WHY LOCAL BONDS?

QUARTER 3, 2019

For some time, we've emphasised our overweight position to local fixed income in our funds. This is despite an extremely negative narrative that has taken hold about the state of government's finances and as a result, our investors often challenge this position. In fact, it is precisely because of this negative narrative that yields are so high and attractive. Put differently, the risks are largely priced in. This is generally the case with financial markets, whether bonds equities or currencies: by the time you read about it in the newspaper, it is already discounted in the price. The trick is to find asset classes where too much bad news has been priced in. We think South African fixed income, particularly government bonds, falls in this category.

Before we unpack some of those risks and look at why they are overstated, a brief description of fixed income as an asset class.

Fixed income as an asset class comprises different forms lending money and earning an interest. In the South African context, this means lending to banks, other corporates, parastatals, municipalities and the national government in the form of various securities (bonds, bills, NCDs, FRAs, etc). The government dominates the local fixed income market. Its R2.5 trillion in accumulated borrowings translates into a sizable market for investors. Its debts are other people's assets (including investors in our funds).

One brief technical note: Most debt securities make a fixed interest payment (known as a coupon) on a regular basis (hence the name). This interest rate is set at the time of issue. When the security is traded in the secondary market, its price can fluctuate and the interest payment as a percentage of the price changes. This is known as the yield. Prices and yields therefore move in opposite directions.

The basic principle of finance holds: more risk implies higher return. There are three main types of risk in this context:

- Credit risk: Will I get the money I've lent back in the end?
- Inflation risk: Will the purchasing power of my money be lower when I get it back?
- Interest rate risk: If I lend money at a certain rate today, and general interest rates rise, will I miss out on a better opportunity?

There is also a time element to these risks. The longer the term of the loan, the more uncertain I am about what the world might look like at the point of repayment, and the higher the compensation I require. In other words, interest rates on long-term loans (measured in years) tend to be higher than on short-term loans (measured in months). If one plots the various terms of loans and associated interest rates on a chart, it depicts the "yield curve". In normal times the yield curve should slope up from left to right (from short term to long term).

Mandates

We employ two fixed income mandates in our funds. The flexible mandate allows managers to use the full spectrum of fixed income instruments, from cash to short-term bank paper to long-term government bonds. As the name suggests, our managers (Coronation, Prudential and Prescient) have flexibility to invest where they see value, but when the bond market rallies, we want them to capture the upside, and we also want them to be defensive if the market sells off. In other words, we want our fixed income managers to consider return and risk. Thus far we are very pleased with how they've done this. The enhanced income mandate is much more conservative and aims to generate a return slightly higher than the money market. There are restrictions in terms of the duration of securities the managers can hold. Over the long term, this mandate should underperform the flexible mandate, but should also be less volatile. As a result, our conservative multi-asset funds (Old Mutual Multi-Managers Cautious fund of funds and Old Mutual Multi-Managers Defensive fund of funds) have an allocation to both mandates. The Old Mutual Multi-Managers Balanced and Aggressive Balanced funds invest in the flexible mandate. As the name suggests, the Old Mutual Multi-Managers Enhanced Income fund of funds invests solely in the Enhanced Income fund. There is a separate money market mandate (managed by Sanlam and Precient) for our Old Mutual Multi-Managers Money Market fund of funds.

Credit Risk

When it comes to local government bonds, most of the discussion at the moment is around credit risk. Ratings agencies explicitly try to give an indication of how creditworthy a borrower is, and by implication, how likely it is to default on an interest payment or capital repayment (or both). All three ratings agencies have downgraded South Africa in recent years, to the point that only Moody's considers rand-denominated bonds as investment grade. The rest consider rand and hard-currency bonds as sub-investment or "junk" status. Some investors pay close attention to these ratings and will only buy bonds with an investment grade rating. A Moody's downgrade will result in South African bonds being excluded from the FTSE World Government Bond index, and funds that mimic this index will have to sell out. No one has a firm handle on the potential amount of this outflow. However, most investors only use ratings as one of many inputs in their investment process and care more about the yield than the rating. Other notable global bond indices do not consider ratings for inclusion of a country's bonds.

Ratings agencies are also a lagging indicator, confirming what we already know. Markets price in real time, absorbing and reflecting all available information. Though South African government bond yields have trended sideways for the past four or so years, other emerging markets have seen their yields decline, especially this year. Relative to our peer group, we have been thoroughly downgraded by the bond market already. South Africa Brazil is case in point.

The more a government (or any other entity) borrows, the greater the risk it will be unable to repay at some point. More borrowing also implies a greater supply of bonds, which all else being equal, should lead to lower prices and higher yields.

In a few weeks' time, (30 October to be precise) the Finance Minister will update the government's borrowing requirement for the coming year. The fiscal deficit (the difference between government spending and tax revenue) is likely to be much larger than estimated at the February Budget speech due to weaker economic growth and the bail-out of Eskom. Government's debt expressed as a percentage of national income (or GDP) will probably rise above 60% for the first time ever.

This is not high in a global context. The problem is rather that it has increased rapidly over the past decade with no sign yet of slowing down. And since government borrows at a high interest rate, the cost of servicing all this debt is consuming a larger and larger portion of the budget. This is clearly not sustainable.

Past efforts to narrow the deficit include a VAT hike, a personal income tax increase, and placing limits on non-interest expenditure. They've had little success because the economy has persistently disappointed, delivering less than-expected tax revenue. The deliberate destruction of tax collection capacity clearly did not help either, while the continued bail-outs of SOEs has added to the spending requirements. Ultimately, faster economic growth is needed to narrow the deficit and place state finances on a sustained footing. Anything else is just a plaster over the wound.

IMF not needed

Would South Africa then need to turn to the International Monetary Fund? It is highly unlikely, and not just because that would imply a loss of sovereignty (IMF loans tend to come with strict conditions). The main reason it is unlikely is that government largely borrows in the domestic market in local currency. This means we avoid the "original sin" of other emerging markets: the lack of a domestic bond market forces borrowers into foreign markets where they are exposed to hard-currency scarcity and exchange rate risks.

The IMF's role is chiefly to supply dollars in cases where countries run out of dollars, but have dollar funding needs. A typical case would be a country whose export prices fall, reducing its dollar earnings, while it still needs to pay for imports with dollars and needs to repay dollar-based loans.

Inflation has declined

We think the market is focusing too much on credit risk, and not enough on inflation and interest rate risks. Inflation has declined substantially and is likely to continue declining given a weak economy and global trends. Lower than expected inflation increases the real value of bonds. We also think that low inflation will allow the Reserve Bank to cut rates again in the future. Lower interest rates mean bonds should rally, leading to a capital gain for existing investors.

The credit risks aren't unimportant as taxpayers and citizens find the increase in government borrowing troubling. But as investors, we have to realise that markets tend to price in known risks already. If things are going to be slightly better than expected, markets will rally. But because yields are so high – the South African 10-year government bond yield was 9% at the time of writing in early October compared to 1.5% for the US, 0.44% for the UK and -0.6% for Germany – we don't need capital appreciation to generate a return. In the context of record low global interest rates, local fixed income stands out as a terrific source of return and portfolio diversification.

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