DOMESTIC YIELDS RISE AS THE **RAND SUCCUMBS TO GLOBAL PRESSURES**

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Following loads of action and an extended run of excellent returns since December 2017, the local bond market took a breather in April. It simply ran out of fresh noteworthy news flow to enable the bull rally that got kick-started by the ANC's December elective conference to maintain positive momentum. This, despite the fact that local economic data releases were actually mildly bond supportive.

On the inflation front, both the consumer and producer price indices surprised with lower than expected year-on-year readings. Two other critical data releases from a bond perspective, namely monthly external trade and national budget data, also left little food for thought for the few bears around. The former showed a sizeable surplus for the month of March, while the latter pointed to a slightly better outcome for fiscal 2017/18 than forecast at the tabling of the Budget earlier this year.

KEY TAKEOUTS

- BOND RALLY WANES DESPITE SOME SUPPORTIVE DATA
- RAND WEAKNESS PUSHES UP LOCAL YIELDS
- BENIGN CPI OUTLOOK STIFLES DEMAND FOR INFLATION PROTECTION

Instead, local bond bears were showered with negative news from elsewhere in the world. This they found in sharply rising US Treasury bond yields, higher crude oil prices and threats of more clampdowns on international trade. A rise in global trade protectionism is a significant threat to small, open economies like South Africa, especially considering its strong Chinese trade ties. In the US, the benchmark 10-year Treasury yield jumped from 2.75%, briefly breaching the 3.0% level before settling at 2.96% by month-end. These international developments contributed, directly and indirectly, to some rand weakness which, in turn, added to upward pressure on local yields.

As a result, the yield of the benchmark R186 (maturity 2026) rose 17 basis points from the previous month-end, to close April at 8.18%. Yields rise as bond prices fall. A similar trend was observed in the inflation-linked bond market, as real yields moved upwards. In the case of the latter, lower than expected inflation data and hardening views of a more benign inflation outlook, in light of the sharp appreciation of the rand these last few months, caused a collapse in the demand for inflation protection.

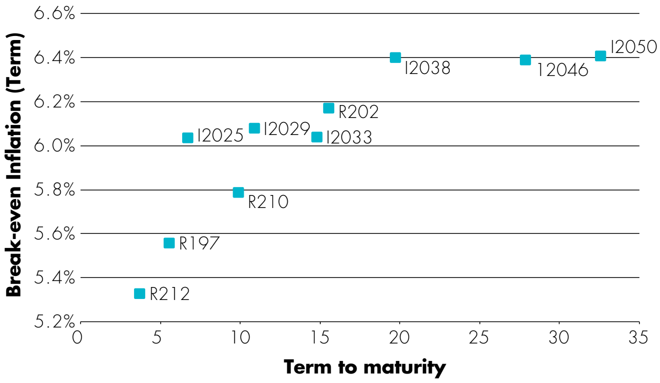
Given the fact that both nominal and real yield curves lifted to higher levels, bond returns have ended in negative territory for the first time since November last year. Total monthly returns for the All Bond (ALBI) and Inflation-linked Government Bond (IGOV) Indices were -0.7% and -2.7%, respectively. Cash managed a return of 0.5% for April, slightly lower than previous months, following the last repo rate reduction.

Even so, in the case of the ALBI, the total return for the first four months of the year remains an impressive 7.3%, and still well in excess of the IGOV and cash returns of 1.3% and 2.2%, respectively.

Inflation break-even levels are still too high relative to the near-term inflation outlook. This implies that nominal bonds offer better value than inflation-linked bonds on a duration-adjusted basis.

MARKET INFLATION BREAK-EVEN LEVELS

(spread between nominal and inflation-linked bonds with similar duration)



Sources: Bloomberg, Futuregrowth

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 to lift the policy rate by another 75 basis points this year. The fact that the US has opted to loosen fiscal policy significantly, at a time when positive economic growth has already gained sustainable momentum, partly 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.

NO MORE RATE CUTS FOR NOW

Our view on monetary policy also remains more cautious than what has been priced by forward money market rates. We do not subscribe to a view of further interest rate cuts in this cycle. Inflation expectations are hovering closer to the top end of the 3% - 6% inflation target range (actual inflation is merely back to the middle of this range), while monetary policy tightening in some parts of the developed world should not go unnoticed. The current account deficit is at risk of widening as a result of a stronger rand, slightly stronger local economic growth and leakage from net negative interest and dividend payments.

At current levels, the bond market is not priced for bad news. As a result, we would maintain our slightly defensive stance, while using opportunities to enhance the running yields of our funds. ■