momentum
investments

in the
moment

Herman
van Papendorp

Head of Investment
Research & Asset Allocation

Sanisha
Packirisamy

Economist

The impact of a potential greylisting on the SA economy and financial markets

Highlights

- When the global Financial Action Task Force (FATF) places a jurisdiction under increased monitoring (ie the grey list), it means that the country is actively working with the FATF to address apparent strategic deficiencies in its regimes designed to tackle financial crimes.
- In our view, much of the responsibility for the weakening of South Africa's (SA) criminal justice system lies with the previous administration's subversion of democracy. During this period, the capacity of SA's tax authority, intelligence agencies and crime-fighting and law enforcement bodies were incapacitated.
- SA has been given until November 2022 to prove it is remedying the country's structural deficiencies when it comes to anti-money laundering and countering the financing of terrorism. If we fail to demonstrate satisfactory progress on these remedial actions by February 2023, a plenary vote of the FATF members will determine the fate of the country's greylisting status.
- Aside from technical factors, the decision to greylist SA depends on the FATF's judgement of government's political willingness to achieve sufficient progress in addressing the concerns highlighted in their report.
- Although global empirical studies show mixed results on the impact of a greylisting event on a country's capital flows, being greylisted could further impair the economy's links to the global financial system, raise SA's cost of capital and create an additional disincentive for offshore companies to deal with SA.
- Nevertheless, with global themes likely to be a larger determinant of the outcome for SA financial markets, local idiosyncrasies, such as a greylisting event, may be overshadowed by high and sticky global inflation, tighter global financial conditions and a rising risk of recession in key markets. Moreover, it can be argued that a compendium of negative SA-specific factors has already been incorporated by local and global investors into elevated risk premia for SA asset classes, as reflected in cheap valuations.
- In any event, we remain steadfast in our view that a well-diversified investment portfolio as encapsulated in our outcome-based investing philosophy provides the best possible protection against any unforeseen global or idiosyncratic market events that may cause short-term instability. Furthermore, history has shown that staying invested throughout any market turbulence has been the superior strategy for long-term returns.
- Momentum Metropolitan Holdings Limited gives its full co-operation to ensure we participate in efforts to prevent or lessen the impact of greylisting on SA.
- Regardless of the outcome of the FATF's decision to potentially greylist SA, we believe this yellow card warning should serve as a wake-up call for SA policymakers, regulators and law enforcement agencies to convince the

country's international counterparts it is worth their effort to maintain relationships in the interim as SA continues to build a more robust legal and compliance framework to remain competitive on the global stage.

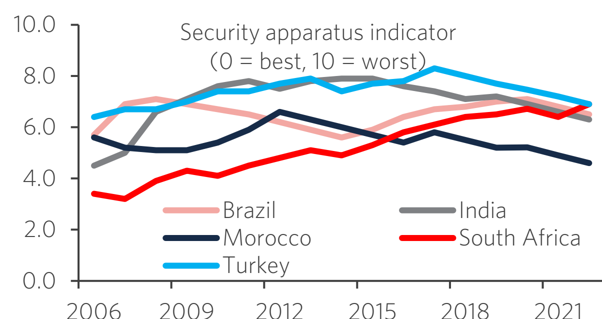
The global watchdog for money laundering risks raised red flags in 2021

The FATF was founded in 1989 by an intergovernmental forum, consisting of the seven largest advanced economies, to formulate policies to curb money laundering and subsequently combat terrorist financing. When the FATF places a jurisdiction under increased monitoring (ie the grey list), it means that the country is actively working with the FATF to address apparent strategic deficiencies in its regimes designed to tackle financial crimes.

The SA government has been aware of the stakes since October 2021 when the FATF released the findings of its Mutual Evaluation Report (based on a site visit between 22 October and 12 November 2019) to Cabinet, following its assessment of the country's ability to investigate and prosecute financial crimes. The report illuminated under-addressed money laundering risks and insufficient monitoring of terrorist financing risks in SA.

In our view, much of the responsibility for the weakening in SA's criminal justice system lies with the previous administration's subversion of democracy. During this period, the capacity of SA's tax authority, intelligence agencies and crime-fighting and law enforcement bodies were incapacitated. Subsequently, the Fund for Peace noted a deterioration in SA's ranking of its security apparatus in contrast to an improving trend for our emerging market counterparts (see chart 1).

Chart 1: Security threats on the rise



Source: Fund for Peace: Fragile States Index, Momentum Investments

The FATF notes that SA's law enforcement agencies lack the skills and resources to proactively investigate money laundering and terrorist financing cases linked to narcotics, corruption and tax offences. Moreover, while large banks were found to have adequate mitigating measures in place, supervision and compliance monitoring remain inadequate for SA's smaller financial institutions and designated non-financial businesses (including estate agents, motor vehicle dealers and legal practitioners). In addition, it was found that opaque ownership structures in SA create an opportunity to disguise the proceeds of unlawful activity. While the FATF acknowledges the existence of SA's financial intelligence framework, it suggests a lack of resources to proactively follow through on criminal investigations to trace and recover assets.

SA has been given until November 2022 to prove it is remedying the country's structural deficiencies when it comes to anti-money laundering and countering the financing of terrorism. If we fail to demonstrate satisfactory progress on these remedial actions by February 2023, a plenary vote of the FATF members will determine the fate of the country's greylisting status.

Although Intellidex notes that Pakistan's greylisted status between 2012 and 2015 triggered a cut in economic growth of between 1% and 2%, we believe there will be less impact on macro dynamics in SA should a clear plan be in place to escape a greylisted status given the experience in Turkey, Botswana, Mauritius and the United Arab Emirates. Moreover, sovereign rating agencies are more likely to move on SA's macro fundamentals rather than allowing for a potential greylisting event to act as the sole determinant of the rating outcome.

Being greylisted could nevertheless further impair the economy's links to the global financial system, raise SA's cost of capital and create an additional disincentive for offshore companies to deal with SA, on top of inept

network industries, inflexible labour markets, energy shortages and policy uncertainty.

Most global investors take the FATF watchlist seriously and it could hamper access to trade and financial systems, however we view this as an unlikely event. Investment opportunities in the country could also be dampened under this scenario. In line with perceived poor corruption scores and increased regulatory red tape (associated with enhanced monitoring and lengthier transactions), SA's ranking on the World Bank's Ease of Doing Business indicator would likely deteriorate further from its 84th position from 190 countries (and sixth best in Africa, underperforming Mauritius, Rwanda, Morocco, Kenya and Tunisia).

According to SBG Securities, evidence from global empirical studies show mixed results on the impact of a greylisting event on a country's capital flows. A May 2021 paper from the International Monetary Fund, *The Impact of Graylisting on Capital Flows: An Analysis Using Machine Learning*, suggests that capital inflows decline on average by 7.6% of gross domestic product (GDP) when the country is greylisted. The results also suggest that foreign direct investment (FDI) inflows dip on average by 3% of GDP, portfolio inflows decrease on average by 2.9% of GDP and other investment inflows fall by an average of 3.6% of GDP. Nevertheless, the range between countries remains wide and SBG Securities argues that, at some stage, investors would be reacting to the weakening fundamentals of the country and not necessarily the greylisting status of the country.

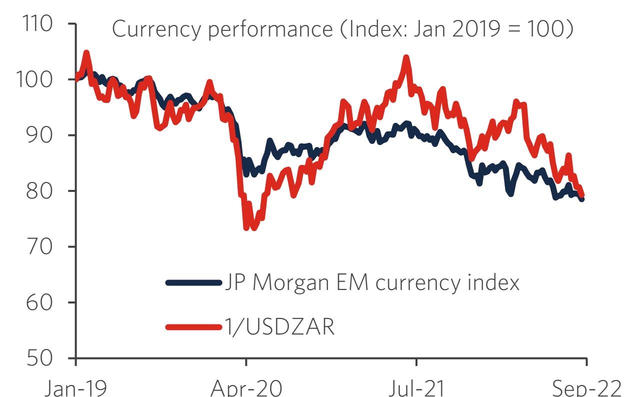
Morgan Stanley highlights the changes to Regulation 28, allowing for a higher offshore allocation limit, as a bigger implication for capital markets and estimates a R550 billion to R800 billion outflow in a worst-case scenario. Nonetheless, in our view, SA fund managers are likely to shift toward a higher offshore allocation over a more gradual timeline, particularly given the relative attractiveness of SA asset classes relative to more expensive global asset classes, at present.

Should this worst-case scenario on Regulation 28 changes materialise, we are of the opinion that the Reserve Bank would act more aggressively to stem the rise in inflation (particularly if there are signs of inflation persistence, ie broad-based pressures) but would also be more cognisant of growth. The sacrifice ratio suggests that much higher interest rates to tame inflation from our base case interest rate view (another 75 basis-point hike in September and a 50 basis-point hike in November 2022) becomes less effective to combat inflation but has a larger negative impact on growth. This would factor in the Reserve Bank's deliberations on the interest rate outcome.

Global themes are larger drivers of SA's economy and asset classes

A much bigger overarching theme is dominating currencies at present. Much of the rand's weakening of late has been dominated by global capital flow trends. Expectations of tighter interest rate policy in the United States (US) have led to further outflows of capital from emerging markets (EM) and as a result EM currencies have sold off. As such, we believe that the rand has depreciated against the US dollar in tandem with EM currencies (see chart 2 below), rather than in relation to local idiosyncrasies.

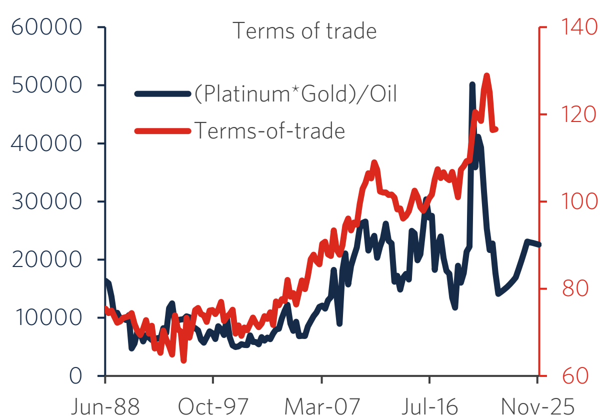
Chart 2: Rand has sold off against the US dollar in tandem with EM currencies



Source: Bloomberg, Momentum Investments

Based on a fair value calculation using the real effective exchange rate, we view the rand as being around 4% undervalued. However, in our view, the local unit is likely to remain on the backfoot in the near term given a decline in the terms of trade (export prices relative to import prices) for SA (see chart 3 below).

Chart 3: Terms-of-trade proxy suggests near-term rand weakness before some recovery



Source: Bloomberg, Momentum Investments

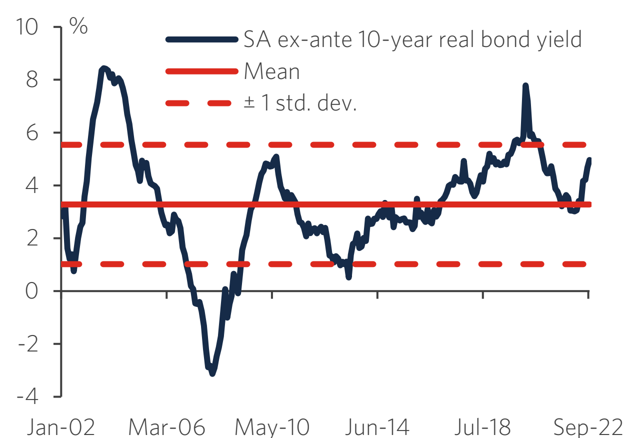
However, as we approach the back end of 2023, we may likely start seeing cuts in interest rates in the US. At that point in the cycle, the US Federal Reserve may shift its focus to ailing growth as inflation starts coming down more consistently in reaction to previous monetary tightening. This would likely trigger a reversal in capital flows out of the US and into EMs/riskier assets (shifting from a risk-off into a risk-on period) and we could see the rand benefit from this stronger overarching theme, notwithstanding what is happening with our local dynamics at the time. The terms-of-trade proxy in Chart 3 also suggests that SA's actual terms-of-trade will head higher after bottoming out in the near term based on the market's forecasts for commodity prices.

Moreover, we expect growth in China to rebound from around 3.5% this year to around 5% next year as lockdown restrictions ease, consumer sentiment improves and government support measures aid an upturn in growth. Better growth in China in 2023 should be supportive of commodity prices and provide a further benefit to the local currency from current oversold levels.

Not your typical grey area

While a greylisting would undoubtedly amplify economic pressures and raise the regulatory burden in SA, arguably, investors have been well aware of the backsliding in SA's rule of law, institutional degradation and allegations of corruption and state capture. As such, local asset prices may already capture some degree of risk incorporating a potential greylisting, while the actual event would merely rubber stamp well-known problems. For instance, it can be argued that the cheapness of the SA bond market, as reflected in consistently high SA real yields in global comparative terms and relative to its history in recent years (see chart 4), as well as the cheapness of SA equity market valuations (see chart 5), imply that a compendium of negative SA-specific factors has already been incorporated by local and global investors into elevated risk premia for these asset classes.

Chart 4: SA real bond yield

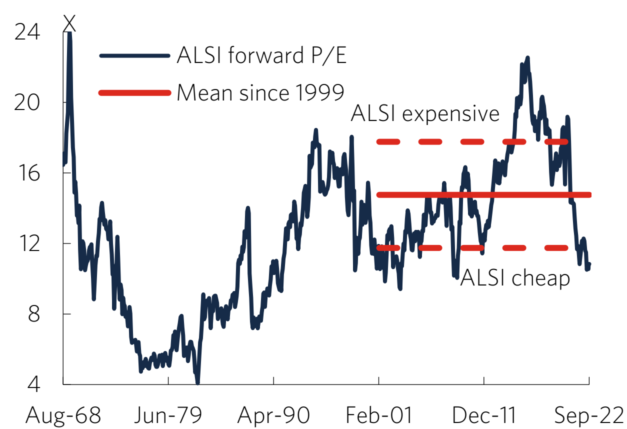


Source: IRESS, Momentum Investments

Moreover, we believe that global inflation, tighter global financial conditions and the risk of a recession will dominate global capital flows. With global themes likely to be a larger determinant of the outcome for SA's asset classes, local idiosyncrasies, such as a potential greylisting, may be overshadowed. In any event, we

remain steadfast in our view that a well-diversified investment portfolio as encapsulated in our outcome-based investing philosophy provides the best possible protection against any unforeseen global or idiosyncratic market events that may cause short-term instability. Furthermore, history has shown that staying invested throughout any market turbulence has been the superior strategy for long-term returns.

Chart 5: SA equity market forward P/E



Source: IRESS, Momentum Investments

With the FATF's D-Day fast approaching, National Treasury has presented urgent amendments to parliament to satisfy the FATF's requirements.

However, many of the issues that the FATF raised fall outside National Treasury's reach and rely on parliament, regulators and the criminal justice system to make the necessary amendments to place SA firmly back on the roadmap to becoming a well-respected partner in the global financial system and a domicile of choice for structuring cross-border investments into the rest of Africa.

Aside from technical factors, the decision on greylisting SA depends on the FATF's judgement of government's political willingness to achieve sufficient progress in addressing the concerns highlighted. Nonetheless, regardless of the outcome, we believe this yellow card warning should serve as a wake-up call for SA policymakers, regulators and law enforcement agencies to convince the country's international counterparts that these grey skies are merely passing clouds and it is worth their effort to maintain relationships in the interim as SA continues to build a more robust legal and compliance framework to remain competitive on the global stage.

The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at momentum.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.