Talking Points

South African Credit Rating Update: Downgrades & Implications

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For Financial Professionals and their clients

Credit Rating uncertainty

South Africa is in a tough fiscal position and the outlook carries a lot of uncertainty. With weak growth, low consumer confidence, declining VAT receipts and an increasing fiscal deficit, it has become increasingly obvious that the credit rating of South Africa is in question. In fact, on the 24th of November we are expecting to hear from two of the most prominent ratings agencies, Moody's and Standard & Poor's, on their latest credit rating assessment for South Africa's local and foreign-currency denominated debt.

Review of Recent Developments

Malusi Gigaba gave his first midterm budget speech as Minister of Finance to Parliament in October. While a stark picture was painted by Gigaba, the revelations were in line with market expectations as Pravin Gordhan, former Minister of Finance, had already sketched out in February that South Africa was in a precarious position.

Further uncertainty rests in the political arena, with December expecting to be a pivotal month. Specifically, the ANC is expected to elect a new president to lead the party for the next general election in 2019. The uncertainty as to who will be elected, and the possible consequences thereof, is of much debate. While speculation is rife, the ultimate outcomes and impacts are unpredictable and unknown.

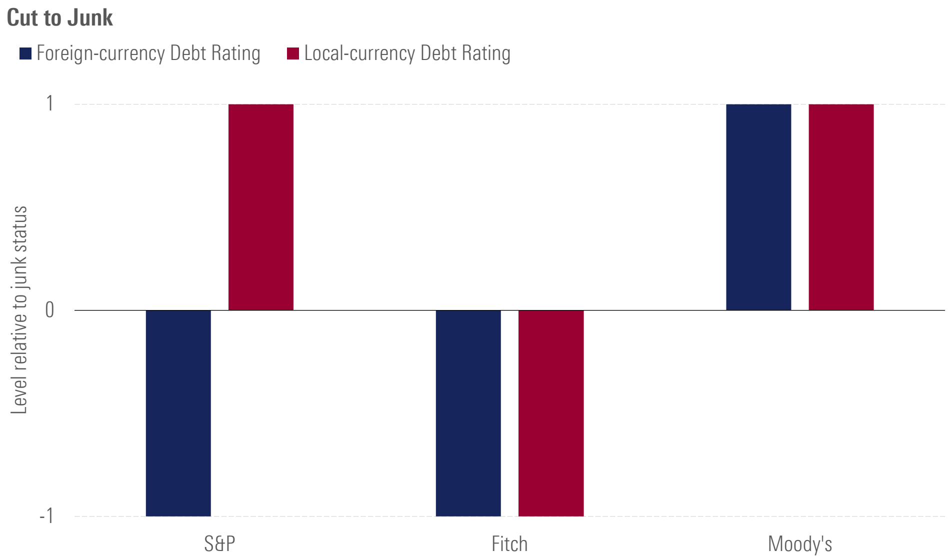
This naturally adds uncertainty to the credit rating of South African debt. While it is believed that the likelihood of our local debt being downgraded to sub investment grade or "junk" status is quite high, the timing and magnitude of any cuts are actually unknown. Therefore, while the direction of travel is reasonably clear, the outcome of the ANC election and the new leader of the party can be expected to play a prominent role.

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 Citibank World Government Bond Index (WGBI) and the Barclay's Global Aggregated Index (Global Agg), which each attract substantial volumes and are very important in ensuring demand is sustained.

More specifically, 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 supported via our inclusion in the WGBI, and to a lesser extent the Global Agg because of the sustainable demand it creates for our debt. 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. Having said this, much of the negative sentiment and impact of the downgrade is already reflected in domestic asset prices, including government bonds, bank shares and certain "SA Inc" shares.

Therefore, there are a lot of moving parts to the South African credit story. However, from an investor's perspective, the key component to watch is whether South African debt remains "investment grade" and does not fall into "junk". The reason this is important is that South Africa's inclusion in these indexes are dependent on it. 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.



Source: S&P Global Ratings, Fitch Ratings Ltd and Moody's Investors Service. Data as at 21/11/2017 and reflects the number of notches above or below junk status.

While S&P has already cut the foreign debt to junk, they haven't (yet) cut the local debt below investment grade. Hence, should S&P and Moody's downgrade our local credit rating to junk status, South African government bonds would no longer qualify for inclusion in the two indexes. While we don't know how markets would price such an event, we do know that there is approximately $14 billion invested in our local bonds via funds that track the indexes and that monumental outflows rarely end well for asset prices.

Keeping Perspective

The key is to be independently minded and to assess the developments with a rational framework that avoids behavioural impulses and political biases. We remind 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 may create a situation whereby South African debt could become undervalued and represent an attractive opportunity for investment.

One must be mindful of what could transpire, but we should attempt to see through the noise and remain focused on valuations and building diversified portfolios that don't only cater for binary outcomes. 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 interim, please do not hesitate to contact us.

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