Rates Compass

Portfolio Insights | Treasury securities | Ghana

28 September 2020

Time to play checkers; not chess

In brief

- The dollar's extended weakness in the last couple of months has begun to threaten its status as a global reserve currency.
- The cedi held its own and remained range bound depreciating by approximately 0.1% and consequently offsetting panic sale reactions by foreign investors on the domestic bond market.
- According to the finance minister, Ghana's fiscal deficit is expected to approach 11.1% for 2020 and this underscores our concerns about how well Ghana can keep its head above water amidst the cedi's relative stability.
- We are thus overweight shorter duration papers as there will be some harder choices to make on how to "allocate" the accumulated costs of policy response.
- Ghana Eurobonds have rallied since the beginning of June albeit not as sharply as during mid-April's slump in crude prices when WTI[1] futures, for the first time ever, traded in negative territory.
- Overall, we are risk-off and prefer to crystallise gains on some of our positions amid significant divergence between fiscal reality and market

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Policy makers are at their wits end

Ultra-loose monetary policy seems to be the preferred and feasible pathway for central banks to combat contractions in various developed economies. The side effects of this approach however are beginning to bite hard in the US and threaten the dollar's status as a global reserve currency. The dollar's 10% decline against a basket of major trading currencies in the last four to five months, however, could prove to be a silver lining for import dependent EM[2] countries heavy-laden with dollar debt.

The cedi held its own and remained range bound, depreciating by approximately 0.1% and consequently offsetting panic sale reactions by foreign investors on the domestic bond market. Yields steepened across the curve between May and August by an average of 76bps as the government repriced its 3-year and 5-year issuances in response to the central bank's monetary support for the rest of the year. Despite the bullish steepening over the period, risk appetite remains tapered as the country returns to the polls in December amidst COVID-19 induced fiscal constraints.

In this issue of Rates Compass, we will further our discussion on some of the evolving themes that have shaped markets from May to August as a result of COVID-19. Moreover, we will share our views on Ghana's macroeconomic outlook for the remaining part of the year as well as how we intend to position our portfolio.

[1]WTI: West Texas Intermediate
[2]EM: Emerging market

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QE is a double-edged sword

In the last couple of months, the declining value of the dollar has been the centre of discussion among major institutional investors as questions have begun to arise as to the true resilience of the greenback as a global reserve currency. Increasing COVID-19 case numbers in the US, fears of renewed lockdowns and expansionary monetary and fiscal policies have dented investors' perception of the dollar.

As an example, Azerbaijan's sovereign wealth fund plans to invest USD 1.8bn in renminbi this year, in what would be one of the largest investments in the Chinese currency to be made public. With a second stimulus bill being tabled before Congress as of writing, the continuous supply of liquidity together with weak macro numbers in the US affirms our expectations of a weaker dollar for the rest of the year.

Despite currency weakness of the greenback, yields on the US 10-year steeply declined by 40bps from June's highs to August's lows of 0.51% and supported the surge in flows into EM assets and global equities.

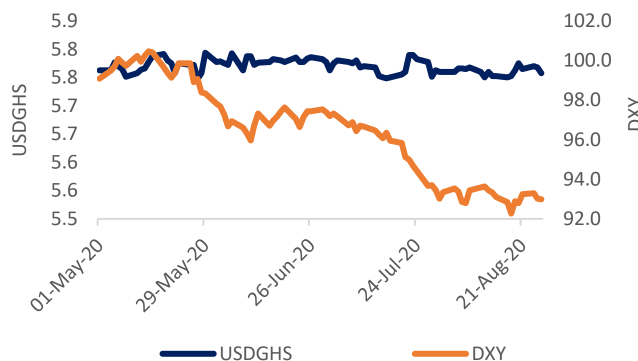
The morphing market irrationality between currency strength and yields highlights the significance of the Fed's[5] balance sheet expansion programme which has seen it purchase ~USD 2.7tn worth of bonds since March 2020 to date. We estimate that the Fed's role in yields declining significantly outstrips investors' buying interest.

With US treasury yields at incredibly low levels together with a weaker dollar, we expect rising risk appetite and the significant decline in foreign investors' sell-off on the Ghana domestic treasuries market to sustain the stability of the cedi. Our forecast of the cedi is further backed by a strong FX[4] reserve of 4.3 months of import cover.

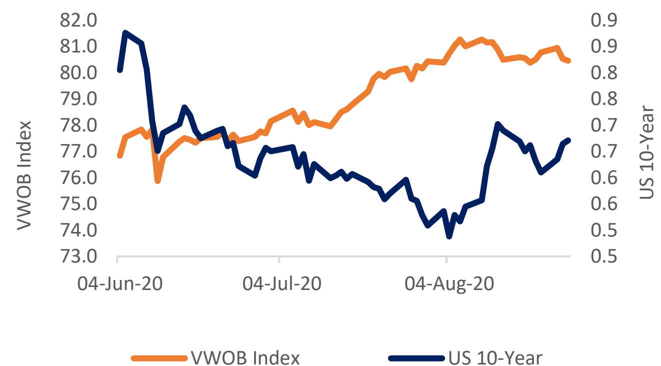
However, looking further down the road, a key question which remains unanswered is whether policy makers address exploding budget deficits or continue to run their economies at full throttle with both fiscal and quantitative easing taps in full flow.

These decisions could have significant implications on the local currency, interest rates and yield curve. Consequently, we remain defensive while open to selective opportunities in rates and currency.

USDGHS vs DXY (Dollar Index)



US 10-Year vs VWOB (Vanguard Emerging Market Bond Index)



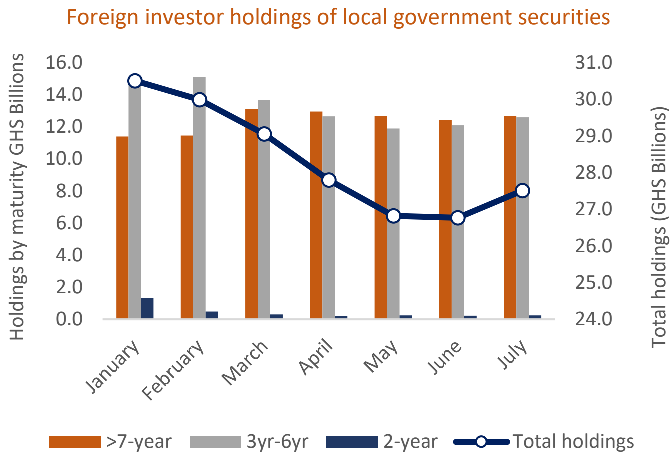
Source: Bloomberg

[3]ETF: Exchange traded fund
[4]FX: Foreign exchange
[5]Fed: US Federal Reserve

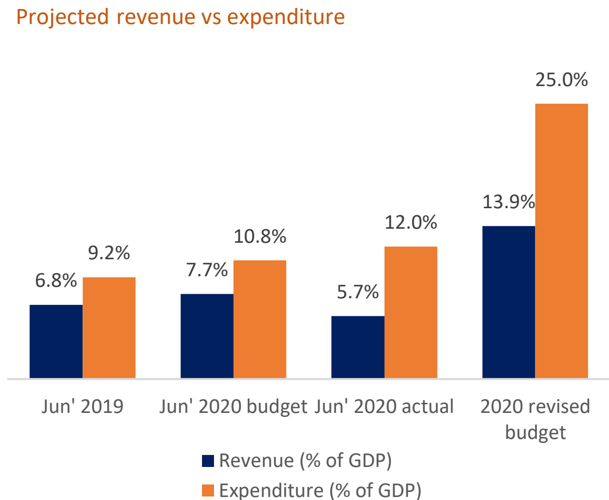
Can we keep our heads above water?

In our maiden issue of Rates Compass, *Defying Optimism amid fiscal struggles*, our initial assessment of the impact of COVID-19 for Ghana was summed up in our overall estimate of the government's fiscal needs: "Ghana like the rest of the world, is throwing the kitchen sink at the pandemic as the country seeks to address the estimated funding gap of GHS 36.8bn […] altogether, we estimate that the government will raise GHS 27.1bn, leaving a funding gap of GHS 9.7bn".

This grim narrative has not changed since then; the government spent GHS 46.35bn alone in 1H2020 (GHS 4.5bn higher than expected) whilst recording revenues of GHS 22bn (GHS 7.7bn below target). According to the finance minister, projected expenditure for the rest of the year is set to increase by GHS 11.6bn with revenue shortfalls expected to hit GHS 13.6bn. Our fiscal deficit is thus expected to approach 11.1% for 2020. This underscores our concerns about how well Ghana can keep its head above water during a challenging fiscal time.



Source: Ministry of Finance and Central Securities Depository



The government in the next four months, has an outstanding maturing debt obligation of ~GHS 25.6bn. The government's favoured path towards repaying its debt has always been through further borrowing on the domestic market specifically at the long end of the curve. As seen from the chart above, foreign investors who typically patronise our long-term bonds, have begun a gradual selloff on the back of the country's worsening fiscal story despite a relatively stable currency.

The current deteriorating economic landscape has thus left the government scratching its head as it struggles to choose between the lesser of two evils in managing its funding requirements; borrowing more at the long end at significantly higher rates which could threaten its medium-to-long-term debt management strategy or borrowing more at the short end at higher rates with little to no breathing space for short-term debt recycling. Per our forecasts, the government is not in a strong position to borrow at higher yields and could explore unconventional methods of financing.

In spite of the limited fiscal space and the grim outlook for Ghana, the yield curve has declined by ~200bps from January to August, highlighting the increased liquidity on the local market. Local investors, primarily pension funds and banks who prefer the short to the midsection of yield curve have found new cash from policy directives from their respective regulators.

In our estimation, the cut in primary reserve requirements released GHS 1.6bn to banks who prefer to lend to the government than to the private sector amid the ensuing pandemic. In addition to the cash from banks, the increase in treasury allocation from 60% to 70% of a GHS 20.0bn private pension industry has unleashed an estimated GHS 2.0bn to the domestic bond market. However, most of the cash released onto the market prefers short duration bonds, reflecting the risk-averse view of domestic investors.

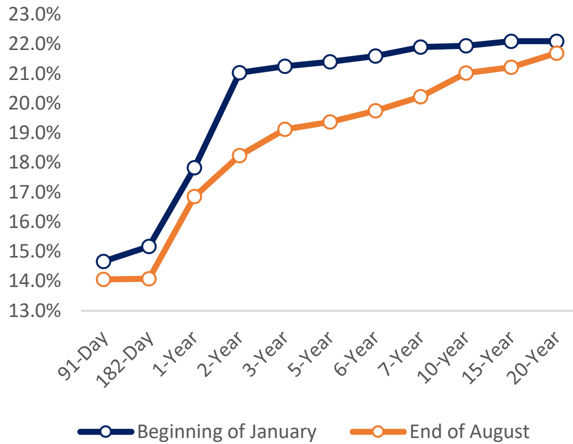
Consequently, the pressure on the yield curve from the belly to the front end (mostly 6-year to 2-year yields) has led to significant reduction in yields compared to the back end which has hardly moved. The decline in yields amid a challenging macro backdrop provides investors with an unpleasant dilemma; stick to the macro story or follow the monetarists?

While we do not pretend to know the answer to this question, we hold the view that the influence of local monetary policy will be limited to the front end of the yield curve. We believe that the back end of the yield curve which is largely held by foreign investors will continue to reflect the fiscal outlook of Ghana.

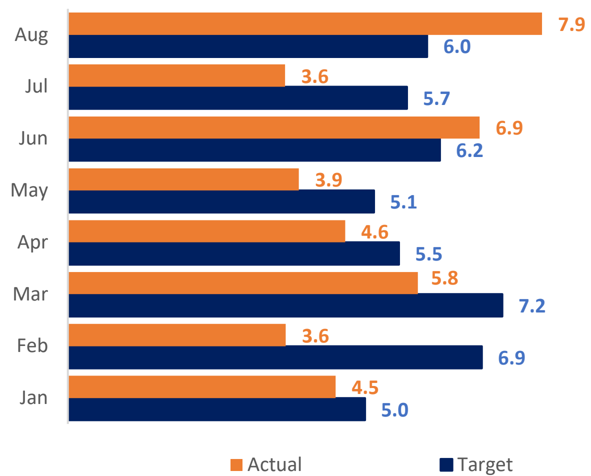
However, this influence is likely to be tapered by the current low interest rate environment across the globe. Consequently, we are yet to be convinced by the argument that yields will spike amid the wall of liquidity erected by major central banks.

We believe that the current yield curve will remain steady with some intermittent bumps as the government rolls over maturing debts. However, we expect the yield curve to steepen and become more curved as both locals and foreign investors gravitate towards the front end of the yield curve.

Local yield curve evolution



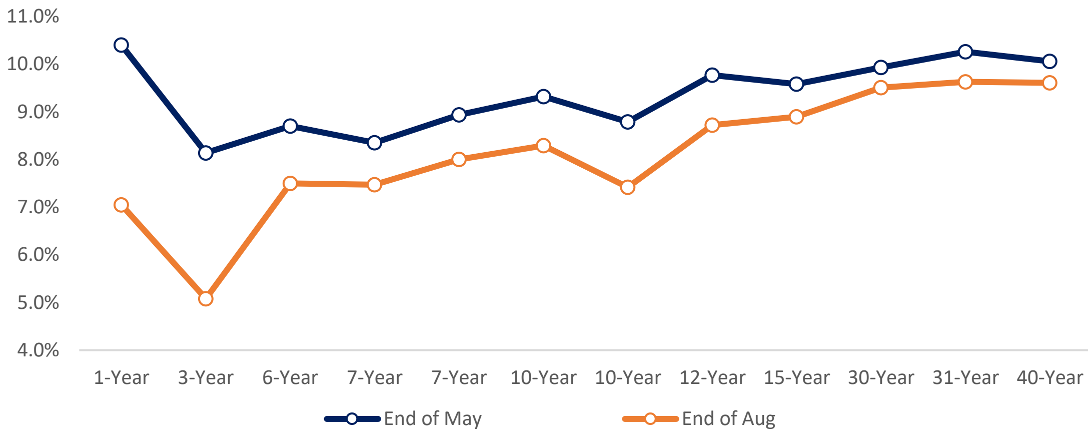
GOG issuances Jan to Aug – Target vs Actual



Source: IC Asset Managers research & Central Securities Depository

With some form of stability returning to world oil prices, Ghana Eurobonds have rallied since the beginning of June albeit not as sharply as during mid-April's slump in crude prices when WTI futures, for the first time ever, traded in negative territory. We have taken some profits off the table since then as we continue to monitor compelling price entry points.

Ghana Eurobond yield evolution



Source: Bloomberg

How to position

The pronounced influence of monetary policy on the yield market has led all of us to unchartered territory. Consequently, we believe this is the time to play checkers instead of chess. Given the confusing outlook amid the wrestle between the fiscal and monetary side of the economy, we prefer to diversify our positions across the short end of the yield curve whilst scooping up decent bargains at the long end. Hence, we will take profit from some of our positions at the short end of the yield curve as we reconstruct that segment of our portfolio.

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