LOW GROWTH COULD **SCUPPER FISCAL TARGETS**

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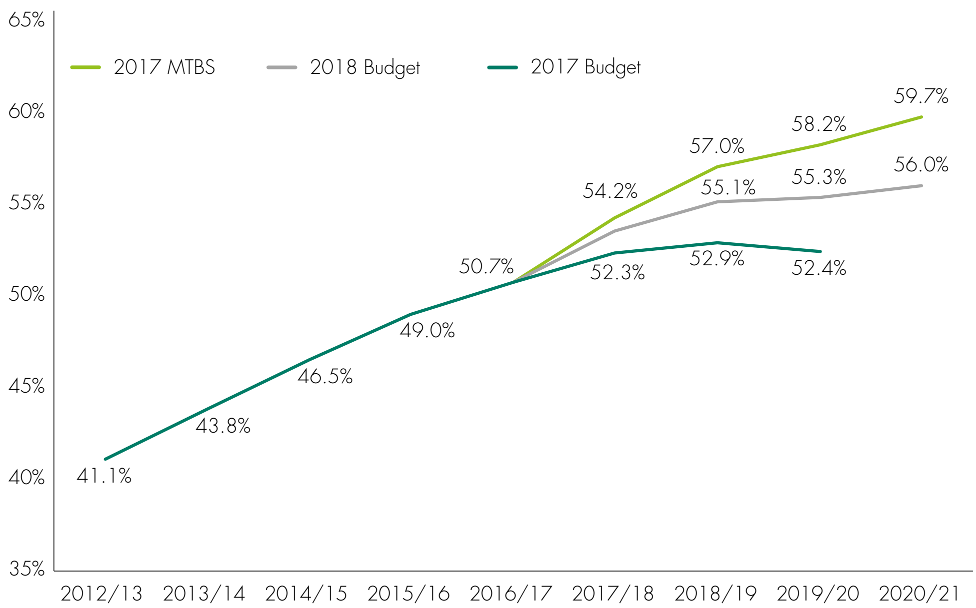
The Ramaphosa-induced euphoria gained momentum in February. Bullish market sentiment flourished as the old guard made way for the new leadership. This also gave National Treasury more room to pull out all the stops to enable the Minister of Finance to present a more palatable National Budget. Most telling was the decision to increase the VAT rate by one percentage point to 15% – a no-go option from a political perspective a mere few months ago. On paper, at least, new revenue and expenditure estimates gave birth to a less alarming, albeit still concerning, government debt profile for the three-year budget period, compared with the horror estimates presented at the mid-term budget in October last year. As the chart reflects, there is some improvement compared with the October 2017 estimates, but the numbers are still significantly worse than the estimates a mere 12 months ago.

The currency and bond markets continued their tandem march to stronger levels, in anticipation of and in response to the events outlined above. Following the significant bull rally, both the inflation-adjusted US dollar/rand exchange rate and

Gross government loan debt as percentage of GDP



Sources: National Treasury, Futuregrowth the bond market are now more fairly valued relative to our estimates. Considering the significantly reduced probability of a Moody's sovereign credit ratings downgrade, it comes as no surprise that foreign bond investors also responded with enthusiasm to the most recent changes. This is demonstrated by the jump in net foreign purchases of local bonds to around R12 billion towards the end of February, up from a worst year-to-date level where foreigners sold a net R6 billion worth of bonds. Confirmation of a benign inflation outlook, following the latest consumer and producer price data releases, served to strengthen market expectations of a near-term repo rate reduction by the South African Reserve Bank.

SA BONDS CONTINUE TO RALLY

The extent of the latest leg of the three-month long bond market relief rally is best illustrated by the yield of the benchmark R186 (maturity 2026), which decreased sharply from 8.46% at the end of January to 8.12% on 28 February, a level last recorded in May 2015. The sharp drop in bond yields across the yield curve gave rise to substantial capital gains. As a result, the All Bond Index returned 3.9% in February, an annualised return of 63%! The sharp drop in nominal bond yields also impacted the inflation-linked bond market in an indirect but a positive way, as real yields got dragged down to lower levels. This, despite the fact that investors' need for inflation protection had been significantly reduced by a more benign inflation outlook. Following this, the JSE Inflation-linked Government Bond Index returned 1.1% over the month. Both nominal and inflation-linked bonds outperformed cash (+0.5%) by a significant margin.

Local news flow and events have blunted the impact of the continued and steady rise of US bond yields. The rising trend in US Treasury yields should be seen in light of sustained strong growth momentum, the significant reduction in unemployment, early evidence of rising underlying inflation pressure and a very large widening of the US Federal budget deficit for the forthcoming fiscal year.

KEY TAKEOUTS

- CURRENCY AND BOND MARKETS STRENGTHEN
- GOVERNMENT DEBT PROFILE IMPROVES, SOMEWHAT
- BENIGN INFLATION AND FISCAL TIGHTENING SUPPORT A RATE CUT

EXPECT GLOBAL BOND MARKET WEAKNESS

Our view remains that, despite the recent pick-up in global bond yields, developed bond markets are still not appropriately priced. We believe that the US Federal Reserve (Fed) is in a position to lift the policy rate by 75 to 100 basis points this year. Considering the strong positive growth momentum and the low level of risk premia following years of aggressive central bank intervention, we expect more global bond market weakness in months to come. Although the Fed is adamant that the unwinding of its balance sheet will be done in an interest rate neutral way, we believe that this process will nevertheless contribute to the lifting of the global bond rate ceiling. In addition, the US has opted to loosen fiscal policy significantly, at a time when positive economic growth had already gained sustainable momentum.

THE RISK IS IN THE EXECUTION

Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and fiscal consolidation, or more specifically the rising debt burden of Government. Recent political changes, action with regard to state-owned enterprise management and the tabling of the latest Budget most certainly went some way to reduce some of the concerns we previously had. However, it would also be irresponsible to ignore execution risk. The structural nature and extent of the country's macroeconomic ills require significant policy adjustment, time and effort to resolve.

Our view on monetary policy also remains more cautious than what had been priced in by the forward money market. Admittedly, the more benign inflation outlook and some fiscal tightening opened the window for a 25 basis points repo rate cut in the near term. However, we would not subscribe to a more bullish interest rate view. Inflation expectations are hovering closer to the top end of the 3% to 6% inflation target range and actual inflation is merely back to the middle of this range, while monetary policy tightening in some parts of the developed world should not go unnoticed. Albeit reduced in size, a significant further contraction of the current account deficit will be hampered by a persistently large negative services account balance and a much stronger rand.

All things considered, we fear that markets have gotten ahead of themselves with unrealistic expectations, specifically in terms of the timing of fixing the country's complex fundamental ills. In contrast to a mere few weeks ago, very few dare consider the possibility of a Moody's sovereign ratings downgrade. Although this risk admittedly has shifted to a low probability, it has also become a potential high-impact event, considering complacent expectations and bullish market positioning.

Unless otherwise indicated, performance figures in the article are sourced from Futuregrowth and I-Net Bridge (Pty) Ltd.