



Bond outlook

The way forward

by **MARK LE ROUX**



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This quarter I want to steer away from the norm and address two issues that we feel are key for the South African bond market going forward. The first is a phenomenon that we are seeing playing out in a number of the developed-country bond markets, namely the advent of 'financial repression'. And the second is what has taken place in the bond market with respect to foreign holders of South African bonds.

Ushering in an era of financial repression

Financial repression: a term used to describe several measures which governments employ to channel funds to themselves, which in a deregulated market would go elsewhere. (Source: Wikipedia)

It can be in the form of keeping short rates artificially low (negative real short rates), introducing regulation to force banks to hold more government debt (Basel III), or introducing legislation that forces investors to hold certain prescribed assets. Looking back at history, periods of financial repression tend to coincide with negative real returns being generated on fixed income assets (both cash and bonds) and periods of stagflation.

Judging from the statement at the most recent Monetary Policy Committee meeting it appears that certain members are keen to keep short rates at their current historically low levels, and potentially even look for the opportunity to cut rates further. This could be hazardous for the economy as inflation is rising at an alarming rate, heading towards the upper end of the target range of 6% – and with the recent currency depreciation could materially breach it.

If we are heading into a version of this scenario, we favour holding positive real yielding assets such as inflation-linked bonds (ILBs), where one is at least guaranteed a positive real return if held to maturity. It is of interest to note that

in a number of the developed countries ILBs are trading at 0% real rates, or even negative real rates.

Burning under the African sun

Foreign interest in buying South African bonds (similar to certain times last year) reached fever pitch towards the end of August. The primary driver of this 'en masse' purchase was the decline in yields on long-dated bonds in the developed world, making our high-yielding SA local currency bonds very attractive.

For the year ending August, foreign investors had bought close to R50 billion of our bonds. Yes, the 'carry' pickup of between 5% and 6% was highly attractive, but as with anything in the market, it doesn't come for free. The risk they appear to have ignored was the expectation that the rand would remain stable (and overvalued) into perpetuity. In September the rand sold off 15% at its lowest point, effectively wiping out the carry yield pickup for foreign investors in South African bonds and a fair deal more. In short, all the South African bonds bought in rands by foreign investors this year are now at a book loss. In response, R14 billion were sold in the latter part of September.

Outlook

In summary, we believe real returns from cash and bonds are likely to be relatively poor over the longer term, both from a South African perspective and a global perspective. Short rates are likely to remain lower for longer and inflation will become problematic.

In our view, the way forward is to run shorter duration positions relative to benchmarks, combined with a liberal inflation-linked bond holding. 