Peak rates benefit domestic assets, but will SA continue to underperform?

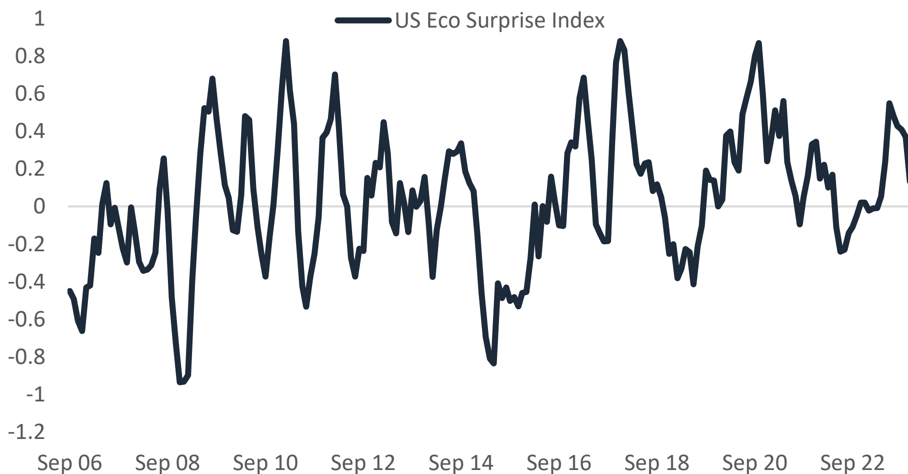
Risk assets surged in the 2023 fourth quarter, as markets priced for a goldilocks scenario in the US in 2024, characterised by slower inflation and lower rates but no recession. In keeping with the historical relationship between bonds and equities through the monetary policy cycle, bonds have responded quicker than equities to the perceived peak in the rate hiking cycle. However, both rallied in the fourth quarter in anticipation of rate cuts in 2024. A soft-landing scenario is fundamentally even more positive for equities than bonds.

The December 2023 Federal Open Market Committee (FOMC) statement was interpreted by markets as signaling the end of the hiking cycle, and the start of rate cuts in 2024. The Fed's median dot plot indicated 75 basis points (bp) of rate cuts, while economists are pricing 100bp-150bp of cuts starting in June, and derivative markets have been even more aggressive, with 160bp of cuts starting in March. Importantly for emerging market assets, interest rate cuts are expected not in response to a US recession, but rather to the normalisation of inflation and monetary policy post the dramatic events following the global financial crisis and Covid. Our view is that 200bps of policy rate cuts and US Treasury (UST) 10-yr yields between 3.5% and 4.0% would be appropriate for a soft-landing, i.e. under this scenario the rally in US bonds may have 50bp to go.

US Economy

Current high frequency US data, while providing frustratingly mixed signals is, on average, consistent with a soft landing. Importantly the US economic surprise index* indicates that data releases are still positive versus consensus but are a lot less positive than in mid-2023 (Figure 1). A positive reading of the surprise index (above zero) suggests that economic releases have on balance been higher than consensus, whereas a negative reading means that data releases have been worse than forecasters expected.

Figure 1: US economic surprise index is falling

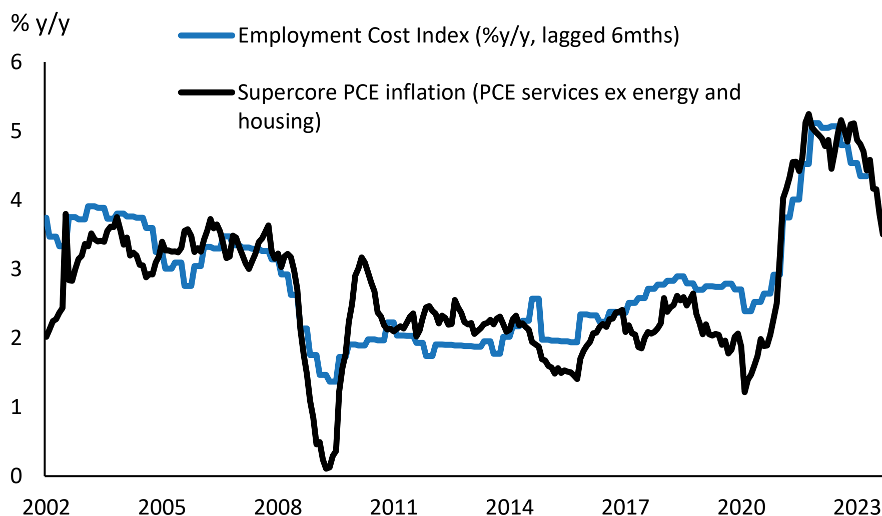


US labor market

US labor market data released in December shows firms and workers are contributing to easing wage pressure. Demand for labor is softening and workers are staying in their current jobs. Importantly for the Fed policymakers, Supercore inflation, the cleanest indication of underlying inflation, slowed from 3.8% in October to 3.5% in November, from a peak of 5.1% in February (Figure 2) .

Market participants will continue to assess recessionary risks and the likelihood that rates can move lower than priced.

Figure 2: Wage price spiral: Earnings vs underlying inflation



South African bonds and currency have underperformed peers

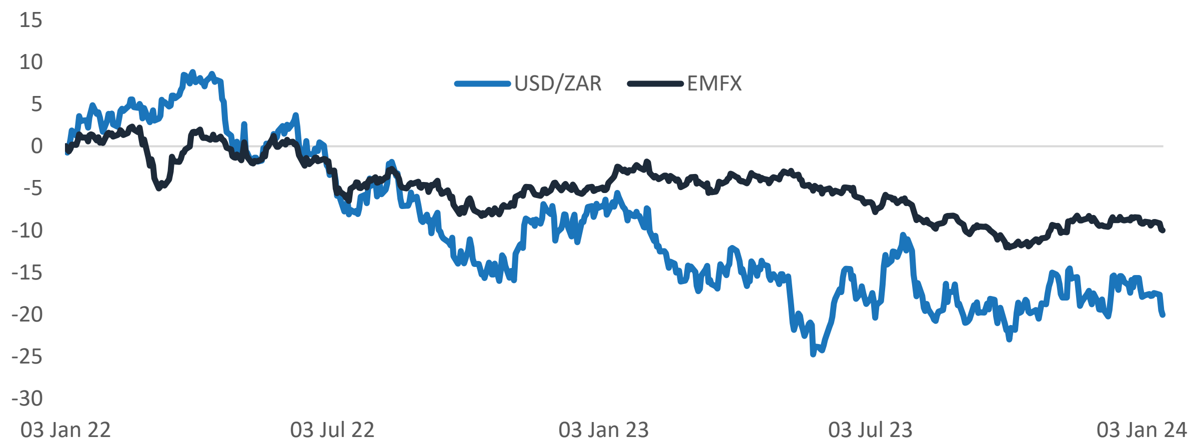
In 2023, emerging market (EM) bonds rallied as UST yields fell, and EM currencies depreciated – indicative of the buffering role played by freely floating currencies (Figure 3).

SA's bond spread over USTs compressed 39bp while BB rated peers compressed 98bp i.e. SA bond yields fell 60% less than peers. Similarly, the USDZAR depreciated 11.4% while the EM FX index depreciated 7.1% i.e. SA's currency depreciated 60% more than peers.

Looking at SA bonds and currency over the year, the underperformance was due to SA-specific geo-political risk in May (Lady R), after which there was some catch-up, but it's likely that intensification of structural growth problems (Eskom and Transnet) kept SA lagging.

In 3Q23, SA bonds continued to underperform, but by less – yields narrowed 100bp while BB peers compressed 130bp and in 4Q23 the rand appreciated 4.5% while EM peer currencies depreciated 4.8% and bond yields compressed 78bp versus BB peers compressing 47bp.

Figure 3: USDZAR vs and Index of EM currencies, indexed to 3 January 2022



Loadshedding – when will it end?

Not anytime soon. A draft Integrated Resource Plan (IRP) 2023 has been released for public comment, warning that loadshedding is likely to remain until 2030. This is despite the plan introducing more than 8GW of new gas projects (why gas?) and extending the life of existing coal power stations. The IRP presents a pipeline of projects which could generate 10.4GW by 2030, however it notes that only 2.8GWs have reached financial close. It concludes that crucial decisions still need to be made and refers to the risk of "policy tensions".

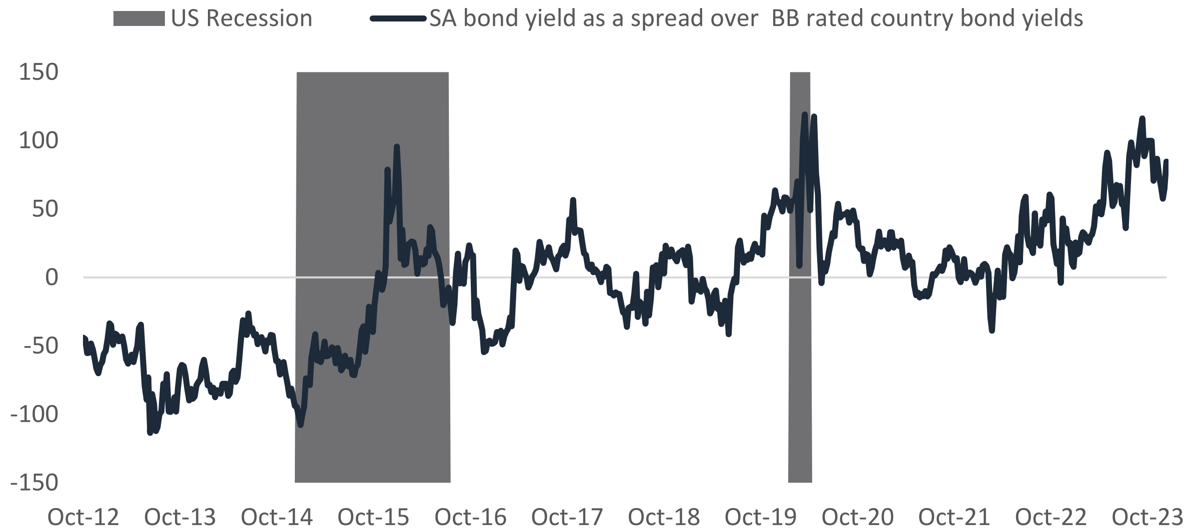
On a positive note, Kusile units 5 and 6 are expected to come online in April 2024 and early 2025. Efforts are also being made to return Medupi Unit 4 to service by July 2024. And Eskom has announced that it will no longer reserve transmission capacity for Karpowership, the Turkish provider of ship-mounted power plants, freeing up capacity for other projects.

Allegations of corruption at the National Student Financial Aid Scheme (NSFAS) by OUTA see the minister, Blade Nzimande, and the SACP, being accused of demanding kickbacks from NSFAS service providers. NSFAS, which cost South Africa R47bn in the previous fiscal year, poses a risk to the budget deficit which will put additional pressure on SA rates.

Do SA bonds have more room to rally?

Since the sell-off in May 2023 SA's average spread over BB rated bonds has shifted structurally higher by around 50bp. Over 2024, while SA's bond performance will continue to be driven by US bonds, the spread over US yields will be determined by structural constraints to growth and geopolitical risk. The global geopolitical landscape is in flux and sovereign alliances and power bases are shifting and unclear. US elections will be pivotal in defining the future global playing field and SA's elections will, to some extent, determine how the country positions itself within that landscape. The SA-specific sell-off in May provides some idea of what to expect if the risk that SA could be sanctioned increases again. It's also important to think about the reduced influence that monetary policy can exert on the exchange rate and consequently inflation. How will the SARB react to this? Will it decide it needs to up the dosage?

Figure 4: SA bond yield as a spread over USTs are dislocating from the BB rated average



**Surprise index that summarises recent economic data surprises and measures optimism/pessimism about the state of the economy. The indexes, on a given day, are weighted averages of the surprises or from a set of macro releases*

Author: Kim Silberman

Kim is a Macro Economist and Fixed Income Strategist Kim joined Matrix Fund Managers in July 2023 after more than 4 years at RMB as the Fixed Income and FX economist. Before joining RMB, Kim worked as an economist for Standard Bank Group Securities and BNP Cadiz Securities. In 2006 she was part of an emerging market hedge fund for Arnhold and S. Bleichroeder Advisers in New York. Her work experience has been varied and includes development and public policy work as well as forecasting and modelling, sector-specific analysis and asset allocation.