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Can the SA bond market avoid indigestion?

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The fast view

- The growing debt burden brings the SA bond market very close to indigestion, i.e. difficulty with absorbing the debt issuance.
- Any deviation from the mini budget's debt-to-GDP projections, will push the country onto an unsustainable debt path.
- If government can stabilise expenditure and implement policy reforms to bolster growth, it would help to get South Africa out of the debt hole.
- A more favourable global backdrop is supportive of emerging market bonds, including the South African bond market.
- The Ninety One Diversified Income Fund is positioned to participate in any bond market rally, while the fund's offshore allocation serves as a risk mitigator.

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Last year was traumatic for the vast majority of the globe. The effects of the economic and human devastation caused by the COVID-19 virus will stay with us for a very long time. Policy makers around the world have scrambled to contain the human tragedy by imposing lockdowns, bolstering health services, introducing economic stimulus measures and more recently, rolling out vaccines for citizens.

Consequently, the debt of governments across the globe has ballooned. Fitch Ratings estimates that global government debt increased by approximately $10 trillion in 2020 to a staggering $77.8 trillion. Previously, it took seven years to increase global government debt by $10 trillion.[1]

Developed markets (DMs) have had more financial fire power than emerging markets (EMs) to help mitigate the devastation inflicted by the coronavirus. For example, the US, UK and Japan have taken on enormous amounts of debt, with their overall government-debt-to-GDP levels now sitting at 91%, 85% and 250% respectively. While these numbers are eye-watering, DMs have a lot more elbow room on the debt front than EMs. Even though South Africa's debt-to-GDP ratio is lower than these three countries (81%), its debt is viewed as unsustainable. SA bond investors question whether the proposed budget consolidation contained in the Medium-Term Budget Policy Statement (MTBPS) will be achieved and the associated debt trajectory will eventually be sustainable.

> South Africa's debt-to-GDP ratio is lower than the US, UK and Japan.

So, what makes our debt unsustainable?

It all boils down to debt serviceability, which is the ability of borrowers to make interest payments on their debt. DMs can afford massive increases in debt because their borrowing costs are very low. Persistently high SA government bond yields mean it is very expensive for our government to service its debt as the interest payments are steep. With bond yields in South Africa much higher than both inflation and GDP growth rates, our debt profile cannot consolidate as national revenues continue to grow at a slower pace than government's interest bill.

Without structural reforms, investors demand handsome compensation for investing in SA government bonds. They are concerned about the deterioration in state finances, which exacerbates this growing debt burden.

South Africa has been spending beyond its means for several years. The COVID-19 shocks to our economy worsened our precarious fiscal situation. Massive revenue shortfalls mean that over time, the government has been borrowing billions of rands to balance the national budget. Consequently, the government's debt servicing costs (interest rate bill) are taking a bigger slice of expenditure every year, crowding out other national priorities. Weak growth and lack of fiscal discipline lie at the heart of South Africa's fiscal problems. In Figure 1 we explore various scenarios, looking at how growth and government spending impact the debt picture.

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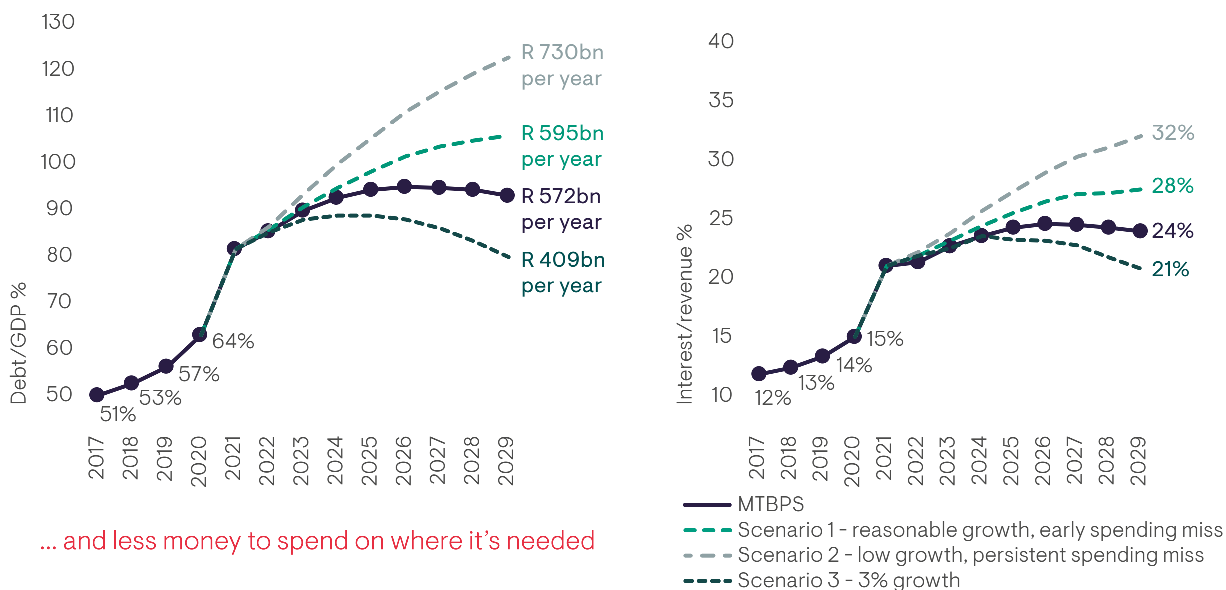
1 "The Growing Inequality in Global Government Debt Burdens", Fitch Ratings, January 2021.

Figure 1: Can South Africa climb out of the debt hole?

Rising debt = government bond indigestion ...



Source: Ninety One data, as at January 2021.

The left chart of Figure 1 shows the debt-to-GDP profile since 2017 and what the projections are for the next eight years. The chart on the right depicts debt interest payments as a share of tax revenue since 2017, with projections to 2029. According to October's mini budget (the MTBPS black solid line), the government will on average have to borrow R572bn a year from the bond market and other financial institutions over the next eight years. These projections from National Treasury bring the SA bond market very close to indigestion, i.e. difficulty with absorbing the debt issuance. The corresponding line in the chart on the right shows that under National Treasury's base case, close to a quarter of revenue gets spent on interest payments. That is a significant share, especially when considering what needs to be spent in South Africa on the social, education, health and infrastructure front.

Our fiscal situation is so precarious that any deviation from the MTBPS projections, for example, spending slippage (Scenario 1) or a combination of lower growth and spending misses (Scenario 2), will push the country onto an unsustainable debt path. If government's borrowing requirements exceed the projected R572bn a year (e.g. Scenario 1 or Scenario 2), the bond market will not be able to absorb the extra issuance. What's more, an even bigger slice of the tax revenue would have to go towards debt servicing costs (Scenario 1: 28% and Scenario 2: 32%). This would leave the state very constrained to provide public goods and services, and invest in the country's future.

The good news is that some improvement in growth would help to get South Africa out of the debt hole. If you take National Treasury's expenditure assumptions, but the country grows at 3% (Scenario 3), SA's borrowing requirements would fall to R409bn over eight years, requiring a much smaller share of tax revenue (21%) to service the interest rate bill.

Policy reforms would make all the difference

South Africa's fiscal and growth prospects can be dramatically boosted by a few key policy actions. Government needs to take concrete action on three critical issues:

Stabilise government expenditure. Concluding a deal with public sector unions that sees the government wage bill remain relatively flat over the coming three years, would help to make our debt sustainable.

Alleviate the energy constraint. Ensuring that the unbundling of Eskom remains on track is key. An independent transmission company would allow the acceleration of independent power procurement, notably from renewables. Cheap global financing should be available to facilitate the transition to greener energy.

Remove the key constraints to mining sector investments. It appears increasingly likely that the post-COVID global economic recovery will be supported by an increase in infrastructure spending, particularly on renewables. South Africa has relevant commodities for the carbon transition – and the government should ensure the industry has the ability and incentive to expand production to take advantage of this.

Progress on these issues could boost growth by one to two percentage points per annum. This would dramatically lower borrowing costs and stabilise SA's debt burden. Action is needed, and quickly. If National Treasury believed that the reforms would be enacted, it could reduce the quantity of its bond issuance. That would be very helpful to lower bond yields and avoid the bond market suffering from indigestion. At the same time, it would reduce the cost of funding.

Outlook

The SA economy was more resilient last year than anticipated, with GDP growth declining by just over 7%, versus the widely forecast -10%. While China has seen a full economic recovery and the US economy is well on its way to pre-COVID-levels, South Africa and other EMs will take a few years to achieve this. So, the growth environment remains challenging, with SA expected to grow by at least 2.4% this year. This is why policy reform in SA is crucial. Fortunately, easier monetary policy and very low interest rates in DMs as well as fiscal stimulus measures are providing support to emerging market assets and currencies. Despite South Africa's fiscal woes, the rand should remain resilient, thanks to our favourable terms of trade, and bouts of dollar weakness.

We expect capital flows to be mixed. Persistently low rates in the US and in other DMs should see foreign capital flows into our bond market. However, global concerns about the coronavirus and the roll-out of vaccines could dampen risk sentiment. We expect market volatility to continue. SA inflation remained firmly under control last year, hovering around 3%. This allowed the South African Reserve Bank to cut interest rates by 300 basis points. We expect inflation to average around 4% over the course of this year, amid rising food and fuel prices. Although we still have weak growth and inflation remains under control, we do not expect more interest rate cuts in the near term.

Portfolio positioning

With cash rates at record lows, government bonds are offering the best yields. Investors can earn around 8.5% on a ten-year government bond, which is very attractive.[2] A combination of government bonds with some foreign exchange exposure to mitigate the risks, allows our investors to earn a decent yield in the portfolio. We have a reasonable allocation to inflation-linked bonds, which also helps us to manage risk in the portfolio. If the government is able to contain its wage bill and we see some concrete progress on the path to structural reforms, SA bonds could enjoy a capital uplift.

The portfolio is slightly underweight credit, with some offshore exposure. On the local front, we favour banks that have strong balance sheets and good credit ratings. Listed property is very volatile, and we remain underweight the sector.

We have a well-diversified portfolio to provide some protection against the multitude of risks locally and globally. This investment strategy has worked well for us during periods where we have experienced bond market volatility or rand weakness.

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2 As at 5 February 2020.

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