Investec

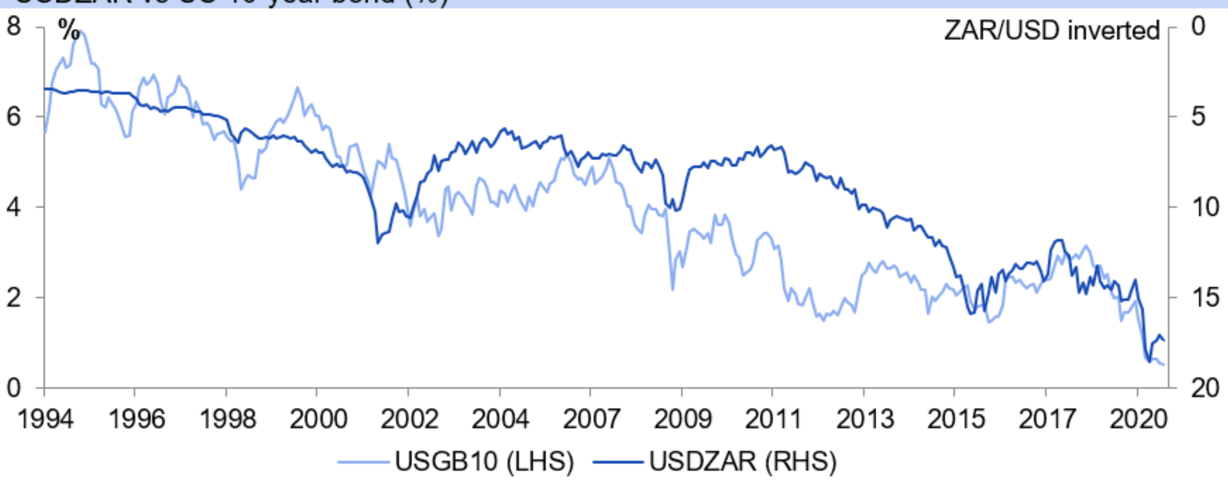
SA Economics

Bond note

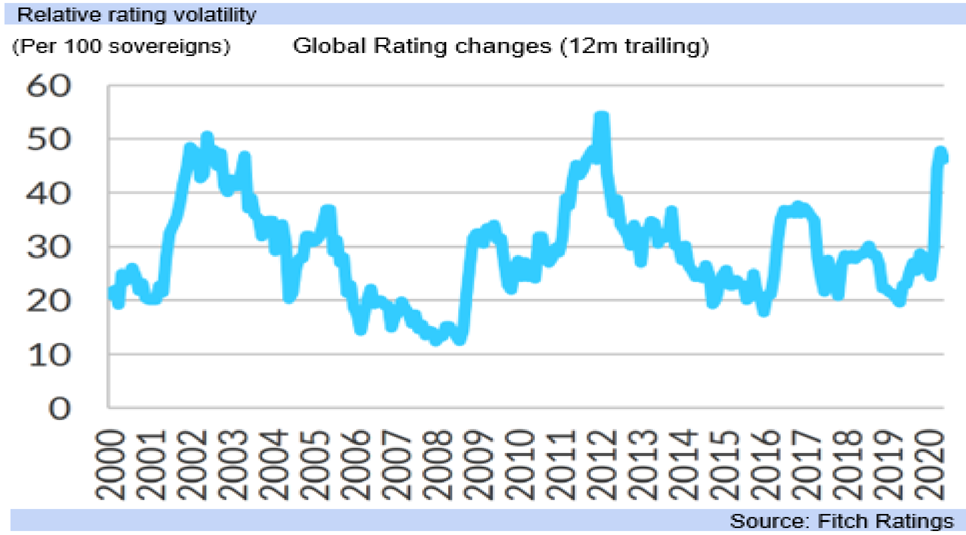
Wednesday 5 August 2020

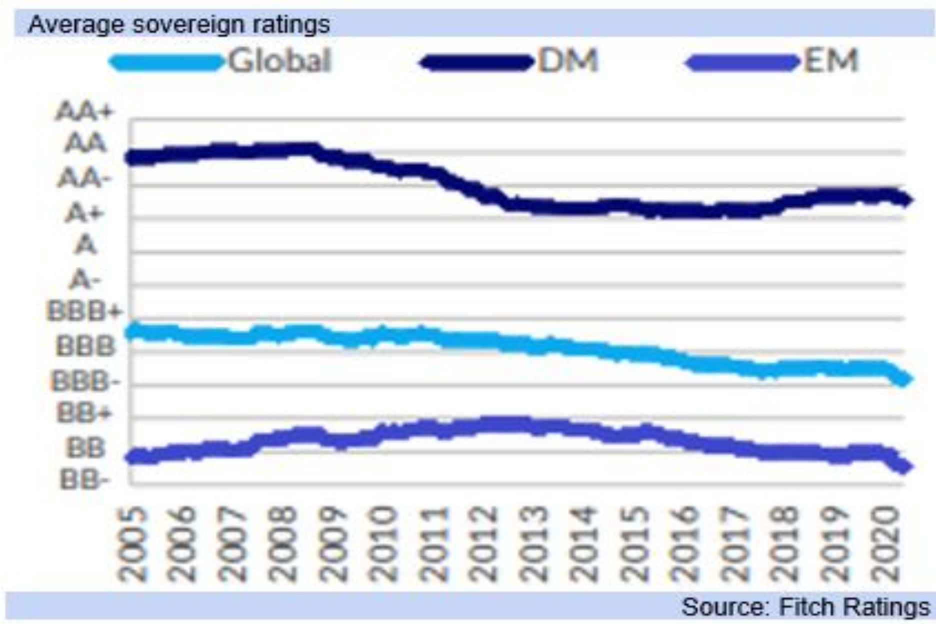
The steep domestic yield curve is reflective of increased investor concerns of a debt default in South Africa in the long-term (and not of faster growth), with some fearing that default could occur even as soon as in five years' time

USDZAR vs US 10-year bond (%)



Source: Iress





- After seeing a strong foreign sell-off over March (-R66.7bn on a net basis) and April (-R17.7bn on a net basis), foreigners turned net purchasers of South African government bonds in June (R3.0bn on a net basis), after only a small net outflow in May (-R3.8bn). July however saw substantial outflows resume (-R17.1bn).

- August so far has got off to a poor start, with net sales of R1.1bn, as the risk-off environment of the past several days persists, with the yield on the R2030 at 9.30% currently, having reached 8.09% temporarily in June in retreat from the high in March of 13.40%, before the SARB bond buying programme kicked in.

- The SARB's intervention in the bond market solved dysfunctionality in pricing, which was driven by extremely thin liquidity in the second half of March on market fears in the face of the Covid-19 pandemic that drove reduced foreign holdings of SA debt in extreme risk-off.

- South Africa's weak fiscal metrics, with little consolidation in the February 2020 Budget, drove foreigner's to disinvest in February (with -R13.6bn in net sales). Fitch has said recently "(w)ith so many sovereigns experiencing deteriorations in their credit fundamentals, … (f)iscal starting positions precoronavirus … matter."

- In particular Fitch stresses that “prior records on correcting fiscal imbalances in the aftermath of downturns and crises will be one means by which to calibrate rating implications.” South Africa has an extremely poor record of fiscal consolidation over the past decade.

- Further credit rating downgrades are a certainty for South Africa, and we expect that Moody’s will drop SA’s BB+ rating to BB this year, while Fitch has SA at BB for local currency (S&P BB-) and at B already for foreign currency (S&P B). As SA declines towards the C grade categories, fears of eventual debt default have been rising.

- Fitch highlights that “(t)he coronavirus pandemic is exerting considerable pressure on sovereign creditworthiness across all regions and rating categories, as governments bear the costs of severe recessions combined with health crises”. Most economies globally are facing the largest contractions in GDP since the 1930s.

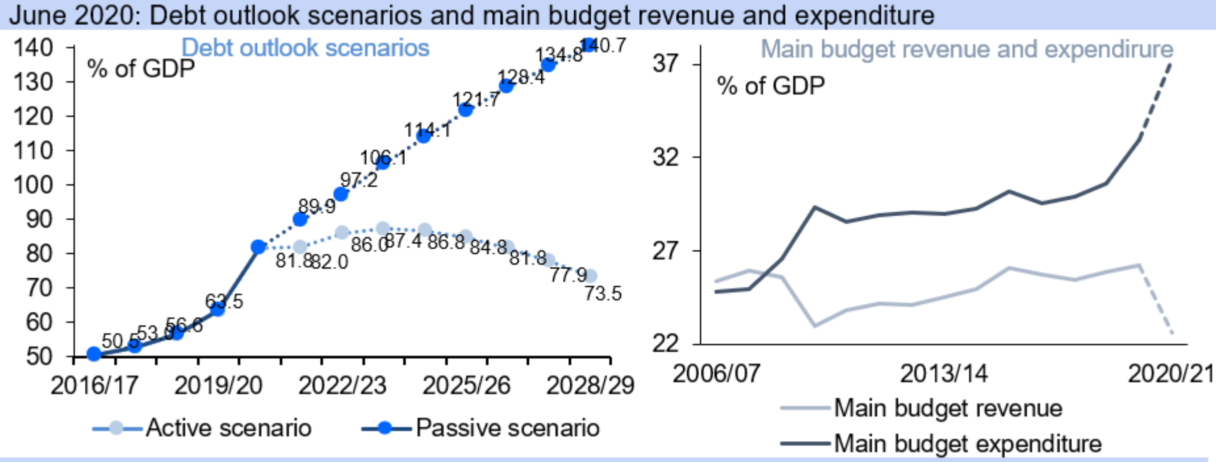
- Globally debt has ballooned as most countries apply fiscal stimulus, but this has seen “more sovereign downgrades in 1H20 (the first half of this year) than any full year prior, and 40 sovereigns are on Negative Outlook, a record high in absolute terms and as a share of the rated portfolio” – Fitch.

- South Africa has seen a huge deterioration in its debt trajectory in the past decade, with 2020 attempting little in significant consolidation before the crisis. South Africa’s ballooning debt has now led many investors to fear eventual default as the active scenario of the recent adjustment budget is not seen as necessarily achievable.

- Fitch highlights “(a)bout one-third of downgrades in the past 12 months have resulted in rating migrations to a lower category. The sovereign portfolio is nearly evenly split between investment-grade and speculative-grade ratings. Five sovereigns rated ‘BBB-’ are on Negative Outlook”.

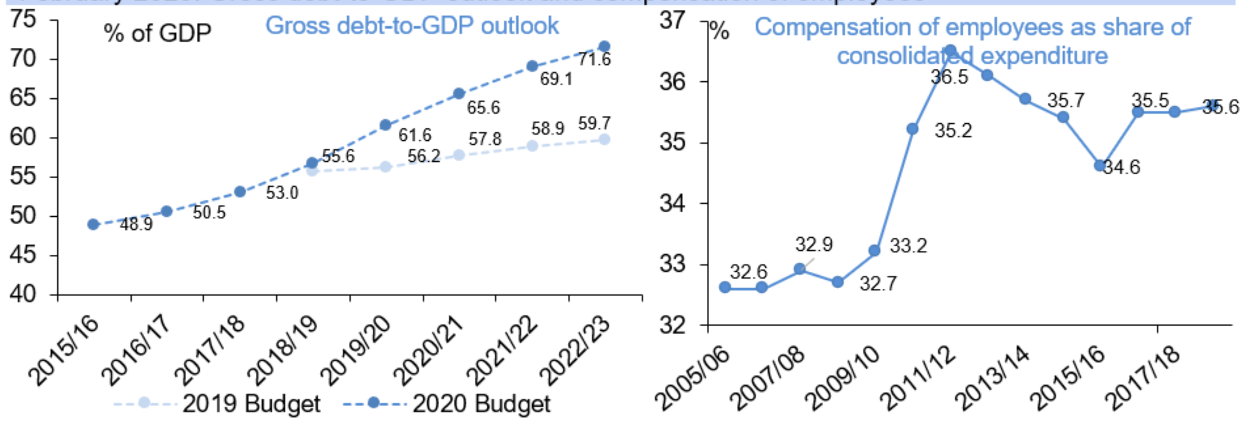
- This suggests globally for economies that “speculative-grade ratings will soon outnumber those in investment grade for the first time. More than one-third of sovereign ratings are on Negative Outlook, a record in terms of the absolute number as well as the share of the portfolio.”

June 2020: Debt outlook scenarios and main budget revenue and expenditure



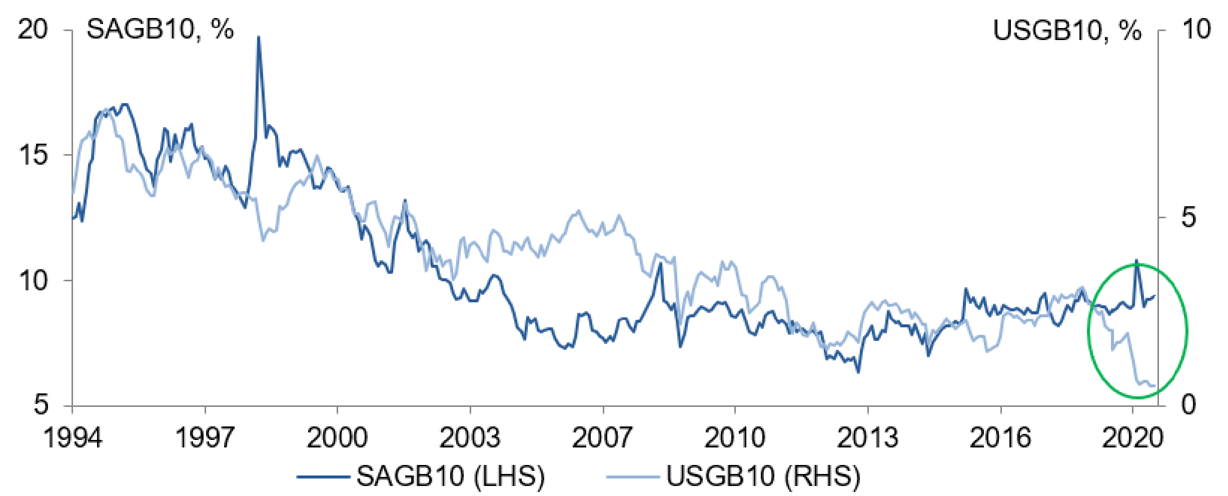
Source: National Treasury

February 2020: Gross debt-to-GDP outlook and compensation of employees



Source: National Treasury

SA 10 year bond vs US 10 year bond



Source: Iress

- The rating agency further clarifies that “(t)he first half of 2020 was marked by a record number of sovereign downgrades (32 rating actions affecting 26 sovereigns), mostly in the ‘B’ category or lower, and centred in Latin America and the Middle East & Africa.”

- “There is no region with less than five sovereigns on Negative Outlook, and Latin America and the Middle East & Africa are in double digits. The unweighted average global sovereign rating was approaching ‘BBB-’ by mid-year, its lowest ever, continuing a downward trend that began a decade ago.”

- Unsurprisingly, Fitch’s Sovereign Dashboard: Mid-Year Outlook - July 2020 also shows that “(r)elative rating volatility – measured by the number of rating changes on a 12-month trailing basis per 100 sovereign ratings – jumped in 1H20, and is likely to exceed its all-time high later this year.”

- South Africa’s economic outlook is weak, due both to failure to rapidly institute National Treasury’s growth plan on a lack of political will, and the legacy of the lost decade of the 2010s. Thirty year bond yields are well above ten year yields, which are well above the five years’ but do not reflect expectations of faster economic growth.

- The lost decade of the 2010’s saw most of the gains made in the prior decade of the 2000s reversed, due also to severe fiscal and governance deterioration, and extreme proliferation of red tape and corruption, which all combined to hamstring the potential for economic growth, with unemployment returning to around 30%.

- The IMF says ”(i)n the near term, policies need to cushion the negative impact of the COVID-19 crisis and protect the vulnerable through … fiscal support. If imbalances that existed prior to the COVID-19 outbreak persist in the medium term, reducing external gaps will require bold implementation of structural reforms …”

- The IMF highlights that structural reforms are needed “to improve competitiveness and gradual but substantial fiscal consolidation while providing space for infrastructure and social spending (to improve educational attainment and skills and help reduce poverty and inequality).”

- “Efforts are also needed to improve the efficiency of key product markets (by encouraging private sector participation in power generation, transportation, and telecommunications) and the functioning of labor markets. These reforms will help attract durable capital inflows such as FDI.“

- The domestic currency has not gained much today, weaker at R17.30/USD, R20.55/EUR and R22.73/GBP from R16.34/USD, R18.84/EUR and R20.78/GBP two weeks ago, still well above the levels of R16.26/USD, R18.00/EUR and R20.02/GBP mid-March, prior to the impact of the Covid-19 crisis on financial market sentiment.

- Global financial market sentiment deteriorated over the past couple of weeks on global growth concerns, with bond yields consequently dropping in advanced economies. The delay in the extension of fiscal stimulus in the US in particular has also driven concerns, as has fears the negative impact of the pandemic has not ended.

- The table below forecasts the SARB’s complied bond yield (nominal yields: 10 years and over on government bonds traded on the stock exchange), and tends to be in the territory of the R2030’s yield. However, SARB bond buying (which is not unlimited or infinite due to restrictions) has caused material yield suppression since March.

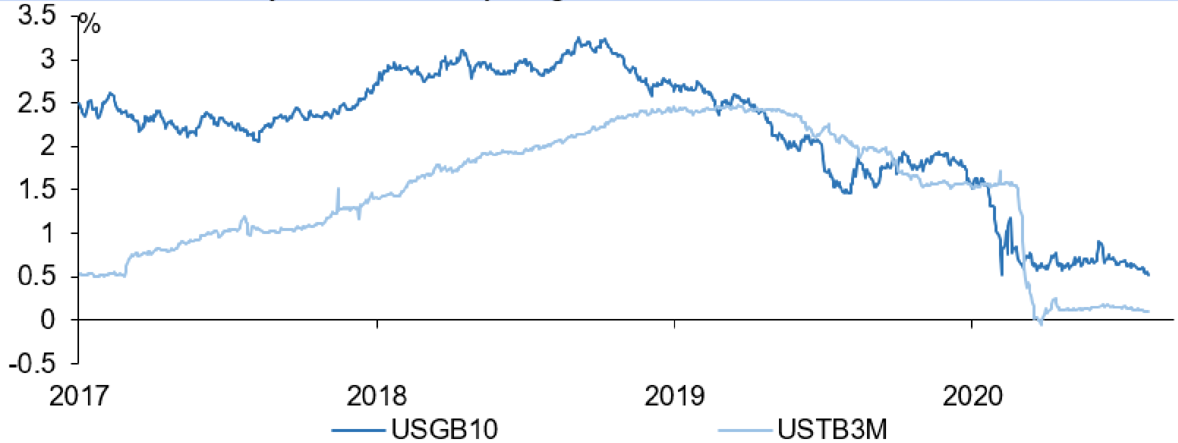
Forecasts	2019	2020	2021	2022	2023	2024	2025
Expected Case (47%)							
SA rand bond (year-end: %)	9.10	9.40	10.20	10.50	10.70	10.90	11.10
SA rand bond (Average: %)	9.09	9.60	9.96	10.54	10.68	10.86	11.03
Repo Rate (year-end: %)	6.50	3.75	4.50	5.25	5.25	5.25	5.50
Prime Overdraft Rate (year-end: %)	10.00	7.25	8.00	8.75	8.75	8.75	9.00
Lite Down Case (46%)							
SA rand bond (year-end: %)	9.10	9.80	10.70	10.80	10.95	11.20	11.40
SA rand bond (average: %)	9.10	9.75	10.35	10.86	10.94	11.15	11.30
Repo Rate (year-end: %)	6.50	4.00	4.50	5.50	5.75	5.75	5.75
Prime Overdraft Rate (year-end: %)	10.00	7.50	8.00	9.00	9.25	9.25	9.25
Severe Down Case (4%)							
SA rand bond (year-end: %)	9.10	10.20	11.20	11.50	12.00	12.50	12.70
SA rand bond (average: %)	9.10	9.98	10.88	11.43	11.78	12.30	12.63
Repo Rate (year-end: %)	6.50	4.30	5.50	6.50	7.00	8.00	9.00
Prime Overdraft Rate (year-end: %)	10.00	7.80	9.00	10.00	10.50	11.50	12.50
						Source: Investec, Iress	

Economic Scenarios: note updated forecasts

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Extreme	USD/Rand (average)	15.38	18.00	15.00	14.00	13.50	13.00	12.50	12.00
Up case	Repo rate (end rate)	5.25	3.75	3.00	3.00	3.00	3.00	3.00	3.00
1%	Impact of Covid-19 pandemic very rapidly resolved - economic growth of 3–5%, then 5-7% for SA. Good governance, growth-creating reforms (structural constraints overcome), strengthening of property rights - individuals obtain title deeds in EWC – no nationalisation. High business confidence and fixed investment growth, substantial FDI inflows, strong fiscal consolidation (government debt falls back to low ratios of 2000s). Strong global growth, commodity boom. Stabilisation of credit ratings, then credit rating upgrades.								
Up case		**Q1.20**	**Q2.20**	**Q3.20**	**Q4.20**	**Q1.21**	**Q2.21**	**Q3.21**	**Q4.21**
2%	USD/Rand (average)	15.38	18.00	16.00	15.00	14.00	13.50	12.00	11.50
	Repo rate (end rate)	5.25	3.75	3.25	3.25	3.25	3.50	3.50	3.50
	Quick rebound from Covid-19 pandemic, rising confidence and investment levels - structural problems worked down. No further credit rating downgrades, rating outlooks move to stable and eventually positive, strong fiscal consolidation (government debt projections fall substantially). Global risk-on, global demand quickly returns to trend growth. Limited impact of expropriation without compensation) to abandoned, unused, labour tenants'' and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy - no nationalisation.								
		Q1.20	**Q2.20**	**Q3.20**	**Q4.20**	**Q1.21**	**Q2.21**	**Q3.21**	**Q4.21**
Base	USD/Rand (average)	15.38	18.00	17.00	16.50	15.75	15.50	15.50	15.10
case	Repo rate (end rate)	5.25	3.75	3.50	3.50	3.75	4.00	4.25	4.25
47%	Temporary sharp global slowdown and global financial turmoil from Covid-19 pandemic (severe currency depreciation, low interest rates) – eventually sufficient global and domestic monetary and other policy supports to growth and financial markets occur and risk sentiment stabilises. South Africa exits recession in Q3.20. Market unfriendly policies like expropriation of private sector property put on hold in the crisis. SA retains BB category rating from Moody's - government debt projections stabilise.								
		Q1.20	**Q2.20**	**Q3.20**	**Q4.20**	**Q1.21**	**Q2.21**	**Q3.21**	**Q4.21**
Lite	USD/Rand (average)	15.38	18.00	18.50	19.50	20.00	18.50	17.00	16.50
(domestic)	Repo rate (end rate)	5.25	3.75	3.75	3.75	4.00	4.00	4.25	4.25
Down case **46%**	The international risk sentiment environment is that of the base case. South Africa continues to fail to see its debt projections stabilise and falls towards B ratings from all three rating agencies. More severe recession in SA over 2020 than in the expected case. Expropriation of some private commercial sector property without compensation, with some negative impact on the economy. Business confidence depressed even further, significant rand weakness, significant load shedding and weak investment growth until substantial fiscal repair ultimately effected.								
		Q1.20	**Q2.20**	**Q3.20**	**Q4.20**	**Q1.21**	**Q2.21**	**Q3.21**	**Q4.21**
Severe	USD/Rand (average)	15.38	18.00	19.50	21.00	22.00	23.00	24.00	22.00
down	Repo rate (end rate)	5.25	3.75	4.00	4.00	4.25	4.25	4.75	5.25
case **4%**	Lengthy global recession on impact of Covid-19 – global financial crisis – insufficient monetary and other policy supports to growth domestically and internationally. Depression in SA, unprecedented rand weakness. Nationalisation of private sector property (title deeds not transferred to individuals). SA rated single B from all three key agencies, with further rating downgrades eventually occurring into C grade as government finances deteriorate (debt projections elevate even further - fail to ever stabilise. Government borrows from increasingly wider sources as it sinks deeper into a debt trap), eventually include widespread services load shedding, strike action and civil unrest.								

Note: Event risk begins Q3.20. Source: Investec

US 3 month treasury bill versus ten year government bond



Source: Iress