Investec


# SA Bond note: yields rise as SA's health of state finances expected to deteriorate

Friday 2 June 2023

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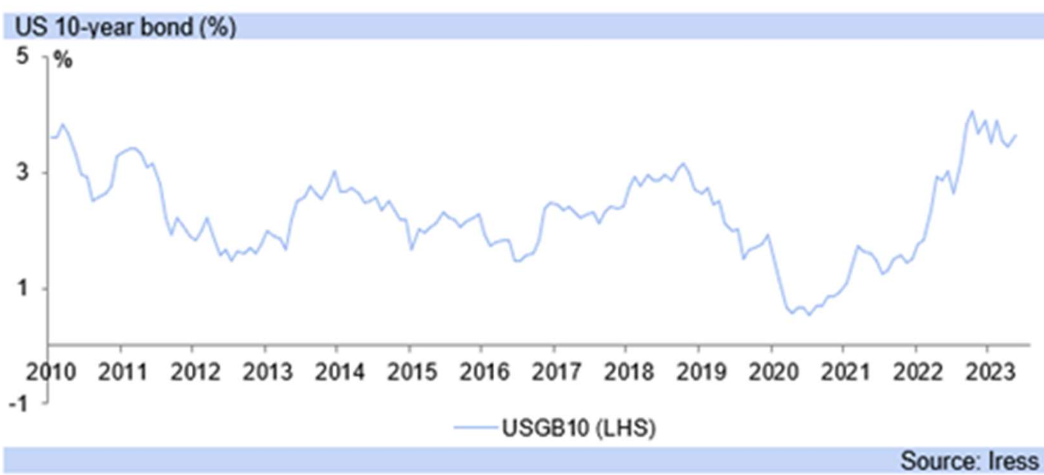



- South Africa has seen a marked deterioration in its bond yields, with the benchmark ten year government bonds seeing well over a 2.0% yield elevation since January this year, as risks are seen as skewed heavily to the downside for South Africa.
- The Reserve Bank (SARB) has warned of increased risks to financial stability, noting "capital outflows and declining market depth and liquidity" with "foreign participation in South African government bonds to 25% from 42% in the last five years".
- This is "further exacerbated by growing fiscal risk, weak demand for new issuances of SAGBs by nonresident investors and South Africa's idiosyncratic risk factors (e.g. high levels of load-shedding and the greylisting by the FATF)."
- "The steepening of the SAGB curve reflects investor concerns about fiscal risks … from above-inflation wage settlements, weakening domestic growth prospects, lower revenues due to lower commodity prices and export volumes, and contingent liabilities in the form of implicit and explicit guarantees for SOEs."
- "(N)et redemptions of marketable government debt (both foreign currency and ZAR-denominated) are estimated at around R1.7 trillion over the next seven years. This highlights the elevated refinancing risk faced by the government … as maturing government debt may possibly have to be refinanced at higher interest rates."
- High levels of electricity load shedding have decimated the economic growth outlook for this year, and so have weakened the fiscal revenue collection potential of the country, which has also negatively affected sentiment in the bond market.
- Foreign demand has weakened for new issuance of state debt, lifting yields as well, with non-residents dumping -R20.3bn worth of their SA bond holdings already so far this year, after selling -R19.6bn for the whole of 2022, both on a net of sales basis.
- The SARB adds, "South Africa's non-aligned stance in the war between Russia and Ukraine is increasingly being questioned, which may pose a future threat to the

participation of South African financial institutions in the global financial system and increases the likelihood of secondary sanctions being imposed on South Africa".

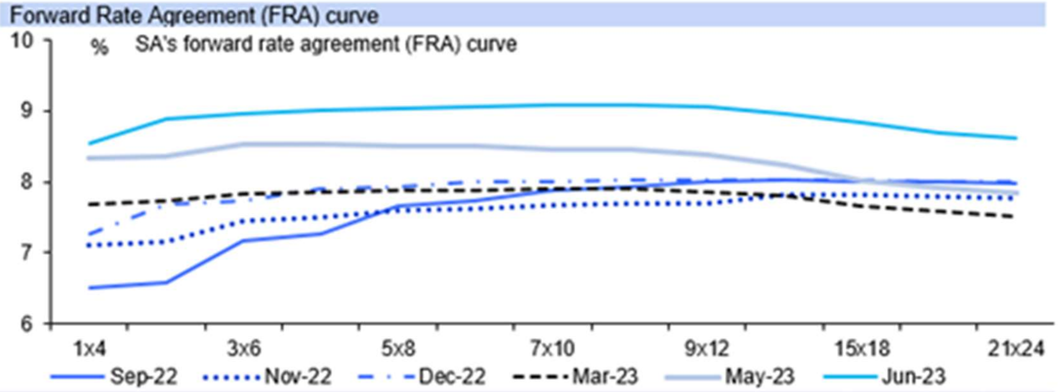
- In contrast foreigners only sold -R0.1bn worth of SA bonds (all net of purchases) in 2021, after purchasing R76.7bn in 2019. The advent of the Russian /Ukraine war in February 2022 has seen increased polarisation of geo-politics, with international financial market players displaying increased risk aversion towards SA.

Please scroll down to the second section below

| Forecasts | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| Repo Rate (year-end: %) | 7.75 | 8.25 | 8.25 | 8.25 | 8.00 | 7.50 | 7.50 | 7.00 |
| Prime Overdraft Rate (year-end: %) | 11.25 | 11.75 | 11.75 | 11.75 | 11.50 | 11.00 | 11.00 | 10.50 |

Source: Iress, Investec

Forward Rate Agreement (FRA) curve




Source: Bloomberg

- For South Africa's financial markets, economic activity and investor sentiment, the South African government is seen to be increasingly playing with fire (see yesterday's economic note of 1st June 2023) in its still close relationships with Russia, while the Western world has taken a strong stance against Russia due to the Ukraine war.

- Negative international financial market sentiment increases towards SA as it shows ongoing alliances with Russia by allowing Russian ships to dock at SA ports, conducts naval exercises with Russian and Chinese fleets and sends delagtions of South African government officials to Russia.

- The rand is the third worst performing EM (emerging market) currency against the US dollar out of a basket of twenty-two monitored by Bloomberg, weaker by -20.8% y/y, after the Turkish lira and Argentina peso.

- The SAGB has reached 12.06% this year, a massive deterioration in yield since near half that in 2013 when SA's ten year benchmark yield neared 6.0% y/y, reflecting high prices and demand versus the opposite for SA government debt to date.
- The SARB notes "(t)he proportion of SAGBs held by local investors increased to 75% in February 2023, compared to 58% in April 2018. This is a significant structural shift, especially considering the significant increase in government bonds issued during this period. It raises concerns about the capacity of South African investors to continue absorbing new issuances of SAGBs in future".
- "As local participants increasingly step in to absorb the declining appetite for new SAGB issuances by non-residents, this raises financial stability concerns regarding market liquidity, increased volatility and higher domestic government bond yields."
- "South Africa's non-investment grade status and recent greylisting by the FATF could contribute to nonresident sell-offs from local markets, with non-resident investor behaviour becoming increasingly speculative in relation to South African assets."
- We have raised the yield in our bond forecast to represent the deteriorating fiscal and economic situation SA faces, which has seen the country fall into the lite down case for this year, increasing the chance of credit rating downgrades.
- We have raised the yield forecasts, as well as weakened the rand for the lite down and severe down cases as the expected case moved into lite down case territory this year ment, with geo political choices made by our state at risk of driving even further deterioration in these metrics.

| Extreme up case Forecasts | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| SA rand bond (year-end: %) | 10.00 | 11.45 | 9.30 | 9.20 | 9.10 | 9.00 | 8.90 |
| SA rand bond (average: %) | 9.82 | 10.81 | 10.08 | 9.35 | 9.13 | 8.98 | 8.93 |

| Up case Forecasts | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| SA rand bond (year-end: %) | 10.00 | 11.45 | 10.10 | 9.70 | 9.50 | 9.50 | 9.40 |
| SA rand bond (average: %) | 9.82 | 10.81 | 10.63 | 9.85 | 9.56 | 9.55 | 9.43 |

| Expected case Forecasts | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| SA rand bond (year-end: %) | 10.00 | 11.45 | 11.50 | 11.00 | 10.10 | 10.00 | 9.90 |
| SA rand bond (average: %) | 9.82 | 10.81 | 11.58 | 10.65 | 10.25 | 10.00 | 9.93 |

| Lite down case Forecasts | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| SA rand bond (year-end: %) | 10.00 | 11.45 | 12.50 | 12.00 | 11.00 | 10.80 | 10.80 |
| SA rand bond (average: %) | 9.82 | 10.81 | 12.00 | 11.80 | 11.18 | 10.88 | 10.88 |

| Severe down case Forecasts | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|---|
| SA rand bond (year-end: %) | 10.00 | 11.45 | 13.00 | 14.00 | 13.50 | 13.00 | 12.60 |
| SA rand bond (average: %) | 9.82 | 10.81 | 13.50 | 14.10 | 13.40 | 12.55 | 12.58 |

Source: All forecast yields are of bonds traded on the stock exchange - Gov. bonds - Nominal yields: 10 years and over (Unit: % (Monthly average bond yield); Source: SARB QB (S-31) - June 2021 No. 300)

**Economic Scenarios: note updated expected and downside qualitative**

**Extreme Up case 1%**

| | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| USD/Rand (average) | 17.76 | 17.60 | 16.50 | 15.50 | 15.00 | 14.60 | 14.50 | 14.40 |
| Repo rate (end rate) | 7.75 | 7.50 | 7.25 | 7.00 | 6.50 | 6.50 | 6.25 | 6.00 |

SA economic growth very quickly rises to 3–5%, then 5-7%. Good governance, growth-creating reforms (structural constraints eradicated), strong property rights, no nationalisation or expropriation without compensation. High business confidence and fixed investment growth, substantial FDI, fiscal consolidation drives debt to low ratios of 2000s. Very subdued domestic inflation on extreme rand strength, very favourable weather conditions. Strong global growth, risk-on, commodity boom. Rapid upgrades of credit ratings to investment grade. Very short grey listing. Quick transition to renewable energy from fossil fuels.

**Up case 1%**

| | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| USD/Rand (average) | 17.76 | 18.20 | 17.40 | 17.00 | 16.90 | 17.10 | 16.90 | 16.60 |
| Repo rate (end rate) | 7.75 | 7.75 | 7.75 | 7.50 | 7.00 | 7.00 | 6.75 | 6.50 |

Economic growth lifts towards 5.0% y/y, rising business confidence and investment, structural constraints eroded, global growth strong, global financial markets risk-on. No nationalisation or expropriation without compensation. Low domestic inflation on favourable weather and global conditions, rand strength, lower inflation on increased privatisation. Credit rating upgrades on fiscal consolidation, markedly lower borrowings. Substantial transition to renewable energy away from fossil fuel usage, comprehensive measures to alleviate climate change impact on economy. Grey listed for less than eighteen months.

**Base case 46%**

| | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| USD/Rand (average) | 17.76 | 19.00 | 18.40 | 18.00 | 17.65 | 17.75 | 17.95 | 17.65 |
| Repo rate (end rate) | 7.75 | 8.25 | 8.25 | 8.25 | 8.00 | 7.50 | 7.50 | 7.00 |

Economic growth modest lifts towards 3.0% y/y on reforms, global financial market risk sentiment is neutral to positive. SA remains in the BB credit rating category bracket on fiscal consolidation (debt to GDP stabilisation). The rand stabilises, then strengthens somewhat. Inflation is impacted by weather patterns via food price inflation. A transition to renewable energy and slow move away from fossil fuel usage occurs and measures to alleviate the impact of climate change on the economy are modestly implemented. The Russian/Ukraine conflict eases. Little to no expropriation without compensation. Temporary grey listing.

**Lite (domestic) Down case 42%**

| | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| USD/Rand (average) | 17.76 | 19.70 | 20.50 | 20.90 | 20.50 | 20.00 | 19.60 | 19.00 |
| Repo rate (end rate) | 7.75 | 8.50 | 9.00 | 9.50 | 9.50 | 9.50 | 9.50 | 9.50 |

The lite down case has the same expected international environment as the base case, but the domestic environment differs. Business confidence depressed, substantial electricity and water shedding, very weak rail capacity, civil and political unrest, little investment growth, swing toward left leaning policies recession. Temporary increase in state borrowings, risk of credit rating downgrades rise, then occur later in period, but sees eventual fiscal consolidation Expropriation of private sector property is very limited and has a modestly negative impact on the economy. High inflation on unfavorable weather conditions, marked rand weakness. Little transition to renewable energy or measures to alleviate climate change. Lengthy greylisting.

**Severe down case 10%**

| | Q1.23 | Q2.23 | Q3.23 | Q4.23 | Q1.24 | Q2.24 | Q3.24 | Q4.24 |
|---|---|---|---|---|---|---|---|---|
| USD/Rand (average) | 17.76 | 20.50 | 21.60 | 22.30 | 23.00 | 23.00 | 22.80 | 23.30 |
| Repo rate (end rate) | 7.75 | 9.25 | 10.50 | 11.00 | 11.00 | 11.50 | 11.50 | 12.00 |

Lengthy global recession, global financial crisis – insufficient monetary and other support domestically and internationally. ANC/EFF coalition in 2024. Widespread, severe services load shedding, severe civil and political unrest. Government borrows from increasingly wider sources, SA rated single B from all three key agencies, eventually CCC grade, increased risk of default, sinks deeper into a debt trap. Failure to transition to renewable energy and to sufficient measures to alleviate the impact of climate change on the economy. Very high inflation on very adverse weather conditions, severe rand weakness. Full implementation of expropriation without compensation occurs (particularly for land held for speculative purposes), with a significant negative impact on the economy. SA blacklisted.

**Note:** Event risk begins Q2.23. Source: Investec