GLOBAL FACTORS WILL POSITIVELY AFFECT SOUTH AFRICAN BONDS IN THE FIRST HALF OF 2015

Global disinflation and the implementation of quantitative easing (QE) by the European Central Bank (ECB) will drive South Africa’s benchmark R186 bond yield down to 6.5% in the first half of 2015.

- The inflation rates of several countries in Europe have moved into negative territory (as shown in Chart 1). Eurozone consumer inflation, which is already in negative territory, is expected to fall further and is in danger of entering into a deflationary trap.
- The ECB has finally implemented QE on a grand scale, with the plan to buy back €60 billion of government and asset-backed debt every month from March this year until at least September 2016. If there still is a threat of Eurozone deflation by then, QE could continue beyond September 2016.
- In anticipation of Eurozone QE, the Swiss National Bank removed their currency peg against the euro, which sent the Swiss franc soaring over 20%. This will suppress their inflation rate even more, given that it is already negative.
- Inflation in the US also fell in 2014, from 2.1% in May to 0.7% in December, despite good GDP growth. The strong dollar and lower oil prices played a significant role in lower US inflation.
- The falling oil price is clearly the main contributor to the global disinflationary trends and deflation in some countries.
- In response to falling inflation and lower growth, central banks in Iceland, Norway, India, Egypt, Peru, Turkey, Denmark, Canada and Switzerland cut interest rates.
- However, oil-producing countries like Nigeria, Russia and Brazil hiked interest rates, as their currencies weakened significantly. Following aggressive hikes, Russia recently cut rates.
- The South African Reserve Bank (SARB) revised their inflation forecasts aggressively from an average of 5.3% to 3.8% in 2015, following a further decline in oil prices. They have also reduced the GDP growth outlook for 2015 from 2.5% to 2.2%.
- The SARB Governor’s statement was not as dovish. He stated that there are hurdles to lower interest rates, and emphasised the risks to the rand as well as the current account.
- The latest inflation release showed that inflation fell from 5.8% year-on-year (YoY) to 5.3%, largely because of lower petrol prices, which fell from R12.98 a litre to R12.29. A further cut of R1.27 a litre in the petrol price in January will lower inflation even more.
- Food inflation fell from 7.7% YoY to 7.4% in December and is expected to fall further in 2015. Meat prices, however, remain sticky.
- The chart shows that whenever consumer inflation falls below 4.0%, it doesn’t stay there for long before rising again. Although inflation is expected to fall below 4.0% to around 3.2% in the second quarter of this year, we therefore don’t expect it to remain there for long before rising again back up to the 6.0% level.
- Higher electricity tariffs, potential rand weakness, a higher oil price and tax hikes will pose upside risks to inflation from the second half of this year.
The chart illustrates the relative attractiveness of South African bond yields via the ALBI yield when compared to the global bond yield.

- It is well documented that some countries in Europe, such as Denmark, Germany, Sweden and Switzerland have bond yields in negative territory. The German bunds, up to the 7-year area of the yield curve, is in negative territory, and the German 10-year bond yield has fallen by 20 basis points this January to 0.34%. The US 10-year treasury fell almost 50 basis points, although from a higher level of over 2.0%.
- The global disinflationary trend and, in some cases, deflation, explain the low level of the global bond yield.
- It is worth noting that the spread between the two sets of bond yields is roughly 6.0%. If we decompose the 6.0% total risk premium into sovereign and currency risk of 2.0% and 3.5% respectively, we get 5.5%. This implies that the ALBI yield could still fall 0.5%. In other words, the benchmark R186 bond (maturing in 2026) could fall to 6.5% in months to come.
- Global bond yields will likely continue to fall further as global disinflation and deflation are entrenched.
- As global bond yields fall further, the attraction of South African bond yields becomes more apparent.

In December last year, foreigners sold R17 billion worth of South African bonds on concerns of the country’s current account deficit. This wave of foreign selling turned into net buying of local bonds in anticipation of QE from the ECB in January. To date, foreigners have bought R8.5 billion worth of South African bonds in January, as shown in the chart. We believe net foreign buying will continue in the months ahead as global investors search for higher yielding debt.

- Our fair value models suggest that the South African 10-year bond yield can go down to 6.5% in the next few months.
- Negative and near zero bond yields in developed markets and QE in the Eurozone will ultimately pull South African bond yields lower in the first half of 2015.
- The implied real repo rate, after the SARB adjusted its inflation forecast to 3.8%, is almost 2.0%. This underscores the value in both the bond space as well as the money market space. One-year NCDs at 6.90% yields an implied real rate of more than 3.0%.
- We expect the South African yield curve to bull flatten as the SARB remains reluctant to cut interest rates, while long-end rates fall further.
- Although risks such as US rate hikes do exist, we expect the rate hikes to be pushed out much later in 2015 if not 2016.

Locally, the current account deficit poses currency risk.