Granate
ASSET MANAGEMENT

Why hold *inflation-linked bonds* when inflation is low?

It can be tempting to think simplistically about inflation-linked bonds (ILBs). Offering a payment profile linked to inflation, they seem to be an obvious buy when inflation is high – and easier to dismiss when inflation is low. But, just as snap assessments may be problematic elsewhere, mental shortcuts are seldom the best approach when it comes to investing.

Alida Malherbe

Back to basics: How exactly do ILBs work?

In an ILB, capital invested (the principal amount) as well as interest payments (or coupons) on that capital are indexed to inflation. Locally, this would be the headline consumer price inflation index (CPI), as determined by Statistics South Africa. In practice, this means firstly that over the duration of your investment, your principal amount grows by inflation. This growth accrues daily, and a cumulative adjustment is applied semi-annually when coupons are paid. Coupons, in turn, are expressed as a real yield above CPI (for example, CPI + 4%). The interest rate you earn will therefore also adjust in line with inflation, and each coupon will be calculated on the inflation-adjusted principal amount.

When held to maturity, this makes ILBs an excellent inflation hedge, helping to protect the buying power of your savings by offering real (after-inflation) growth. It stands to reason, then, that ILBs become intuitively more attractive in a rising inflationary environment. Not only would this make inflation protection more of a priority, but it would also mean higher investment returns.

Inflation is currently low. So why hold ILBs now?

As with all bonds, the price of an ILB moves inversely to its yield. Simply, if there is an increase in the demand for ILBs, investors are willing to buy them at a higher price. This means that the bond issuer (with the South African government being the primary issuer in the local market) can offer them at a lower rate (with the opposite also being true). These shifts may be dictated in response to fiscal or fundamental developments, or to changes in sentiment.

Let's consider the real yields currently on offer from local government ILBs. At the time of writing, these were sitting

at around CPI + 4.3% for a four-year ILB, and CPI + 4.88% for a longer-dated ILB maturing in December 2033. But what exactly does this yield – intended to compensate investors for risks unrelated to inflation – comprise? Primarily, like with nominal bonds, a sovereign risk component, due to the fiscal risk associated with investing in South African government debt. There is also a component to compensate for potential illiquidity, given that the ILB market does not always trade as freely as nominal government bonds do. It is based on the first component that we believe ILBs have room to strengthen from current price levels.

ILBs have not kept pace with nominal bonds in repricing fiscal risk

Heading into the General Election in 2024, the country was on a knife's edge – along with our financial markets. This election held the potential for two starkly opposing outcomes: one at risk of becoming deeply divisive, and the other that offered the potential for broad political inclusion and continued structural reform. As the country held its breath, markets moved: The 10-year nominal bond yield spiked to over 12% (compared to a corresponding level of around 10.5% currently), while the yield on its closest ILB counterpart jumped to 5%, versus current long-term ILB yields of around 4.7%.

Of course, we know now how the story ended. But while it seems that the nominal bond market knows too, ILBs still appear to be turning the page. Consider the graphs below, which sets out the change in nominal bond and ILB yields following the formation of the Government of National Unity. It shows that while the contraction in nominal yields has been significant, the contraction in ILB yields has been more modest.

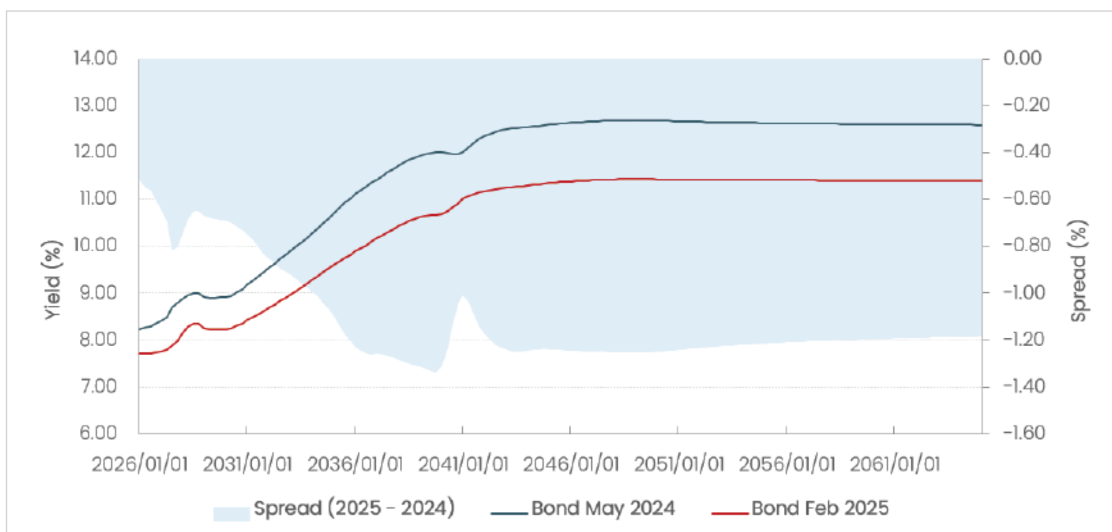

Figure 1
Nominal government bond curves

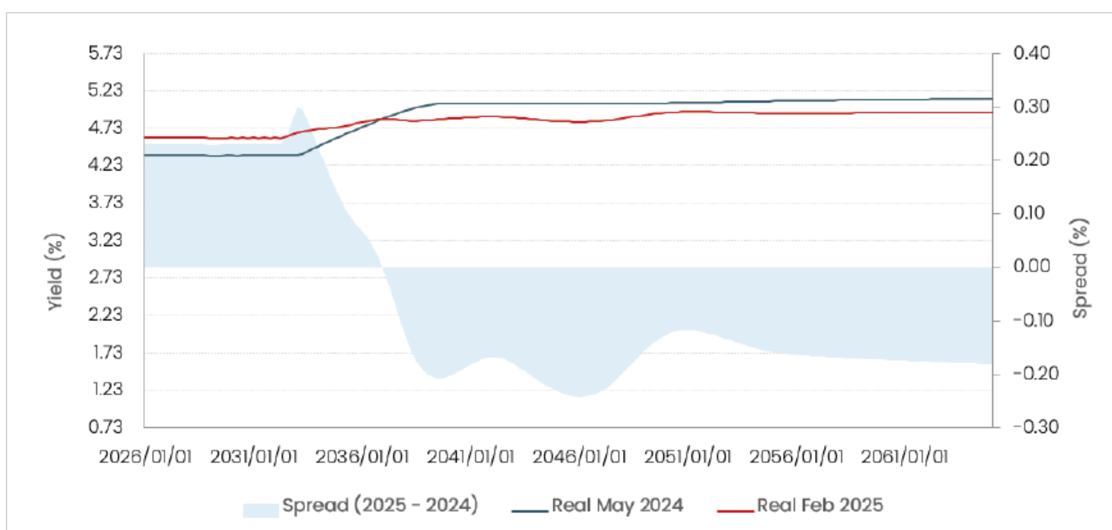

Figure 2
Government ILB curves

Source: Bloomberg, Granate Asset Management

An opportunity for further price gains underpinned by a valuable hedge

We do not expect ILBs to behave exactly as nominal bonds do and are aware that structural market differences necessitate different ways of thinking about these instruments. However, we do believe that further price appreciation is possible from current levels. We have lightened ILB exposures somewhat following the strengthening seen since we started to build our positions in the latter half of 2024. However, they still represent meaningful proportions of our fixed income mandates. This affords the additional benefit of serving as an inflation hedge, given that the prevailing political and economic backdrop presents credible upside risks to the current inflation outlook.

It is also a natural outcome of our process, which seeks not only to harvest attractive pockets of opportunity from across the fixed income universe as-and-when they arise, but to build robust portfolios that are well positioned to meet our clients' objectives under a range of future scenarios.

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