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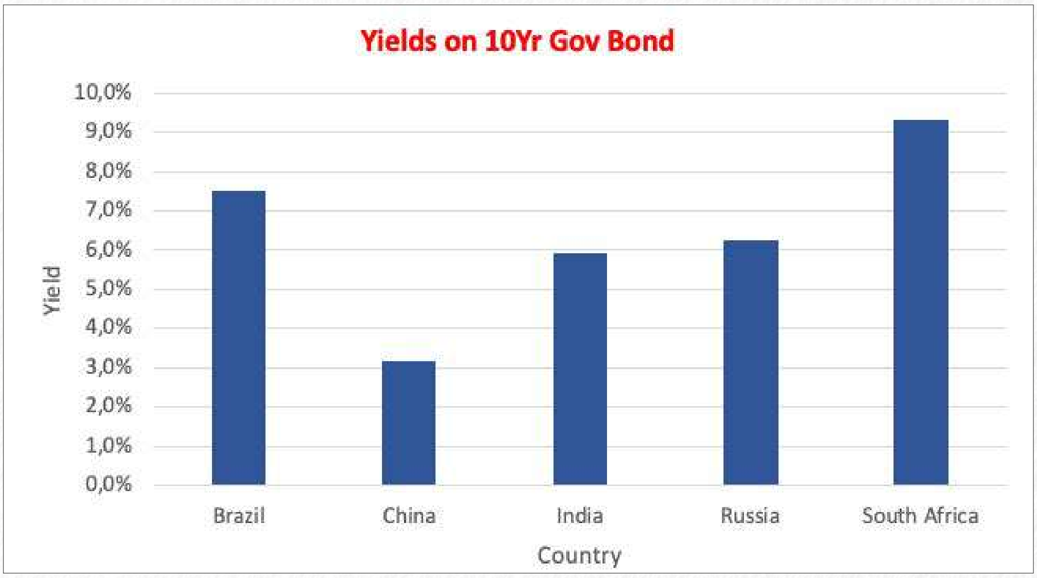
Are South African government issued bonds a good investment?

Investments are governed by a fundamental question, "Am I willing to accept the risk related with this investment for the return on offer?" Given the devastating impact that COVID 19 has had on global markets, with South Africa being no exception, this question is perhaps now more relevant than ever before.

Please note all information below is as at 31 October 2020.

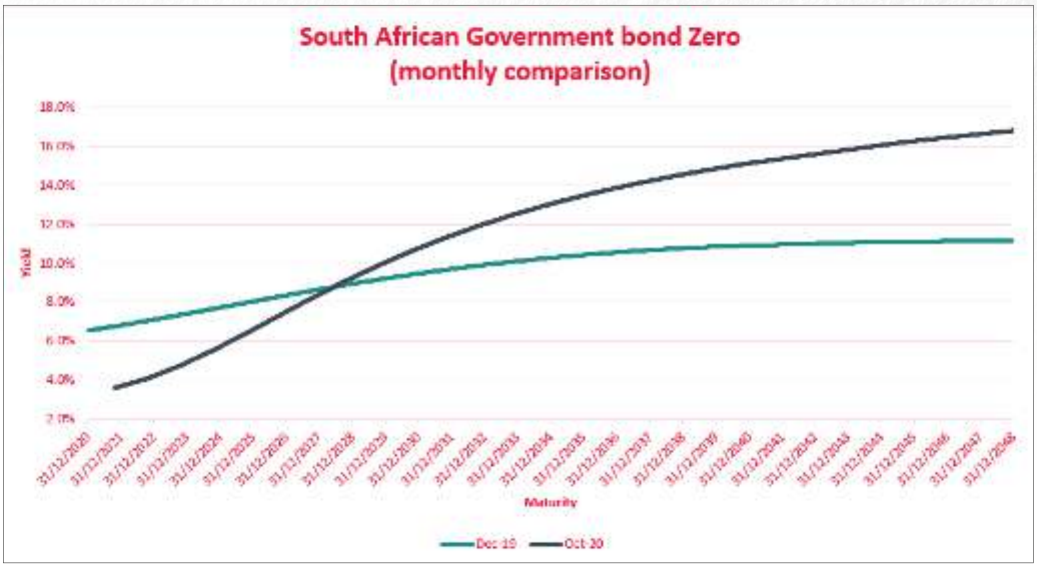
RETURNS

The return on offer in the local government bond market is priced attractively at approximately 9.315% for a 10 Year Government Bond. To give context to this rate of return, it is considerably higher than returns in other BRICS[1] emerging markets.



Source: Refinitiv

Furthermore, yields on government securities have increased over the long-term implying increased sovereign risk, due to COVID 19 impacting long term economic growth. This increased return implies that tenure selection[2] when assessing your investment is a critical consideration.



Source: Refinitiv

[1]BRICS – Brazil, Russia, India, China, South Africa.
[2]Tenure- term to maturity of a debt instrument.

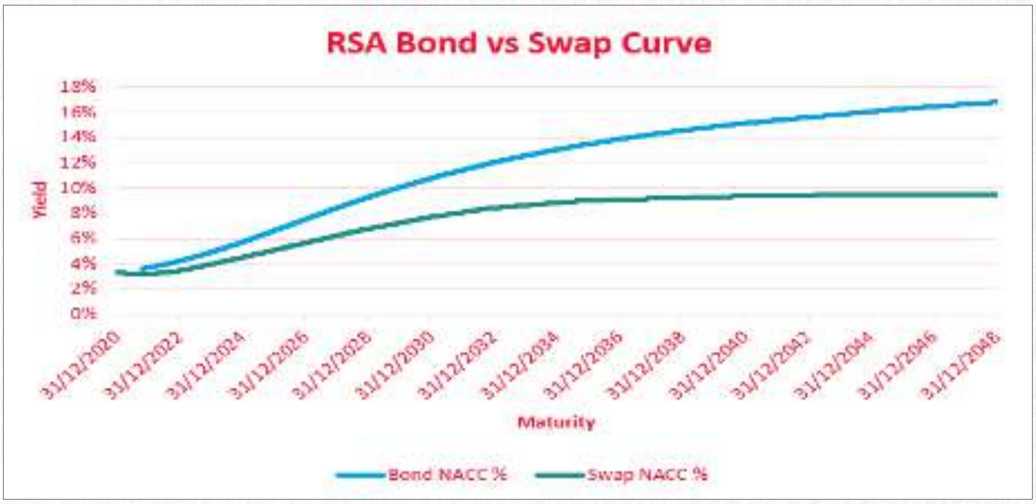
RETURNS CONT...

Given the above, we can see that yields on government issued debt securities are quite attractive, however if one compares this yield to returns on other fixed income securities in the South African market, then these bond yields look even more attractive.

Interventions from the South African Reserve Bank (SARB) to combat the economic impacts of COVID 19, such as reductions in the South African repo rate, have resulted in lower yield on money market instruments. These rates on offer are lower than those we have seen in recent years, and are not expected to increase significantly in the near future, with a possible rates hike only expected in Q3 and Q4 of 2021, by the SARB Monetary Policy Committee (forecast to be around 25bps each).

The rates on offer on cash investments, are further hampered by the rate of inflation, which although low, still put pressure on money market returns on offer in the market. With inflation expected to increase in 2021 to above 4%, based on forecasts by the SARB Monetary Policy Committee ("MPC"), we can expect money market returns to continue to be strained in the market.

The final alternative for local fixed income investments is the local corporate bond market. The best comparison to make here is to compare yields on the forward looking local Jibar[3] swap and government bond curves.



Source: Refinitiv

As can be seen from the above graphic, government bonds offer better returns than corporate bonds. Furthermore, the swap curve does not consider company specific factors, and so the inherent risk of the bond issuing counterparty may be considerably higher than the South African government, and the corporate is unlikely to be able to offer the security features, which the national government does, i.e. the risk and return relationship does not necessarily hold, as the swap curve would be expected to be trading at a premium to the bond curve based on a risk profile build up.

Taking all of this into account, an argument can be made that government returns are attractive on a risk-adjusted basis, when comparing to returns on other fixed income securities in the South African market.

[3]Johannesburg Interbank Average Rate

RISKS

The above returns are a function of risk, and given the returns on offer for RSA government bonds, the implication is quite simply that the risk profile as a country demands the higher return. Some of the most fundamental risk factors relevant to South Africa ("SA") include:

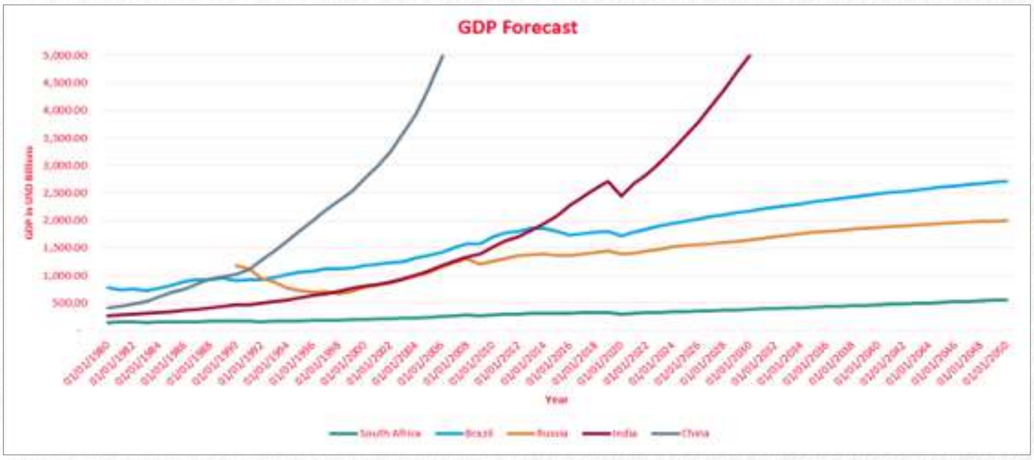
GDP growth forecasts

GDP dropped by a staggering 51% in Q2 of 2020 (Stats SA), and although Q3 should see strong quarter-on-quarter growth, year-on–year growth is anticipated to be a decline of around -8.2% (SARB: MPC). Growth rates for 2021 are expected to be around 3.9% and 2.6% in 2022, suggesting that a V-shaped recovery is not likely. These low growth rates, together with added pressure on employment (unemployment rose to 30.8% in Q3), imply lower revenue from tax collection and further constrains in the government's ability to increase spending on developmental, infrastructure and employment creating projects.

Debt to GDP

To finance fiscal assistance during the COVID 19 pandemic, government has had to take on increased debt to fund its initiatives. The South African Debt to GDP ratio is around 72% and is expected to increase to around 80% by the end of the year. The increased debt levels will result in higher interest costs, required to be financed by a constrained revenue forecast.

To give context to the above point, and why it is worrying, SA has the lowest growth forecast amongst the BRICS nations, but has debt levels which exceed some of them, and are aligned to nations with significantly better growth outlooks, such as India.



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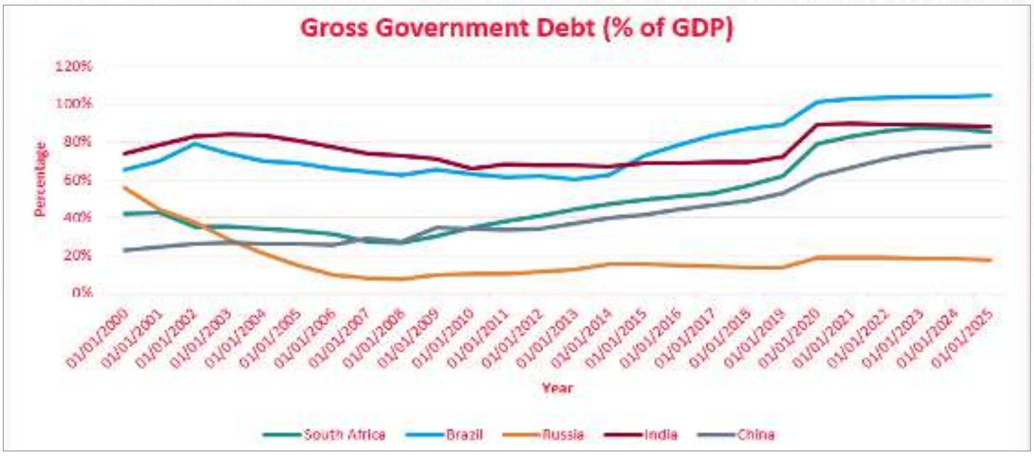


Source: Refinitiv

RISKS CONT...

Political uncertainty

Political uncertainty and poor governance continues to constrain growth forecasts for the local economy. Fiscal and development policy certainty is key, however more importantly, is the implementation of adopted policies and a willingness to carry these out from government and state-owned entities.

Foreign Direct Investment

One of the significant risk areas for South Africa includes its ability to attract Foreign Direct Investment ("FDI") into the country. As at 31 July 2020, FDI fell to approximately 30.1%, which represents a decrease larger than seen in recent years.

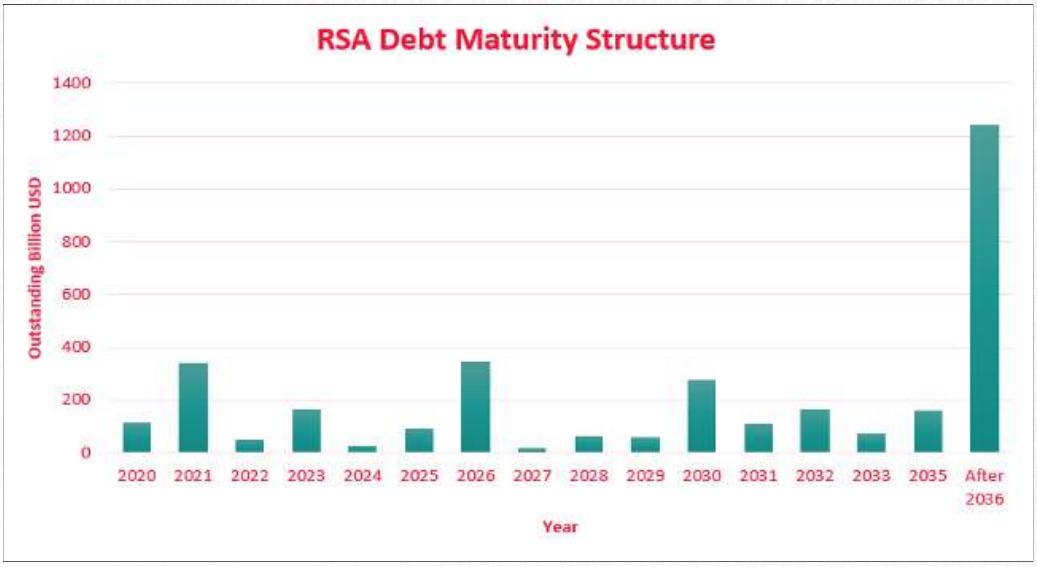
Furthermore, the SA sovereign credit rating is ranked as junk by the three major credit ratings agencies, with only S&P assigning SA a stable outlook.

All of the above raises questions on our ability to generate sufficient FDI to boost the country's growth forecasts.

POSITIVES

The risk outlook does not look positive for the South African government, however there are certain positive aspects to note.

Debt maturity structure



Source: Refinitiv

As can be seen, National Treasury has been able to stagger debt maturities to avoid large repayments of capital at one go, in the near future.

Availability to financial resources

The SA government has access to a number of funding sources, which include the local bond markets, international bond listings and international funding sources, such as the IMF and World Bank to diversify their debt structures. Furthermore, as a government, there is another tool which could be made use of to avoid default, which is quantitative easing[4]. Given that the forecasted inflation rates are not expected to breach the top-end of the SARB's target range (3%-6%) in the near future, this is an option that could be applied as a last resort to default.

[4]Quantitative easing - When a Central/Reserve bank purchases government issued debt securities to inject finances into the local economy.

CONCLUSION

Considering all factors noted, one could conclude that although the returns on local government issued debt securities are attractive, the risks may similarly appear significant to justify an investment.

However, the risk factors are only contributors to one main question, "Will the SA government default on their debt obligations?"

If you are able to accept that a default event is an eventuality that the SA government simply can't afford to allow, and that National Treasury has diversified the country's high debt levels, both in maturity and source, then investing in local SA government issued bonds could indeed be an attractive risk-adjusted investment given the current returns available.

WE TAKE IT PERSONALLY.
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