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Investing for a
world of change

Where to from here for SA fixed income investors?

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The fast view

- The South African Reserve Bank has stepped up its war on inflation. We currently expect another two interest rate hikes this year of 50 basis points at each of the last two Monetary Policy Committee meetings in September and November.
- South Africa's GDP growth is back at pre-Covid levels, but the picture is mixed. We believe key policy reforms, such as the President's energy plan, and measures to advance infrastructure development and stabilise government expenditure should boost growth.
- The country's fiscal prospects are considerably better than feared. The debt-to-GDP ratio has improved steadily since June 2020, but it is crucial that government continues to focus on expenditure control.
- Bonds remain an important source of income for our investors in the Ninety One Diversified Income Fund. This trend should continue for the remainder of 2022 and into 2023.
- The Ninety One Diversified Income Fund is positioned to participate in any bond market rally, while the Fund's offshore allocation helps to protect capital in times of weakness.

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High inflation, rising interest rates and falling markets have battered investors this year. Aggressive rate hikes in the US to stem rampant inflation have not only driven equity markets sharply lower but have also pummeled bond markets. While inflation in South Africa has not reached the highs of US and European inflation, we still saw consumer price inflation (CPI) surge to 7.4% in June – a 13-year high.

Now that we are firmly in the third quarter of 2022, what is the outlook for SA fixed income assets?

Inflation risks are materialising

For some time, South Africa had muted inflation when the rest of the world was experiencing rampant inflation. We have not been able to escape it entirely, with rising food and fuel prices the main drivers of SA inflation. Fortunately, the South African Reserve Bank (SARB) has been pre-emptive in terms of policy action to contain inflation. It has been one of the leading central banks globally on this front.

> We currently expect another two interest rate hikes of 50 bps this year – one in September and one in November.

The SARB started hiking interest rates in November last year when developed market central banks were still saying that inflation was transitory. The central bank was concerned about rising SA inflation pressures when CPI was still below 5%.
As inflation moved outside the target band, the SARB was quick to react and hiked rates by a further 75 basis points (bps) in July. We currently expect another two interest rate hikes of 50 bps this year – one in September and one in November. This should bring the repo rate to a real rate of about 1% above South Africa's expected average inflation rate for 2023. We expect CPI to average around 5.5% next year if the oil price stabilises and food prices moderate.

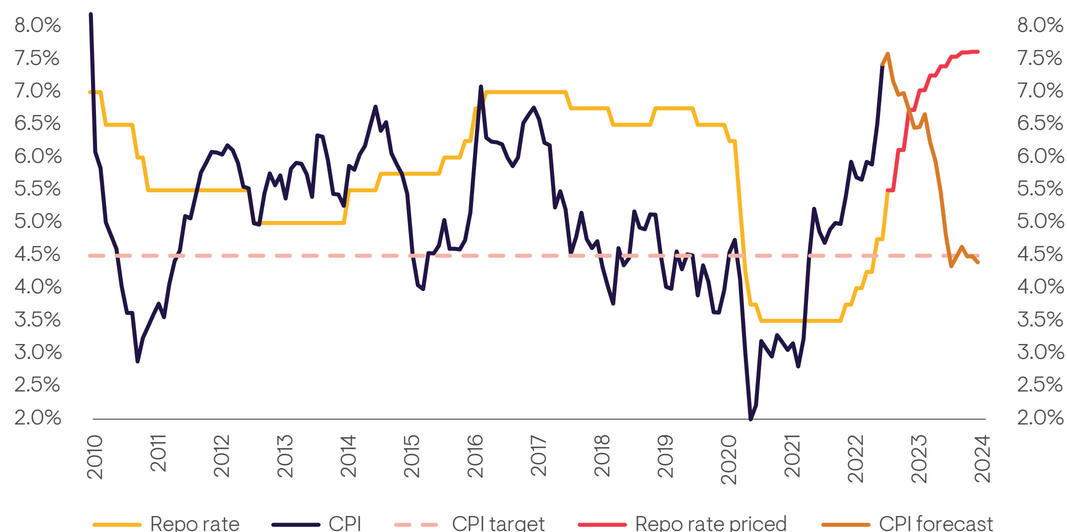
This will mean that the SARB's monetary policy will no longer be accommodative, and the central bank can then react to the data as it unfolds. Historically, the SARB used to run real policy rates of 2%. So, we expect that there will be some debate among Monetary Policy Committee members next year on where real rates should settle when the repo rate has reached around 6.5%. But it is likely that the new equilibrium will be between 1% and 1.5%.

> If there are upside surprises in terms of rate hikes, SA bond yields are unlikely to spike materially.

We are comfortable from a valuation perspective that even if there are upside surprises in terms of rate hikes, SA bond yields are unlikely to spike materially. (When bond yields rise, bond prices fall.)

We expect the US Federal Reserve's (the Fed's) hiking cycle to end at the latest in the second quarter of 2023, which will take pressure off the SARB to keep increasing the repo rate.

Figure 1: More interest rate hikes to come but largely priced in
SA inflation and repo rate outlook



Source: Ninety One, August 2022.

SA economy showing some resilience

The economy has been more robust than we expected going into 2022. While low-income consumers are reeling from higher food and transport costs, broad-based growth across retailers indicate there is still decent demand from middle-income consumers. This likely reflects pent-up spending from savings built up during the Covid pandemic.

GDP growth is back at pre-Covid levels, but the picture is mixed. There has been a solid recovery in the primary sector; however, growth in the mining and agricultural sectors is starting to slow down. The tertiary part of the economy, which includes technology, financial services and tourism, has also rebounded, surpassing 2019 levels. The critical manufacturing and construction sectors have remained laggards, hovering below pre-Covid levels. Unfortunately, these secondary sectors are a large part of the economy in terms of job creation: electricity constraints, and a lack of business confidence and policy reform have hindered their growth.

> Growth in the mining and agricultural sectors is starting to slow down.

It seems like the country's electricity crisis is finally getting urgent attention from the SA government. The President announced several measures in July that seek to not only address the current energy shortfall, but to bring new energy projects online that can meet the country's long-term electricity needs. Government is removing red tape to accelerate private investment in energy generation. This should be positive for the renewable energy sector, and in turn, the construction industry, helping to create much-needed jobs. We believe key policy reforms, such as the President's energy plan, and measures to advance infrastructure development and stabilise government expenditure should boost growth into 2023.

Fiscal prospects considerably better than feared

A higher growth rate would help to improve the government's debt situation. As bond investors, we carefully monitor the government's debt levels. Fortunately, we have had strong tailwinds from the commodity and agricultural sectors over the last year, which have bolstered government revenues. Two years ago, South Africa was heading towards an unsustainable debt path. Government's debt servicing costs (interest rate bill) were taking a bigger slice of expenditure every year, crowding out other national priorities. The SA bond market also came close to 'indigestion', i.e. difficulty with absorbing the debt issuance.

Since June 2020, there has been a big improvement. When finance minister Enoch Godongwanga delivered his first budget in February of this year, the projected debt-to GDP figures fell to 72% from 86% (budget 2021). More recent fiscal data gives cause for some optimism. Over the first 3 months of the 2022/2023 fiscal year, the government actually recorded a budget surplus. Corporate income tax collections have surprised on the upside, and revenue from personal income tax is also running comfortably ahead of last year's numbers. While tax collections have been strong, there has been some under-expenditure within the department of public enterprises, giving rise to the surplus. We estimate that South Africa's debt-to-GDP numbers have continued to improve since the February budget, but we are not out of the woods yet.

The SA government should be aiming for a debt-to-GDP ratio of below 50%. This would make the fiscus less vulnerable to local or global economic shocks in the future. So it is crucial that government continues to focus on expenditure control. We view it as a positive development that the finance minister will be leading the public sector wage negotiations. A wage increase settlement of close to the budgeted 3% will ensure further consolidation of our debt, as it will help to control a big ticket item in the budget.

SA bond valuations remain compelling

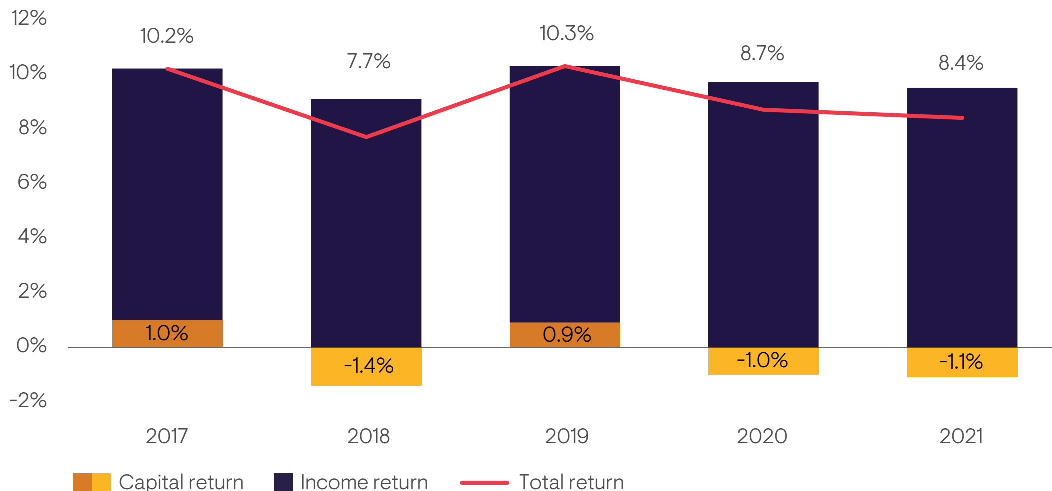
Poor global investor sentiment, fuelled by inflation concerns and aggressive rate hiking by the Fed, has resulted in emerging market (EM) bond yields moving much higher this year. The valuation buffer that the market weakness has created provides some comfort that we should not see significant capital outflows out of EMs, including South Africa. Inflation is still a concern in the US, but global markets are already pricing in a move in the federal funds rate to above 3.5% over the next few months. So, aggressive tightening by the Fed is already reflected in markets.

Our government bond yields remain attractive versus EM yields, cash rates and inflation. SA bond investors can earn a yield of around 10.4% on 10-year government bonds, which is well above inflation.[1]

Portfolio positioning – participate and protect

Over the past 5 years, income made the biggest contribution to SA bond returns, as opposed to capital (Figure 2). Consequently, bonds have been an important source of income for the Ninety One Diversified Income Fund, contributing handsomely to returns. This trend should continue over the remainder of 2022 and into 2023. Higher cash rates and wider credit spreads are also contributing to a more favourable income environment. If the government is able to contain its expenditure and we see some concrete progress on the path to structural reforms, SA bonds could enjoy a capital uplift.

Figure 2: All Bond Index returns for the last 5 years



Source: Bloomberg, Ninety One, 20 July 2022.

1. As at 10 August 2022.

We have decreased our forex (FX) exposure as the global risk sentiment in markets has started to improve. The rand is more fairly priced at present as our terms of trade have come off the highs. Looking ahead, we expect the local currency to remain relatively range bound for the remainder of the year. We maintain a core offshore allocation to mitigate some of the local and global risks. The Fund has a reasonable weighting in inflation-linked bonds, which helps to protect against any inflation surprises.

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An increase in our credit exposure has taken the portfolio to a slightly overweight position, with minimal exposure to the cyclical components of the credit market. We maintain a preference for quality defensives, namely banks, insurers, telecommunications and government-guaranteed debt, as well as large blue-chip corporates with strong balance sheets. As the fundamental picture for listed property has begun to clear, we have increased our allocation. However, we maintain a lower exposure than what would have been the case a few years ago as there are currently fewer opportunities in this economic climate.

This investment strategy has worked well for us during periods where we have experienced bond market volatility or rand weakness.

We have a well-diversified portfolio that, when combined with active allocation, is designed to participate in the bond opportunities discussed but also to provide some protection against local and global risks. This investment strategy has worked well for us during periods where we have experienced bond market volatility or rand weakness.

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