2024 OUTLOOK: INCOME FUNDS

High interest rates provided compelling returns to fixed income investors of late, but what can we expect in 2024?

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End of the rate hiking cycle

During the Covid years, central banks around the globe embarked on extensive and synchronised monetary policy stimulus. Global interest rates were slashed in 2020 and many central banks bought back massive amounts of debt securities (quantitative easing). This was done to flood global markets with cheap money and increase disposable income to fuel economic recovery.

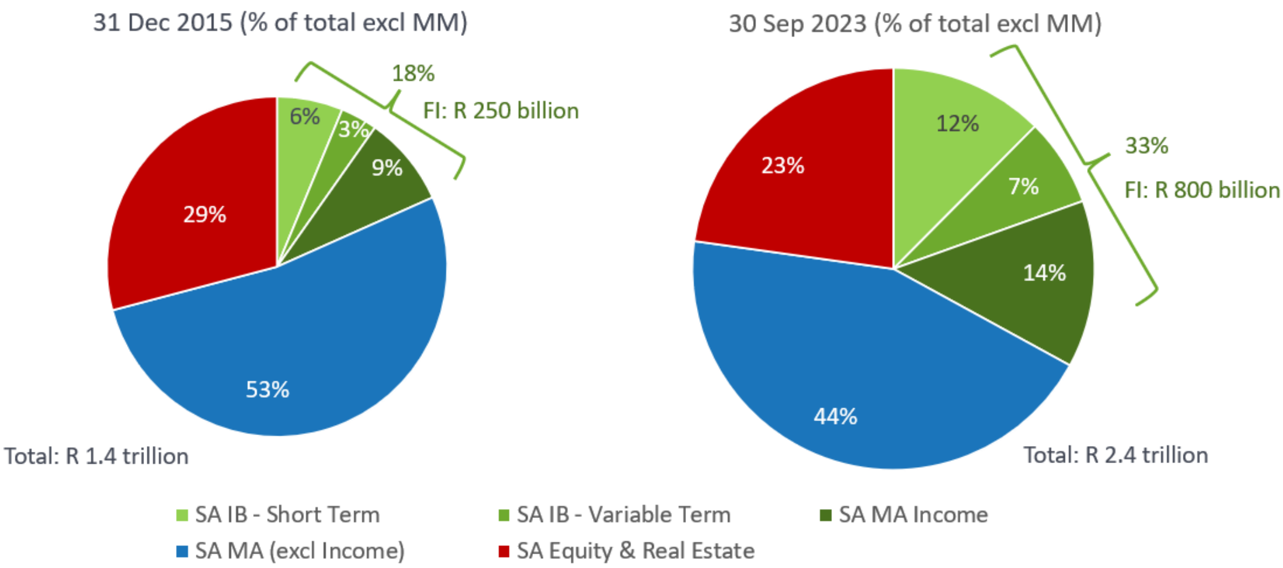
But this was ultimately inflationary and, combined with disrupted global logistics and the Russia-Ukraine conflict, we saw prices soaring. The antidote for high inflation is higher interest rates and so the hiking of policy rates commenced early in 2022. We are now possibly at the top of this hiking cycle as global inflation is coming under control and fears turn to economic recession instead.

With the world's attention focused on the US Federal Reserve (the Fed), and expectations of imminent rate cuts in the US, the belief is that the rest of the globe will follow suit. So, after having been spoilt with high short-end yields over the last year or two, with income funds that have been performing very well relative to other categories, we need to ask whether these funds will remain a good option for investment.

Massive flows into fixed income funds

If we look at the South African unit trust industry, it is interesting to note that the AUM of fixed income funds (excluding money market funds) has grown from R250 billion at the end of 2015 to around R800 billion at the end of the third quarter of last year, now comprising 33% of the AUM of SA unit trusts (excluding money market funds).

Figure 1: Growth of fixed income unit trust funds (excluding money market funds)



Source: ASISA Local Fund Statistics, SA funds excluding money market funds

Note that, apart from money market funds, ASISA has three fixed income focussed fund categories:

- SA Interest Bearing (IB) Short Term (e.g. the Matrix SCI* Stable Income Fund)
- SA Interest Bearing (IB) Variable Term (e.g. the Matrix SCI* Bond Fund)
- SA Multi Asset (MA) Income (e.g. the new Matrix SCI* Enhanced Income Fund)

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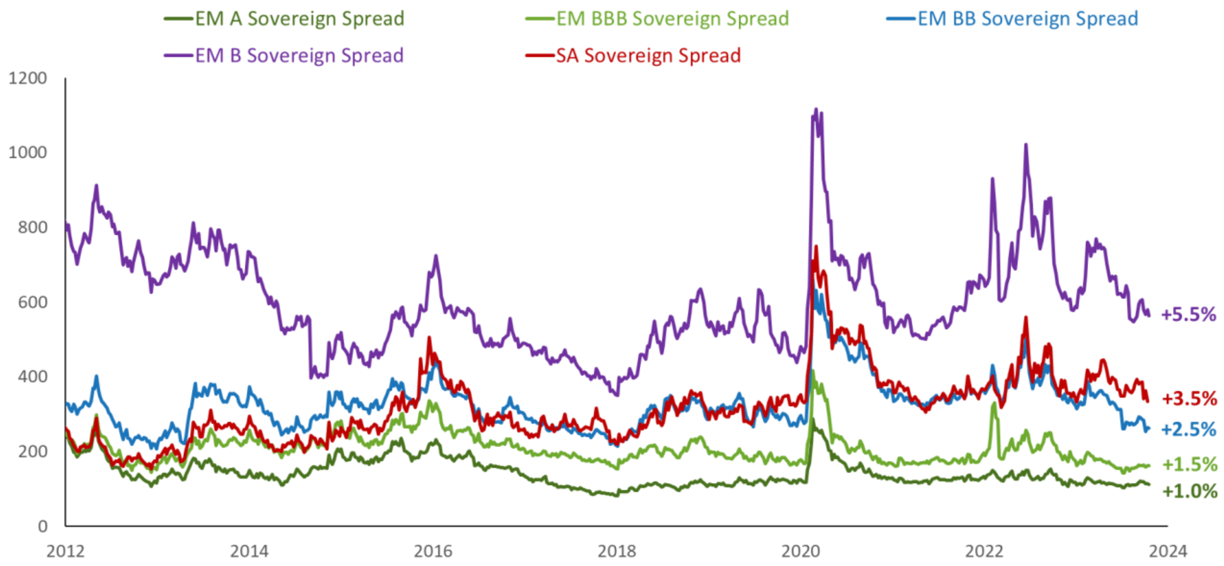
What's driving this growth?

To some extent the hiking cycle can account for the flow of funds into interest-bearing assets, but a key factor has been the steady erosion of South Africa's global sovereign credit rating (measuring the government's ability to repay its global debt) and the yield pick-up driven by that.

Figure 2 shows how the 10-year SA sovereign debt credit spread (red line) has fluctuated and deteriorated over the past decade. We see it tracking the A-rated sovereign spread (e.g. China) and then tracking the BBB-rating spread (e.g. Mexico) and then jumping up to the BB-rating spread (e.g. Brazil) from December 2015. BB, B and lower rated sovereign debt are commonly referred to as high yield debt or (less flatteringly) junk bonds.

It is interesting to note that the SA credit spread anticipated each rating downgrade, moving well ahead of the official announcements. Right now, we are seeing South Africa's spread edging towards a B-rating (e.g. Turkey), indicating that the international market expects that a further downgrade of our country's creditworthiness is possible. As things stand, the SA government may well need to pay around 100 basis points (1 percentage point or 1%pt) more per annum for new debt than the average BB-rated sovereign. Further deterioration to a B-rating may see SA paying as much as 5.5%pt more than AAA-rated sovereigns for 10-year debt in the same currency.

Figure 2: Sovereign credit spreads over time



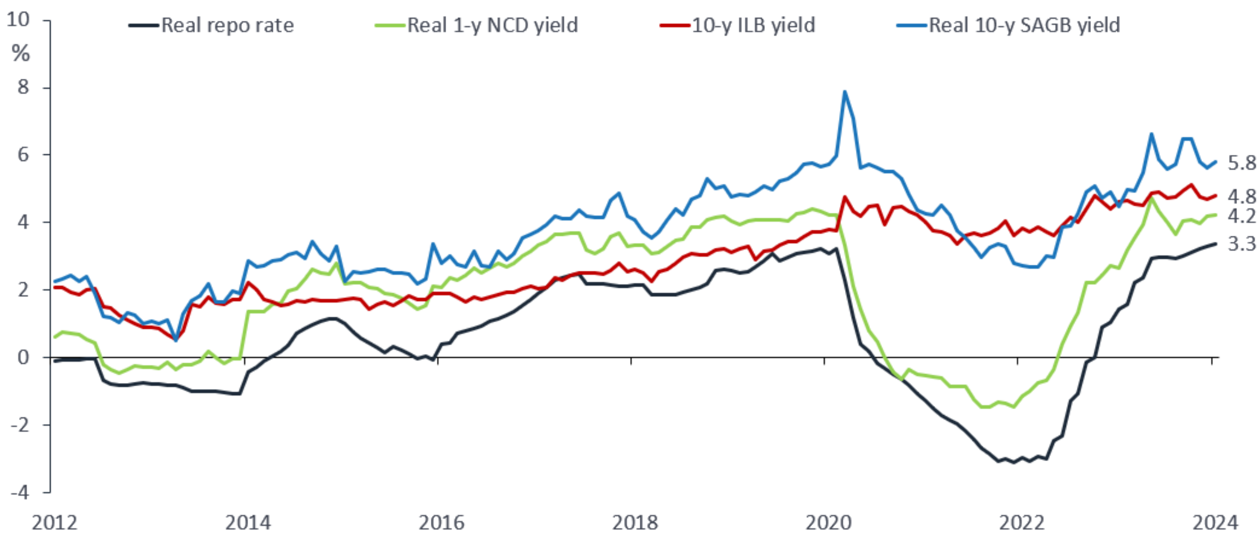
Source: Bloomberg

Bad news can be good news…

Well, the bad news is that SA is a high yield country. The SA government and other SA borrowers need to cough up more in interest payments because of our junk bond status. The South African Reserve Bank (SARB) has had to keep policy rates extra high to attract capital, support the rand and maintain price stability. The cost of debt has increased across the yield curve.

Conversely, if you are a net saver, the good news is that we are a high yield country! You will be earning more interest now than you would have before our sovereign downgrades – all else being equal. In fact, you may now be earning an unprecedented real yield (interest yield above inflation). Who says you can't beat inflation by investing in the money market?

Figure 3: SA fixed income real yields (interest yield over inflation)



Note: Real yield = nominal yield less average inflation over the next 12 months. Bloomberg Consensus forecasts used where actual data is not available.

Figure 3 shows real policy rate and expected real yields offered by a variety of fixed income assets. You can see the extraordinary accommodation that took place during the Covid years (2020-2022) as the real repo rate (black line) dips well into negative territory. It has since recovered and fixed income instruments are now offering expected real yields at extremely attractive levels.

Prior to 2016, it was not a foregone conclusion that investing in the money market (bank deposits and such) would provide inflation beating returns. However, since December 2015 (Nenegate and state capture revelations) we can see how the real repo rate has moved structurally higher and – barring the covid stimulus – investors have been able to earn handsome real yields of between 2% and 4% above inflation, by investing in low-risk bank deposits. This has been a paradigm shift for SA income fund investors.

What about rate cuts, now that we are at the top of the hiking cycle?

With inflation fears subsiding and recessionary fears brewing, markets are widely expecting policy rates to fall. In the US, inflation peaked at 9.1% in mid-2022 and then came back all the way to around 3% by the end of 2023. The US Fed Funds policy rate was steadily pushed up from 0% to 5.5% as inflation surged and is now expected to be cut by some 200 basis points to around 3.5% over the course of 2024 and 2025.

In SA, inflation peaked at 7.8% in mid-2022 and is currently at around 5.1%. The SARB's repo rate was hiked from an unprecedented low of 3.5% to 8.25% through the inflationary cycle. SA market participants are now expecting the SARB to cut rates by around 100 basis points (to 7.25%) over the next 12 to 18 months. With the first cut possibly as early as March 2024.

At Matrix we agree that we are at the end of the hiking cycle and that policy rates are due to come down. However, we believe that the timing of SA monetary policy accommodation will lag that of the US by more than the market expects – possibly only seeing rate cuts toward the third or last quarter of 2024.

The primary reason for this is that US real policy rate is currently very high relative to history – around 3%pt (300 basis points) above expected inflation. This is at a similar level as the SA real policy rate and placing pressure on the rand.

We see the SARB starting with rate cuts when it becomes clear that SA inflation is settling around the midpoint of the target range (4.5%) and the US real policy rate is around 1-2%pt lower than the SA real policy rate. We also believe that the SARB will maintain its real policy rate around 2-3%pt above expected inflation.

What can we expect from income funds in 2024?

We believe that fixed income yields will continue to offer good value to investors – especially income funds.

Our base case scenario sees nominal money market rates (income fund yields) down by around 0.75%pt by the end of 2024, with most of the cuts later in 2024. Furthermore, rates should only move lower when inflation settles at lower levels. This means that the real yield that you earn on your income fund investment should remain at elevated levels over the coming year. Naturally there are many risks and alternative (bull and bear case) scenarios as well as unexpected news flow that may impact on this base case assessment throughout the year.

In summary, nominal yields may fall by 50 to 100 basis points during the latter part of 2024, but real yields offered by income funds should remain as compelling as they were in 2023 (around 3% above inflation).

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About the author

Jean-Pierre joined Matrix in 2019 as Head of Product, responsible for the development and distribution of the Matrix product range. He is also a Key Individual, Representative and member of the Matrix Investment Committee. JP started his career in financial markets in 1996 as a fixed income analyst and trader. He has been a long-standing proponent of the hedge fund industry in South Africa and was involved in the establishment of various alternative asset management and securities trading businesses over the years. Before joining Matrix, JP was a portfolio manager and head of business at a large institutional alternative asset manager. He has a degree in actuarial science and is a CFP and CFA charter holder.