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Can South African bonds continue to deliver good returns?

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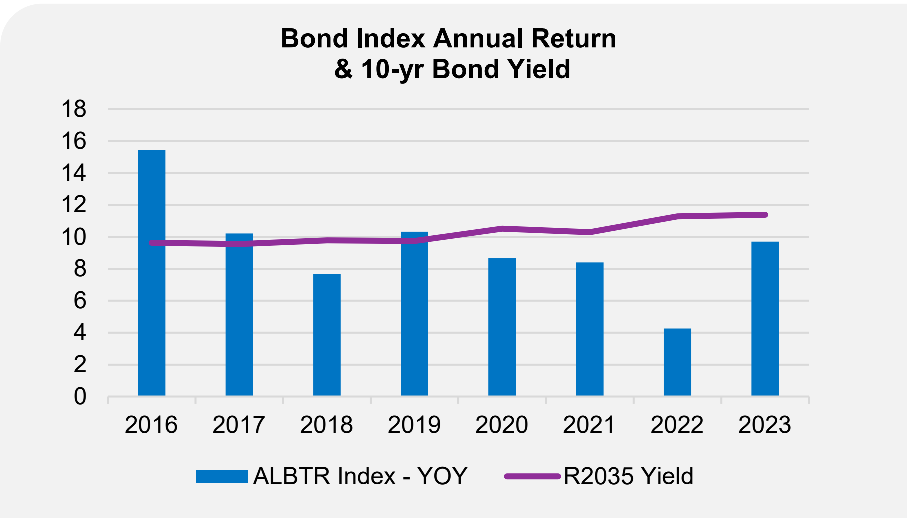
At the end of September 2024, South African bonds as represented by the JSE All Bond Index had delivered 16.74% on a year-to-date basis and a remarkable 26.17% over twelve months. These numbers are even more impressive considering that up to the end of May 2024, bonds were trailing cash returns. Indeed, in the first five months of the year local cash was the best performing major asset class. So, where to from here?

It is important to recognise that these good returns from South African bonds, are nothing more than “payback” for poor or low returns over the last couple of years. From the chart below we can see that the total return on the JSE All Bond Index was lower than the prevailing yield on bonds. To this end, bond investors “experienced” capital losses, and the reason bonds experienced positive returns at all was due to income or coupons to investors.

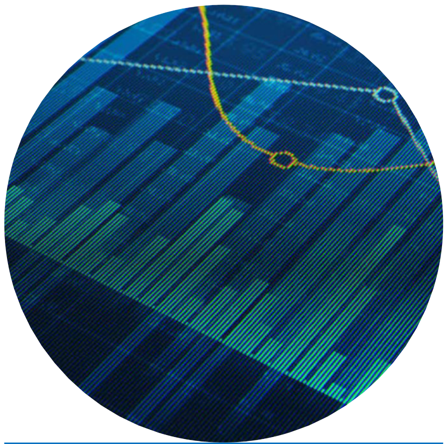


In the short to medium term local bonds will be driven by several factors including the inflation outlook, geopolitics and local growth prospects. Starting with inflation outlook - the decrease in the rate of inflation experienced over the last twelve months has been driven by lower oil and energy prices and the normalisation of supply chains post Covid.

The aggressive monetary policy response to high Covid inflation resulted in very restrictive real monetary policy rates, suggesting that there is scope to ease policy. While the central bankers have pushed against market expectations, there is nonetheless scope for policy to ease further both in the developed markets and locally by cutting interest rates. Following a 0.25% rate cut on 21 November 2024, the local market is expecting another rate cut of 0.25% for the remainder of the cutting cycle. Further monetary policy easing will support bond yields. In the US, the market is pricing another 0.95% of easing to the end of 2026 for targeting an interest rate of 3.8%, which should it be delivered, will create space for the SARB to ease further if inflation is well behaved.

On the 5th of November, Americans went the polls to elect a new president. In the weeks before the election, the race tightened. Of concern for investors was that neither candidate was talking about reducing the budget deficit, which is currently around 6%, with each party's economic plans expected to make deficits wider. Donald Trump's win and his plans to increase trade tariffs may see inflation increase significantly. The dollar is likely to strengthen with US bond yields rising, consequently impacting bond yields in South Africa and emerging markets. The Israeli war in the middle-east also poses upside risk to bonds via the oil inflation channel.

South Africa has experienced low economic growth since the Global Financial Crises of 2008. Government responded to the slowdown by increasing spending in the hope that a looser fiscal policy would spur growth. However, this only resulted in higher debt levels. The problem was made worse by governments response to the Covid pandemic, which saw debt levels rise further. Attempts to raise tax revenues via tax increases have gone as expected, suggesting that taxes are already too high. On paper debt levels of 75% to GDP are not inherently a problem, however, the challenge for South Africa is that the cost of debt far exceeds the rate of economic growth, indicating that the debt problem is getting worse. High debt levels and budget deficits leaves little wiggle room for National Treasury to respond to negative shocks. Post the Medium-Term Budget Policy Statement the Finance Minister was quoted as saying that the "country has a growth problem". That is to say, only through higher economic growth which delivers higher revenues for the fiscus, can the country's finances be put on a sustainable path.



Despite the risks mentioned above, South African bonds still offer value. Going forward, it is unlikely that returns from South African bonds will be of the same magnitude as the past twelve months. With inflation largely under control, the SARB will have scope to cut policy rates over time. We are likely to see more pragmatic and less ideologically driven policies now that the Government of National Unity (GNU) has made delivering growth its number one priority. Commitment to reforms and a more business-friendly environment should improve sentiment and make investors demand a lower discount on South African assets. For now, the market has given the GNU the benefit of the doubt. With the exception of any external shocks to the system, South African bonds are likely to deliver high single- or double-digit returns over the next twelve months, albeit lower than returns experienced during the past year.