Further into junk

1 Outcome of rating

- Standard and Poor's Global Ratings (S&P) affirmed its SA foreign-currency sovereign rating at BB- and kept its local-currency rating steady at BB, which reflects known weaknesses in the economy
  ➔ no change to its stable outlook on the rating
- Moody's downgraded both ratings to Ba2 and maintained a negative outlook, due to a further expected weakening in SA's fiscal strength
- Fitch downgraded both ratings to BB- and maintained a negative outlook to reflect high and rising debt, very low trend growth and extreme inequality

2 Reasons for rating decision

- The pandemic has intensified SA's economic challenges and social obstacles to reforms
  ➔ lower capacity to mitigate the COVID-19 shock
- Fiscal consolidation and the Economic Reconstruction and Recovery Plan face high implementation risk
- Deterioration in debt affordability
- Poor financial performance of state-owned enterprises (SoEs) ➔ exacerbated by crisis
- Challenges to business environment ➔ labour market rigidities and unreliable power supply
- Lofty expectations on freeze in government wage bill

Negative outlook reflective of:

- Larger-than-forecasted deterioration in debt burden and debt affordability
- Chance of additional financial demands from SoEs
- Potential for higher interest rates

3 Rating agency forecasts

- Moody's expects the SA economy to contract by 6.5% in 2020 (Fitch: negative 7.3%) before recovering by 4.5% (Fitch: 4.8%) in 2021
- Moody's sees the budget deficit expanding to 15.4% of GDP in fiscal year (FY) 2020/2021 (Fitch: 16.3%) before narrowing to 11.8% in FY2021/22
- Moody's expects the government debt ratio to reach 93.3% by FY2021/22 from 70.8% in FY2019/20
- Fitch forecasts a rise in government's debt ratio to 94.8% by FY2022/23

4 Triggers for further negative ratings action

- Materially faster rise in SA's debt burden and further related pressures on debt affordability
- Additional difficulties in implementing growth-enhancing reforms
- Persistent shocks to primary expenditure or revenues
- Sustained rise in the level or volatility of interest rates
- Diminished access to funding at interest rates that would further endanger debt sustainability
- Destabilising large net capital outflow

5 Triggers for positive ratings action

- A rating upgrade is unlikely in the near future, given the negative outlook by Moody's and Fitch
- An outlook change to stable could occur on:
  - Efforts to arrest the increase in government's debt burden
  - Confidence in stronger growth prospects
  - Labour market or power sector reforms
  - Agreement with labour unions on a wage deal that moderates future wage increases

momentum
investments

6 Rating strengths

- Well-regulated and resilient banking sector ➔ despite likely rise in credit losses
- Fully flexible exchange rate regime
- Favourable debt structure ➔ long tenure of 13 years and mostly denominated in local currency
- Low share of foreign-currency denominated debt ➔ 11.8% of total government debt
- Net external debt in line with peers
- Very large local non-bank financial sector ➔ assets = 160% of GDP
- Caps on foreign holdings contain external financing risks
- Societal openness and smooth political changes
- Effectiveness of core institutions ➔ judiciary and the central bank

7 Rand implications

- Only five out of the 23 analysts surveyed by Bloomberg expected a rating downgrade, given the pending outcome of the ongoing government wage bill negotiations and the broad-based effect of COVID-19 on SA's peer group
- The rand temporarily spiked to R15.47/US$ ➔ hopes for an early dissemination of a viable COVID-19 vaccine has alleviated volatility in markets, prompting investors to participate in riskier asset classes, including the SA rand
- Non-residents share of total local government bonds has fallen from a peak of more than 40% in early 2018 to 29% ➔ any outflows following the recent downgrade are likely to be small given previous outflows

8 Investment implications

- By definition, the rating downgrades further into junk status imply that holders of SA sovereign debt should include a higher risk premium in the valuation of the asset class to reflect a higher future risk of default ➔ however, international precedent has shown that ratings downgrades within the non-investment grade bracket is less consequential for sovereign yield levels than a downgrade from investment grade status to junk, as the latter move could have mandate implications for bond holders and, hence, trigger forced selling ➔ as such, SA's exclusion from global bond indices after it was downgraded into junk status by Moody's in March this year was of more importance to yields
- In addition, the current downgrades happen against a general risk-on global backdrop, driven by the US election outcome and indications that the approval of efficient vaccines against the COVID-19 virus is not too far off ➔ this has ignited a global capital flow into risky asset classes, including emerging market bonds
- Furthermore, the expectation that SA inflation is likely to sustainably remain below the mid-point of the inflation target (4.5%) in the coming years has provided a positive fundamental underpin for SA bond yields and assures attractive prospective real yields for investors in the asset class ➔ as such, we only expect a marginal negative effect on local yields, if any, due to the negative rating action

9 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 further negative bias on ratings could lead to a more depreciated currency ➔ higher cost of imported goods ➔ raised inflation and limited extent to which the SA Reserve Bank can keep monetary policy accommodative
- On Moody's scale, SA's sovereign rating is now in line with Brazil, but above Turkey (B2) ➔ on Fitch's scale, SA ranks in line with Turkey and Brazil
- At 234 points, SA's five-year corporate default swap spread (CDS) is 263 points below the April 2020 COVID-19-related peak ➔ it is trading 60 points higher than Brazil's CDS and 143 points below Turkey's CDS

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