

# FISCAL CONSOLIDATION MILLSTONE **STILL WEIGHS ON THE SA ECONOMY, AND BONDS**

## **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

Following a temporary reprieve in November, the fourth quarter of 2018 turned out to be an extension of most of the year in terms of market volatility and weakness. Emerging markets had to face the consequences of compromised international trade and its potentially negative impact on global economic growth, the continued shift away from global quantitative easing, a 40% drop in crude oil prices since October and rising political risk, specifically the emergence of populist leaders in Latin America's two biggest economies. As a result, investor caution manifested itself in foreign investors selling emerging market bonds.

Considering our own significant structural economic hurdles, South African financial markets got dragged down in this maelstrom of global risk aversion. This was evidenced by foreign net sales of local currency denominated bonds totalling R71 billion in 2018. In addition to offshore developments, the foreign selling was also in response to a disappointing, but realistic Medium-Term Budget Policy Statement delivered in October 2018. The Finance Minister acknowledged that much-needed fiscal consolidation was, once again, being pushed out, causing longer-dated bond yields to rise sharply. The yield on the benchmark R186 (maturity 2026) spiked to 9.32%, the weakest point since November 2017.

## **MORE ATTRACTIVE YIELDS LURE LONG BOND INVESTORS**

The fiscal disappointment was offset by a hawkish central bank. In November, the South African Reserve Bank (SARB)'s Monetary Policy Committee raised the repo rate by 25 basis points (bps) to 6.75%, the first rate increase since February 2016. This decision, mostly driven by concerns about high inflation expectations, had a direct impact on both the level of bond yields and the shape of the nominal yield curve. Short-dated bond yields increased marginally in response to the repo rate increase. At the back end, local investors expressed their approval of the SARB's intention to contain inflation despite weak economic growth by buying long-dated nominal bonds at the higher, more attractively priced yields. This,

## **KEY TAKEOUTS**

- **SARB FOCUSED ON CONTAINING INFLATION, DESPITE WEAK GROWTH**
- **INVESTORS AFFIRM SARB AND BUY LONG BONDS**
- **NOMINAL BONDS GENERATED SOLID RETURNS IN 2018, DESPITE VOLATILITY**

coupled with a stronger rand, caused the yield on the R186 to decrease by around 30bps from its weakest intra-quarterly point of 9.32%. Consequently, the yield on the benchmark R186 (maturity 2026) moved lower to 8.88% on 31 December, 9bps lower than the September close of 8.99%.

The more recent economic data releases did little to change our assessment of our broad investment theme: a benign inflation outlook amidst sustained weak economic activity. The underlying inflation trend at both producer and consumer levels remained fairly subdued and is reflective of a rather strong disinflationary environment. On a negative note, the release of the latest external trade account data showed another significant current account deficit of -3.5%, calling into question Government's ability to sustainably shrink the size of the negative current account balance.

## **INFLATION-LINKED BONDS UNDERPERFORM**

Inflation-linked bond yields receded marginally in the second half of November. Even so, market weakness in the first half of the month gave rise to a steepening of the real yield curve slope. The yield of the benchmark R197 (maturity 2023) initially increased to 3.05%, its weakest level since April 2010, before pulling back to close the fourth quarter of 2018 at 2.92%, only marginally higher than the September close of 2.90%. Despite this, the bearish steepening of the yield curve caused the JSE ASSA Government Inflation-linked Index (IGOV) to render a poor return of 0.43% during

the quarter, underperforming both nominal bonds and cash by a significant margin.

Despite significant intra-quarter nominal bond market volatility, the JSE ASSA All Bond Index managed to deliver a return of 2.8% over the three-month period ending December 2018. Cash performance, as measured by the STeFI total return index, rendered a return of 1.8% during the quarter. The return profiles of the three interest-bearing asset classes for the 2018 calendar year follow the same pattern as the past quarter's return. The inflation-linked bond index (0.3%) underperformed both nominal bonds (7.7%) and cash (7.3%) by a significant margin.

At a global level, the shift from quantitative easing to quantitative tightening remains the main trend for now. However, the risk to a sustained global economic recovery should not be ignored and this may cause a slowing of this tightening monetary policy trend over the next year. This tightening trend also implies that global bond



yields, more specifically the US Treasury market, may have already peaked for now and could hover in a tight, slightly lower range in the near term.

Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and fiscal consolidation – or more specifically, Government’s rising debt burden as a consequence of a lack of fiscal consolidation, which continues to threaten the country’s sovereign risk profile as well as placing pressure on domestic funding costs. By way of example, the chart shows Eskom’s significant share of Government’s contingent liability. The realisation of this liability onto the central government’s balance sheet will have a notable impact on Government’s debt service cost and thus fiscal consolidation efforts.

The risk of a failed economic recovery has not dissipated, and despite the strong third quarter rebound in gross domestic product (GDP) growth of 2.2%, the underlying economy remains structurally weak. This makes us question the quality of tax revenue collections, which, in turn, keep the risk of a budget deficit overrun at elevated levels.

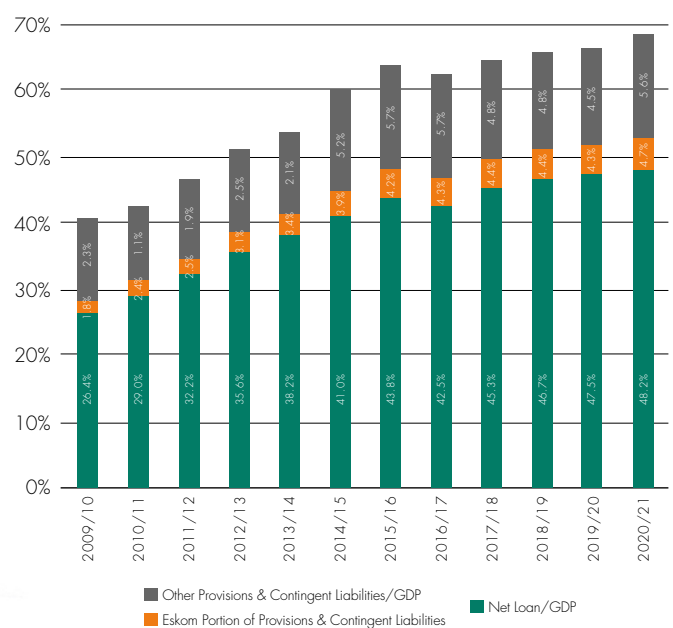
## SARB KEEPS A KEEN EYE ON INFLATION

On the monetary policy front, we maintain our view that, following the recent repo rate increase in November, the SARB will remain hostage to the opposite forces of a lacklustre economic growth outlook and limited upside risks to inflation in light of the strong disinflationary environment. For now, this suggests to us 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 risk 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, mostly due to stubbornly high inflation expectations.

While the observable investment theme and related real-time developments mostly have negative consequences for the local bond market, it is important to note that the current market valuation is largely reflective of this. Cheaper market valuations following the sell-off during the second quarter afforded us an opportunity to cautiously increase risk by selectively buying nominal bonds. We shall continue to look for opportunities to increase bond market exposure, but only into bouts of weakness, considering the level of uncertainty discussed above. ■



## THE SOUTH AFRICAN GOVERNMENT’S NET LOAN POSITION, OTHER PROVISIONS AND CONTINGENT LIABILITIES (PERCENTAGE OF GDP)



Sources: National Treasury, Futuregrowth