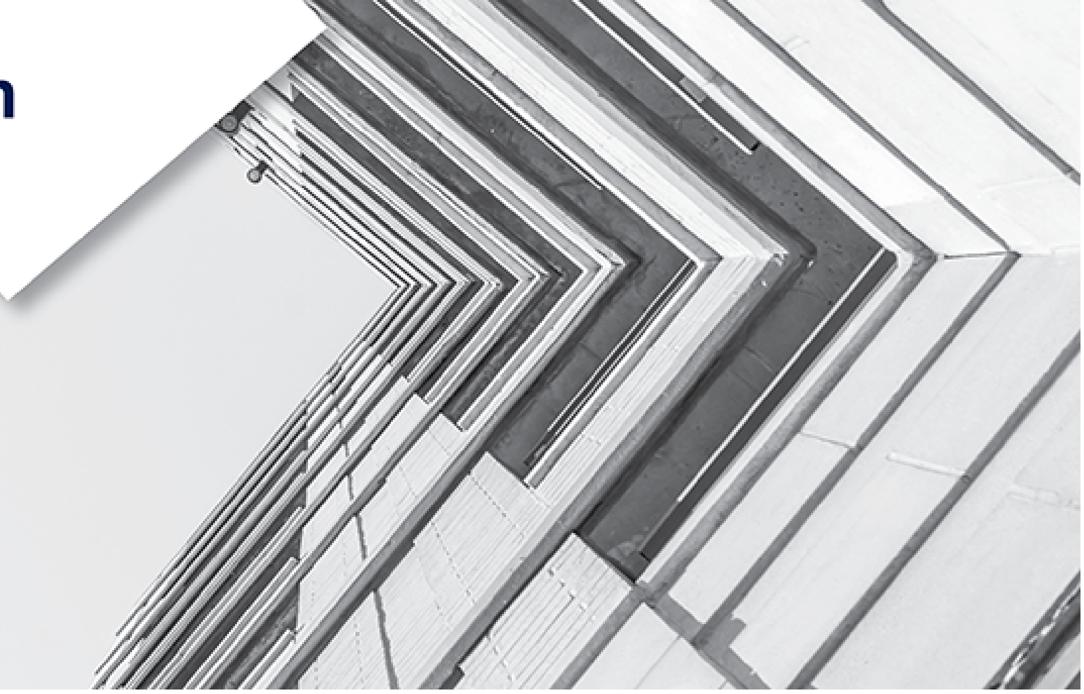
momentum
investments



IN THE
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Rating downgrades and interest rate cuts, chaos? I think not...

The market turmoil of the first quarter of 2020 has given rise to opportunities in the South African fixed income market. In an environment of low economic growth and inflation, there are good opportunities to lock in high real yields for investors.

This is according to Ian Scott, the head of fixed income at Momentum Investments, who spoke at the first virtual Outcome Matters event for 2020.

Scott said it was important to understand the macroeconomic drivers of these opportunities.

"March 2020 was not a repeat of 2008, which was a solvency event. Valuations simply got too expensive, and the market corrected. In contrast, March 2020 was a liquidity event – the US bond market and, to a greater extent, the South African bond market, became illiquid – and when liquidity disappears, prices fall rapidly."

Scott explained that, against this backdrop, it is important to note that the US Federal Reserve (Fed) sets the base interest rate for the global economy. "During the market turmoil in February and March, the Fed stepped in and cut US interest rates aggressively, and we expect them to hold rates at these low levels for a long time. Coupled with this, they increased their balance sheet exponentially and are buying assets in the market, thereby supporting and fuelling the recent recovery, which followed the market lows at the end of March."

The US has been in a low-inflation environment for quite some time, with the average inflation rate at around 1.6% per year. During the next five years, the market expects inflation in the US to be below this level – and low inflation is good for bonds.

Emerging-market bonds were particularly hard hit by the turmoil, as fear gripped the market and investors wanted to exit at all costs. As a result, emerging market bond yields shot up, as the bonds were aggressively sold off.
According to Scott, the South African bond market, given its liquidity, suffered a disproportionate sell off compared to emerging-market peers. "This means South African bonds are very attractively priced compared to developed and emerging market peers," he said.

"The very steep South African yield curve tells a story. The market is pricing in a lot of negative risk for South African bonds. It prices in the fact that the South African government finances are stretched, the economy is without growth and that Eskom is a major overhang on economic growth." Having that, Scott believes the South African yield curve is still too steep compared to emerging-market peers.

Comparing the South African 10-year bond fair-value curve to US treasury yields, it is noteworthy that the market expects inflation in South Africa to be more than 6% per year for the next three to five years.

Momentum Investments, however, forecasts inflation at about 3% in the same period. This means that if the South

African 10-year bond yield is 10.5%, it yields a real return of 7.5% per year. "This return is analogue to yields expected on equity, but at lower bond risks. We, therefore, believe South African sovereign nominal bonds are very attractive for investors. There is simply too much negative risk priced in at the current levels."

Not all South African fixed income investment opportunities are equal, however. "We are forecasting cash to return 5% to 5.5% in the next year; credit to return 6% to 6.5%; inflation-linked bonds to return 6% to 7%; and nominal government bonds to return 8.5% to 9%," Scott elaborated.

The South African listed credit market is also of concern to the investment team, said Scott.

"Government nominal bonds are our preferred current investment option," says Scott. "In the current low-inflation and growth environment, there are excellent opportunities to lock in attractive real yields for investors. This, coupled with the fact that the Sarb cut rates by 250 basis points for the year to date, with further rate cuts of 50 to 100 basis points forecasted, provides strong tailwinds for South African fixed income."

Scott said that fixed income investments might be the only asset class that will deliver an income in the next couple of years.

"Dividends in the equity sector have all but been suspended, and South African real estate investment trusts (Reits) have also stopped distributions. Fixed income could, therefore, be a crucial asset class in portfolios, which require income.

"We always tell our clients that it is in times like these that you have the opportunity to set yourself up for the next few years, by partnering with the right investment professionals and investing in high-quality assets at reduced prices," Scott concluded.