For professional Advisors only

THE DILEMMA OF MISPRICING IN THE FIXED INTEREST MARKET

A multitude of factors has driven the SA Fixed Interest markets into unfamiliar territory for most local investors in March. The global outbreak of COVID-19, has resulted in broad scale country lock-down actions engineered by world governments – severely impacting all markets and economies. This turbulence has caused global and local investors alike to sell all liquid risk assets (any asset that is not risk free), which at one stage in March even meant a sell-off in US Treasury Bonds and Gold, the so-called 'safe haven' assets. Combine these factors with an expectation of similar economic headwinds for emerging markets coupled with the SA Debt Downgrade at the end of March and we experienced a R63 billion outflow from SA Fixed Interest markets as global investors sold our Government Bonds.

One should appreciate that SA Fixed Interest Funds were the beneficiaries of a large amount of inflows as the ailing SA economy over the past 6 years experienced lower company earnings and a fall in many share prices. These inflows found their way into a combination of local Fixed Interest Funds. All markets work well in normal circumstances when there are similar numbers of buyers and sellers. The debt downgrade and investor nerves have produced more sellers than buyers which has the effect of pushing interest rates higher.

In local Fixed Interest Funds, when sellers appear, it means that they sell their most liquid instrument, especially when there are fewer buyers for longer dated assets. On one particular Monday in March, representatives of large local and global banks were not willing to price SA Government Bonds due to the market imbalances. The mark-to-market yields of long-dated SA Government Bonds spiked to 13% at one stage. The South African Reserve Bank (SARB) intervened two days later and started purchasing SA Government Bonds from the market - effectively 'printing money' to affect these purchases. Two days later Moody's finally downgraded SA Debt to below investment grade! Now, one would expect a negative market reaction the following Monday, but sometimes investors sell on the 'rumour' and buy on the 'fact' and SA Bond yields retreated lower as buyers entered the market again attracted by the higher yields.

SA 10 Year Government Bond Yield

Source: Bloomberg

Now why would these actions cause negative price action in Flexible Income Funds?

Most Flexible Income Funds aim to outperform a cash plus type mandate or a CPI plus benchmark over a 12 to 24 month period. That means they mainly buy assets with a longer duration than money market instruments (money market instruments can only have a maximum duration of 90 days and reset as interest rates move up or down). These Flexible Income Funds can include several income generating assets including Corporate Credit or Inflation Linked Bonds, Local Bank Credit, Property, SA Government Bonds and even US Dollar denominated credit of SA or local corporates.

When the market is flooded with buyers, the prices of these assets go up, especially when yields reduce due to either high demand or interest rate cuts by the SARB. As soon as the conditions change and we have more sellers than buyers in credit markets, yields spike higher and the capital price of these longer duration assets reduces due to the inverse relationship of bond yields to bond prices.

Inverse relationship of bond yields and prices

The best way to explain this is: imagine you hold a bond with a yield of 10% with a duration to maturity of 10 years. As demand changes, the capital price of your bond fluctuates. Now imagine you want to or must sell this bond…

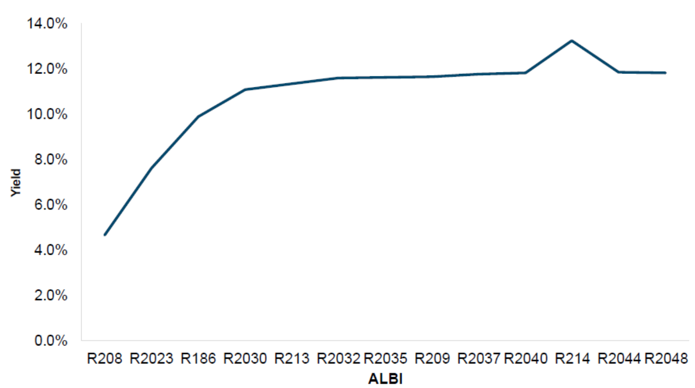
One scenario is where there is demand for this bond – or as interest rates fall. In this scenario the yield of 10% appears to be attractive: the yield – for example, now trades at 9%. To calculate your gain to sell this bond, one needs to know the duration of a bond. In this case it is 10 years, and a rule of thumb dictates a 10% gain.

The alternative scenario is different! Due to the global risk-off scenario, investors started selling more fixed interest assets which included SA Bonds. The fact that we were expected to be downgraded by Moody's simply exacerbated the situation which caused investors to sell R63 billion of bonds in March alone. That meant that the yield spiked up and in the example of your 10% bond, the yield spiked up by, say, 1%. This now means a capital price loss of 10% if you sell it. It is important to understand that it is not a permanent loss of capital if you do not sell the bond and elect to hold the bond to maturity in 10 years which is what most fund managers do. Based on the expectation that the bond issuer is in the position to pay you your capital and interest (10%) over 10 years, you will receive your capital and income over the 10-year term.

So, why did the prices of Flexible Income managers fall between 2-5% in March?

The extent of the price fall simply depends on the nature of the assets the Fund Manager held and the duration of these assets. If they held a short duration asset, the capital price movement is less severe relative to a fund that holds longer duration assets.

SA Fixed Coupon Bond Yield Curve



Source: Prescient

Does this price decline mean a permanent loss of capital?

Usually not, as the fund manager is unlikely to sell and more likely to hold onto the bond. Permanent loss of capital occurs if the investor sells out of the Fund.

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Apparently, SA Bonds will be sold by World Government Bond Index (WGBI) holders only at the end of April. Does that mean we can expect higher yields or more price action?

We can expect between US$ 1.5 billion to US$ 2 billion of SA Government Bonds to be sold by the end of April, but we can also assume that there may be an equivalent number of buyers due to our high and attractive yields. That said, it is only speculation! Much selling has already occurred, so it is difficult to estimate how much more still needs to be done.

It is important to know that the exposure most of the large Flexible Income Funds have to long-dated Government Debt is low and in some cases zero (as their mandates do not allow it in some cases). This means that there is no need for investors to panic due to this temporary price action as we can expect the markets to normalise at some stage in the future and these temporary losses can quickly turn into capital gains. It is also important to understand that the yields available from these Flexible Income Managers vary between 7.5% and 10% - depending on the nature of the assets they hold.

Are there Income Funds that have less credit/duration risk?

Most Income Funds will have some exposure to SA Corporate Credit. This market does not include Government Credit or credit from the four large banks – ABSA, FirstRand Bank, Nedbank and Standard Bank.

Currently the SA Corporate Credit market is frozen, this is due to numerous factors:

- There is a lack of buyers and sellers in the market
- Foreigner have little exposure to this market
- The rush of sellers to sell all risk assets, resulting in the most liquid instruments (i.e. higher rated credit) being sold first
- Current economic uncertainty impacting corporate balance sheets and companies' abilities to service the interest and honor the capital promise at maturity (some SA REITs come to mind)

Due to there being no market makers (buyers and sellers) in the SA Corporate Credit market the prices of these counters are not adjusted within the funds that hold it. This means that most Income/Flexible Income Funds that hold any percentage of corporate credit are exposed to the current price anomalies in the SA Corporate Credit market.

We know that the regulator has been informed of this situation, but we do not know what to expect. A similar situation arose in the past where *Edcon* (a large retail group) debt was involved. The landlords of Edcon stores, Edgars and Jet amongst others agreed to a price adjustment to accommodate the potential of a debt default by the issuer. In the current environment it is a broad-based phenomenon and it is anybody's guess as to what could happen to the pricing of corporate credit in the next couple of weeks or months.

Something to be mindful of is that Income Funds with a large exposure to short duration assets may appear to be stable and currently outperforming their peers with a large exposure to longer duration assets. But due to the pricing anomalies in the SA Corporate Credit market this may not reflect the true state of the funds with exposure to shorter duration assets.

It is important to establish the amount of corporate credit a Flexible Income, Income and Money Market Fund holds to ascertain the potential future price/default/liquidity risk the fund may be exposed to. It is also important to understand how a fund is positioned along the yield curve to ascertain the risks and opportunities at a fund level.

The standard comment from Flexible Income Managers will be as follows: 'Although the capital value of the Fund is marked down somewhat, we do not foresee any credit defaults of the instruments we hold resulting in permanent losses and in fact, we expect a strong recovery once markets normalise. It is reassuring that the income yields remained relatively stable' and there is nothing wrong with this response.

But ideally one also needs to ascertain if the fund holds any corporate credit and if the manager used the spike in yields as an opportunity to lock in 'higher' yields for future potential benefit?

It may be a storm in a teacup, but liquidity risks can translate into potential default risk, if not addressed. It appears critical for the SARB and the regulator to become involved to address these short-term anomalies. Our economic destination and that of SA Capital Markets will be influenced by the next steps of the regulator, the SARB, SA Government and foreign/ local capital market investors.

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Conclusion

The SA Fixed Interest market is experiencing a perfect storm. A multitude of factors (SA Economy/SA debt downgrade/COVID-19/liquidity demand) has caused a spike in SA debt market yields. This has resulted in temporarily lower prices of all fixed income assets with longer duration.

Investors need to be prepared to face ongoing volatility in the price action of SA Fixed Interest markets during this period of uncertainty and nervousness. Investment professionals need to ascertain the extent of the risks associated within each fund in their client portfolios to ensure that the client's risk appetite, and term horizon are matched appropriately. Be careful not to overreact to the current market turmoil and switch all assets to a Money Market Fund. Fixed Income managers are well aware of these factors and will be highly averse to incurring permanent losses of capital especially when holding on to the temporarily depressed instrument means a high rate of interest for the investor.

It can lead to either:

- Locking-in the (potentially temporary) loss,
- Re-investment risk if interest rates get cut while risk assets become more attractive when COVID-19 factors stabilise.

Be safe and careful out there.

Roeloff Horne
Head of Portfolio Management (SA)

www.mitonoptimal.com