BOND HUNGRY FOREIGNERS **IGNORE GLOOMY GROWTH AND FISCAL OUTLOOKS**

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During the third quarter, US dollar weakness and falling global bond yields, followed by a sharp correction late in September, stood out as significant for bond investors. In the US, the price of the benchmark 10-year Treasury bond initially defied gravity, with the yield drifting down from 2.39% to a low of 2.05% (levels last seen in November 2016), before racing back in a matter of days to close the quarter at 2.32%. The swings in investor sentiment were the result of a number of developments: Stubbornly low US inflation, speculation about the timing and extent of US monetary policy tightening, the well-telegraphed unwinding of the US Federal Reserve (Fed) balance sheet, ongoing speculation about near-term US fiscal policy changes (including the much-mooted Trump tax plan) and US/North Korean tensions.

Despite stronger global economic growth, the lack of inflation momentum turned out to be more widespread among industrialised nations. As a result, even after considering short-term volatility, developed market government bond yields still languish near their lowest levels since 2013. This continued to feed the frantic global reach for yield offered by more risky corporate and emerging market sovereign bonds. In response, emerging market borrowers have been issuing bonds this year at the fastest pace in history, with hard currency bond sales already past the US$500 billion mark.

KEY TAKEOUTS:

- TRADE IMBALANCE TOO BIG FOR A LOWER REAL REPO RATE
- LOW GLOBAL YIELDS FEED THE EMERGING MARKET BOND FRENZY
- FISCAL CONSOLIDATION RISKS POINT TO DOWNGRADE

Locally, the main rand exchange rates and local government bond yields moved in tandem with global markets, with local developments taking a back seat for most of the time. One reason is persistent net foreign buying of rand-denominated government bonds, which now totals R72 billion for the first nine months of this year. The widely expected deceleration of the local inflation rate, the continued trade account improvement and weak economic growth convinced the South African Reserve Bank (SARB) to reduce the repo rate by 25 basis points in July, and keep rates unchanged at its September meeting. Against this background, the yield of the benchmark R186 (maturity 2026) fluctuated in a wide range of between 8.38% and 8.93%, before closing the quarter at 8.55%, or 23 basis points (bps) lower than the closing yield at the end of June.

BUDGET FALLS WAY SHORT OF TARGET

The events described above were not enough to offset the one major negative factor: rising risks to National Treasury's commitment of fiscal consolidation. Main national budget data to the end of August points to a significant shortfall relative to the budget that was tabled in February this year. As we feared, low economic growth has already had a large negative impact on tax revenue collections. In addition, the more optimistic nominal GDP assumption National Treasury used at the tabling of the current fiscal year's budget is, in reality, turning out to be a lot lower. The deteriorating financial situation at many state-owned enterprises is not helping either.

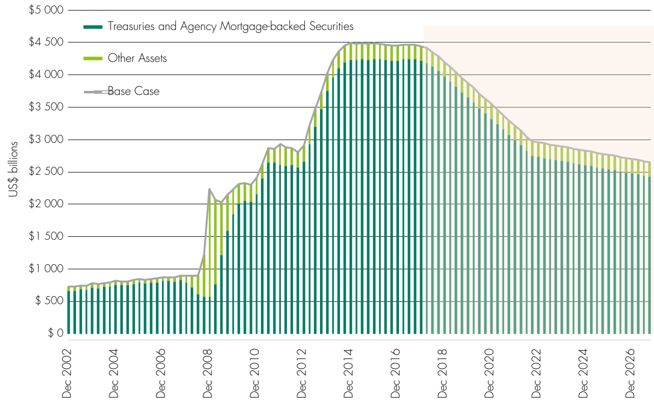
With this in mind, the SA government's reasonably successful placement of euro-denominated bonds in September should be seen in the light of foreign investors' insatiable appetite for yield – caused by extremely loose monetary conditions in many parts of the world. It most certainly is not an acknowledgement of prudent fiscal management. South Africa is merely one of many borrowers of lesser quality that managed to place debt in international markets at reasonably favourable terms over the past few months.

Even so, the JSE All Bond Index (ALBI) managed to render a strong return of 3.7% for the three months to the end of September. This is significantly better than cash (1.7%) and the JSE Inflation-linked Government Bond Index (IGOV), which managed to return 1.3%. The inflation-linked bond market got a boost from lower real yields, which managed to offset falling inflation.

STRONG EASING CYCLE SHOULD NOT BE PURSUED

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 are not appropriately priced, leaving some room for rising yields. Although the US Federal Reserve and European Central Bank are both adamant that the unwinding of their respective balance sheets will be done in an interest rate neutral way, we believe that this long process will contribute to the lifting of the current ceiling on global bond rates over time.

Unwinding the US Federal Reserve Balance Sheet



Sources: Bloomberg, Futuregrowth

Locally, the downward trend in inflation is entrenched, supported mostly by significantly lower food price increases, with weak consumer demand also playing a role. While the SARB surprised many by keeping rates on hold, we remain of the view 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 foreign investors' continued aggressive accumulation of local currency bonds. This mismatch presents a potentially 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.