A refresher on the A-Z of bonds

Melanie Stockigt, portfolio manager at Laurium Capital, pointed out that bonds differ from shares in that they pay coupons, which are a defined series of payments (rather than a dividend which is not pre-defined). In addition, there is a set maturity date on which the investor will receive the principal amount back.

View presentation

Fixed rate bonds

Of the many types of bonds listed on the JSE, fixed rate bonds comprise almost 70.4% of the SA bond market.

Another characteristic of bonds is the inverse relationship between price and yield. When market rates change, the price of a fixed coupon bond moves in the opposite direction. If the market yield increases, the bond price decreases. A bondholder loses when market rates rise, and gains when market rates fall. For example, if the coupon is 10% and the market yield is 12%, the bond price falls. Conversely, if market rates fall to 8%, and the coupon is 10%, the price of the bond will increase.

Gauging fair value

Essentially there are three factors that drive the change in bond prices over time. These include the risk-free rate, relative inflation and risk premium.

Risk premium

Let's consider a 10-year bond issued by the SA government, currently trading at about 10%. We'd look at what the risk-free rate is globally – we mostly use the 10-year US Treasury as the risk-free rate and then determine the fair value for that. Thereafter we look at SA and make an adjustment for SA inflation dynamics. This is driven by where we are in the domestic growth cycle. We then make another adjustment due to the difference in the credit worthiness of the SA government relative to the US government.

Relative inflation and the domestic cycle

A big theme in the global market right now is inflation. Stimulus cheques given to US citizens during COVID-19 were spent on goods and this has pushed inflation higher. Rising oil prices have also played a role. Bond yields globally have risen to compensate investors for the higher inflation outlook.

Locally, our reserve bank is mandated to keep inflation between a range of 3 – 6%.

Risk premium

Risk premium is the additional compensation required to invest in SA bonds versus US bonds. This is driven by external balances such as the current account, how much we owe and balance sheet metrics such as debt to GDP.

As an exporter of a range of commodities SA has benefited from the surging commodity prices, resulting in a healthier current account which helps the rand and the inflation outlook.

In terms of creditworthiness, our debt to GDP as a country is too high. Long-term growth is key to stabilising our debt level.

Yield curves

A positively sloped yield curve reflects an economy expected to grow at normal rates of growth and inflation. Long-term investors get a higher reward for taking on the risk.

A steep curve is a signal that the economy will grow quickly in the future, usually at above potential levels. This usually means inflation pressures, and therefore more restrictive monetary policy. Long-term investors require a much higher reward for this risk.

An inverse, or negatively sloped yield curve seems to present a paradox. But the reason long-term investors settle for lower yields than short-term investors is because they believe rates will trend even lower, so they want to lock in the current rates before they fall. The yield curve shape sends important signals about the economic cycle and where it’s headed. Traditionally, an inverted curve has always come before a recession.

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Glacier Financial Solutions (Pty) Ltd.

A member of the Sanlam Group
Private Bag X5 | Tyger Valley 7536 | Email client.services@glacier.co.za | Tel +27 21 917 9002 / 0860 452 364 | Fax +27 21 947 9210 | Web www.glacier.co.za | Reg No 1999/025360/07
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Private Bag X8 | Tyger Valley 7536 | Tel +27 21 950 2600 | Fax +27 21 950 2126 | Web www.smmi.com *|*Reg No 2002/030939/07
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Glacier International is a division of Sanlam Life Insurance Limited
Sanlam Life Insurance Ltd. | Email life@sanlam.co.za | Tel + 27 21 916 5000 / 0860 726 526 | Fax +27 21 947 9440
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