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South African bonds remain investment grade… for now

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Are bonds currently offering value?

Investors can determine if a bond is fairly priced and offering sufficient risk compensation by calculating its intrinsic value. This is done by looking at the real risk-free rate (proxied by the US 10-year bond yield), relative inflation rates and South Africa's sovereign risk premium. The way this is calculated is shown in Table 1.

Table 1: Nominal bond fair value calculation

	Current	Risk scenario
Risk compensation	1.00%	0.90%-0.40%
Current South African 10-year bond yield	9.05%	9.05%
Fair value	**8.05%**	**8.15%-8.65%**
US 10-year bond yield	2.40%	2.50%-3.00%
Inflation differential	3.25%	3.25%
SA sovereign risk premium	2.40%	2.40%

Source: Cadiz Asset Management

The South African 10-year bond is currently trading at a yield of 9.05%, while the fair value yield (pricing off the equivalent US bond (2.40%), the country's inflation differential (3.25%) and South Africa's sovereign risk premium (2.40%) is 8.05%. At first glance, the current price of a South African 10-year bond could be considered undervalued. The yield of 9.05% has a risk compensation margin of 1.00% (or 100 basis points) before it reaches 8.05% at which point the price of our 10-year bond is equal to fair value. This could be perceived as a substantial margin of safety by investors. However, the risk scenario incorporates the general view that the US 10-year bond is overpriced and will likely sell off to between 2.50% and 3.00%. This leaves a risk compensation level of between 0.40% (or 40 basis points) and 0.90% (or 90 basis points). Is this a sufficient margin of safety?

A long-term view indicates enough risk compensation to invest

When the current price of the bond versus its intrinsic value is compared over time, 40 basis points to 90 basis points under the risk scenario does offer sufficient compensation. This is because the average risk compensation for the South African 10-year bond has been 22.7 basis points since 2006 (as shown by the dotted red line in Chart 1). This spread has widened to above one standard deviation over the past six months, offering investors a large safety margin. At the current 100 basis points spread, the bond is trading between +0.5 (upper dotted orange line) and +1 standard deviation (upper dotted yellow line) above the average spread.

Chart 1: Risk compensation: 10-year bonds (2006-2016)

Sources: Cadiz Asset Management, J.P. Morgan, I-NET, Bloomberg

Ratings agencies have kept South Africa at investment grade… for now

Most South African debt is denominated in South African rand and issued within our borders. Therefore, although rating agencies rate both local and foreign currency debt, in South Africa the local rating is more relevant. South Africa’s current ratings are shown highlighted in white in Table 2.

Table 2: South African credit ratings are still investment grade

	Moody's	S&P	Fitch	Moody's	S&P	Fitch
Long-term ratings	Local currency			Foreign currency		
Investment grade	Baa1	BBB+	BBB+	Baa1	BBB+	BBB+
	Baa2	BBB	BBB	Baa2	BBB	BBB
	Baa3	BBB-	BBB-	Baa3	BBB-	BBB-
Non-investment grade	Ba1	BB+	BB+	Ba1	BB+	BB+
	Ba2	BB	BB	Ba2	BB	BB
	Ba3	BB-	BB-	Ba3	BB-	BB-

Sources: Moody's, S&P, Fitch

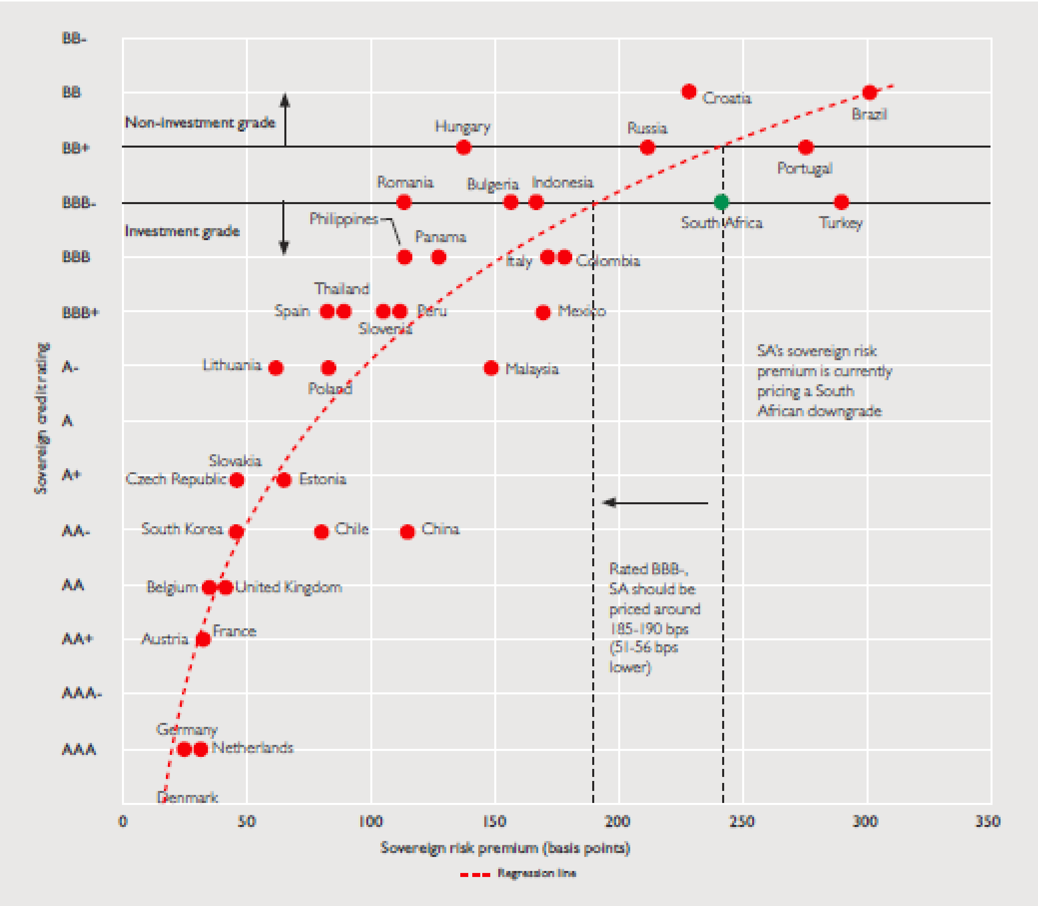
A downgrade to non-investment grade may result in a significant sell-off

The distinction between investment grade and non-investment grade is important within the debt market space. Most investment mandates require portfolios to be invested in debt products that maintain an investment grade rating. A drop from an investment credit rating to non-investment credit rating may lead to the widening in the sovereign risk premium. This would result in a significant sell-off, an excess supply of South African debt in the market, and inflated yields. The cost of South African debt would rise materially.

The South African risk premium indicates that a downgrade is already priced in

The sovereign risk premium is the additional compensation required by foreign investors when investing in riskier bonds. Investors that are attracted to lower quality bonds require compensation in the form of higher yields. The sovereign risk premium of a country and its respective credit ratings are inversely related. The higher the credit rating, the lower the premium required to entice investors to invest (as shown by Chart 2).

Chart 2: South Africa's credit risk premium



Sources: Bloomberg, Cadiz Asset Management

South Africa is currently trading at a sovereign risk premium of 240 basis points. According to the regression line, a premium of 240 basis points represents the price of a country trading at a sovereign credit rating of BB+, the highest non-investment grade credit rating. This indicates that South Africa's foreign bond is already pricing in a 2017 downgrade. At a credit rating of BBB-, South Africa's premium should be priced at around 190 basis points. This offers investors in South African debt some margin of safety, unless the threatened downgrades do occur. South Africa still holds some risk for potential investors, and the low GDP growth environment continues to hinder South Africa's fiscal performance. Despite our low growth, South African policymakers continue to be distracted from implementing growth-enhancing initiatives by ongoing political events.

We only invest in undervalued assets with a margin of safety

Cadiz Asset Management's investment philosophy is to invest in assets that are undervalued and that have an attractive margin of safety. Even though it may be argued that a sovereign credit rating downgrade is already priced in, bond yields can be volatile as we approach the announcement of the next credit rating by rating agencies in the middle of 2017. Minimising potential capital loss is vital during times of increased volatility. Ahead of any ratings announcements, we incorporate extensive risk management tools to mitigate the potential negative effect of a significant bond sell-off.

Glacier Research would like to thank Craig Thompson for his contribution to this week's Funds on Friday.

Craig Thompson, Bcom Hons (Financial Analysis)

Craig has a B Com Honours degree and has passed all three levels of the CFA exams. He started his career at Cadiz in April 2016 as an assistant in the fixed income team performing tasks such as fixed income technical and fundamental analysis. In October he was then appointed as a graudate analyst where he conducted credit anaylsis both at a micro and macro investment analysis level. In January 2017 he was appointed as an equity analyst.

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