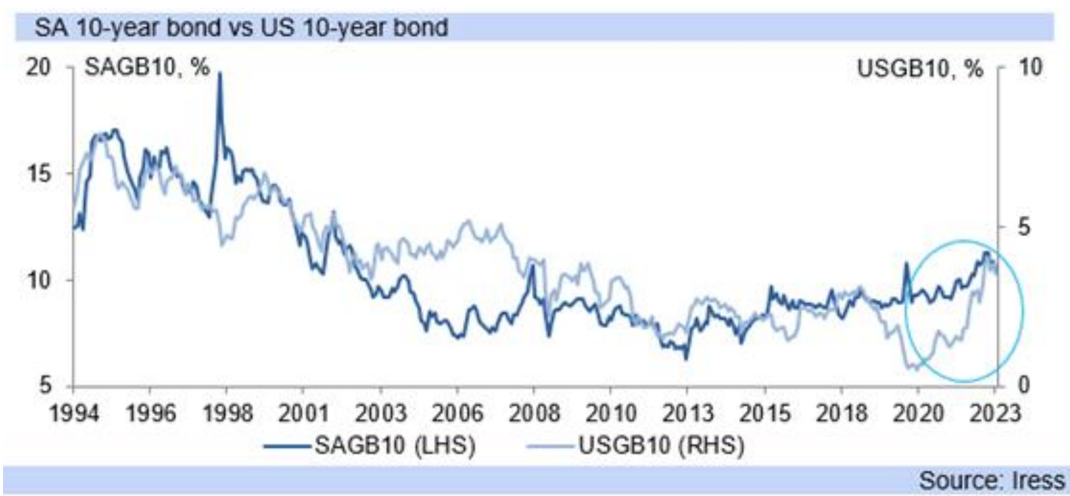
Investec

SA bond note: the pace of dissipation of inflation will be key to bond yields this year

Tuesday 10 January 2023



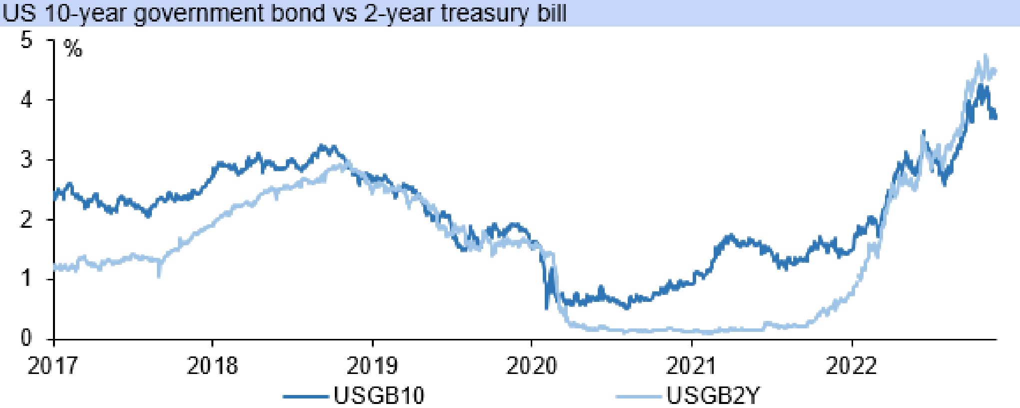
US 3-month treasury bill versus US ten year treasury yield

Source: Iress

US 3 month treasury bill versus ten year government bond

Source: Iress

US 10-year government bond vs 2-year treasury bill



Source: Iress

Spread between US 10-year and 3-mth treasury bill

Source: Iress

- SA's benchmark government bond narrowed its yield differential with the equivalent US treasury bill, from 8% to 7% over the course of the past year, as inflation rose sharply and Central Bank rates did too, in a generally risk averse year.
- Falling inflation and smaller interest rate hikes are likely to be supportive of bond markets this year, particularly lower than expected inflation, with room for downside inflation surprises as price drivers are expected to weaken, although risks persist as well.
- SA's ten year government bond rose by 120bp from start to end 2022, versus the 240bp lift in the ten year US treasury, as the US hiked rates by 4.25%, while SA only saw a 3.25% lift in its rate hike cycle over 2022.
- The US has seen wage increases moderate in the latest set of hourly earnings data (for December), halved to 0.3% m/m versus 0.6% m/m in November, and on an annual basis, at 4.6% y/y versus 4.8% previously, and both lower than the expected outcomes.
- The slowing in US wage growth began in April last year, in the process of establishing a downwards trend, but is not back at the pre-COVID hourly wage growth rates of 2.0% y/y to 3.0% y/y. The ongoing moderation is supportive of the slowing pace in US interest rate hikes.
- The hourly earnings data indicates that the labour market is not necessarily tightening rapidly, but also does not show enough reduction to signal an end to US rate hikes either yet. US yield inversion (10 year vs 3 months) shows markets still fear US recession.
- A slower interest rate hike environment will still maintain some pressure on bond yields, expected over H1.23 but US interest rate hikes are likely over the whole of 2023, and evidence of a definite weakening in economic activity is becoming more evident in some areas.

- Factory orders contracted in the US in November, by -1.8% m/m, the lowest rate in the past few years, durable goods orders falling by -2.1% y/y. The FOMC notes the rapid slowing in the US economy, providing a more balanced monetary policy view recently.
- The February Budget is expected to see SA stick to projected reduced borrowing by its government, but yield strength is likely to be limited in Q1.23, with many risks still concerning investors, not least one of US recession.

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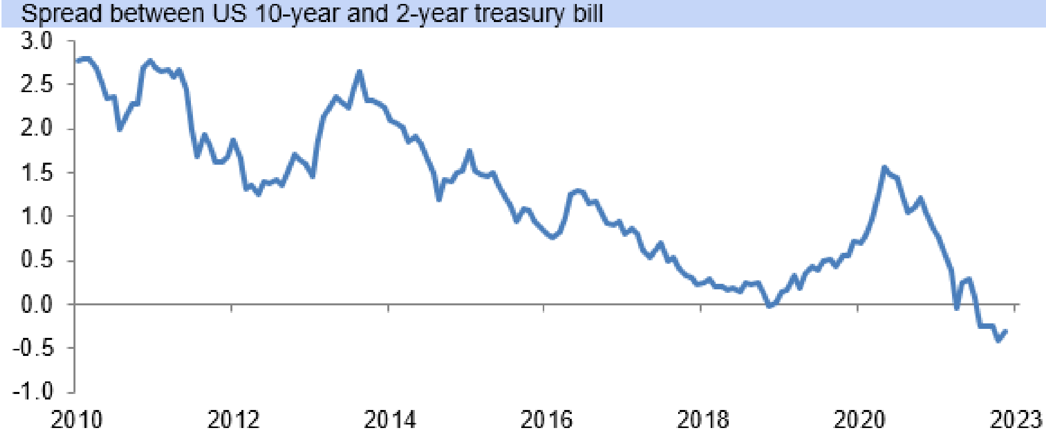
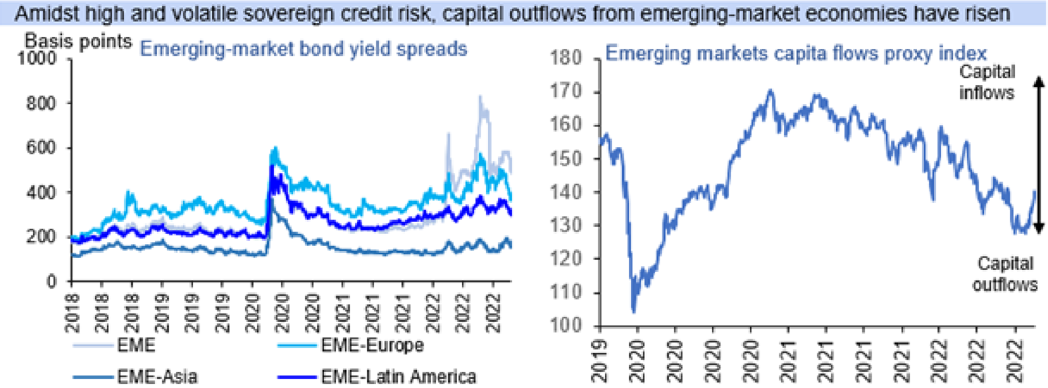
Spread between US 10-year and 2-year treasury bill



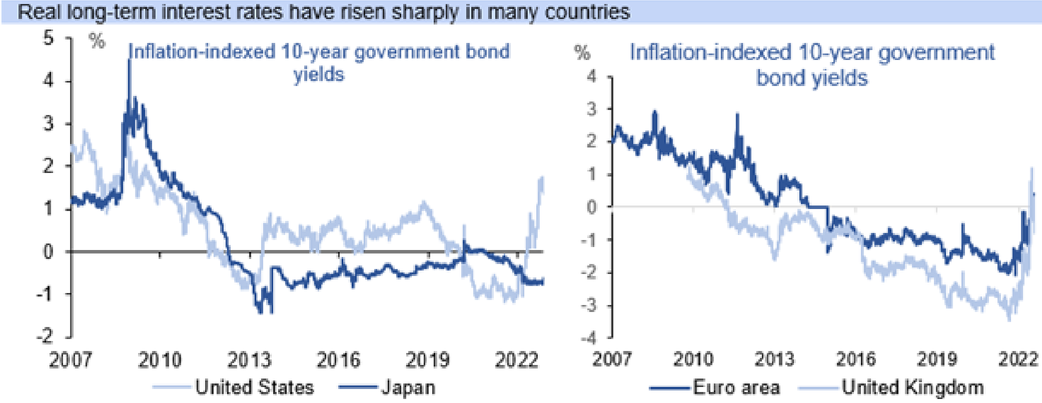
Source: Iress

Amidst high and volatile sovereign credit risk, capital outflows from emerging-market economies have risen



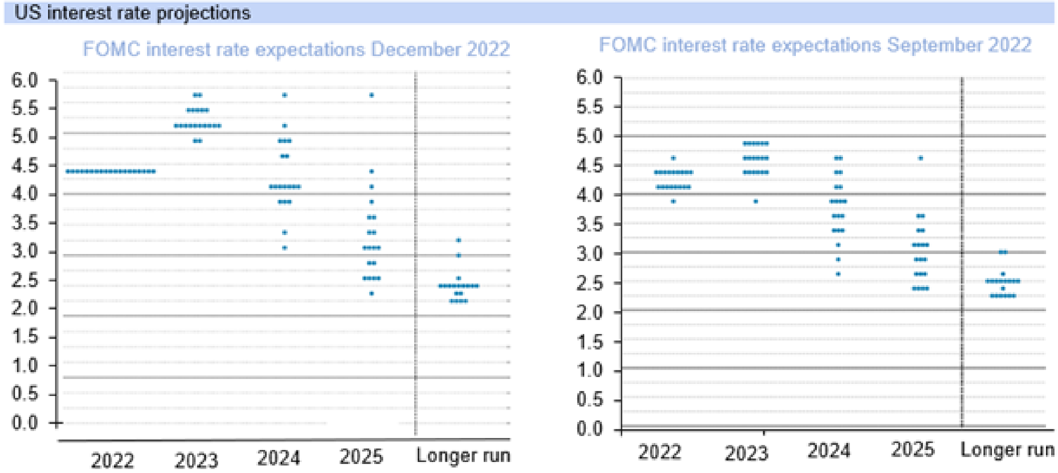
Source: OECD Economic Outlook November 2022

Real long-term interest rates have risen sharply in many countries



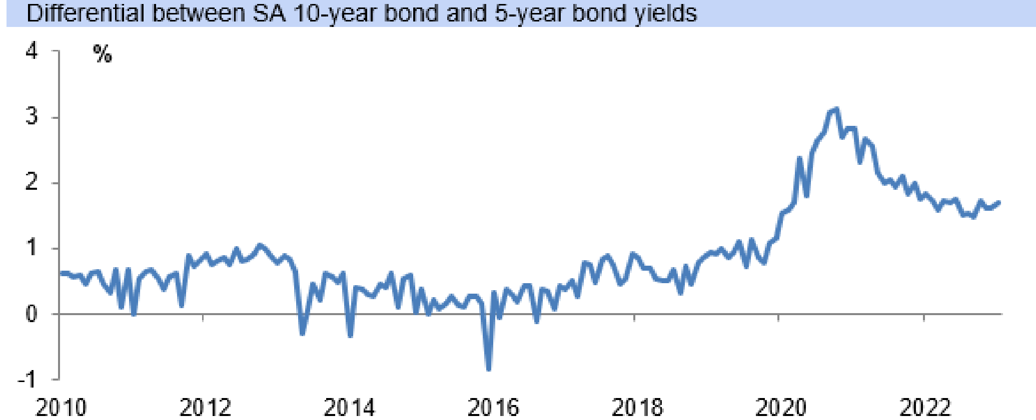
Source: OECD Economic Outlook November 2022

US interest rate projections



Source: FOMC, Bloomberg

Differential between SA 10-year bond and 5-year bond yields

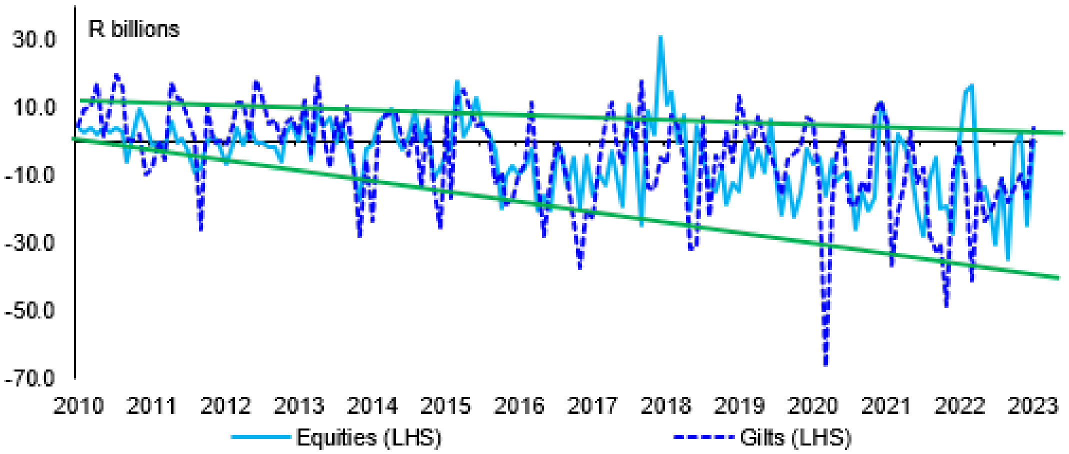


Source: Iress

- The full reopening of the Chinese economy, and attendant impact on commodity prices, particularly oil, are amongst the key risks for inflation, while wage increases add to concerns, with the ECB seeing Europe at particular risk in the next few quarters.

- Noting "wage growth … is expected to be very strong" on “robust labor markets that … haven't been substantially affected by the slowing of the economy, increases in national minimum wages and some catch-up between wages and high rates of inflation."
- Eurozone unemployment dropped to a historic low of 6.5% y/y in November, on a downward trend from 8.6% y/y in Q3.20, while German industrial production rose in the latest data (November) by 0.2% m/m, giving rise to hopes of a milder Eurozone recession than feared.
- The EU plans to continue hiking interest rates, and while the US has signalled more gradual interest rate hikes, but the end (or terminal) rate is not yet apparent in the current US cycle, although markets continue to expect it to be reached in the first half of this year.
- Markets focus on data showing cooling economic activity and inflation drivers in the US potentially showing an earlier terminal rate, although coming at juxtaposition with comments from various US Federal Reserve officials expecting the target rate over 5.0% this year.
- That is, the recent update to the Fed’s dot-plot chart shows its target rate peaking at the 5.00% - 5.25% range, which is a higher peaking for the target rate for this year than in its previous publication of 4.50% to 4.75%.
- However, the rapidity of the descent in inflation will be key for US, and so global, monetary policy, with worker renumeration, economic demand and the housing market key influencers, along with global inflation pressures, including those of supply chains and oil.
- In South Africa, yields have moderated in the year to date, from 10.84% to 10.45% for the ten year benchmark, and 2023 to date has seen foreigners net purchasers of SA bonds this year, of R3.0bn for five recorded days (Bloomberg, JSE data).
- Risk aversion has eased somewhat on hopes the US sees a rapid wind up of its rate hike cycle, and indeed interest rate cuts in H2.23, with the implied Fed fund futures still showing hopes of the latter.

Non-resident portfolio net purchases (+)/ sales (-) vs USD/ZAR (monthly averages)



Source: Iress, Investec

Extreme up case Forecasts	2021	2022	2023	2024	2025	2026	2027
SA rand bond (year-end: %)	10.00	10.55	9.50	9.10	9.00	9.00	8.90
SA rand bond (average: %)	9.82	10.84	9.65	9.25	9.10	8.98	8.90

Up case Forecasts	2021	2022	2023	2024	2025	2026	2027
SA rand bond (year-end: %)	10.00	10.55	10.00	9.60	9.50	9.50	9.40
SA rand bond (average: %)	9.82	10.84	10.33	9.75	9.54	9.55	9.40

Expected case Forecasts	2021	2022	2023	2024	2025	2026	2027
SA rand bond (year-end: %)	10.00	10.55	10.90	10.50	10.10	10.00	9.90
SA rand bond (average: %)	9.82	10.84	11.03	10.65	10.25	10.00	9.93

Lite down case Forecasts	2021	2022	2023	2024	2025	2026	2027
SA rand bond (year-end: %)	10.00	10.55	11.50	12.00	11.50	11.00	10.80
SA rand bond (average: %)	9.82	10.84	11.75	11.85	11.63	11.18	10.88

Severe down case Forecasts	2021	2022	2023	2024	2025	2026	2027
SA rand bond (year-end: %)	10.00	10.55	12.40	12.60	12.50	12.80	12.90
SA rand bond (average: %)	9.82	10.84	12.33	12.55	12.65	12.60	12.90

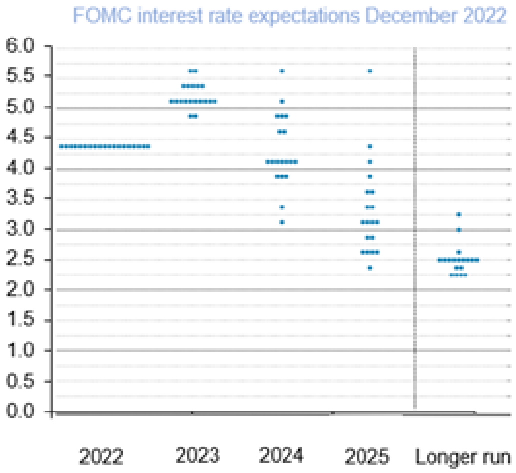
Source: All forecast yields are of bonds traded on the stock exchange - Gov. bonds - Nominal yields: 10 years and over (Unit: % (Monthly average bond yield); Source: SARB QB (S-31) - June 2021 No. 300)

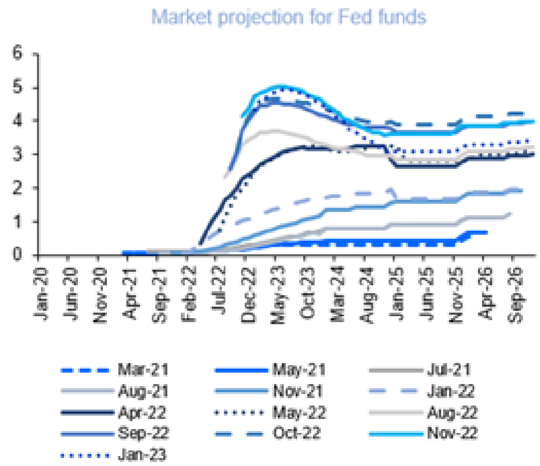
Economic Scenarios: note updated probabilities

		Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
Extreme	USD/Rand (average)	16.40	15.50	14.50	14.00	13.60	13.40	13.30	13.10
Up case	Repo rate (end rate)	6.50	6.25	6.00	5.75	5.50	5.25	4.75	4.75
1%	SA economic growth very quickly rises to 3–5%, then 5-7%. Good governance, growth-creating reforms (structural constraints eradicated), strong property rights, no nationalisation or expropriation without compensation. High business confidence and fixed investment growth, substantial FDI, fiscal consolidation drives debt to low ratios of 2000s. Very subdued domestic inflation on extreme rand strength, very favourable weather conditions. Strong global growth, risk-on, commodity boom. Rapid upgrades of credit ratings to investment grade. No grey listing. Quick transition to renewable energy from fossil fuels.								
Up case		Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
4%	USD/Rand (average)	16.60	15.90	15.50	15.00	14.70	14.60	14.50	14.90
	Repo rate (end rate)	7.00	6.75	6.50	6.25	6.00	6.00	5.50	5.50
	Economic growth averages 3.3% over five-year period, but lifts towards 5.0% y/y by period end, rising confidence and investment levels, structural constraints eroded, global growth strong, global financial markets risk-on. No nationalisation or expropriation without compensation. Low domestic inflation on favourable weather and global conditions, rand strength, lower state-controlled price inflation on increased privatisation. Credit rating upgrades on fiscal consolidation, markedly lower borrowings. Substantial transition to renewable energy away from fossil fuel usage, comprehensive measures to alleviate climate change impact on economy. No grey listing.								
		Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
Base	USD/Rand (average)	16.90	16.45	16.20	16.40	16.20	16.45	16.80	16.60
case	Repo rate (end rate)	7.50	7.50	7.00	7.00	6.50	6.50	6.50	6.50
48%	Economic growth modest (1.9% average over 5 years) but lifts towards 3.0% y/y by end period on reforms, global financial market risk sentiment is neutral to positive. South Africa follows fiscal consolidation (debt to GDP stabilisation) leading to positive outlooks, then likely credit rating upgrades. The rand stabilises, then strengthens somewhat. Inflation is impacted by the course of weather patterns via food price inflation. A transition to renewable energy and slow move away from fossil fuel usage occurs and measures to alleviate the impact of climate change on the economy are modestly implemented. The Russian/Ukraine conflict eases and does not exacerbate. Little expropriation without compensation. Temporary grey listing.								
		Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
Lite	USD/Rand (average)	18.30	18.50	18.00	18.20	17.90	18.10	18.20	18.30
(domestic)	Repo rate (end rate)	7.50	8.00	8.50	9.00	9.00	9.00	9.00	9.00
Down case 36%	Weak GDP growth (0.9% average over 5-years), swing toward left leaning policies. Business confidence depressed, substantial electricity and water shedding, very weak rail capacity, civil and political unrest, very little investment growth, recession. Increased state borrowings, risk of credit rating downgrades rises, then occurs later in period. Some expropriation of private sector property without compensation with a negative impact on the economy. High inflation on unfavorable weather conditions, marked rand weakness. Little transition to renewable energy or measures to alleviate climate change. Grey listed.								
		Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
Severe	USD/Rand (average)	18.70	19.30	19.50	19.70	19.90	19.90	20.00	20.50
down	Repo rate (end rate)	8.00	9.00	10.00	10.50	10.50	11.00	11.50	11.50
case 11%	Lengthy global recession, global financial crisis – insufficient monetary and other support domestically and internationally. ANC/EFF coalition in 2024. Widespread, severe services load shedding, severe civil and political unrest. Government borrows from increasingly wider sources, SA rated single B from all three key agencies, eventually CCC grade, increased risk of default, sinks deeper into a debt trap. Failure to transition to renewable energy and to sufficient measures to alleviate the impact of climate change on the economy. Very high inflation on very adverse weather conditions, severe rand weakness. Expropriation of private property without compensation with a marked negative economic impact. Grey listed								

Note: Event risk begins Q1.23. Source: Investec

US interest rate projections





Source: FOMC, Bloomberg

Fed Fund Futures implied rates – 10 January 2023

Meeting	#Hikes/Cuts	% Hike/Cut	Implied Rate∆	Implied Rate	A.R.M
02/01/2023	+1.246	+124.6%	+0.312	4.643	0.250
03/22/2023	+2.035	+77.9%	+0.506	4.838	0.250
05/03/2023	+2.379	+35.4%	+0.595	4.926	0.250
06/14/2023	+2.431	+5.2%	+0.608	4.939	0.250
07/26/2023	+2.185	-24.6%	+0.546	4.878	0.250
09/20/2023	+1.775	-41.0%	+0.444	4.775	0.250
11/01/2023	+1.226	-54.9%	+0.307	4.638	0.250
12/13/2023	+0.506	-72.0%	+0.127	4.458	0.250
01/31/2024	-0.315	-82.1%	-0.079	4.253	0.250

Source: Bloomberg