LOW GROWTH **A BLOW TO FISCAL CONSOLIDATION**

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KEY TAKEOUTS:

- TAX SHORTFALL AND OVERSPENDING RAISE BUDGET DEFICIT
- GROWTH AND FISCAL OUTLOOK NEGATIVE FOR CREDIT RATINGS
- FOREIGNERS ARE OVERLOOKING SA WOES

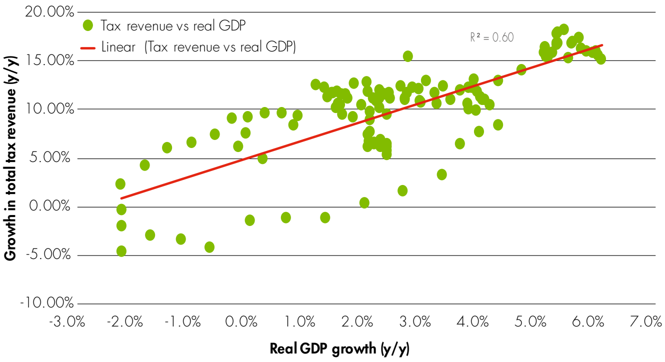
Following the sharp upward correction in yields during the last week of June – when markets were spooked by the European Central Bank president's remark implying that the bank may be nearing the end of exceptionally loose monetary policy – developed global bond markets stabilised. During July, nothing of material interest came the way of market participants to cause another major shift in expectations.

LONG BONDS UNMOVED BY SURPRISE RATE CUT

Locally, the South African Reserve Bank (SARB) surprised most analysts, including us at Futuregrowth, with the 25 basis point (bp) repo rate reduction. In our view, the local bond market responded appropriately – as short- and medium-dated bonds moved in tandem with the cut, while long-dated bond yields ended July at similar levels to the previous month's close. During July, the yield of the benchmark 10-year RSA government bond traded in a fairly wide range of 8.50% and 8.93% before closing the month at 8.61%, or 17bps lower than the June close. In contrast, the long-dated R2048 (maturity 2048) closed the month at 9.86%, a mere one basis point below the previous month's close. The back end of the bond market is not sold on the rate cut and also remains concerned about the fiscal outlook – a view we share. The latest monthly government finance data confirmed these concerns, as the combination of a growing tax revenue shortfall and an expenditure overrun caused a larger than expected budget deficit for the first three months of the 2017/18 fiscal year.

Low real GDP growth will negatively impact tax revenue collections, in turn putting plans for fiscal consolidation at risk. This may force Government to sell more bonds in order to finance the shortfall.

TAX REVENUE COLLECTION AND REAL GDP (MARCH 2006 - MARCH 2017)



Sources: Bloomberg, Futuregrowth

BUYERS ARE BACK. NO WAIT, THEY NEVER LEFT

Despite the larger deficit, the higher nominal yield offered by the local bond market, new-found global bond market stability and the repo rate cut enticed foreign bond investors to turn net buyers of rand-denominated government nominal bonds, to the tune of almost R10 billion in July. This more than reversed the net selling in June and lifted net nominal purchases for the first seven months of the year to R52 billion, or nearly 50% of the total outstanding rand-denominated debt issued by the South African government. This is a very significant holding considering that it is 5% higher than the combined holding of the South African banking, long-term insurance and pension fund industries. It also clearly illustrates that the average foreign bond investor does not share the same concerns we have in respect of persistent low growth and its negative implications for fiscal consolidation and South Africa's sovereign credit rating profile.

Although the rate of inflation at both consumer and producer levels continued to decelerate, the inflation-linked bond market managed to consolidate its long losing streak that started in April last year. The yield of the benchmark R197 (maturity 2023) actually declined 8bps to close July at a yield of 2.47%.

As a result of the above developments, the JSE All Bond Index (ALBI) rendered a total return of 1.5% for the month of July. This is significantly better than cash (0.6%) and the JSE Inflation-linked Government Bond Index (IGOV), which only managed a mere 0.1%. The ALBI is leading the pack for the first seven months of this year, with a very respectable 5.6%, especially considering the number of supposedly bond bearish events over this period. An investment in cash would have rendered a return of 4.0% over the year to date. The global reach for yield has, once again, saved the day.

FUTUREGROWTH VIEW

The modest global economic recovery sets the scene for limited inflationary pressure and a steady monetary tightening cycle for the few economies that are in a position to normalise policy. Our view remains that global bond markets, in general, are not appropriately priced, leaving room for rising yields.

Locally, the downward trend to inflation is entrenched, supported mostly by significantly lower food price increases, with weak consumer demand also playing a role. While the SARB has surprised many with the timing of the recent cut, we still believe that a strong easing cycle should not be pursued. The external trade imbalance, albeit improving, is still too big to allow for a significantly lower real repo rate.

Our main concern remains the strong link between the local low economic growth backdrop and tax revenue collection. Persistent sub-trend economic growth and macro policy uncertainty have negative implications for fiscal consolidation and eventually sovereign credit ratings.

Negative ratings momentum in the medium to longer term, caused mainly by sustained sub-trend economic growth and uncertainty about the fiscal outlook, does not match the continued aggressive accumulation of local currency bonds by foreign investors. This mismatch presents a potential lethal mix for the local bond market. Considering this, we shall continue to approach the market with extreme caution.

Unless otherwise indicated, performance figures in the article are sourced from Futuregrowth and I-Net Bridge (Pty) Ltd