At what price are South African Bonds attractive?

I thought it would be interesting to answer the question, at what price are South African bonds attractive?

Remember, bond returns are tricky.
If Interest rates decline the value of a bond rises, if interest rates rise the value of a bond declines. At first this may seem strange.
However, if you think about it, it is quite obvious why this happens.

Say I bought a bond that paid me R10 p.a. for every R100 I had invested.
If another buyer could go onto the market and receive R11 for every R100 he invested he would certainly not pay me R100 for my bond.
Likewise, if the market would only give you R9 for every R100 you had paid, I certainly will expect more than R100 for my bond.

Bond prices are affected by many factors:

There is the risk factor. If I invest in a bond I want to be sure that I get my money back. The longer the life of the bond, the greater the risk I take that the borrower might default. Consequently, I would want a better return on a 10 year bond than I would get if I kept my money in a call account or a money market account.
In normal times you would expect that a 10 year bond would yield more than a 5 year bond, which in turn would yield more than a 3 year bond.

For the time risk I am taking I would certainly expect more than would get by simply investing in a money market fund.

There is another risk, namely the solvency risk. If I lend money will I get it back. Often investors are tempted to invest in an investment offering above market average returns. This is dangerous. Why would they be offering above average returns? If they are as sound as they say surely they should be able to borrow at the same rate as other borrowers.

Government bonds are meant to be safe, because if a government runs out of money it just creates more,

It is customary for non-government borrowers to pay higher interest rates than the government does. Depending on investors attitudes towards risk this could vary from 0.75% to 2.5% to 3%. This can give rise to attractive investment opportunities when large financially secure companies want money. The problem is that because the amounts involved are large, they seek this money from institutions and not from individuals.

When investing in fixed interest investments a great risk is inflation. It is only in very unusual circumstances that an investor would not want a return on money which is more than inflation.

In the unusual financial world we find ourselves in, about 30% of worlds government bonds won't even give you all of your capital back when your investment matures.

In more normal times one would expect a government bonds to give you a better return than inflation. Since 1900 the average real return (i.e. after inflation) in South Africa has been 1.8% p.a.

If South Africa existed on its own, we could get some idea of what would be a fair return on a government bond.

Inflation	6%
Time Risk	2%
Solvency Risk	1.0%
Total	9.0%

Some would argue that seeing it is a government bond there should be no risk of default. I don't believe it.

If 9% is a fair rate for a government bond then you would expect parastatals and companies to pay more depending on how credit worthy they are.

South Africa, however, does not exist on its own. Indeed, it is estimated that in excess of 30% of our government bonds are held by foreigners.

How do they arrive at a fair price for our bonds?

They can invest in 10 year US Treasury Bonds and earn 2.2% on them. Although South African interest rates are higher, they need to take into account inflation.
The difference between US and SA inflation is about 4% to 5% p.a.

If there was no risk in investing in South Africa a return of 6.2% to 6.7% may be acceptable. However, there is risk, and that seems to be in the neighbourhood of 3% to 3.5% p.a. at the moment. This figure, however, fluctuates on a daily basis.
When overseas investors become scared, the risk premium goes up, when they become more confident the risk premium comes down.

When they are scared, overseas investors sell our bonds and money flows out of the country. When confidence returns money flows in.

Although shares, over the long term, give better returns than bonds, there are times when investments in bonds become attractive. But deciding when they are attractive is not easy to work out because of all the factors one needs to take into account.

Kind regards
Brian