Rates Compass

Portfolio Insights | Treasury securities | Ghana
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The real test lies ahead

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IN BRIEF

- Mixed economic releases in the last few weeks have prompted a reassessment of the bubble of growth optimism that characterised markets and drove asset prices higher in the first half of the year

- Some key emerging markets are contending with rising inflation and have begun hiking rates in an attempt to avert a potential crisis

- In Ghana, whilst inflation expectations seemed highly correlated with yields in developed markets, yields on our local sovereign bonds declined further by 87bps in 2Q2021 on the back of a favourable cedi outlook and massive central bank liquidity

- The local currency has felt the heat of mounting pressures from higher corporate demand and thin market liquidity despite active supply management from the central bank

- We picked-up some bargains across the belt and long-end of the curve to enhance our portfolio's yield and carry as investors dialed back on duration

- As liquidity continues to drive yields at their current levels, we will continue to develop a much deeper understanding of how and when the tide can change so we are in the best position to tweak, readjust and rebalance our positions in order to capture the most value on the curve

Introduction

The first half of every year always serves as an ideal hiatus for banks, hedge funds, asset managers, and investors to hit the reset button, reassess market views and strategies and consequently reposition and rebalance portfolios accordingly if need be. In the last 14 months, bond markets, both global and local have experienced varying degrees of divergence from fundamentals mainly driven by the enormous liquidity support from procyclical fiscal and monetary policies.

This theme has not changed significantly but instead evolved since the beginning of 2Q2021 with mixed views about how transitory the FED[1] views inflation after consecutive upbeat CPI[2] data from the US. Transitory or not, a broad consensus was reached by most fixed income teams and strategists in 2Q2021. Markets would have to play the cards being dealt by the FED for the time being whilst reflationary trades become the go-to play for the remaining part of the year as vaccine rollouts are ramped up across the globe. The latter part of 2Q2021 has however prompted reconsideration of the reflationary trade idea as growth seems to have peaked. In a surprising twist of events, fears of rising prices have now given way to worries about economic growth.

In Ghana, while inflation expectations seemed highly correlated with yields in developed markets, yields on our local sovereign bonds declined further by 87bps in 2Q2021 on the back of a favourable cedi outlook, scarcer market opportunities for local bonds and massive central bank liquidity that is yet to subside. The local sovereign yield curve currently appears fiscally and economically secular with one leg hinged and slightly tilted in favour of any shocks in developed market yields and the remaining leg cautiously balanced on the performance of currency.

As crowding intensifies at the short-end and belly of the curve and local pension funds max out their allocations to treasuries, the unsettling reality for fixed income portfolio managers has opened a Pandora's box of re-evaluating fair valuations across the yield curve.

The first half of the year was surprisingly easy to navigate as optimism for economic recovery was largely buoyed by vaccine rollouts, accelerated economic growth in China and rising commodity prices. The last few weeks however have shown that this unchartered path that begun in 2020 is far from over and the real test of how to position our portfolios lie ahead in the coming months as the discovery of the delta virus rages on.

In this issue of Rates Compass, we will share our views and outlook on currency, rates both global and local and our strategy that will enable us to navigate the next uncertain months that lie ahead of us.

[1]FED: US Federal Reserve
[2]CPI: Consumer Price Index

The Growth Story: More warp, less fuel

In our earlier issue of Rates Compass for this year, we held a more optimistic view concerning growth and recovery across the globe. At the time, US Treasuries had briefly touched 1.7% and US CPI had soared to a 13-year high of 4.2% amid coordinated vaccine rollouts especially in developed markets. Considering the sequence and timing of these events, all the chips seemed perfectly lined up for a continuation of the anticipated V-shaped recovery led by China, the world's barometer as the "first in, first out" of the pandemic.

Mixed economic releases in the last few weeks have however prompted a reassessment of the bubble of growth optimism that characterized markets and drove asset prices higher in the first half of the year. China, after reporting an outstanding GDP growth rate of 18.0% for the first quarter grew by a mere 7.9% for the second quarter. This data print coincided with a decline in China's credit impulse – a measure of the growth in financing – and a cut in its bank reserve requirements by its apex bank effectively releasing ~ ¥1tn into the market. Arguably this has sent wary signals to the market concerning slowing growth.

Tighter labour conditions and marginal improvements in industrial production in the US are also sending mixed signals to investors but the underlying dull growth expectations of investors is currently being reflected in US Treasury yields which declined sharply at the end of June and beginning of July. It is therefore not farfetched to say that markets are conclusively worrying less and less about inflation but more concerned about growth. The copper-gold price ratio – a key indicator of the physical market's inflation outlook – plunged from an eight-year high of 0.262 in May to 0.239 in July and further rehashes the market's fading concerns about inflation. The need for inflation-hedging by most investors as a result has declined at least for the short-term.

Base effects, rising inflation and higher NFP[3] numbers are clearly not as impressive as we thought and hence the growth story that took off on a good note at the beginning of this year is beginning to reveal some cracks. The jury is still out but investors will now have to answer the bigger question of "What to do in the wake of plateaued growth?"

Whilst growth seems to have petered out in the developed world and the threat of inflation inadvertently fades into the background, some key emerging markets are contending with rising inflation and have begun hiking rates in an attempt to avert a potential crisis. Noteworthy among them include Brazil, Russia, Mexico and Turkey.

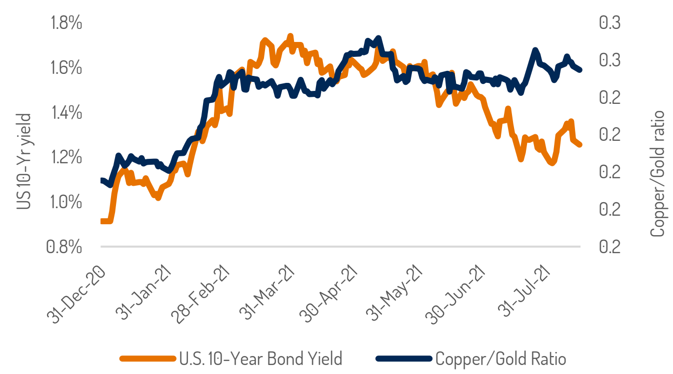
On the brighter side however, this development sends a much positive signal to investors concerning growth in the region which is expected to climb to high levels not seen in years.
What this effectively means is that some of the best carry trade ideas will abound in the region leaving frontier market countries like Ghana parched in terms of foreign portfolio flows. This scenario has already begun to play out on our local bond market and contributed partly to the gridlock we have seen for the most part of 2Q2021 and 3Q2021.

As a team, we forecast liquidity to be the main driver of the existing standoff being witnessed on the local rates market in the coming months. The government, so far this year, has conveniently refinanced a lot of maturing debt at cheaper rates across various maturities due to the low yield environment and the wall of liquidity erected by the central bank. Hence, low yields will likely stay with us for a while up till when external shocks force a repricing of rates across the globe.

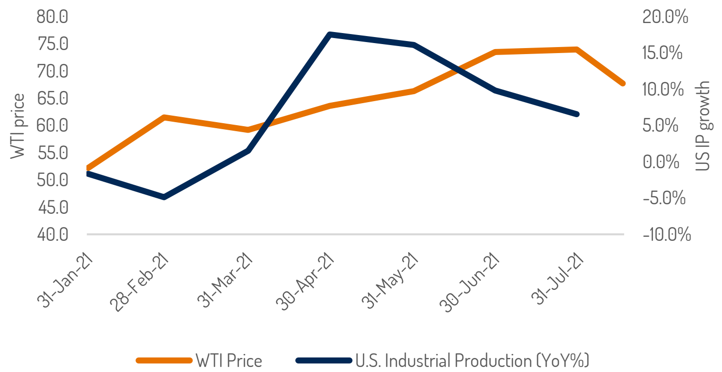
We expect investors to pay more attention to high-frequency economic data from the US and China to garner more clarity on growth. For Ghana, as yields remain range bound at their depressed levels, further currency weakness and a sharp downturn in commodity prices remain some of the key risks to the outlook.

The threat of the delta variant gaining grounds in Ghana has also now evolved to the point of concern however, a consequent lockdown of the economy remains a tail risk in our opinion.

US 10-Yr Treasury Yield vs Copper/Gold Ratio



WTI[4] Oil Price vs US Industrial Production (y/y growth)



[3]NFP: Non-Farm Payrolll
[4]WTI: West Texas Intermediate
Source: Bloomberg

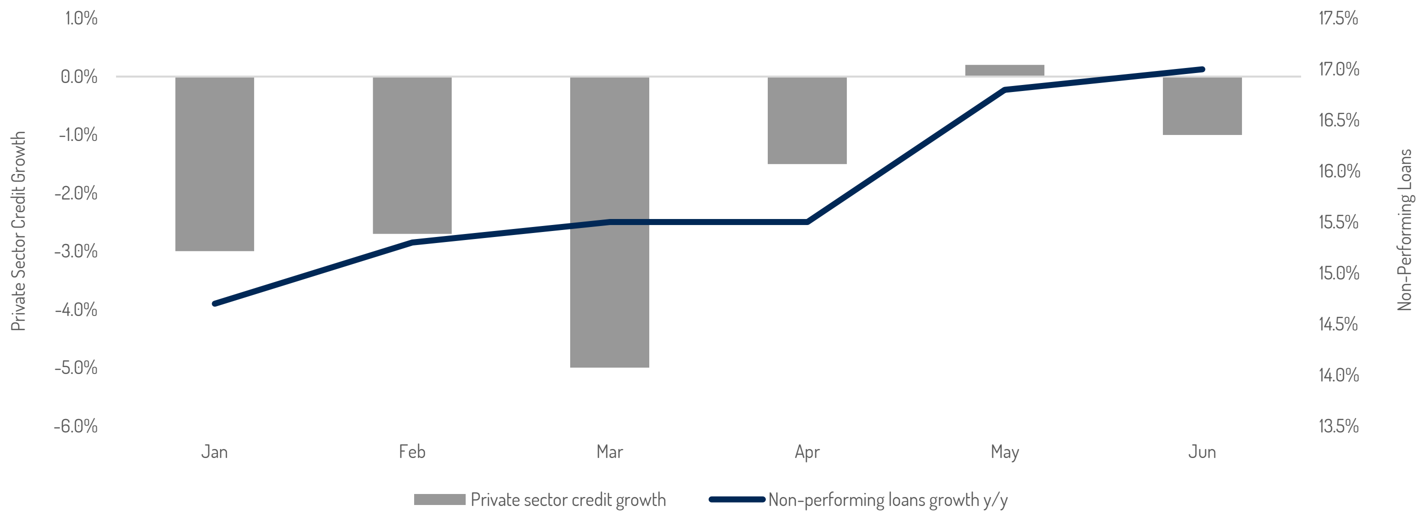
Liquidity - The central bank may be backing itself into a tight corner

For our readers who might be growing increasingly tired of the conversation surrounding central bank liquidity, the subsequent few paragraphs may seem as though we are preaching to the choir. However, as a team, we have found it worth exploring to attempt answering a few significant questions based on a number of scenarios that could play out considering the existing market standoff on the rates market. Whilst we acknowledge not to have all the right answers, we hope our views and assessment of the liquidity issue provides a fresher perspective on how yields are currently positioned.

Being the first African country to lift lockdown restrictions back in 2020, Ghana enjoyed a major boost in terms of economic recovery. Schools reopened whilst businesses, both small and big resumed operations in an attempt to claw back losses realised from the pandemic and the resulting lockdown. For markets and even policy makers, the expectations of increased demand for money which would reflect in a surge for consumer goods production needed to satisfy pent-up demand were high and optimistic. After the Real CIEA[5] growth numbers touched pre-pandemic levels, Ghana's recovery narrative seemed to be on course but the growth of private sector credit has lagged since the beginning of the year and raises further questions about how organic rising economic activity has been for 2021.

What this intuitively suggests is, whilst business and economic activities have picked up, banks are not yet willing or keen to lend especially as NPLs[6] have been on an upward trajectory since the beginning of the year. A more granular assessment of the economy shows that the local business environment is still in a readjustment phase as labour gaps are gradually being filled and manufacturers find ways to optimize production costs amid new taxes and rising commodity prices. For good measure, the discovery of the delta variant and its potential risks enhances the argument for banks to extend less credit and so banks cannot be necessarily faulted concerning their unwillingness to lend.

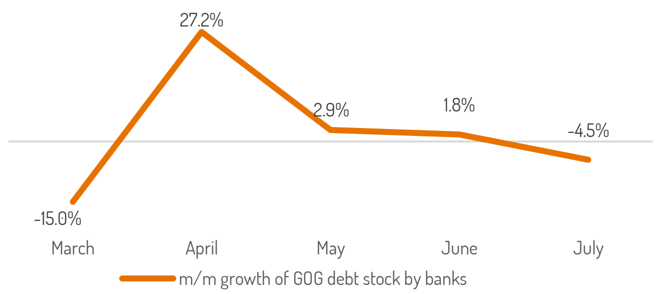
Private Sector Credit growth vs Non-Performing Loans



Source: Bank of Ghana
[5]CIEA: Composite of Economic Activity
[6]NPL: Non-Performing Loans

Consequently, most commercial banks have turned to government bonds to improve net profit margins since the pandemic hit but even for banks, it appears they may be approaching a cliff as to the amount of local bonds they can buy on their balance sheets.
On average, commercial banks hold ~38.0% - the highest among the various investor types - of the total outstanding debt stock (including cocoa bills, corporate bonds and local statutory papers) per data from CSD[7] with government bonds making up ~60% of the pie.
However, in the last three months, we have witnessed the month-on-month growth of government bonds held by banks plummet after a

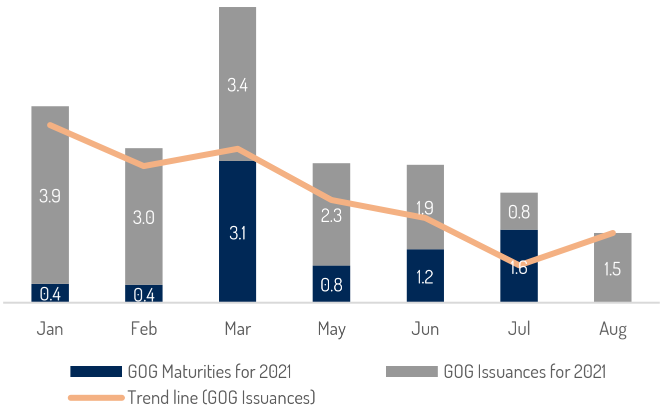
Month-on-month growth of GoG debt stock by banks for 2021



double-digit peak in April where commercial banks collectively added on about ~GHS 8.2bn more worth of three-year tenored bonds on their balance sheets.

On the other side of the fence, pension funds are essentially maxed out on their allocations to treasuries even after the 60% waiver approval from the NPRA[8]. It is thus reasonable to assume that if the two largest holders of government debt stock are running out of room for bond buying, the government is left with little choice but to borrow less domestically. It therefore comes as no surprise that we are seeing a gradual decline in primary issuance sizes since January of this year.

GoG Maturities vs Issuances for 2021



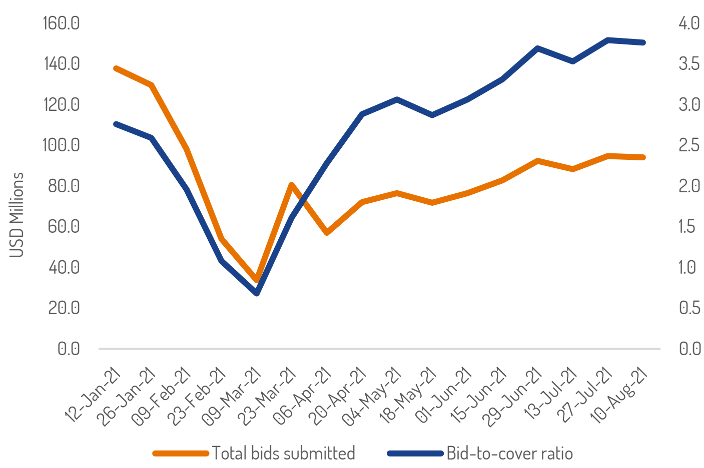
[7]CSD: Central Securities Depository
[8]NPRA: National Pensions Regulatory Authority

Source: Central Securities Depository and IC Asset Managers research

Currency – Is "6" the number for cause to panic?

After a stellar performance even by its standards in 2020, the cedi continued its decent stable run and traded in a tight range between 5.7 and 5.8 throughout the period for 2Q2021. In recent weeks however, the local unit has felt the heat of mounting pressures from higher corporate demand and thin market liquidity. The widening spread in the bid-to-cover ratio as shown in the chart below further highlights the increasing demand for US dollars on the market despite active supply management from the central bank.

FX Bid-to-cover ratio vs Total FX bid tickets



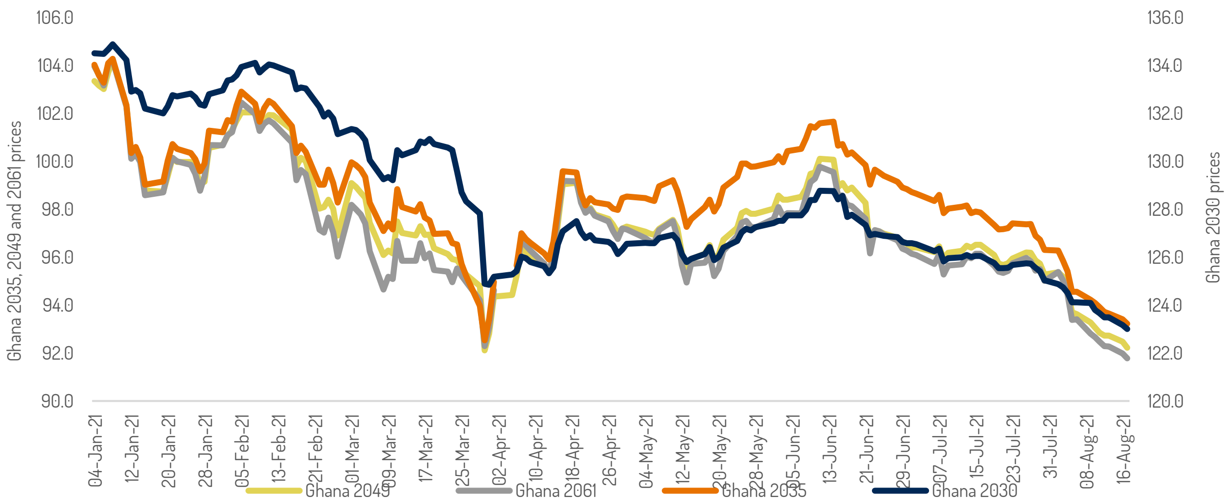
USDGHS Exchange rate evolution

Source: Bank of Ghana and Bloomberg

As a result, the USDGHS pair has finally crossed the "6" ceiling and has been seen quoted on the market at 6.1 levels. For the first time ever this year, the central bank in its most recent forward auction offered three times the size it usually puts on sale for total bids submitted. Further efforts to shore up the cedi's recent streak of weakness by the apex bank with an additional supply of USD 99m outside of the FX forwards market only proved futile as quotes closed at 6.14 levels. Heading into the next quarter, the country's healthy reserves of ~USD 11.0bn may soon come under pressure but the IMF's[9] recent SDR[10] facility of ~USD 1.0bn to Ghana should provide some buffer to the cedi in the short-term.

Despite negative real yields in the US, the dollar has advanced in the last couple of months to re-cement its status as a safe haven amid the intensifying spread of the delta variant. There is also talk of a hawkish tilt from the FED in its last meeting where most members agreed that the tapering of bond buying could begin much sooner. The confluence of these factors could sustain the strength of the dollar and drive the USDGHS pair higher than we are seeing today but we do not anticipate a downward slide in the exchange rate at its current levels in the next few months.

Ghana Eurobond prices evolution for 2021



Source: Bloomberg

[9]IMF: International Monetary Fund

[10]SDR: Special Drawing Rights

The widespread surge in COVID delta variant cases across various economies in June and July reflected in Ghana Eurobond prices as global investor risk appetite deteriorated. The tricky emergence of different phases of the pandemic and its effect on Eurobonds has left most local Eurobond investors sitting on the sidelines. This dilemma has been compounded by sooner-than expected FED rate hikes in the medium term and a possible tapering of its $120bn monthly bond buying program. Our low participation in the asset class over the last three months thus reflects our sentiments about the prevailing uncertainty and our short-term neutral view on currency.

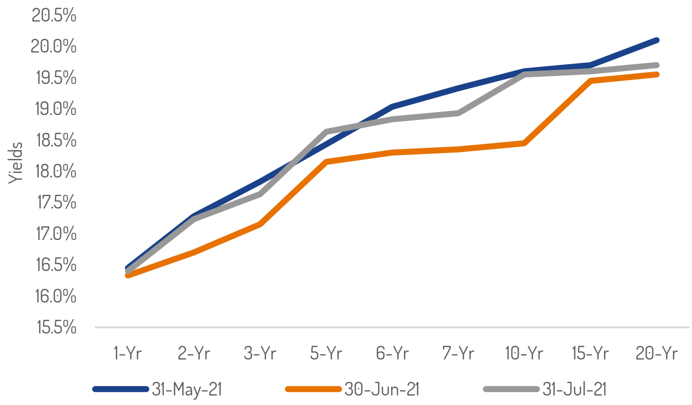
Portfolio Review and Strategy

Since our last issue of Rates Compass in May this year, the occasional decline in liquidity on the treasury bond market as a result of the GHS 2.7bn cocoa bill issuance and other central bank activities have forced yields slightly higher to the levels we saw in May. As investors dialed back on duration and positioned at the short-end and belly of the curve, we picked-up some bargains across the belt and long-end of the curve to enhance our portfolio's yield and carry. In hindsight, this has served us well as the unrealised gains we booked during the period continues to offer volatility cushion to our mark-to-market portfolio. For the broader market, the Mar-26 turned out to be one of the best trade ideas during the period exchanging hands at 18.30% with a total trade value of ~GHS 11.5bn.

From time to time, we continuously come across compelling opportunities at the long end of the curve that enhances portfolio yield and carry and provides us with that little extra edge that consistently delivers competitive returns for our clients. Consequently, we prefer to be short duration whilst we cherry-pick at the belly of the curve.

For as long as liquidity continues to drive yields at their current levels, we will continue to develop a much deeper understanding of how and when the tide can change so we are in the best position to tweak, readjust and rebalance our positions in order to capture the most value across the curve.

Yield curve evolution



Source: IC Asset Managers research