Fixed Income dynamics

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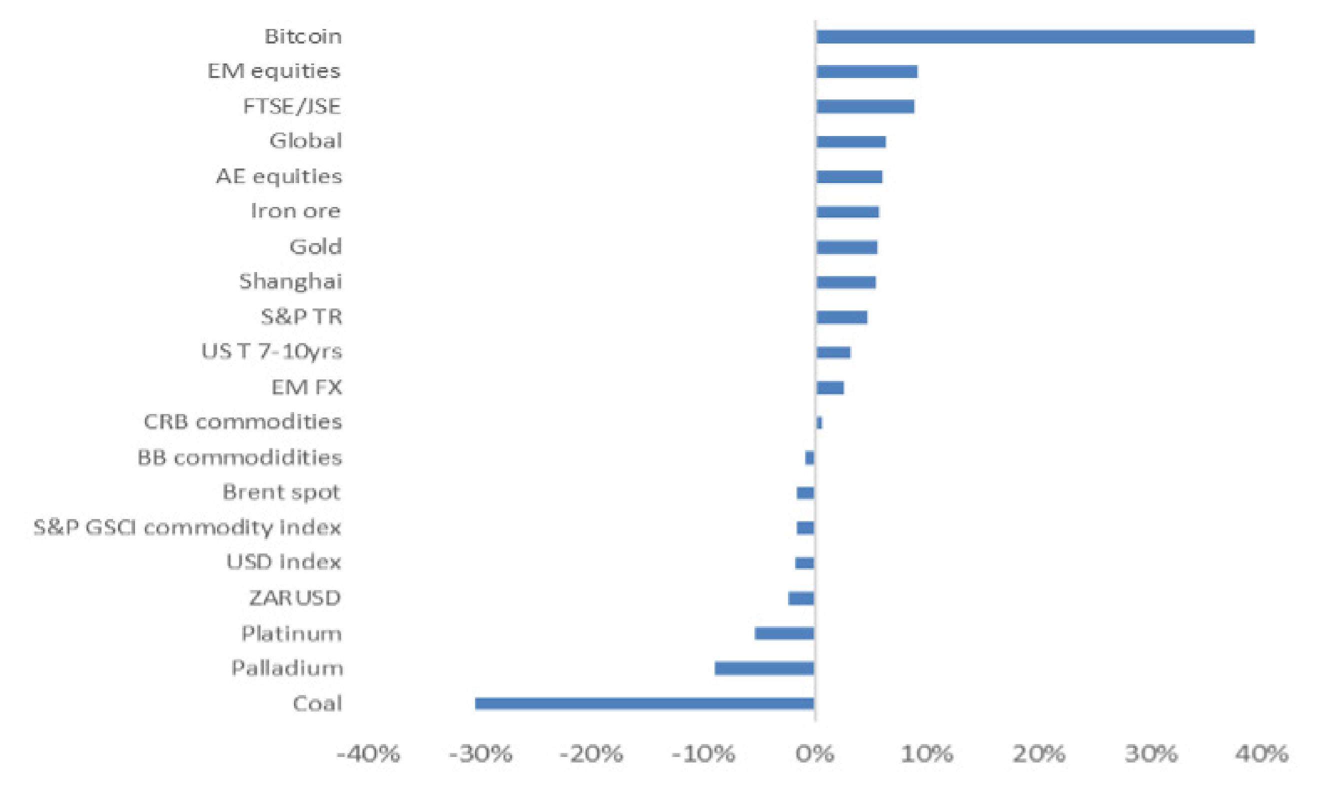
This month's report discusses the key drivers of South Africa's fixed income and FX markets in January. We reflect on the key risks in the context of current valuations, and flag February's heavy calendar of event risks. The drivers of the SAGB yield curve are analysed in the wake of the MPC's decision to dial down the pace of rate hikes, as inflation has turned the corner. Fiscal risks, however, are likely to become more pronounced in F23/24, as the growth outlook has deteriorated. We discuss dynamics around the SARB and ICIB's GDP growth forecast with reference to the impact of different stages of load shedding and Eskom diesel requirement.

International market drivers: Global macro drivers provided a strong start to the year. Expectations of an earlier pause in the Fed's rate hiking cycle, as headline inflation prints surprised on the downside, (even though the labour market remained strong), China's abrupt decision to reopen the economy, a milder winter in Europe which saw gasoline price retreat to pre-Russian invasion levels, and expectations of Europe avoiding a recession, were the main catalysts.

In its January 2023 World Economic Update, the IMF changed its outlook to "less gloomy" than in October 2022. Growth is expected to be bottoming out and inflation is declining, although core inflation forecasts have been revised higher. Global growth is forecast to slow from 3.4% in 2022 to 2.9% (P: 2.7%) in 2023 and then rebound to 3.1% in 2024. However, growth in AE will be relatively weaker, with a decline from 2.7% (P:2.4%) in 2022 to 1.2% (1.1%) and 1.4% in 2023 and 2024. Growth in China is forecast to rebound to 5.2% (P4.4%) with India seen to be a bright spot at 6.1% (4.4%). South Africa's GDP growth rates for 2022 and 2023 were revised higher to 2.6% (P: 2.1%) and 1.2% (P: 1.1%) and 1.2% in 2023, which is well above the SARB's most recent forecast of 0.3% and ICIB's 0.6%.

The macro catalysts in January caused a strong risk on rally in AE equity markets (MSCI World +6.0%) and EM equities (MSCI EM +9.2%); volatility in bond markets declined and yield curves flattened (with a deeper inversion in the US T curve bolstering the return in 7-10 yrs by 3.2%); Bitcoin surged (+38.2%) and EM FX rallied (+2.5%). Risk on sentiment, flared up in the final days of January. The catalyst was a surprise acceleration in Spain's headline CPI inflation rate to 5.8% (from 5.7%) and above consensus expectations of 5.0%, partly owing to a reweighting of the inflation basket. This triggered concern that European inflation could prove stickier, with preliminary January readings (except for Germany), published on February 1. A rise in peripheral European bond yields spilled over to the rest of the world. Added to this was a better than expected performance of the Eurozone economy in 4Q 22. Contrary to expectations of a contraction of 0.1%q/q, the region posted positive growth of 0.1%q/q (1.9% y/y). Incoming US data provided some comfort of a moderation in wage increases, as the employment cost index increased by 1.0% in 4Q22, which was below consensus expectations of 1.1% and 1.2% in the previous quarter.

Figure 1: Selective asset class global returns – January 2023



Source: Bloomberg, ICIB

The month ahead: Market dynamics in February may switch from inflation to growth, as the moderation in inflation is widely anticipated. Internationally, Central Bank meetings in the advanced economies will be the key focus. The Fed is expected to dial back on rate hikes, by raising the Fed funds rate by 25bps, whereas the ECB and BOE will continue with 50bps rate hikes, after slowing the pace of rate hikes from 75bps to 50bps at the December meetings. But the dynamic between the Fed's tolerance of easier US financial conditions and the ECB terminal rate, are sources of uncertainty. Recently, the economic surprises indices have shown a divergence between the US and Europe, as incoming data in the US such as retail sales have surprised on the downside. In China, the reopening of the economy as Chinese return from the Lunar holidays, will be closely monitored as the reopening recovery could have an uneven start.

In South Africa, the FATF announcement and government's February 2023 Budget Review are key events in the context of ongoing load shedding. Developments in dealing with the energy crisis will include a press conference by President Ramaphosa, where he is expected to announce an energy support package to households and SME's, and diesel financial for Eskom. (Eskom has approached banks for diesel financing backed by a government guarantee.)

Incoming high frequency real economic indicators such as manufacturing and mining production for December will reveal the intensification of load shedding. The merchandise trade surplus for January will provide insight into export performance, as global growth slows down, and the effect of the infrastructure crisis on local production challenges. Headline CPI inflation is anticipated to recede below 7.0% for the first time since May 2022.

FIGURE 2: KEY GLOBAL AND SA DATA/EVENTS IN FEBRUARY 2023

International		South Africa	
1/2	OPEC meeting/Global PMIs/FOMC (+25bps to 4.75%)/ BCB (unchanged at 13.75%)/ EZ headline CPI & 4Q GDP	President Ramaphosa to announce an energy support package	
2/2	ECB (+50bps to 3,0%)/BOE (+50bps to 4.0%)	9/2	SONA, US CPI
3/2	US Non-farm payrolls (+185k vs 223k) and hourly earnings (4.3% vs 4.6%)	22/2	SA CPI/Budget Review 2023
14/2	US CPI	28/3	Trade balance/private sector credit extension/tax receipts (Jan)
News flow around BoJ monetary policy, which holds implications for the JPY and financing the carry trade		FATF decision	
		Cabinet reshuffling and appointments to the Economic cluster (DMRE, DTI, Labour, Tranpsort)	
		Eskom diesel financing	
		Eskom new CEO?	

Source: Bloomberg, ICIB

Eskom's diesel requirement and GDP growth forecasts

The energy crisis is not going away any time soon, with the best case scenario currently a permanent Stage 2 or 3 status (see FIC/Many rabbits in the hat, 1 January 2023). This, however, is contingent on Eskom's ability to burn more diesel. At a January 2023 brief, Eskom provided a statistical forecast of load shedding over the next 10 months. The forecast showed that until August 2023, Stage 3 load shedding will be experienced on most days of the month, provided that diesel was burned to make up for the shortfall.

The diesel required to keep the system at Stage 3 varied from R3bn to more than R7bn in a month. The intensification in load shedding was exaggerated by issues surrounding the burning of diesel. We estimate that Eskom spent nearly R17bn on diesel by October, which is R11.1bn over and above Nersa's approval of a 2% load factor for Eskom's diesel-fired peaker stations. In F23/24, the revenue increase granted by Nersa translates into a tariff increase of 18.65%, allowing for a load factor of 6% (R8.4bn). This will clearly not be sufficient to reduce load shedding by two stages. Depending on the number of days in the year they operate the plants, these costs could be somewhere between R12bn and R18bn per year for diesel to try and have load shedding reduced.

Eskom has approached the banks for diesel financing, that will be backed by a government guarantee.

GDP growth implications: The load shedding stages hold implications for South Africa's growth outlook. A key focus point of the SARB's MPC statement last week was a material downward revision to its 2023 GDP growth forecast from 1.1% to 0.3%, and 0.7% from 1.4% in 2023. The SARB estimated that load shedding could subtract 2.0% of GDP growth in 2023, and 0.8% in 2024. This was ascribed to the associated costs with higher stages and more frequent load shedding. The number of load shedding days was revised up to 250 days from 100 days. The costs associated with Stage 3 to 6 load shedding from R204m – R900m, per day. The level of uncertainty regarding the growth outlook is high. An assumption is that investment in more back-up electricity infrastructure will be installed in 2023, which would be supportive of sector fixed investment. We have revised our GDP growth forecast from 1.0% to 0.6%. However, in a scenario of higher fixed investment, import volumes are expected to be higher amplified by higher diesel and refined oil. Hence the risk to our current account deficit forecast of 0.5% is for a higher deficit (SARB: -1.5% of GDP).

The hare, the rabbit and the tortoise hold implications for the USD – Central Bank interest rate decisions

It seems like everyone is reading Aesop's Fables these days, with Bloomberg now also using the Tortoise and Hare analogy in explaining where we are in the "Great interest rate repricing" dynamic that started in 2022.

With the US rate hiking cycle expected to peak in the next few months, after 425bps of tightening in 2022, the ECB and BOE still have more to go. The forward guidance from the Central Banks have both been that they are not yet ready to dial down on the size of the rate hikes from 50bps, after moderating the pace of rate hikes from 75bps to 50bps at the December interest rate meetings. The implied forward curves (US vs ECB see figure 3) shows a further narrowing in EUR/USD interest rate differentials in the front-end of the curve. Moreover, the 1y1y US OIS rate has started to decline in November, just as the implied terminal rate has started to consolidate at 4.90/5.0%, which in turn led to a descent in the value of the USD index.

The FOMC meetings in February and March will therefore be important in the context of the labour market that remains strong, while there has been a moderation in economic activity (housing market and retail sales). (Friday's January labour market data will be closely monitored for new jobs created, and the extent to which hourly earnings are moderating, as the vacancy rate remains an important indicator of wage pressures).

Our UK economics team flags the possibility of the first real discussions on what members would need to see from the data in terms of labour demand, spending and inflation before holding rates steady. If correct, this is likely to make for an interesting press conference. Markets are currently split between whether the Fed will hit peak rates in March or June: 58bps of rate hikes are currently pencilled in by June. Our own forecasts envisage a terminal rate of 4.75-5.00% in March, 25bps lower than the peak suggested by the FOMC in its latest economic projections. There seems to be a broad agreement however that the Fed is in its last stages of interest rate hikes in this cycle. Further guidance from Chair Powell in the press conference on when we may hit peak US rates would likely trigger some moves in markets. His comments on such are likely to be careful and well thought-out though. The minutes from the last FOMC meeting proved that the Fed is acutely aware of the communication challenge it faces as it winds down the pace of tightening. If press reports are indeed correct, we imagine that at Wednesday's press conference at 19:30 GMT Chair Powell will attempt to strike a balanced tone in which he warns markets of an upcoming policy pause, but accompanies that with a few hawkish hits to try and avoid an undue loosening in financial conditions. After all, attention is never purely just on what the Chair says, but also on the way that he says it.

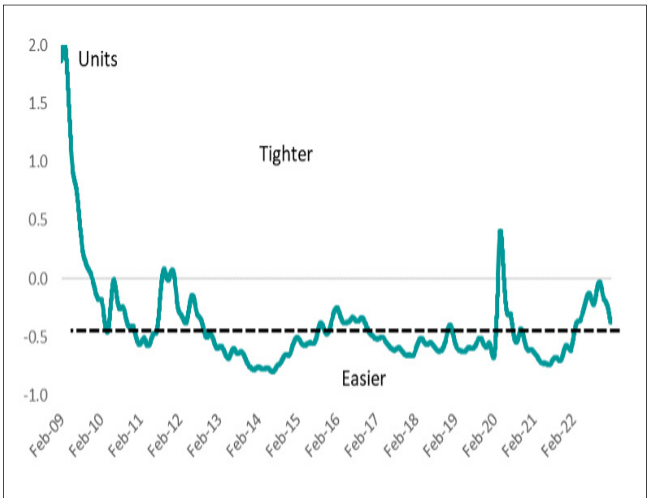
Risk: The inversion of the US yield curve as measured by the difference between 10yr and 3m T-bill rates has widened to -70bps from 14bps at end 2022. The slope of the yield curve, seen to be a leading indicator of economic activity, attaches a probability of 47% of a recession according to the New York Fed.

However, easier financial conditions could remain supportive of growth. The Fed's statement will therefore be all the more important. A more hawkish statement as opposed to signaling a pause or more data dependence, raises the risk of an upward correction in the medium term implied forward rates. And possibly reinforces a harder landing risk scenario, with implications for earnings forecasts and the direction of the USD.

Figure 3: US vs ECB implied forward rates – more narrowing in interest rate differentials ahead

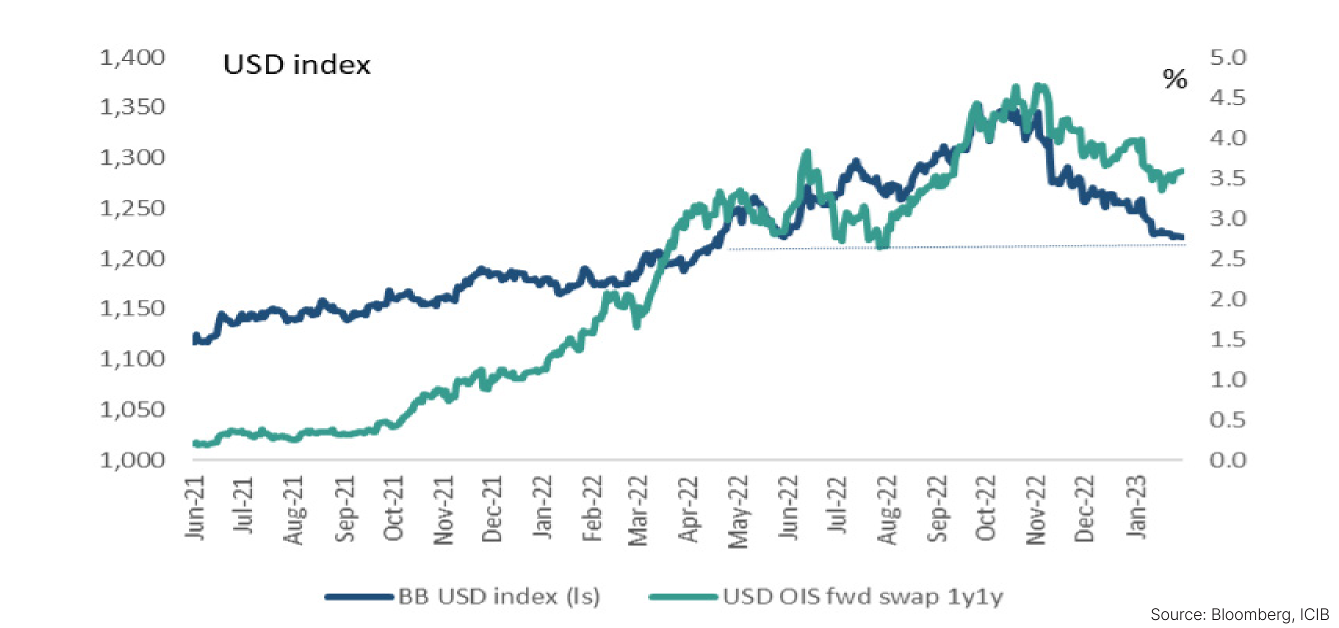
Source: Bloomberg, ICIB

Figure 4: But how dovish can the FOMC sounds when financial conditions have eased



Source: Bloomberg, ICIB

Figure 5: Market pricing in a dovish Fed: 1y1y OIS forward rates at 3.5%

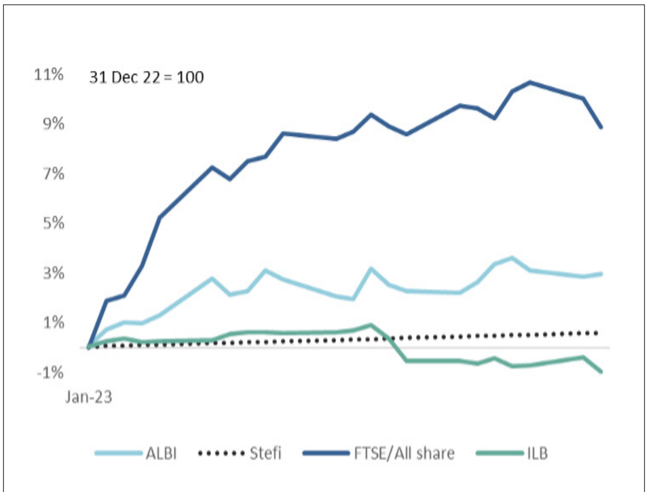


Source: Bloomberg, ICIB

FIC dynamics
January performance

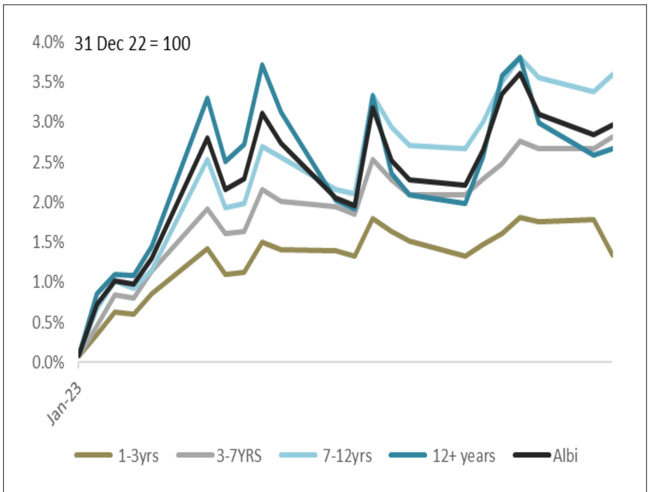
- **Money market:** The Stefi index yielded a return of 0.6%m/m in January. The money market yield curve flattened following the MPC's decision to raise the repo rate by 25bps to 7.25%. The 3m JIBAR rate increased by 21bps to 7.46%, whereas the 12m JIBAR rate declined 5bps to 8.26%. The term premium on longer dated money market rates, measured by the spread between the 3 and 12-month JIBAR rates, declined to 104bps from 143bps at end December, the lowest level since September 2021.
- **Inflation-linked bonds (ILBs):** SACPI bonds continued to under perform nominal bonds, yielding a negative return of 1.0%. Local investors opted to remain invested in SAGBS instead of SACPI, implying there is an absence of a marginal buyer. The market has become a primary market, with the secondary market only used to sell bonds. Renewable energy hedges have added further upward pressure on the SACPI market (ICIB FIC trading deesk).
- **SAGBs:** The Albi yielded a return of 2.97%. Yields declined across the maturity spectrum, led by the front-end and belly of the yield curve, as implied forward rates declined in anticipation of an earlier pause in the Fed and SARB's rate hiking cycles. The slope of the SAGB curve steepened with yields such as the R186, R2030 and R2032 declining by 62bps, 50bps and 46bps respectively. This compared to longer dated yields such as the R2040's decline of 24bps. The 7-12 year segment outperformed with a return of 3.59%, followed by the 3-7 and 12+ year segments of 2.81% and 2.67% respectively. The 1-3 year segment yielded 1.34%.

Figure 6: Financial asset performance in Jan-22: Equities >ALBI>Cash>ILBs



Source: Bloomberg, ICIB

Figure 7: ALBI: 7-12 year segment outperforms

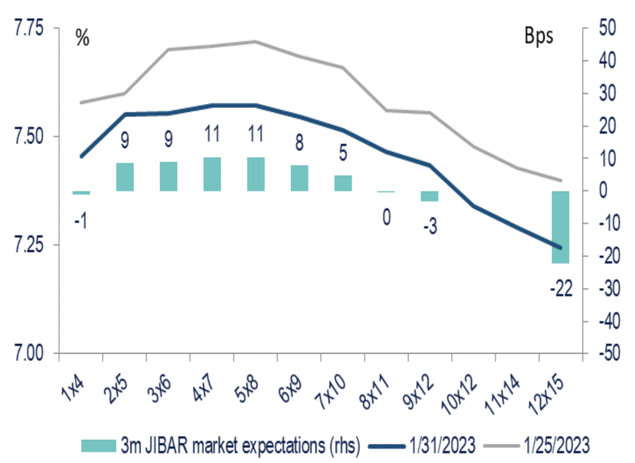


Source: Bloomberg JSE, ICIB

Drivers of the SA yield curve

- The decline in SAGB yields in January was led by the front-end of the yield curve. The repricing of SA's terminal rate expectations, from nearly 8.0% to 7.50% (9×12 FRAs) were the catalyst for the R186 yield to decline from 8.76% to 8.12% during the month. There was strong demand for the R2030s, which allowed for a wider investor base, as the bond moved into the 3-7 year segment in the November 2022 reweighting of the Albi.
- Non-residents returned to the bond market, although JSE statistics for T+3 trades showed net purchases of only R3.3bn. ICIB's trading desk noted that non-residents accumulated mostly R2030's/R2032/R2035s. A decline in volatility in AE sovereign bond yields as headline inflation started to descend, and a weaker USD index has revived the carry trade.
- The long-end of the curve was stickier, as yields on the R2040 and R214 declined by 24bps and 19bps and stayed above 11.0% (11.33% and 11.25%). This, in our view, reflects renewed fiscal concerns as National Treasury's revenue forecast for FY23/24 and F24/25 faces downside risks on weaker growth forecasts. Added to this, ICIB's trading desk flags dynamics around the carry pickup for SAGBs. Investors do not get rewarded for accumulating SAGBs beyond R2035's. The 1yr carry, assuming no further rate increases, can yield 53bp holding R2030's, 58bp holding R2035's and only 51bp holding R2048's. Speculation of a new 30yr SAGB in FY23/24, could add further supply pressure in the slope of the yield curve.
- Asset/swap spreads narrowed in the early part of January, especially in the R2030 and R2032 area of the curve. Demand remains supportive from the banks.

Figure 8: FRA curve flattens, pricing in a 40% probability of a 25bp rate hike

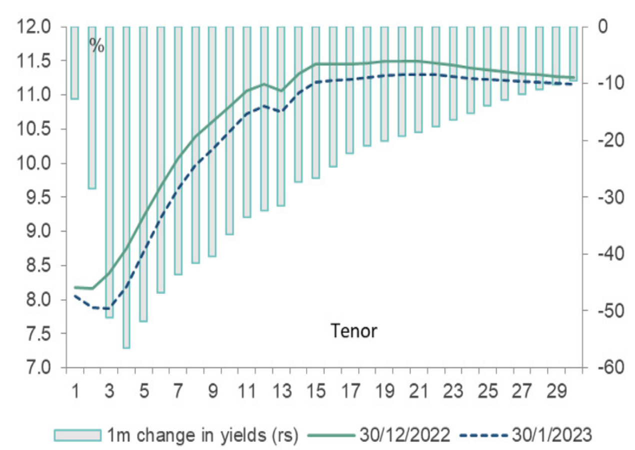


Source: Bloomberg, ICIB

Figure 9: 9×12 FRA vs R186 and R2030 – Repricing of rate expectations lead front-end of SAGB yield lower (%)

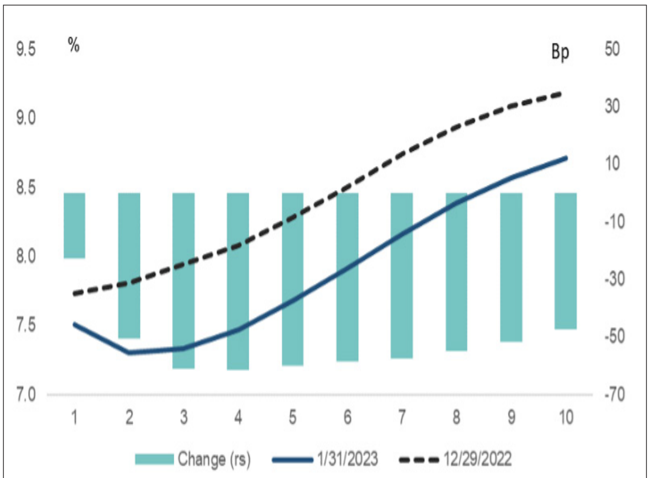
Source: Bloomberg, ICIB

Figure 10: Slope of SAGB yield curve steepens



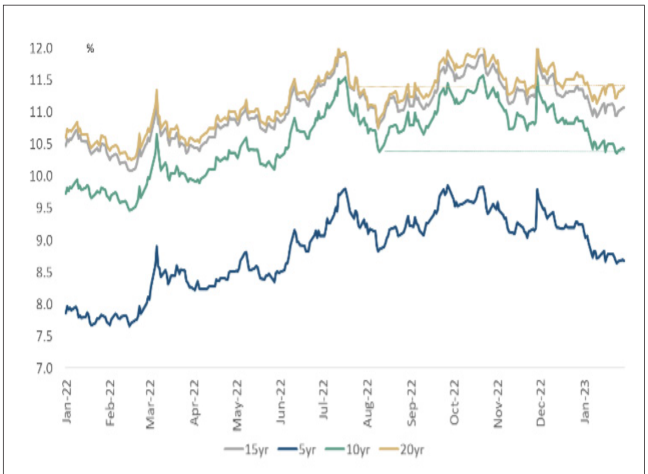
Source: Iress, ICIB

Figure 11: Swap curve flattened



Source: Bloomberg, ICIB

Figure 12: ASW narrow and then consolidates



Source: Bloomberg, ICIB

Figure 13: Non-residents small net buyers of SAGBs (Rm, 3m rolling average)

Source: Bloomberg, JSE, ICIB

SA generic 10yr yield expected to trade above our fair value estimate

The SAGB 10-year generic yield has moved from roughly 2SD away from the 24 months mean of 10.0% in December, to less than 1SD in January. In view of persistent growth and fiscal risks over the medium term, a wider fiscal premium could partially counter a compression in the inflation adjusted real yield as inflation moderates to 5.0% by mid-2023.

The February 2023 Budget Review, tabled on 22 February, holds several uncertainties regarding the revenue forecast and spending pressures. Internationally, a US recession could lead to a renewed selloff in EM currencies (with risk-off at month-end causing the rand to selloff to R17.42/$). Our fundamental fair value calculation of the generic 10-year SAGB yield for a 12 month forecast horizon shows a yield of 9.5%. This assumes a country risk premium of 3.50% (10yr CDS spread), the 10yr US Treasury yield at 3.40% (Bloomberg consensus forecasts for 4Q 23) and inflation differential of 3.5%. However, in the composition of South Africa's current 10yr bond yield, this would require a reduction in the currency risk premium.

The SA/US 10yr spread also needs to be considered. The spread has narrowed to 6.9%, which is below a two year average of 7.88% and more in line with the 2019 average of 6.86%.

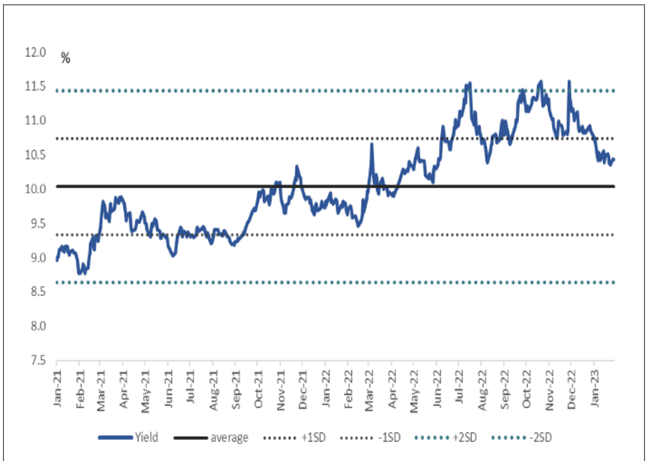
Considering these dynamics, our view is that the 10yr yield should continue to trade above our fair value, in a range of 10.0% to 10.50% in 1Q 23. The 3 – 7 year segment of the yield curve, however, should be better anchored at current levels on the assumption that short-rates have peaked. We also think that the implied forward rates could become less sensitive to movements in the rand, as upside inflation surprises in the context of the disinflationary trend, which could lead to the SARB staying on hold for longer, rather than hiking interest rates.

FIGURE 14: INTEREST RATE FORECAST (%)

CPI inflation	Current	March'23	June'23	Dec'23
Quarter-end, % y/y	7.2	6.6	5.2	5.0
Interest rates (%)				
Repro rate	7.25	7.25	7.25	7.25
3m JIBAR	7.46	7.46	7.25	7.25
10y	10.4	10.3	10.0	9.9
20y	11.38	11.1	11	10.7

Source: ICIB

Figure 15: Generic 10yr SAGB yield has return to within 1SD of the two year mean of 10% (sub-IG grade period vs 2SD of 9.64% mean 2019-t-d)



Source: Bloomberg, ICIB

Figure 16: But the SA/US 10yr sovereign spread is back at 2019 levels

Source: Bloomberg, ICIB