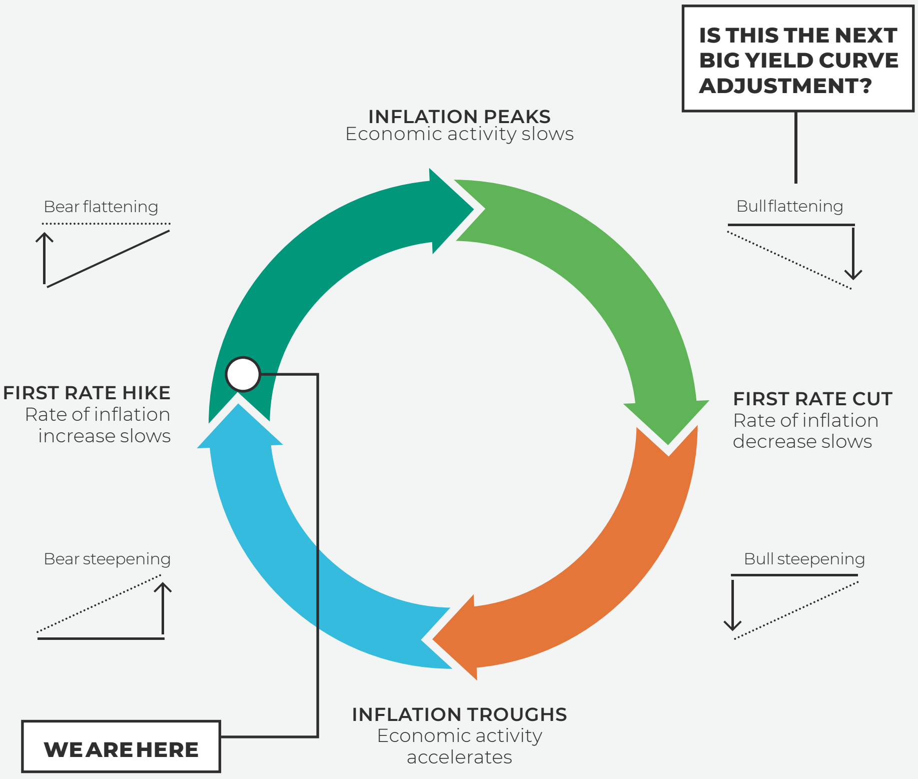
WHAT COULD DRIVE A BOUT OF BULLISH YIELD CURVE FLATTENING IN THE NEW YEAR?

WRITTEN BY
WIKUS FURSTENBERG,
PORTFOLIO MANAGER
AND HEAD OF INTEREST
RATE PROCESS

Credit: Clem Onojeghuo

Following a rather protracted period during which political and market events introduced some distortion to the interest rate cycle, a level of "normality" returned by the end of 2017. What do we mean by "normality", you may ask? Simply put, the focus has returned to growth and inflation drivers, as opposed to political events, influencing monetary policy and the interest rate cycle.

FIGURE 16: THE INTEREST RATE CYCLE... WHAT IS THE NEXT BIG YIELD CURVE ADJUSTMENT?


IS THIS THE NEXT BIG YIELD CURVE ADJUSTMENT?
INFLATION PEAKS
Economic activity slows
Bear flattening
Bull flattening
FIRST RATE HIKE
Rate of inflation increase slows
FIRST RATE CUT
Rate of inflation decrease slows
Bear steepening
Bull steepening
WE ARE HERE
INFLATION TROUGHS
Economic activity accelerates

Bear Steepening: longer-dated bond yields rise faster than yields at the short end (often happens when inflation is expected to rise).

Bear Flattening: short-term bond yields rise faster than long bond yields (often precedes interest rate increases).

Bull Flattening: longer-dated bond yields fall faster than yields at the short end (lower inflation and the end of the monetary policy tightening cycle expected).

Bull Steepening: short-term bond yields fall at a faster rate than long bond yields (often precedes interest rate decreases).

Sources: Bloomberg, Futuregrowth

Considering all the various drivers of the interest rate cycle, our view of where we are at the time of writing (December 2018) is indicated below (see Figure 16). However, of greater importance is where we are heading and, more specifically, how the yield curve will behave.

01/ WHAT IS THE NEXT BIG YIELD CURVE ADJUSTMENT?

While it goes without saying that financial markets never move in an orderly fashion, it is clear that the dominant yield curve change over the past year or two was for the yields of longer-dated nominal bonds to rise to higher levels, while the yields at the short end still tracked the repo rate lower until as recently as March 2018.

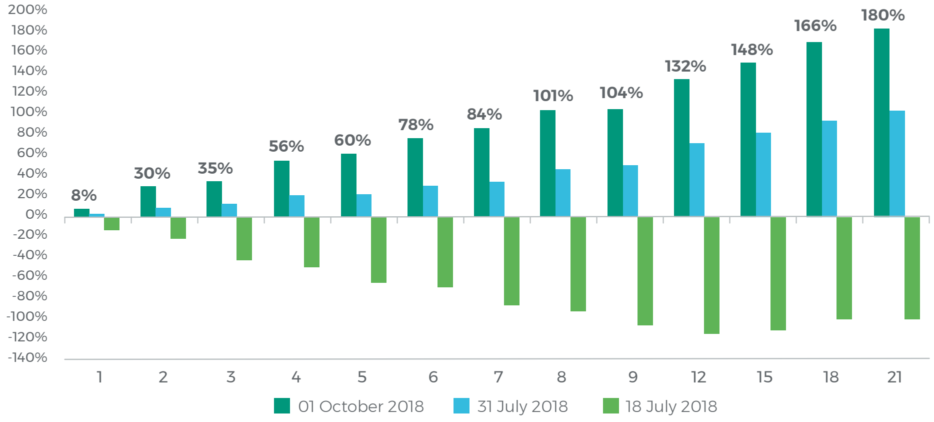
This is also known as bearish yield curve steepening. With inflation rearing its head and the South African Reserve Bank (SARB) concerned about the potentially negative implication of volatility drivers (namely, the weaker rand and higher crude oil prices), the Bank deems it prudent to "talk tough" and even consider raising the repo rate in the near term.

This scenario, called a bearish yield curve flattening, is already priced in by financial markets. However, we are of the view that, if anything, the market has been too aggressive in pricing monetary policy tightening (see Figure 17 on the following page).

02/ DRIVERS OF THE NEXT BIG YIELD CURVE ADJUSTMENT

Given that the market has priced in the move to a bear flattening yield curve, our focus has already shifted to the next potential major yield curve change – a bullish yield curve flattening (refer back to the interest rate cycle graphic). In this case, the yields of longer-

FIGURE 17: RATE HIKES ALREADY PRICED IN... SA FORWARD RATE MARKET (PROBABILITY OF A 50 BASIS POINT OVER TIME)



Sources: Bloomberg, Futuregrowth

dated nominal bonds decrease in anticipation of lower inflation and the end of the monetary policy tightening cycle. As this unfolds, longer-dated bonds will render a higher return than short- and medium-dated bonds (remembering that bond yields fall when prices rise). The potential drivers of such an outcome are considered below.

US TREASURY MARKET YIELDS HAVE APPROACHED OUR FAIR VALUE ESTIMATE

Sustained strong economic growth and a significantly reduced unemployment rate, combined with moderate inflationary pressure, afforded the US Federal Reserve (Fed) an opportunity to finally start the process of interest rate normalisation and raise its policy rate for the first time in the almost 10 years since the start of the global financial crisis. In the process, the US Treasury market has drifted to more realistic levels, with the benchmark 10-year Treasury yield now close to our estimate of fair value of 3.2% - 3.5%. Although it could very well drift to a higher level, we feel comfortable that the market now did most of the work by appropriately pricing in this shift, especially since we are not convinced that this cycle is going to be as strong as in the past, mostly due to strong disinflationary forces. With US yields more contained, and in light of the fact that this remains the global benchmark, upward pressure on local yields from this source would be significantly reduced.

THE RAND HAS DEPRECIATED SHARPLY AND APPEARS TO BE OVERSOLD

The rand has weakened significantly since the end of the first quarter of 2018. While nobody can predict currency movements with any degree of certainty, we can safely state that the rand seems oversold relative to our estimate of its purchasing power parity (Figure 18). While some of the recent weakness admittedly might still find its way into higher prices of local goods and services, weak local growth might offset most of the negative relative price changes.

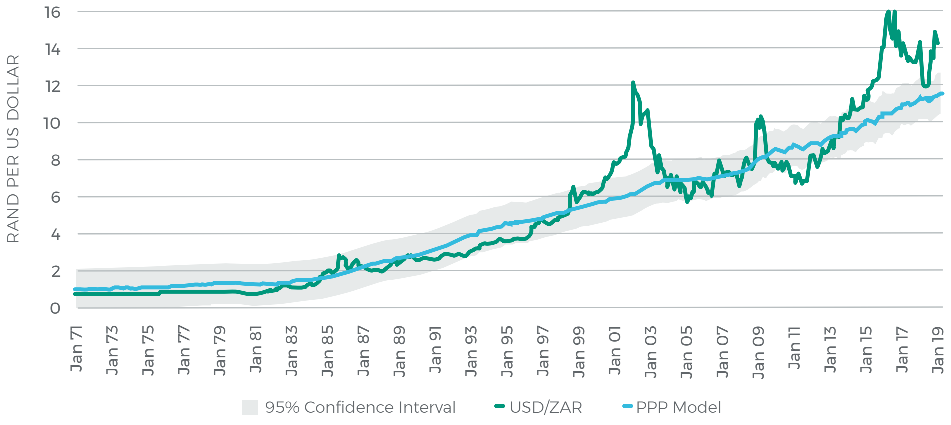
LIMITED RAND DEPRECIATION PASS-THROUGH SUGGESTS A STRONG DISINFLATIONARY BACKDROP

As clearly illustrated in Figure 19, the inflation rate and exchange rate have decoupled. Of course, the combination of subdued global inflation, weak local economic growth and strong competition in the retail sector has an important role to play. Unless economic growth picks up significantly, and in a very short space of time, we believe that the inflation outlook will remain relatively benign over the next 12 months. This, in combination with a fairly hawkish central bank, is supportive of an eventual decrease of longer-dated nominal bond yields.

FOREIGN INVESTORS HAVE REDUCED THEIR HOLDINGS OF RSA LOCAL CURRENCY GOVERNMENT BONDS

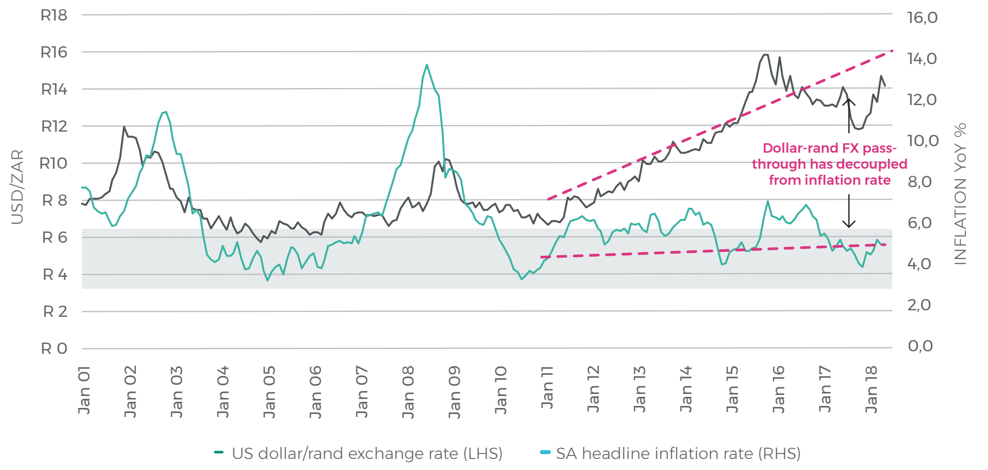
The significant net selling of SA bonds by foreign investors could be attributed to various factors. These include risk aversion in response to significant emerging market turmoil, the gradual draining of excess global liquidity and SA idiosyncratic factors. Noteworthy is the fact that this selling had been concentrated in nominal bonds with a term to maturity of eight years and longer. With this large and important section of the broader investor base significantly reducing their holdings of longer-dated bonds (refer to Figure 20), future potential selling pressure is lessened and, if market conditions indeed turn more favourable, these investors may be lured back. It must be stressed that this is a technical market driver. As a prerequisite, the fundamental drivers need to fall in place.

FIGURE 18: THE RAND COULD STRENGTHEN... USD/ZAR EXCHANGE RATE ESTIMATE BASED ON PURCHASE POWER PARITY



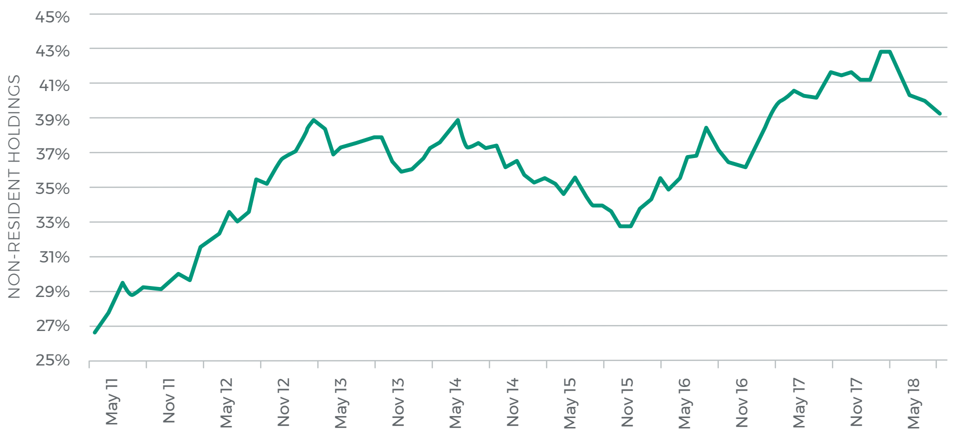
Sources: Bloomberg, Futuregrowth

FIGURE 19: BENIGN INFLATION... PASS-THROUGH FROM RAND DEPRECIATION HAS BEEN LIMITED



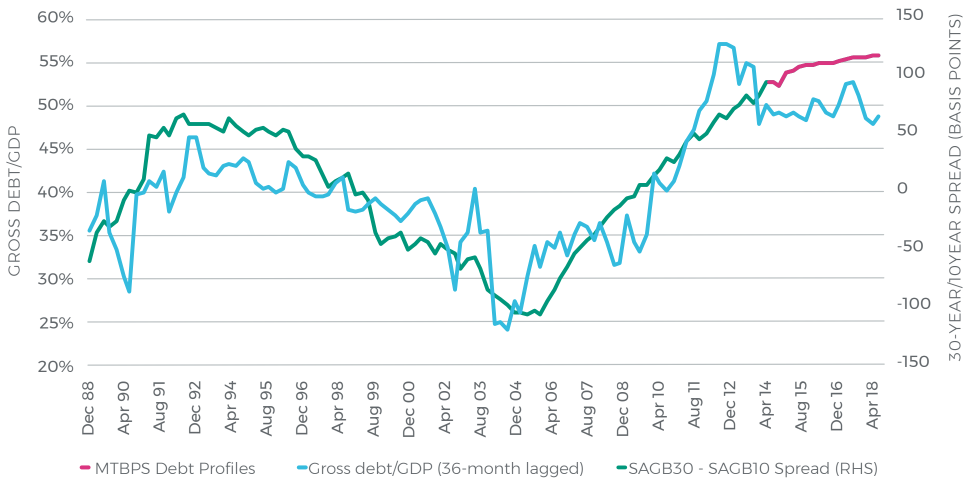
Sources: OMIG Economic Research Unit, Futuregrowth

FIGURE 20: THE DAMAGE IS ALREADY DONE... FOREIGN OWNERSHIP OF RSA GOVERNMENT BONDS (NOMINAL AND INFLATION-LINKED BONDS)



Sources: National Treasury, Futuregrowth

FIGURE 21: GOVERNMENT'S BOND DEBT LOAD HAS A STRONG BEARING ON THE YIELD CURVE SLOPE



Sources: National Treasury, Bloomberg, Futuregrowth

THE RISK TO FISCAL CONSOLIDATION REMAINS, BUT THE CLOUD IS NOT AS DARK AS IT WAS LAST YEAR

Of all the drivers mentioned, this is the most significant hurdle for bullish yield curve flattening. Our thoughts on the link between sustained low economic growth and the negative impact on the fiscal situation, mainly via the tax revenue channel, and the resultant threat to the country's sovereign risk profile, are well telegraphed. The question is: what may contribute to a change to our thinking? Clearly, a recovery in the growth outlook, tax efficiency gains at the South African Revenue Service and some improvement in expenditure management at all levels of government will improve the outlook for much-needed fiscal consolidation. In our minds, this is a significant red light that might continue to overshadow the more favourable factors listed above. Even so, a rate of change in the right direction may very well suffice for a more muted curve flattening, considering how much negative news has been priced in at this point in the cycle.

03/ OUR INVESTMENT STRATEGY

Considering the factors discussed above, we are cautiously optimistic about the rising probability of a scenario where long-dated bond yields decrease at a faster rate than short- and medium-dated bond yields in the medium term. This may also be seen as a reflection of at least some recovery, with the possibility of lower inflation towards the back end of 2019 and a slightly better economic growth outlook. For this reason, we have used bouts of market weakness over the past few months to reduce our initial significant underweight position in long-dated bonds.