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world of change

# The new economics of fixed income



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South African fixed income markets are undergoing a meaningful structural shift. For investors, the implications extend beyond cyclical movements in yields and into the deeper mechanics of inflation, liquidity, and global capital flows. Understanding these changes is critical to positioning portfolios effectively in the years ahead.

## A structural reset in inflation and rates

One of the most important developments in recent years has been the shift in South Africa's inflation framework. The South African Reserve Bank's move toward a 3% inflation target, reinforced by National Treasury, represents a step change in policy ambition.

For fixed income investors, the implications are clear: over time, lower and more stable inflation should translate into lower nominal interest rates. As credibility in this framework builds, inflation expectations – particularly at the long end of the curve – are likely to continue declining.



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This process is already underway. Long-term inflation expectations have compressed meaningfully, bringing down long-dated bond yields. While this reduces the risk of inflation eroding income, it also means that investors face a lower buffer against uncertainty. In other words, the margin for error is narrowing.

## Compression in yields reflects improving fundamentals

The strong performance of South African fixed income markets over the past year reflects both domestic and structural improvements.

On the domestic front, progress on fiscal consolidation has reduced the risk premium embedded in government bonds. At the same time, the anchoring of inflation expectations around a lower target has reinforced confidence in the long-term outlook.

Together, these forces have driven a material compression in yields. For investors, this raises an important question: where does value lie in a lower-yield environment? The answer increasingly depends on understanding relative opportunities across the curve and within credit markets, rather than relying on broad-based yield compression.

## Foreign participation and the importance of global liquidity

South Africa's bond market remains highly integrated into global capital flows. Foreign investors account for a significant share of ownership, and their behaviour is often driven by global liquidity conditions rather than domestic fundamentals alone. This creates both opportunity and vulnerability.

In benign global environments, characterised by a weaker US dollar and ample liquidity, South African assets tend to benefit from inflows. However, these flows can reverse quickly during periods of stress, particularly where positions are hedged or funded through global markets.

For investors, this underscores the importance of distinguishing between segments of the market that are more exposed to global liquidity shocks and those that are more domestically anchored. Local credit markets, for example, tend to exhibit greater resilience due to lower foreign participation.

## A changing external backdrop

The global environment has become more complex. Rising geopolitical tensions and higher oil prices introduce new risks, particularly through the inflation channel.

For South Africa, higher oil prices represent a negative terms-of-trade shock and add upward pressure to inflation. Even modest increases in inflation can have meaningful implications for monetary policy, potentially delaying or reversing expectations of rate cuts.

This dynamic matters for liquidity. Tighter monetary policy reduces liquidity in the system and can weigh on asset prices. While markets have thus far absorbed these developments relatively well, a prolonged period of elevated oil prices or further geopolitical escalation could lead to more pronounced tightening in financial conditions.

In this context, maintaining a cautious and flexible approach to duration and risk exposure is essential. At the same time, periods of market adjustment can create opportunities, particularly where long-term yields begin to reflect more attractive valuations.

## The role of central bank credibility

A key anchor for South African markets remains the credibility of the South African Reserve Bank.

Over the past decade, the SARB has demonstrated a consistent and disciplined approach to inflation targeting. This credibility is critical in navigating external shocks. When inflation rises, a clear and orthodox policy response helps to prevent second-round effects and maintain investor confidence.

In our view, this institutional strength remains one of South Africa's most important advantages in the emerging market universe.

## Structural considerations: concentration and governance

South Africa's financial system is characterised by a relatively concentrated banking sector. For fixed income investors, this introduces an additional layer of risk that must be actively managed.

Effective portfolio construction requires careful diversification, strict exposure limits, and rigorous liquidity stress testing. Understanding where liquidity will come from in stressed scenarios is just as important as assessing returns in normal conditions.

Equally, governance has become increasingly central to investment decision-making. In an environment of heightened scrutiny, robust processes, clear mandates, and disciplined risk management are essential.

## Digitisation and the future of liquidity

Looking ahead, technological developments are likely to reshape the fixed income landscape.

Advances in digitisation, including tokenisation and improved settlement systems, have the potential to reduce transaction costs, accelerate settlement times, and broaden market access. These changes could enhance liquidity, particularly by enabling a wider range of participants to access fixed income markets more efficiently.

While still evolving, these developments point to a more dynamic and accessible market structure over time.

## Conclusion: navigating complexity with discipline

The fixed income landscape is becoming more complex, shaped by structural policy shifts, global liquidity dynamics, and evolving market infrastructure.

For investors, success will depend on a nuanced understanding of both local and global forces. It requires identifying where risks are concentrated, where resilience can be found, and where value is emerging.

In a world of lower yields and tighter margins, disciplined portfolio construction and deep market insight are more important than ever.

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