

GLOBAL BONDS SIGNAL INVESTOR CONCERNS

FUTUREGROWTH INTEREST RATE TEAM



DAPHNE BOTHA
Portfolio Manager and
Head of Risk
Management



RHANDZO MUKANSI
Portfolio Manager



YUNUS JANUARY
Interest Rate Market
Analyst



WIKUS FURSTENBERG
Portfolio Manager and
Head of Interest Rate
Process



REFILWE RAKALE
Research Analyst

Broad-based weak economic data, coupled with a very muted inflation backdrop, forced some of the world's major central banks to abandon intentions of future policy tightening. Fragile market sentiment went into a tailspin following the US Federal Reserve (Fed) signalling no further interest rate increases for the remainder of this year. It further announced that the current central bank balance sheet runoff will end in September. This announcement was close on the heels of the European Central Bank (ECB) which, earlier in March, reiterated a cautious monetary policy stance and restarted a crisis-era bank lending programme in response to a raft of underwhelming eurozone economic data.

NEGATIVE YIELDS MAKE A COMEBACK

The major global bond markets had already entered a bull trend in November last year, in response to a muted economic growth outlook. Even so, the recent changes in policy stance from two of the world's major central banks forced yields even lower, as investors rushed to the perceived safety of government bonds. In the eurozone, the rally forced the yield of the 10-year German Bund into negative territory for the first time in three years. However, this rush to safety comes at a perplexing price: investors who bought at the negative yield are guaranteed a nominal loss should they hold the bonds to maturity. In the US, the 10-year Treasury yield reached its lowest level since December 2017,

as it decreased sharply to 2.41% at the end of March. This is a very significant 83 basis points below the high of 3.24% recorded in October last year.

These global developments present somewhat of a dilemma for emerging markets. On the one hand, the weaker global growth outlook bodes poorly for vulnerable, small and open economies like South Africa – specifically from an economic growth and a balance of payments perspective. Moreover, in the case of South Africa, downside risk to an already anaemic growth outlook is of particular concern, considering the fragile state of South Africa's government finances. On the other hand, an ease in global monetary policy in a benign inflation environment often



leads to lower global bond yields, while also holding the promise of an improved growth outlook as a result of policy stimulation. Typically, it is the latter that investors tend to focus on and this time was no different: foreign buying interest in domestic bonds during the quarter amounted to a net R9 billion. This lent much-needed support to our bond market and the non-resident share of total marketable rand-denominated RSA government debt stabilised at just above 38% – albeit still well below the peak of 43% reached in March 2018.

Even though the short-term correlation between the rand exchange rate and the local bond market has weakened considerably in recent times (as a result of a substantial breakdown between local currency movements and inflation), it remains difficult for a bond bull rally to be sustained in the presence of significant rand weakness/volatility. Although the rand/US dollar exchange rate is back at end-2018 levels, the intra-quarter range of R13.25/US\$ to R14.65/US\$ made it one of the world's most volatile currencies so far this year. Nervousness around Moody's biannual scheduled credit ratings review for South Africa and contagion from the volatile Turkish lira (amid concerns of the central bank supporting the currency) were some of the noisy negative developments that largely contributed to recent volatility.

KEY TAKEOUTS



- LOW GLOBAL YIELDS BOOST APPEAL FOR SA BONDS
- MOODY'S DEFERS ITS SOVEREIGN RATINGS DECISION
- A HIGHLY VOLATILE RAND MAKES A BOND RALLY UNSUSTAINABLE
- GLOBAL GROWTH CONCERNS COULD TRAP YIELDS AT LOW LEVELS

DEBT CEILING BREACHED TO SAVE ESKOM

Local bond market investors paid close attention to the tabling of this year's National Budget – particularly the extraordinary fiscal support to Eskom. R69 billion is budgeted over the medium-term expenditure framework (MTEF) as a “provisional allocation” for reconfiguring the entity, which is to be transferred as a cash injection of R23 billion a year over a three-year period. This allocation negates the benefit of departmental expenditure constraint in the 2018/19 fiscal year and ultimately results in the lifting of the previously sacrosanct expenditure ceiling by R16 billion over the next three years. The net effect of this extraordinary fiscal support for Eskom is a wider budget deficit over the MTEF – budgeted to peak at -4.5% of GDP in 2019/20. As a result, the gross debt-to-GDP profile is now expected to peak in excess of 60% in 2023/24. To us, this clearly points to sustained fiscal slippage with no near-term prospect of urgent consolidation. Using the phrase “going over the fiscal cliff” is arguably melodramatic, but it is difficult to simply brush this risk aside, especially considering the fundamental challenges to persistent anaemic economic growth.

While the fiscal situation remains perilous, the conservative South African Reserve Bank (SARB) continued to receive welcomed news on the inflation front. The rate of inflation at both consumer and producer levels continued to drift lower – in line with the Bank's stated intention of keeping inflation around the mid-point of its target range of 3% - 6%. Even though our forecasts suggest that the inflation cycle has bottomed, the outlook remains relatively benign, primarily the result of weak domestic economic activity and a slowing global growth backdrop. The combination of benign inflation, low economic growth and global monetary policy easing assisted the SARB in retaining a neutral policy stance at its March Monetary Policy Committee (MPC) meeting.

During the first quarter of this year, the yield of the benchmark R186 (maturity 2026) was bound to a relatively narrow range of 8.60% to 8.94%, especially considering the developments described above. As mentioned, foreign investors provided some support. Another supportive factor is the real yield of almost 4% offered by longer-dated nominal bonds. On a comparative basis, SA nominal bonds also appear

relatively attractive against its emerging market peer group. From a risk perspective, domestic nominal bonds are already trading at a sub-investment sovereign credit rating level.

In contrast, inflation-linked bond yields came under renewed upward pressure. The combination of sharply lower inflation, a benign inflation outlook and the fragile fiscal situation did the inflation-linked market no favours. Following a brief respite in January, real yields continued to drift higher. The yield of the medium-dated R197 (maturity 2023) increased from 2.90% at the end of 2018 to 3.17% at the end of March 2019, its weakest level since November last year. The real yield curve slope also steepened as long-dated real yields increased more than those of shorter-dated bonds.

The impact of the above developments on market returns was mixed. The net decrease in medium- and long-dated nominal bond yields during the quarter resulted in the ASSA JSE All Bond Index (ALBI) rendering a solid total return of 3.8% for the first three months of the year. This was significantly higher than both cash (1.7%) and the JSE Inflation-linked Government Bond Index (IGOV), which returned a mere 0.5%.

GLOBAL GROWTH UNCERTAINLY KEEPS YIELDS LOW

At a global level, the shift from quantitative easing to tightening has stalled and, in some cases, even reversed due to fears of a global growth slowdown. Even so, we are of the view that authorities are prepared to respond relatively quickly and, in certain instances, are already taking steps to avoid a broad-based collapse in economic growth. Global bond yields and, more specifically, the US Treasury market, have already responded as if an easing cycle has commenced. Our view is somewhat different in the sense that, although we agree with the risks of a global growth slowdown, the risk of collapse is small enough to argue in favour of higher bond yields and steeper curves from current levels. However, given the level of uncertainty about the growth outlook, yields may be trapped at the lower levels for a while.

Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and the lack of fiscal consolidation – or more specifically, Government's rising debt burden as a consequence of the lack of fiscal consolidation.

This debt burden continues to threaten the country's sovereign risk profile and places pressure on domestic funding costs. In addition, the risk of a failed economic recovery has certainly not dissipated. Even when accounting for the rebound in GDP of 2.6% and 1.4% in the third and fourth quarters of 2018, respectively, the underlying economy remains structurally weak, with growth for the 2018 calendar year an uninspiring 0.8%. A weak economy calls into question the quality of tax revenue collections and the health of the tax base, which, in turn, keep the risk of a budget deficit overrun at elevated levels. The financial burden of poorly managed state-owned enterprises on state finances has now reached a point where the delivery of a credible National Budget was near impossible in the absence of substantial remedial action. The proverbial chickens (mainly in the form of Eskom) have come home to roost and this required more than the usual liquidity provision. Addressing solvency is an entirely different matter – requiring more than simply kicking the can down the road via more liquidity bailouts.

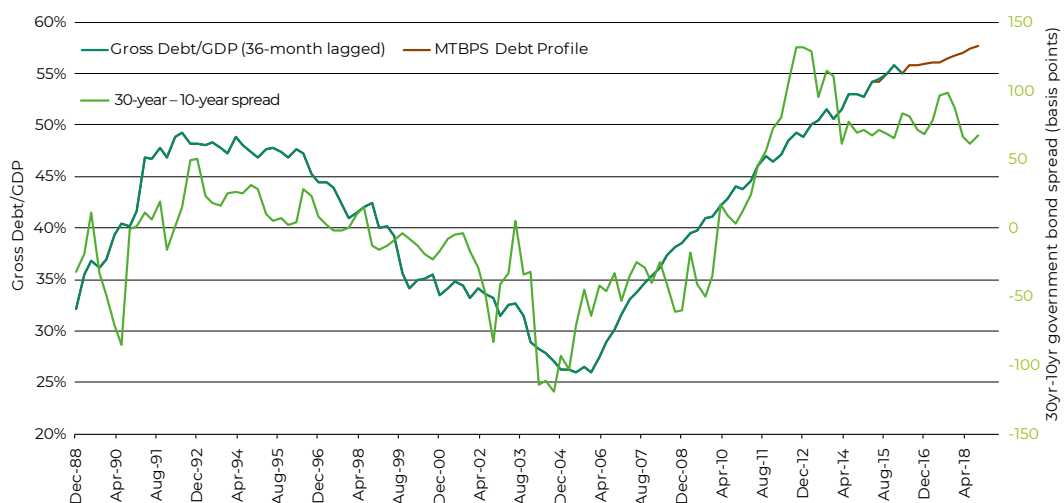
On the monetary policy front, we maintain our view that, following the repo rate increase in November 2018, the SARB will remain hostage to the opposing

forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of the strong disinflationary environment. For now, this suggests a stable policy path combined with a central bank that will keep warning of their response to the threat of higher inflation outcomes. The underlying domestic disinflationary trend and the risks to the global growth outlook should not be ignored. On balance, the risk to the stable repo rate outlook is still skewed to the upside, but our base case remains for a stable repo rate.

The recent bull rally, combined with renewed concerns about the fiscal state, convinced us to reduce risk into bouts of market strength. In doing that, we endeavour to strike a balance between avoiding capital loss (in the case of a market sell-off) and losing out on the accrual offered by a steeply sloped yield curve. We have also considered the fact that nominal bonds are currently trading at an attractive real yield of around 4%. So, while our broad interest rate investment strategy remains defensive, the modified duration variance of -0.60 is still some way off the maximum allowed position of -1.0. Real yields have retraced sufficiently to entice us to close some of our underweight positions.

OUTSTANDING GOVERNMENT GROSS DEBT (EXPRESSED AS A RATIO TO GDP) AND THE SLOPE OF THE NOMINAL BOND YIELD CURVE (EXPRESSED BY THE YIELD SPREAD BETWEEN THE 10- AND 30-YEAR POINTS ON THE CURVE)

Government's deteriorating gross debt to GDP ratio severely limits the extent to which long-dated nominal bond yields may decrease on a sustainable basis.



Sources: National Treasury, Futuregrowth