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What can catalyse a structural re-rating in SA bonds

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SA bonds: Structural re-rating depends on growth

Like most emerging market (EM) income instruments, South African government bonds (SAGBs) are priced at a discount to US Treasury (USTs). This is because of idiosyncratic risks in most emerging markets, such as exchange controls or higher political risks that influence monetary policy decisions. That said, emerging market instruments tend to be preferred during risk-on periods when the risk premium relative to USTs generally compresses. Price action during the last two quarters of 2023 is a case in point. The average credit default swap (CDS) spread for major EMs has compressed to the bottom quartile of its history (Figure 1).

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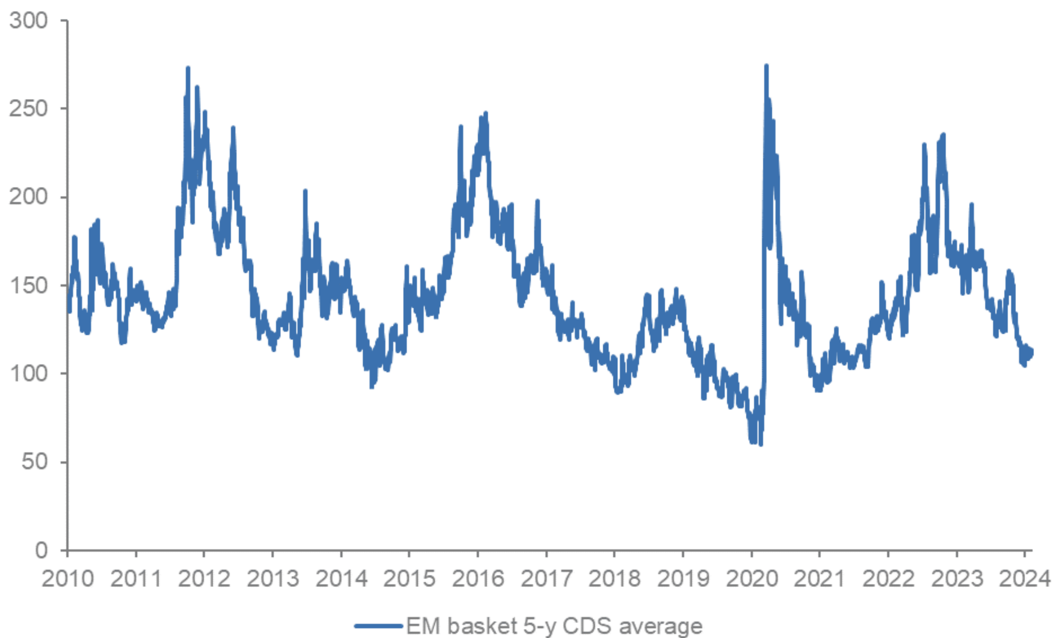
Figure 1: Average EM CDS spread at the bottom quartile of its history



Average of SA, Colombia, Brazil, Mexico, Indonesia, Peru, Philippines, Chile
Source: Bloomberg, Terebinth Capital

Following the "Lady R" saga in the third quarter of 2023, SAGBs priced a significant risk premium relative to USTs as the market anticipated South Africa would be sanctioned and therefore result in wholesale disposal of South African assets. This negative sentiment permeated throughout the quarter, impacting expectations for the Medium-Term Budget Policy Statement (MTBPS). While the wage agreement entered before the MTBPS was higher than expected in the 2023/24 Budget statement, load-shedding adversely impacted revenue assumptions. The better MTBPS outcomes improved sentiment from a fiscal perspective, which played a significant role in the subsequent bond rally.

However, the December Fed pivot in US monetary policy sustained the risk-on sentiment, which dragged SAGBs along. As a result, this year started with SAGBs pricing very closely with USTs, yielding minimum excess risk premium to provide a buffer (Figure 2). We are mindful that there are still risk events on the horizon from a local and global viewpoint. These include the National Budget and two Monetary Policy Committee meetings before we get to the elections that will most likely be held in May. Therefore, in assessing prospects for the SAGB market, one needs to evaluate both global factors impacting USTs and local idiosyncratic considerations at this point in the cycle.

Figure 2: SAGBs provide minimum risk premium buffer to USTs

Source: Bloomberg, Terebinth Capital

Prospects for UST strength that could drag SAGBs along

There are several ways of assessing the fair value of USTs. In principle, the state of the economic environment and outlook are critical factors in determining fair value. This means that our fair-value assessment must adjust at different points in the economic cycle. Trading opportunities will then come about as we assess how much of that view is priced into the market. This highlights the importance of combining a top-down macroeconomic approach with quantitative precision as part of an investment philosophy and process.

A simplistic approach when looking at the US 10-year is assessing current long-term inflation and growth expectations. In the US, inflation should revert to the Federal Reserve Bank's (Fed's) target of 2% (with risk of stickiness at 2.5%), while growth should settle between 1.5% - 2.0%. Therefore, expectations around where the USTs find a steady state based on the current economic outlook are 3.5% - 4.5%. According to Bloomberg, this aligns with consensus expectations (Figure 3).

Figure 3: Bloomberg Consensus Expectations for the US 10-Year (February 2024)

United States
US 10-Year
Market Yield 4.10
Recent Updates

	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	Q2 25	Q3 25	Q4 25	Q1 26	Q2 26
Bloomberg Wgt Avg	4.04	3.89	3.78	3.74	3.69	3.66	3.64	3.62	3.58	3.58
Implied Forward Yield	4.10	4.09	4.09	4.11	4.13	4.15	4.18	4.20	4.23	4.26
Median Forecast	4.05	3.90	3.80	3.75	3.70	3.60	3.60	3.50	3.50	3.50
Average Forecast	4.04	3.89	3.78	3.74	3.69	3.66	3.64	3.62	3.58	3.58
High Forecast	4.55	4.40	4.39	4.40	4.55	4.70	4.80	4.90	4.20	4.40
Low Forecast	3.50	3.30	3.10	3.00	2.90	3.10	3.13	3.04	2.87	2.89
Responses	51	51	51	52	44	42	40	41	24	23

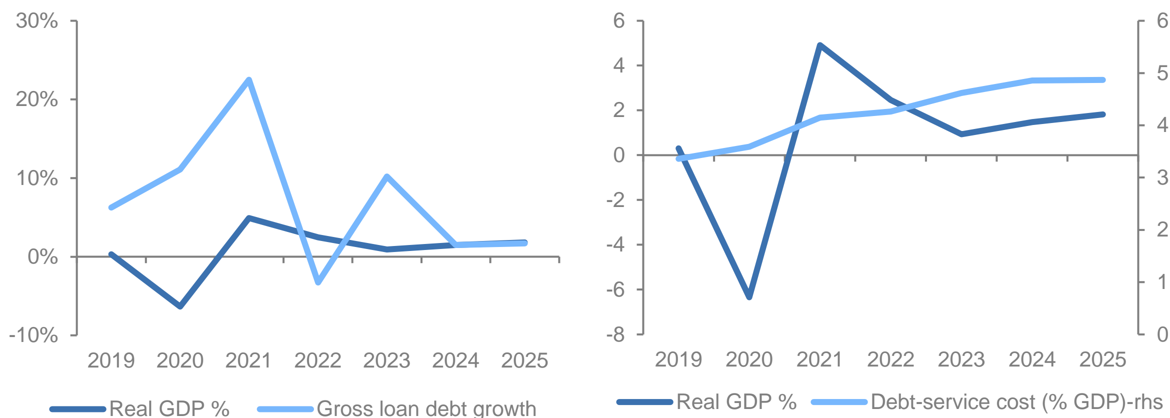
Source: Bloomberg

Therefore, as the global risk-free rate is used as a starting point in assessing fair value in other markets, there is as much as 75bp downside but still a potential 25bp upside risk to the yield on the SA 10-year. This ignores the local factors, as outlined below that are required as catalysts to reduce the SA-specific risk premium. The outcome of such could either offset any benefit from the global risk-free rate or function as a further tailwind to the outlook.

What can catalyse a structural re-rating in SA bonds?

SA-specific catalysts are instrumental for the re-rating of SAGBs. This relies largely on a structural improvement in growth prospects. We need GDP growth to outpace government interest costs, which is currently not the case in South Africa. According to IMF forecasts, real GDP growth is expected to remain lower than gross loan debt growth and fiscal debt-service expenses (Figure 4). This is often referred to as the r – g (real interest rate less real GDP growth) problem in industry jargon. When r – g is negative, it means the economy is growing faster than the government's cost of debt, which is a good thing and allows for debt stabilisation. If r – g is positive, then economic growth is too low to carry the debt burden, and the interest costs cause an increase in the debt ratio (particularly when the primary budget is in deficit).

Figure 4: Debt sustainability at risk



Source: National Treasury

An increasing proportion of government resources is being channelled towards servicing rising debt instead of being used to stimulate economic growth through infrastructure spending and better education and healthcare services.

Other impediments to growth include rail constraints (Transnet) and electricity supply issues (Eskom). Last year, the government introduced initiatives to combat the electricity constraint issue, including the appointment of the Minister of Energy and the release of the Integrated Resource Plan (IRP 2023). The IRP is a living plan expected to be revised and updated, with the last update done in 2019. Despite the minimal progress to date, full implementation of the plan could be a significant catalyst for growth.

At the core, the issues hindering South Africa's growth are primarily politically driven. This year, the National and Provincial elections will be crucial in assessing the economic prospects for the local economy and, therefore, the outlook for government bonds. The foreign investor community will stand on the sidelines

regarding local assets until we see the outcome of the elections. This means we may trade in a tight range, primarily driven by SA-specific factors.

Currently, the market is agnostic about the election outcome, not pricing in a sharp shift in either direction. As such, whether we see a “left” or “right” aligned coalition or the status quo will lead to volatility and with those opportunities in the local bond market.

Glacier Research would like to thank Nomathibana Matshoba and Oyena Mtuzula for contributing to this week's *Funds on Friday.*

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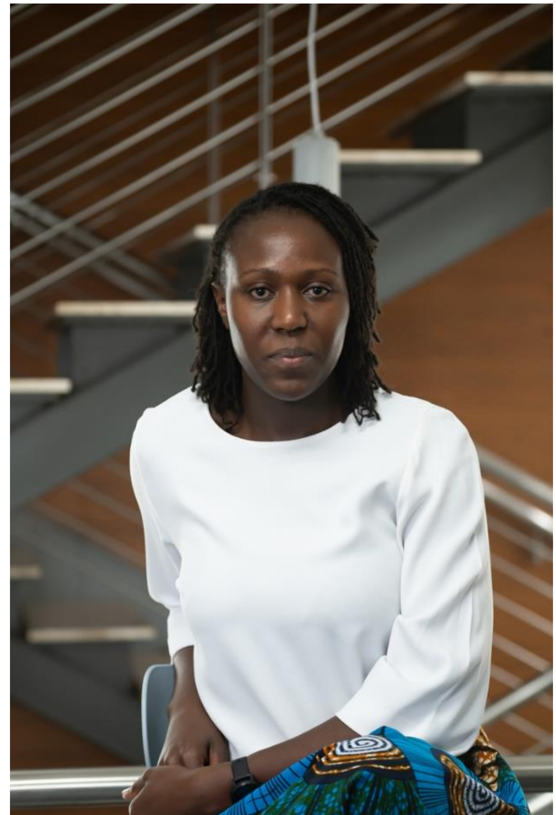

Nomathibana is the Managing Director (MD) of Cape Town-based boutique asset management firm, Terebinth Capital, where she is an equity partner and Senior Portfolio Manager. In her role as MD, she oversees the strategic direction of the business. She also has Portfolio Management responsibilities across the Fixed Income product set, including Income, Bond and Hedge mandates. Nomathibana has a Master of Philosophy degree, with a major in Mathematics of Finance and a Bachelor of Business Science, with a major in Actuarial Science from the University of Cape Town. She is also a CFA Charter holder.

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