

## Shifting gears into momentum

### In brief

- ✦ Strong data prints and impressive earnings from developed markets have restored some calm to investors broadly, but inflation and reflation fears linger.
- ✦ Above-trend growth now remains the base case scenario for 2Q2021 for most banks and portfolio managers as vaccine rollout in 1Q2021 remained the key driver of optimism across developed economies.
- ✦ We view Ghana's growth prospects as far ahead of the curve as evidenced by the strong reading of the Real Composite Index of Economic Activity based on recent data from the Bank of Ghana.
- ✦ Considering the gradual fading of foreign portfolio inflows in recent times, we have adjusted our earlier underweight view of the dollar to neutral.
- ✦ We have pivoted towards a core-satellite strategy that involves crystallising gains on some of our short-dated papers whilst buying duration to magnify carry on our portfolio.
- ✦ Based on our view on currency, we remain neutral on Ghana Eurobonds and view them as fairly priced at their 95-98+ levels although a 12.0% mispricing between Ghana Eurobonds and local bonds persists.

### Fading ambiguity

Today's investor could arguably describe the last 12 months for global markets as the most nuanced since the OPEC oil price shock of 1973 and the Asian crisis of 1997. COVID-19 has certainly warranted a number of reflections for families, governments, central banks and investors and has since charted a path that some refer to as "a new normal". Time-tested century old economic theories gave way to unconventional fiscal and monetary solutions such as Modern Monetary Theory (MMT); trillions of dollars of debt securities dived deeper into negative yield territory whilst corporate valuations at some point seemed absurd.

The beginning of 2021 however ushered in a fresh optimistic theme closely tied to vaccine rollouts and their impact on the global economic recovery. Strong data prints and impressive earnings from developed markets have restored some calm to investors broadly but inflation and reflation fears have lingered since the US 10-year treasury spiked to a year high of 1.7%. Readjusting our lenses back to Ghana, a few tailwinds drove asset prices higher on our local bond and equities market. Foreign inflows of ~USD 1.0bn in January and a relatively stable currency sustained risk-on sentiments for investors. At the other end of the spectrum however still lies our worrying fiscal situation that has been largely overshadowed by the successful treasury issuances on both the local and international market - inclusive of the USD 3.0bn Eurobond issuance last month and the cedi's strength.

In our first issue of Rates Compass for the year, we will discuss our views on currency, direction of yields for 2Q2021 and 3Q2021 and lastly, our active management strategy to generate risk-adjusted alpha on our portfolios.

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## Growth and recovery still have legs

Above-trend growth now remains the base case scenario for 2Q2021 for most banks and portfolio managers as vaccine rollout in 1Q2021 remained the key driver of optimism across developed economies, especially the US. Europe has finally circumvented the disruption it faced with regards to its vaccine rollout and is playing catch up with the rest of the developed world.

Data from the US for 1Q2021 shows consumers have amassed a huge pile of savings that could translate into a further 2% leap in US GDP growth assuming 20% of those excess savings are spent. Consumers are currently eager to spend, travel and dine out as economies gradually ease lockdown restrictions but this wall of pent-up demand currently overarches the available supply of goods and services as a result of the ongoing pandemic-induced bottlenecks in the global supply chain.

As a confirmation of the above thesis, US consumer prices for April soared to a 13-year high and circles investors back to the conversation about inflation and reflation. The FED has continuously attempted to reassure markets that the spike in economic activity and even the most recent CPI data is nothing short of a blip that will subsequently fade away once the pandemic recedes. It thus remains confident about its inflationary views especially as five-year forward inflation expectations are close to where it wants it to be – 2.25%.

As a result, real treasury yields are still firmly negative despite nominal yields climbing up to 1.6% and suggests that the FED wants and expects the economy to run a little hotter before tapering its QE programme at the beginning of 2022 and eventually hiking rates in 2023.

Considering the current posturing of the FED, bond investors are currently not convinced about real yields climbing above negative territory anytime soon and that has largely contributed to the over

~USD 4.0bn of foreign inflows into Ghana through bond issuances on both the local and international market since the beginning of this year. The government's recent USD 3.0bn Eurobond issuance in which it debuted a zero-coupon bond had investors bidding the order book for the zero-coupon bond by over two times despite the country's high debt distress and bears further proof of bond investors' ongoing hunt for yield.

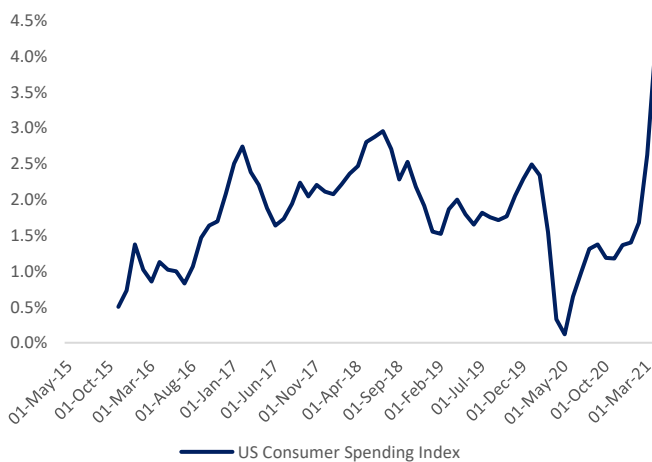
Still on the conversation about growth and recovery, Ghana's growth prospects are arguably far ahead of the curve as evidenced by the strong reading of the Real Composite Index of Economic Activity based on recent data from the Bank of Ghana. However, what remains the crux on our local market is how sustainable the local currency's strength is, given the macro backdrop of the economy.

The successful issuance of the USD 3.0bn has further anchored the local currency's strength and pushed fiscal risk discussions to the back burner. Local yields have consequently come off significantly by 185bps and tightened term premiums across the curve underscores our view that the current low interest rate environment will be sustained, barring any significant weakness in our local currency.

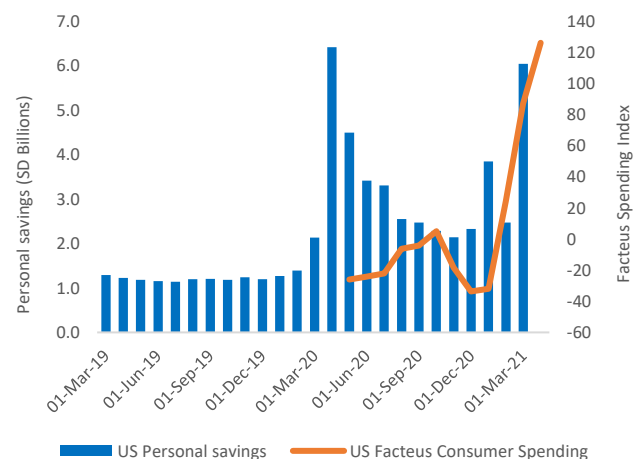
Looking further into the next four to six months, we view currency as the needle that moves yields upwards but our biggest conundrum remains "when". In gathering clarity on the uncertainty of "when", we intend to monitor closely any significant shift in the tone of the FED.

With the number of market opportunities gradually thinning out by the day, we have explored active management strategies in rebalancing our portfolios and commenced a core-satellite strategy that we believe will offer the most carry in the short to medium term.

US Consumer Price Index



US Personal savings vs US Facticeus Consumer Spending



Source: Bloomberg

The Facticeus Consumer Spending Index tracks daily change in spending of low to middle income households in the US since the pandemic began and is focused on three sectors namely Retail, Entertainment and Travel

## Demystifying the cedi

The cedi's performance over the last five quarters has stoked different discussions and perspectives from investors about its fundamental stability amid Ghana's unfavourable macroeconomic backdrop. If historical data should serve as a guide, our local currency is expected to depreciate on average 10% every year.

However, that expectation was met with a different twist at the end of 2020 with the Ghanaian cedi finishing the year off with a 3.9% depreciation against the dollar. In hindsight, we believe the performance of the cedi in 2020 was attributable to the intense hunt for value by bond investors in a yield-starved environment, largely turbocharged by various QE programs from central banks. Frontier markets like Ghana, as a result, benefited from the significant portfolio inflows into their local bond markets and that further explains the compression we saw on the local yield curve for most of 2020. This has been further supported by the recent USD 3.0bn Eurobond issuance. However, considering the gradual fading of foreign portfolio inflows in recent times, we have adjusted our earlier underweight view of the dollar to neutral.

Reassessing the cedi's recent strength in the last few months has led us to believe that favourable externalities have shielded against our high debt service burden and fiscal slippages that are yet to crystallise. Firstly, the FED's excess liquidity since the pandemic hit has broadly debased the dollar's value and reduced its previous appeal and demand as a store of value and safe haven. Moreover, with interest rates and real yields still low in developed markets, there is little incentive for investors to prefer dollar denominated assets.

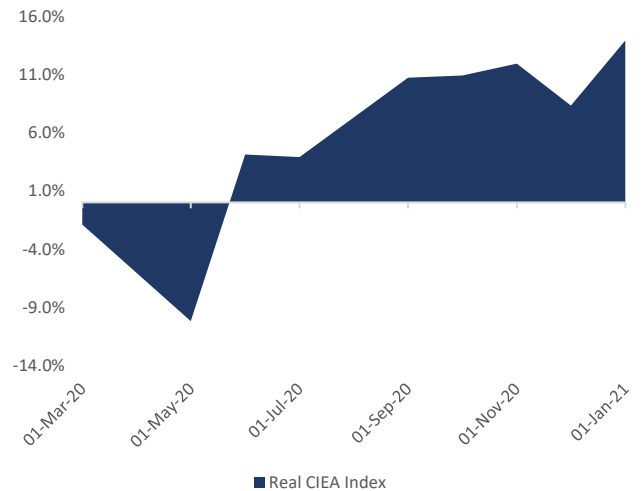
One may ask "What upends our favourable view of the cedi?" We consider a significant rise in import activity to be the main downside catalyst for the cedi's strength. Available data from the bank of Ghana implies a resumption of import activity back to pre-pandemic levels. Therefore, should business and economic activity maintain their current trajectory for the rest of the year, we would expect some demand-pull pressure for the US dollar to poke some weakness in the cedi's relative stability. That could further coincide with fiscal slippages finally crystallising and yields correcting upwards, as expected.

USDGHS vs DXY (Dollar Index)



Source: Bloomberg

Real Composite Index of Economic Activity

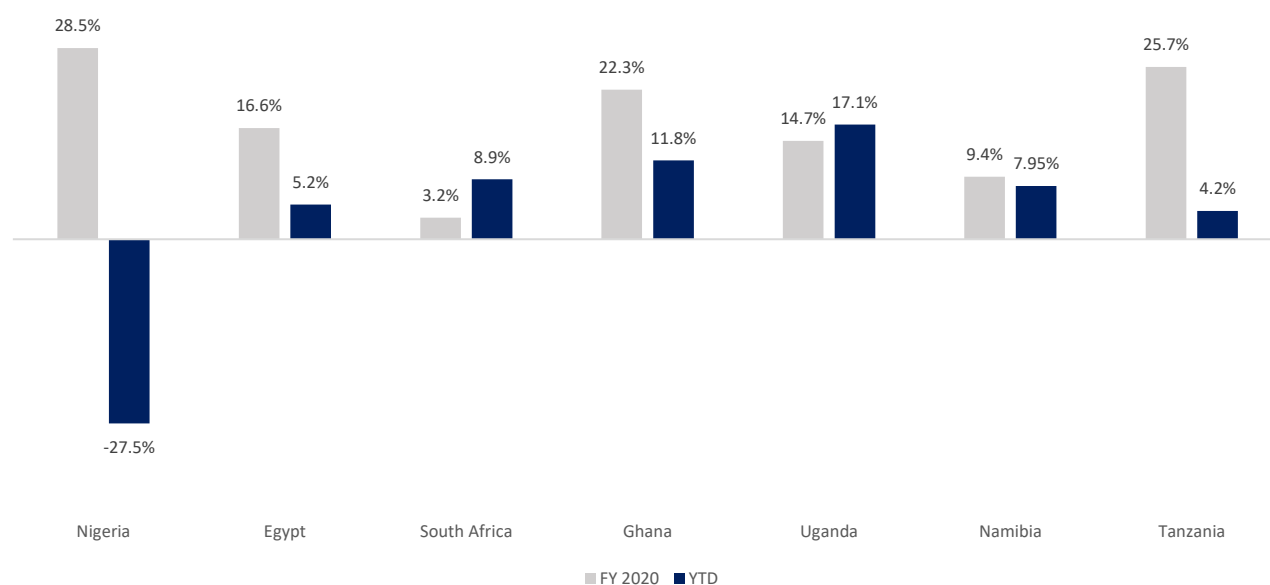


Source: Bloomberg and Bank of Ghana

## Ghana amongst favourites as a preferred destination for bond investors

African bond markets have made a compelling case as the preferred asset class destination for most investors since yields turned negative in developed markets. The effect of accommodative policy from central banks has driven rates down on better quality fixed income products hence the demand for high-yield sovereign bonds. In 2020, African bond markets with more depth and breadth witnessed a huge chunk of inflows that drove overall performance for the year. Nigeria's bond market for instance delivered a staggering 28.53% in USD returns at the end of 2020 but has reversed all gains so far this year with a YTD return of -27.47%. The tide has gradually shifted since the beginning of this year, as investors are taking profits from these markets and moving into frontier markets like Ghana and Uganda that have recorded double-digit returns year-to-date.

S&P Bond market returns (USD) of select African countries



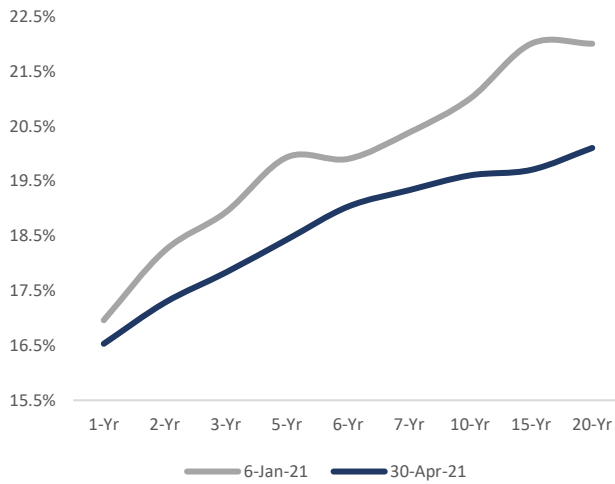
Source: S&P Global Bond Indices

The shift in flows into frontier markets like Ghana is what supports our duration bias in the midst of a flattening yield curve. Yields on the one-year and ten-year paper were seen trading at 16.30% and 19.50% levels respectively, as compared to the 17.50% and 21.0% levels we saw in the early part of last year. The long end of the curve gave in to the enormous buying pressure of foreign players and hence, the decline of ten-year paper yields from 21.0% to 19.50%. Eventually, investors have intuitively taken profits at the long-end and crowd-positioned at the short-end of the curve.

Assessing the wave of liquidity that continues to float both on our local market and in developed markets, we view this crowding at the short-end of the yield curve could be a premature positioning against fiscal risks which are yet to crystallise. Carry has been the major driver of returns across various bond markets in Africa, but we do not estimate this to continue for much longer, especially for Ghana, considering the low pricing of primary auctions we have seen this year. The government has taken advantage of the low-cost funding environment by issuing some long-tenured bonds at much lower yields as compared to last year and will continue to do so for as long as the yield hunt party goes on. Consequently, we intend to adopt a blended strategy of carry and duration that is tilted in favour of duration by looking in the opposite direction of where markets are currently positioned.

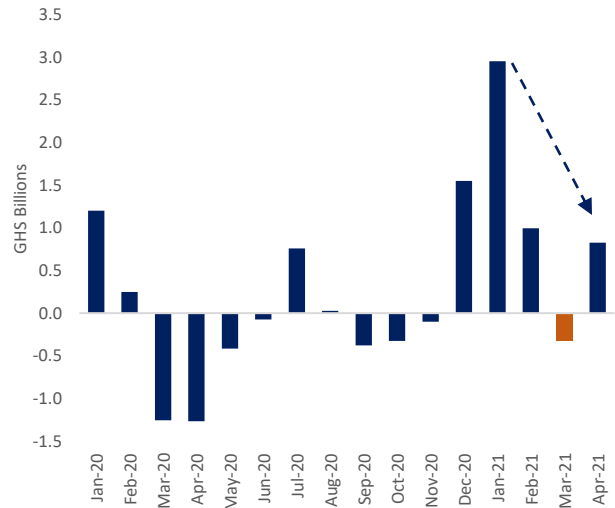
In line with the above, we have crystallised gains on some of our short-dated papers as they approach parity whilst buying duration at a steep discount to magnify carry on our portfolio. We have since sold off some securities across various maturities, crystallised gains of ~GHS 20m in the process and reinvested the sale proceeds at the long-end of the curve.

### Local yield curve evolution

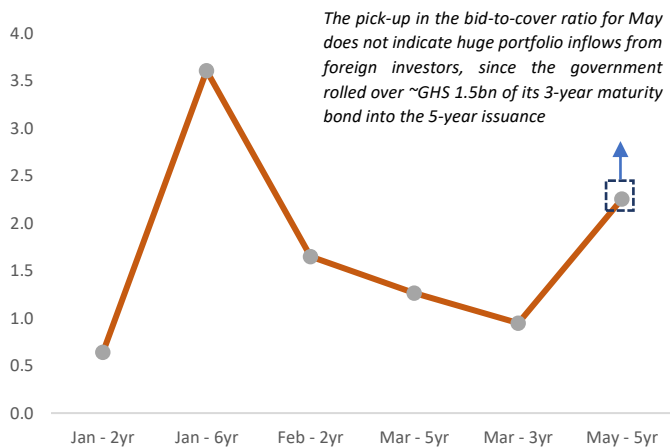


Source: IC Asset Managers research and Central Securities Depository

### Net portfolio flows by foreign investors



### Bid-to-cover ratio



Source: Central Securities Depository

In reiterating our views concerning our local bond market, we estimate yields to be approaching their bottom as we saw six months ago. Portfolio flows have faded in the last two months and so for our readers and most investors, we will continue to ask the question of “when” in respect of a correction of the local yield curve to reflect the country’s unfavourable macro story. For bond markets in Africa and Ghana, there is a plausible chance that portfolio flows by foreign investors will find their way back to developed markets once inflation soars unabated in the US. However, a key theme that will be central in determining the timing of this event will be data releases and central bank meetings from China, Europe, US, India and other Asian countries in the next few months. Consensus will be largely formed on the impact of the vaccine rollout so far and whether now is the time to fully open up economies and rethink interest rates to avoid a global inflation blow out. For Ghana Eurobonds, based on our slightly favourable currency forecast, we hold a neutral view and consider them fairly priced at their 95-98+ levels although a 12.0% mispricing between Ghana Eurobonds and local bonds persists. Over the last five quarters, spreads between our local treasury papers and Ghana Eurobonds of similar maturity have hovered around 12.0% on average and suggests that market has been baking in a currency depreciation of 12.0%. However, that has not been the case due to the favourable externalities we have highlighted in earlier paragraphs - i.e. liquidity support from the FED and low yields in developed markets. In the past, Ghana Eurobonds have exhibited an appreciable level of correlation with US treasuries and so we estimate their yields to remain low in tandem with yields in the US and other developed markets.

## Conclusion

As vaccine rollouts continue smoothly across the globe in tandem with the ongoing economic rebound, the ambiguity that characterised markets in 2020 is expected to gradually fade out in 2021. However, the discovery of new COVID variants in Vietnam, South Africa, Brazil and some parts of the world however pose a real downside risk to the global economic recovery we are witnessing. We remain committed to monitor the impact of the new variants on livelihoods and market trends. Pent-up demand across various sectors of the global economy is expected to buoy momentum and optimism for the remaining part of the year.

At IC Asset Managers, we believe this momentum needs to be accompanied with a preference for active portfolio management and a well-managed appetite for extra risk. We are in the process of tweaking our risk-reward ratios accordingly in the midst of a prolonged low-yield environment, whilst keeping a close eye on any new developments that have the potential to significantly sway markets in the other direction.