# Current opportunities in fixed income

Mark Seymour
Director Fixed Income

*The Northstar SCI* Income Fund follows a flexible asset allocation approach that takes advantage of the drivers of returns for the different asset classes at each point in the interest rate cycle, which results in outperformance for investors. This article explains how the Fund is positioned in the current macroeconomic environment and where Northstar sees value in the context of our base, bull and bear case scenarios.*

The Northstar SCI Income Fund provides investors with a regular and stable income that targets inflation-beating returns over the long-term, while actively managing the risk of capital loss in the short-term. The Fund invests in high-quality fixed income assets comprising fixed coupon, floating-rate and inflation-linked bonds predominantly in senior A-rated paper as well as listed property, global bonds and global currencies.

While investors in the Fund require real returns and capital preservation over relatively short periods of time (one to three years), the interest rate cycle may take longer to unfold. In managing the Fund, we therefore follow a flexible asset allocation approach that takes advantage of the different characteristics of these assets at different parts of the cycle to generate outperformance for investors.

The long-term drivers of returns in the fixed income market are the price paid, the point in the interest rate cycle, inflation and changes to sovereign and credit risk. The impact of changes in interest rates and inflation on the various classes of fixed income assets are shown below:

- **Cash and floating rate notes** do well with rising interest rates, especially when there is a comfortable margin between yields and the expected future inflation rate.
- Falling interest rates favour **fixed coupon bonds**, particularly when the yield on these bonds are higher than the future inflation rate.
- **Inflation-linked bonds** do very well when bought on high real yields and inflation expectations surprise to the upside.

## The current macroeconomic outlook favours fixed and inflation-linked bonds

Our base case anticipates that South Africa's sovereign risk will increase with large budget deficits, interest payments exceeding 20% of tax revenue and unstable debt-to-GDP projections. We expect growth to rebound more slowly than in the US and other countries, with lower tax collections, rising public wages and difficulty in implementing the policies necessary to address these issues. Interest rates are expected to stay on hold for the next 12 months, with inflation increasing from current levels of around 3% to settle at 4%, 0.5% above the current repo rate.

*SCI refers to Sanlam Collective Investments

In this scenario, cash and floating rate notes will generate negative or very low real returns. The low interest rate environment will support fixed bond returns and rising inflation will benefit inflation-linked bonds. While longer dated inflation-linked bonds remain over-valued, inflation rising above the short-term breakeven level of 3.7% will result in valuations favouring the 1- to 7-year maturities. Rising sovereign credit risk is keeping the yield curve at historically steep levels with volatility likely to remain high at the long-end of the curve and valuations favouring the 6- to 11-year fixed bond maturities.

### Other credit opportunities

Credit spreads represent the difference in yield between a South African government bond and another bond of similar maturity issued by corporates or other issuers. Fixed coupon bond credit spread opportunities are available in shorter-dated bonds, but spreads are compressed by historic measures. We find ourselves in an unusual situation where mid- to longer-dated fixed coupon bond credit spreads are trading in line with government bonds, offering no opportunities for yield enhancement in this credit segment. As a result, the Northstar SCI Income Fund is currently holding a higher than usual proportion of government bonds to take advantage of their low risk, high liquidity and equivalent yields.

Credit spreads on senior floating rate notes issued by South Africa's banks are currently compressed (55bps - 130bps), resulting in very thin real yields. Spreads on Tier 2 and additional Tier 1 floating rate notes are also compressed (140bps - 240bps and 140bps - 400bps respectively), resulting in reasonable to decent real yields, but at elevated risk due to deteriorating loan quality and profitability in the banks.

### Other fixed income assets

Preference shares have been negatively impacted by falling interest rates, resulting in lower prices, but these are not low enough to provide the necessary yields above our fair value hurdle rates. Property stocks were hit hard by the COVID-19 crisis, with certain segments (logistics) outperforming others (retail, commercial and office). Although prices have adjusted lower to accommodate the deteriorating fundamentals of impaired balance sheets and income streams, the high levels of economic uncertainty prevent us from allocating these assets to funds with short-term investment horizons.

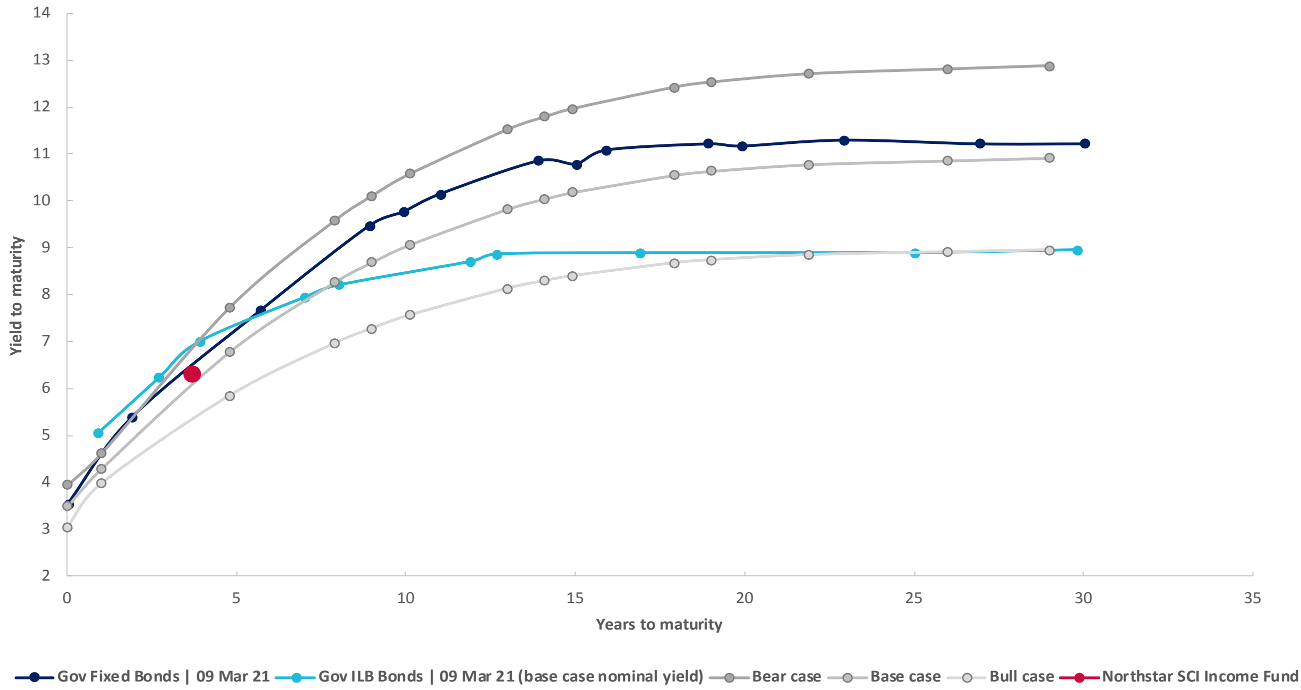
### Range of outcomes and possible left-field events

In assessing the investment opportunities on offer, Northstar considers a range of potential outcomes. In addition to the base case discussed above, our bull and bear cases are as follows:

| BULL CASE | BEAR CASE |
|---|---|
| South Africa could be thrown a lifeline with US stimulus spending, a weaker US dollar and increased demand from China causing commodity prices to surge. With the commodity index[1] up 100% since the COVID-19 lows, market commentators are asking whether this is the start of a new commodity supercycle, which is supportive for the local economy and a bull case outcome for fixed coupon bonds. In this scenario, lower fiscal risk translates into lower sovereign credit risk, the rand remains strong and inflation is contained. This creates lower fixed coupon bond yields and strong fixed bond out-performance. | Our bear case anticipates a global risk-off event on the back of rapid inflation, rising interest rates and a strong dollar. A weaker rand and rising inflation result in a bear case for fixed bonds, while short-dated inflation-linked bonds do relatively well in nominal terms. Rising interest rates are supportive of floating rate notes, but credit spreads widen resulting in negative capital movements that offset higher yields. |

[1]The Goldman Sachs Commodity index has risen from a low of 228 on 21 April 2020 to the latest high of 491 on 5 March 2021, a 115% gain over the period.

**Chart 4: Fixed coupon and inflation-linked bond yield curves vs one-year exit yields**




Source: Inet Bridge, JSE & Northstar

Chart 4 shows the relative values of fixed coupon (blue line) and inflation-linked (turquoise line) government bond nominal yields against Northstar's bear, base and bull case fixed coupon bond exit yields (grey lines) over a period of one year.

| Key metrics for fair value modeling | Base case | Bull case | Bear case |
|---|---|---|---|
| Change in interest rates | 0bps | -25bps | +25bps |
| CPI (1 year average) | 4.0% | 3.5% | 4.5% |
| CPI structural | 4.5% | 3.5% | 5.5% |
| 30 year bond: Required real yield | 6.5% | 5.5% | 7.5% |

The chart shows good value in the 6- to 11-year maturity fixed coupon bonds and in the 1- to 5-year maturity inflation-linked bonds, where exit yields are expected to be lower than current yields. Because the value and yield of bonds move inversely, higher yields mean the bonds are available at lower prices.

The large red dot in the chart highlights the maturity (3.7 years) and yield (6.3%) for the Northstar SCI Income Fund, taking note that these metrics include the Fund's 14% global cash holdings, which offset the majority of interest rate risk in the portfolio.

We believe that the Northstar SCI Income Fund's asset allocation, curve positioning and credit exposure are appropriate given the current performance drivers and valuations, point in the interest rate cycle, prevailing macroeconomic conditions and fiscal dynamics. This positions the Fund well to continue to outperform its benchmark and meet the return objectives for our clients.

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**NORTHSTAR ASSET MANAGEMENT**

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

**SANLAM COLLECTIVE INVESTMENTS**

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/002865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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