The *duet* of offshore and local corporate credit spreads

Local corporate credit spreads have been on a downward trajectory.
In dance, the more curved the arch of your foot, the healthier and stronger your feet are. After analysing the curves of our credit markets we're currently seeing healthier feet offshore.

by Dalya Abromowitz

Let's take a spin through the South African corporate debt market, where credit spreads – the yield above a reference rate that compensates investors for the risk they take on – have meaningfully contracted since 2018. Local debt issuers are not offering attractive risk compensation when compared to those in the global line-up.

This is largely due to the dance-off between supply and demand. In a weak economic environment, corporates have had less incentive to gear up for growth and are therefore issuing less debt. In some instances, issuers have withdrawn from debt capital markets altogether. In contrast, rising interest rates have made fixed income assets more attractive. This has set the stage for aggressive bidding in debt auctions, driving corporate credit spreads progressively lower.

The current local credit curve is approximated in Figure 1, which shows spreads for two different rankings of bank credit. Lower-ranked bank credit (otherwise known as Tier 2 debt, which is at greater risk of not being repaid if a bank falls into distress) trades at higher spreads than senior bank debt to offer greater risk compensation. The most senior debt from local corporates is priced somewhere in-between. And as the following graph shows, this pricing band has narrowed.

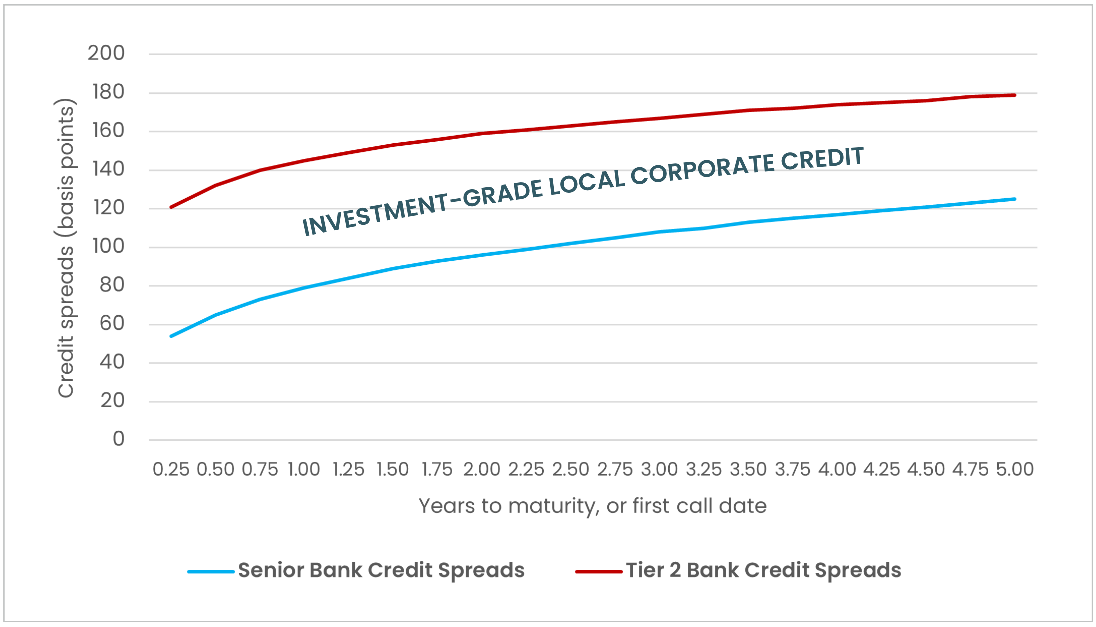


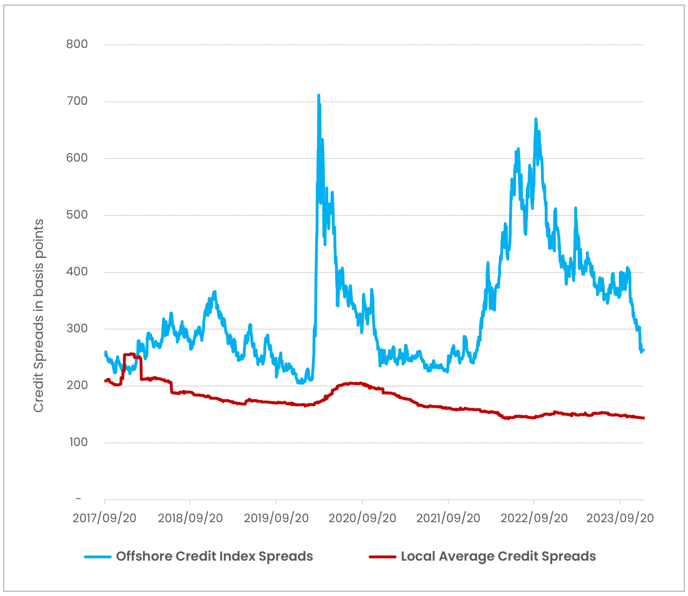
Figure 2
South African credit curve

Source: Avior Capital Markets

Spreads available offshore are more on point

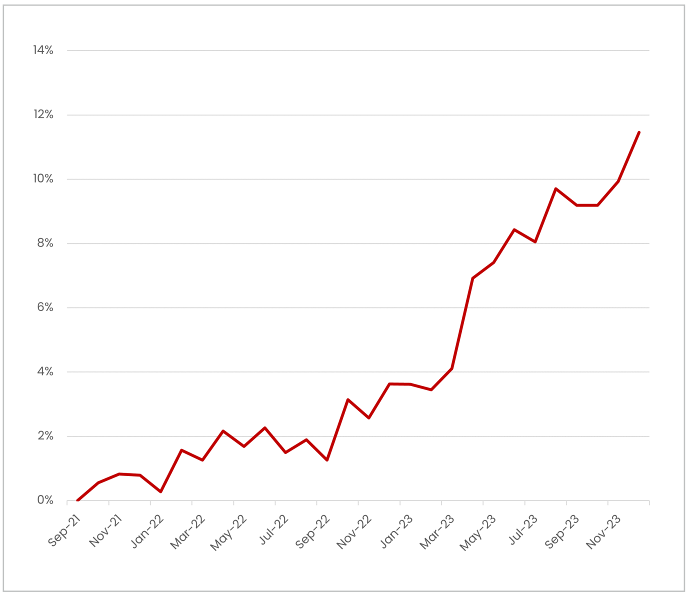
We believe that the spreads on offshore credit (where markets are more liquid and instruments more easily traded) currently provide a more reliable gauge of 'true market value'. For example, the spreads offered by an offshore credit index (shown in Figure 2) offer greater risk compensation in periods of credit distress. This is reflected by the blue line, which shows the higher spreads observed during the Covid crisis, the Russia-Ukraine war, periods of high inflation and, more recently, the higher interest rate environment coupled with global growth concerns. Against the same backdrop, local corporate credit spreads have continued their downward trajectory, as shown by the red line. We can capitalise on higher spreads by investing selectively offshore – and have been doing so over the past two years. To eliminate currency volatility, we hedge offshore exposure into rands. As Figure 3 shows, this has resulted in the Granate BCI Multi Income Fund growing its exposure to offshore bonds from zero two years ago to close to 12% today.

Figure 2
Offshore credit spreads vs local credit spreads



Source: Standard Bank Credit Research, Bloomberg, Granate

Figure 3
Offshore bonds as % of Granate BCI Multi Income Fund



Source: Bloomberg, Granate

By casting our search wider, we look to minimise credit spread duration risk

Locking in local corporate credit at current levels could pose credit spread duration risk, especially for longer-dated bonds. If spreads widen, the value of bonds locked in at lower spreads will fall. So, in a market where the rhythms of prices and fundamentals seem to defy typical choreography, we should be cautious of blindly joining the dance of the herd and becoming price-takers.

Rather, we continue to bid where we believe we see real value while taking advantage of the attractive opportunity offshore prospects offer, in a global showcase of possibilities.

Granate is a people business.
We are committed to creating a rich and rewarding culture through our shared values. Granate is configured thoughtfully and intentionally so that our team can thrive for the benefit of our clients. We care about the same things you do and are *relentlessly* **committed to protect and grow your savings**.