Bonds are known for their predictability. You get out what you put in at a set future date and earn interest at an agreed rate along the way. Government bonds are more predictable still, as a default would have such dire consequences to the financial stability of the country that it's deemed a remote possibility.

So, when yields on longer-dated local government bonds spiked to above 13% in September (up from 12.5% at the end of August), it was enough to draw me away from my leave and back to my screen (though I did make up for it with a farm visit after). We were happy buyers for our funds.

What happened? In short, investors have become concerned about government finances.

When the budget doesn't balance, government is forced to borrow

A government receives taxes from its citizens and uses this revenue to fund its expenses. These include the services it provides, maintaining and growing infrastructure, wages for civil servants and social grants. But what happens if tax revenues don't cover expenses? Well, governments do exactly what us ordinary folk do: they borrow to fund the shortfall.

Most of these borrowings occur via the bond market, with government paying interest on the debt it issues to the investors who it borrows from. When these rates are attractive, the bonds can make for good investments – provided you have comfort that the interest will be paid and your capital returned to you. It is therefore essential for a government to make sure its bonds are a compelling investment (so that it can tap this revenue source) but also to manage its overall debt burden, as overindebtedness can cast doubt on a government's ability to pay or repay investors what they are due.

So where has it gone wrong for the South African government?

Inefficient expenditure against the backdrop of weak economic growth

Growth has been muted in the local economy over the last decade while a hefty chunk of government spending has gone to wages and social grants. The relatively smaller proportion of funds directed to infrastructure spend have further failed to galvanise growth or boost employment. Once we throw COVID-19 lockdowns and heavy loadshedding into the mix, it's easy to see why the South African budget is taking strain. And unfortunately, the bond market is voting with its feet.

When the bond market realises that government borrowing is set to increase, it demands a higher rate to extend this financing. (Of course, this means that government's interest bill grows, which increases its expense bill and the level of funding it requires.) Any whiff of credit deterioration also means lower demand. This is evident in South Africa, as foreign buyers have largely moved on.

What has changed since the Budget was presented in February?

There was a bit of hope at the last Budget meeting. Post COVID-19, South Africa did much better than most expected. Revenues looked healthier as the performance of SARS improved and it became more efficient at collecting taxes, while mining profits (and associated corporate taxes) boomed due to restricted global supply and supply chain bottlenecks. (Unfortunately, this windfall was somewhat stifled by troubles at Transnet.) At the same time, government spoke about plans to cut its expenses by limiting wage increases and reducing COVID-19 grants and some capital expenditure.

But were any of these factors sustainable? The values of some commodities have now almost halved as the effects of higher interest rates globally take hold and global growth slows. Furthermore, it was always going to be difficult to hold off on wage increases and reverse COVID-19 grants given such high unemployment rates. Fast forward to today and it is becoming very apparent that the immediate reduction of South Africa's debt burden is looking unlikely. This is spooking investors, with the result that bond yields on offer are even higher than those seen during the first COVID-19 lockdown when investor sentiment was in the doldrums.

Is it all doom and gloom for bond investors?

We don't think so. Firstly, we don't believe that South Africa is close to a default scenario. While we admit that South Africa's debt burden is worse than we expected in February, there are signs of improvement in the structural reform agenda. Electricity production is effectively in the process of being privatised, with homes and businesses set to prop up Eskom's ailing power stations over time. There have also been developments at Transnet, with a new board instituted, an underperforming management team departing and a few private sector partnerships already being approved. We are hopeful that the first steps to an improved growth path for South Africa are currently being taken, which should help to support growth in taxes and improve the country's debt profile over time. All the while, as a bond investor you are getting paid between 12% and 13% to hold the bond. As the Reserve Bank is doing a good job of keeping inflation well anchored, we think it's a good investment if you are prepared to be patient.

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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**.

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