Analysis

Bulent Badsha
Fixed Income Analyst

Fixed income opportunities in a changing interest rate environment

Key take-aways

- Before the Coronavirus crisis, SARB Governor Lesetja Kganyago moved away from the very easy monetary policies of his predecessor to help bring down inflation and inflation expectations, but subsequently had to implement negative real interest rates to revive the economy.
- Cash investments have been delivering below-inflation returns, and it has been best for most investors to avoid them.
- In the rising inflation and interest rate conditions now prevailing, fixed-income investors should consider carefully before moving away from bonds and into cash, as the former still offer much higher real return prospects.

Inflation is the enemy of the fixed income investor. Thankfully, the constitutional mandate of the South African Reserve Bank (SARB) is to achieve price stability. They do this by conducting monetary policy independently and setting the appropriate level of short-term interest rates. The Coronavirus crisis ushered in record low levels of interest rates, leaving cash investors earning very little – in many cases not enough to even beat inflation. Yet despite easy monetary policy, there have been, and still are, opportunities in the fixed income space that investors can take advantage of. So just what do we at M&G Investments believe are these opportunities, and what will change as interest rates rise?

About the SARB

The SARB is a creature of statute, subject to the SARB Act 90 of 1989. Its primary mandate, as explained in South Africa's Constitution, is to "protect the value of the currency in the interest of balanced and sustainable economic growth". Central banks conduct monetary policy through the control of the money supply to achieve price stability. To do this effectively, the SARB adopted an inflation targeting monetary policy framework at the turn of the century. The Monetary Policy Committee (MPC) of the SARB has the responsibility to determine the repo rate, the anchor for short-term interest rates in the economy, which it adjusts as necessary to keep Consumer Price Index (CPI) inflation within the target band of 3% to 6%. The target band was set by the National Treasury, with consultation from the Bank, which then has the autonomy to independently determine the appropriate monetary stance.

Unprecedented policy

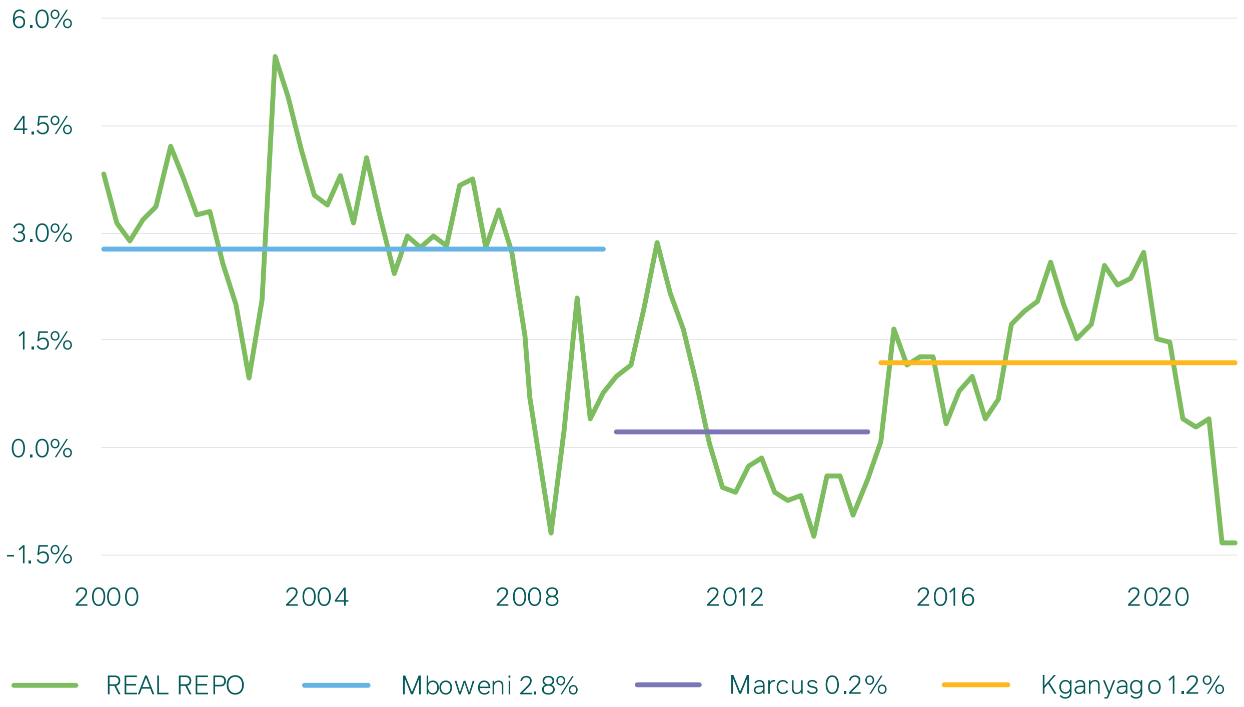
The monetary policy actions taken by the MPC provide the foundation for the term structure of interest rates in South Africa: generally, the longer the term for which the government, entities and individuals borrow, the higher the interest rate paid. These different borrowing rates at different periods help to form the South African yield curve. Furthermore, the SARB's decisions have consequences for both the level and shape of the yield curve. Interest rate cuts tend to lead to steeper yield curves, while hikes drive flatter curves as the market processes the inflationary consequences of monetary policy actions.

In January 2020, the MPC lowered the repo rate by 25 basis points (bps) to 6.25% against a backdrop of lower realised inflation outcomes and a decline in inflation expectations. This was already a low absolute level in historic terms. Upon the local outbreak of the Covid-19 pandemic, the MPC followed the lead of other central banks by aggressively cutting interest rates by 100bps in March 2020, and again by 100bps in an unscheduled meeting during April. Thereafter, they further adjusted the policy rate lower by 50bps in May and by 25bps in July. These policy actions were unprecedented, with a cumulative 300bps of easing over a six-month period, and the repo rate remained unchanged at a record low level of 3.5% until November 2021. While the MPC cut rates, the yield curve steepened (since shorter-term rates are more sensitive to central bank actions), but more recently it has reversed that trend, flattening amid growing market expectations of coming interest rate hikes.

Getting real

The nominal level of interest rates garners a lot of attention in the news, but any central banker knows that it's the real (or inflation-adjusted) rate that is the true measure of monetary policy. We have viewed monetary policy from this perspective since the adoption of inflation targeting. As Graph 1 shows, the real repo rate (nominal repo rate less the targeted inflation rate) averaged +2.8% under the leadership of Governor Tito Mboweni. During Governor Gill Marcus's tenure, the real repo rate averaged 0.2% and under the present Governor, Lesteja Kganyago, it has averaged +1.2% so far. Its most recent level was -1.5% in October, after having hit all-time record lows earlier this year.

Graph 1: Real repo rate under inflation targeting



Source: Iress, Bloomberg, Stats SA

Given how crucial interest rates are for investors, understanding some of the history behind how they've come to be where they are now is important. As clearly evidenced in Graph 1, three notable developments (or phases of monetary policy) since the February 2000 introduction of inflation targeting have shaped the country's monetary policy. First was the fact that Governor Mboweni, who launched inflation targeting, was consistent from the outset in his maintenance of positive real interest rates to drive down inflation expectations. He succeeded in garnering credibility for the SARB and its inflation-fighting credentials in the face of both the 2001 currency crisis and the 2008 Global Financial Crisis (GFC).

However, in the aftermath of the GFC, that approach to monetary policy was deemed to be too strict, especially considering the dramatic shift in the domestic political environment, where growth was set as the overriding priority. Stemming from this, the second development in February 2010 saw then-Minister of Finance Pravin Gordhan sending a letter to the new Governor of the SARB, Gill Marcus, titled “Clarification of the Reserve Bank’s Mandate”. The gist of this message: to relax the Bank’s stance from being a strict inflation-targeting central bank and adopt a more flexible approach. This allowed for negative real interest rates and resulted in inflation and inflation expectations becoming unanchored from the 3%-6% target over the next few years.

Then in October 2015, Governor Lesetja Kganyago delivered a remarkable and sobering speech in Cape Town at a Bureau for Economic Research (BER) conference entitled “South Africa’s growth performance and monetary policy”, where he admitted that the adoption of a flexible inflation targeting approach came with a huge cost in the form of higher inflation and inflation expectations. As Governor, he embarked on a journey to re-establish the SARB’s credibility and inflation-fighting credentials, with a focus on driving inflation and inflation expectations towards 4.5%, the midpoint of the inflation target range. He did this by raising the level of real interest rates and maintaining positive real interest rates through the worst of the pandemic conditions, until March 2021.

“Cash-type investments also offered somewhat higher returns for investors.”

The investment consequences of this policy shift? During this period rising real policy rates and lower inflation expectations among investors were very supportive of nominal bonds, helping lower the risk associated with them. Cash-type investments also offered somewhat higher returns for investors. By contrast, inflation-linked bonds (ILBs), with their inherent inflation protection, underperformed both cash and nominal bonds.

Investment implications: Avoiding cash under Covid

Exceptionally low interest rates like those prevailing since the onset of the pandemic are a boon for the indebted but a tax for savers, especially those drawing an income from life savings. A wise man once told me that a central bank Governor will know whether monetary policy is right or not based on how skewed the two trays containing letters from the public complaining about 1) how high and 2) how low interest rates are. I would guess it would currently be very lopsided towards the latter.

"...bond investors extending their investment terms can earn a higher-than-usual yield for the usual amount of accompanying risk"

In a reversal of fortunes from pre-pandemic conditions, negative real interest rates have made cash a very unattractive investment proposition. Contrary to conventional wisdom, during this period it has been more risky to hold cash in a portfolio due to its inability to deliver above-inflation returns. Over the past 12 months to the end of October it has returned only 3.8% (as measured by the STeFI

Index). This is why in managing our multi-asset portfolios we have been holding exceptionally low levels of local cash. Fortunately, as investors in search of positive real yields we have found better investment opportunities for our clients in longer-dated fixed-income assets such as nominal bonds and inflation-linked bonds (ILBs), further along the term structure.

Real yields in the nominal bond and ILB markets have been trading above their historic levels in both absolute and relative terms, and both have featured strongly upward sloping yield curves, offering attractive opportunities for the risk involved, in our view. The steeper slope has meant that bond investors extending their investment terms can earn a higher-than-usual yield for the usual amount of accompanying risk.

Our investor portfolios have benefitted from our preference for these assets, with nominal bonds delivering 10.9% and ILBs returning 11.0% over the 12 months to end-October (as measured by the IGOV and All Bond Indices), both significantly higher than cash. Nominal 10-year bonds are currently discounting inflation of 6.2% p.a. on average over the next decade. We believe this is overly pessimistic, in that it assumes that the SARB will not be able to meet its 3%-6% inflation target despite its historic success. For us, the current yields make a compelling investment case for nominal bonds going forward. Meanwhile, we have already taken significant profits in our ILB holdings following their strong performance (absolutely and relative to nominal bonds) earlier this year, and currently prefer nominal bonds to ILBs in our multi-asset portfolios.

Graph 2: Repo rate hiking expectations

Source: Iress, Bloomberg, SARB

Monetary policy normalisation and investment prospects

It is now over 18 months since the Covid outbreak reached our shores, and the financial crisis is largely behind us. Along with other investors, and the SARB itself, we expect monetary policy to continue to normalise now that the SARB has initiated a new hiking cycle with a 25bp repo rate increase in November. As Graph 2 highlights, the SARB's most recent forecast projects further increases totaling 229bps over the next two years, taking the repo rate to approximately 6.0% by the end of 2023. At the same time, the Forward Rate Agreement (FRA) market is currently pricing in the repo rate reaching 7.3% by the end of 2023.

If either of these projections materialise and inflation remains anchored near the midpoint of the target range, that would improve the prospects for holding more cash as an investment again in our portfolios. However, in our view both SA nominal bonds and ILBs currently offer the prospect of much more attractive returns. While a shift towards cash may be appropriate for more conservative investors or those with shorter-term investment objectives, others with longer-term goals should think twice before being tempted back into cash just yet. ◻

Bulent joined M&G Investments in June 2021 as a Fixed Income Analyst and is currently involved in portfolio construction, dealing and research. With 20 years of industry experience, Bulent started his career as a Deputy Economist at the South African Reserve Bank in 2001, before working in a range of Fixed Income and Economist roles at several of the county's leading asset managers. His qualifications include: BCom (Economics), University of Natal.