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Navigating a fast-changing fixed income market

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It has been a tough year to date across all markets and fixed income has not been spared. After years of stable inflation-beating income returns, a return in excess of inflation has been hard to come by this year. Markets have been disrupted, while South Africa experienced the first bout of inflation outside the South African Reserve Bank's (SARB's) 3%-6% inflation target band in many years. Volatility, particularly in fixed rate instruments such as government bonds, has meant that for the most part, income returns have disappointed over the short term.

In our view, this volatility is unlikely to subside as we face an unwinding of global monetary policy alongside a barrage of macro concerns. Over the past two weeks, we have argued that we are heading into a polycrisis environment in which investors will have to think and act differently if they want to be successful. Read these ***Funds on Friday*** articles by **Anet Ahern** and **Kevin Cousins** for further insight on this topic. However, an overly defensive strategy may result in a poor outcome for clients. We believe a few factors and trade-offs need to be considered when constructing your income portfolio:

- Cash returns, driven by a higher repo rate, have a high probability of underperforming investors' income needs as the SARB is unlikely to hike excessively.
- Overpaying for perceived, safer (less volatile) securities may have unintended consequences.
- Liquidity, and the optionality it provides, will be a lot more valuable in a fast-changing fixed income environment.

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Navigating these challenges successfully will require a re-evaluation of the risk/return trade off

We have seen many funds turn to floating rate corporate bonds to address clients' income needs. While corporate bonds can play a valuable role in rate-hiking cycles, we would only favour large exposures when these assets are cheaply priced. We exercise caution when investing in corporate bonds today, because:

- the SA interest rate cycle is unlikely to be as steep as anticipated
- they are expensively priced
- we believe their perceived low volatility is rather a reflection of an illiquid market

We unpack these arguments in more detail below.

SA is unlikely to see a steep repo rate-hiking cycle

South Africa's latest inflation print was at 7.6% year-on-year for the month of August 2022 (down from a 13-year high of 7.8% for July). The print above the SARB's target range has been driven by significantly higher energy (electricity), fuel and food prices. However, core inflation, a measure of underlying inflationary pressures in SA was significantly lower at 4.4% year-on-year. While it is difficult to be certain, the consensus view is that inflation peaked in July and is likely to return to within the SARB's target band in the early stages of 2023. However, market expectations for the current cycle have become too aggressive in our view, pricing for extensive interest rate increases of 2.5% in the next 12 months (measured using forward rate markets). We believe this is unlikely given the construct of inflation in SA which is exhibiting weak demand-led inflation. An income fund strategy which relies on a steep repo-rate cycle, is therefore likely to disappoint.

Corporate bonds are expensive today and do not compensate investors sufficiently for additional risk

Corporate bond yields need to compensate investors for taking the risk of default, i.e., not receiving capital and coupons back over the term of the investment. Therefore, we expect them to offer sufficiently higher yields than their 'risk-free' government bond counterparts. However, we believe corporate bonds are currently expensively priced when taking their risk characteristics into account. The spreads above cash rates (compensation for taking credit risk) have been on a downward trend since 2017, due to high flows into fixed income funds, creating demand that has not been matched by issuance of paper. Despite this, we continue to see significant support from the market. Floating rate notes, those that do well in rate hiking cycles, have seen spreads continue downwards. Well-subscribed auctions (high bid-to-cover ratios) indicate that this trend has not abated. In addition, we have seen an enormous quantum of structured notes being issued by banks to meet investor demand. However, these notes are typically very illiquid, meaning that they are only traded infrequently, and that if a specific note needs to be unwound at short notice, it could result in sharp price movements.

The market misreads low trading frequency for low volatility

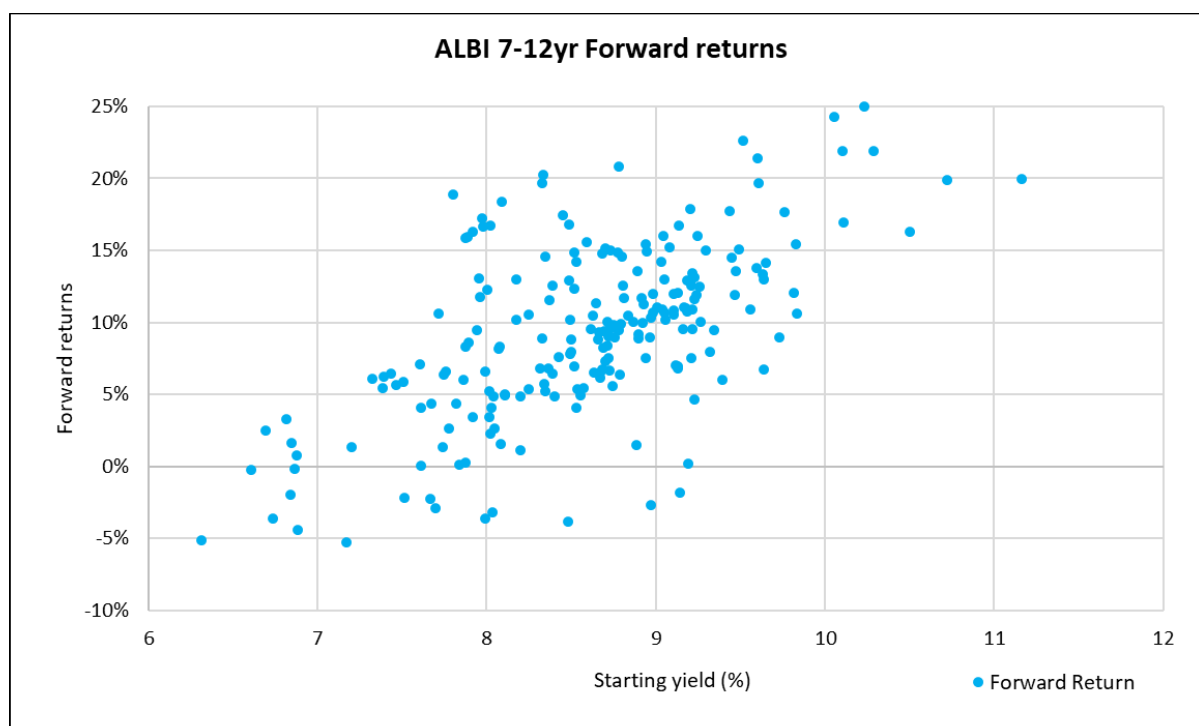
Corporate bonds are often viewed as offering the additional benefit of low correlations to other asset classes and low price volatility. As observed this year, despite that barrage of market-moving events, corporate bond yields have hardly budged in response. However appealing this may appear in current volatile markets, these features are not due to unique fundamental/economic drivers. Rather, these securities have low relative liquidity (trade infrequently), and when choosing to invest in them, investors are sacrificing their ability to adapt portfolios to changing market dynamics. In our view, the ability to adjust positions as market conditions change is likely to

become more valuable in the years ahead. Consequently, we favour SA government bonds as the better alternative when considering the challenge of how to meet future investor income needs.

SA government bonds are well placed at the current margin of safety

It is well known that SA government bonds offer some of the highest real yields globally and for SA income-seeking investors, and this area of the market has been reliable in its delivery of inflation-beating returns despite short-term volatility. We do not believe a default is a high risk in SA government bonds and the key fundamental risk to consider is how much compensation is right given the duration risk taken (interest rate sensitivity). As highlighted in **Kevin Cousin's** article, there is a world of difference between how markets are pricing the future inflation risk in different economies. Even if inflation stays elevated, a holder of SA government bonds will still earn attractive real returns. The fact that SA government bonds are trading at high premiums to inflation and close to COVID-distressed yields, signals significant fear and apprehension from the market. We are likely closer to a high in yields. Buying in such bouts of weakness and market volatility has offered asymmetrical payoffs for investors able to see through the short-term volatility as evidenced by the graph below. We analysed 20 years of bond returns on the ALBI (seven- to 12-year area) relative to the entry yield bought. In most scenarios, buying into yields above 10%, investors have earned an attractive 12-month forward return of at least 15%. We are currently buying the 10-year bond in excess of 11%.

Figure 1: ALBI 7-12yr Forward Returns



Source: PSG Asset Management and Bloomberg

Optionality will be invaluable in the years ahead

We believe the client's journey in an income fund is of utmost importance. However, there is significant risk in overweighting the most recent market volatility to inform your asset allocation or fund selection for the years ahead. Buying cheap or mispriced securities as a guiding principle should always overshadow the need to reach for the highest yield, especially where the risk of a default in securities with lower liquidity (ability to exit) is potentially being underestimated. Fortunately for SA income investors, SA fixed and inflation-linked government bonds offer attractive yields with enough liquidity to enable dynamic allocations. While these bonds carry duration

risk, there are smart ways to structure portfolios to ensure clients can enjoy the journey while tipping the odds in their favour to earn attractive inflation-beating returns.

Glacier Research would like to thank Lyle Sankar and Ané Craig for their contribution to this week's *Funds on Friday*

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Lyle was appointed as the head of Fixed Income in April 2022. He joined PSG Asset Management in 2014 as a credit analyst and trader. He currently co-manages the PSG Money Market Fund and is the fund manager of the PSG Diversified Income and PSG Income Funds. Prior to PSG, he completed his articles with Deloitte Cape Town before joining Coronation briefly in business development.

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