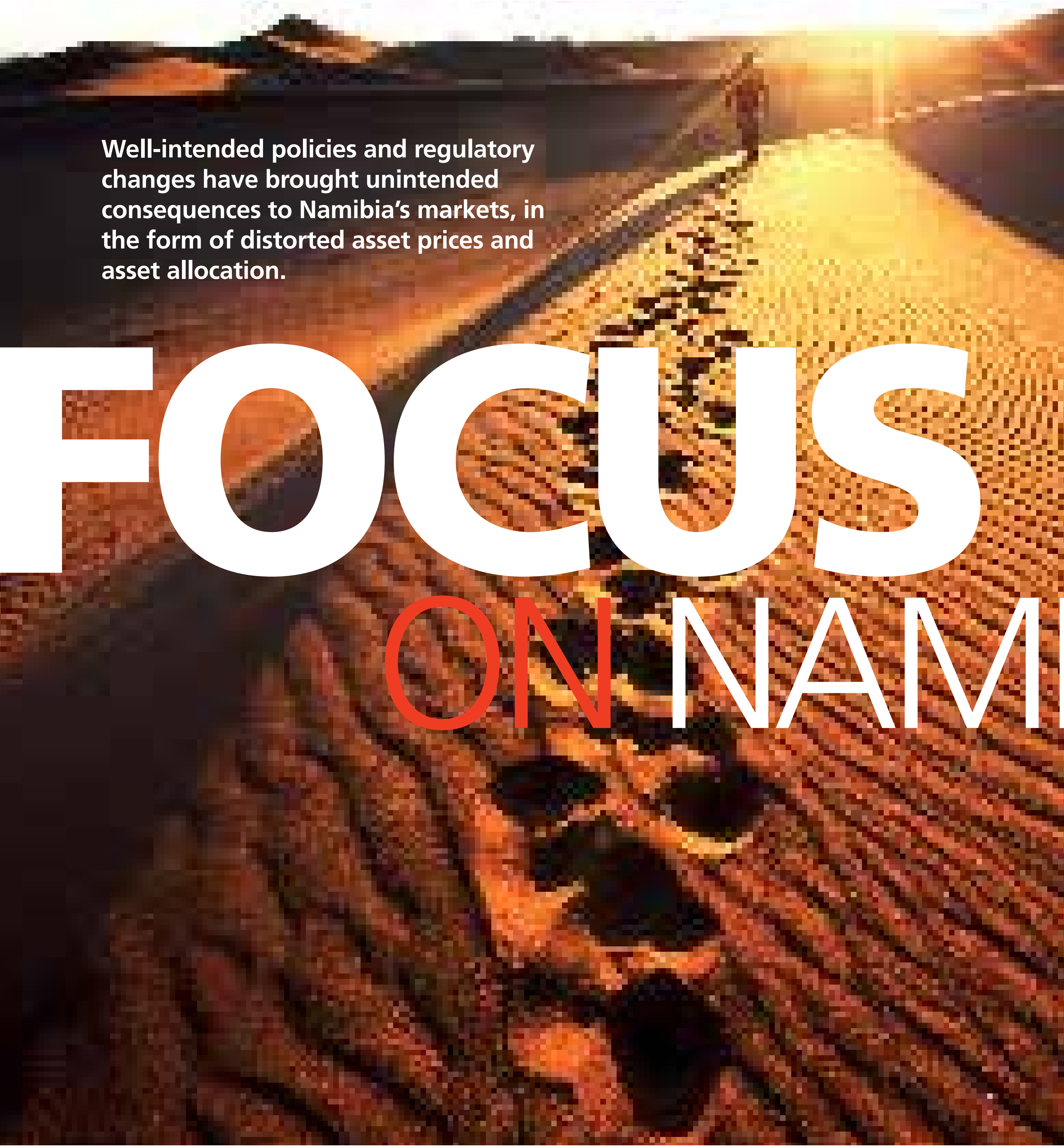


Well-intended policies and regulatory changes have brought unintended consequences to Namibia's markets, in the form of distorted asset prices and asset allocation.

FOCUS ON NAMI

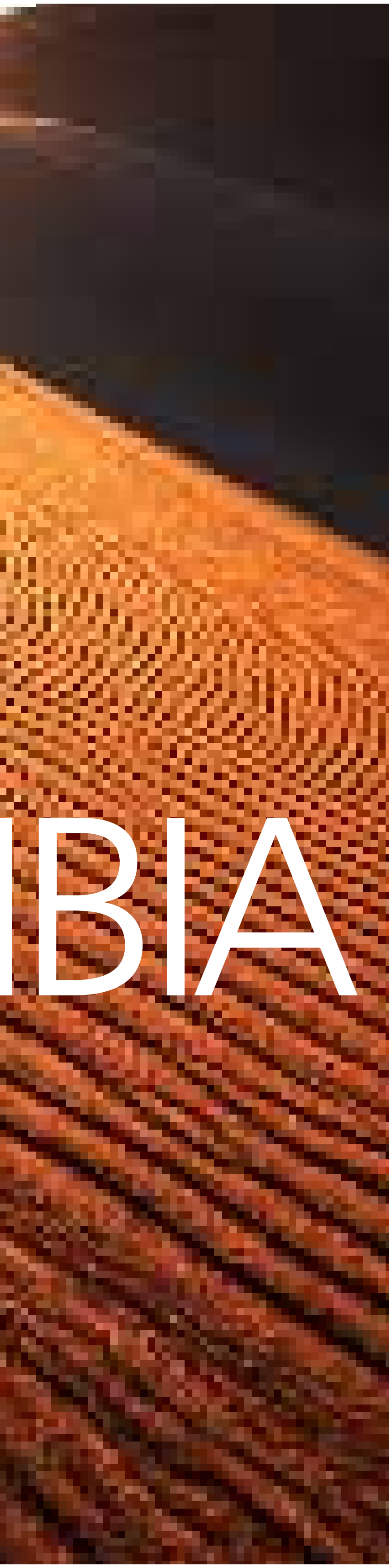


IMAGE: ADOBE STOCK

Anthea Angermund,
Fixed Income Analyst at Prudential Investment Managers

As some investors may know, the Namibian government has again phased in an increase in the level of the minimum domestic asset requirements for pension fund investments. This has moved from 35% in a series of step-ups starting near the end of 2018 to settle at 45%, effective from March 2019. This change in regulation was intended to support and deepen the domestic capital markets as more funds are required to stay in the country; to spur financial innovation; and to encourage new listings on the stock exchange. However, as is so often the case with well-intended policy, there have been far-reaching unintended consequences in the form of distorted asset prices and changes by investment managers to their asset allocation in favour of fixed income instruments. These negative impacts have been the subject of discussion at recent conferences in Namibia, and have occurred against the backdrop of an extended economic recession.

ABOUT THE RECESSION

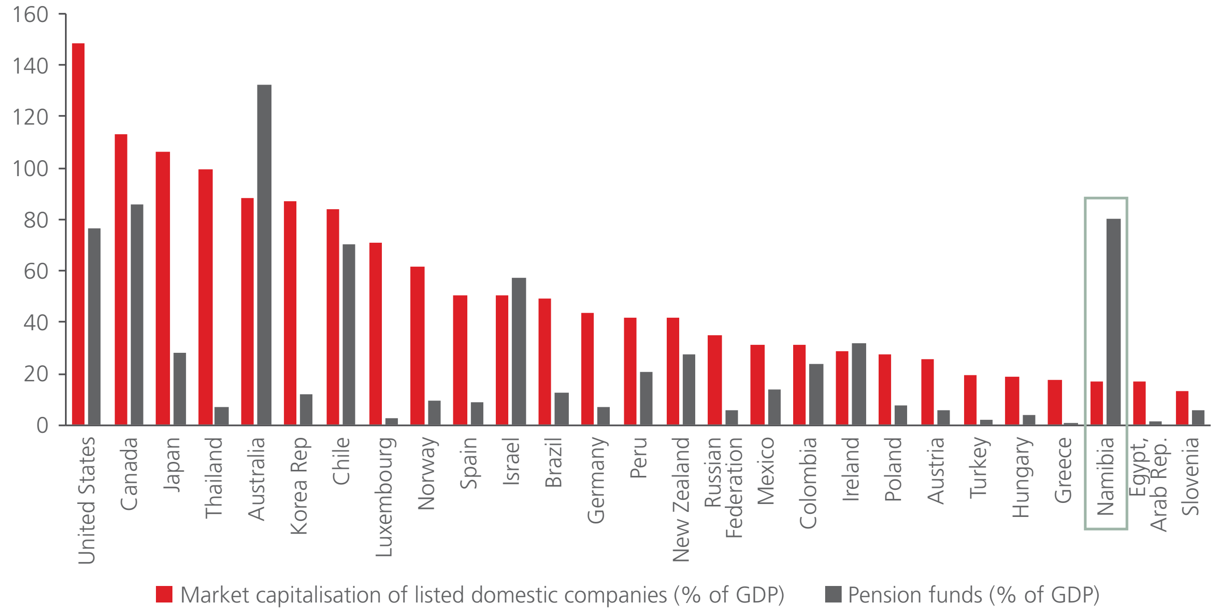
The composition of the Namibian economy and the concentration of its key economic drivers make the country very vulnerable to shocks, both to the upside and the downside. A construction boom in the first half of this decade, fuelled by foreign investment into the mining sector and a highly expansionary government budget, drove very robust real annual GDP growth of over 5.0%.

This has reversed quite sharply since 2016 on the back of a number of factors, including a crippling drought; the end of the commodity super cycle; constrained fiscal coffers; and many second-round effects of an economy leaning very heavily on (now limited) government stimulus and liquidity to spur growth. All the above resulted in the country's first-ever annual contraction in GDP in 2017. Unfortunately, the downward pressure is yet to show signs of abating, with the latest two quarterly GDP prints showing the sharpest declines since the economy started faltering in 2016.

HIGHER REQUIREMENTS BUT LITTLE INNOVATION

In light of the noble objectives of this policy, some analysis is warranted to establish the effectiveness thereof. The prescribed holding of local assets for pension funds was introduced in June 1994 at 10%, increasing to 15% by December 1994, and to 25% and then 35% during 1995. It has finally settled at 45% in this last round of incremental increases. Over the course of the past decade, the number of domestic brokers has remained sticky at a total of four and very few innovative investment products have come to market (the most notable being the listing of two Capital Pool Companies in past two years, a first in Namibia). The local equity investable universe has not seen nearly the amount of deepening envisaged, with only ten locally listed shares on the NSX currently, up from

GRAPH 1: STOCK MARKET CAP VS PENSION FUND AUM



Source: IMF Namibia Financial Stability Assessment March 2018

nine in 2006. There are also no derivatives products to help hedge risk, such as futures and options.

As such, Namibia remains a country with an impressive amount of savings but limited options for investing it at home. There is a stark disparity between the sizes of its pension fund assets as a percentage of GDP and local stock market capitalisation as a percentage of GDP. Graph 1 shows how it is a notable outlier across both developed and emerging markets, with substantial pension fund savings of over 80% of GDP compared to a stock market capitalisation of only around 20% of GDP. Therefore, although its stock of savings as a proportion of GDP is higher than that of the OECD average, it is challenging to invest those savings efficiently within Namibia because of a lack of listed companies.

This deficit in local equities has been largely supplemented by the local bond market – despite the two asset classes not being fungible. This is evidenced by the shift in pension funds' asset allocation from 2016 to 2017 as shown in Graph 2. Equity holdings fell from an average of 45% of portfolios to approximately 32%, while average bond holdings rose from around 27% to 38%. More recent data may show an even starker swing pending the last step up, as investors have deployed most of the repatriated funds into the bond market on the back of equity supply constraints.

GOVERNMENT DOMINATES LOCAL BOND MARKET

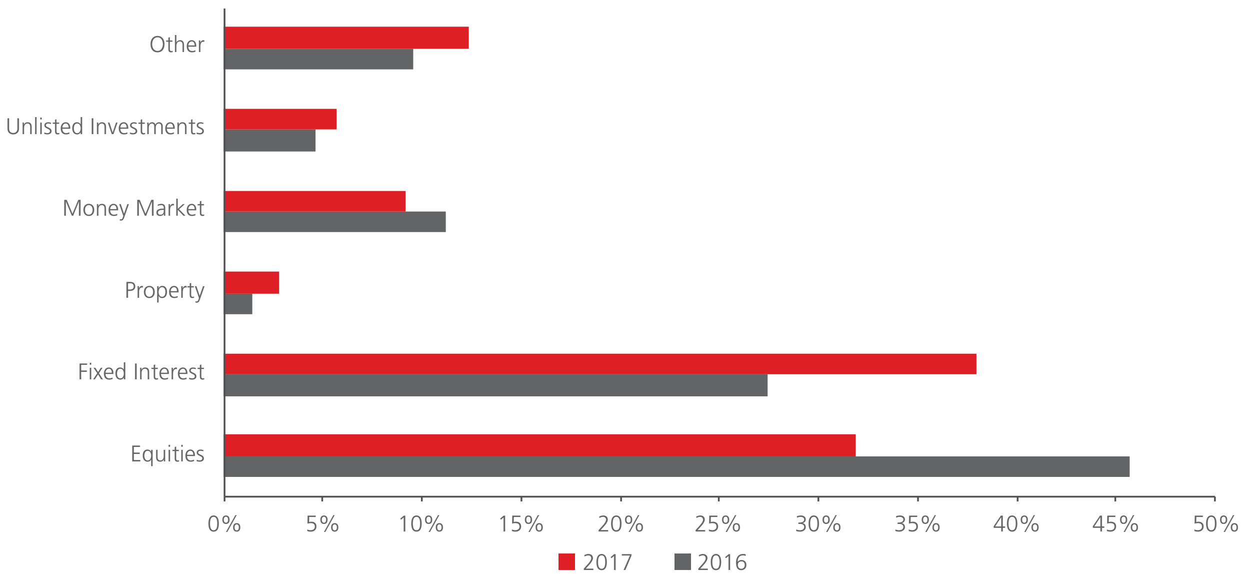
The total amount of local government debt outstanding at September 2019 is N$59.0 billion, up 187% from the R20.4 billion in issue at the start of 2015. Government bonds comprise 90% of the country's total domestic debt in issue, while corporates account for the balance of N$6.5 billion. Government has also issued South African-listed debt of R2.9 billion and two Eurobonds to the value of US$1.25 billion – the latter translating to 23.4% of the total government debt being in hard currency. This is a key figure when it comes to measuring the creditworthiness of the Namibian government, given that any depreciation of the Namibian dollar makes it increasingly more expensive to repay offshore bond holders.

Looking at the government debt maturity profile, roughly 30% of its total debt comes in the form of Treasury bills (with maturities of less than one year), while the rest is heavily weighted towards bonds maturing over the next seven years. This makes the Namibian government's debt burden heavily skewed towards relatively shorter-term repayment requirements compared to countries like South Africa that have a much longer repayment runway, putting extra pressure on government funding requirements.

BOND PRICES JUMP ON INFLUX OF CAPITAL

Before the latest step up to 45% was tabled towards the end of 2018, we saw lacklustre demand in government bond auctions. However, this reversed very dramatically this year, when we

GRAPH 2: NAMIBIAN PENSION FUNDS SHIFT ASSET ALLOCATION



Source: Namibia Financial Institutions Supervisory Authority (NAMFISA)

experienced much stronger demand for bonds – even for longer-dated bonds that had previously been performing relatively worse than shorter-dated paper on the back of concerns around the constrained state of the government fiscus and the poor macroeconomic climate. The massive influx of capital and the resultant demand for government bonds has caused a dramatic rise in their prices and fall in their yields. This consequently resulted in a decline in the spreads of Namibian government bonds over those of their South African counterparts – from the highs of 200bps seen in mid-2017, to a mere 70bps recently. This extra yield of 0.7% for Namibian government bonds compared to South African government bonds doesn't appear to be enough to compensate for the extra risk involved in holding them, especially bearing in mind that the Namibian economy has been contracting versus a still (albeit mutedly) growing economy in South Africa.

Equally, this dislocation in valuation has the potential to reverse since most of the money required to be repatriated back into the country now seems to have found a home. However, the government still has a sizable funding requirement, and further bond auctions may be met with waning demand and rising yields and spreads.

THE ROAD AHEAD

That Namibia needs to deepen its capital markets is a crucial element of charting a path to a more stable economic footing and a healthier financial climate. However, the mechanism employed in the form of an increase of the domestic asset investment requirements for pension funds, while driven by noble aspirations, has possibly jumped the gun by creating demand for local assets before a diverse supply thereof could be established. The resultant tilt in asset allocation towards fixed income has had a negative impact on potential returns. Among other market reforms underway, the Namibian Stock Exchange is in the process of dematerialising (converting share certificates from paper to digital format), after many years of wrestling with restrictive regulations. The hope is to finally attract foreign flows into both the bond and equity markets, and more local companies are encouraged to list. The government is also debating listing some of the country's state-owned enterprises (SOEs). Foreign demand will be a function of pricing, however, and in the face of arguably inflated bond prices the market may still weaken even in light of these positive developments, especially considering that the country's sovereign credit rating was recently downgraded by Fitch to BB from BB+, two notches below investment grade.

The road ahead certainly seems a tricky one. Though new listings may make local equity investments more plausible for investors and alleviate some of the fixed income tilt in pension fund investments, significant challenges remain. Times of crisis usually see the greatest innovations, though. Namibia will hopefully be no exception to this.