Rising inflation concerns lead global markets to look for earlier monetary policy action

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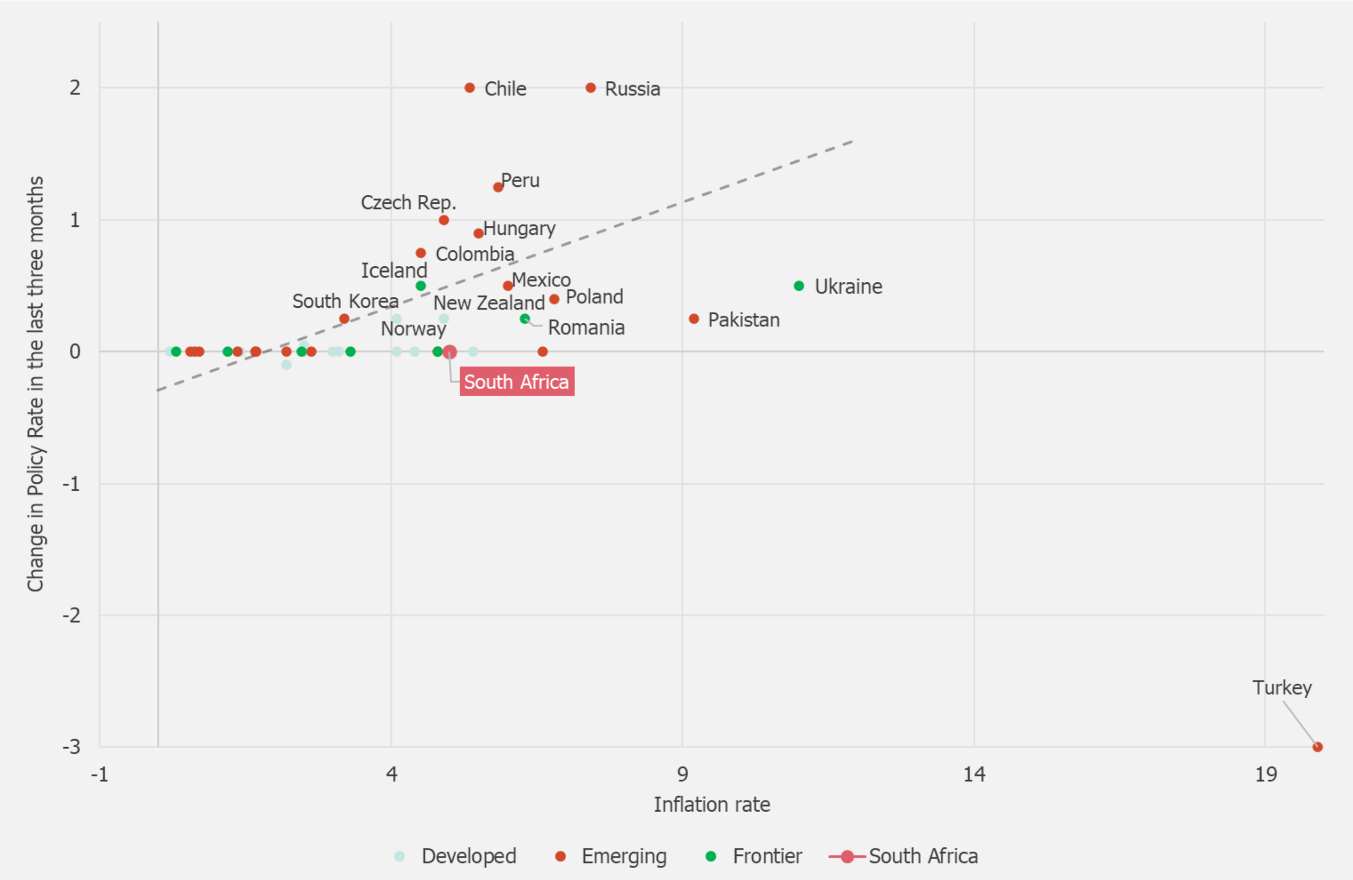
More central banks turn their backs on easier monetary policy conditions

The global supply chain remains strained: a textbook example of the downside risk to global interconnectivity, which, for over three decades allowed for more efficient allocation of global production factors. The persistent supply constraints contributed to upward price pressures, which are lasting longer than initially anticipated. As a result, the word "transitory" is now used more sparingly when it comes to the expression of inflation views, both by market participants and central banks. In a number of emerging markets, the resultant longer-lasting spike in inflation forced central banks to respond. Monetary policy tightening is also gaining traction in advanced economies, though at a more pedestrian pace. In stark contrast, the upside-down response by the Turkish central bank, as it cut rates by a further 200 basis points (bps) in the face of sky-high inflation (which has averaged 17% over the past calendar year) offers a textbook example of macro policy mismanagement as a result of political interference.

Figure 1: Central bank policy rate changes versus inflation



Source: Bloomberg, Futuregrowth

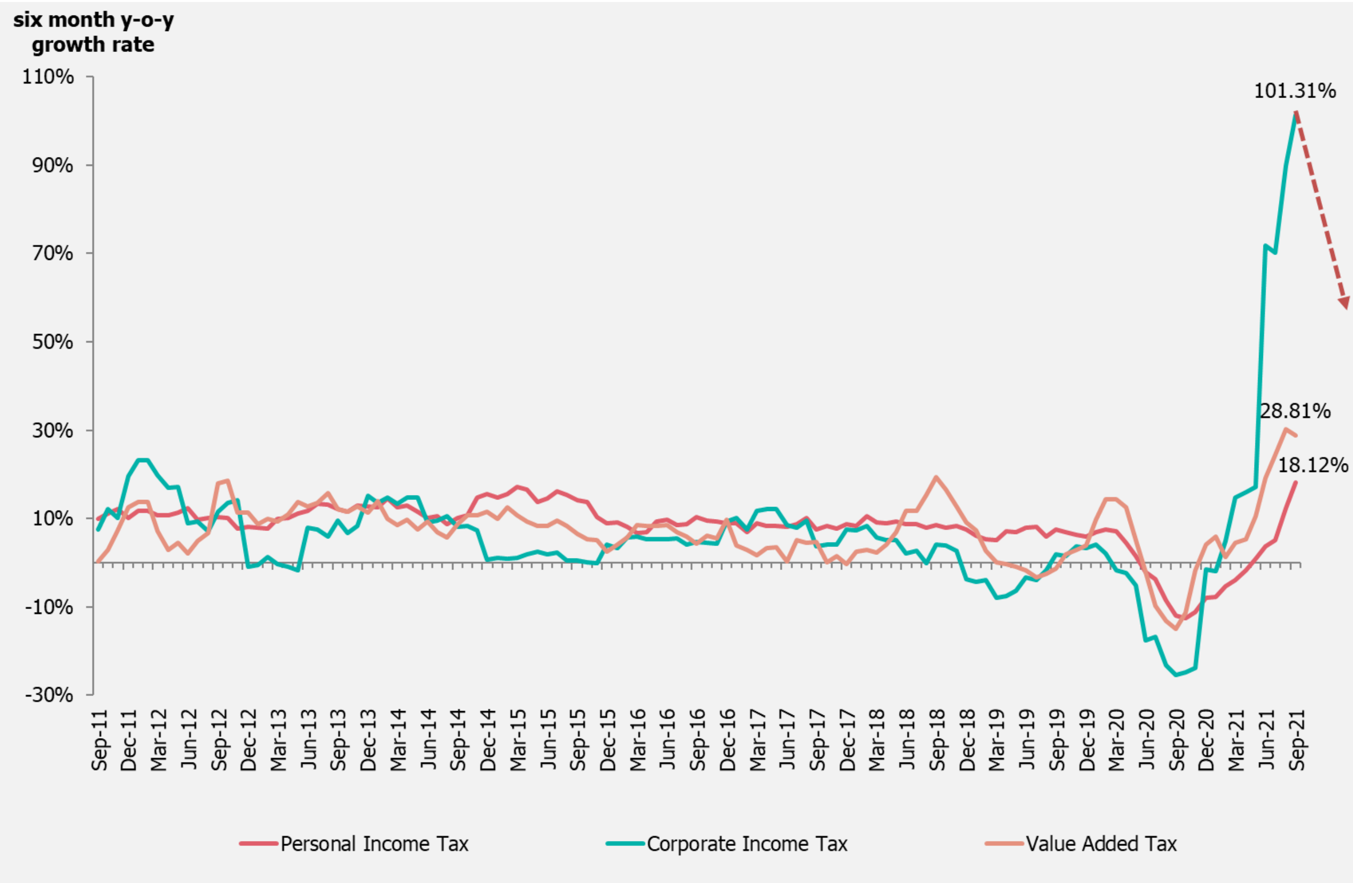
Bond markets respond to rising inflation concerns

The rising inflation concerns also forced financial markets to look for an earlier and more aggressive monetary policy response. This is reflected by faster-rising bond yields in the majority of advanced and emerging economies. The sharp increase of US Treasury yields in October (with two year-yields almost doubling to 0.5%) is particularly noteworthy as it anticipates the taper of the long-awaited and well-telegraphed US Federal Reserve's USD120 billion a month bond-buying programme. While inflation may have surprised with its persistent elevated levels, poor bond market valuation was a sure sign that yields only have one way to go: upwards. This is less obvious in the case of the majority of countries in the emerging market group, where the general level of bond yields appears to reflect less complacency - both in terms of inflation and monetary policy expectations - while valuation relative to global reference rates seem reasonable.

Recent worse-than-expected inflation prints might turn the remaining SARB doves
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 is clear that the next change to the repo rate will be upwards. While 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 space relative to South Africa's emerging market peer group, the recent higher-than-expected September producer price index (PPI) inflation print could spark an earlier start to the tightening cycle. PPI inflation for final manufactured goods accelerated to 7.8% year on year from 7.2% year on year the previous month. While the longer-term correlation between the Consumer Price Index (CPI) and PPI at the total level is not particularly strong, inflation bears will focus on the stronger correlation in the sub-components. The stronger positive correlation between CPI for goods and PPI for final manufactured goods is admittedly a reason for concern. As a result, the Forward Rate Agreement (FRA) market continues to reflect more bearish expectations of an earlier start and a steep rise in the repo rate over the next 21 months.

The fiscal backdrop has improved – but this is not unexpected
The most recent public sector finance data continues to point to a significant improvement, particularly relative to the previous fiscal year which was battered by the pandemic-induced growth collapse and additional expenditure pressures. However, this is mainly backward looking, as 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 had 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 six months of the 2021/22 fiscal year will not be repeated. It follows that, unless current government expenditure is reduced and structural economic growth is sustainably improved, the outlook for faster fiscal consolidation has once again become murkier, which may only be clearly reflected in the 2022/23 fiscal year.

Figure 2: The earlier boost to company tax revenue is at risk in light of recent commodity gyrations

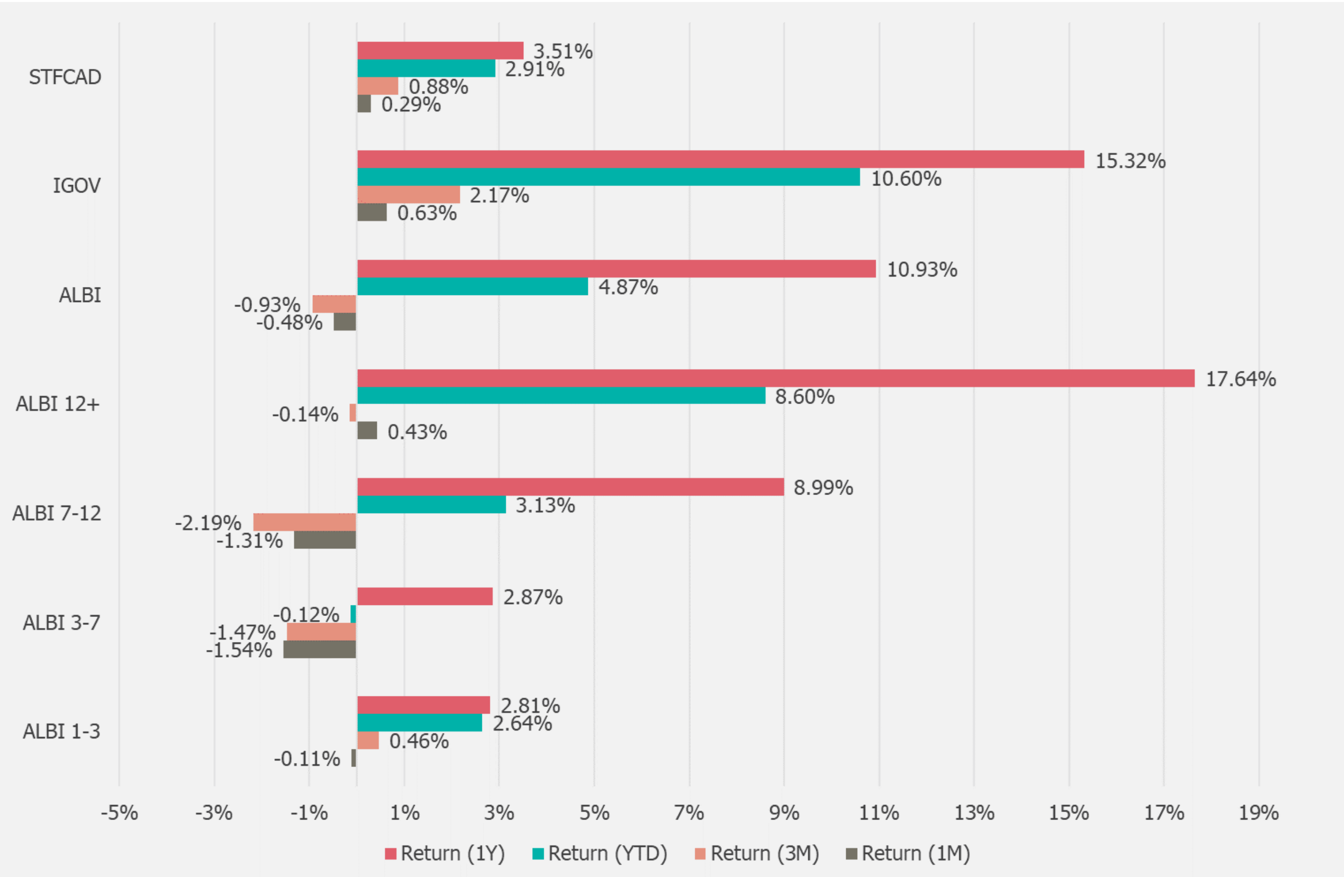


Source: Bloomberg, Futuregrowth

Nominal bonds continued their recent poor run

The developments described above contributed to significant market weakness during October. In addition to a general uptick in bond yields, changes to the yield curve reflected expectations of imminent monetary policy tightening, as the yields of shorter-dated bonds increased by more than those of ultra-long-dated bonds. As a result, bonds in the 3- to 7-year maturity band of the FTSE JSE All Bond Index (ALBI) rendered a return of -1.54%, with bonds in the 12+ year maturity band doing slightly better by returning 0.43%. At total index level, the ALBI's return of -0.48% was significantly worse than the 0.29% 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 0.63% for the month. This asset class also managed to retain its first position for the first ten months of this year, with the IGOV returning 10.60% compared to 4.87% and 2.91% for the ALBI and cash, respectively.

Figure 3: Bond market index returns (periods ending 31 October 2021)



Source: JSE, Futuregrowth

THE TAKEOUT: Risk appetite was negatively impacted by rising concerns about the persistence of inflationary pressure, hence the timing and strength of monetary policy response. While global bond yields headed higher in response to more hawkish expectations, commodity market gyrations and a stronger US Dollar contributed to significant rand depreciation. As a result, nominal bond yields drifted higher, with medium-dated bonds taking the brunt of the upward correction as the yield curve bear flattened in response to a sharp rise in short-dated US treasury yields and in anticipation of the possible earlier start of the local tightening cycle. Against this backdrop, inflation-linked bonds proved slightly more resilient and, as a result, managed to render a return stronger than 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 5.8%% and 4.0% 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, inhibits 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. Locally, the release of stronger-than-expected second quarter GDP data supported our view of a strong economic growth rebound this year. Our latest GDP forecasts for 2021 and 2022 are 5.6% and 2.3% respectively, compared to -6.4% for 2020. The lacklustre growth rates from next year onwards underline long-standing and persistent structural weaknesses, namely, macro-policy uncertainty, weak policy implementation, low levels of fixed capital investment, unreliable power generation, and an underdeveloped, rigid labour market. While we acknowledge recent progress in addressing some of these issues, much still needs to be done, especially when it comes to actual implementation of the recovery plans. **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 are therefore an unreliable indicator of structural changes to inflation dynamics. More generally speaking, inflation has reached levels that open the door for more broad-based monetary policy normalisation, albeit at a gradual pace. The passing of unfavourable base effects, the sustained sharp decline in housing rental inflation, and very muted services inflation are all expected to contribute to an ease in the rate of local headline CPI in the months ahead. However, the persistence of the global energy crisis that gave rise to higher crude oil prices, a weaker rand, and general supply constraints pose a risk to this view, especially in the short term. On the positive side, 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 TAKEOUT:** Locally, inflation has reached our expected peak in this cycle, mostly as a result of extraordinarily strong base effects, making it largely transitory. However, upside risks to our earlier more benign inflation view are more prominent, in light of persistent supply side pressures and, in particular, a higher rand oil price.
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 its positive momentum following the recent sharp drop in commodity prices other than energy. This, in turn, has caused a weakening of South Africa's terms of trade. Even so, the country is still expected to end 2021 with a positive current account balance, following the 2.0% surplus recorded last year. **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 2021.
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 communicating the pace of their recently announced tapering of bond purchases and the eventual return to monetary policy normalisation. The clearer communication in this regard has helped stave off a strong negative market response similar to that experienced during the 2013 "Taper Tantrum". The South African Reserve Bank (SARB) made it clear at its September MPC meeting that it would retain its current policy stance, with a hint of concern about upside risk to its latest inflation forecast. We have become more concerned about the upside risks to inflation and, as a consequence, see a rising risk of an earlier start to the tightening cycle, potentially at the end of this year as opposed to early next year. Nonetheless, we continue to disagree with the aggressive pricing by the forward market in terms of the strength of the tightening cycle. Our view remains based on the fragile economic recovery from next year onwards and a relatively muted underlying inflation outlook in the medium term. **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 has shifted decisively 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 start raising rates this quarter or, at the latest, in the first quarter of 2022, and in a measured way, but with a risk of an earlier start. We are in disagreement with

	the local FRA market with respect to the strength of the upcoming tightening cycle.
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 that the primary balance remains in 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 took 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 especially 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 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 this quarter or, at the latest, early in the first quarter of next year.

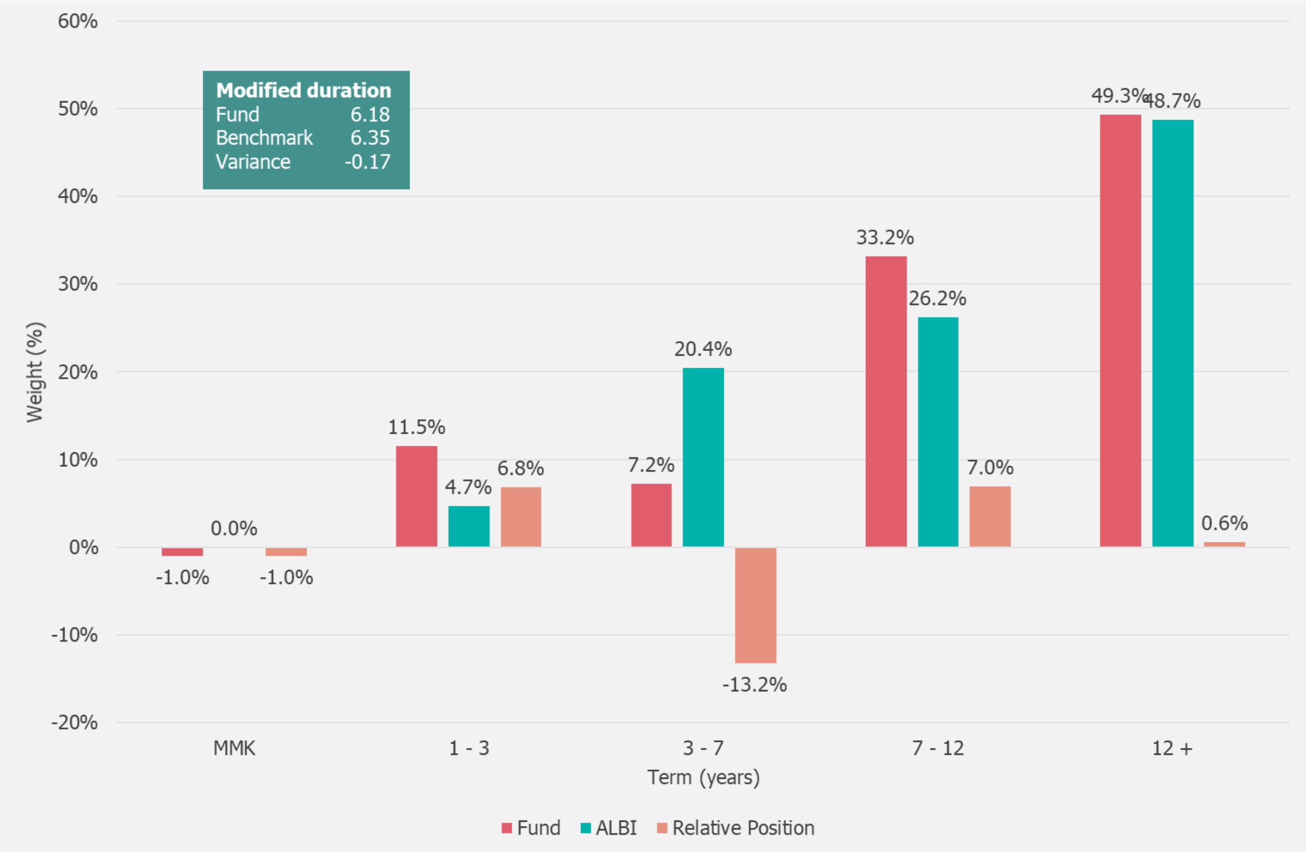
In terms of the yield curve, our earlier view of an anchored front end has been replaced by an expectation of an imminent start of the monetary policy tightening cycle. Although we maintain that the tightening cycle will be a gradual and measured one, short-dated fixed rate bonds are more sensitive to a rising repo rate. In addition, rising short-term rates also undermine potential yield curve roll-down gains from shorter-dated fixed rate bonds. 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 steep positive yield curve slope and the reasonable level of yields on an inflation adjusted basis, 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. We have also rolled away from short-dated fixed rate bonds to make way for the negative impact of a higher repo rate. Considering the combination of monetary policy tightening, upward pressure on global bond yields and the dire fiscal backdrop, the best risk-adjusted area of the yield curve remains the 10- to 15-year maturity band, we avoid holding both short and ultra-long-dated fixed rate nominal bonds.

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 even with some upside risk, the dire fiscal backdrop, and the better inflation-adjusted yields currently offered by medium-dated fixed rate 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 4: 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%	5.8%	4.0%
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

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