METHODICAL
INVESTMENT MANAGEMENT

December 2023 Quarterly note

What happened?

Global disinflation remained the dominant financial theme while wages and employment held up. This resulted in a very positive quarter for US treasuries at the end of 2024, with the US 10-year decreasing from 4.57% to 3.9% for the last three months of the year. We have also seen significant rate cuts priced into the market, with the 1.5% of US rate cuts priced into by the end of 2024. The Goldilocks/soft-landing narrative continues to dominate expectations. A significant amount of supply is coming to the US treasury market, so further rallying against this backdrop will be difficult.

Geopolitical risks have risen with the conflict in the Middle East and the continued conflict in the Ukraine, although the markets appear to be broadly ignoring the impact of these. We also have several elections this year, including the US election, which will likely not be short of drama.

In South Africa, we continued to endure load-shedding, although the frequency and impact were lower than the record levels earlier in the year. Economic growth continued to disappoint, and politics will grab more headlines as we head towards a potentially tightly fought general election in 2024. SA inflation followed the global trend lower but remains higher than the Reserve Bank would like with headline at 5.5% inflation expectations remain uncomfortably high. SA bonds had a strong quarter led by the performance of US treasuries and more a benign MTBPs. This resulted in an 8.11% fourth quarter. The belly of the curve outperformed over the one year.

The Methodical BCI Income fund had a strong performance during the 4th quarter as the duration rally added to returns from yield in the portfolio. The US dollar exposure detracted from performance during the quarter but had a positive impact over the year.

The Methodical Bond fund performed well over the quarter, with the rally in SA Bonds having been positioned well throughout the year to benefit from the outperformance of the belly of the curve.

Q4 2023 performance

		4th quarter 2023	12 month
Cash	Stefi	2.07%	8.03%
Bonds	ALBI	8.11%	9.67%
ILBs	CILI	0.80%	2.99%
Methodical BCI Income Fund		3.15%	8.91%
Methodical BCI Bond Fund		7.43%	9.73%

Bond sector	4th quarter 2023	12 month
1 to 3 years	4.11%	9.22%
3 to 7 years	5.65%	10.32%
7 to 12 years	9.43%	11.89%
12+ years	9.22%	7.47%

What does the future hold?

We could see rate cuts in the US on the back of lower inflation, but there continue to be parts of the market (particularly wage growth) that are still higher than where the US Fed would like them to be. The latest inflation number was a little higher than expectations, and while the path appears to continue to be down, the final mile might be more difficult.

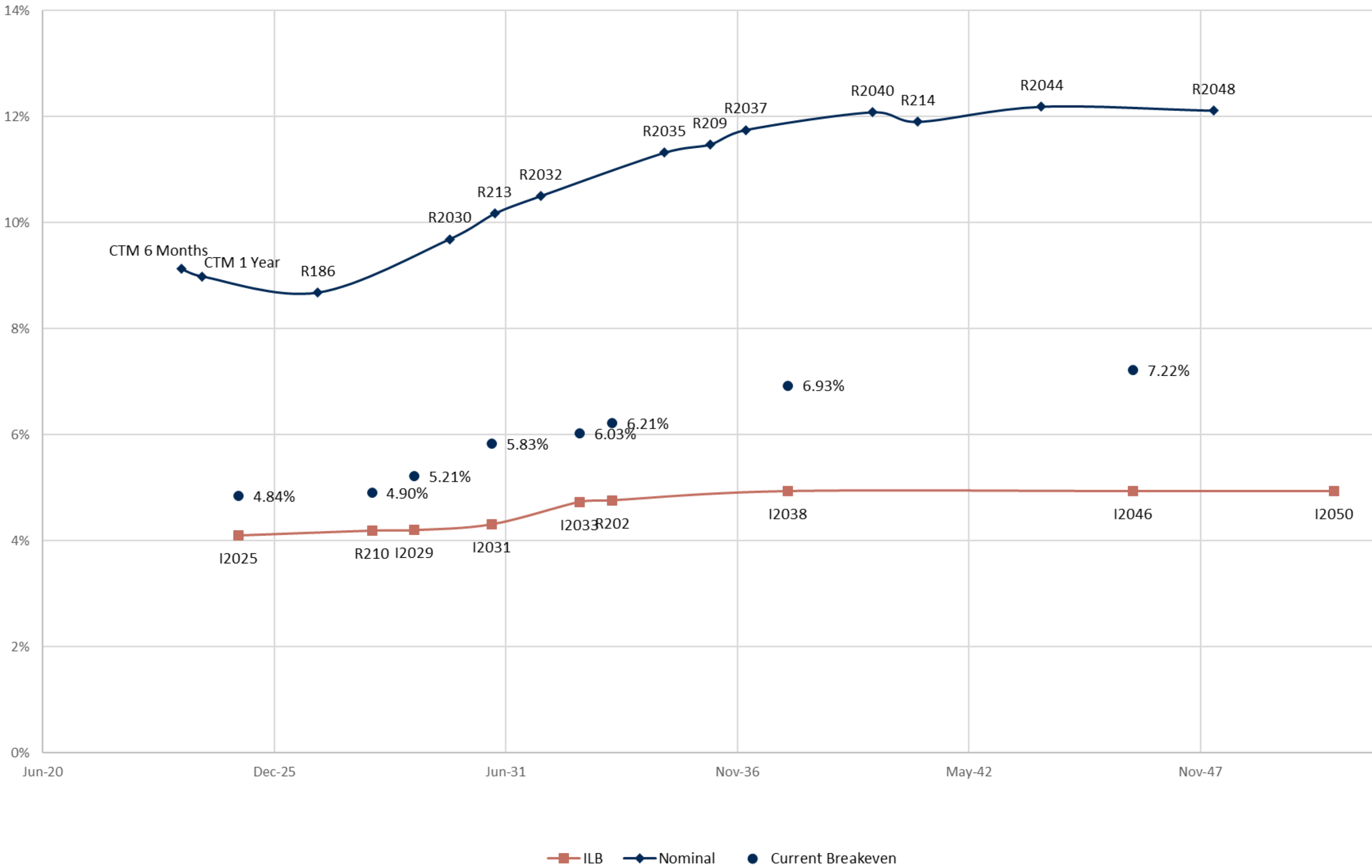
And the impact on South Africa?

SA Bonds face a tough time with a difficult budget, a stretched fiscus and potentially a less supportive treasury market. We also have elections this year, meaning the headline/event risk will be high. We now have 1% of rate cuts priced into our market, but I think this is heavily predicated on inflation continuing its downward path. We are likely to continue to require a higher neutral real rate, which means the scope for a large rating-cutting cycle while the global economy is still OK is limited.

Market developments

- **Short-end ILBs reflect moderating inflation with short term breakeven below 5%**

Chart 1. SA government versus SA ILB yield curves



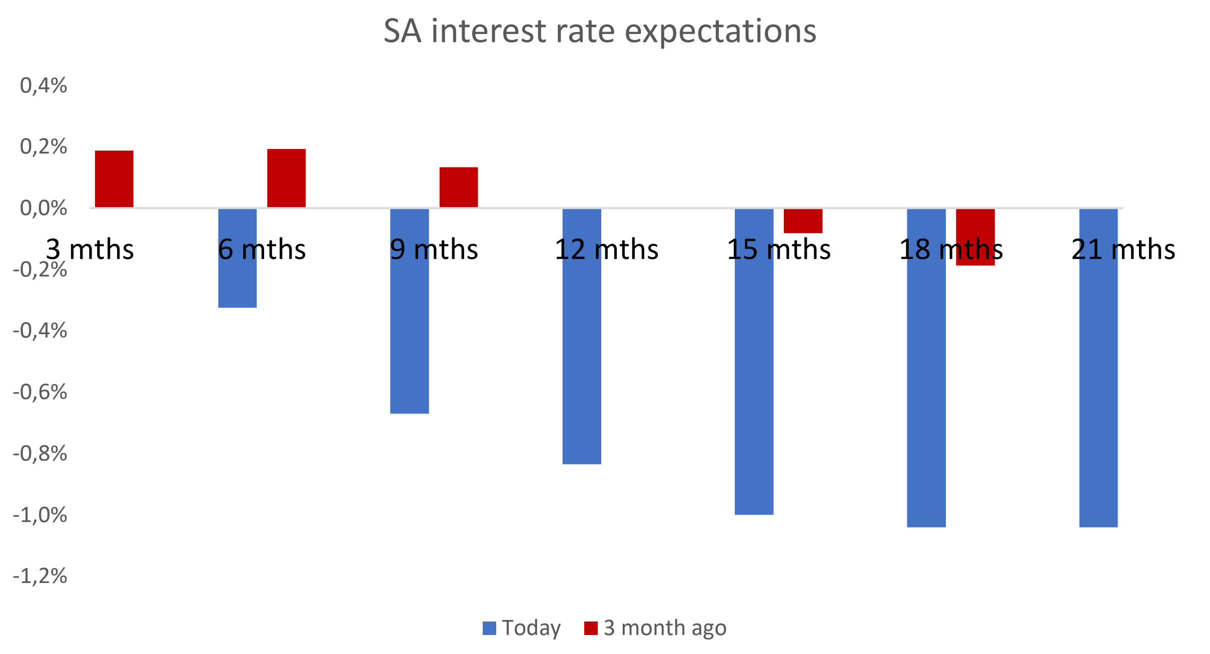
Source: Prescient Securities

The inflation breakeven (the difference between fixed rate governments and inflation-linked real yields) at the longer end is high, reflecting a premium for having inflation protection, while the front end still looks attractive on a relative basis with break-evens below 5%.

- **The market expects rate cuts in 2024**

The market is pricing in rate cuts from here, this is predicated on SA inflation continuing to remain contained. Currently, the SA repo rate at 8.25% implies a positive real rate of approximately 3%, and while there is scope to lower if inflation declines, we are likely to continue to see higher real repo rates.

Chart 2. Forward market 3-month JIBAR compared to current rate



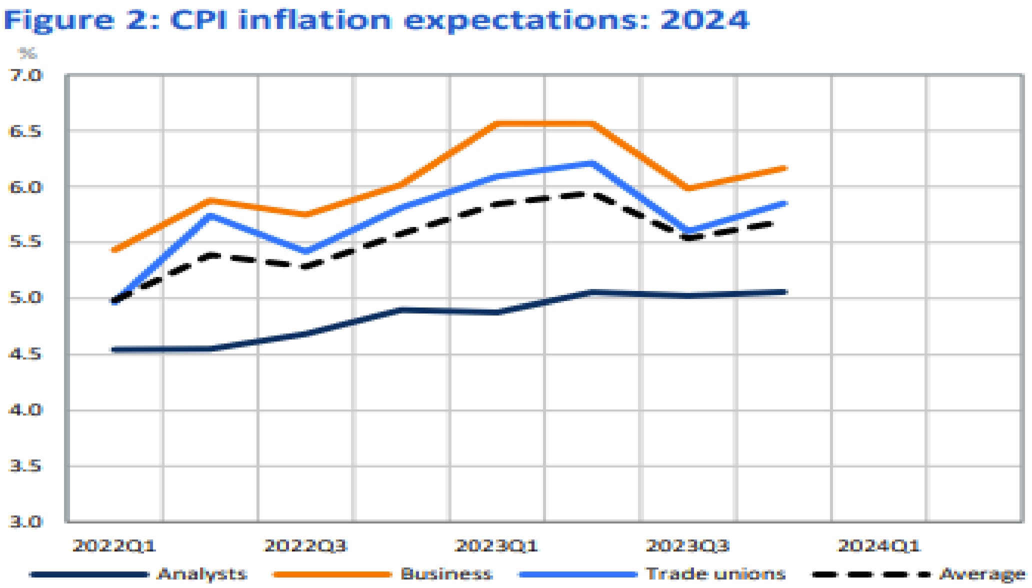
Source: Bloomberg

The SA inflation swaps (chart 3) is reflecting the likelihood that inflation comes back to the mid-point of the SARB inflation target.

Chart 3. 2-year inflation swap indicates a moderation in inflation down to 4.5%

Source: Methodical/Bloomberg

Chart 4. Inflation expectations have moderated but remain sticky at higher levels



Source: BER

➢ SA longer duration bonds

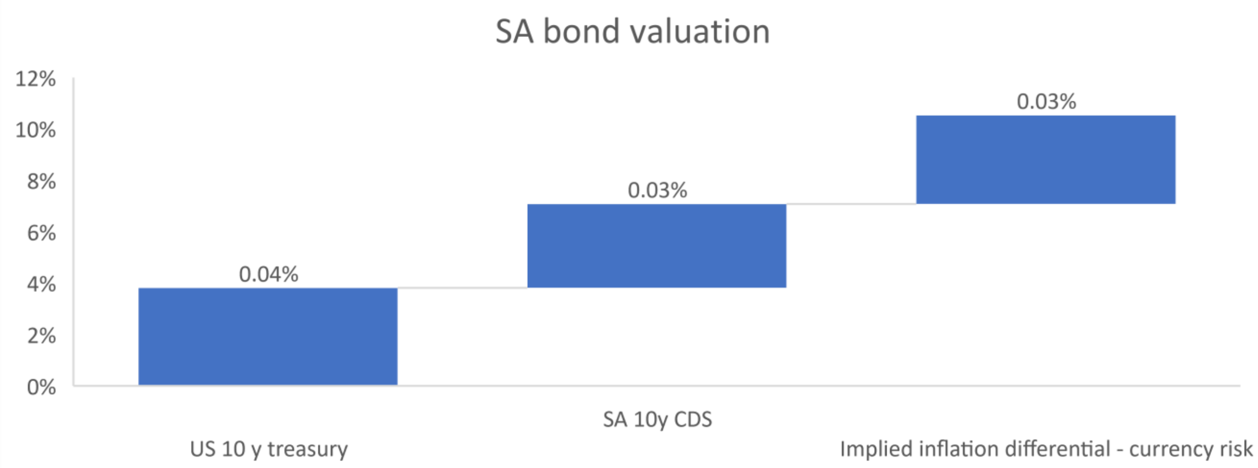
The fair value model for 10-year bonds has implied inflation below 6%.

SA 10y - R2032	10.53%	
US 10 y treasury	-3.81%	3.81%
SA 10y CDS	-3.27%	3.27%
Implied inflation differential - currency risk		3.45%

Expected US inflation (US inflation swaps)	2.48%
SA implied inflation	5.93%

Source: Methodical/Bloomberg

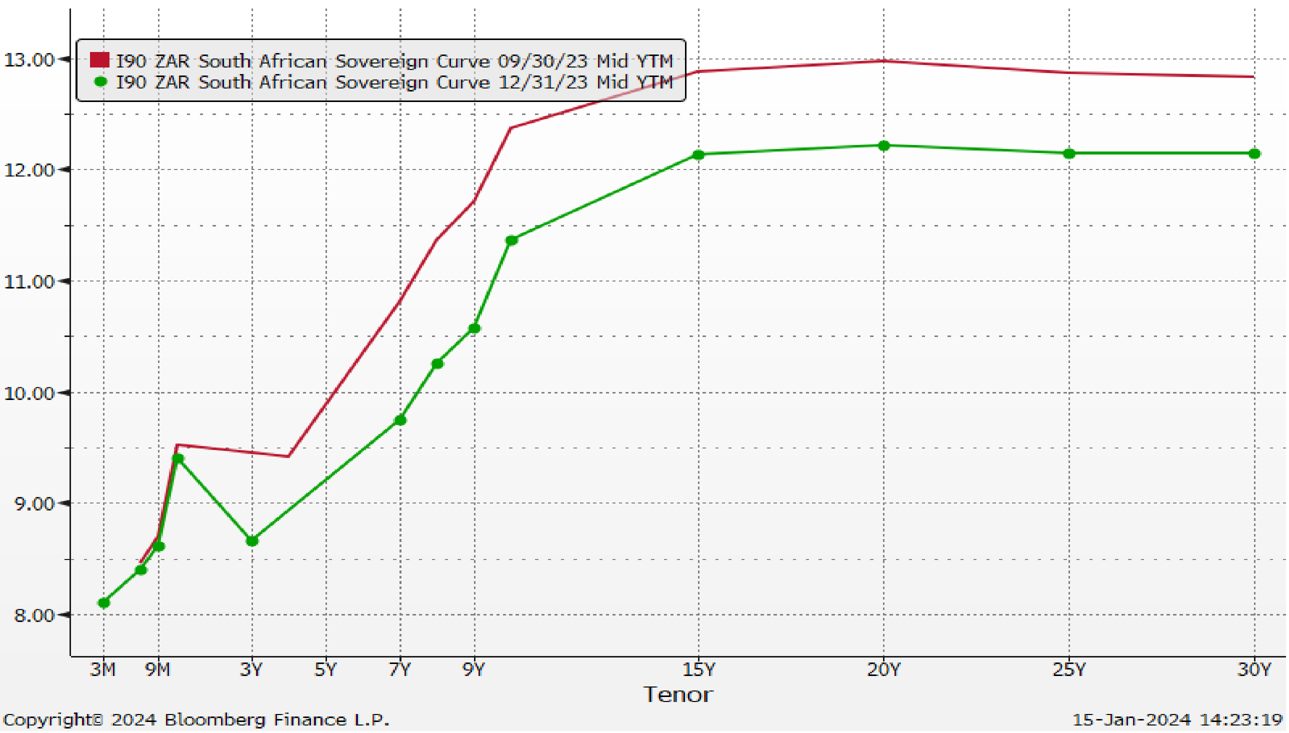
Chart 5. SA 10-year bond premia



Source: Methodical/Bloomberg

In Chart 6 below, the SA bond curve had a big rally in the 3rd quarter due to the rally in US treasuries.

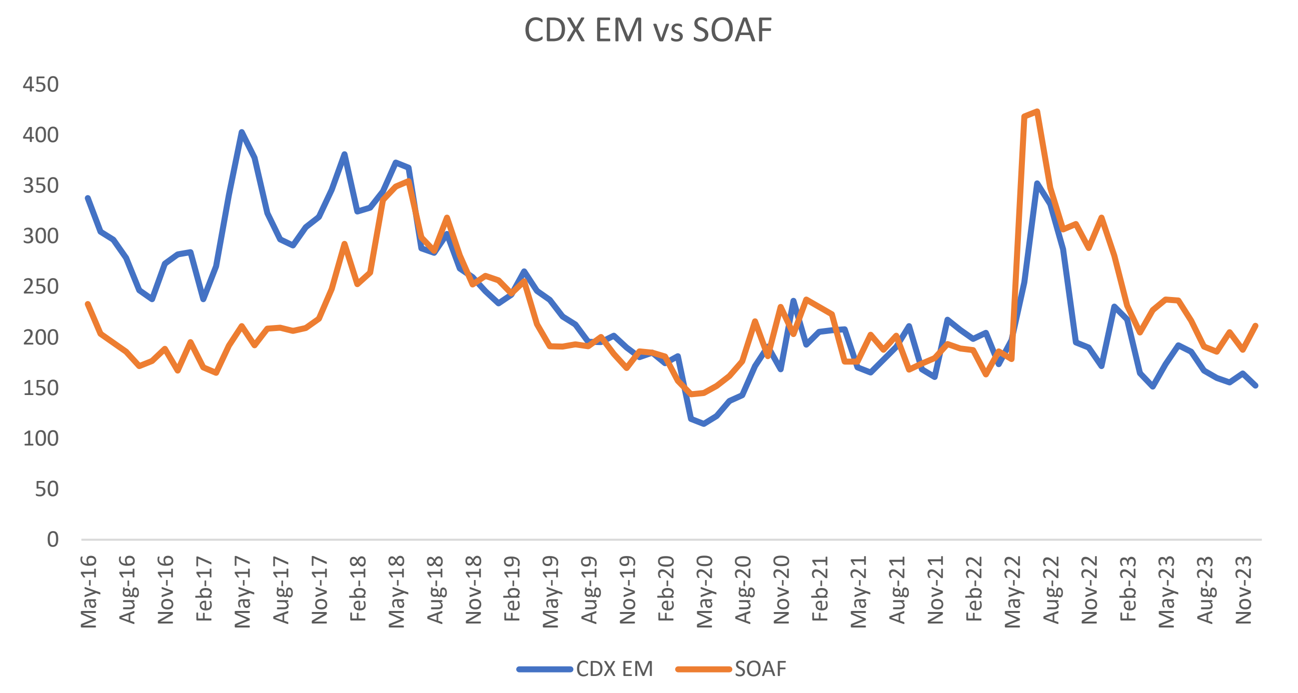
Chart 6. SA Government bond yield curves changes during the quarter



Source: Methodical/Bloomberg

- **Global credit**

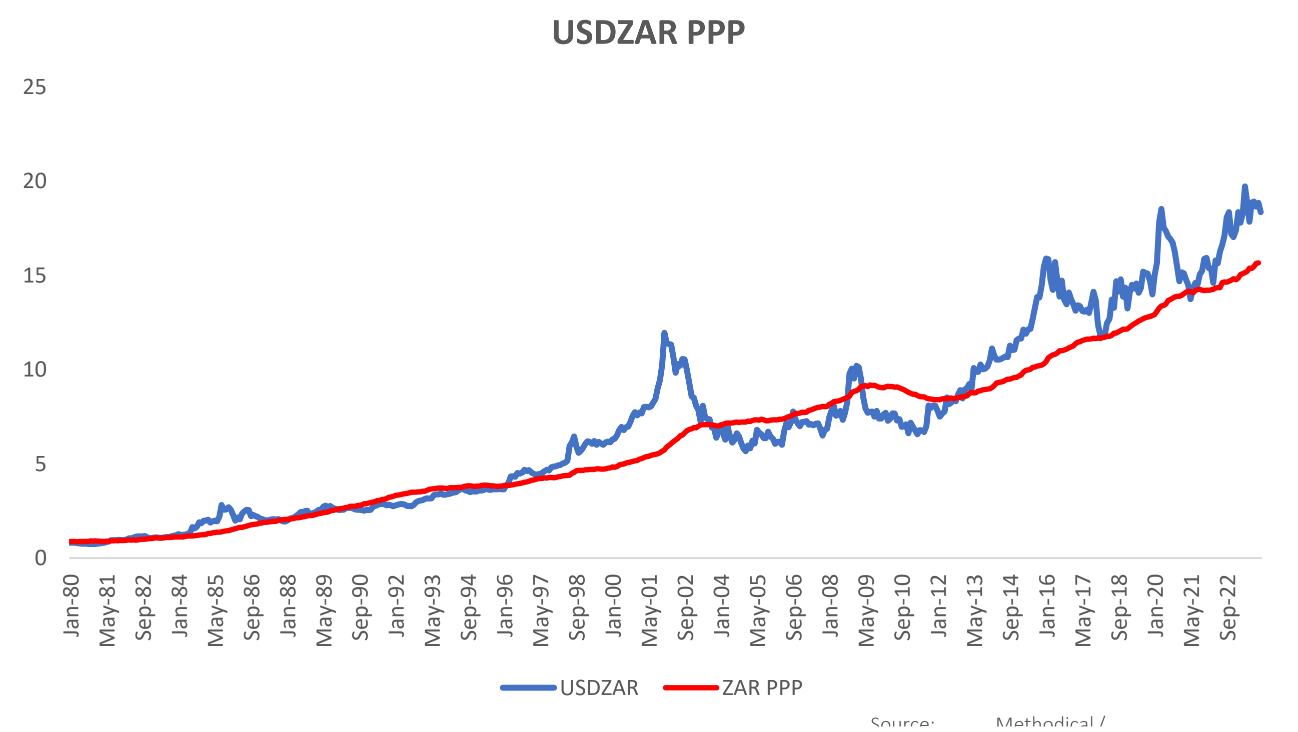
Chart 7. EM spread and South Africa (SOAF) CDS spreads have remain contained despite fiscal concerns because of the global goldilocks' scenario. There has been a slight recent divergence, probably as SA-specific risks emerge.



- **The Rand**

The rand strengthened during the quarter by 3% versus the US dollar, making the 12-month performance a 7.8% weakening against the greenback. The US dollar was weaker during the quarter, with the trade-weighted USD declining 4.6% and a 2.1% decline for the year.

Chart 8. Rand to US dollar is above long-term PPP levels, reflecting the risks to economy



Conclusion

2024 is likely to be a year full of event risk.

Given the many elections and conflicts happening worldwide, global geopolitics will make headlines. Whether the market will continue to ignore these risks will remain to be seen.

Global central bankers will likely be trying to walk the tightrope of continuing to control inflation and managing expectations for rate cuts and the financial conditions implications of the market pricing rate cuts.

In SA, we are going to have a tough budget and an election which is likely to be the closest one we have seen in 30 years, which should add up to plenty of opportunities for active fixed-income managers.

I hope you have a fantastic 2024.