Fixed income and FX

Insight

7 August 2023

Much of the upside has compressed as cash looks competitive

Where nominal bonds appeared attractive across the curve for the past two months, much of the upside has compressed for now, in our view. At this point, we believe cash appears attractive relative to the front and back ends of the nominal curve. Our analysis suggests only the 7-year to 15-year bucket appears attractive and provides better expected return than cash. The same goes for inflation-linked bonds (ILBs), although we believe the curve may bear steepen somewhat and shorter maturities may provide better value in an environment where an adverse inflation impulse remains likely.

Our model fair value (FV) for key nominal bond maturities moves marginally higher

After a strong rally in bonds in the past two months and another month of fiscal data for South Africa (SA) that became available last week, we revisit our bond estimates and bond strategy for nominal bonds and ILBs. Given our baseline assumptions, our model result provides us with a 10-year FV of 10,9%, marginally up from our previous FV of 10,7%.

We remain cognisant that fiscal dominance is high

We believe fiscal dominance of ultra-long bonds is high and growing. Our estimates suggest that almost 70% of the 30-year bond yield is driven by local fiscal policy, making ultra-long bonds largely "mute" to less hawkish monetary policy.

Issuance increases on average, sees curve steepening despite this topic being well covered

There is a real and growing risk that weekly auction sizes for nominal bonds would need to increase. Despite the government's financing requirement being a well-researched topic, it appears that the curve still steepens after an announcement that nominal bond issuance will increase. In short, any issuance increases may not be well priced.

Nominal bonds seem more of a "hold" rather than a "buy" right now

We believe the space for yields to rally has largely compressed for front-end and ultra-long bonds where expected returns are like those of cash. If cash is not preferred, our expected return estimates suggest the R2030 to R2037 area still provides most value. Our 12-month expected return for the ALBI index now stands at 11,1% (vs cash at 9,5%).

ILBs could see some pressure; our 10-year FV moves up, too

We believe upward pressure on real yields is building as fiscal risks materialise. Our 10-year FV is now at 4,9%, up from 4,7% previously. Our expected return for the CILI index is 9,1% (vs cash at 9,5%). For ILBs, our general view is that less duration is better.

ANALYST DETAILS

Walter De Wet, CFA

WalterD2@Nedbank.co.za

Reezwana Sumad

ReezwanaS@Nedbank.co.za

+27112941753

CIB Research Portal

Upside has compressed as cash looks competitive

After a strong rally in bonds in the past two months and another month of fiscal data for SA that became available last week, we revisit our bond estimates and bond strategy for nominal bonds and ILBs. Where bonds appeared attractive across the curve for the past two months, much of the upside has compressed for now, in our view. This is especially the case as we continue to forecast a larger funding requirement, with a strong bias for further slippage rather than less.

Our base-case assumptions remain largely unchanged – wide deficits and growing debt

Our core macroeconomic assumptions that drive our bond view remain largely unchanged. We still expect growth of 0,3% yoy in 2023 and 1,3% in 2024. At the same time, we expect fiscal slippage in the budget, wider budget deficits and a higher debt-to-GDP ratio over the MTEF, growing to 76,7% at the end of the MTEF. For a detailed analysis and our latest view on SA's fiscal situation, see our note Fiscal crunch: funding a larger deficit dated 31 July 2023. On the monetary policy front, we expect headline CPI to decline to 4,9% by mid-2024, resulting in a 25-basis-point (bps) cut by SARB in 2Q 2024. For both CPI and the repo rate, our bias is for higher outcomes rather than lower.

Our model FV for key nominal bond maturities moves marginally higher

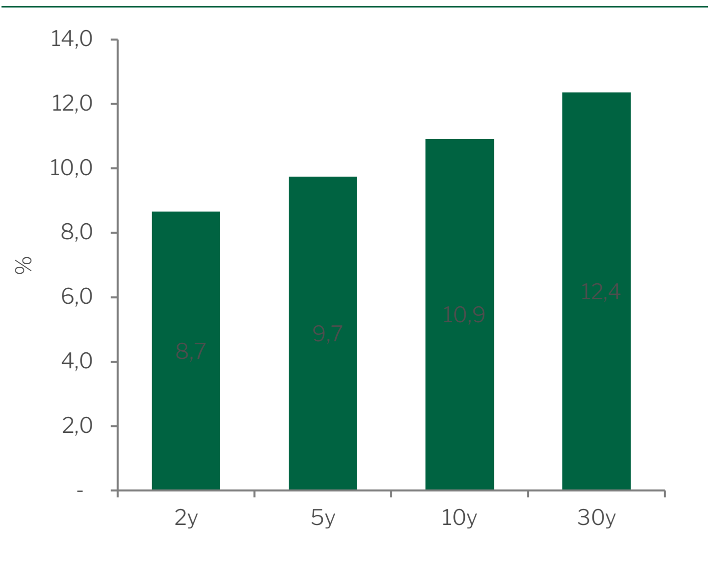
The model result from our baseline assumptions provides us with a 10-year FV of 10,9%, marginally up from our previous FV of 10,7%. At the same time, our 30-year FV yield estimate moves up, from 12,0% to 12,4%. The change is largely driven not only by the risk of higher debt stock for SA, but also by an assumption of marginally higher US bond yields of 10 bps across the curve.

Exhibit 1: Key input assumptions for our bond view

	Input assumptions (%)
US 2-year yield (12 months ahead)	4.20
US 5-year yield (12 months ahead)	3.80
US 10-year yield (12 months ahead)	3.60
US 30-year yield (12 months ahead)	3.70
Repo (12 months ahead)	8.00
SA current account (avg. next three years)	-2.30
SA budget balance (avg. next three years)	-4.90
SA gross debt/GDP (end of MTEF)	77.0
Headline CPI (12 months ahead)	4.90

Source: Nedbank CIB Markets Research

Exhibit 2: Our FV estimates for key maturities



Source: Nedbank CIB Markets Research

We remain cognisant that fiscal dominance is high and it's muting less hawkish monetary policy

We believe fiscal dominance of ultra-long bonds is high and growing (see our strategy note Bonds, the monetary surprise and fiscal dominance dated 25 July). Our estimates suggest that almost 70% of the 30-year bond yield is driven by local fiscal policy (Exhibit 3). As a result, any sustainable move in ultra-long-dated yields will have to be driven by a change in fiscal policy. This implies not only that a less hawkish monetary policy stance will have little impact on long-dated yields, but also that the fiscal bind that SA faces will keep yields elevated. This also shifts our bias towards less duration rather than more.

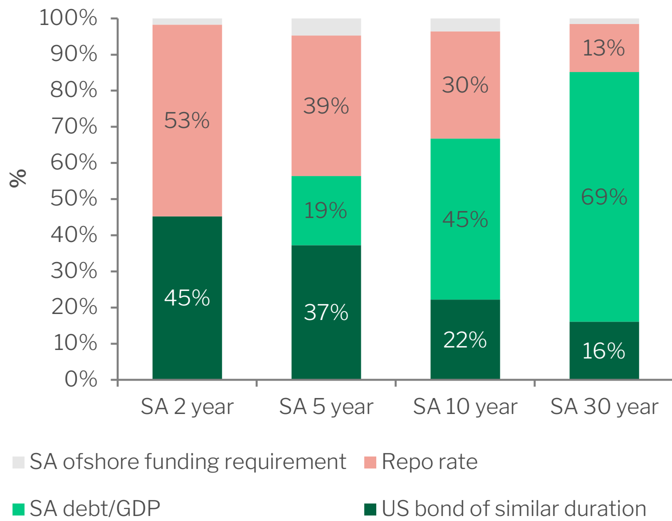
Also, issuance increases on average, sees curve steepening despite this topic being well covered

Equally important but more short-term is the real and growing risk that weekly auction sizes for nominal bonds would need to increase. Despite the weekly issuance size being a well-talked-about and well-researched topic, it appears that the curve still steepens after such an announcement.

We calculate an index of the change in the 30-year/10-year spread ahead and after the announcement of weekly auction size increases since 2013 to gauge how the bond market reacts before and after these announcements (Exhibit 4). In total, there were 11 announcements of weekly auction size changes, of which 8 were increases. We exclude the announcement of an issuance increase in May 2020 during the height of the pandemic, as bond yields around this period were distorted by many factors other than the issuance increase. We weigh the spreads by the size of the increase in the weekly auction of each announcement so that a bigger change in auction size carries a larger weight in the index.

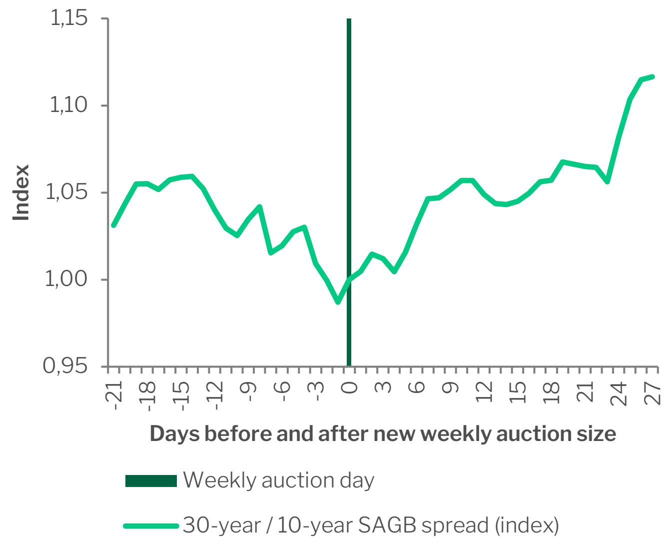
Our index suggests that, on average, the 30-year/10-year spread steepens after the announcement for a period of at least 30 days. While there are other factors that influence the shape of the curve ahead and after auction announcements, this does suggest that one should have at least a bias for steepening after the announcement. It appears that the curve is less efficient in pricing changes in issuance increases than what the constant market chatter on this subject would suggest.

Exhibit 3: Factor influence of the yield curve in 2023



Source: Nedbank CIB Markets Research

Exhibit 4: Yield curve steepens, on average, after auction size increases



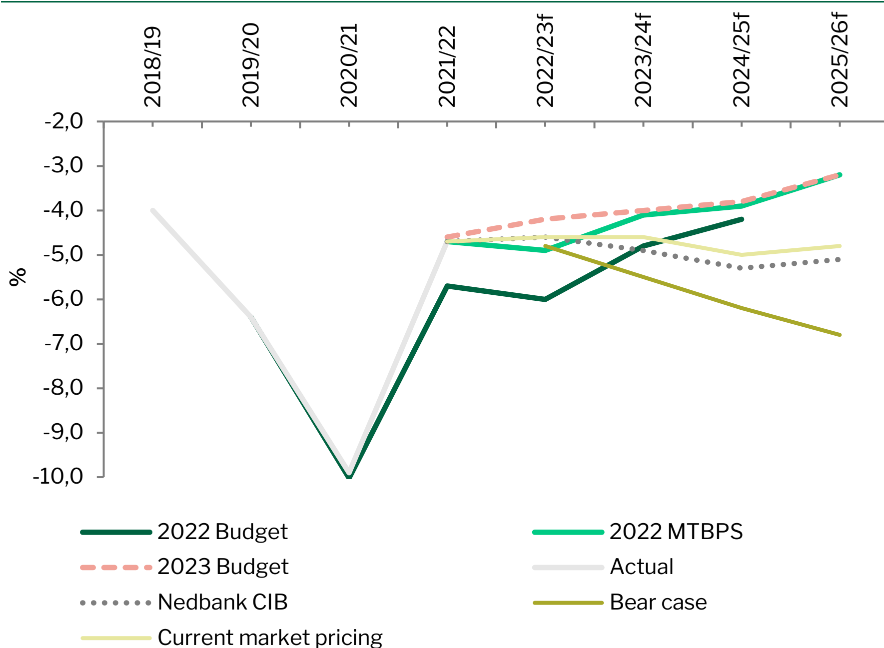
Source: Nedbank CIB Markets Research

Base case sees a R400m/week issuance increase; bear case could see a significantly larger increase

Our base-case fiscal outcome suggests that the heavy lifting to fund fiscal slippage will be spread across the funding sources (cash usage, foreign loan issuance, a marginal expenditure reduction and a R400m/week increase in weekly issuance), a much larger deficit will place significantly more strain on weekly nominal and ILB issuance (see our note Fiscal crunch: funding a larger deficit dated 31 July 2023).

We believe the National Treasury's (NT's) projections in the February 2023 Budget Review is a best-case outcome, while our bear-case outcome for the consolidated budget deficit is presented in Exhibit 5. With a budget deficit of 5,5% of GDP for 2023/24 in the bear case (vs our base case of 4,9% and the NT's forecast of 4,0%), weekly issuance would need to increase by R1,3bn, particularly in an environment where the floating-rate note (FRN) take-up is even weaker than previously expected and revenue undershoots constrain the government's cash build-up. As highlighted in Exhibit 4, the market does not seem efficient in pricing issuance increases well but we do believe our base case is much better priced than the bear case, which would be a surprise, in our view.

Exhibit 5: Consolidated budget deficit forecasts (% of GDP)



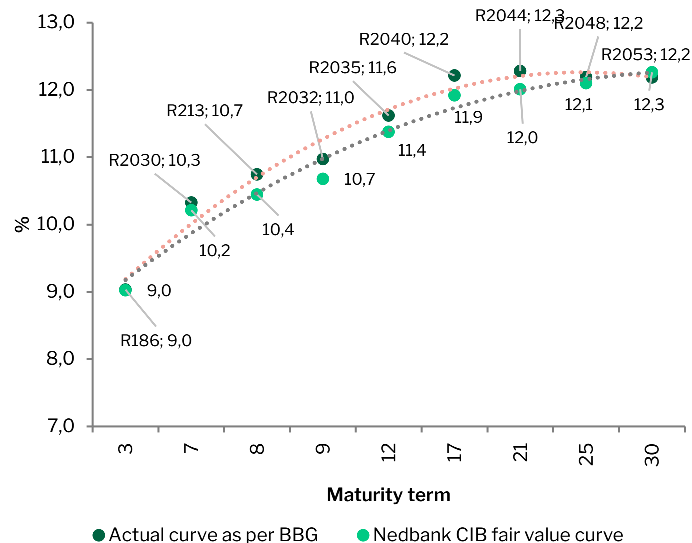
Source: Nedbank CIB Markets Research

Nominal bonds seem more of a “hold” rather than a “buy” right now

We believe the space for yields to rally has compressed, especially for front-end and ultra-long bonds, with both ends of the curve now at our FV estimates (Exhibit 6).

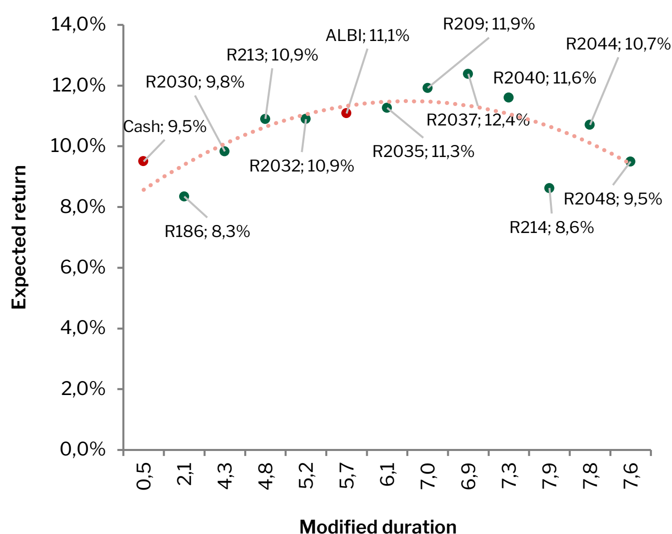
At the front end, cash returns are now likely to compete well, with expected returns on the R186 making the latter less appealing at this point. At the ultra-long end, the funding risk remains ever present and here, too, expected returns are similar to cash returns, in our view. As a result, our expected returns do not justify the duration risk of these bonds. If cash is not preferred, our expected return estimates suggest that from a duration/return perspective, the R2030-R2037 area provides the most value (Exhibit 7).

Exhibit 6: Our FV nominal bond curve vs current market yields



Source: Nedbank CIB Markets Research

Exhibit 7: Expected bond return (12-month horizon)



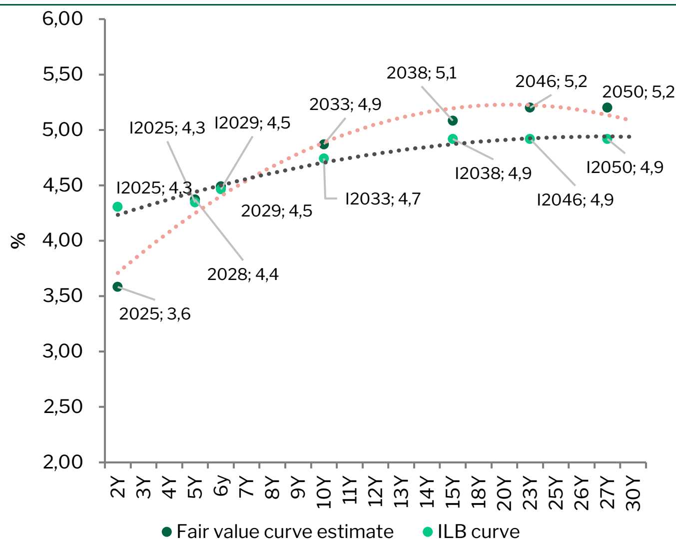
Source: Nedbank CIB Markets Research

ILBs could see some pressure; our 10-year FV moves up, too

Throughout the sell-off in nominal bonds in April and May, we thought ILBs were priced and reflected the underlying fiscal risk well. However, this has now changed, and we believe upward pressure on real yields is building as fiscal risks materialise. Our 10-year FV is now at 4,9%, up from 4,7% previously.

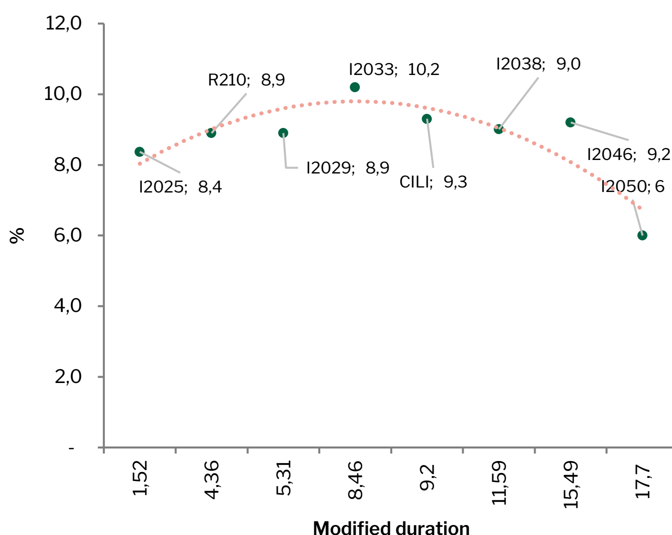
Our updated ILB curve suggests that yields beyond the 10-year point should move higher, largely on the back of our expectations for upward pressure on SA’s debt-to-GDP ratio and, by implication, a larger funding requirement. We previously pencilled in debt to GDP to reach 75% by the end of the MTEF. That has now shifted up to 77% (according to Exhibit 1). Furthermore, it does appear that core US real yields may remain higher for longer. That said and contrary to recent moves in the ILB curve at the front end, we believe there is value on the back of inflation risk that remains to the upside. Overall, we expect the ILB curve to steepen somewhat, from a very flat profile currently.

Exhibit 8: Our ILB FV curve suggests some steepening



Source: Nedbank CIB Markets Research

Exhibit 9: ILB expected return vs modified duration



Source: Nedbank CIB Markets Research

Cash looks better than ILBs, but there could be value against another adverse inflation shock

Our expected return for the CILI benchmark index currently stands at 9,3% on a 12-month horizon (Exhibit 9). This is marginally less than cash and nominal bonds. For ILBs, our general view is that less duration is better, and that beyond 2033, there is little value in holding these bonds on a standalone basis. Worth noting: we believe ILBs, especially short-dated ILBs, hold more value than what our expected return data suggests, largely because we believe the bias remains for adverse inflation shocks over the medium term....