Fundamentals

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Macroeconomic update | Multi-asset strategy | Ghana

When risk-free turns risky

IN BRIEF

- Recent market discussions point to a potential debt restructuring on "risk-free" assets which could involve haircuts on coupons, principal or both
- In this report, we attempt to unpack the impact of the potential default on key sectors such as the banking, pensions and insurance industries under various scenarios
- We also try to determine what the spill over effect could mean for the fiscal position
- Overall, our simulations show that commercial banks, collective investment schemes, pension contributors and individuals are the most vulnerable group of investors, if loss events materialise
- Banks could lose nearly GHS 8bn in the worst-case scenario (i.e. 15% haircut on principal + 30% haircut on coupons) with the potential to cause a recapitalisation of the sector yet again
- Real returns on pension assets could remain negative yielding over the near-term in our base case scenario with the sector losing about GHS 1.3bn in the bear case scenario
- While local investors may be forced to adopt any port in a storm approach, we recommend hedging the currency through commodity-linked exchange traded funds in the absence of U.S. dollar liquidity
- We believe that at current levels, the market has priced in a significant amount of the negative press surrounding Ghanaian sovereign credit. An equal portfolio split between local and foreign currency bonds is likely to generate significant alpha post a bailout programme
- Furthermore, we consider the short-end of the yield curve to be riskier. Consequently, we recommend swapping any short-term maturities for medium and long-dated bonds

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Ghanaian bonds on average have lost nearly 35% and 57% across both the local and foreign currency yield curves respectively since the start of the year as the country grapples with debt sustainability, hyperinflation, currency weakness and credit rating downgrades. As if this was not enough, recent market discussions point to a potential debt restructuring which could involve haircuts on coupons, principal or both on "risk-free" assets.

In this report, we attempt to unpack the impact of debt restructuring on key sectors such as the banking, pensions and insurance industries under various scenarios. We also try to determine what the spill over effect could mean for the fiscal position. Our analysis, however, is limited to local currency treasury securities based on our view that debt servicing on outstanding Eurobonds in the near-term is not as material as that of Cedi-denominated bonds (i.e. 4Q2022 – FY2023 Eurobonds maturity = GHS 1.6bn vs GHS 60.3bn for local debt). Furthermore, we believe that negotiations with Eurobond holders are likely to be protracted thereby making it counterproductive in government's efforts to create immediate fiscal space.

Debt restructuring – what are the plausible scenarios?

Given the high exposure of key investor base to the domestic debt, Ghana's pre-emptive debt restructuring (if decided upon) remains complex and requires a delicate balance between public debt sustainability and liquidity risk to bondholders. We believe the authorities are fully aware of the complexities and would be mindful of the options, especially after the costly financial sector clean-up between 2017 and 2020.

While we believe all options are plausible, including a bull case of no restructuring, we expect the combination of any of the following:

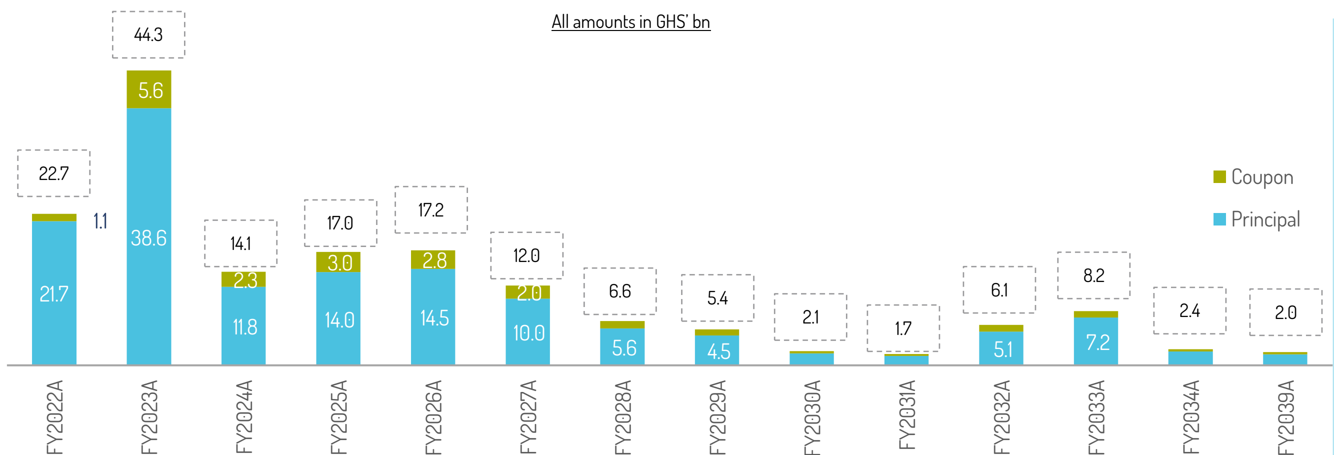
Base case: Debt swaps and lengthening maturity

In our base case scenario, we envisage an exchange of existing longer-dated bonds for near-term maturities and/or an offer of freshly minted securities with lower coupon rates and longer tenors. Under this scenario, we assume a tenor of not less than seven years to allow for fiscal rebalancing under an IMF programme as well as an economic recovery post COVID-19 and the Russia-Ukraine war. This would imply new maturities of 2029 and longer as this period shows low refinancing pressure compared to the near-term maturities.

From our analysis, we estimate a total of GHS 60.3bn in government securities (including Treasury bills) maturing between 4Q2022 and FY2023 at a weighted average cost of 20.8%. Using our base case scenario, this exposure can be swapped or refinanced into longer-dated tenors of 7-year or longer maturities. This could be at relatively lower coupon rates of between 17.0% and 18.0% compared to the current estimated weighted average cost of 20.8% for the near-term maturities.

Consequently, the weighted average cost of near-term maturities could reduce by up to 300bps to ease the debt service burden, which stood at 69% of revenue as of 1H2022. Furthermore, this maturity profile would also ease the total refinancing burden over the period 2023 – 2030 when Eurobonds amortisation kicks-in.

Maturity profile of domestic treasury securities



Source: CSD, IC Insights

Potential impact: Minimal casualties but elevated liquidity risk

We do not envisage a significant fallout within the investor community with our base case scenario. We expect profitability and capital buffers of banks and insurance companies to remain fairly robust although some impairments will filter through on the income statement.

The above notwithstanding, we could see some elevation in liquidity risk. This is likely to arise due to our expectation that any debts restructured under this scenario could be tagged as non-tradeable to prevent distortion in yields of similar tenors on the market.

The pensions industry is also likely to be more receptive to this scenario. However, real returns on pension assets are likely to remain negative-yielding over the near-term.

Retail investors are likely to be the most negatively impacted under this structure due to their significant holdings in money market securities, with over 40% share in treasury bills. Should the government include money market treasuries in this scenario as we have done, retail investors will face significant liquidity risk as the new maturity profile of the rescheduled securities will be longer than their initial investment horizon. This would weigh on retail investor participation in the money market in the immediate term after the debt reprofiling.

Bear case option 1: Haircut on coupons

In order to create the much-needed fiscal space, the government could opt for a reduction in their coupon obligations across domestic notes and bonds.

From the Treasury's annual debt report, we observed a weighted average cost for domestic debt at 17.9% as of FY2021. Our updated estimate shows a current weighted average cost of the domestic notes and bonds at 19.0%, with the highest coupon rate at 29.9% - the Jul-25 bond (3-year tenor).

Our scenario analysis of probable haircut on coupon obligations considered three (3) options: (a) 10% haircut (b) 20% haircut, and (c) 30% haircut on coupon obligations.

Under the 10% haircut scenario, the weighted average cost of the domestic notes and bonds reduces by ≃190bps to 17.1%, dropping 80bps below the FY2021 weighted average cost of 17.9% on the domestic debt. When applied on a total stock of outstanding bills, notes and bonds worth GHS 139.7bn, our 10% haircut on coupon obligation results in a total coupon loss of GHS 2.1bn to bondholders. This reduced the projected FY2023 interest-to-GDP ratio by just 0.4% to 6.4%.

By extension, the coupon loss for bondholders doubled under the 20% haircut scenario to GHS 4.2bn (-0.7% of GDP to 6.1% for interest-to-GDP ratio in FY2023) and tripled under the 30% haircut scenario to GHS 6.3bn (-1.1% of GDP to 5.7% for interest-to-GDP in FY2023).

Sensitivity analysis on coupon haircuts

	Weighted average coupon rates			
	Current	10% haircut	20% haircut	30% haircut
2022	18.2%	16.3%	14.5%	12.7%
2023	18.8%	17.0%	15.1%	13.2%
2024	19.5%	17.5%	15.6%	13.6%
2025	21.6%	19.5%	17.3%	15.2%
2026	18.8%	16.9%	15.1%	13.2%
2027	19.8%	17.9%	15.9%	13.9%
2028	19.2%	17.3%	15.3%	13.4%
2029	19.8%	17.8%	15.8%	13.9%
2030	19.3%	17.4%	15.4%	13.5%
2031	19.8%	17.8%	15.8%	13.8%
2032	19.8%	17.8%	15.8%	13.8%
2033	13.7%	12.4%	11.0%	9.6%
2034	17.4%	15.7%	13.9%	12.2%
2039	20.2%	18.2%	16.2%	14.1%

Source: CSD, IC Insights

At the granular level, our scenario analysis revealed that bonds with higher coupon rates are most likely to suffer the deepest cut. From the analysis, we observed that the 2025 maturities have the highest weighted average coupon rate of 21.6%, influenced by the Jul-25 (coupon: 29.9%), May-25 (coupon: 25.0%), Mar-25 (coupon: 21.7%) and the Jan-25 (coupon: 21.0%) bonds.

The results showed an estimated average reduction of 216bps on the weighted average coupon rate for the 2025 maturities under the 10% haircut scenario (higher than the average reduction of 190bps on the total stock of notes and bonds).

Given that domestic pension funds typically invest along the mid-section of the yield curve, we believe that a deep cut in the coupon rates for the 2025 maturities will significantly impact the nominal returns on their portfolio.

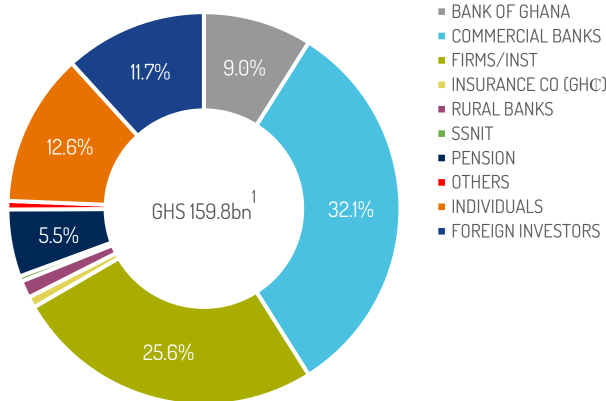
For banks and insurance companies, we estimate a total loss of GHS 2.2bn under our worst-case scenario i.e. 30% haircut on coupons. We expect this to be largely recognised as impairments on the income statements which would erode annualised 1H2022 earnings by 36.7% for the banking industry and by 11.7% for insurers. Consequently, return on equity could decline by 7.2pp y/y to 13.4% in FY2022 for banks, should haircuts apply. In addition, we expect a decline in rates on term deposits in response to the haircut but we caution that this could be short-lived. A potential liquidity crunch could force rates to re-adjust upwards as illiquid banks seek deposits at a higher cost.

The above notwithstanding, we do not expect any significant distortions to capital buffers for banks and insurance companies with just coupon haircuts.

Bear case option 2: Haircut on coupons and principal

Under this scenario we took a sector- focused approach by first determining the distribution of marketable debt across each investor type.

Distribution of government securities by investor type as of August 2022



Source: CSD, IC Insights
[1] Excludes non-marketable securities

We then applied a 5%, 10% and 15% haircut on principal held by each investor type while maintaining our 10%, 20% and 30% haircut scenarios on coupons. To simplify the analysis, we paired each scenario within a band e.g. lower band = 5% haircut on principal + 10% haircut on coupons and determined its impact on each investor type.

From the analysis, the banking sector will be the most impacted, losing nearly GHS 8bn in the worst case under this scenario. (i.e. 15% haircut on principal + 30% haircut on coupons). With eligible capital (tier 1 and tier 2 capital) at GHS 20.3bn and GHS 105.0bn in risk weighted assets as at 1H2022 per our estimates, the losses under this scenario will result in capital adequacy ratio declining below the 13.0% threshold to 11.8% from 19.4%. Consequently, the sector may have to recapitalise again.

Similar to option 1 although more exacerbated, a possible liquidity crunch brought on by the haircuts could lead to defaults on fixed deposit by banks and force a downward re-rating of yields on money market securities. Consequently, the pensions and insurance sectors will experience a double whammy as the haircuts will not only affect the government securities asset class but also the money market securities asset class including repurchase agreements.

Distribution of losses from coupon and principal haircuts by investor type

Total losses per investor type (GHS m)

	Lower Band	Midpoint	Upper Band
Banks	2,527	5,409	7,951
Firms & Institutions	2,022	4,352	6,387
Insurance	71	152	223
Rural Banks	127	331	462
Bank of Ghana	703	1,489	2,194
Pensions	416	834	1,250
Individuals	1,157	3,052	4,240
Foreign Investors	885	1,771	2,656
Total loss	**7,910**	**17,388**	**25,364**

Source: IC Insights

We envisage a significant public dissatisfaction from any potential haircuts to principal and as such, while we admit that this scenario remains an option and is likely to provide the most fiscal space for government, its devastating social impact makes it the most unlikely scenario to occur.

Recommendation – We cannot control the wind but we can direct the sails

We expect markets to remain volatile until an IMF programme indicating clearly how Ghana will turn around its macroeconomic woes is announced. Government has indicated that it is working to have a programme in place before year-end but we believe the more feasible timeline is 1Q2023. Consequently, we envisage further speculation on the currency as balance of payments worsen as well as additional erosion of purchasing power with elevated investor apprehension as risk-free assets turn risky.

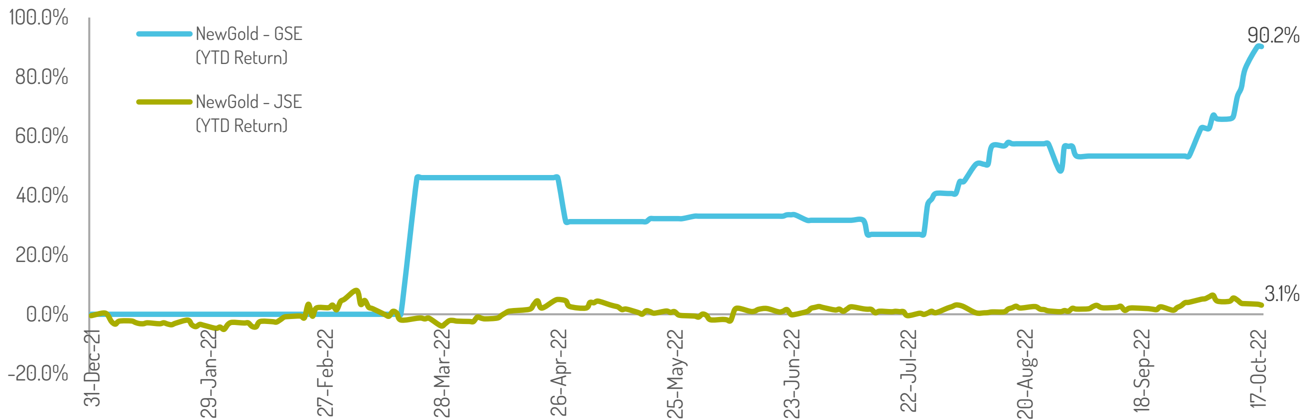
Based on these expectations, our recommendation is focused on capital preservation with a potential for alpha generation post IMF bailout announcement.

Hedge currency through commodity ETFs or buy USD cash

The Ghanaian cedi has softened by 50.6% against the U.S. dollar since the start of the year and remains vulnerable to further depreciation as investor confidence wanes amid U.S. dollar shortage. To prevent further erosion of cedi assets, we recommend U.S. dollar cash (if you can find the liquidity) and/or exposure to NewGold ETF. The Exchange Traded Fund has gained 90.2% on the Ghana Stock Exchange since the start of the year, driven largely by higher USDGHS exchange rates.

Despite the general bearish outlook for gold, the absence of U.S. dollar liquidity on the Ghanaian market, makes the NewGold ETF a natural currency hedge. Furthermore, global recession fears in 2023 could see the precious metal regain its position as the safe haven asset and potentially offer additional alpha.

Year-to-date (YTD) performance of NewGold ETF on both GSE and JSE

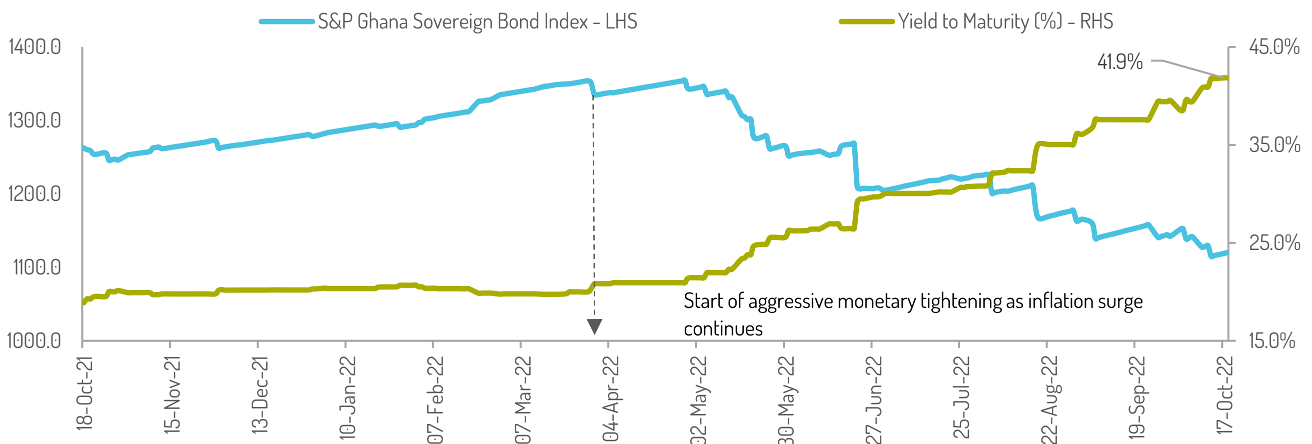


Source: Bloomberg

Diversify treasury position by including foreign & local currency bonds at current levels

While the risk of default on Ghanaian bonds remains elevated, we believe that at current levels, the market has priced in a significant amount of the negative press surrounding Ghanaian sovereign credit. An equal portfolio split between local and foreign currency bonds at current levels is likely to generate significant alpha post a bailout programme.

One-year performance of the S&P Ghana Sovereign Bond Index



Source: S&P Global, IC Insights

Swap short-term maturities (2023s and 2024s) for medium and long-dated bonds at higher yields for alpha

We believe Ghana will weather the storm, albeit at a significant cost. In that regard, we consider the short-end of the yield curve to be riskier. Consequently, we recommend swapping any short-term maturities for medium and long-dated bonds (i.e., post 2025 maturities). We are of the view that once the yield curve normalises, more alpha can be generated at the belly and long-end.

Haircuts may present a buying opportunity for some equities

At the current yields, the cost of equity for Ghanaian stocks remains significantly elevated impacting negatively on valuations. A haircut will force a downward repricing of Sovereign credit and potentially cause yields to decline. Consequently, cost of equity could normalise to pre-pandemic levels (~22%), supporting valuations.

That notwithstanding, we are of the view that poor earnings and margin compressions will keep valuations depressed for banking and consumer stocks, respectively. However, we see defensive-oriented stocks, like MTN Ghana, benefitting enormously from the potential improvement in cost of equity.

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