CREDIT PRICING INSTABILITY EXPECTED TO PERSIST IN THE MEDIUM TERM

The listed credit market picked up during the second quarter of 2022, but we continue to face major economic headwinds.

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Listed credit market quarterly update - as at 30 June 2022

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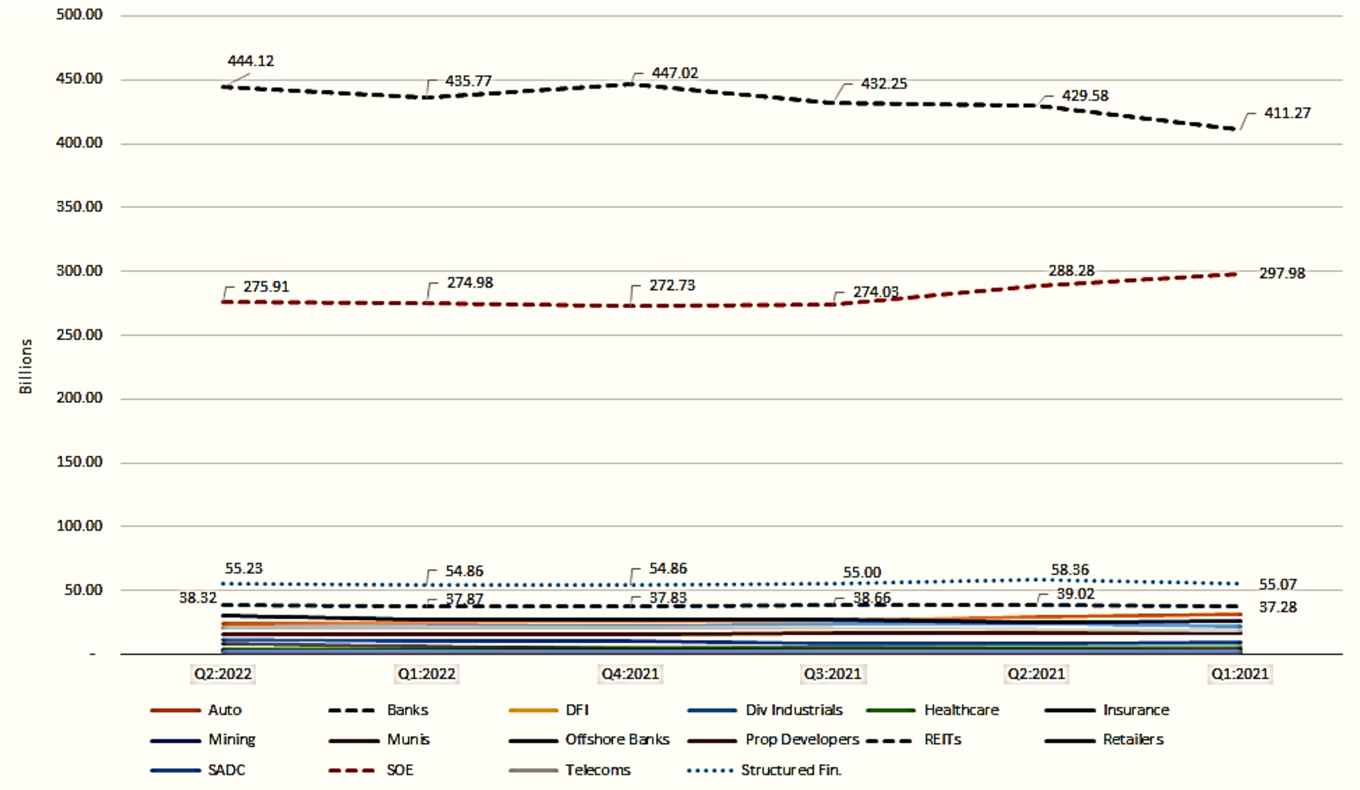
Overview

After a low first quarter issuance, the listed credit market picked up, registering a R61.65 billion gross issuance in Quarter 2:2022 from R57 billion in Quarter 1:2022. This was propelled by bank issuance, inclusive of structured credit, and a marginal uptick in REITs, SOEs and securitisation. During the quarter, banks issued R32 billion, R13.0 billion of which was structured credit. The SOE primary market trade stagnated somewhat after a buoyant first quarter. Denel notes were delisted and SANRAL tapped HWAY35 while Eskom executed a R2 million switch from ES23 to ES26. Various insurers also returned to the market in the second quarter with R3.2 billion net issuance, after a quiet first quarter. As a result, the average issuance tenor lengthened marginally, owing to the slightly longer insurer and bank issuances. In aggregate, the market still shows a bias toward banks, leading to a R18.3 billion market net issuance. Eskom were R5 billion net issuers as the utility de-gears. A further equity injection from government is expected early next year, which would assist the issuer to further de-gear. Given the sheer size of Eskom, we continue to watch out for a possible credit market imbalance due to the de-gearing activity.

Figure 1: Credit market size (by sector)

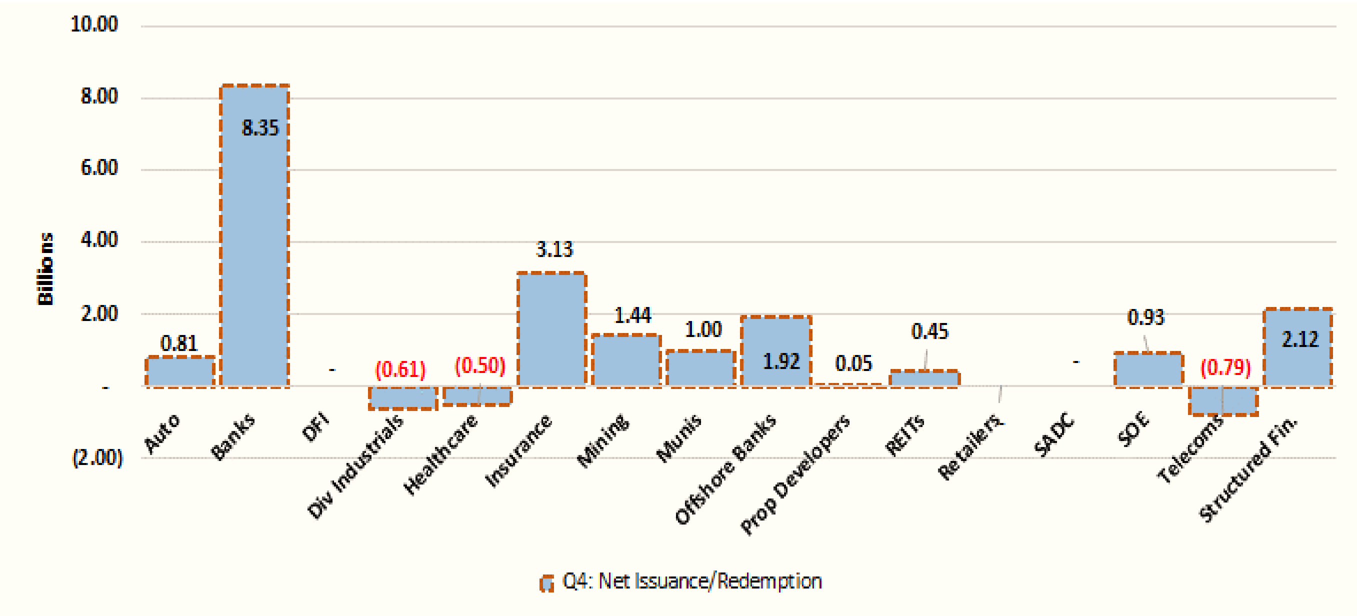


Source: JSE, Futuregrowth

Primary market activity

Several sectors were in a net issuance position, led by bank gross issuance that moved from R41 billion in Q1:2022 to R32 billion in Q2:2022. The bank issuance was largely driven by bank senior issuance amounting to R17.2 billion. The Automotive sector reversed its net redemption position of R1.48 billion in Q1:2022 to a net issuance of R13.0 billion in Q2:2022. It is encouraging to see more market players, with inaugural issuances from Scania and Daimler Trucks this year. The latter was spun off Mercedes Benz and carries a strong offshore parent company guarantee. The SOE trade remains depressed, but the market expects increased activity over the next twelve months, owing to the R45 billion capital market refinance requirement. ABSA bank raised more than R2.5 billion in senior green bonds across 3-years, 5-years and 7-years at 120bps/3m Jibar, 143bps/3m Jibar and 155bps/3m Jibar, respectively. This use of proceeds from green bonds references renewable energy projects off the bank's balance sheet. Four insurers, namely Santam, Discovery, Old Mutual and Momentum, collectively placed R4.3 billion gross issuance during the quarter. Both Santam and Old Mutual's 5-year sub-debt cleared at 155bps/3m Jibar, while Momentum's cleared at 160bps/3m Jibar. Discovery issued 5-year and 7-year senior notes clearing at 173bps/3m Jibar and 180bps/3m Jibar, respectively.

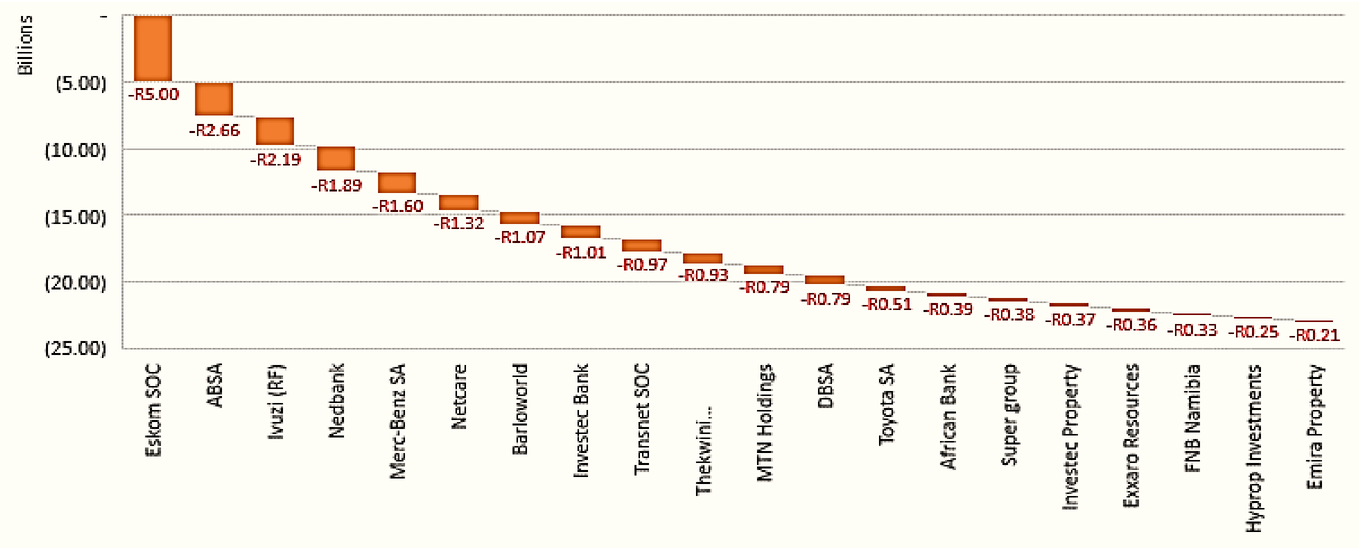
Figure 2: Net issuance/redemption



Source: JSE, Futuregrowth

At an issuer level, a couple of entities reduced exposure to capital markets, led by Eskom's R5 billion net redemption. ABSA's R2.66 billion net redemption position was only due to the bank's reduction in its structured credit issuance, while a few other issuers had prefunded in the in the preceding quarter.

Figure 3: Top 20 quarterly net redeemers



Source: JSE, Futuregrowth

The quarterly net issuer list was dominated by insurers, securitisation refinance and increased bank issuance activity compared to the previous quarter, due to the tapering of the structured credit trades. The top 20 net redeemers registered R16.5 billion. Standard Bank's R3.1 billion net redemption is largely made up of credit-linked notes, referencing, in the main, government bonds (SAGBs). eThekwini Metro came to market with a R1.0 billion issuance which was not well supported. This was no surprise, given the state of the municipal finance presented by the AG(SA). There has been a sector-wide credit deterioration in the Muni sector and, given the current economic state, a sector rebound is not expected in the near term.

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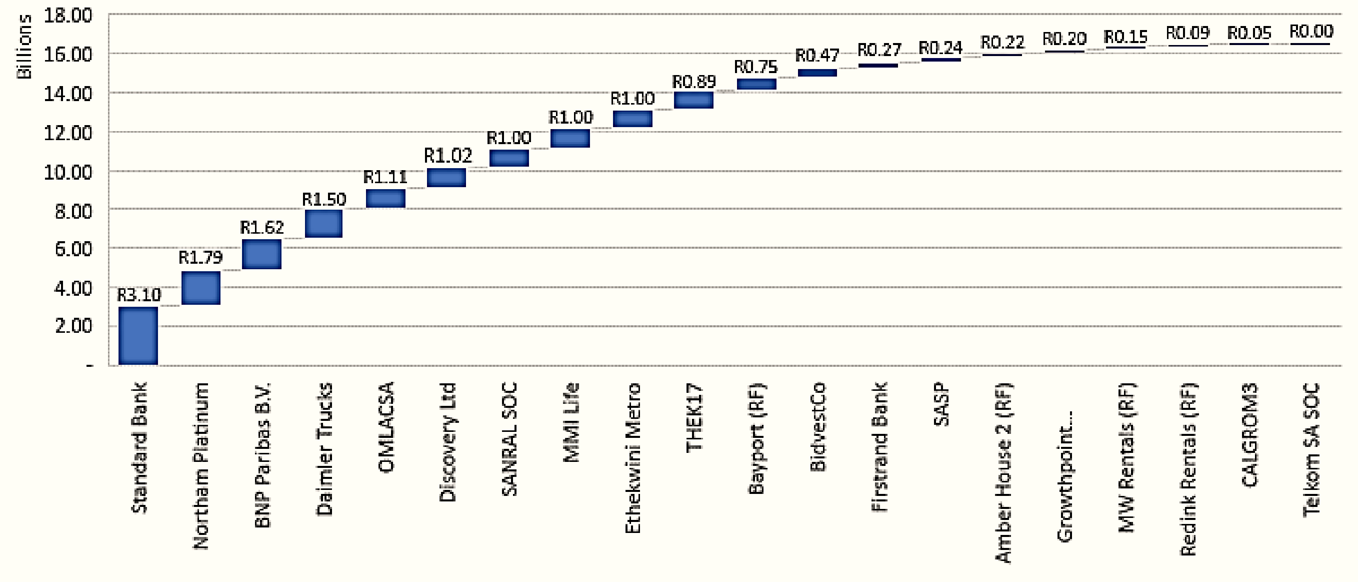
Figure 4: Top 20 quarterly net issuers



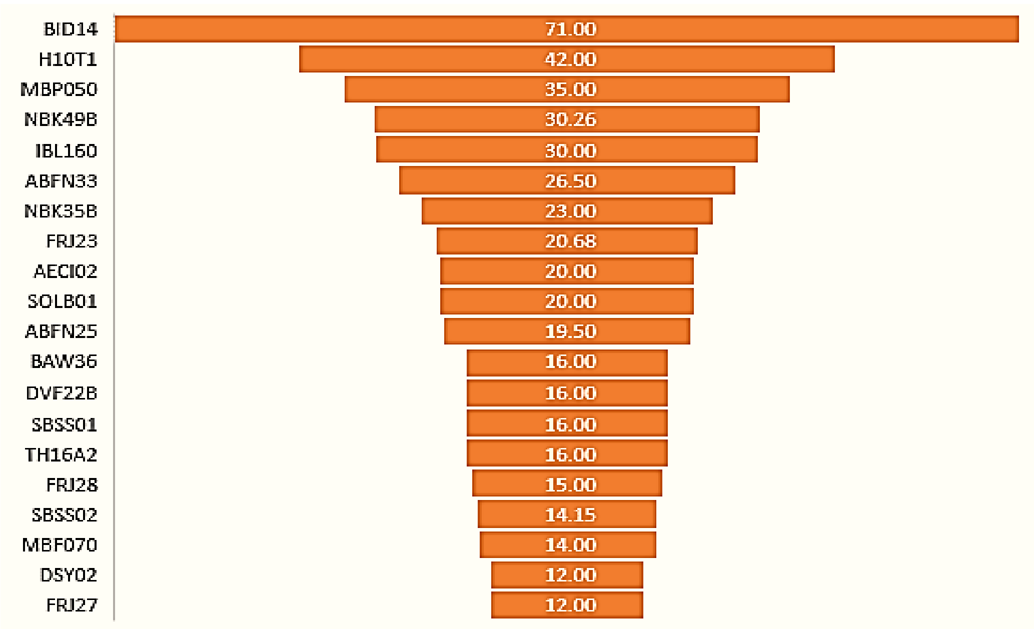
Source: JSE, Futuregrowth

Secondary market

The aggregate credit spread momentum is still on the tightening side. The total number of listed credit instruments with spread movement increased from 323 in the previous quarter to 365. There were 252 bonds with spread compression during the quarter (252 in Q1:2022) and 113 with spread widening (71 in Q1:2022). The sectors leading the spread compression are mainly Banks, REITs and Industrials. The latter two sectors are still experiencing post-COVID normalisation, whereas widening instruments were fixed rate bonds from Banks and SOEs adjusting for asset swap movements.

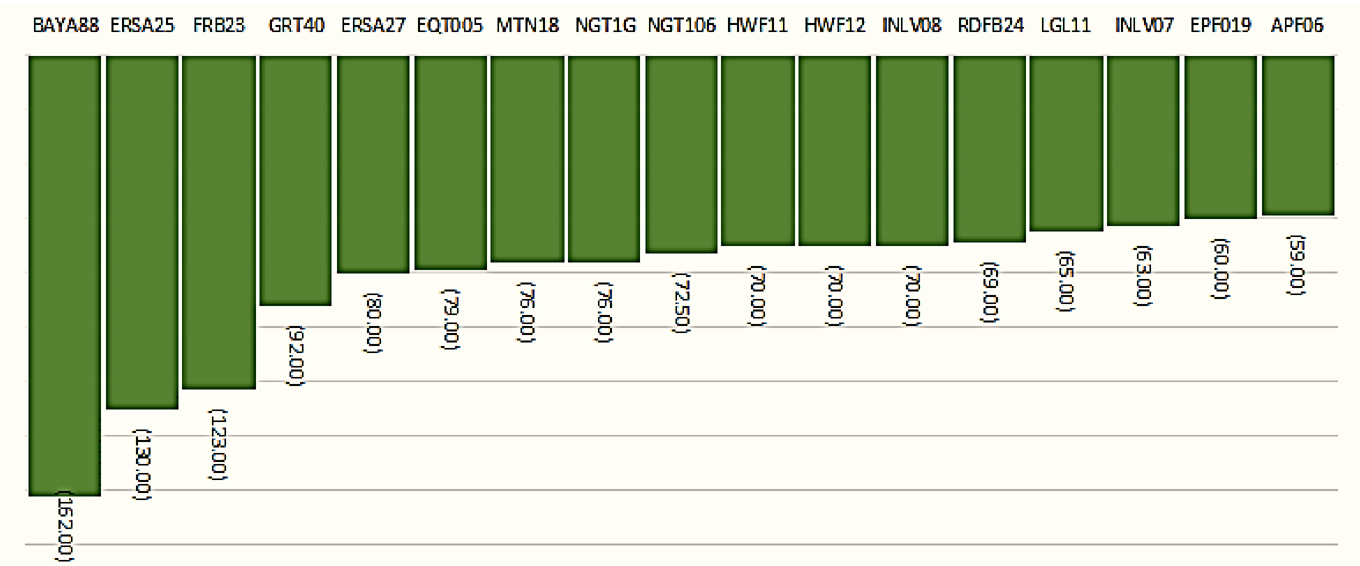
Figure 5: Spread movement

Top 20 quarterly spread widening (instrument level)



Source: JSE, Futuregrowth

Top 20 quarterly spread tightening (instrument level)



Source: JSE, Futuregrowth

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Bank maturity profile

Q2:2022 bank issuance diminished to R32 billion, but still managed to record a net issuance status due to an even lower refinance requirement. The R2.55 billion AT1 issuance was executed by Nedbank and Standard Bank. The upcoming bank maturities for the Q3:2022 amount to R28.77 billion, R12.2 billion of which is senior unsecured. When refinancing the senior notes, we expect the banks to prefer the 3-year tenor, due to lingering uncertainties about FLAC. The third quarter also has a high refinancing requirement for subordinated debt and, despite rising interest rates and unfavourable credit conditions, bank sub-debt has managed to generate a lot of demand as investors continue to chase yield. Standard Bank and Investec have the largest Quarter 3:2022 maturities, with R7.7 billion (R2.5 billion structured notes) and R7.2 billion (R4.1 billion structured notes), respectively.

Figure 6: Bank issuance

Sector	*Below 1yr*	*1yr - 3yrs*	*3yrs - 5yrs*	*5yrs - 7yrs*	*7yrs - 12yrs*	*12yrs Plus*	*Total*
Bank Issuance	*5,095,000,000.00*	*5,350,000,000.00*	*8,533,354,868.00*	*10,849,000,000.00*	*2,294,000,000.00*	*600,721,605.00*	*32,722,076,473.00*
- Bank Senior	4,060,000,000.00	4,192,000,000.00	3,401,000,000.00	4,026,000,000.00	1,472,000,000.00	-	17,151,000,000.00
- Bank Sub-Debt T2	-	-	-	-	-	-	-
- Bank Sub-Debt AT1	-	-	-	2,559,000,000.00	-	-	2,559,000,000.00
- Bank Structured Notes	1,035,000,000.00	1,158,000,000.00	5,132,354,868.00	4,264,000,000.00	822,000,000.00	600,721,605.00	13,012,076,473.00
	5,095,000,000.00	**5,350,000,000.00**	**8,533,354,868.00**	**10,849,000,000.00**	**2,294,000,000.00**	**600,721,605.00**	**32,722,076,473.00**

Sector	*Q3:2022*	*Q4:2022*	*Q1:2023*	*Q2:2023*	*Grand Total*
Bank Maturities	*28,772,619,275.00*	*16,924,900,000.00*	*23,205,672,558.00*	*8,926,416,000.03*	*77,829,607,833.03*
- Bank Senior	12,215,108,275.00	10,464,500,000.00	12,132,000,000.00	4,440,600,000.03	39,252,208,275.03
- Bank Sub-Debt T2	3,812,000,000.00	1,250,000,000.00	5,000,000,000.00	-	10,062,000,000.00
- Bank Sub-Debt AT1	3,900,000,000.00	-	350,000,000.00	-	4,250,000,000.00
- Bank Structured Notes	8,845,511,000.00	5,210,400,000.00	5,723,672,558.00	4,485,816,000.00	24,265,399,558.00
	28,772,619,275.00	**16,924,900,000.00**	**23,205,672,558.00**	**8,926,416,000.03**	**77,829,607,833.03**

Source: JSE, Futuregrowth

Credit market outlook

Just under R60 billion maturities are expected during Q3.2022, of which the SOE sector accounts for R4.3 billion. A large portion of the upcoming redemption is SANRAL. The issuer has prefunded some of this maturity and also sits on a lot of cash reserves to fully redeem the notes. The forward-looking view on credit pricing is still unstable, with many exogenous factors that could potentially change the structure of the credit market. These include the *monetary policy implementation framework (MIPF)* which may lead to an increase in the demand for credit capital market instruments. This is likely to have tightening pressure on credit spreads because of the potential excess demand. The inaugural Govi FRN issuance has also added another dimension in credit pricing - as the real risk-free curve is built up over time, the market expects this to be the true benchmark above which risky credit should be issued.

Figure 7: Maturity schedule

Sector	Q3:2022	Q4:2022	Q1:2023	Q2:2023	Grand Total	REDEMPTION - FULL Q2:2022
Auto	2,500,000,000.00	1,250,000,000.00	4,000,000,000.00	410,000,000.00	8,160,000,000.00	(1,694,000,000.00)
Banks	28,772,619,275.00	16,924,900,000.00	23,205,672,558.00	8,926,416,000.03	77,829,607,833.03	(24,345,401,616.64)
DFI	-	-	-	-	-	-
Div Industrials	2,676,000,000.00	3,120,000,000.00	400,000,000.00	1,080,000,000.00	7,276,000,000.00	(2,689,000,000.00)
Healthcare	500,000,000.00	-	1,572,000,000.00	300,000,000.00	2,372,000,000.00	(500,000,000.00)
Insurance	1,548,000,000.00	2,000,000,000.00	900,000,000.00	500,000,000.00	4,948,000,000.00	(1,000,000,000.00)
Mining	-	-	-	2,290,500,000.00	2,290,500,000.00	(1,693,185,996.00)
Munis	-	-	-	4,098,000,000.00	4,098,000,000.00	-
Offshore Banks	5,810,000,000.00	-	60,000,000.00	-	5,870,000,000.00	(4,030,000,000.00)
Prop Developers	-	-	40,000,000.00	-	40,000,000.00	-
REITs	1,315,000,000.00	3,087,000,000.00	2,074,000,000.00	997,000,000.00	7,473,000,000.00	(600,000,000.00)
Retailers	-	-	800,000,000.00	-	800,000,000.00	-
SADC	-	1,560,000,000.00	-	-	1,560,000,000.00	-
SOE	4,361,000,000.00	5,827,000,000.00	31,381,314,561.00	3,284,000,000.00	44,853,314,561.00	(70,000,000.00)
Telecoms	2,015,000,000.00	529,000,000.00	-	1,950,000,000.00	4,494,000,000.00	(793,000,000.00)
Structured Fin.	8,671,776,246.24	4,571,169,656.00	1,001,500,000.00	2,568,793,596.00	16,813,239,498.24	(5,938,481,715.00)
	58,169,395,521.24	**38,869,069,656.00**	**65,434,487,119.00**	**26,404,709,596.03**	**188,877,661,892.27**	**(43,353,069,327.64)**

Source: JSE, Futuregrowth

The Sovereign continues to face major headwinds, and a slow rebound is projected by various market practitioners. It is uncertain how asset allocation across the savings industry will be reconfigured off the back of the 45% offshore allowance. A sustained weakness in the Sovereign could potentially leave investors with little choice but to exploit the offshore allowance. This could potentially have a contractionary effect on the local demand for various asset classes, especially credit. The MIPF, Sovereign strength and the Govi variable coupon curve will most likely have an impact on credit pricing in the long run. Currently, and considering the above structural change drivers in the credit market, pricing credit has not been smooth. The structural changes are expected to be phased in over a period of time. It is for this reason that we expect the credit market imbalance to persist for the foreseeable future, and thus, credit pricing should also be somewhat unstable. Investor consideration of the above structural shifts is still haphazard, and, as the understanding of the impact becomes clear, the resultant changes should become evident in the credit pricing. The market has seen an increase in higher quality credit participants in the market. As a result, credit spreads have tightened, despite the interest rate hiking cycle and yet-to-improve credit quality. We believe that a macro-fundamental asset selection during such dislocations and uncertainty should trump the quest for mechanistic diversification. Likewise, credit pricing ought to include the structural change forward impact (downside and upside risks).