South African Credit Rating Update: Downgrades & Implications

Morningstar Investment Management South Africa
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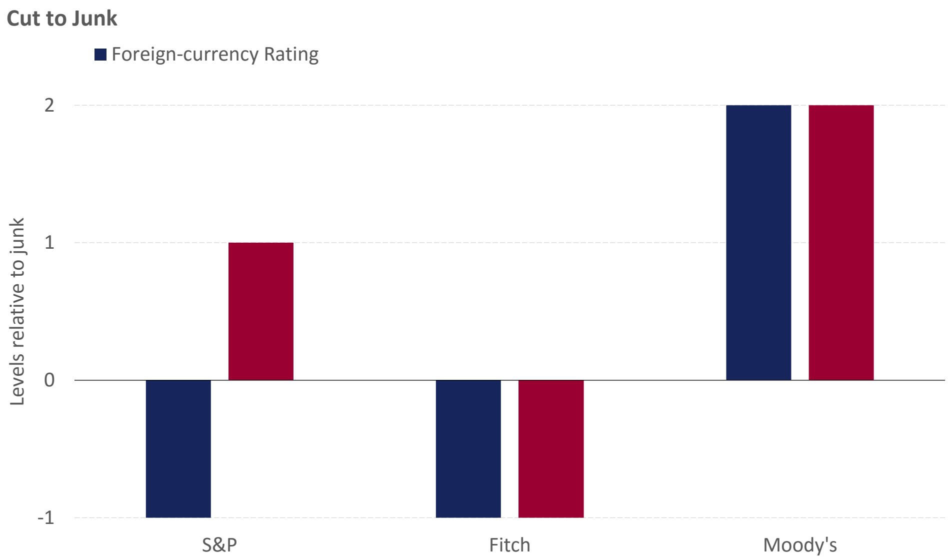
For Financial Professionals and their clients

Following recent developments in the South African political landscape, we thought it would be beneficial to outline the progress being made by ratings agencies and the impact this may have on the 'fair value' of investment markets.

Update on the Credit Rating

During the first week of April, two of three major ratings agencies (S&P and Fitch) decided to downgrade our foreign credit and one (Fitch) also downgraded our local debt.[1]

The third major agency, Moody's, have placed our credit rating under review and will make their decision known in the coming weeks. At this stage, many are expecting Moody's to cut both the local and foreign debt by at least one notch.



Source: S&P Global Ratings, Fitch Ratings Ltd and Moody's Investors Service

Why Credit Ratings Matter

The primary concern with the downgrades is the fact that South Africa's local currency debt is at risk of being excluded from two major global indexes. These indexes are the Citi Bank's World Government Bond Index (WGBI) and Barclay's Global Aggregated Index (Global Agg), which each attract substantial volumes and are very important in ensuring the sustainability of South Africa's debt.

[1] http://www.tradingeconomics.com/south-africa/rating
http://www.futuregrowth.co.za/newsroom/sovereign-rating-downgrade-what-this-means-for-international-index-inclusion/

As a nation that is increasing its debt levels and has become accustomed to running budget deficits, we require a range of counterparties to be willing to meet our debt requirements. Hence, one should not underestimate the importance of having sustainable funding sources. One of the most effective means of achieving this has been automated via our inclusion in the WGBI, and to a lesser extent the Global Agg. While it is impossible to comprehend the outflows at risk from these downgrades (index funds would likely be forced sellers plus other fund managers using benchmarks could be discretionary sellers), we could see a spike in bond yields and monumental outflows rarely end well for asset prices.

The key component to watch is that South Africa's inclusion in these indexes are dependent on the credit ratings being 'investment grade'. Specifically, the WGBI requires either S&P or Moody's to hold our local debt above junk status, while the Global Agg criteria is slightly looser, requiring a sovereign to maintain an investment grade rating from either S&P, Moody's or Fitch.

While S&P has already cut the foreign debt to junk, they haven't (yet) cut the local debt below investment grade. Therefore, should S&P and Moody's downgrade our local credit rating to junk status, South African government bonds would no longer make part of the two indexes. This would likely mark a period of panic and cause bond prices to fall – potentially dramatically.

Keeping Perspective

To quote from the article we wrote at the start of the month, we reminded investors that "panic can create opportunity". Hence, despite the challenges posed by the downgrading of our local and foreign debt, a spike in bond yields creates a situation whereby South African debt could become undervalued and represent an attractive opportunity for investment. Of course, one must be mindful of what could transpire, with plausible outcomes ranging from the removal of President Zuma all the way through to an ugly sovereign default in the name of 'radical change'.

The key is to be independently minded and to assess the developments with a rational framework that avoids behavioural impulses and political biases. We will continue to monitor proceedings with this in mind and keep our investors updated as the situation evolves. Should you have any questions or require further information in the meantime, please do not hesitate to contact us.

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