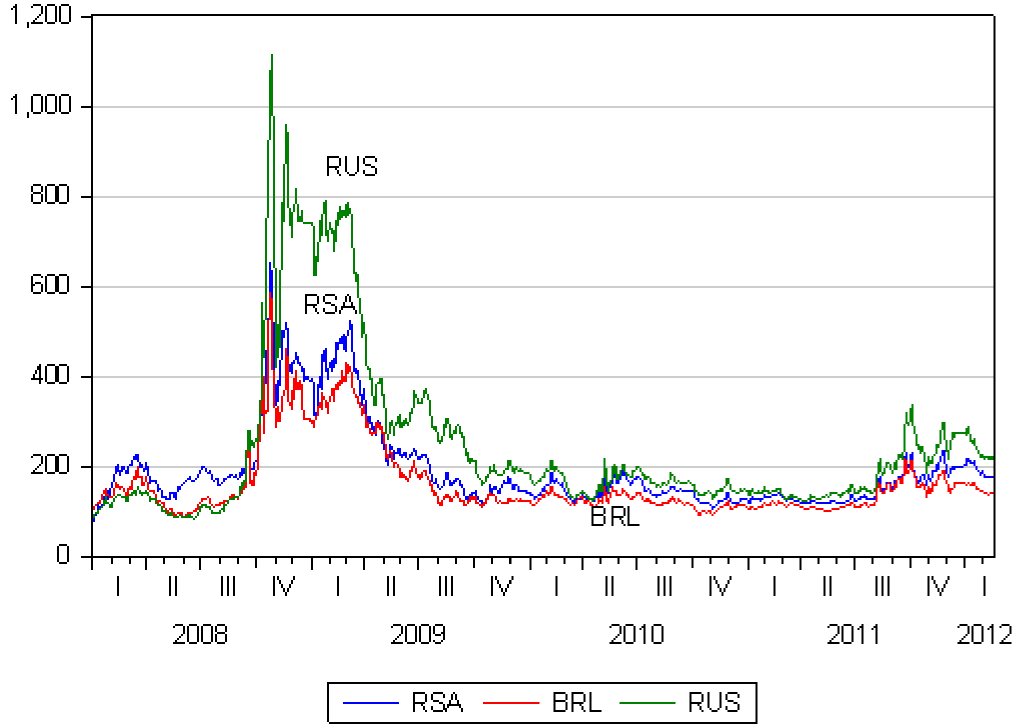
SA bonds and the rand: Are the stars for SA infrastructure spending aligning?

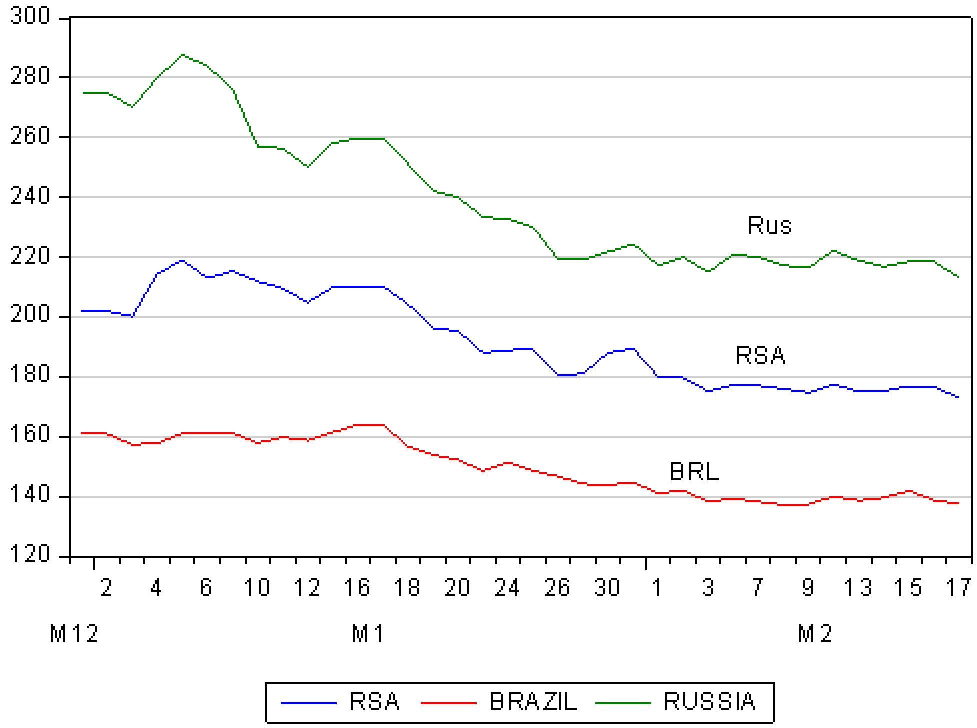
The risks of investing in emerging market foreign currency denominated debts have continued to recede as the Eurozone debt threat to global financial markets has diminished. RSA sovereign debt is no exception in this regard. The credit default swap (five year) risk spread on RSA debt was 202 bps at the beginning of 2012 - it is now nearly 30bps lower. The spreads on Russian and Brazilian debt have declined similarly as we show below, with Brazil continuing to enjoy a significant debt premium over RSA debt.

Credit Default Spreads over US Treasuries (five year), Daily data 2008-2012



Source: Bloomberg and Investec Wealth & Investment

Credit Default Spreads over US Treasuries (five year), Daily data 2012



Source: Bloomberg and Investec Wealth & Investment

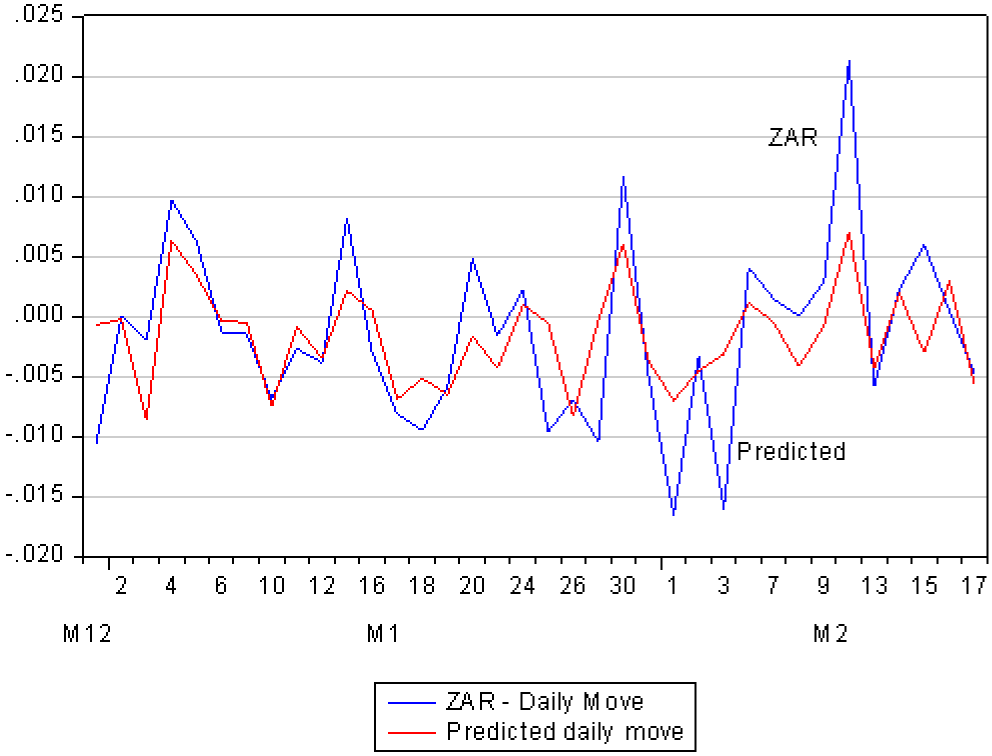
When risks recede equities improve and this year has proved no exception to this iron law of economics. The implied volatility priced into option on the S&P 500 has also declined, but not as steadily as the sovereign risk spreads. The S&P 500 has also strengthened as we show below.

Source: Bloomberg and Investec Wealth & Investment

The rand continues to behave as a risk on currency, gaining when risks decline and equity values improve and vice versa. Daily moves in the rand/US dollar rate are shown below and compared to the daily moves predicted by a model that predicts the rand/US dollar using the emerging market index and the RSA sovereign risk spread as explanatory variables. As may be seen, the daily movements in the rand/US dollar this year are very well explained by these global forces. It may be confidently predicted that global, not SA specific forces, will continue to move the currency.

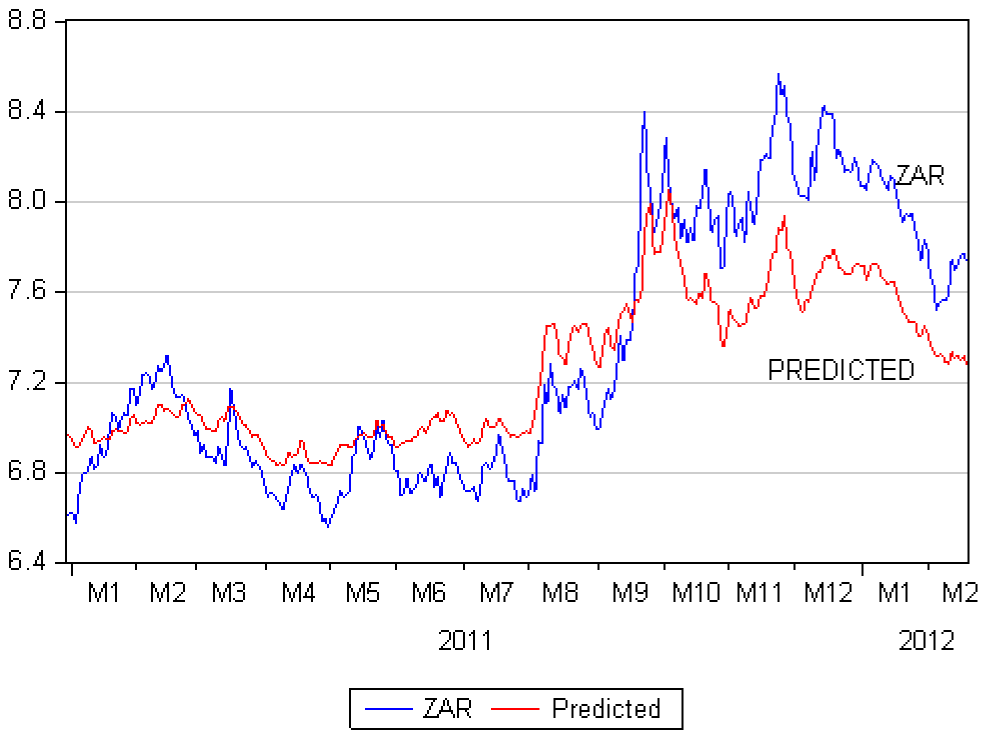
However the same model suggest that the rand/US dollar has become somewhat undervalued over the past few months given the state of emerging equity markets and the risk spread. This undervaluation was first noticed in October 2011 and persists to this day. The rand is about 4% weaker than its predicted value against the US dollar. Thus further upside for the rand is very possible, especially if risks recede further and the equity markets make further gains.

The rand and its value, predicted by emerging equity markets and RSA risk, Daily moves



Source: Bloomberg and Investec Wealth & Investment

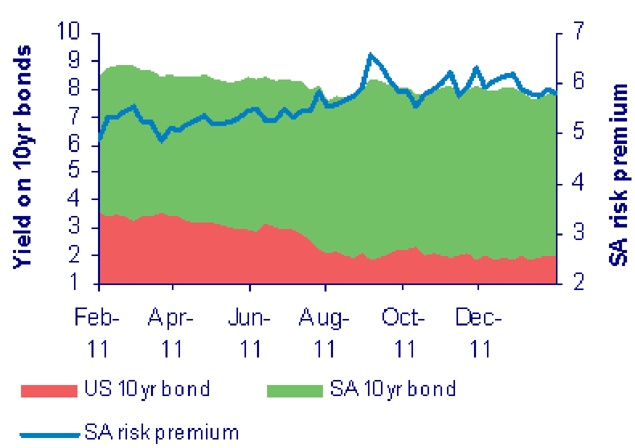
The rand/US dollar and its predicted value



Source: Bloomberg and Investec Wealth & Investment

The one SA risk measure that does not seem to have improved over the past few months is the spread between RSA 10 year rand denominated bonds and their US equivalents. This spread – the difference between SA and US interest rates – known as the interest rate carry, may be regarded as the break even exchange rate depreciation. Clearly the recent strength in the rand has not changed the belief that the rand will continue to depreciate against the US dollar over the next 10 years by close to 6% per annum on average. Given further strength in emerging equity markets, accompanied by less risk priced into assets, this carry might well seem very attractive to hedge funds and other speculators, at least on a short term basis. If so, the rand might well benefit from additional flows into the RSA bond market. With a bit of luck (or that is to say more appetite for risk globally) this might well prove a very good time to issue rand bonds to fund the spending on the SA infrastructure. ***Brian Kantor***

The South African Risk Spread: the interest rate carry



Source: Bloomberg and Investec Securities