Viewpoint

STRATEGIC VIEW OF RATES GOING FORWARD

TACTICAL AND STRATEGIC VIEWS CONVERGE

Although the current EM sell-off could persist in the short-term, the same fundamentals driving bonds and the rand weaker will set in motion forces that will result in a slowdown of economic growth in SA.

One such force is the market pressuring strongly for rate hikes having fully priced in three 50bps rate hikes in the coming 18 months. This is standard for this phase of the business cycle, where the economy tilts its nose into slowdown mode while price inflation accelerates. Even if the SARB does not hike interest rates, rising market rates (bank deposit rates and corporate/government bond yields) will induce recessionary forces in the economy.

There has been such strong momentum behind the fixed income market's direction that should it extend further in the short-term, this could pressure the SARB into a quick, but ultimately short-lived, rate hike cycle to save face, prevent further rand and bond blowout, and make a last-ditch attempt to quell price inflation as is unfolding in Brazil. One way or another, this economy will look to rebalance and whether it happens through a short rate hike cycle or further ZAR weakness as a result of not hiking, consumption needs to be brought back into line with production, or production must rise. The later seems unlikely in a weak growth environment. As a result, we see the rising possibility that the SARB responds (very reluctantly) to current developments with 50bps rate hike before year-end. That move need not be long-lived and should not detract from the house view that we have held for some time, namely that strategically (i.e. over the very long term) rates remain lower for many years to come.

This will set in motion bearish cyclical forces, weighing on already weak GDP growth which at current levels of 0.9% q/q annualised recorded in Q1 remains fragile. Rate cuts could quite quickly come back into realistic focus once consumption is curtailed, inflation tops out and the rise is seen as fleeting. The growth outlook would unequivocally be supportive of monetary easing of sorts. The Reserve Bank of Australia went through a similar cycle for a year from 2009-2010, after which it was forced to embark on another rate cut cycle that continues until today. Perhaps the biggest distinction between the two economies is that the Australian economy was nowhere near as imbalanced as SA's is.

STRATEGIC BOND MARKET VIEW

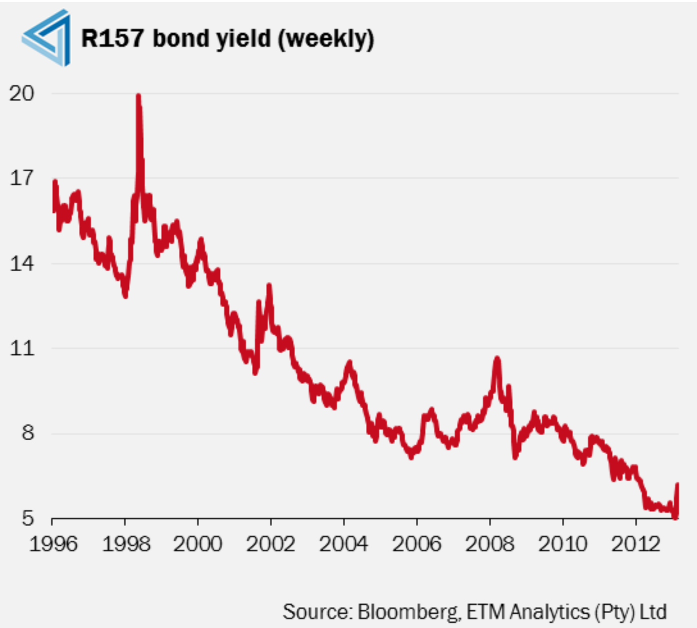
Looking through this short-term interest rate up-cycle, long-term pressure remains toward rate cuts as the wall of Fed/BoJ/BoE money continues to seek yield, and as rand weakness (and the bond correction) offers value. Even following this short-term tactical correction that has seen local bond yields rise sharply, the long-term strategic bull market is likely to remain in place until such a time that the Federal Reserve and other major global central banks genuinely remove the punchbowl by tightening monetary policy or there is a major AAA sovereign bond market crisis.

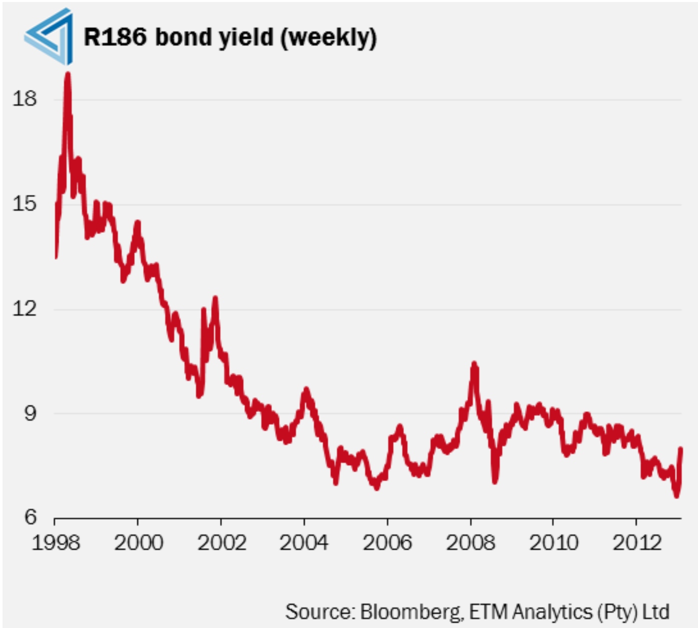
On that point, several Fed or former Fed officials have spoken of scaling back on QE. They are operating under the assumption that the US economic upturn is self-reinforcing and that the underlying momentum will be strong enough to override the effects of the sequester and tighter fiscal policy. Undoubtedly, there is a strong argument to scale back on QE simply due to the improved fiscal outlook and the fact that scaling back QE is now not only warranted but necessary so as to prevent the Fed from crowding out investors even more than they already have.

The counter argument is that US money supply growth is not performing particularly well and certainly not as well as one would expect from a recovering economy. Furthermore, the effects of QE are not contained solely to within the borders of the US. The crowding out of US fixed income funds due to the relatively expensive bonds has pushed investors down the risk curve to seek meaningful real yield elsewhere. EMs have enjoyed much of that in the past two years and it has pushed yields to levels where they contributed to the consumption culture in some of the EMs. SA is arguably one of the best examples of this helping the country generate significant imbalances in the process. The fragility and volatility of all this is plain to see and certainly not a dynamic that fosters neither economic growth nor price stability. EM economies have taken an almighty beating in the past three weeks and it has been massively destabilising both in terms of their own economic performances as well as policy. Moreover, the effects have to some degree spilled over into the Eurozone as well with peripheral bond yields steadily rising. It is fair to say that propagating the idea that the US Fed will scale back on QE, is very quickly starting to undermine the positive growth dynamics that existed a few weeks back and that more of the same will only serve to increase the pressure on EMs and on the global economy to the point where it will feed back to the US economy. The point to be made is that withdrawing QE too early could threaten the very economic recovery that the Fed has been trying to engineer and there is a good chance that the longer the current adjustments in the EM world unfold, that the Fed may think twice about scaling back this year.

Should they ultimately still press ahead with the decision to do so, we have the examples of QE1 and QE2 withdrawals to compare to. In both cases the decision to pull back on QE was short lived after some of the consequences became evident. With so many markets distorted through the actions of the Fed and other major CBs, those same central banks would need to accept that volatility and a major adjustment in the financial markets will be required. In the past, the Fed has quickly stepped back in to calm markets back down. Will this time be different?

Turning our attention back to the local market and placing this bond pullback in context it is clear that the recent sell-off is still in keeping with the longer term trends in the bond market.





After this sell-off, even with R157 and R186 yields as high as 6.60% and 8.40% respectively, yields would still be well below where they were a decade ago. It would be premature to call for an end to this long-term downtrend of local bond yields unless yields break sharply higher and rise a further 150-200bp and foreign market conditions deteriorate to such an extent that we do not foresee any more foreign inflows coming into SA. It remains too early to make that call.

FIXED INCOME VIEW

Bonds: Bond market sell-off overdone in a tactical sense and likely to spark a rotation out of equities into bonds at these yield levels. In a strategic sense, investors are likely to start adding to long domestic bond positions around present yield levels and to move out of longer-term equity allocations into overweight income funds and bond positions.

R186-R157 yield curve: Following recent curve steepening, building curve flattening positions is attractive again with the view that the looming growth slowdown will be bullish for long bonds while at the same time the market prices for SARB rate hikes. The risk that the SARB embarks on a short-term rate hike cycle should keep the R157 underperforming longer dates, supporting the flattening trend.

FRAs: We have long held the view of a risk to another rate cut in late 2013, but the velocity and degree of rand and bond weakness has led us to revise this view and we are now noting there are real risks that the SARB responds to the current state of market and economic affairs with a rate hike, possibly two. That said, the SARB will want to do everything in its power to avoid actually hiking rates so they may resort to talking tough on inflation, without actually doing anything. The risk is that FRAs are paid too high and offer value to be received lower as the business cycle turns lower.

Repo: Baseline view that repo is hiked 50bp and in the event of a ZAR closer to 11.0000/dlr possibly a second 50bp hike in a short-lived hiking cycle, with rate cuts recommencing perhaps 6-12 months after hikes. In other words, 12-18 months from now repo could easily be 5.00% but with rate hikes and cuts between now and then. This emphasises the point above about value having emerged to receive the longer end of the FRA curve and the shorter end of the swap curve.

Published by ETM Analytics (Pty) Ltd

Author:
George Glynos and Chris Becker

ETM Analytics (Pty) Ltd:
Tel: +27 11 875 8556
Web: www.etmanalytics.com
Physical Address:
Block 5, Killarney
Fourways Golf Park, Roos Street
Fourways, Johannesburg
South Africa, 2055