

# INVESTMENT NOTE

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## RAND SHEDDING AND RESTRICTIVE INTEREST RATES



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On top of everything else, South Africa is now also in the grips of a serious interest rate squeeze. Interest rates have not only risen sharply since the start of the year in absolute terms, but also relative to what was expected.

There are many different interest rates in a sophisticated economy since there are many borrowers with unique credit profiles and loan horizons. A poorer quality borrower will generally pay more, and longer-term loans or bonds will have higher rates to compensate for the greater uncertainty into the far future.

The two most important rates are normally the central bank's short-term policy interest rate, which acts as the base from which bank loans are priced and also the government long-bond yield (usually the 10-year yield), which is a benchmark for all bond market activity. In other words, the one key rate (or set of rates) is set deliberately by the central bank, while the other important rate is set by the market. The distinction is important, but the market will also always keep an eye on what the central bank does and vice versa.

### RESTRICTIVE

Let's start with the first, the central bank policy rate. Despite a bigger-than-expected decline in the April inflation rate to 6.8% year-on-year from 7.1%, the SA Reserve Bank's Monetary Policy Committee raised the repo rate by 50 basis points to 8.25% in a unanimous decision. It was 7% at the start of the year and 3.5% at the bottom of the cycle. The sharp increase from the Covid lows is one of the fastest since the early 1980s, repeating a pattern that we've seen across the world.

For the first time, the MPC statement acknowledges that policy is now in "restrictive" territory.

Unlike the rest of the world, or at least the developed countries, South Africa does not have a demand-led inflation problem. The economy is simply too weak for that. Most of the inflation shock has come from supply side pressures, namely food and fuel prices, and to the extent that firms pass on the cost of running generators, due to load shedding. Higher interest rates



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cannot address supply constraints. All it can do is prevent firms from passing on higher input costs by weakening what little demand remains left. This so-called second round impact of higher input costs is what the Reserve Bank is particularly concerned about.

The same goes for a weaker currency, which has emerged in the past few weeks as a major risk factor. The Reserve Bank can ignore a weaker currency if it thinks the effects will be temporary, but when there are concerns that businesses will push up prices because of the weaker rand, it acts. Over time, this passthrough from rand weakness to inflation has declined, partly due to falling global goods prices. However, when the rand's depreciation becomes front-page news, businesses often believe they have an opportunity to raise prices, because they can blame the exchange rate and customers will accept it.

This is also a pattern that is drawing increased scrutiny globally. The more inflation is front-page news, the more companies have opportunities to raise prices and blame general inflationary conditions, the war in Ukraine or Covid-related disruptions. There is even a term for it, "greedflation". But it is not just companies, central banks are also worried about wage growth in the context of low unemployment in rich countries, as higher incomes support spending growth, which puts sustained upward pressure on prices. Despite high unemployment in South Africa, the Reserve

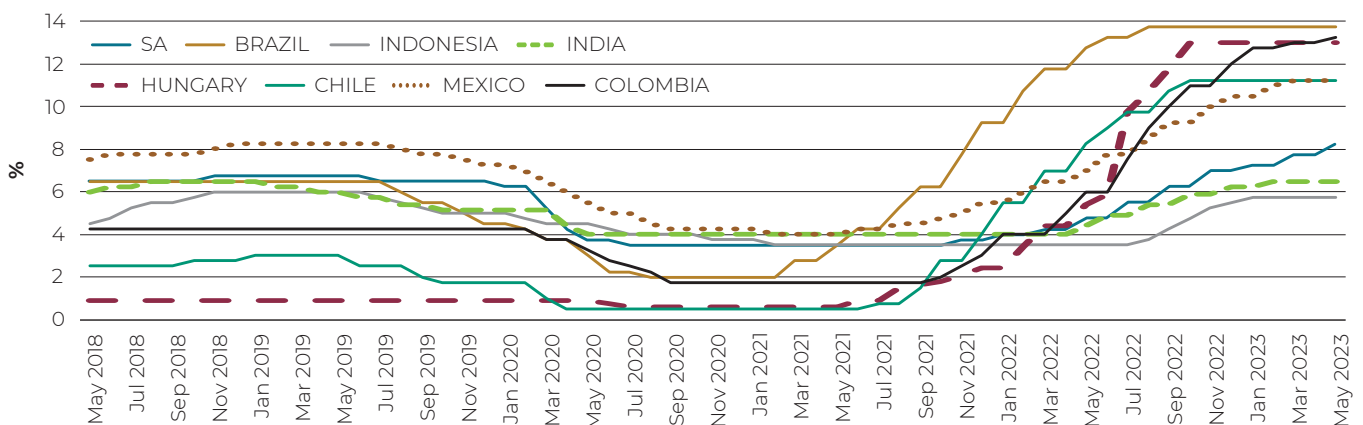
Bank specifically noted its concern with rising average salaries.

Having said all that, what is notable about the Reserve Bank's decision is that its own inflation forecasts have not changed dramatically. Inflation is still likely to decline steadily in coming months as food inflation stabilises and the lower global oil price reflects in the numbers. This highlights the Reserve Bank's fear of a further disorderly depreciation in the rand.

By hiking rates further, the Reserve Bank can squeeze out the ability of firms to raise prices by further dampening consumer demand, but it can also directly affect the exchange rate by increasing its carry, the interest foreign buyers can earn on rands. The Bank rarely if ever acknowledges that it is trying to prop up the rand. The language is all about inflation, second-round effects and expectations, but the currency is certainly part of the thinking as is evident from past rate decisions. Therefore, if the rand doesn't stabilise – it fell further after the announcement – further rate hikes cannot be ruled out.

Unusually, South African policy rates have fallen behind the peer group as chart 1 shows. We were among the highest in 2019 but are only middle of the pack today. On a relative interest rate basis, it has been more attractive for foreigners to buy the Brazilian real or Mexican peso. The latest hike moves us closer to the front range of the pack.

**CHART 1: EM POLICY INTEREST RATES %**



Source: Refinitiv Datastream

## RAND SHEDDING

The main reason behind the rand's weakness is of course load shedding, but the US dollar has also rebounded since the start of May. There also seems to be a growing concern that the government's domestic policy incoherence is spilling over to the foreign policy sphere, with negative

implications for the country's ability to attract long-term investment.

This brings us to the other set of important interest rates: the government bond market. South African government bonds have long traded at a discount to peer countries (i.e.

have higher yields) because of concerns over government debt levels, or more particularly, the government's interest burden. South African government debt is equal to around 70% of national income, which is not terribly high in absolute terms, but spending 4% of national income on interest payments is. The real predicament is that the more the market worries about the sustainability of this number, the more the yields rise. This means the government will end up spending even more on interest payments and less on other important areas.

The more the yields rise, the more the government must compensate by cutting spending, not only to make the numbers add up, but also to convince the market that the numbers will add up. But with an election looming next year, the market is worried about spending discipline.

It is a different story if the economy grows strongly, and tax revenues overshoot expectations. This is what happened during the short-lived 2021 and 2022 commodity price boom. But as the electricity supply outlook has deteriorated in recent months and economic growth forecasts are slashed, tax revenues are likely to fall short of the Budget projections.

The market response has been brutal. South African long-bond yields are now trading at levels approaching those of the global Covid-panic of early 2020, reflecting the fear of a similar shutdown of the economy. In other words, the market is pricing in something like sustained stage 8 load shedding or even grid collapse. This is probably an overreaction, and if we can get through winter relatively unscathed, the bonds are likely to calm down. The global climate will also be crucial, as it always is.

**CHART 2: SOUTH AFRICAN 10-YEAR GOVERNMENT BOND YIELD, %**



Source: Refinitiv Datastream

Therefore, we should not panic about a debt-interest rate spiral yet, but it depends on how quickly things stabilise. Treasury deliberately maintains a long maturity profile, meaning that most bonds mature years from now, minimising the risk that they are rolled over when funding conditions tighten and interest rates spike. New borrowing does have to take place at the current rates, however.

This is where the Reserve Bank comes in. The simple reality is that the more fiscal policy lacks credibility, the more monetary policy must overcompensate. It is therefore important that South Africa has an independent central bank that is prepared to take the politically unpopular step of raising interest in defence of the long-term economic and financial stability of the country.

We can quibble with the Reserve Bank's decision-making – everyone makes mistakes like we all do – but there is no questioning that it strongly believes it is doing the right thing for the country and that the short-term pain will be worth the long-term gain. We have seen time and time again how badly things go wrong when central banks become politicised and lose credibility. Turkey and Argentina are two current examples. Turkey's annual inflation rate is 43% today but was as high as 85% in October last year. And it experienced inflation rates above 100% in the 1990s. Argentina's inflation rate is currently running in triple digits and hit four digits in 1990. That hurts the poor much, much more than higher interest rates will ever do, and is politically, socially, and economically destabilising.

## CURVE BALLS

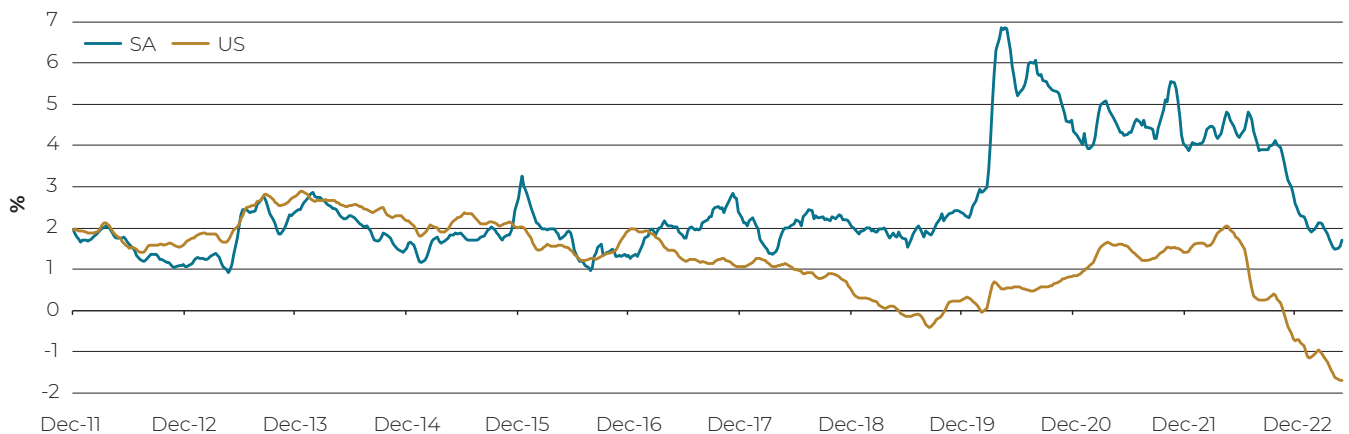
How should we think about this from a portfolio point of view? Different interest rates at different maturities can be compared in a yield curve, and investors can choose where they want to position themselves on that curve given the inflation and growth outlook and what is available in other asset classes and countries.

Contrasting the US yield curve with the South African version is instructive. In the US, the Federal Reserve has also aggressively jacked up its policy rate. Short-term yields have risen in sympathy. Long-bond yields have not risen nearly as much, therefore pricing in that rates will decline in the years ahead. When short yields rise above long yields, the curve is said to be inverted. This is typically seen as a recession

indicator – and has a good track record predicting recessions – since the high near-term yields will squeeze the economy, forcing rate cuts down the line. An inverted yield curve can also impact bank lending by squeezing bank profits. This is because banks typically borrow short (including deposits) and lend long (including mortgages). Nonetheless, the inversion does not cause the recession, it just signals that the bond market expects one. There is normally quite a lag between inversion and economic contraction.

Comparing US 3-month and 10-year bond yields, a common yield curve measure, shows the deepest inversion since 1980. It is flashing red as a recession warning.

**CHART 3: 10-YEAR MINUS 3-MONTH BOND YIELDS, %**



Source: Refinitiv Datastream

In contrast, the South African yield curve remains steep with long yields higher than short yields, but not nearly as steep as during the Covid crash. This steepness does not indicate that the economic outlook is healthy, which is what a positive yield curve slope normally shows. Rather, it is because a massive fiscal risk premium is built into longer-term bond yields, and indirectly also in the short end of the curve.

Since bond prices move in the opposite direction to yields, SA bonds have suffered substantial capital losses this year. But given that the Reserve Bank remains determined to keep inflation under control, long-bond yields offer incredibly attractive real yields of 6% or 7%. These are equity-like potential returns, but also comes with equity-like volatility

at times. Investing in long bonds therefore requires equity-like patience these days. Remember that when yields are this high, the interest income can compensate for negative price movements.

The good news is that higher short-term interest rates present better opportunities for investors seeking low volatility returns or high levels of current income. Money market and income funds, and guaranteed annuities are all offering attractive yields, especially considering that inflation has peaked and should gradually decline in the months ahead – and stay in check over time. For borrowers, unfortunately, higher interest rates across the curve are negative and will continue to put pressure on an already beleaguered local economy.

## EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 828.0	-0.53%	-0.28%	8.64%	3.06%
United States	S&P 500	US\$	4 205.0	0.31%	0.86%	9.51%	3.62%
Europe	MSCI Europe	US\$	1 891.0	-2.32%	-4.11%	9.18%	5.88%
Britain	FTSE 100	US\$	9 419.0	-2.42%	-4.77%	4.48%	-1.25%
Germany	DAX	US\$	1 514.0	-2.57%	-2.57%	11.78%	9.00%
Japan	Nikkei 225	US\$	219.9	-1.60%	3.87%	10.47%	5.03%
Emerging Markets	MSCI Emerging Markets	US\$	973.0	-0.41%	-0.41%	1.78%	-4.89%
Brazil	MSCI Brazil	US\$	1 500.0	-0.13%	5.49%	2.81%	-13.54%
China	MSCI China	US\$	59.7	-3.52%	-5.94%	-6.66%	-7.61%
India	MSCI India	US\$	770.9	2.37%	2.78%	-0.02%	4.60%
South Africa	MSCI South Africa	US\$	365.0	-2.93%	-12.47%	-13.30%	-19.25%

## EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	76 590.0	-2.03%	-2.08%	4.85%	10.23%
All Share	All Share (Total Return)	Rand	13 218.0	-2.00%	-1.98%	6.56%	14.89%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	31 131.8	-1.94%	-4.49%	1.20%	6.51%
TOP 40/Large Caps	Top 40	Rand	12 227.0	-2.17%	-1.55%	8.24%	17.71%
Mid Caps	Mid Cap	Rand	19 222.0	-1.31%	-5.91%	-3.21%	-0.30%
Small Companies	Small Cap	Rand	28 661.0	-0.98%	-5.14%	-2.44%	2.72%
Resources	Resource 20	Rand	5 590.4	-2.79%	-2.26%	-2.68%	-6.71%
Industrials	Industrial 25	Rand	22 445.0	-1.96%	0.32%	18.55%	44.62%
Financials	Financial 15	Rand	10 295.0	-1.33%	-6.39%	-2.87%	-2.19%
Listed Property	SA Listed Property	Rand	1 597.1	-0.93%	-5.66%	-5.61%	1.99%

## FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	76.4	-1.26%	-3.20%	-0.75%	-8.84%

## FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	841.3	0.71%	-4.01%	-1.89%	0.77%
Government Bonds	BESA GOVI	Rand	829.1	0.71%	-4.03%	-1.93%	0.67%
Inflation Linked Bonds	BESA CILI	Rand	323.7	0.59%	-2.08%	-0.76%	-0.13%
Cash	STEFI Composite	Rand	522.3	0.15%	0.58%	2.94%	6.45%

## COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	77.0	1.81%	-3.81%	-10.52%	-34.23%
Gold	Gold Spot	US\$	1 947.0	-1.57%	-2.16%	6.74%	5.36%
Platinum	Platinum Spot	US\$	1 022.0	-3.86%	-4.84%	-4.75%	7.81%

## CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	19.66	-1.08%	-6.99%	-13.39%	-20.15%
ZAR/Pound	ZAR/GBP	Rand	24.28	-0.29%	-5.35%	-15.20%	-18.41%
ZAR/Euro	ZAR/EUR	Rand	21.09	-0.32%	-4.45%	-13.60%	-20.05%
Dollar/Euro	USD/EUR	US\$	1.07	0.93%	2.99%	0.00%	0.00%
Dollar/Pound	USD/GBP	US\$	1.23	0.77%	2.03%	-2.02%	2.03%
Dollar/Yen	USD/JPY	US\$	0.01	1.98%	3.15%	7.26%	10.65%

Source: I-Net, figures as at 26 May 2023

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