About Moody's rating decision

1 Outcome of rating

- Moody's announcement to downgrade South Africa's (SA's) sovereign rating into junk status (from Baa3 to Ba1) has lagged the decisions of Standard and Poor's and Fitch by nearly three years
- Moody's maintained its negative outlook to reflect downside risks to growth and fiscal metrics
- SA's sovereign rating is now in line with Morocco, above Brazil (Ba2) and Turkey (B1), but below India's rating of Baa2
- SA's five-year corporate default swap spread (CDS) has reached levels last seen in March 2009 and is trading c.130 basis points higher than Brazil's CDS

2 Reasons for rating decision

Threats to the rating

- Continuing deterioration in fiscal strength
- Very weak structural growth
- Risk of the debt burden climbing faster and further
- Weaker debt affordability and access to funding
- Constrained capacity to stimulate growth, compounded by unprecedented global deterioration
- Limited reforms do not constitute a step change
- Weak economic and fiscal fundamentals could exacerbate adverse capital flows

Supporting the rating

- SA's exposure to global financing conditions is mitigated by its reliance on local currency debt
- Economic diversification
- Strength of key institutions

3 Moody's forecasts

- Moody's warned that achieving meaningful savings in the public sector wage bill will be challenging
- Moody's expects the budget deficit to expand to 8.5% of gross domestic product (GDP) in 2020 ➔ expecting a very gradual narrowing thereafter
- The government debt ratio (including government guarantees) is projected to reach 91% by 2023 from 69% in 2019 ➔ an improvement in tax compliance and lower interest rates only lowers the expected 2023 level to 87%

4 Triggers for further negative ratings action

- Very weak growth
- Failure to reduce the primary deficit
- Rising threat to SA's access to financing at manageable costs
- A higher-than-projected debt ratio ➔ associated with a greater uncertainty of eventual stabilisation
- Weaker institutional policymaking capacity

Moody's highlighted the following flags in this regard:

- Government's ability in the next year to contain the effects of the global recession on the SA economy
- Government's ability to promote a recovery through agreement and implementation of reforms
- Acting on the framework for reliable electricity supply
- Fiscal reforms to contain expenditure and enhance revenues

5 Triggers for positive ratings action

- The outlook could shift to stable if government's fiscal consolidation tracked Moody's central expectations, if financing risks remained low and if there was a slow, but durable, pick-up in growth
- A shift to a stable outlook would be consistent with a gradual reduction in SA's primary deficit and a stabilisation in the debt ratio below 90%

6 Rand implications

- Only 13 out of the 23 analysts surveyed by Bloomberg expected a downgrade by Moody's, given heightened uncertainty in economic forecasts
- The uncertainty of the COVID-19 pandemic has caused investors to retreat to safe-haven securities to the detriment of risky asset classes, including the rand
- Non-residents hold 37% of total domestic government bonds ➔ the rebalancing of the World Government Bond Index (WGBI) has been delayed to the end of April 2020 ➔ analysts forecasted outflows of anywhere between US$8 billion and US$12 billion in November 2019 ➔ but it is likely that outflows following an exit from the WGBI will be much smaller, given the recent market sell off

7 Investment implications

- In line with the global sell off in risk asset classes in recent months related to COVID-19, SA investments already experienced significant downside pressure. The rand fell by 20% so far this year against the dollar, SA 10-year bond yields rose by about 275 basis points in the last month and the SA equity market was 26% lower since the middle of February 2020
- While Moody's decision to downgrade SA's rating could potentially cause further short-term pain for local asset classes in a knee-jerk response from a sentiment-driven and liquidity-scarce global market place, the reality is that a lot of negative news is already discounted in local investments
- The SA bond market, in particular, already offers the best real yields in the investable emerging world (about 7% on prospective inflation at the 10-year point) and already had significant foreign sales in the run up to the Moody's downgrade and in recent years (R51 billion in 2020 so far and R140 billion from 2018 to 2020). Compare this with the R129 billion of foreign bond inflows around SA's WGBI inclusion in 2012. So, any further sell off in the interim that could be exaggerated by a lack of liquidity in the local bond market will further enhance the attractiveness for investors, once global risk appetite returns in the aftermath of the COVID-19 crisis
- With the bulk of the SA equity market's earnings now coming from global markets, any further near-term rand weakness should have a positive effect on the SA equity market, all else being equal

8 What does this mean for SA?

- Higher borrowing costs for government will crowd out spending on much-needed social and economic programmes
- A further knock to business sentiment could lead to lower rates of fixed investment, weaker growth and increased downward pressure on employment
- A more depreciated currency leads to a higher cost of imported goods ➔ which could raise inflation and limit the extent to which the SA Reserve Bank can react to the COVID-19 crisis

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