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Previously Investec Asset Management

SA fixed income: with all the risks – is there value?

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The fast view

- Our offshore allocation is higher than at any other period over the last four years. It acts as a buffer against local interest rate-sensitive risks and helps to offset any inflation risks from rand weakness.
- We favour shorter-dated bonds that are tethered to the SARB and less dependent on the fiscus.
- With cash rates already at the 4%-level and heading lower fast, our combination of bond duration and asset allocation maintains yields substantially above that.
- Our balance of exposures should provide some protection against the multitude of risks locally and globally.

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Not even the Global Financial Crisis dished up the market turmoil we faced in the first three months of the year. The impact of the coronavirus (COVID-19) pandemic on the global economy and financial markets has been unprecedented. We saw a scramble for liquidity as a result of this exogenous shock; there was nowhere to hide with massive price impacts across all markets. In the first quarter, our bond market suffered one of its worst ever performances (-8.7%), with foreign investors selling more than R50 billion worth of bonds. Moody's finally downgraded South Africa's credit rating to below investment grade, which means that from 1 May South Africa no longer forms part of the FTSE World Government Bond Index.

Investors also saw ten-year bonds spike to 13.25% in late March (from below 8.75% at the time of the February budget). In an attempt to maintain effective monetary policy transmission,[1] the South African Reserve Bank (SARB) restored market functioning by buying bonds in the secondary market – an unprecedented but justifiable move. Ten-year bonds are now back to trading at yields of around 10.5%. But even after a quarter of extreme market stress, the relentless flow of bad news has left investors uncertain how to digest all the changes. The SA government announced a R500bn stimulus package to help our economy to recover from the fallout from COVID-19. The SARB has also come to the party with unprecedented market intervention and liquidity provision, as well as aggressive interest rate cuts. Where to from here for fixed income assets? In this article, we unpack some of the main drivers of our fixed income market.

Low inflation and declining interest rates are positive for bonds

> The SARB still has leeway to drive rates even lower.

Amid all the bad news and uncertainty, there are still solid reasons for liking bonds. Inflation and interest rates are the two key factors that drive bond markets. Both are declining in South Africa, which is very supportive. With inflation being under control for some time already, and now threatening the lower end of the SARB's target band, the Bank has had plenty of room to ease monetary policy. The repo rate was 6.5% coming into the year, but after a series of cuts is down to 4.25%. We believe that the SARB still has leeway to drive rates even lower, potentially cutting the repo rate by an additional 50 to 100 basis points. When you take a step back and think about that quantum of easing – for those individuals and businesses who are paying interest on debt – their monthly payments will have decreased by up to a third. That is a significant boost to an economy struggling in intensive care.

[1]The process through which monetary policy decisions affect the economy and price levels.

It seems strange to think that the SARB has so much room to cut rates, considering the depreciation in the rand this year. However, given the halt to economic activity and the resulting lack of demand, on top of the spectacular collapse in the oil price, upside inflation is not a worry. Of course, the rand is always a very important determinant of inflation, and its recent weakness remains a concern. However, we believe the rand scenarios that result in high inflationary outcomes are a long way off. As South Africa is an oil importer, the extent of the oil price decline has helped to contain inflation. Figure 1 shows our inflation forecasts for this year under different rand and oil scenarios. This illustrates how much further the currency needs to depreciate and oil needs to move higher, before the SARB needs to worry about inflation.

Figure 1: The SARB has more room to cut rates: 2020 inflation scenarios

Oil price \ Rand	16.4	17.4	17.9	18.2	18.9	19.9	20.4	20.9
18.8	1.7%	2.0%	2.2%	2.3%	2.5%	2.8%	3.0%	3.1%
23.8	1.9%	2.3%	2.4%	2.6%	2.8%	3.1%	3.3%	3.5%
28.8	2.2%	2.5%	2.7%	2.9%	3.1%	3.4%	3.6%	3.8%
33.8	2.4%	2.8%	3.0%	3.2%	3.3%	3.7%	3.9%	4.1%
38.8	2.7%	3.0%	3.2%	3.4%	3.6%	4.0%	4.2%	4.4%
43.8	2.9%	3.3%	3.5%	3.7%	3.9%	4.3%	4.5%	4.7%
48.8	3.2%	3.6%	3.8%	4.0%	4.2%	4.6%	4.8%	5.0%
53.8	3.4%	3.8%	4.0%	4.2%	4.5%	4.9%	5.1%	5.3%
58.8	3.6%	4.1%	4.3%	4.5%	4.7%	5.2%	5.4%	5.6%

Source: Ninety One SA.

The table captures a range of outcomes for oil and the rand because markets are so fluid, and both have seen sharp movements in a very short space of time. We have assumed $34 a barrel for Brent crude oil and a dollar rand exchange rate of R18.20 for the remainder of 2020. That gives us an inflation rate of 3.2%. The SARB is targeting inflation of 3% to 6%, which means 3.2% is close to the lower end of the band. Inflation would only start to threaten the upper limit of the SARB's target band, if our currency weakened to R21 against the dollar and the oil price moved close to $60 a barrel. So, we believe inflation is well contained, leaving the SARB room to cut rates further.

Our economy needs all the help it can get

The economic fallout from COVID-19 and the necessary lockdown measures, has been immense. South Africa had already entered a recession before the virus crisis hit. We estimate that just less than half of the economy was able to operate under the strict nationwide lockdown (level five). As these measures are gradually relaxed over the coming months, we expect 85% to 90% of the economy to be back on stream by September. We estimate that economic growth will contract by a staggering 13% over the second quarter (not annualised!), with some bounce back in activity towards the end of the year. This should give us an overall decline in GDP of 8% for 2020 with a high level of uncertainty (and downside risks). The government's stimulus package of R500bn aims to alleviate the financial stress of consumers and businesses, bolster healthcare services and ultimately, help our fragile economy to recover. Lower interest rates are also a key relief measure. We are hoping for some recovery next year but remain concerned about the economy's health beyond 2020 – given how weak the economy was, going into the crisis.

So, how will the ailing economy and the stimulus package impact the fiscus?

Prior to the COVID-19 crisis, the government's deficit for this year was budgeted to be 6.8% of GDP. But GDP is now expected to contract sharply, with tax collections suffering. On top of that, government faces additional spending pressures under the fiscal package. So, we expect the budget deficit to increase to approximately 13% of GDP, taking into account the stimulus measures. The good news is that government has been smart about financing the R500bn stimulus package:

- A large portion will be funded by using banks' balance sheets (the R200bn loan guarantee scheme). It will only be a contingent liability to the state and therefore doesn't require extra bond issuance.
- A further R130bn will come from reprioritising spending in the existing budget.
- The Unemployment Insurance Fund, which has a surplus of R150bn, will be another source of funding.
- The government has access to R100bn in funding from multilateral agencies such as the IMF and the World Bank, so it could easily fund the balance of the stimulus package.

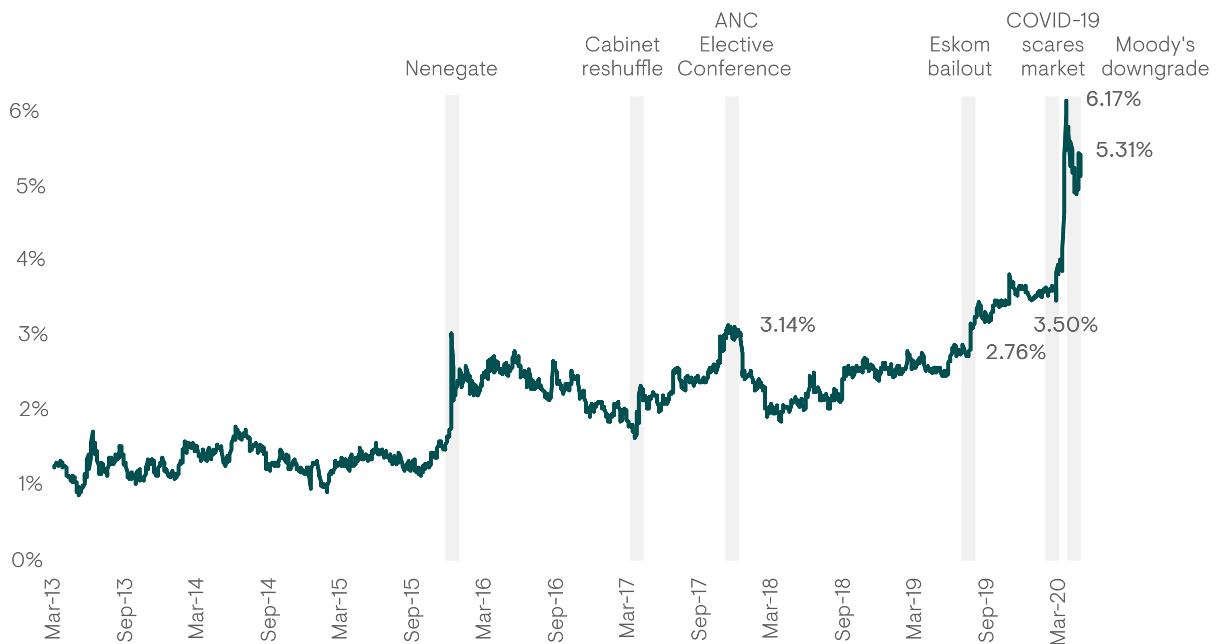
Given the way it has been funded, the additional expenditure does not present a cash-flow problem for National Treasury and therefore is less of a near-term concern for the bond market. However, government's ballooning debt, with an economy unable to grow, is a solvency problem. With debt to GDP now climbing to an estimated 80%, implementing structural reform to unshackle growth and confidence is crucial. The bond market's fate (along with South Africa's) will ebb and flow with the perceived 'political willingness to reform' – a somewhat tedious game that's all too familiar.

> There will be stiff competition for capital over the next few years.

SA bond market valuations remain attractive

The COVID-19 crisis sparked a wave of global market risk reduction, with investors seeking refuge in 'safe-haven' and liquid assets such as developed market (DM) government bonds. While bond yields are low to negative in DMs, yields in emerging markets (EMs) have generally risen to compensate investors for the higher levels of risk (bond prices fall when yields rise). South African government bonds, which were already trading at a discount to EM peers, are now substantially cheaper in price. As can be seen in Figure 2, pre-2015, the yield spread of nine-year SA government bonds over their comparable EM peers was approximately 1% to 1.5%. This has steadily widened to a rate of 5.3% above EM peers. The discount (in price), while arguably excessive due to current market conditions, is to an extent justified – given the deterioration in our country's debt metrics mentioned earlier. But it is important to understand what this discount could mean for us as a country when the South African government competes for capital globally.

Figure 2: SA nine-year bond yield versus EM spread



Source: Bloomberg, March 2020.

The borrowing needs of governments across the world are increasing at unprecedented rates due to fiscal stimulus measures to bolster their economies. So, there will be stiff competition for capital over the next few years. DMs will be at the front of the queue, given their central banks' ability to monetise those borrowings in a non-inflationary way. But South Africa's higher yields (and deeper discount) mean it is further up the queue to attract foreign capital than a lot of its EM peers. SA bonds look cheap not only versus inflation, but also relative to EM peers.

How are we positioned?

The Ninety One Diversified Income Fund aims to 'participate and protect' – and given the terrible first quarter for all South African fixed income assets, it was certainly a period where we aimed to 'protect'. While the All Bond Index lost 8.7% over the quarter, the Ninety One Diversified Income Fund avoided a quarterly drawdown and posted a small, yet positive return. Our active offshore allocation and bond downside protection were a significant help.

When thinking about approaching the opportunities going forward, it is important to remember that risk and return rank equally in the portfolio. So, we don't seek return at the expense of risk and vice versa. This means that when markets are volatile, we are very measured in seeking opportunities. Position sizing is therefore important to us.

We have painted a picture where:

1. Interest rates are heading lower, because inflation allows it.
2. Local fiscal and economic risks are large; they are being managed but cannot be ignored.
3. SA bonds are at a significant price discount to their EM peers.
4. There will be a global queue for capital which introduces currency risk and volatility.

Point 1 and 2 mean that we favour shorter-dated bonds that are tethered to the SARB and less dependent on the fiscus. As an example, the R186 bond (5.5-year maturity) ranged between 9% and 11% in April. Given that the repo rate is 4.25% (and heading lower) and the SARB is supporting the secondary market, these shorter-dated bonds seem like good value to us.

Because the SARB's 'rand anchor' (of keeping repo rates higher) is being lifted and global competition for capital is fierce, we think the rand will remain vulnerable. Our offshore allocation is therefore strategically higher than at any other period over the last four years. It acts as a buffer against local interest rate-sensitive risks and helps to offset any inflation risks from rand weakness.

Our offshore allocation is higher than at any other period over the last four years.

We have maintained an underweight position in listed property for some time and remain cautious. We have gradually started to increase our allocation, focusing on the valuations of quality companies with stronger balance sheets. The portfolio has maintained a defensive investment-grade credit positioning in light of the weak local growth outlook in recent years.

We have built up a decent liquidity buffer to take advantage of the opportunities that will arise over the near term. With cash rates already at the 4%-level and heading lower fast, our combination of bond duration and asset allocation maintains yields substantially above that. As outlined above, we have a balance of exposures 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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