



# Bond outlook

by **MARK LE ROUX**



**MARK LE ROUX** is responsible for the fixed interest investment process and portfolio management functions for both institutional and retail portfolios. Mark has more than 20 years' experience in managing both traditional and alternative portfolios.

For the local fixed income market, 2011 was characterised by rising inflation, a depreciating currency (the rand lost 22% against the dollar), rocketing food prices and a materially increasing fiscal deficit. Under 'normal' circumstances such a combination would be hugely negative for a bond market, but 2011 was far from normal; concerns over global growth continued, global bond yields plunged (US 10-year now below 2%), worries over the fiscal situation of a number of European countries persisted and the foreign bond investor appetite for yield was heightened by record low domestic short rates. All of which resulted in a decent offset to the fundamental negative backdrop for bonds.

The bond market performed largely in line with its yield to maturity (YTM) for the year. The long dated benchmark government bond (R186 2026 maturity) started at a YTM of 8.30% and ended slightly weaker at 8.47%. The All Bond Index recorded 8.80% for the year, with the star performer being the shorter dated R203 (2017 maturity) at 10.80%, and the ultra long dated R209 (2036 maturity) the worst performer with a return of only 2.70%.

Inflation-linked bonds (ILBs) performed strongly, with the index returning 13% for 2011. The five-year government ILBs produced the top return of 16.5%. For the first time in South African history the very short dated ILBs saw their real yields decline into negative territory (R189 2013 maturity declined to -0.15% real yield). This was driven by the sharp increase in demand for inflation protection as headline inflation breached the upper end of the South African Reserve Bank's (SARB) target range and short rates on money market instruments now in negative real territory.

## Themes and expectations for 2012

### ■ Inflation

We expect inflation to remain elevated and above the 6% upper end of the target range during the course of 2012. The main drivers of this are food prices and the depreciation in the currency. The maize price again made new highs in December 2011, with this very important soft commodity's year-on-year rate of change now running at 99%.

SAFEX WHITE MAIZE PRICE % YEAR-ON-YEAR



Source: I-Net Bridge

### ■ Short rates

The next move in short rates, we believe, will be upwards. However, given the recent relatively dovish stance of the Monetary Policy Committee, this will most likely only take place in the second half of the year. With a repo rate at 5.50% and inflation (in our view) averaging above 6%, negative real returns can be expected in money market assets.

## ■ Yield curve

Government needs to borrow in excess of R150 billion from the bond market to fund the budget deficit in the new fiscal year. This is a sizeable issuance for the market to absorb and is likely to place upward pressure on bond yields during the course of the year, especially at the back end of the curve where most of the issuance is expected to take place. With the SARB trying to keep short rates unchanged for as long as possible, this may result in the yield curve continuing to steepen in the early part of the year. However, as soon as the first rate hike is signalled and believed by the market, the yield curve should flatten quite quickly.

## ■ Looking forward

Global government bond yields at below 2% are unsustainable. A sell-off in global bonds would be a major risk to our bond market, particularly when combined with the large funding overhang that we face this year. In addition, any delay by the SARB to take action against the rising inflation trend could have major ramifications for the local bond market – the longer they wait the more entrenched higher inflation expectations become.

Across our bond portfolios, we continue to run lower than benchmark duration positions coupled with a holding in inflation-linked bonds. 🏠

US GOVERNMENT 10-YEAR BOND



Source: I-Net Bridge