Economic Snapshot August 2019

LOCAL HIGHLIGHTS & LOWLIGHTS

- ‘Ramaphoria’ officially ended, divide in ANC now public.
- Public protector spat with various politicians, constant losses and rebukes at high court levels, personal cost orders.
- Local property market rebounding.
- Retail sector up higher than expected in second quarter.
- National Health Insurance bill released and causing waves.

GLOBAL EVENTS OF NOTE

- Both USA and China not backing down from trade war.
- Chinese industrial growth data disappointing.
- Emerging market currencies doing well, except for the ZAR.
- South Korea and Japan also trading punches in trade war.

Rand/$ (1 month view, R15.34/$ @14 Aug)

JSE AllShare: 55,191 (from 51,264 2 Jan ’19)

(Data: Google currency, Bloomberg)

FOCUSED COMMENTARY: Bonds and credit ratings - the current state of affairs

The bond market is often misunderstood and individual bonds rarely reach the media spotlight - that is until there is talk of downgrades and ratings changes, then we have to perk up and listen. We are in that exact boat at the moment, so this month we will delve into the issue of our sovereign bonds. (*Doctor’s note: I’ll discuss the topical news events first, but please read the “How bonds work” section at the bottom if you want to test if you know exactly how bonds function.*)

The South African sovereign credit rating (meaning the creditworthiness of our long term government debt) is currently receiving a lot of international attention, and for good reason: We are facing a possible downgrade by Moody’s in November 2019. Moody’s is the last of the three international rating agencies that still regard our Rand-denominated debt as investment grade, and if they downgrade us one more notch then our debt will be classified as non-investment grade (see Link: Bond Credit Ratings for detail about the investment vs non-investment grades).

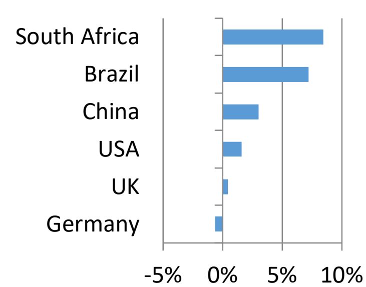
This downgrade will force many international investors to sell our bonds due to their portfolio investment guidelines, but will also allow speculative bond fund managers to start buying into our national debt. While some say the mass-buying will negatively impact the Rand, there is a school of thought that says the effect may remain neutral because of the speculative buyers who will buy into our high-yielding bonds.

The chart below shows selected 10y government bond yields from across the globe (www.TradingEconomics.com):

Here are some thoughts and facts around what is currently happening:

- The government is increasing its debt issuances due to the guarantees it provided for our SOE, chiefly Eskom (Fin24Eskom).
- Many investors are expecting a downgrade in November due to the increased support for Eskom (Article: Junk pricing)
- Foreigners are selling an average of R1.8bn worth of our bonds a day in anticipation of the downgrade (Bloomberg), after being net buyers over the preceding few years (Foreigners dumping billions).
- The reports that South Africa will need an IMF bailout seem to be unfounded and contain a bit of fear-mongering (IMF Bailout).
- Junk status takes around 6 to 7 years to turn around, on average (Junk bounceback)

Selected 10y government bond yields :



Opportunity Global Investment
Suite 201, 2nd Floor, Edward 2 Building, Edward Street,
Bellville, 7530, Cape Town, South Africa
Reg: 2004/013672/07

021 919 9944
admin@opportunity.co.za
Vat: 4320223722
www.opportunity.co.za

How bonds work: Yields and pricing

- Bonds are fixed interest instruments, implying they are basically large, standardised loan agreements that normally pay out periodic interest (called coupons) and a principal value at the end. An 8% semi-annual coupon bond with a 10 year maturity and a R100mil principal value will pay R8mil per year in the form of two coupons of R4mil each, and then the R100mil after 10 years. But what does the investor pay for this predictable income stream?
- The price of the bond changes constantly because all the cash-flows are discounted by what is called a bond yield, and this is where all the action happens.
- The bond yield is a function of (i) inflation, (ii) a unique risk-premium associated with the bond-issuer (which is basically a risk penalty), and (iii) interest rates . When any one of the three drivers increases, it increases the investors' yield requirement, implying that investors are looking for a higher return and are willing to pay less for the fixed income stream (Read Link: Yield drivers explained).
- Thus, the higher the yield is, the lower the price becomes and vice verse. The probability of an issuer defaulting on a payment of either the coupon or the principal is reflected in both the traded yield and the credit rating.

Newsletter compiled by Dr Rousseau Lötter (Senior lecturer @ Department of Statistics and Actuarial Science, University of Stellenbosch)