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Mind the gap, steep yield curve ahead

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With local inflation stabilising and settling at the lower end of the SARB's target band, coupled with the treasury's struggles to maintain fiscal discipline, we've arrived at a point where the yield curve is at the steepest level in recent history (see Figure 1 below). The question is, "Do long bonds present a buying opportunity?"

The SARB

The South African economy was already under strain going into the COVID-19 crisis, having not recovered from the blows of the global financial crisis and the crippling injuries of state capture and other state failures during the Zuma era. Against a backdrop of falling worldwide inflation and then the massive dislocation of the global economy due to worldwide lockdowns, central banks sprang into action and simultaneously began slashing interest rates in an attempt to support their economies.

The SARB's response was to cut interest rates by 3.5% (from 7% in 2017 to present 3.5%), as a result of the combination of lower inflation (7% high to 2.2% low over the same period) and weak growth (1% average over the last five years). Long bond yields (R2044), on the other hand, continued to rise, increasing from 9.2% in March 2017 to current levels of 11% (apart from the COVID-19 crisis peak above 13%). Under normal circumstances, falling repo rates would result in long-dated fixed bond out-performance, yet these bonds have under-performed cash over the last three years (STeFI Call 18.1% vs. ALBI 12+ years 16.3%).

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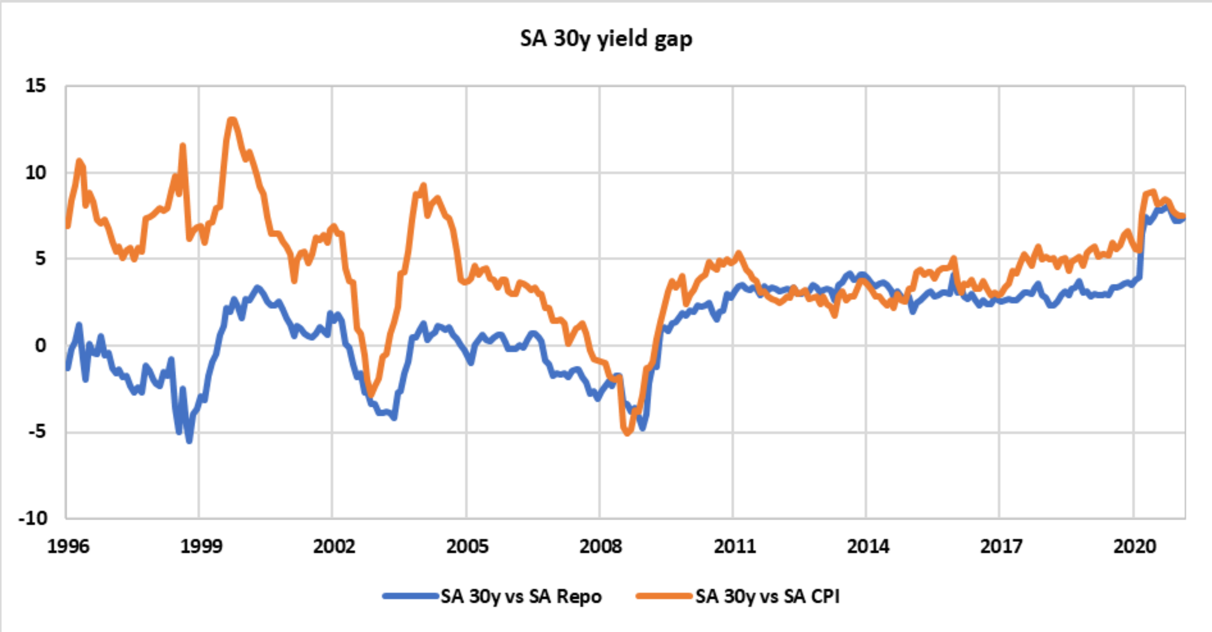

Figure 1. SA 30y yield gap vs Repo & SA CPI as at Jan 2021 Source: Inet Bridge & Northstar

Treasury

Despite the tailwinds of lower US bond yields, stable credit default swap spreads, lower inflation, and a resilient rand, SA long-dated bond yields have been unable to rally in-line with their shorter-dated counterparts. The main headwinds have been increased bond issuance (approximately R12bn/week vs. R7bn/week a year ago), increasing terms, and deteriorating fiscal metrics.

Because of sharply lower GDP growth, lower tax collections, and increased expenditure, the books no longer balance, and investors are becoming increasingly concerned about getting their money back. Public debt exploded, up from 62% of GDP in March 2020, projected to eclipse 80% this year and to continue to deteriorate. To contextualise the dilemma, the government would need to apply a three- to four-year public sector wage freeze to stop the bleeding and stabilise the debt trajectory. As it stands, the debt servicing costs are projected to exceed 20% of the tax revenues, which is also a death knell, signalling a point of no return. Global credit rating agencies have been paying attention and steadily lowering SA's sovereign credit ratings, now three notches below junk status, a warning to investors that they are engaging in speculative activity.

Markets in distress

It's worth comparing current bond pricing to previous periods of distress when sovereign credit ratings were at the same sub-investment grade rating (see chart below). This may provide a realistic gauge of the potential pricing we can expect from our bonds over the near term. The Asian crisis in the late 90s turmoil offers us the most recent comparative period.

In 1997, the Asian crisis unfolded, with the Thai government floating its currency as they ran out of foreign currency to support their dollar currency peg. The result was a massive flight of capital out of Asian countries, particularly Thailand, Indonesia, and South Korea, whose currencies collapsed and required IMF bailouts. The combination of very high foreign-denominated debt burdens, slowing local growth, and large current account deficits juxtaposed by an improving US economy, higher US inflation, rising US interest rates, and a strengthening dollar resulted in the sell-off in markets known as the Asian crisis.

The event spread to other countries morphing into an international financial crisis, which profoundly affected many emerging market countries, including South Africa. During 1997 and 1998, GDP fell from 5% to 0%, the US dollar strengthened 40% vs. the rand (USDZAR 4.41 low to USDZAR 6.20 peak), the All Share index experienced significant volatility with a 41.6% drawdown, and the SA 30y bond yield spiked from a 12.6% low to a 20% high. Investors on the wrong end of the equation lost a lot of money.

South Africa's finances were in better shape in 1997 with a debt-to-GDP ratio below 50% and poised for a dramatic improvement after the crisis. In 1997, the budget deficit reached an extreme of 7.4% versus the current 17% and the foreign portion of total borrowings was at 5% versus 11.3% today. However, SA has been thrown a lifeline with US stimulus spending, a weaker US dollar, and increased demand from China, causing commodity prices to surge. With the Goldman Sachs commodity index up 100% since the COVID-19 lows, market commentators are asking whether this is the start of a new commodity super-cycle, an environment which would be very supportive for the local economy.

Outside of these dynamics, the SA growth recovery is likely to be slower than the US and other major economies. As a result, it is unlikely that SA's financial metrics will improve over the short to medium term, which does not bode well for investor sentiment.

Valuations

As shown in the chart below (Figure 2), the market demands the highest real yields when credit ratings are at their worst (credit rating notch of 1 = AAA, credit rating notch of 10 = BBB-). At the beginning of the Asian crisis, the SA 30y bond was trading on a real yield of 5.5% when SA's credit was rated at BB+ (one notch below junk status). As real yields peaked at 13% during the crisis, SA's credit rating improved to investment grade BBB- and yields subsequently rallied. For the subsequent 12-year period (February 2000 to March 2012), SA enjoyed improving credit ratings and real bond yields dropping to an average of 2%. Since then, credit ratings have unravelled and the 30y real bond yield has risen back above 5.5% and up to 7.5%. This is reasonable given the comparative range of 5.5% to 13%, which occurred during the Asian crisis and SA was on a similar credit rating.

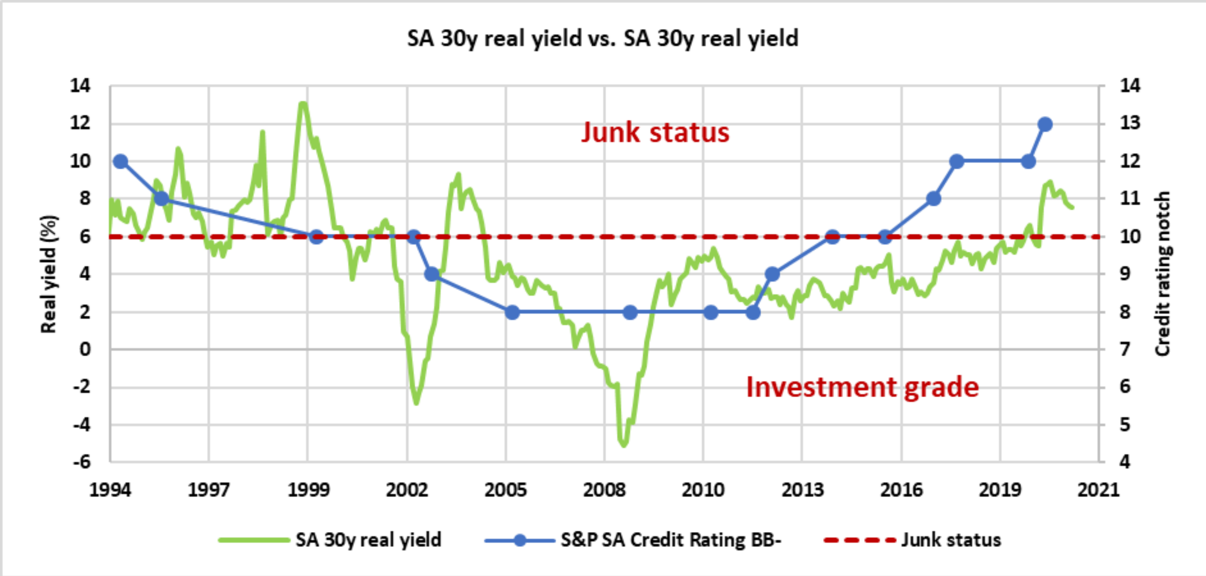

Figure 1. SA 30y real yields vs. S&P South Africa credit rating as Jan 2021 Source: Trading Economics, INet Bridge & Northstar

Looking at first principles and factors which explain the differential between SA and US bond yields, the US 30y is trading at an arguably depressed yield of 2.18%. Under normal conditions, outside of the stresses and strains of the COVID-19 pandemic, yields should be closer to 4%, derived from a rational 2% real yield hurdle. Given the very challenging growth environment, fair value may be closer to 3%. Adding a long-term sovereign risk margin of 5% and an inflation differential of 2.5% gets us to a reasonable value range of between 10.5% to 11.5%. The US bond yields trading at a low 2.2% may justify lower SA bond yields; however, the deteriorating SA fiscal risk arguably demands a wider offsetting sovereign risk margin.

From our perspective, the 10.9% yield for the SA 30y looks reasonably priced to the fundamental 10.5% to 11.5% range mentioned above, and there is no clear argument that SA 30y yields are undervalued, despite the historically steep yield curve. The yield curve steepness may normalise due to rising interest rates rather than falling yields, an event entirely congruent with distressed market conditions.

Although the SA 30y looks optically attractive, we would offer a word of caution and say, despite the large gap between the SA 30y and cash yields, the curve is likely to remain steep and volatile on the basis of rising fiscal risks.

Glacier Research would like to thank Mark Seymour for his contribution to this week's Funds on Friday.

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