GLOBAL BOND MARKETS **AT THE MERCY OF US POLITICS**

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Bond bears would have been delighted by further evidence of higher inflation in some of the key developed markets over the last while. What is more encouraging to these bears and, in particular, to policymakers (who for years have frantically dug deep into the monetary policy tool chest to avert deflation) is the fact that the latest inflation data releases generally surprised consensus forecasts to the upside. It certainly appears that the so-called "reflation trade" continues to gain momentum, which in turn should keep bond markets on the back foot. Reflation trade refers to the different ways investors can take advantage of the expected higher growth and inflation as a result of policy stimulus. However, it is important to note that most of the upward pressure on inflation is still mainly the result of higher energy (specifically oil) and raw materials prices. Significant feed-through to core inflation is still lacking.

For this reason, upward momentum to key bond yields faded somewhat in January, most notably in the US. This was not the case with some European bond markets. Here the combination of slightly improved economic activity, higher headline consumer inflation and rising political uncertainty forced yields higher. This brought significant capital loss to those who bought bonds at lower yields barely a few months ago.

RAND SUPPORTS LOCAL BONDS

The impact of the above on the local bond market was diluted by rand appreciation, partly the result of downward pressure on the US dollar. A better than expected (not seasonally adjusted) monthly trade balance played a secondary role. The strong US dollar consensus trade recently encountered a few setbacks, including awkward attempts by the Trump administration to "talk down" the currency. The local bond market also largely shrugged off slightly higher than expected inflation data releases, while it managed to absorb net selling by foreign investors. As a result, local bond yields ended a fairly volatile month marginally lower, with the All Bond Index delivering a reasonable return of 1.3%.

INFLATION-LINKED BONDS HOLD THEIR OWN, FOR NOW

Following a persistent rise in real yields from the lows in April 2016, the inflation-linked bond market managed to settle somewhat in January, despite increasing evidence that the rate of local inflation is most likely to decelerate significantly later this year. The combination of high historical inflation and stable to slightly lower real yields in the past month contributed to a strong Inflation Government Index return of 1.6%. This is significantly higher than the monthly return of 0.7% offered by cash.

On the policy side, the South African Reserve Bank (SARB) left the repo rate unchanged at its first Monetary Policy Committee meeting of the year. This was in line with broader consensus. The committee did surprise by releasing an upward adjustment to its inflation forecast. We believe that this is too bearish. Monthly data on the fiscal side implies that National Treasury remains on course to match its October 2016 deficit estimate, although we think that the risk is skewed to a small shortfall. While political noise has died down a little, uncertainty still hovers, especially persistent rumours about an imminent cabinet reshuffle.

With the exception of the US, and more encouraging signs of some improvement in other G10 countries, the global growth recovery still remains fragile. This sets the scene for a modest rise in inflation as well as monetary policy divergence. It also implies a steady tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should limit significant upside to global bond yields, especially following the recent bearish correction. On the negative side, the continued uncertainty about the global, and particularly the Chinese, growth outlook remains a risk – especially for emerging market commodity producers with

KEY TAKEOUTS:

- HIGHER INPUT PRICES LIFT DEVELOPED MARKET INFLATION
- GLOBAL REFLATION COULD HURT BONDS
- STRONGER RAND SUPPORTS SA BONDS
- SA TREASURY ON TRACK TO MEET DEFICIT TARGET

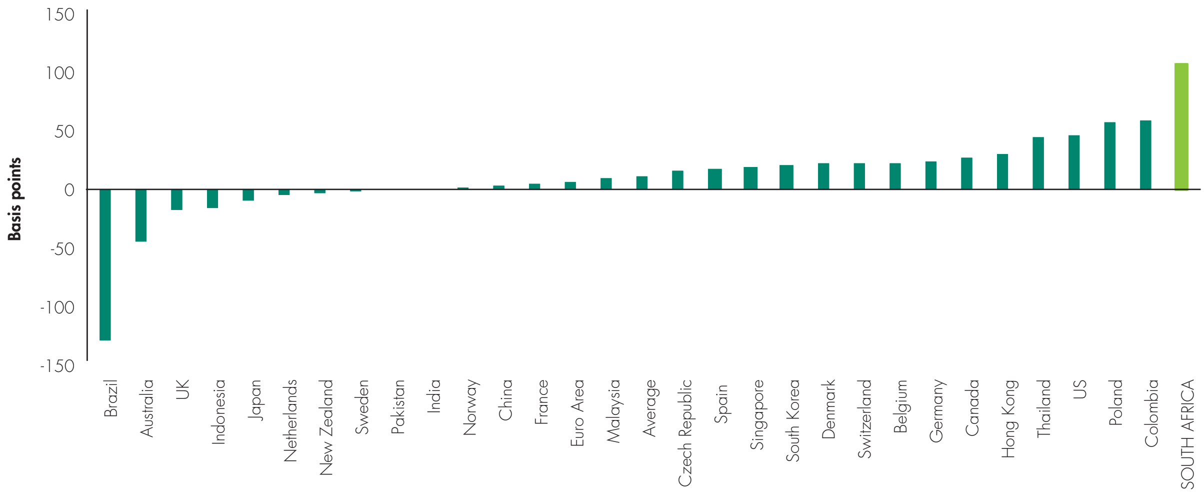
a weak external position in both absolute and relative terms, like South Africa. The anti-global trade tirade by the Trump administration is expected to add uncertainty to the mix.

Locally, the downward trend to inflation is imminent, supported mostly by significantly lower food price increases. While the SARB has now adopted a neutral bias, it is unlikely that they would consider interest rate cuts soon. The external trade imbalance is simply too big to allow for a lower real repo rate, while unpredictable currency swings continue to pose a risk to the more benign inflation outlook. Although the Minister of Finance is clearly determined to rectify the damage to fiscal policy credibility and, by implication, avoid a sovereign credit downgrade to non-investment grade status, the jury is still out on actual delivery. Therefore, the risk of a credit rating downgrade over the next 12 months still lingers. In the short term, local political uncertainty remains a nagging risk.

Considering the above, we will continue to approach the market with caution. The emphasis therefore remains on capital preservation. This is expressed by the large underweight modified duration and 12+ year nominal bond positions. We have reduced our inflation-linked bond holding significantly in response to the more benign 12-month inflation outlook and have instead opted to create an overweight position in short- and medium-dated nominal bonds. The biggest risk to our cautious stance is US dollar weakness and consequent rand strength.

GLOBAL MONEY MARKET YIELD CURVE SLOPES (SPREAD BETWEEN 3- AND 12-MONTH MONEY MARKET RATES)

The South African money market slope is particularly steep on both an absolute and a relative basis, especially considering that we do not expect more monetary policy tightening in this cycle. We therefore remain keen buyers of 12-month money market instruments.



Sources: Bloomberg, Futuregrowth