A lower inflation target: How has the *bond market* responded?

South Africa's inflation target is too high and too wide. This is the view of the South African Reserve Bank (SARB), which has recommended lowering the target from its current range of 3% to 6% (with an emphasis on the 4.5% midpoint) to a point target of 3%. It was the reason for bond market strength observed over the quarter, with resultant gains only recently arrested by renewed concerns over U.S. tariffs.

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Why does the SARB want a lower inflation target?

The SARB believes that there are permanent benefits to be gained from lowering inflation, and notes that target setting plays out in actual inflation outcomes. As illustration, between 2010 (post the financial crisis) and 2017, South Africa's headline consumer price inflation index (CPI) averaged 5.4% and was often close to the top of the band. Between 2018 (after the SARB's announcement of its preference for the 4.5% midpoint) and 2019, CPI fell to an average of 4%. Setting a new target of 3% – a level the SARB deems optimal, and which would bring South Africa in line with emerging market peers – should therefore aid in driving inflation lower.

What are the benefits of lower inflation?

The SARB highlights several benefits to lower inflation. Two of the most significant are the potential for increased fixed investment in the local economy, and gains for South Africa's fiscal framework. This is because sustained lower inflation would reduce the inflation premium included in short- and long-term interest rates, allowing these rates to compress.

Lower interest rates would reduce government's high debt servicing costs, allowing this spend to be directed to more productive use. This could be meaningful, given that 20 cents out of every rand the government currently spends goes towards its interest bill. Lower rates would also bring down the cost of capital for investment, while a low inflationary environment allows companies to better predict, plan and price for the future costs of doing business.

Why now?

Inflation has moderated towards the lower end of the SARB's current target range, with the latest CPI print for May 2025 (unchanged from April) coming in at 2.8%. The SARB highlights that lower inflation expectations are core to driving actual inflation lower, as they influence the setting of prices and wages. It therefore believes it can

capitalise on recent low inflation outcomes by concurrently communicating its revised inflation target, to be carried out over its inflation forecast trajectory to end 2027.

How has the market responded?

With SARB Governor Lesetja Kganyago strongly arguing the case for the move to a 3% target – and having more recently signalled that the SARB and National Treasury's joint review of the matter should be completed soon – the bond market reacted positively. In response to expectations of lower inflation and interest rates, nominal bond yields compressed, with the move being more pronounced in shorter maturities less sensitive to fiscal concerns. The yield on the 10-year nominal bond contracted from a high of 11.11% in April to just under 10% by quarter end. Inflation-linked bonds (ILBs) responded in a similar way but to a lesser extent, given that demand for these instruments generally weakens when lower inflation outcomes are expected.

The FTSE/JSE All Bond Index (ALBI) returned 5.88% for the quarter, while the FTSE/JSE Inflation-Linked Index (CILI) returned 0.88%.

How have we responded?

Despite recent strengthening, we still believe that there is value to be offered by nominal government bonds. However, with the bond curve having steepened (i.e., with shorter-end bonds strengthening by more than longer-end bonds), we have been shifting some exposure to the longer end. In the Granate BCI Multi Income Fund, we have done so without increasing duration risk, by substituting shorter-term bonds with longer-term bonds up to a duration-neutral point. The excess cash generated from these trades has generally been deployed into floating-rate government debt. Therefore, while the fund's overall nominal bond exposure has remained broadly unchanged, its exposure to different segments of the bond curve has changed. ILB exposure has reduced, as we have grown less constructive on the asset class.

We continue to monitor market developments for pockets of opportunity

Soon after quarter end, renewed concerns over U.S. tariffs resulted in some bond market weakness, interrupting the steady strengthening trend observed up until that point. In addition, it's important to bear in mind that deliberations around a revised inflation target remain ongoing, and that the timing around a decision is unclear. The horizon remains clouded by risks and uncertainty – and is one in which changing market dynamics can present opportunities at short notice. It's an environment in which open lines for on-the-go discussion and debate are especially key, in addition to maintaining cash buffers so that we can act quickly when we need to.

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