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The SA bond market – a new era of higher risk and return?

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Over the past five years, we have seen significant structural changes in the South African government bond market. This includes the loss of our global sovereign investment grade credit rating, resulting in foreign holdings of SA bonds almost halving (from around 43% down to 26%). Over the same period, we have also seen a significant increase in SA bond holdings from the local unit trust industry, doubling from around 10% to just over 20% of current total nominal outstanding.

Why are unit trust managers buying SA bonds?

SA bond yields offer compelling expected real returns (above inflation), especially relative to traditional money market and income fund-type investments. Following the 2020 monetary policy response to COVID, we have seen the gap between expected real yields in the bond market and money market widen significantly. Until recently, real yields in the money market were unattractive and close to zero. Expected money market yields recently clicked up a bit and are now close to 2%, but this is still vastly inferior to expected real bond yields northwards of 5%, albeit at higher anticipated volatility.

The graph below – what we like to refer to as the "crocodile graph" – shows how expected real yields have moved between fixed income asset classes over time:

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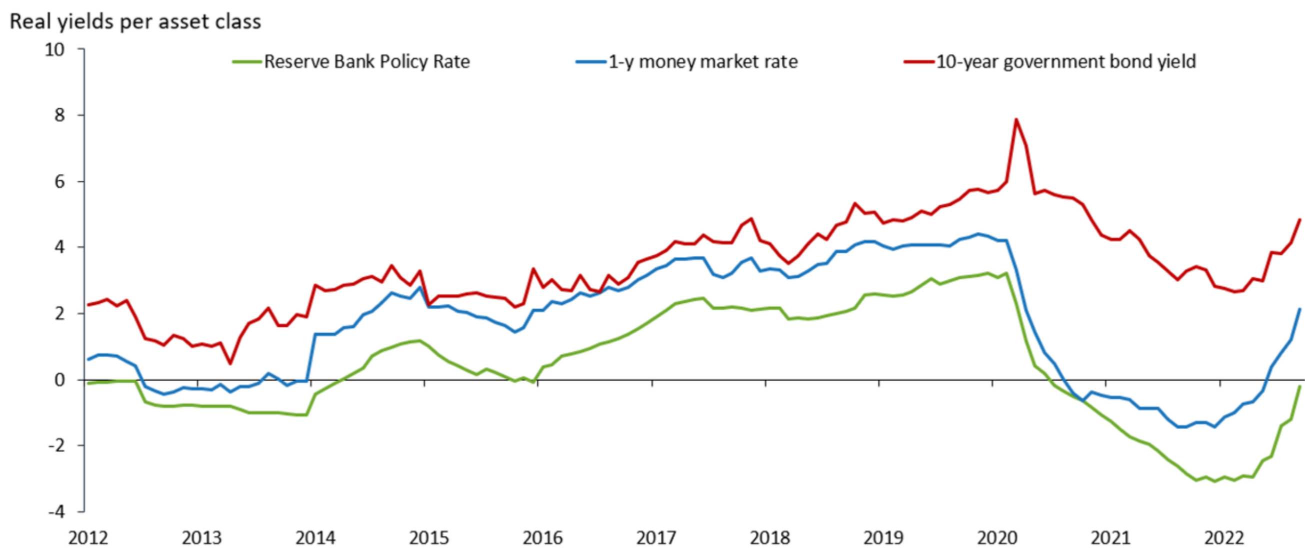


Source: SARB, Stats SA, Bloomberg, Matrix Fund Managers

It is no wonder that bonds now represent a far more significant holding in mutual asset funds and discretionary fund manager (DFM) solutions that target returns between 3% and 5% above inflation. But these elevated real yields come at a cost – higher expected volatility (bond capital price fluctuation).

A primary driver of this volatility is the fact that SA sovereign debt is no longer regarded as investment grade on an international (global) scale. It should also be noted that, on a national scale, SA government debt still represents the safest (AAA.za rated) debt that a local investor can own in our country.

So, if SA government debt is rated AAA on a national scale, why should the loss of our global investment grade credit rating matter to local investors?

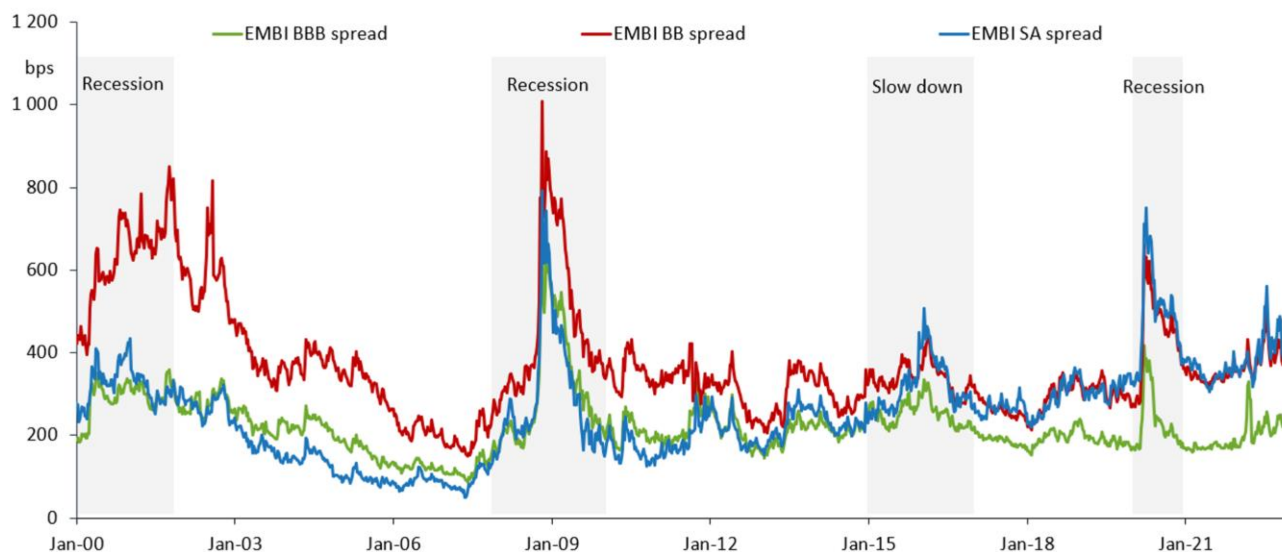
Well, it's all about the way that the market determines the fair value yield of a bond. One of the commonly used formulae to calculate the fair value yield of a rand-denominated SA bond looks something like this:

FV (SA Bond Yield) = US Treasury Yield + SA Credit Spread + Expected Inflation Differential

The SA credit spread is therefore a major determinant of the fair value yield of our SA bonds.

For most of the past 20 years, SA government bonds were rated as global investment grade (between BBB- and A- depending on the rating agency). Downgrades to speculative grade started in 2017 with Standard & Poor's and Fitch leading the way. In March 2020, the Moody's downgrade to sub-investment grade also came through. Today, all three of these agencies rate SA government debt firmly as speculative grade between BB- and BB. Speculative grade bonds are also often referred to as high yield bonds or junk bonds.

The chart below shows how the credit spread of a 10-year SA bond has fluctuated over the last two decades (as indicated by the SA Credit Default Swap (CDS) spread):



Source: Bloomberg, Matrix Fund Managers

The points to note are:

- Credit spreads are measured in basis points over US treasuries i.e., a spread of 400 points implies a spread of 4% per annum over US 10-year treasuries.
- The green line denotes the 10-year credit spread of typical BBB investment grade emerging market sovereign debt.
- The red line denotes the 10-year credit spread of typical BB sub-investment grade emerging market sovereign debt.
- The blue line denotes the SA 10-year sovereign credit spread.
- Credit spreads spike when economies go through recessions and BB-rated credit spreads spike significantly higher than BBB-rated credit spreads.
- SA credit spreads used to move in line with BBB spreads prior to 2017 but moved in line with BB spreads thereafter.
- Prior to 2017, the SA 10-year credit spread typically moved in a relatively narrow band between 200 and 400 basis points (2% and 4% over US Treasuries).
- Now, we can expect SA 10-year credit spreads to move in a much wider band between 250 and 600 basis points, with more dramatic spikes when recession fears abound.
- Finally, it should be noted that a 100bps change in the credit spread should result in roughly a 6% change in the capital price of a 10-year bond.

Expected bond yields are now attractive

- SA government bonds offer attractive expected real yields. To some extent, this is due to the fact that our average credit spread is higher than it used to be.
- We can expect SA government bonds to be more volatile in future than they have been in the past due to the more volatile nature of our sub-investment grade credit spread.

At Matrix we have a constructive view on SA bonds at these levels. The attractive running yields add value across a range of portfolios, especially where we target returns in excess of inflation. However, we are very aware that the capital value of our bond holdings may prove to be more volatile in future than in the past, and we will be keeping a steady eye on those CDS spreads to help us navigate this new era of higher risk and return.

Glacier Research would like to thank Jean-Pierre Matthews for his contribution to this week's *Funds on Friday*

Jean-Pierre 'JP' Matthews,

Head of Product

Matrix Fund Managers

Jean-Pierre joined Matrix in 2019 as head of Product, responsible for the development and distribution of the Matrix product range. He is also a key individual, representative and member of the Investment Committee at Matrix. JP started his career in financial markets in 1996 as a fixed income analyst and trader. He has been a long-standing proponent of the hedge fund industry in South Africa and was involved in the establishment of various alternative asset management and securities trading businesses over the years. Before joining Matrix, JP was a portfolio manager and head of business at a large institutional alternative asset manager. He has a degree in Actuarial Science and is a CFP® and CFA® charter holder.