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THE STATE OF SA INC, CORONAVIRUS AND THE SA BOND MARKETS

"40 to 70% of the human population could potentially be infected by the virus if it becomes a pandemic. Not all of these people would get sick." – Marc Lipsitch, Epidemiologist, Harvard University, 21 February 2020

"Now we also face an immediate crisis. In the past week, Covid-19 has started behaving a lot like the once-in-a-century pathogen we've been worried about. I hope it's not that bad, but we should assume it will be until we know otherwise." – Bill Gates on 28 February 2020. Bill Gates also offers the view that the coronavirus could hit Africa worse than China, and that 10 million may die worldwide.

What impact would this have on the economy? A slowdown in trade and economic activity and, market action in response to the virus fear.

Slowdown in economic activity

Global growth and trade forecasts will be revised down sharply, and central bankers are responding by cutting interest rates and adding liquidity. The injection of liquidity will help to support the financial markets. For South Africa,at risk of downgrade, the combination of rising debt levels, union resistance to pronounced labour cuts to help alleviate this together with a lower growth outlook, will hasten Moody's day of reckoning. Moody's is concerned about SA's vulnerability to external shocks. The stabilisation of SA public debt, a shock to domestic growth in an economy laden with rising public debt and a zero percent savings rate, will give them cause for concern.

The question remains, to what extent is the downgrade priced into the market? In terms of the CDS spreads, default risk on SA debt is priced at similar levels to Brazil that is currently junk – we don't expect this risk premium to widen further relative to EM peers on a downgrade announcement. However, what we have noticed over the last year is a widening in the SA currency risk premium as investors demand higher yields for SA currency risk(currently 5%). This is the excess yield global investors' demand for Rand currency risk. It is difficult to know where this could go but if foreigners sell bonds on a downgrade, and growth and SA's fundamentals continue to deteriorate, then it is possible that this premium widens further. Foreigners are not net buyers of SA bonds this year indicating that at current levels they do not yet see compensation for the risk they are taking.

Market response to coronavirus outbreak

The consequence of easy money conditions globally has been an increase in leverage in the financial system. When panic sets in as the world sneezes, traders face margin calls, cut positions and markets implode. Market movements are then exacerbated beyond what fundamentals tell us about potential shocks to earnings.

The 15% fall from the recent high is the fastest 15% from a high in the history of the US equity market. During the pandemonium, the gold price fell close to $70 at a point of flight to safety. It seems the major reason for

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this was traders, faced with margin calls on equity positions, were forced to cut wining trades to meet margin. Now, as equity markets have recovered, gold is rising again - the high level of leverage in the system has unforeseen consequences and risk is rising.

What does the market risk off selling mean for SA bond markets? The flight to quality away from risk assets saw SA bond yields rise sharply early March and further risk off activity will likely see SA bond yields rise further.

The combination of a weaker economy, rising national debt and a government that is unable to contain the deficit, all in combination with a general global risk off environment, are all negative for SA bonds. Having said that, real yields are historically high and further sell offs in the market will provide an opportunity to purchase bonds as real yields rise further.

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