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Investor strategies need to evolve as the fixed income market does

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Since the start of the COVID-19 pandemic, there have been substantial changes in the fixed income investment landscape, both in terms of the yield on offer in securities available for income funds, as well as the risks that need to be taken to earn these income yields. Specifically, yields closely linked to the repo rate have fallen by close to 3%, whereas sovereign bond yields remain elevated and above pre-crisis levels. We believe this requires investors to be critical of the exposure they take on in the fixed income space when seeking appropriate income returns (above cash and inflation).

After the initial upheaval in bond markets (caused by both a broad-based deterioration in fundamentals and a technical liquidity squeeze in markets), it is understandable that the bear thesis around South Africa's fiscal situation may result in investors fearing both the credit (default) and duration (interest rate sensitivity) risks of bonds issued by the sovereign. However, we believe a sensible exposure to these assets is where investors can increase the odds of achieving their income targets – both on an absolute level (above cash and inflation) as well as relative to the lower yields available on other income generating securities. Since inflation targeting began in the early 2000s, interest rate (and inflation) cycles provide investors with a longer-term approach with a unique opportunity to earn outsized, risk-adjusted returns in sovereign bonds. The current environment of a very visible bear thesis implies that yields likely reflect the negative sentiment – an opportune time to incorporate these longer duration assets into your exposure. The rich market liquidity and very low or contained inflation present an attractive opportunity to replicate performance similar to previous rate cutting cycles.

Assessing credit risk in the market

We define risk as the permanent loss of client capital. In fixed income, mitigating credit risk should therefore be the major focus, which can be achieved through the application of a consistent process that seeks to avoid credit pitfalls, while earning yields that are acceptable for the risks. In our view, the market is currently placing a relatively low bar for assessment of corporate credit risk (lending client capital to corporates), while placing a high bar on sovereign bonds despite the gaping yield differential (compensation). While we believe risks related to South African government bonds are concerning, as we have seen a deterioration over many years, there are also very crucial mitigating factors present which are often ignored by the market and that make a sovereign credit event very unlikely over the medium term. The risks in corporate credit (a large component of the income market) however, appear to be dismissed and deemed safer than the sovereign as evidenced by the tightening of credit spreads we have seen of late. Continuously deploying client capital into these areas in our view increases risk and when choosing which side of the equation to be on, we opt in favour of South African government bonds where credit risk (risk of permanent capital loss) is lower and real yields remain attractive, which increase the odds of achieving your income targets.

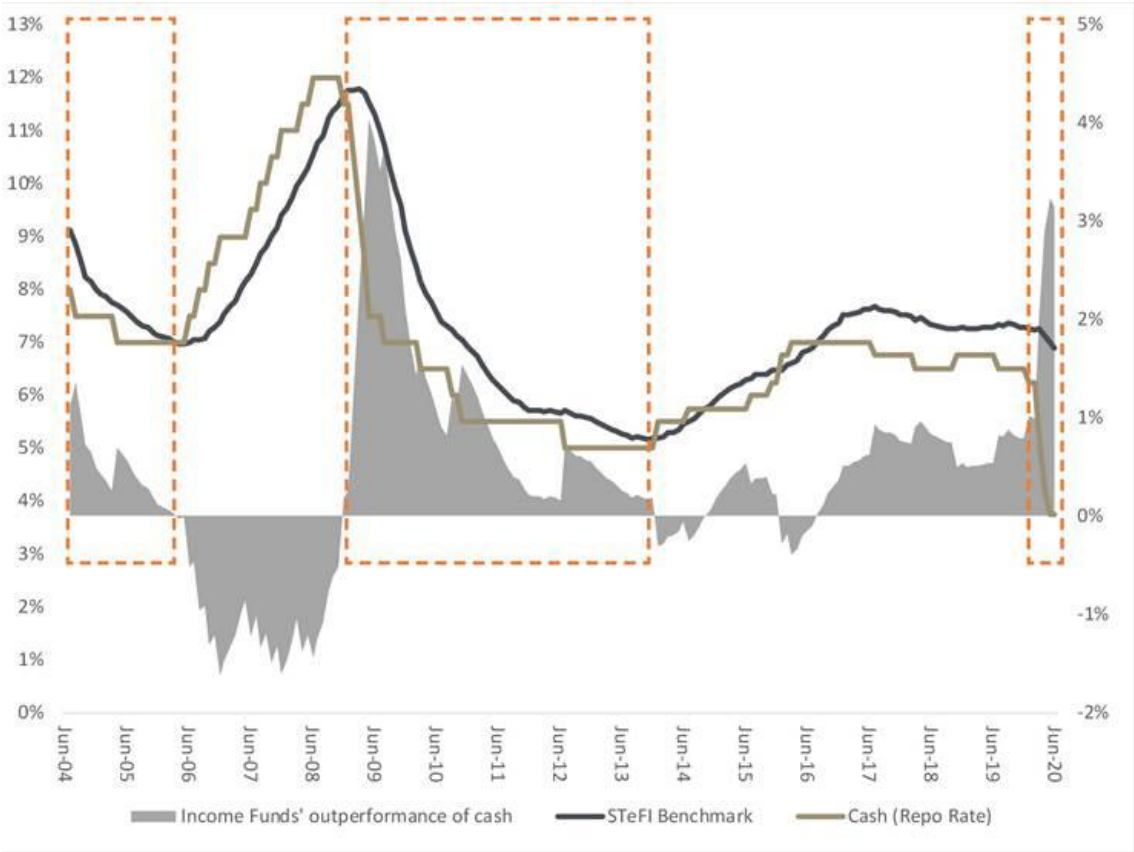
Assessing the mitigating factors to South Africa's current fiscal backdrop:

- South Africa's institutions have shown resilience during a difficult period. The South African Reserve Bank (SARB) acted quickly and decisively by cutting the interest rate buffer they had built through years of prudent monetary policy. Injection of liquidity also ensured market liquidity stabilised. The banking sector, having built capital buffers in a tough economic environment, were also able to absorb the shock of the crisis.
- Government has indicated its continued commitment to the fiscal restraint demonstrated during this year's budget as well as the supplementary budget. We believe these measures presented in the supplementary budget are manageable with the appropriate willingness to reform and are crucial to long term fiscal stability, a factor acknowledged by National Treasury.
- The South African rand, while volatile, has provided the stabilising effect expected in a crisis as evidenced by the recent current account surplus.
- South Africa remains one of the emerging markets with the longest debt maturity profiles (implying interest rate costs rise slower) and low offshore debt which mitigates the impact of the weak rand on the fiscus. Further, South Africa's foreign currency reserves remain robust and South Africa has not opted to manage the currency as seen elsewhere in emerging markets.
- National Treasury is currently able to raise local funding in primary market weekly auctions for the increased borrowing requirement due to the impact of COVID-19. Despite the risks, these auctions have been well oversubscribed. In addition, significant foreign funding has already been raised which aids the borrowing requirement, but also the stability of South Africa's balance of payments.
- Emerging market flows into South African bonds have been heavily impacted by risk-off sentiment in recent years but continued low global interest rates has seen this trend begin to show positive signs as foreigners have returned to these weekly market auctions.

Interest rate cycles: Looking to past precedent

Fixed income investors may take some comfort from the fact that, historically, income funds have continued to deliver both inflation-beating (real) and above-cash returns even after interest rates have been cut. Typically, income funds perform close to cash in rising interest rate cycles, and significantly outperform cash in a falling interest rate environment. This outperformance of cash was evident in the previous rate-cutting cycles of the early 2000s, post the Global Financial Crisis (GFC) and currently, following the 3% cut in rates. Looking at the more recent GFC example, there were sharp cuts in interest rates in 2008/09 where we saw bond yields fall to very low levels (the 10-year bond dropped to a yield of nearly 6%) and credit spreads compress sharply, driving strong performance of fixed income assets. For investors willing to incorporate a sensible allocation to duration, sovereign bonds delivered attractive absolute and relative returns to other areas of the fixed income market. During the period income funds outperformed cash by a significant 4% as rates were cut, similar to the current level of outperformance.

Graph 1: Income fund returns (STeFI) vs cash (repo rate)



Sources: Bloomberg, JSE Market Data, PSG Asset Management. STeFI is typically the benchmark of income funds, while the repo rate provides a proxy for cash returns.

Managing duration risks

We take a through-the-cycle view of interest rates, focusing on securing real yields that we believe compensate for risks. When inflation is rising (and available real rates are low), we believe it is appropriate to have a portfolio with low exposure to duration. Conversely, we look to take advantage of longer duration assets when they offer compelling real yields, the rate cycle is favourable, and inflation is falling/low. We therefore remain optimistic on the outlook for fixed income investors over the medium term as a well-positioned exposure to duration assets (sovereign bonds) under this backdrop is attractive in our view.

While risks are elevated, we believe they are also known and therefore included in the generous risk premia on offer in longer-dated government bonds. While the fiscal backdrop is weaker than in 2008/09, investors should not ignore the similarities in the current interest rate cycle, and let fear deter them from taking advantage of the opportunity to lock in higher yields while they are still available. We believe the attractive real yields of 5% to 7% in sovereign bonds above a normalised headline inflation rate can differentiate the performance of income funds over the years to come.

Selectivity will be key for fixed income investors

We have been extremely selective in the fixed income market for a considerable time, focusing on buying cheap securities (where yields compensate for risks) rather than overpaying for perceived lower risk assets. We believe the current rates cycle and low inflation outlook present compelling prospects for income-seeking investors willing to look through the current noisy environment. However, we caution investors that opportunities are not evenly distributed across the fixed income market, specifically in exposure to credit risk where spreads are not reflecting the fundamental risks embedded in these instruments. Now, more than ever, investors should be very selective about what they are exposed to within the fixed income universe and consider exposure to longer-dated assets.

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

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Lyle joined PSG Asset Management as a credit analyst and money market trader in 2014. He is manager of the PSG Money Market Fund, PSG Income Fund and PSG Diversified Income Fund. In addition, Lyle performs credit and fixed income research. Prior to joining PSG, he completed his articles with Deloitte Cape Town. Lyle holds B.Bus Sci degree and a Post-graduate Diploma in Accounting, as well as the CA(SA) and CFA designations.