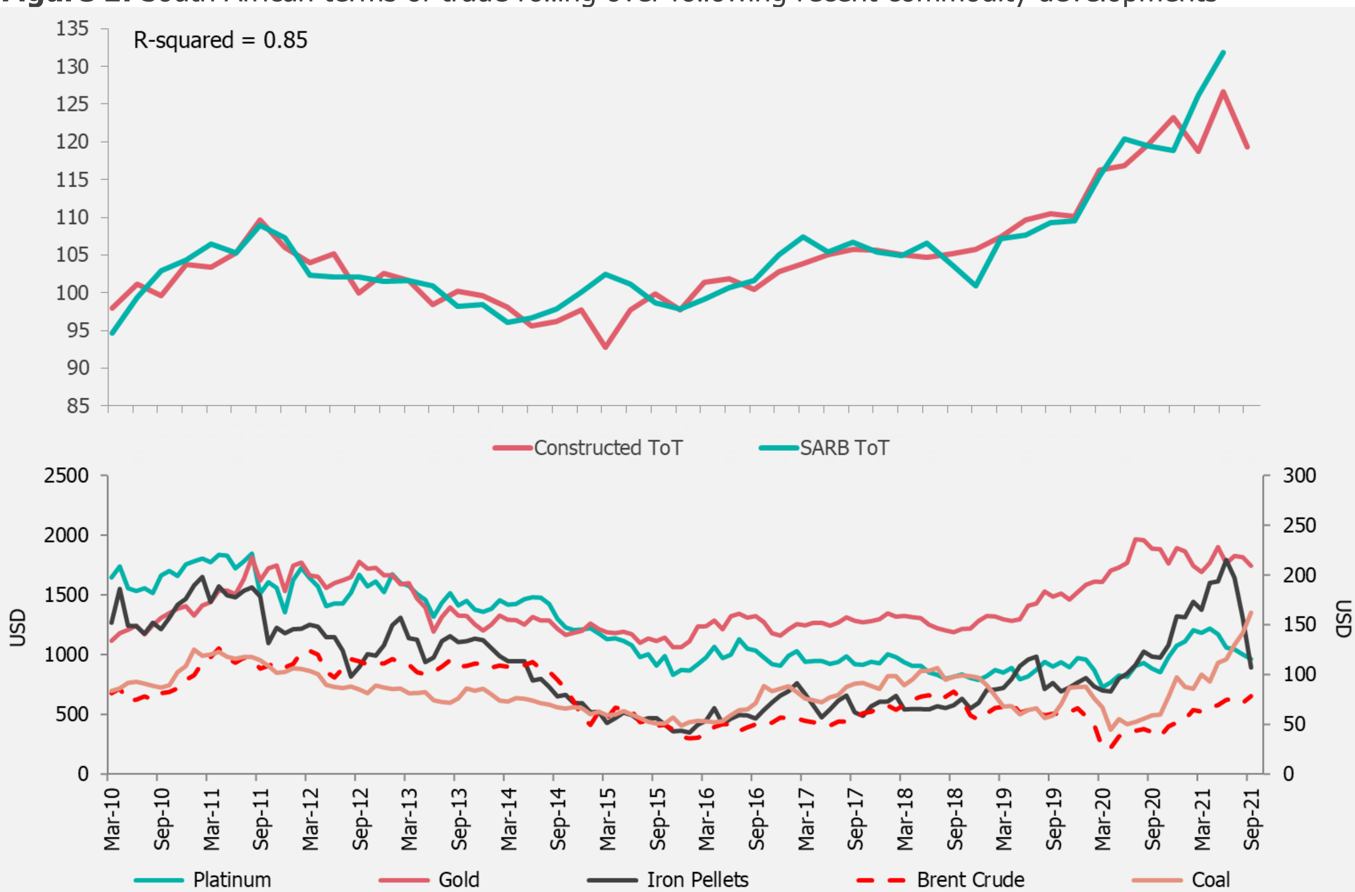
“The improvement of key fiscal metrics does feed into a marginally reduced probability of near-term sovereign credit rating downgrades. This helped to lift investor sentiment somewhat but may not be a sustainable supportive factor.”

**Bond market bulls were swept aside by an avalanche of sentiment-busting events**
**Author: Futuregrowth Interest Rate team**
**Published: October 2021**

## Global risk aversion took centre stage

Investor sentiment was impacted by several developments during the past quarter, resulting in a strong negative response across most markets. Globally, one of the main catalysts of risk aversion was the resurgence of COVID-19 infections earlier in the quarter, even amongst nations with a high vaccination rate, which cast doubt on the economic recovery. Concerns about slowing Chinese economic growth, and panic about possible contagion risk linked to the Evergrande real estate saga, contributed to the reaction. The loss of global growth momentum and a number of negative developments in China forced elevated non-energy commodity price levels sharply downwards. In stark contrast, crude oil prices spiked, reflecting concerns about supply/demand imbalances. Elsewhere, global supply bottlenecks and transport disruptions persisted, which, in turn, continued to boost input costs, thereby feeding inflation concerns. The US debt ceiling circus also contributed to market jitters.

**Figure 1:** South African terms of trade rolling over following recent commodity developments



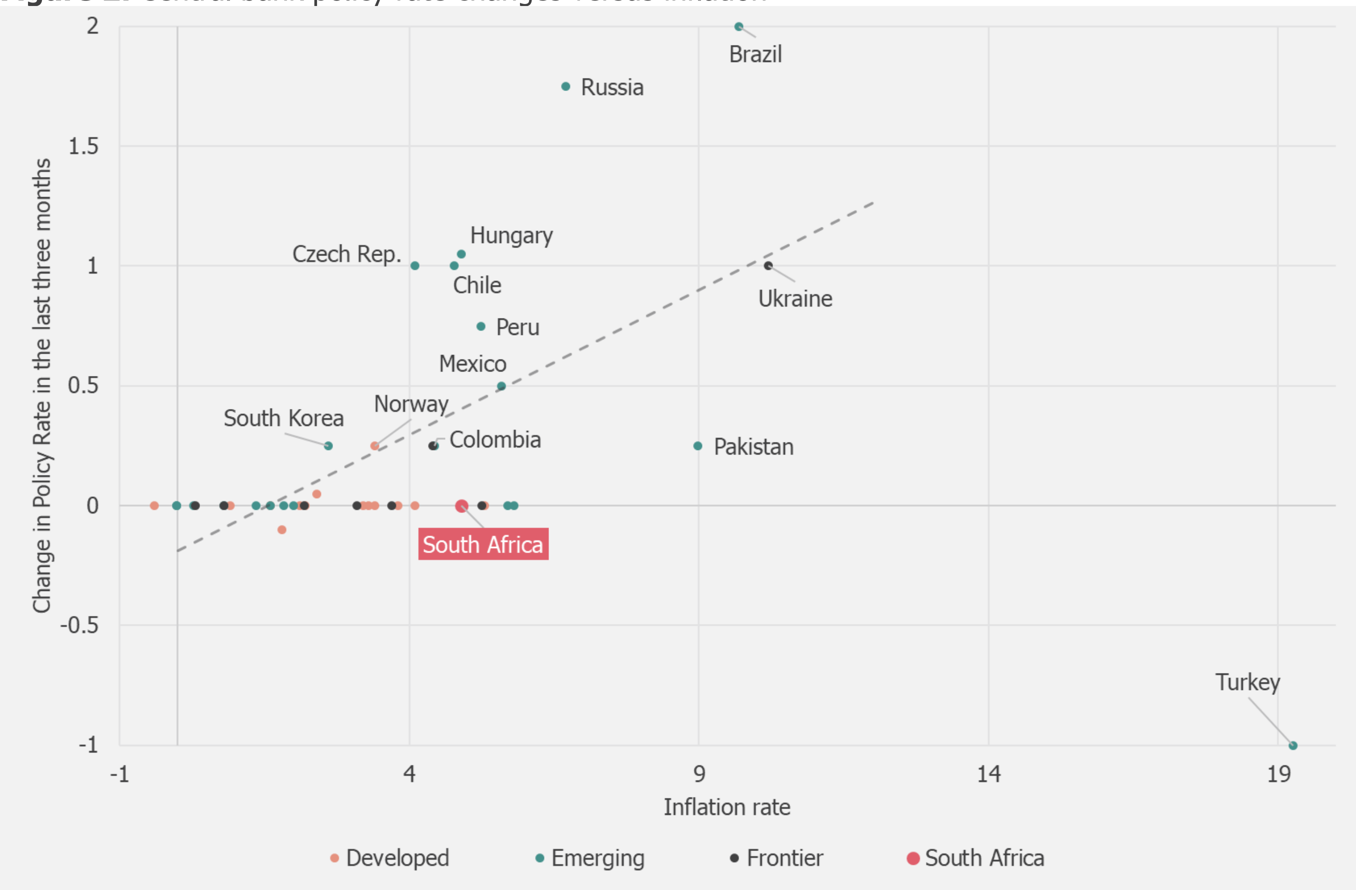

*Source: Bloomberg, Futuregrowth*

## Global monetary policy continued its gradual shift onto a more hawkish path

Despite the haze caused by the developments mentioned above, the latest round of central bank meetings across the global made it abundantly clear that the broader trend for policy had shifted in the direction of tightening. This was mainly in response to rising concerns that elevated inflation may persist for longer than initially expected. In fact, a growing number of emerging market central banks lead the way in this regard, as higher inflation (in some cases in hyper territory) forced policy tightening. The Norwegian central bank was the first of the advanced economy central banks to pull the trigger on its policy rate. In the case of the biggest global economy, the US Federal Reserve revealed that it may indeed commence with the gradual tapering of its asset purchase programme by year end, but with rate increases to follow much later. This is thanks to stronger economic growth, the gradual labour market recovery and rising inflation. While this had been well telegraphed by the US central bank and thus should have been anticipated in advance, US treasury yields nonetheless drifted higher in direct response to the latest announcement, causing most global bond markets to follow suit.

**The South African Reserve Bank opts not to play "follow the leader" – for now**
While the members of the Monetary Policy Committee of the South African Reserve Bank (SARB) unanimously voted in favour of no rate action at the September meeting, it remains clear that the next change to the repo rate will be upwards, possibly sometime during the first quarter of next year. In the short term, the combination of a fragile economic recovery in the outer years, a relatively benign inflation outlook, and a stronger balance of payment position allows for some breathing room relative to its more hawkish peer group. In contrast, the Forward Rate Agreement market continues to reflect more bearish expectations of an earlier start and a steep rise in the repo rate over the next 21 months. We remain less convinced of such an aggressive path with respect to local monetary policy adjustment, for similar reasons highlighted by the SARB.

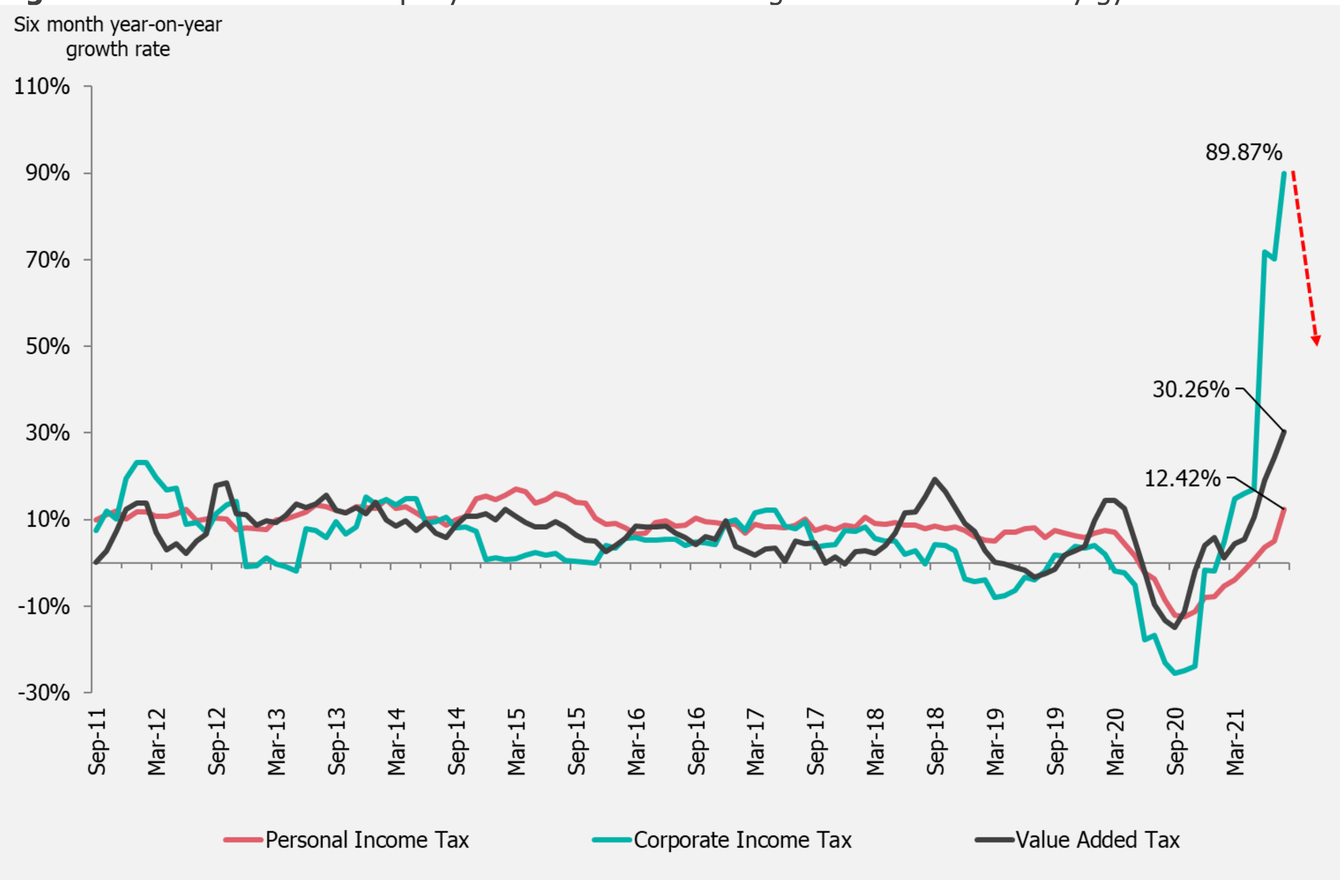
**Figure 2:** Central bank policy rate changes versus inflation




*Source: Bloomberg, Futuregrowth*

**Recent commodity market gyrations are of particular concern to South Africa**
The recent sharp weakening in the country's terms of trade as a result of commodity market gyrations is particularly concerning. Not only did commodity weakness, along with a stronger US Dollar, contribute to significant rand depreciation, it also has negative consequences for general economic activity and the fiscal position, both of which remain particularly fragile. In the absence of a non-energy commodity price recovery, which seems unlikely at this stage, the extent of the upside surprise to company tax revenue receipts in the first three months of the 2021/22 fiscal year will not be repeated. It follows that, unless current government expenditure is reduced, the outlook for faster fiscal consolidation has once again become murkier.

**Figure 3:** Earlier boost to company tax revenue at risk in light of recent commodity gyrations




*Source: Bloomberg, Futuregrowth*

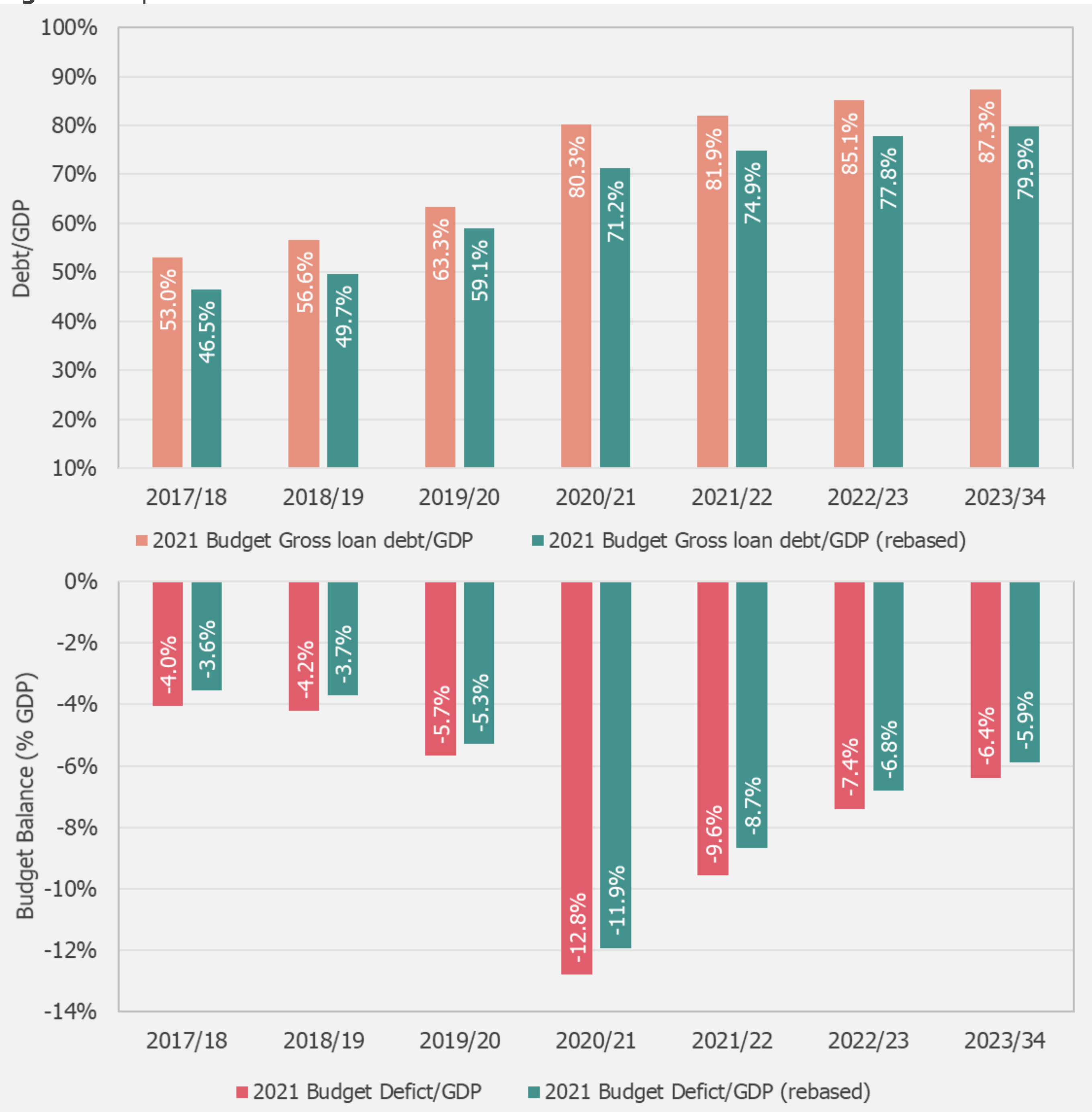
**National account rebasing impacted key metrics positively - but be aware of becoming tricked by optics**

In August, Statistics South Africa released its rebased and reweighted gross domestic product (GDP) estimates. This is a regular statistical exercise guided by international best practices. The last update occurred in 2014. The latest revision resulted in an 11% increase in the size of the economy in 2020. Upward revisions to economic activity in the informal sector and so-called illegal activities contributed significantly to the GDP adjustment. Notably, changes to the composition of the supply and demand components of GDP revealed that more than 60% is attributed to household consumption, while fixed investment spending declined from an already low 16% to less than 14%.

However, it is critical to note that the growth rate of the economy has not changed materially over time. In fact, it remains dismal. While the upward adjustment to the GDP base allows for some cosmetic improvement to key macroeconomic metrics, such as the public sectors' deficit (from the budgeted -6.3% to -5.8% by 2023/24) and debt to GDP (from the budgeted 87.3% to 79.9% by 2023/24) ratios in light of the application of a larger denominator, these are mere optics. The focus should remain on fundamental drivers such as fixed investment spending and the economic growth rate which continue to show protracted decay. From a fiscal perspective, the ability of the economy to grow faster, become more inclusive, generate a more broad-based tax revenue stream and enable the better management of the growing public sector debt burden has not changed. The release of the second quarter 2021 Labour Force Survey results served to emphasise the worsening unemployment crisis in our country.

Even so, the improvement of key fiscal metrics does feed into a marginally reduced probability of near-term sovereign credit rating downgrades. This helped to lift investor sentiment somewhat but may not be a sustainable supportive factor.

**Figure 4:** Impact of revised GDP estimate on fiscal metrics




*Source: National Treasury, Bloomberg, Futuregrowth*

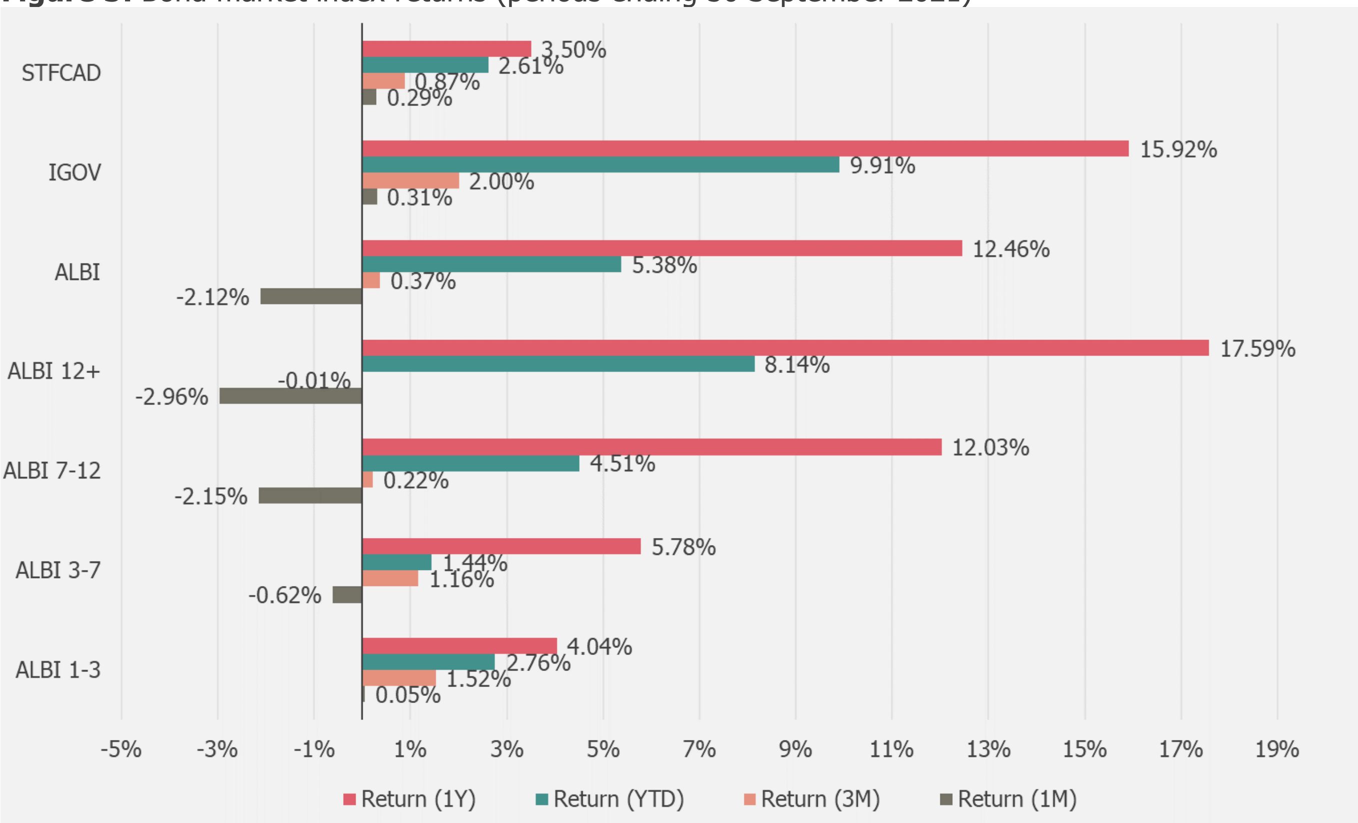
**South Africa's main budget balance is still on track to show an improvement relative to official estimates**

Despite significant monthly swings in the main budget balance (partly the result of normal seasonal factors but also supported by higher commodity prices that fed through via higher company tax receipts) data for the first five months of the current fiscal year point to a smaller deficit compared to forecasts at the time of the tabling of the budget in February. The cumulative budget deficit for this period is around 40% smaller than the R324 billion deficit for the same period last year, and about R100 billion ahead of National Treasury's schedule. Therefore, our view of a lower budget deficit for FY21/22, relative to National Treasury's February estimate, remains unchanged, even though we have taken care to temper our enthusiasm in light of recent negative commodity market developments and ongoing expenditure demands on National Treasury.

**Inflation is stabilising at slightly lower levels – and well within target**
Locally, the August Headline Consumer Price Index (CPI) recorded a year-on-year increase of 4.9%, a touch higher than the 4.6% than the previous month, but still off the cycle peak of 5.2% in May. Core CPI increased to 3.1% (compared to 3.0% in July), still clearly pointing to subdued underlying price pressures. Inflationary pressure also started slowing at the producer level. The Producer Price Inflation Index (PPI) for final manufactured goods rose from a year-on-year increase of 7.1% in July to 7.2% in August. This is still well below the 7.7% recorded in June. While the latest increase was mainly the result of higher fuel and transport equipment, inflation appears to be stabilising or easing in many of the other categories.

**The local bond market was hurt by the most recent bout of risk aversion**
The developments described above served as catalysts for bearish yield curve steepening, as the yields of long-dated bonds increased by more than those of shorter-dated bonds. As a result, bonds in the 12+ year maturity band of the FTSE JSE All Bond Index (ALBI) only managed to return -0.01% for the quarter, well below the 1.52% offered by bonds in the 1- to 3-year maturity band. At total index level, the ALBI managed to eke out 0.37%, well below that of the 0.87% offered by cash. In contrast to nominal bonds, inflation-linked bond yields edged lower while investors continued to benefit from a reasonable inflation carry. As a result, the FTSE JSE Government Inflation-linked Index (IGOV) rendered a decent return of 2.0% for the quarter ending September. This asset class also managed to retain its first position for the first nine months of this year, with the IGOV returning 9.91% compared to 5.38% and 2.61% for the ALBI and cash, respectively.

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




*Source: JSE, Futuregrowth*

**THE TAKEOUT:** Risk appetite was negatively impacted by a number of global and local developments during the quarter. Of most direct significance was the upward pressure on global bond yields as central banks increasingly became more hawkish, while commodity market gyrations and a stronger US Dollar contributed to significant rand weakness towards the end of the quarter. The national account rebasing (which revealed a bigger than previously estimated South African economy) on key economic and particularly fiscal metrics, and an ease in local inflationary pressure, was overshadowed by negative offshore developments, impacting risk appetite negatively. As a result, nominal bond yields drifted higher, with long-dated bonds taking the brunt of the upward correction as the yield curve bear steepened. Against this backdrop, inflation-linked bonds proved more resilient and, as a result, managed to render a return superior to that offered by nominal fixed rate bonds and cash.

**AN OVERVIEW: Macroeconomic outlook, market view and investment strategy**

| | |
|---|---|
| **Economic growth** | Our base case remains for a global economic recovery, even though the strength of this will remain uneven across regions. The latest estimates for global growth are 6.0% and 4.4% for 2021 and 2022, respectively. However, progress will not be in a straight line, as risks to the recovery persist. In the case of emerging markets, many countries are lagging with vaccination programmes, while the issue of vaccine efficacy remains a concern. COVID-related lockdowns are still playing havoc with supply pipelines, which, in turn, weighs down on global manufacturing activity. The Chinese economic slowdown is another drag on global growth. Even so, the need for extraordinary monetary and fiscal support is generally fading in the majority of advanced economies.<br><br>Locally, the release of stronger-than-expected second quarter GDP data supported our view of a strong economic growth rebound this year, even though the economy will still be smaller following last year's collapse. Our latest GDP forecasts for 2021 and 2022 are 5.6% and 2.3% respectively, compared to -6.4% for 2020. The tragic and economically disruptive events in July initially forced us to scale down our growth forecast by around 0.5%, but this was later reversed given the strong GDP performance in the second quarter. More importantly, the unrest served as another stark reminder of the consequences of the widening income gap and the hardships faced by the unemployed. To address this, structural weaknesses (namely, macro-policy uncertainty, weak policy implementation, low levels of fixed capital investment, unreliable 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 implementation. |

| | |
|---|---|
| | **THE TAKEOUT:** The need for the pandemic-induced extraordinary direct and indirect monetary and fiscal stimulus is fading in advanced economies. This allows for a move towards policy normalisation, although the pace will vary across regions. Locally, any short-term policy response (which is likely to lag behind that of advanced and some emerging market economies) must be accompanied by more sustainable solutions to the many structural hurdles South Africa faces. Although we acknowledge some progress with initiatives to address some of the structural issues, policy response and implementation remain too slow and tepid. |
| **Inflation** | Our base case of an inflation surge, mainly due to a combination of extraordinary base and supply-sided bottle-neck effects, has 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 our view that underlying inflation is expected to remain relatively benign in most developed economies, as the drivers of the more stable core inflation are still largely entrenched. This includes inflation expectations which, until now, have not changed in a meaningful way. That said, we need to remind ourselves that inflation expectations are backward looking, and therefore an unreliable indicator of structural changes to inflation dynamics. More generally speaking, inflation has reached levels that open the door for monetary policy normalisation, albeit at a gradual pace.<br><br>Locally, recent inflation data releases confirmed that the peak in the current cycle was reached in May. The passing of unfavourable base effects, 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 the months ahead. More importantly, a relatively muted core CPI reading continues to reflect the subdued structural pricing power already evident over the past two years. This includes strong evidence that the pass-through of rand weakness to headline inflation remains exceptionally weak, which, in turn, is reflective of the inability of producers and retailers to pass large price increases on to the end consumer on a sustained basis. The forecast for next year remains unchanged at 4.5%.<br><br>**THE TAKEOUT:** Locally, inflation has reached our expected peak in this cycle, mostly as a result of extraordinarily strong base effects, making it largely transitory. The rate of inflation is now expected to |

| | |
|---|---|
| | stabilise and settle around the midpoint 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 and gained significant momentum during the first seven months of this year, has lost some of the positive momentum following the recent sharp drop in commodity prices other than energy. This, in turn, caused a weakening of the South African terms of trade. Even so, the country is still expected to end the current year with a positive current account balance, following the 2.0% surplus recorded last year.<br><br>**THE TAKEOUT:** While South Africa's terms of trade remain relatively favourable, the significant improvement in the past few quarters is unlikely to be sustained. Firstly, the sustainability of the strong commodity price increases should be interrogated. Secondly, and in addition to recent rand strength, the anticipated recovery in the economy and rising crude oil price is likely to lead to some resurgence in imports over the course of this year. |
| **Monetary policy** | Broadly speaking, the tide for monetary policy stimulus has turned. While divergence in 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 rate of policy normalisation is still expected to be very gradual, considering the transitory nature of the short-term inflation surge. The Federal Reserve has little choice but to keep preparing markets for the start of gradual tapering, and markets should take note.<br><br>Locally, the South African Reserve Bank (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 for the remainder of this year. We continue to expect the commencement of the gradual tightening cycle sometime in the first half of 2022. The risk to this view is an earlier start to the tightening cycle, but we do not expect that this will be as aggressive as implied by the forward market.<br><br>**THE TAKEOUT:** Market focus has shifted to the potential inflationary consequences of a stronger economic recovery and the implication for monetary |

| | |
|---|---|
| | policy. Globally, the trend had decisively shifted to more broad-based monetary policy tightening, although the timing of this will be 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 FRA market that is pricing a higher repo rate as early as the fourth 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 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-blown fiscal crisis. Tailwinds include the recent national accounts revision that left the South African economy bigger compared to previous estimates, but this "improvement" should be treated with extreme caution. 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 unplanned additional pressure on expenditure as a direct consequence of the July unrest does take us one step backward, although the impact is expected to be relatively small. The positive surprise in tax revenue collection, specifically corporate income tax, is also likely to be unsustainable, given that it has been a function of cyclically elevated commodity prices which translated into strong mining sector profits. An inability to turn the fiscal ship around, despite the recent boon of excess revenue collection, will have 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.<br><br>**THE TAKEOUT:** A combination of stronger economic growth, better tax revenue collection, and marginal 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. The additional expenditure pressure following the public sector wage deal agreement and the July unrest forced the country to take one step backwards. Therefore, the risk of more sovereign credit rating downgrades in the medium term cannot be completely dismissed. |

**Our investment view and strategy**

Our main concern about the local bond market remains the strong link between the lacklustre underlying 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, potential expenditure pressures, 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 stronger 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 quarter of next year.

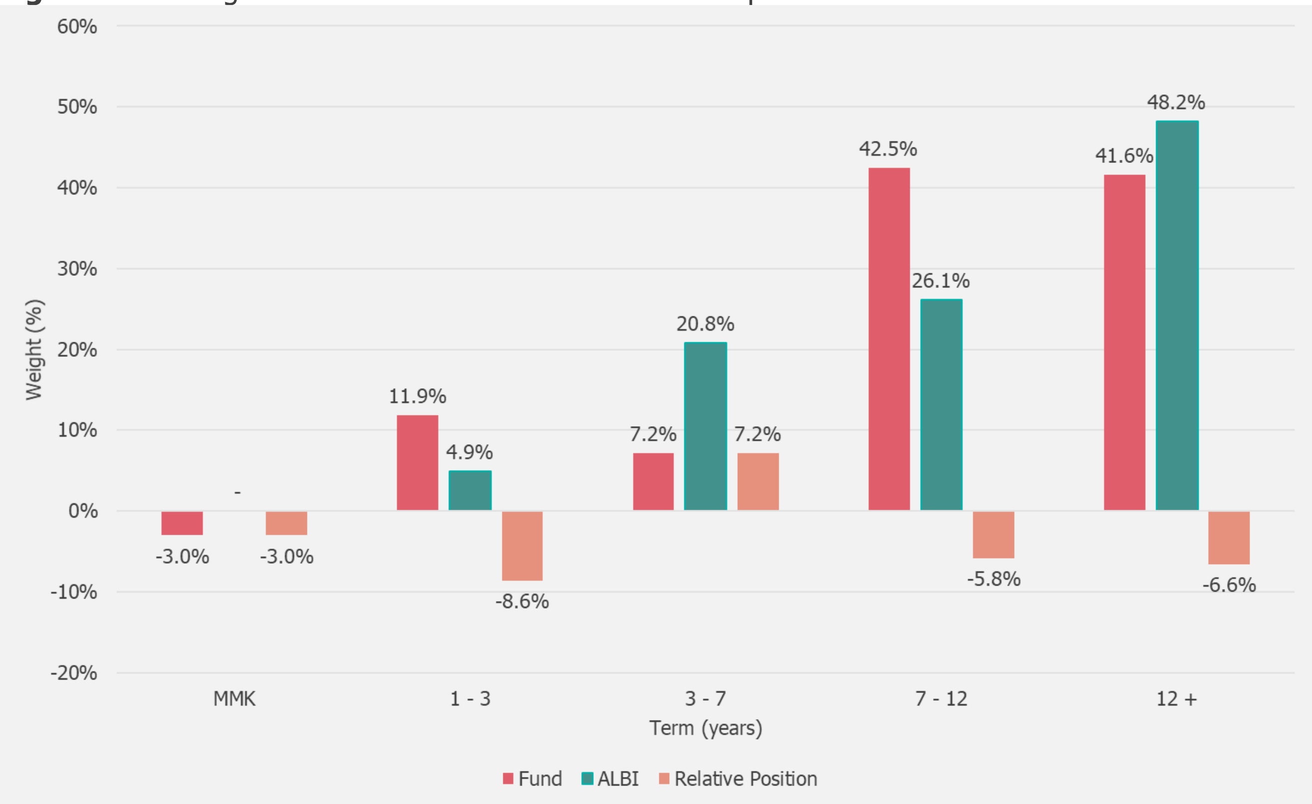
In terms of the yield curve, the expectation of an anchored front end is increasingly at risk considering the approaching start of the monetary policy tightening cycle. Although we maintain that the tightening cycle will be a gradual and measured one, short-dated fixed rate bonds are more sensitive to a rising repo rate, while rising short-term rates will also undermine potential yield curve roll-down gains. Further out onto the yield curve, gyrations around global risk sentiment and the dire local fiscal situation will most likely continue to contribute to back-end volatility. However, with the positive yield curve slope still quite steep, the challenge remains to find an optimal balance between managing potential capital loss from rising yields and benefitting from holding 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 low yielding cash, while we also rolled away from short-dated fixed rate bonds. Considering the risk of fiscal slippage, we 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, 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.

**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. We do acknowledge that the prominence of roll-down potential is fading as pressure builds for the SARB to start normalising policy, even though this is expected to be at a very gradual pace. 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 at this point, while we keep one eye firmly on medium-term inflation developments.

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** | 3.5% | 3.5% | 3.2% | 2.6% | -3.6% | 6.0% | 4.4% |
| **SA GDP** | 0.7% | 1.2% | 1.5% | 0.1% | -6.4% | 5.6% | 2.3% |
| **SA Headline CPI** | 6.3% | 5.3% | 4.6% | 4.1% | 3.3% | 4.4% | 4.5% |
| **SA Current Account** (% of GDP) | -2.7% | -2.4% | -3.0% | -2.6% | 2.0% | 4.5% | 0.5% |

*Source: Old Mutual Investment Group*

Published on www.futuregrowth.co.za/insights.

Futuregrowth Asset Management (Pty) Ltd ("Futuregrowth") is a licensed discretionary financial services provider, FSP 520, approved by the Registrar of the Financial Sector Conduct Authority to provide intermediary services and advice in terms of the Financial Advisory and Intermediary Services Act 37 of 2002. The fund values may be market linked or policy based. Market fluctuations and changes in exchange rates may have an impact on fund values, prices and income and these are therefore not guaranteed. Past performance is not necessarily a guide to future performance. Futuregrowth has comprehensive crime and professional indemnity in place. Performance figures are sourced from Futuregrowth and IRESS.