WHERE TO FIND YIELD TODAY...
NOT NECESSARILY WHERE YOU WOULD
NORMALLY LOOK

For the global investor, sources of yield remain limited. Extraordinary monetary policy has pushed interest rates to or close to zero in many developed economies and developed market bond yields remain close to historic lows. Indeed, it remains true that global investors can find better sources of yield in equity markets than bond markets.

Locally, however, the environment is very different. Interest rates here have been rising and investors can find reasonably attractive yield even adjusting for inflation in the fixed income market. The catch for investors, though, is that interest rates in South Africa have likely peaked and could be cut later this year as inflation falls back below 6%. In this scenario, we expect cash yields to fall and, in the funds we manage, we have been using cash to invest in longer-duration assets, which will benefit from lower interest rates. From outright yield we think it’s important that investors focus on “growing” yield. South African property and parts of the equity market offer this and we have added exposure to these assets over the last year.

GLOBAL BONDS – RISK WITHOUT COMPENSATING YIELD
Despite a recent correction, developed economy bond yields are at very low levels compared to history. Indeed, adjusting for inflation, bond yields in Japan, Germany and the UK are negative. In other words, investors who hold these assets to maturity are guaranteed negative returns. Even in the US, real yields are only just positive and are well below long-run average real yields. Compared to history, investors in these assets are asking very little by way of compensation (yield) relative to what they have received historically. In short, global bonds offering little yield are expensive and it is no surprise that we do not hold developed economy bonds in our multi-asset portfolios.

HOW MUCH UPSIDE RISK TO GLOBAL BOND YIELDS?
One yardstick that can be used to measure fair value in bond markets is the nominal rate of growth of the economy. In chart 2 we show the nominal rate of growth in the US economy against the 10-year US government bond yield. While these two rates may differ at points in time (depending on economic conditions and monetary policy), over time we would expect the nominal bond yield to tend towards that of the nominal rate of growth in the economy. Since 2009, central banks have held long bond yields down, which has resulted in low bond yields relative to GDP growth. However, as the US and global economy begins to accelerate and central banks start to normalise monetary policy (the US Federal Reserve is currently raising interest rates, but has not yet started reducing its balance sheet), we expect global bond yields to begin moving higher towards the nominal path of GDP. In the US’s case, the central bank expects inflation to rise to around its 2% target and consensus expectations are for real...
GDP to grow at or slightly ahead of 2%. This implies a nominal US bond yield of closer to 4% rather than the current 2.4% – considerable downside for investors in global bond yields. While we cannot be certain of the path of global bond yields, we are sure that at current levels investors receive precious little yield and face potentially significant capital losses should bond yields normalise higher.

WHERE TO FIND YIELD IN DEVELOPED MARKETS?
So where should global investors look for yield? Outside the hunt for yield in emerging markets such as South Africa, the counter-intuitive answer is in equities. Chart 3 shows the difference between government bond yields and equity market dividend yields for developed economies. Typically, over time investors have earned a premium yield in bonds relative to equities. However, in much of the developed world today, dividend yields in equity markets are at a premium to bond yields. While the exception is the US, even there the premium of bond yields relative to dividend yields is considerably lower than the long-term average. We continue to think that this is a powerful argument in favour of allocation to global equities relative to global fixed income. Indeed, as seen in chart 4, most South African assets currently offer a premium yield relative to global assets.

HOW DO SOUTH AFRICAN ASSETS STACK UP AGAINST GLOBAL ASSETS FOR YIELD?
Compared to global developed market assets, South African assets offer much higher yield. As shown in chart 1, South Africa stands in marked contrast to developed markets in that bond yields are not only higher than inflation, but the current real (i.e. inflation-adjusted) bond yield is considerably higher than the long-run average real yield. In other words, unlike in many developed economies, holders of South African government bonds are getting more than average compensation for holding South African government bonds. Indeed, as seen in chart 4, most South African assets currently offer a premium yield relative to global assets.
South Africa offers a richer hunting ground for yield than do global markets. This is in part because the interest rate cycle here has been rising and real interest rates are positive. As a result of a still hawkish central bank and increased sovereign risk, fixed-income assets’ yields are high compared to global assets even accounting for inflation differentials. South African 12-month NCDs, for instance, offer a yield of 8.3% – around 2.8% after adjusting for expected inflation of 5.5% over the next 12 months. Given the relatively turbulent time in risk assets over the past two years, it is not surprising that many investors find cash relatively appealing today. However, the catch is that interest rates in South Africa have most probably peaked and are likely to be cut later this year as inflation slows to within the central bank’s 3%-6% target range. What this means is that cash yields are likely to fall and as they do, longer duration assets, particularly those sensitive to the interest rate cycle, will benefit. Investors therefore face the risk of being stuck in cash with falling yields as other riskier assets outperform.

**FALLING CASH YIELDS POSE A RISK TO INVESTORS**

So what should investors be doing?

In our view they should be adding to duration and risk – and this is precisely what we have been doing in our multi-asset portfolios over the last year. One area we have spent cash on is South African property. This may seem strange given the strong performance from the listed property index over the last few years: Surely yields are low and, consequently, future returns from the sector will be low? At an aggregate level this is true. Chart 6 shows the dividend yield of the South African Listed Property Index (SAPY) has compressed significantly.

However, this is in part due to the strong performance of companies that have expanded offshore over the past few years. In the chart we have also shown the yield for only those property companies that operate primarily in South Africa – what we have called SA-only Property. South African property companies offer yields in line with their long-run average and, as shown, compare favourably to other asset classes on the basis of yield. While these companies are expected to continue experiencing subdued operating conditions, we think the entry yields are reasonably attractive and that they will continue to generate steady growth in distributions. As cash yields fall, we think investors who want some yield need to look for assets that can provide a growing income stream, and South African property fits the bill.

**CHART 5: SOUTH AFRICAN REPO RATE AND 12-MONTH NCD YIELD**

**CHART 6: SAPY AND SA-ONLY PROPERTY DIVIDEND YIELDS**

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