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Reading the cyclical and structural tea leaves for SA's fixed income markets

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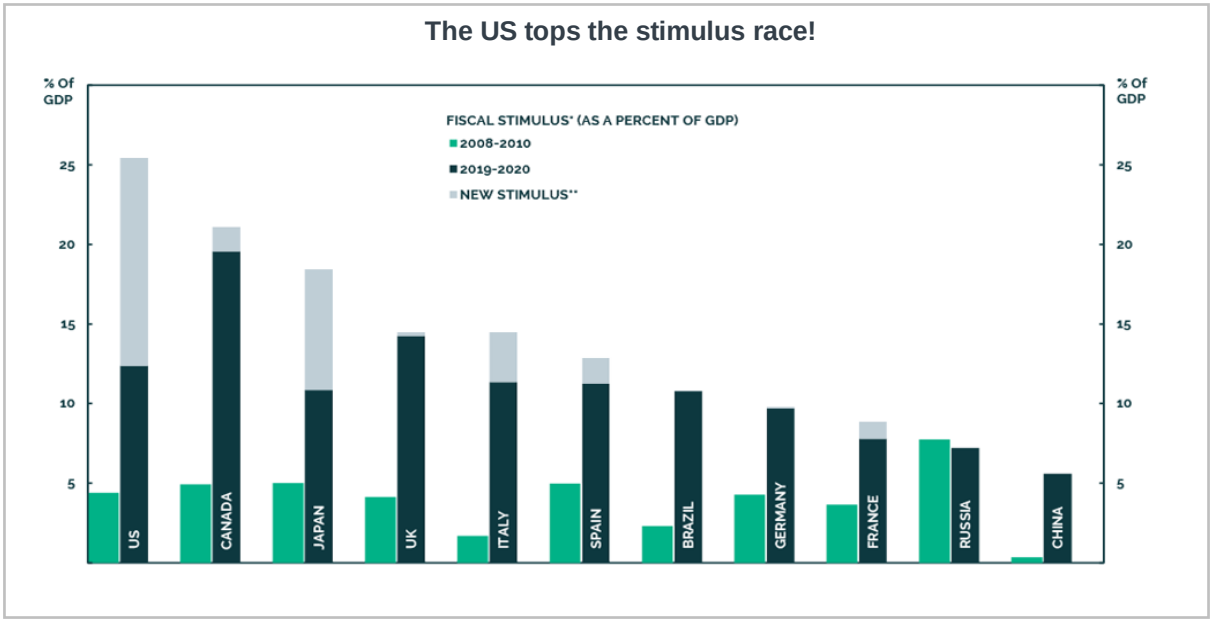
2020 was such an exceptional year for financial markets in so many ways. The initial alarm of rising COVID-19 cases spreading to every corner of the globe and the extreme reaction from governments to control the spread – actually ordering citizens to remain inside their homes – was an event that was hard to find parallels for (akin in some ways to a major conflict like a world war). Global policymakers reacted quickly and with extreme urgency, widening their toolboxes even further from the Global Financial Crisis (GFC) innovations, and some well-resourced governments took the extraordinary measure of physically sending payments to individuals to cushion against income shocks, regardless of actual stress experienced. With so many virus-induced negative impulses, set off in real time by extraordinary policy responses across the globe, it seems an opportune time to step back and critically assess which of the primary forces that influence SA bond yields are cyclically altered. Also, we need to consider which are likely to have a more enduring, structural impact on valuations and our analysis of the market. We discuss a few of the issues that are top-of-mind.

The US bond market has long been an influential input into our thinking around domestic bond valuations, with both the very short end of the US yield curve (i.e. the Federal Funds rate) as well as longer-dated yields being important in our analysis (we widely use our forecast for the 10-year yield as a direct input into our valuation models). The Fed outlook is relevant in our thinking due to the fact that any changes in their approach to monetary policy accommodation (or withdrawal thereof) has been seen to have a significant impact on global risk appetite and currency movements, particularly appetite towards the emerging market complex, to which SA belongs.

For many years post the GFC, monetary policy by developed market central banks was relied on to do the 'heavy lifting', with central bankers creatively widening their toolbox and implementing a range of previously unconventional measures to inject liquidity into the market. Although central banks reacted swiftly in 2020, and broadened their range of tools even further, what was different in this crisis was that fiscal policy was unleashed on a substantial and unprecedented scale – governments were clear in their intent that they would prefer to do too much, than too little, in their attempt to fully offset any negative COVID-related negative economic shocks and prevent permanent scarring from taking hold. Many developed economies succeeded – for illustration, after suffering a blow to GDP of -3.5% in 2020, the US economy is expected to grow a heady 6% to 7% in 2021, and the economy as a whole is broadly anticipated to exceed its pre-COVID growth path by the end of this year, illustrating the extraordinary success of the policy response. This isn't a free lunch of course, with rising inflation fears and elevated debt concerns two immediate consequences.

The magnitude of the US fiscal push relative to other countries is well illustrated below with an incredible 25% of GDP expected to be injected from fiscal policy into the economy, dwarfing the response seen after the 2008 GFC. Although we clearly don't expect this type of stimulus to be repeated in the near term (these incredibly large amounts won't be spent every year on a recurring basis), and the cyclical impact will therefore fade over time, what we do think has changed from a structural perspective is the willingness by policymakers to use fiscal policy as a tool – both in terms of magnitude, as well as in broadening their thinking of how to use these powers (such as the US stimulus cheques referred to above).

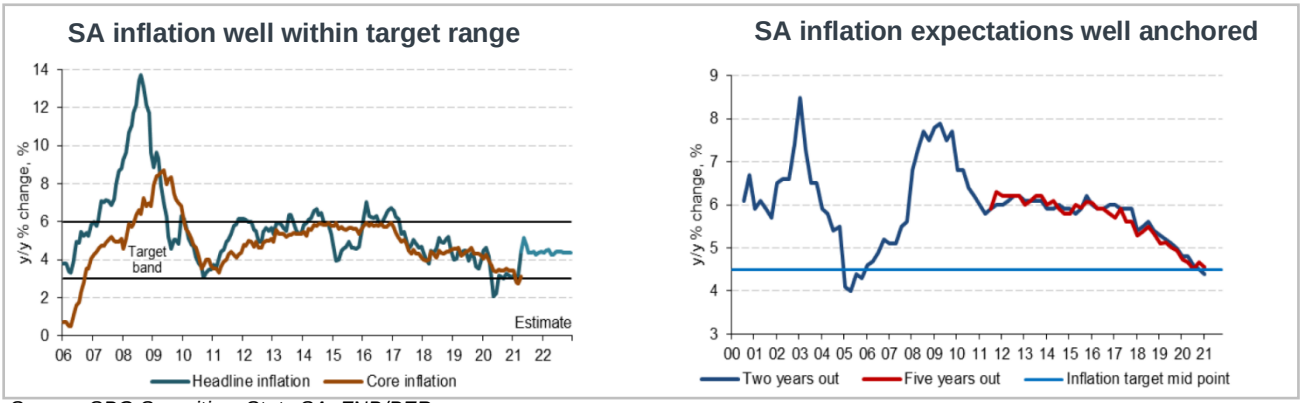


Source: BCA Securities

The same drivers behind the surge in expectations for strong US economic growth this year have also led to a strong acceleration in inflation. A key question that will be answered over the next year is whether this will be a temporary rise on the back of pent-up demand and supply constraints on the re-opening of economies, and will recover back down to central bank target levels, or whether inflation becomes a more durable feature by feeding into wages and becoming embedded into inflation expectations. This theme (transitory or sustainable) will be a key driver for the longer-term outlook for US bond yields.

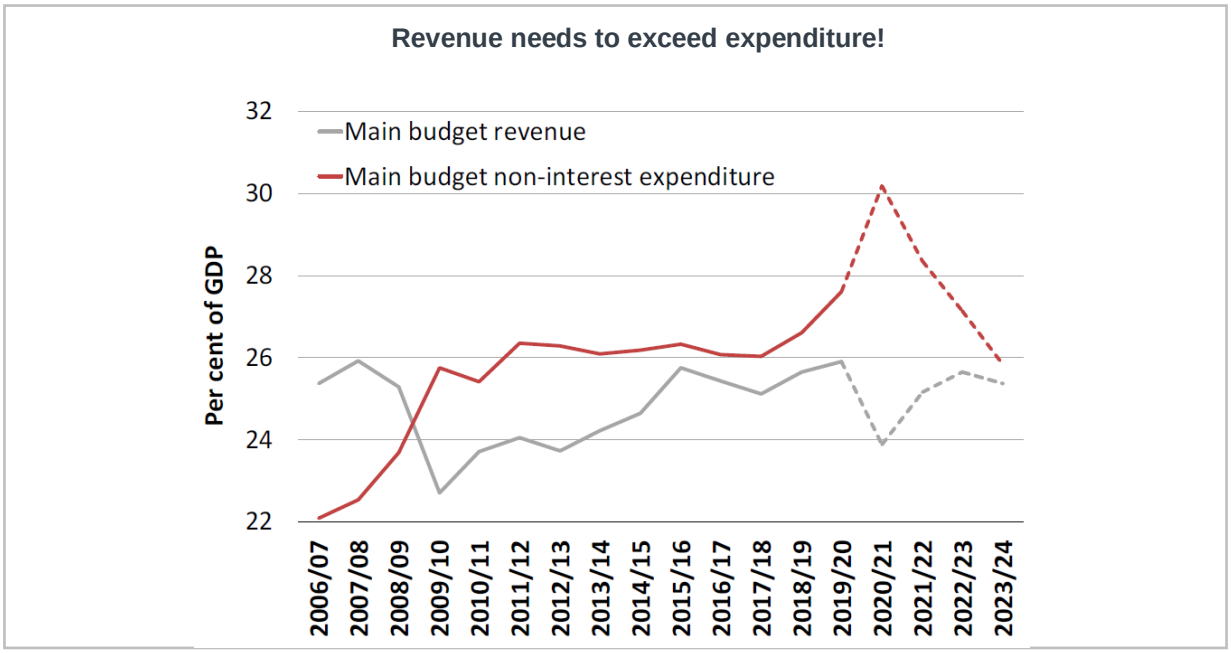
Extending the discussion to the South African policy response, the SARB acted swiftly and comprehensively during the crisis and implemented a range of exceptional intervention measures (such as extending regulatory relief to banks and conducting financial market interventions in the form of liquidity measures and government

bond purchases). They also rapidly and significantly cut the repo rate, from 6.25% in February 2020 to 3.5% by July 2020 (the lowest level in five decades). With inflation widely expected to settle at 4.5%-5.0%, the current level of the repo rate is seen to be at an emergency level (with real interest rates currently at -1 to -1.5%), and this extraordinary accommodation would be expected to be unwound as the economic recovery takes hold. What does seem to have structurally changed, however, is SA's inflation outlook – inflation has remained very well behaved in recent years and has trended below the midpoint of the SARB's 3% to 6% inflation target range, with inflation expectations also seemingly well anchored at the mid-point (see graph below). Should this trend be sustained, SA interest rates could well move to a structurally lower level than we've seen in the past. For illustration, if long-term trend inflation is 4.5%, and the neutral real interest rate level targeted by the SARB is 2.5% or lower, the neutral nominal interest rates in SA could be 7% or below – significantly lower than the 12% and 13.5% peaks in the two-rate cycles leading up to 2010. Should SA's fiscal risks reduce, the neutral rate could fall even further as the risk premium required in the real rate component is reduced.



Source: SBG Securities, Stats SA, FNB/BER

On the subject of the fiscal outlook, the most material influence that COVID inflicted on the SA bond market was via the fiscal impact. SA entered the COVID crisis with an already weak fiscal position (with a pre-existing condition, so to speak!), with debt/GDP ratios already at concerning levels (the 2019 budget forecast that debt/GDP was likely to peak at a high 60.2% in FY23/24). The significant contraction in GDP in 2020 resulted in a sharp fall in revenue receipts, whilst expenditure levels increased to accommodate COVID-related spending – this dynamic saw SA's debt/GDP levels rise sharply to very vulnerable levels, with the 2020 Mid Term Budget (MTBPS) anticipating a debt/GDP ratio of 95.3% in FY25/26 – a dramatic deterioration. This weakness had already been building for a number of years, with SA's expenditure (as a % of GDP) exceeding revenue actually collected (see graph below), and COVID merely exacerbated this trend. There are unfortunately no easy ways to stabilise and reverse this trend – debt stabilisation (and stemming the rapid rise in interest payments on SA's growing debt burden) can only be achieved by closing this gap from both ends – firstly by remaining firmly committed to the expenditure restraint outlined in the Budget, and secondly, by urgently implementing the long awaited structural reforms necessary to lift SA's structural growth rate from the anaemic 1-1.5% stagnation levels experienced over the last decade.



*Source: National Treasury *Expenditure excludes Eskom financial support and transactions in financial assets and liabilities*

Fortunately, there have been some promising developments on this front, with a number of welcome reforms announced in electricity generation (with the lifting of the embedded generation cap), SOEs (with SAA potentially attracting a majority equity partner) and steps to improve the efficiency of our ports, which certainly signal reasons to be hopeful. The recent strength in prices in SA's key commodity exports have also been significantly positive for SA fundamentals, providing a substantial boost to our terms of trade, and resulting in many economists materially upgrading their 2021 GDP forecasts to between 4.5-5.0%. This dynamic is very constructive for SA bond valuations for a number of reasons. Firstly, it improves SA's trade balance and current account position, thereby reducing our external vulnerability as a country (particularly useful at this juncture when the Fed is anticipated to become less accommodative). Secondly, the resultant constructive rand backdrop should keep any risks to inflation from the currency well contained. Thirdly, the boost to economic growth and increase in tax receipts from mining companies are also definite positives for the fiscal position, with clear potential for the budget deficit to narrow below the 9% deficit pencilled in by National Treasury in the February Budget (welcome evidence of this boost was seen in May when National Treasury announced a further reduction in weekly primary market bond issuance).

The magnitude of the deficit improvement will be determined by whether expenditure deviates from the Budget forecast. For a durable fiscal improvement to materialise, it is imperative that Treasury hold the line and show limited slippage in the public sector wage bill forecasts, as well as not utilise the cyclical commodity windfall to implement new structural spending items (such as a universal basic income grant or an acceleration in the rollout of NHI). We currently expect this commodity price-related improvement in our economic growth, current account and fiscal fortunes, to be cyclical in nature (and not a commodity super-cycle). However, it certainly does provide SA with a much-needed window of opportunity to implement the required reforms needed to structurally reduce the fiscal risk premium so clearly evident in our high bond yields and steep yield curve.

Glacier Research would like to thank Melanie Stockigt for her contribution to this week's Funds on Friday.

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Melanie joined Laurium in December 2020 as a portfolio manager and head of Fixed Income. Melanie was a founding member of Tantalum Capital where, for 15 years, she was head of Fixed Interest and the portfolio manager for the fixed income portfolios as well as contributing to the multi-asset portfolios. From 2002 to 2005 Melanie was at Coronation Fund Managers where she was head of the Fixed Interest team, managing fixed interest institutional and retail portfolios as well as the Strategic Income Fund. Melanie started her career in 1997 at Standard Corporate & Merchant Bank. Initially, she focused on interest rate and liquidity management before she moved to the Treasury Sales and Structuring Desk where she gained significant experience in structuring and marketing fixed income, credit and securitised products to institutional investors.