M&G Investments

Consider This

2024 in the rearview mirror

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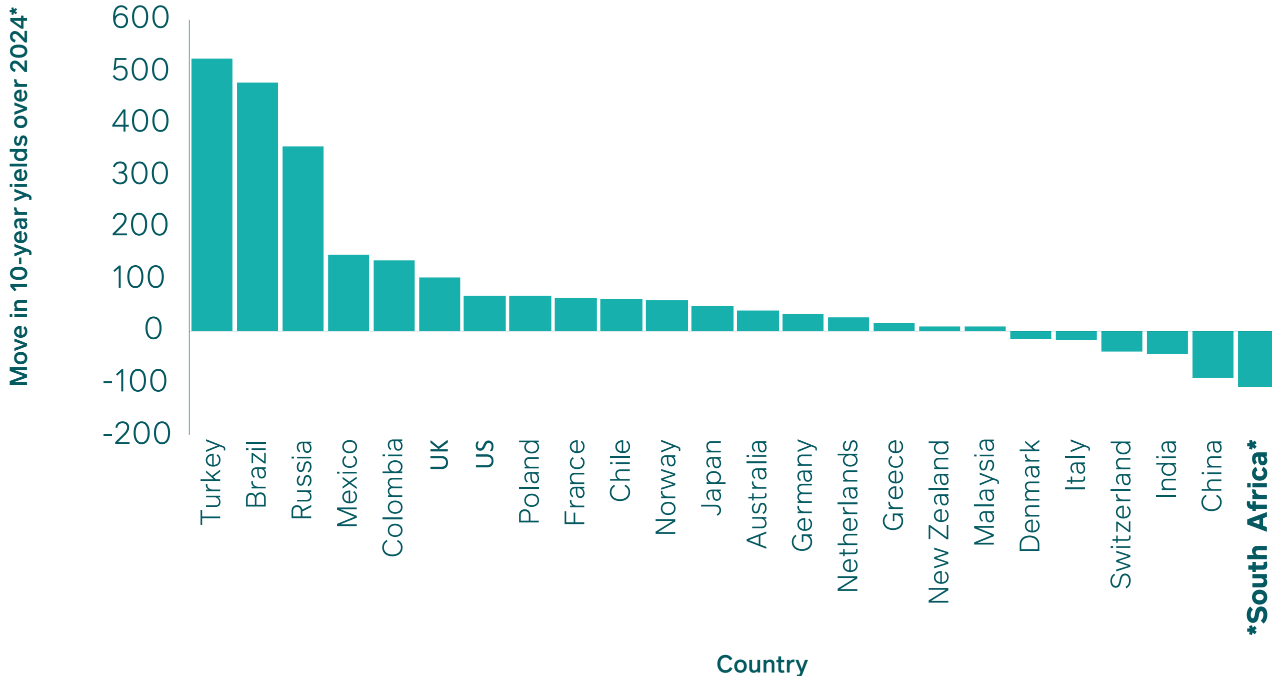
What a remarkable year for investors in South African nominal bonds. The All Bond Index (ALBI) delivered a handsome return of 17%, comfortably the highest annual return the local bond market has delivered in well over a decade. In fact, the South African bond market stood out as one of the best performing domestic bond markets globally when considering 10-year local currency bond yield moves over the year (see chart below). With the rand ending the year only slightly weaker versus the US dollar, those foreign investors with unhedged exposure to the local bond market would have enjoyed a bumper hard currency return.

One of the best performing domestic bond markets globally when considering 10-year local currency bond yield moves over 2024



Source: Factsheet
* Remember the inverse relationship between yields and prices: Yields falling is a positive, as prices go up.

Investors in the M&G Bond unit trust fund and the M&G Enhanced Income Fund experienced handsome absolute returns for the year on the back of the bond markets strong performance. Both funds also outperformed their respective benchmarks over the year and, over three years, both funds have continued to deliver top quartile performance in their respective sectors – a particularly pleasing result for our investors.

What drove this performance?

The formation of the Government of National Unity (GNU) in June was arguably the single biggest catalyst to the change in investor sentiment towards South Africa this year. Unsurprisingly, the ANC lost its majority in the election for the first time since the advent of democracy in 1994, with most commentators having this as a base case scenario ahead of the election. Concern lay around the tail risk outcome in which the ANC would only secure around 40% of the vote and that this could lead to a coalition with either the EFF or perhaps the MKP. Such an outcome, with its associated governance and policy implications, held the prospect that the country would lurch towards a more populist form of government, jettisoning the reform agenda and carrying all manner of risk for investors.

Instead, what transpired was quite the opposite. With the ANC managing to secure only 40% of the vote, it conceded defeat in a peaceful manner. Instead of a coalition with the EFF or MKP as many feared, it spearheaded the formation of the GNU.

Doubling down on reform

Importantly, the GNU and its composition signaled a renewed commitment and re-energising of the reform agenda. This hugely positive outcome set the stage for a marked shift in market confidence and sentiment. With South Africa's key challenge being the lack of economic growth over the last decade, the prospect of not only a commitment to reforms but an acceleration caused investors to reduce the significant risk premium embedded in South African asset prices – kickstarting a rally in local assets.

While the formation of the GNU heralded the change in sentiment towards South Africa and coincided with the rally in local bond yields, other aspects created and supported an environment for bonds to rally.

At the forefront of these was the country's energy situation. Having being part of the South African lexicon since 2007, it is remarkable how "loadshedding" and its daily impact on every facet of South African life and the economy has seemingly just vanished. However, this turnaround did not occur overnight. Instead, it reflects the concerted efforts over the last four years to reform the electricity sector.

Central to these efforts has been Operation Vulindlela, a joint initiative between the Presidency and National Treasury to accelerate meaningful reforms across key sectors within the economy. The turnaround at Eskom reflects the reform agenda's impact on the ground and its potential to build investor and consumer confidence, which is vital in creating the optimal environment to deliver much needed economic growth.

The absence of loadshedding since 5am on 26 March is tangible evidence of the removal of a key constraint on growth. Importantly, it shows what's possible when an enabling environment is created to catalyse private capital investment to deliver solutions. Reform momentum continues to grow with a similar focus on the Transport sector (specifically Transnet).

More recent announcements highlighting a focus on municipal reforms set the stage for further good news. The Minister of Home Affairs announced progress in overhauling the South African visa system to attract critical skills and promote tourism growth, instilling confidence in the pace of reform. The focus is now clearly on delivering tangible outcomes rather than empty promises.

While the formation of the GNU and the improved energy situation highlight the positive impact of reforms and were clear drivers of the rally in bond yields, the inflation backdrop also played its role in creating an environment for bonds to rally. With inflation having fallen within the South African Reserve Bank's (SARB) 3-6% target band in June 2023, it continued to hover just above 5% for the most of the first half of the year to June. In the following months, inflation continued to fall with October's inflation print of 2.8% being the lowest since the 2020 Covid lows. With inflation and inflation expectations being well behaved and central banks globally having embarked on rate cutting cycles, the SARB cut interest rates for the first time in four years. The relatively benign inflation outlook and a SARB that, while initiating a rate-cutting cycle, continued to emphasise its vigilance regarding potential upside risks to inflation created an environment conducive for bonds to rally. Throwing the topic of lowering the SARB's inflation target into the mix, something the Governor has vocally supported, certainly gave bond bulls a longer-term story to get behind.

From a global investor perspective, the South African investment case was also somewhat less complicated than many other markets. The ongoing political reforms, the visible energy turnaround and the benign local inflationary dynamics all contributed to a relatively compelling investment case for South African bonds. In contrast, various other emerging

markets were grappling with worsening fiscal and inflationary dynamics, heightened uncertainty over the potential impact of tariffs following Trumps presidential win, or negative spillovers from political developments.

Navigating the road ahead

2024 was a fantastic year for investors in South African domestic bonds. It is worth highlighting that South African asset's and in particular bonds were very cheap at the start of the year reflecting the large, embedded risk premium investors were demanding. The partial unwind of this risk premium drove investment returns over the course of the year but South African assets continue to embed a significant risk premium. For all the positives this year brought, many challenges and risks remain that need to be addressed.

Fiscal risk, in particular, remains elevated. While the lights remain on, significant investment is required in electricity transmission and generation to secure the energy supply into the future. Eskom is grappling with the fact that many municipalities are simply not paying for the electricity they are consuming – an unsustainable situation. Transnet is far from out of the woods and it's difficult to see how the government can avoid providing it with significant support going forward. The country is faced with ever-mounting challenges in the water sector requiring significant investment. At the same time, the fiscus simply lacks the capacity to undertake significant capital investment – a key reason why reforms are needed to catalyse private sector investment.

As a result of these risks, bond yields remain elevated. However, we continue to believe that they provide more than adequate compensation for investors. The M&G Inflation Plus and Balanced Funds continue to hold meaningful exposures to SA bonds, while the M&G Enhanced Income Fund continues to find value in the shorter part of the yield curve. Finally, for investors wanting to concentrate their exposure to nominal bonds, the M&G Bond Fund provides a compelling means to do so having managed to outperform its benchmark, the All Bond Index, convincingly over the last four years.

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