

Investigation of high South African Bond Yields

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Abstract

South African yield spreads in mid to longer dated bonds are currently relatively high to the historical experience.

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JEL classification L250, L100

1. Introduction

It was pointed out by economists that current yield spreads in local mid to longer dated bond yields have been historically high. Yield spreads between bonds of different maturities reflect how investors view the economic conditions. For example, widening spreads indicate largely different views between short to long term, and illustrates a view of better long term conditions than present.

The price of a bond moves inversely to its yield, therefore a riskier bond is cheaper in price but greater in yield. Yield spreads are an indication of market sentiment. Relevant to the South African case, if investors are risk averse, they favor safer bonds, and therefore the spread between developed market bonds and emerging market bonds widen.

Furthermore, yield differentials between bonds of the same class but with different maturities are also helpful indicators of sentiment. Longer-dated debt usually is considered riskier than short-dated debt, owing to the maturity risk premium. So, long-term debt typically would have a positive yield spread relative to short-term debt. But, at turning points in the market cycle, when a recession is priced in and fear of the immediate future prevails, investors shun shorter-term debt in favor of longer-term debt, thus pushing up short-term yields and dampening long-term yields.

In this paper, I review these avenues to investigate the higher-than-usual yield spreads in South Africa.

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2. Historical Overview

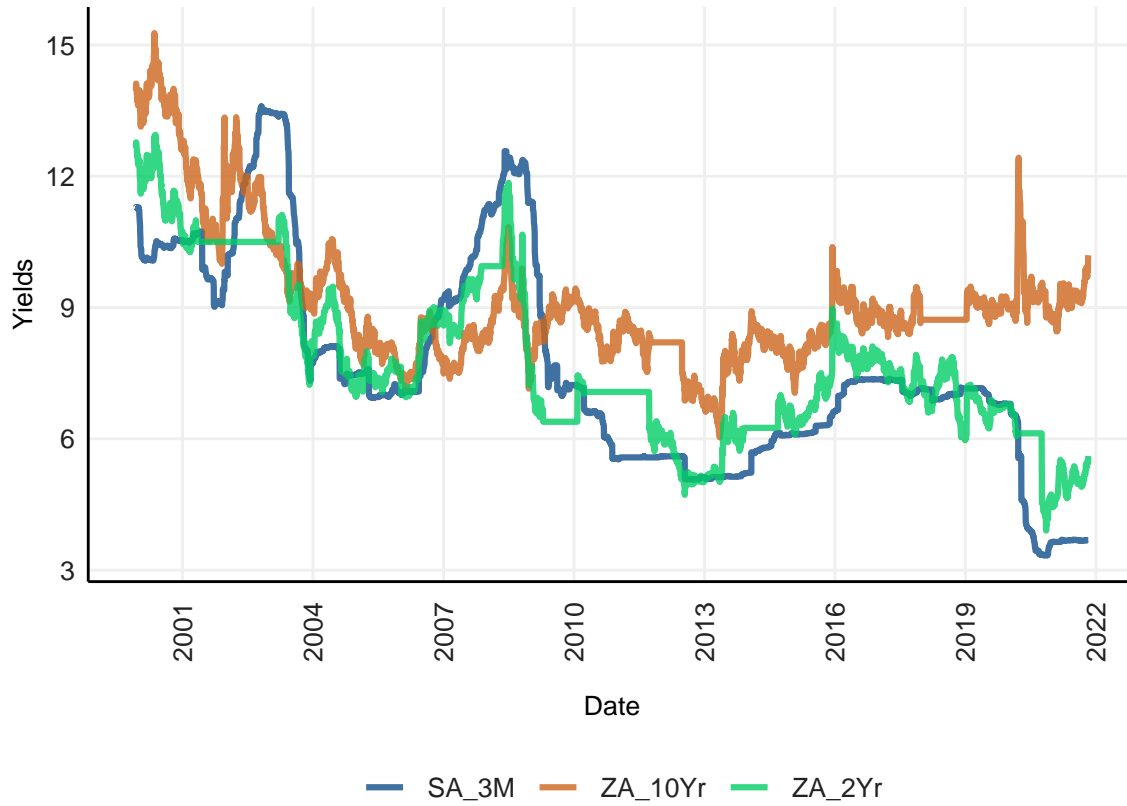
The first plot below shows the historical view of yields from 1999 to 2021, whilst the second plot shows the historical view of yield spreads over the same period in South Africa. The bond yields included are the 3-month, 2-year and 10-year government bonds.

The first plot shows an increasing spike in the 10-year yield from the end of 2019 or start of 2020. Increasing yields during the period of Covid-19 is expected for a few reasons. There is a global risk of sentiment, so investors move out of EME bonds, this reduces bond prices and increase the yields. Secondly, the bonds are more risky as treasury embarked implemented fiscal stimulus amid already existing high debt levels. The 3-month bond and 2 year bond yields decrease over the same period as the SARB implement interest rate cuts and for the first time, intervene along the yield curve with some sense of quantitative easing.

The second plot shows that current yield spreads are higher than the historical yield spreads. The yield spreads spike at the end of 2019 or start of 2020, and stabilise at high levels. The spread between the 10-year and 3 month bonds are the greatest, followed by the difference between the 10 year and 2 year, and then the 2 year and 3 month. As shown in the first plot, the 10-year yield spiked upwards, while the 3-month and 2-year fall dramatically downwards. This causes the initial spike upwards that one observes in the yield spreads where the 10-year bond is involved, while the spread between the 3-month and 2-year is more tame. In order to understand this better, I review want to get an idea of the international investor sentiment.

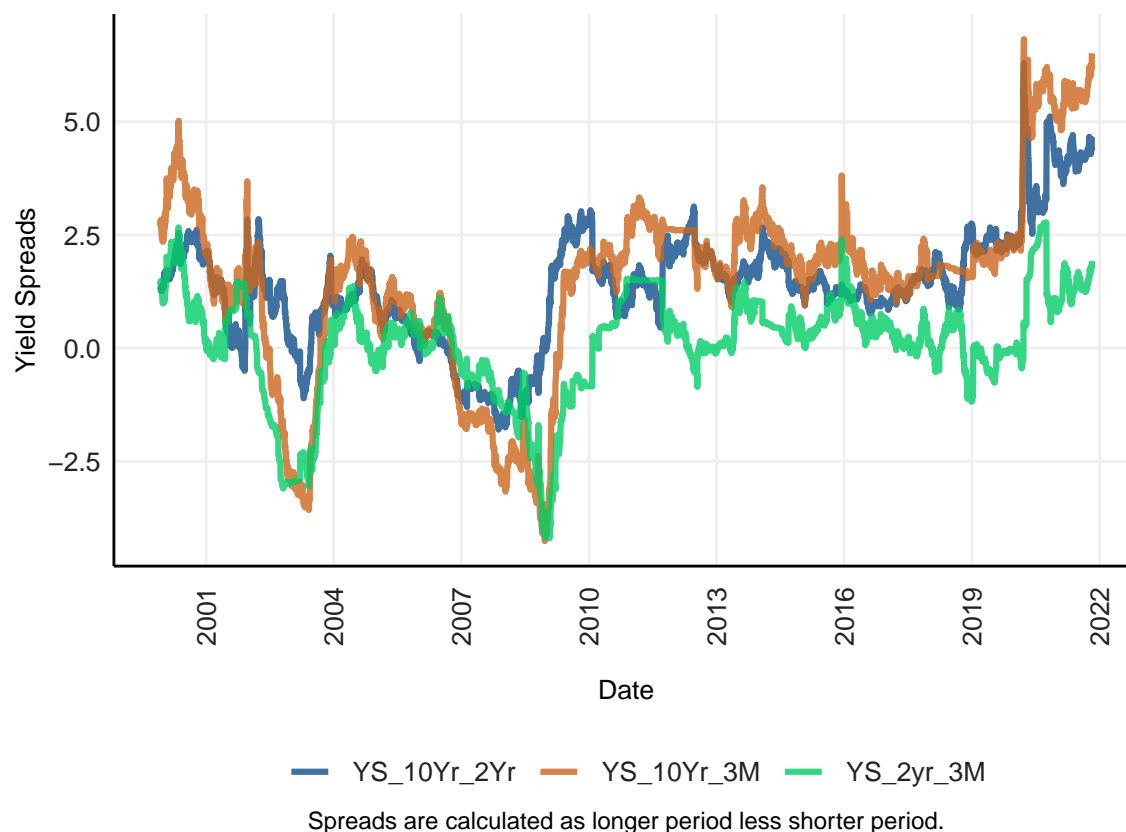
Yields in South Africa

Historical view of yield spreads in South Africa, 1999 to 2021



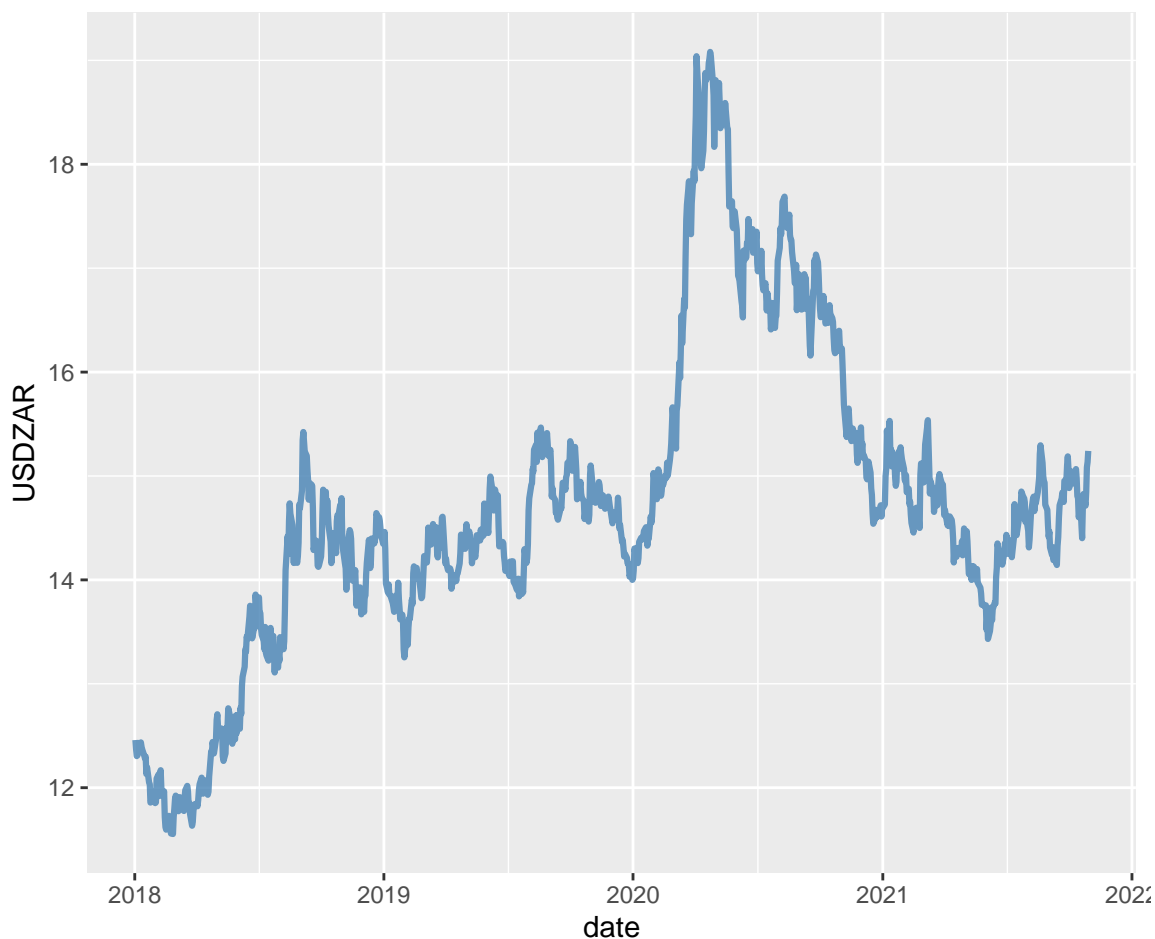
Yield Spreads in South Africa

Historical view of yield spreads in South Africa, 1999 to 2021



3. International Sentiment

Firstly, I plot the USD/ZAR exchange rate to obtain an idea of volatility in carry trade and capital outflows. This figure shows a large spike in the exchange rate to levels above R18 per dollar. This is an indication of substantial capital outflow out of South Africa. This is anecdotal evidence to expect that demand for SA bonds decreased largely by international investors. I argue that the reason we do not observe this as in the 3-month or 2-year is because of the substantial SARB intervention.

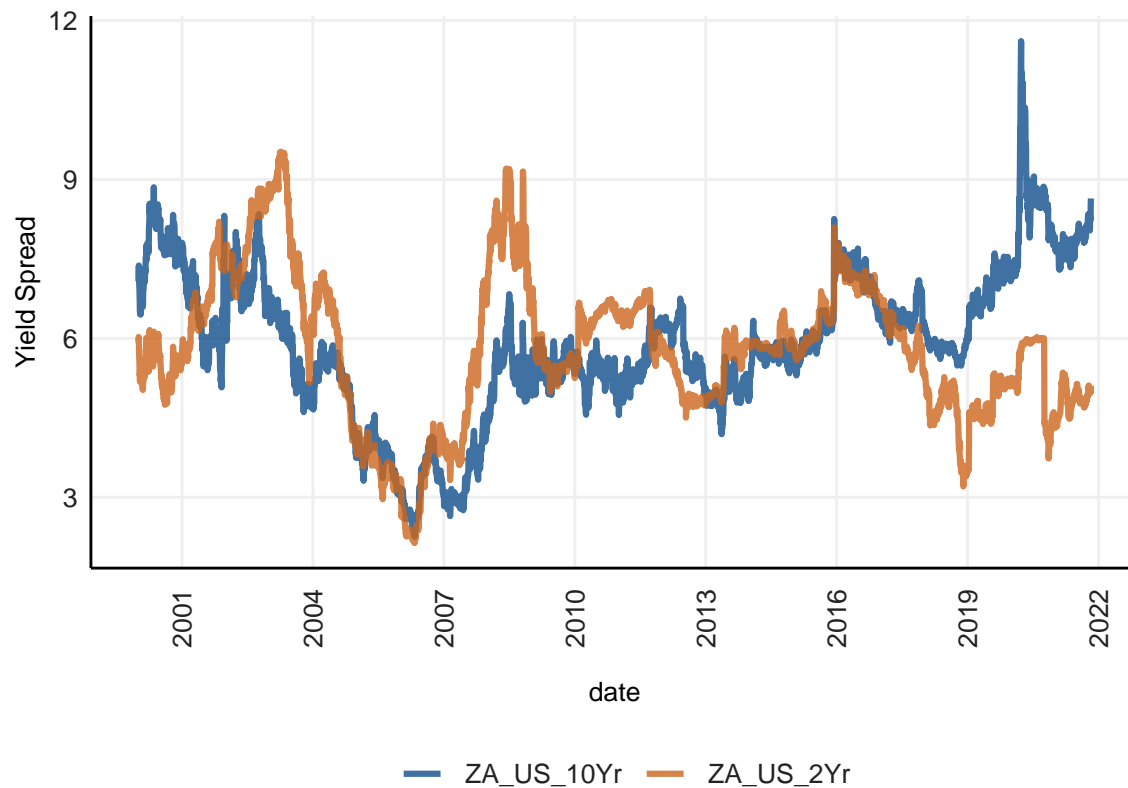


To confirm this finding, I compare the yield spread between the SA and US 10-year bonds, and the yield spread between the SA and US 2-year bonds. Fedderke (2021) argue that higher South African economic growth, lower inflation, public and private debt, as well as Rand-Dollar appreciation are all associated with a statistically significantly lower South African - United States yield spread. In addition to that, I would add global risk sentiment as contributing to yield spread evolution between SA and the US.

The figure shows a clear spike in the yield spread between the US and SA. The spread is calculated as the SA yield less the US yield. This confirms that global risk sentiment, movement out of emerging market bonds and into safer developed markets bond is a contributing factor to higher yields in South Africa. In addition to this, I have omitted an discussion of an important factor being inflation. Investors are concerned about real yields, and therefore, if inflation expectations increase, then investors demand higher nominal yields to ensure constant real yields. Initially, there was a fear of deflation in the US, but this fear became less apparent as fiscal and monetary policy makers adopted great expansionary policy.

Yield Spreads between South African and US Bonds

Historical view of yield spreads between South Africa and the USA, 2000 to



Spreads are calculated as SA yield less USA yield.

4. Conclusion

My main line of argument is that capital outflows into safer developed market bonds caused the demand for South African bonds to decrease, and therefore their yields to increase. I argue that the substantial action by the SARB, especially its adoption of a mild form quantitative easing for the first time, kept the 3-month and 2-year yields low. However, the 10-year yield increased, and in turn its spread with bonds of shorter maturity. Higher yields for expected for longer-term bonds, but I do agree with the initial hypothesis that the yield spreads are greater than historical norms.

References

Fedderke, J.W., 2021. The South African–United States sovereign bond spread and its association with macroeconomic fundamentals. *South African Journal of Economics*.

Appendix

Appendix A

Some appendix information here