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DO SOUTH AFRICAN BONDS OFFER VALUATION COMPARED TO EMERGING MARKET PEERS?

By Grace Debeila, Fixed Income Analyst at Prescient Investment Management

For the most part, it is agreed that there is no need to be concerned about non-resident purchases of South African bonds holding up as long as foreigners are cash-flush. Interest rates in developed markets remain low relative to those in emerging markets, and prolonged easy monetary policy in the developed world has ensured that there is an excess supply of money available. So, it comes as no surprise that developed market investors have been purchasing emerging market debt in pursuit of higher returns than they are able to attain domestically – seemingly irrespective of the relative risks embedded in each sovereign.

Recently, there have been signs that the tide is about to turn. Central banks in developed markets have begun to signal that their economies are nearly ripe for increases in interest rates and tighter monetary policy to prevail. The risk is that when that happens, there will be a sudden and sharp reversal of capital flows into emerging markets.

Even if there is only a gradual and controlled reduction in capital flows, we face the risk that foreign buyers of emerging market bonds will start to look more closely at the potential returns and associated risks of South African debt specifically in relation to its emerging market peers, and allocate their funds in a more discriminating manner towards those that are deemed to be less risky. It is therefore worthwhile to consider whether South African bonds still offer value relative to those of its peers.

A quantitative way to look at this is to decompose the long-term returns on bonds issued by emerging market countries into:

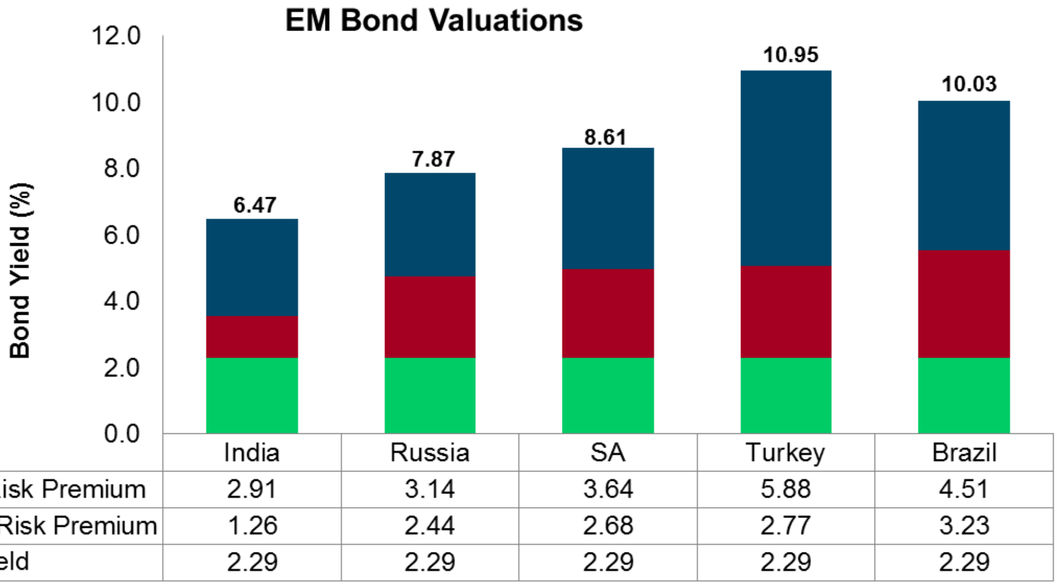
(US 10-year bond yield) + (country risk premium) + (currency risk premium)

The US 10-year bond yield is widely considered to be the risk-neutral long-term borrowing rate for the globe. As long as it remains low, we can expect the current level of non-resident net purchases of emerging market bonds to be maintained.

A decent proxy for the country risk premium is the price in the market that investors are willing to pay for insurance on their holdings of that country’s dollar-denominated debt. It represents the risk that the government might default on its obligations by refusing to repay the debt, or restrict the movement of capital outside of the country.

The currency risk is then deduced as the residual after subtracting the above figures from the quoted local currency bond yield for that sovereign. It represents the extra return foreign investors require to compensate them for the risk of losing money when they convert the rand proceeds from their bond holdings to their local currencies.

A graphical representation of this decomposition of 10-year bond returns in South Africa, and a few similarly rated emerging market countries, is currently as follows:



	India	Russia	SA	Turkey	Brazil
Currency Risk Premium	2.91	3.14	3.64	5.88	4.51
Sovereign Risk Premium	1.26	2.44	2.68	2.77	3.23
US 10yr Yield	2.29	2.29	2.29	2.29	2.29

Overall, emerging market bond returns versus US bond returns have compressed markedly over the past year – South Africa is no exception. This is because of the generally low volatility that has prevailed in global financial markets lately, and the higher interest rates that can be earned in emerging markets.

After the downgrade to its credit rating earlier this year, South Africa is now similarly rated to Russia and Turkey by the major rating agencies. The country risk premium embedded in our bond yields is intuitively broadly in line with that of Russia and Turkey. For reference, the ratings are:

	India	Russia	SA	Turkey	Brazil
Domestic Rating: Local Currency	AAA	AAA	AAA	AAA	AAA
International Rating: Local Currency	BBB-	BBB-	BBB-	BBB-	BB
International Rating: Foreign Currency	BBB-	BB+	BB+	BB+	BB

Furthermore, investors do not seem to be demanding an elevated risk premium for our currency versus comparable emerging market peers. The independence of our central bank remains intact, and the market's reaction was muted even after our Public Protector (wrongly) tried to interfere with its mandate. Turkey stands out as having an extremely high value for this premium due to the extreme, sustained political and economic turmoil it has experienced recently.

We can deduce that our bond yields are still fairly valued on a relative basis. As long as our own macroeconomic fundamentals, political stability and the perceived strength of our institutions remain comparable to other emerging market economies, there is no need to be concerned that we would be relatively discriminated against when there are limited funds for investment due to tightening of developed market monetary policy.

This analysis does not consider the potential devastation associated with a rapid drying up of liquidity and the large foreign outflows that would ensue - as opposed to a controlled, gradual reduction in flows to emerging markets.

We believe there is cause to be concerned about this and we are monitoring the situation ever more closely.

Ends.

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Grace Debeila joined Prescient Investment Management in February 2017 as a Fixed Income Analyst responsible for providing support to the fixed income team together with general research in building and testing fixed income strategies. Grace comes to Prescient with more than 7 years of experience in the industry, having served at Prudential Portfolio Managers as Asset Allocation Analyst.

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