Dynamic risk management as the economic cycle shifts

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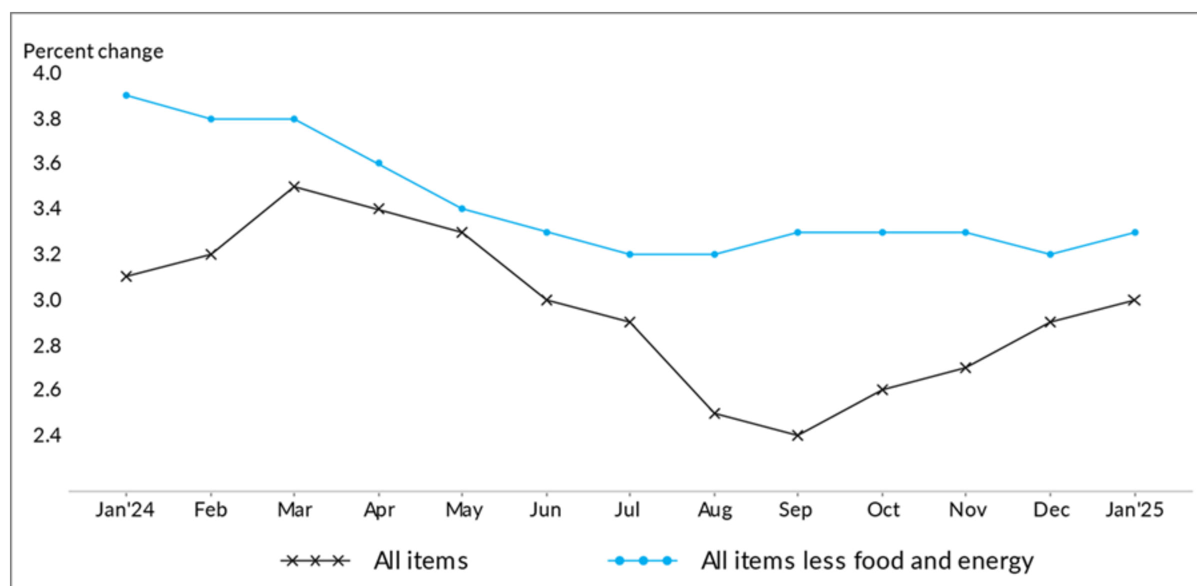
Towards the second half of last year, it seemed like the long-awaited global interest rate cutting cycle had finally arrived. However, markets are dynamic, and the interest rate and inflation paths anticipated towards the end of last year have undoubtedly shifted. We believe although fixed income markets are still positioned to deliver good real returns to investors, the return path will not be smooth, and therefore it is critical that investors partner with an investment manager who has a successful track record of managing downside risk.

The US drives the global interest rate cycle

In 2024, geopolitical risk and inflation were key drivers of market dynamics, disrupting expectations and keeping uncertainty at elevated levels. At the beginning of 2024, expectations were high that rate cuts were imminent in the US, as inflation numbers had started trending down (even though the economy remained robust). At one point in time, markets were pricing in up to eight 25 basis point rate cuts – making it a highly favourable environment for bonds. The US Federal Reserve finally moved to cut rates by a jumbo 50 basis points in September 2024, but in retrospect, this appears to coincide with inflation bottoming. Given the delayed start to the cutting cycle and ambivalent macroeconomic indicators, the market started pricing out some of the anticipated rate cuts. Thus, the environment became a more challenging one for bonds as the year progressed.

12-month percent change in US CPI for all urban consumers



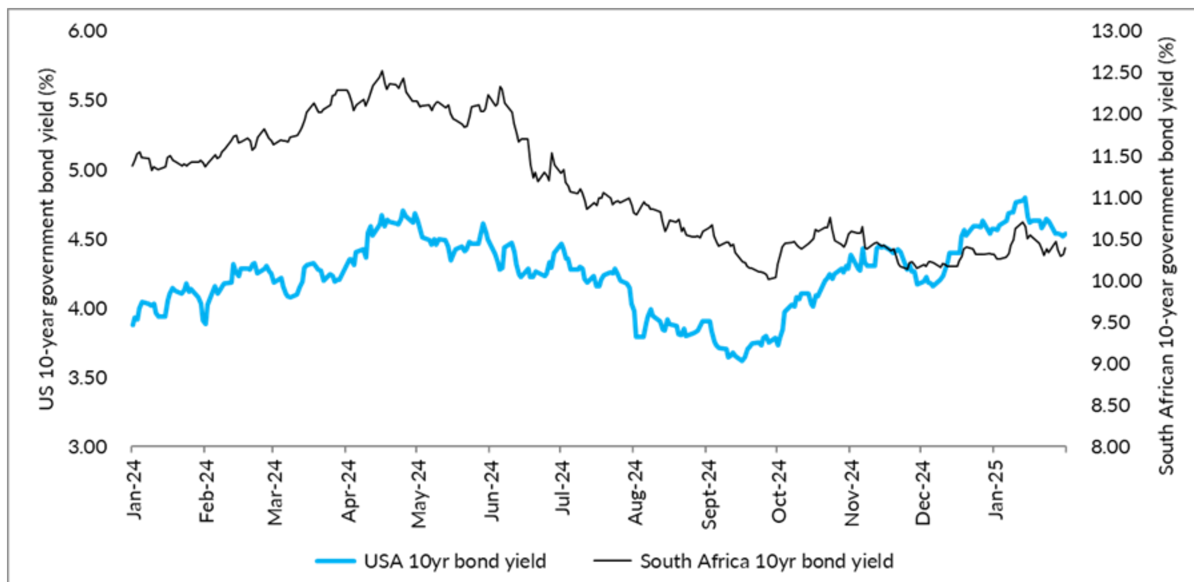
Source: US Bureau of Labour Statistics

The Trump factor

Even before US election results were known, it already seemed likely that the rate cutting cycle would be shallower and shorter than initially anticipated. However, President Donald Trump's policies are not only causing widespread confusion and uncertainty, but they are also most likely inflationary and are expected to have a detrimental impact on the already strained US fiscal position, despite the promises of trimming government spending through the Department of Government Efficiency (DOGE). This is also starting to feed into inflation expectations in the US, which have

been rising as a result. How the US interest rate cycle develops from here will have a fundamental impact on global asset prices.

South Africa: Robust performance within a tough global backdrop



Sources: PSG Asset Management and Bloomberg

SA seems surprisingly robust

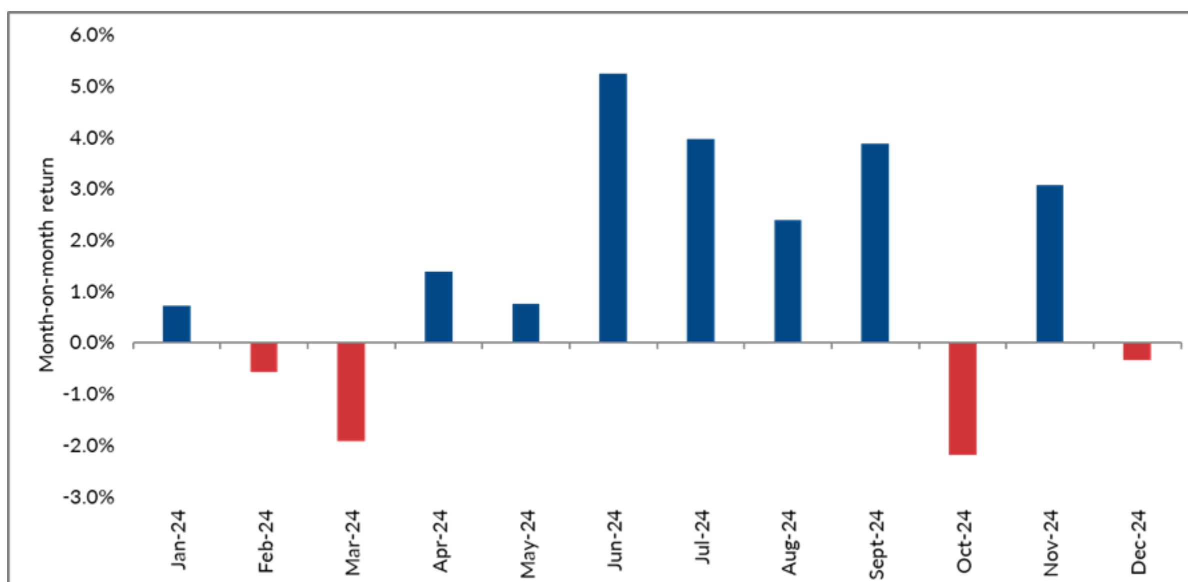
Many of the consumption-led inflation drivers that are problematic in the US don't exist locally. However, the US dominates global markets and SA markets will undoubtedly be impacted by changes in US inflation and interest rate dynamics. Moreover, we will not be immune to supply chain disruptions and the spillover effects of geopolitical tensions, which could impact local inflation.

It should be clear that SA's economic fundamentals – both economic and fiscal – are coming off a much lower base than that of the US, and that the US remains the economic powerhouse of the world. However, SA's fiscal outlook seems more promising than a year or two ago, and after more than a decade of lost growth, the economy is finally positioned to potentially shift onto a higher growth trajectory. Risks remain and the global environment can add uncertainty to local market dynamics, but we believe there is more scope for positive growth surprises than commonly anticipated.

Looking ahead in fixed income markets

Last year offered the valuable lesson that even when market outcomes are positive, the path taken to achieve those returns is not always smooth. Although bond markets (ALBI Index) delivered phenomenal returns for 2024 – outperforming equity markets and delivering returns in excess of 17% for the year – we saw negative returns in four months and large negative returns in March and October, as markets began to digest changes in expectations for global interest rates.

Monthly returns from SA bonds



Looking ahead, for the remainder of 2025, we anticipate that the path of global inflation (and by implication interest rates) and geopolitical risks will remain the key factors driving markets. Global bond yields are at attractively high levels on an absolute basis. However, we believe that the year ahead will be one in which investors need to be conscious of risk management, particularly protecting the downside, within their portfolios.

While global market dynamics may have delayed the anticipated structural shift downward in the SA bond cycle, local government bonds remain attractive. They're currently offering nominal yields of around 10% to 11%, which translates into real yields of around 6%, and we expect local inflation to be relatively contained during 2025. Thus, the real returns on offer from government bonds remain substantially above their long-term average, which is between 2% and 3%. Negotiable certificates of deposit (NCDs) and high-quality credit also offer nominal rates of between 8.5% and 9% for the year. Thus, all of these alternatives are offering returns in excess of what is available on cash. Meanwhile, we anticipate that listed property, which is sometimes included in multi-asset income portfolios, will likely have a more tempered year from a return perspective compared to 2024, given the potential for a shallower rate cutting cycle.

Aim to benefit from real returns on offer, focusing on protecting the downside

In a declining interest rate cycle, investors should be aware of the relative opportunity cost of being invested in cash, as bond prices typically appreciate as interest rate cuts are priced into the market. That said, there are upward risks to inflation over the next 12 to 18 months and we expect that markets could be volatile, particularly as US government policies have the potential to create inflationary pressures and add to investor uncertainty. With real returns of 6% on offer locally, but potentially being quite volatile, it is important that investors leverage the expertise of an investment team with a long-term track record of delivering attractive returns while also carefully managing downside risks.