BOND MARKET **OVERLOOKS FALLING INFLATION RATE**

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ABOUT **THE AUTHOR**

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KEY TAKEOUTS:

- WEAK US DOLLAR AND FALLING GLOBAL YIELDS SUPPORT SA BONDS
- FISCAL CONSOLIDATION RISKS CLOUD OUTLOOK
- NORTH KOREA AND LOW INFLATION DRIVE US BOND RALLY

US dollar weakness and falling global bond yields stood out as two of the more significant market drivers for local bond investors. In the US, the price of the benchmark 10-year Treasury bond defied gravity, with yields drifting down from 2.30% to 2.13% (remember, as bond prices rise, the yield falls). Yields are now back to levels last seen in November 2016. The US bond bull rally was driven by a combination of flows into so-called safe haven assets (in reaction to North Korean missile testing), and growing evidence of stubbornly low US inflation. The latter forced interest rate bears (those believing interest rates are unsustainably low) to reconsider their stance on the near-term path of US monetary policy. Moreover, persistently low inflation appears to be widespread among developed markets, in particular, causing bonds yields to test lower levels.

SA NOT AS BULLISH

Although the rand strengthened in response to sustained US dollar weakness, the local bond market had a more muted reaction. The yield on the benchmark R186 (maturity 2026) initially rallied from its closing level of 8.61% at the end of July to an intra-month low of 8.50%, ending August at 8.57%. Clearly, bond investors had very little interest in following the bullish trends in both global bond markets and the rand – even though both consumer and producer rates of inflation continued to decelerate. (Lower inflation expectations tend to boost bonds, as it indicates less potential for income erosion.)

So, why is SA not as bullish? We strongly suspect that the reason could be found in market perceptions of the risk around National Treasury's commitment to fiscal consolidation. Although admittedly still early days, main data to the end of July points to a significant shortfall relative to the Budget 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 growth assumption National Treasury used at the tabling of the current fiscal year's budget is, in reality, turning out to be a lot lower.

Even so, the JSE All Bond Index (ALBI) still managed to render a reasonably decent total return of 1% during August. This is significantly better than cash (0.6%) and the JSE Inflation-linked Government Bond Index (IGOV), which again only managed to eke out 0.1%. The ALBI is leading the pack for the first eight months of this year, with a very respectable 6.6%. An investment in cash would have rendered a return of 4.6% over the same period.

TAKING A CAUTIOUS APPROACH

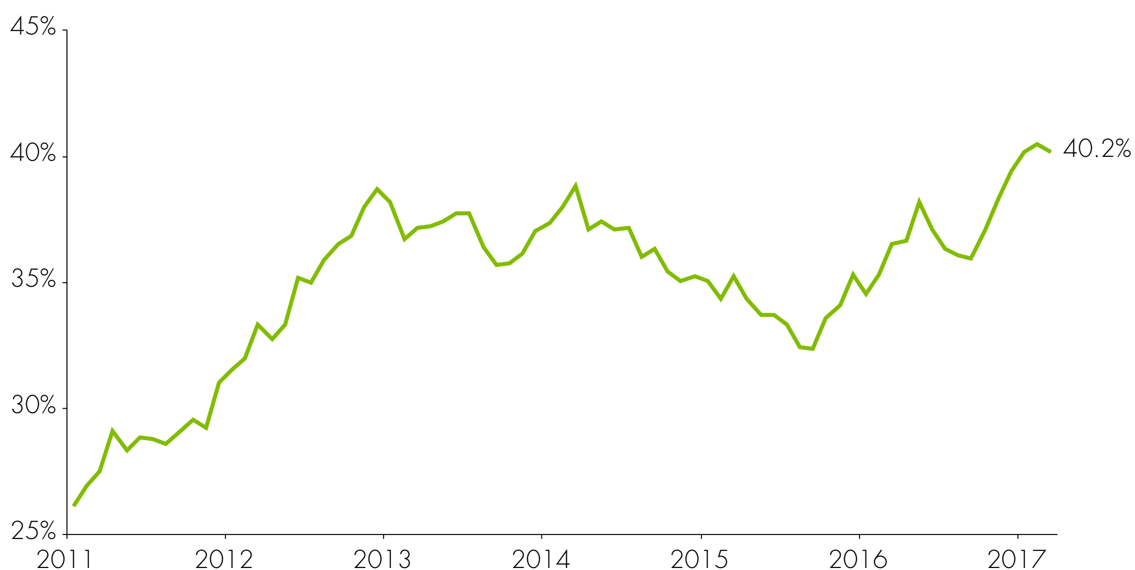
The modest global economic recovery sets the scene for limited inflationary pressure and a steady monetary tightening cycle for the few economies that are in a position to normalise policy. Our view remains that global bond markets in general are not appropriately priced, leaving room for rising yields.

Locally, the downward trend in inflation is entrenched, supported mostly by significantly lower food price increases, with weak consumer demand also playing a role. While the South African Reserve Bank (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 foreign investors' continued aggressive accumulation of local currency bonds. Foreign investors now own 40% of our government bond market. This mismatch presents a potentially lethal mix for the local bond market. Considering this, we shall continue to approach the market with extreme caution.

FOREIGN OWNERSHIP OF RSA GOVERNMENT BONDS (NOMINAL AND INFLATION-LINKED) MAY 2011 - JULY 2017



Sources: JSE, National Treasury

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