BOND YIELDS RISE IN UNSUPPORTIVE **GLOBAL AND LOCAL ENVIRONMENT**

During May, South Africa's currency and bond markets were dragged along by strong global tides, which caused investor risk sentiment to take a turn for the worse. Argentina and Turkey, once again, rocked the emerging market boat, while rudderless Italy also had a role to play in the latest bout of investor unease. Persistent threats of a global trade war and the sharp increase in crude oil prices also continued to fray market nerves, particularly with regard to the implications for global growth.

SA'S VULNERABILITY IS ONCE AGAIN EXPOSED

In light of these events, as a small and an open economy with strong Eurozone and China trade links, South Africa's vulnerability to global risk-off investment strategies was once again exposed. In the case of the bond market, this was demonstrated by foreign investors' significant net selling of around R33 billion of local currency bonds. This, apart from a strong US dollar that tends to do well in periods of global risk aversion, caused the South African currency to lose some ground, which, in turn, caused bond bears to gain confidence.

BOND BULLS FIND LITTLE TO CELEBRATE

In addition to an unsupportive global backdrop, local data releases also offered little respite to the few bond bulls around – with the first quarter contraction in GDP growth topping the list. The rate of inflation at both consumer and producer levels during April accelerated at a faster than expected pace. This confirmed that the inflation cycle trough is now visible in the rear-view mirror. While the external trade account recorded a small surplus, early indications are that the current account deficit has widened further over the first quarter this year. Although one month's worth of data is insufficient to conclude a trend, the April monthly national financing data nonetheless reflected a worrisome picture. Against this backdrop, it comes as little surprise that the initial euphoria following the election of President Ramaphosa lost more momentum during May, as the reality of the enormous challenge ahead started to dawn.

With uncertainty mounting, both domestically and abroad, the South African Reserve Bank appropriately opted to keep the repo rate unchanged at its May monetary policy committee meeting. Most encouraging to fixed income managers who fear inflation, is that the committee, once again, sounded the hawkish alarm bell regarding future inflation risks.

Against this background, the path of least resistance for bond yields has been upwards. The yield of the benchmark R186 (maturity 2026) increased 36 basis points to close the month of May at 8.54%. As long-dated bond yields rose by more than those of shorter-dated bonds, it caused the yield curve slope to steepen. This, in turn, resulted in a slump in the All Bond Index's monthly return to -2.0%, below the cash return of 0.5%. Even so, the extent of the bull rally during the first three months of the year was big enough for the All Bond Index (+5.2%) to remain well ahead of cash (+2.7%) for the calendar year to the end of May. The real yield curve steepened slightly, with long-dated inflation-linked bond yields increasing faster than those of short-dated bonds, resulting in the Inflation-Linked Government Bond Index (-0.2%) also returning less than cash during May.

US RATES ON THE RISE

Our view remains that, despite the recent pick-up in global bond yields, developed bond markets are still not appropriately priced. We believe that the US Federal Reserve is in a position

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to lift the policy rate by at least another 75 basis points this year, with the next increase as soon as June 2018. The fact that the US has opted to loosen fiscal policy significantly at a time when positive economic growth has already gained sustainable momentum supports this view.

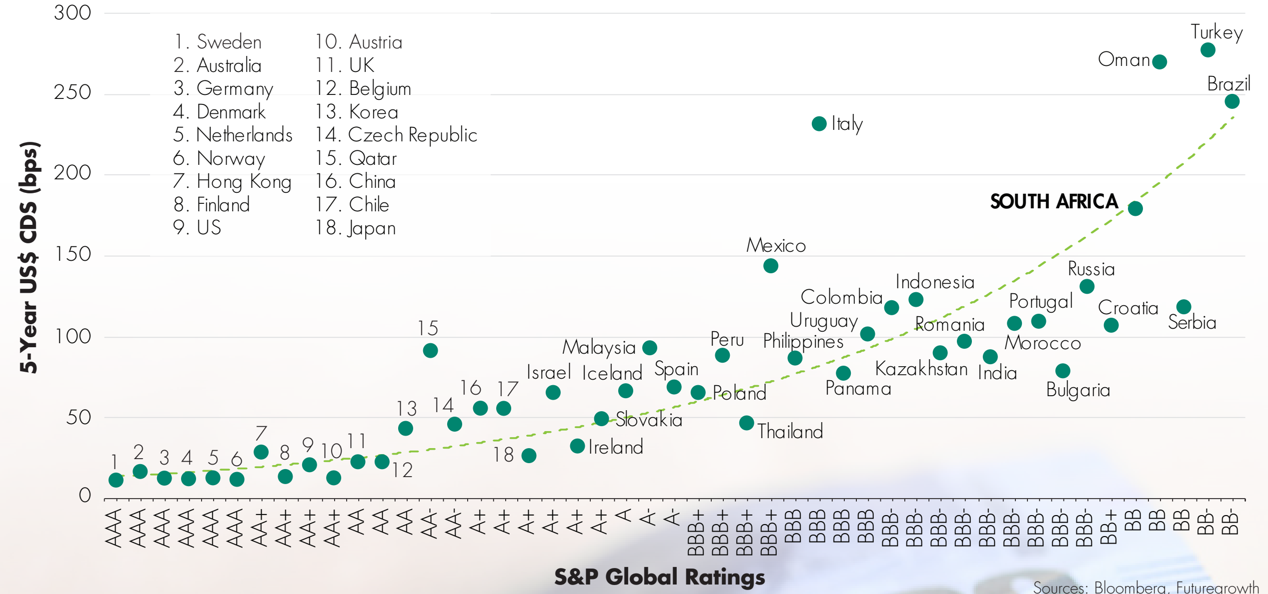
Locally, our main concern with regard to the bond market remains the strong link between lacklustre economic growth and fiscal consolidation, or more specifically the rising debt burden of Government. Recent political changes, action with regard to state-owned enterprise management and the tabling of the latest Budget most certainly went some way to reduce some of the concerns we previously had. However, it would also be irresponsible to ignore execution risk. The structural nature and extent of the country's macroeconomic ills require significant policy adjustment, time and effort to resolve.

Our long-held view of no more interest rate cuts in this cycle, and the risk of global risk aversion to local market stability – especially considering the size of foreign bond holdings – is playing out. The current account deficit is still considered to be at risk of widening, as a result of rising international trade tension, a relatively stronger rand and a higher oil price compared with levels prior to December 2017, and leakage from net negative interest and dividend payments.

While the observable investment theme and real-time developments related to it have mostly negative consequences for the local bond market, it is also important to note that current market valuation is reflective of this. We were defensively positioned prior to the recent correction and have managed to limit the drawdown of the negative market movements on our portfolios. Cheaper market valuations are affording us an opportunity to cautiously increase risk by selectively buying bonds into bouts of market weakness. ■

5-YEAR CREDIT DEFAULT SWAP (CDS) SPREADS VERSUS S&P FOREIGN CURRENCY SOVEREIGN RATINGS

The latest CDS spread for South African US dollar-denominated government bonds appears to be fairly priced on a relative basis.



Sources: Bloomberg, Futuregrowth

KEY TAKEOUTS

- INVESTOR NERVES FRAY AS GEOPOLITICAL TENSIONS RISE
- GLOBAL UNCERTAINTY DRIVES FOREIGNERS TO OFFLOAD SA BONDS
- INFLATION CYCLE TROUGH IS LIKELY PAST