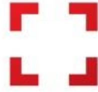
momentum

investments



The Macro Research Desk

From left to right: Herman van Papendorp (Head of Macro Research and Asset Allocation),
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SA dodges the downgrade bullet for now

S&P affirms SA's foreign currency sovereign rating at BBB-, but outlook remains negative on weak growth

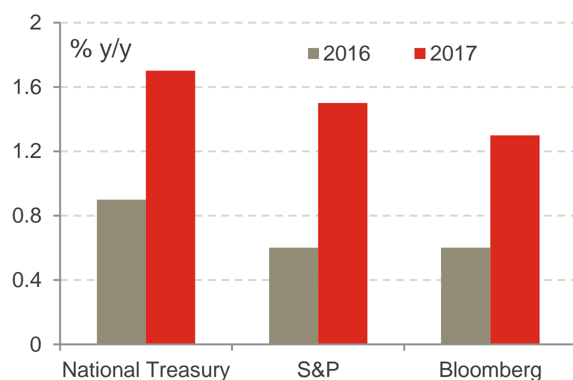
In line with our and the market's expectations, S&P Global Ratings kept SA's long-term foreign currency sovereign credit rating at BBB- and affirmed the local currency rating at BBB+. Nevertheless, S&P maintained the negative outlook that was issued in December last year, warning against the threat low economic growth poses to government's social contract with business and labour.

The rand reacted positively to the news on Friday evening, strengthening from 15.25 to the US dollar prior to the release to 15.10 following the statement. Earlier in the day, the US dollar weakened considerably as concerns around the health of the US economy arose on the back of a dismal payrolls print.

Downward revisions to growth estimates

S&P noted that adverse terms of trade and weak external demand have left economic growth weaker in SA, but added that domestic-specific events have compounded the fragile growth outlook. Cyclical factors such as the drought and subdued mining and manufacturing activity have lead S&P to downwardly revise their 2016 growth forecast from 1.6% in December 2015 to 0.6% (in line with the Bloomberg consensus and our own internal forecast) and their 2017 projection from 1.8% to 1.5% (marginally higher than the Bloomberg consensus forecast of 1.3% and our own internal forecast of 1.2%). S&P expects real GDP growth to gradually recover to 2.1% by 2019, led by an improvement in weather patterns and a more favourable terms of trade based on the assumption that China remains moderately supportive of world growth.

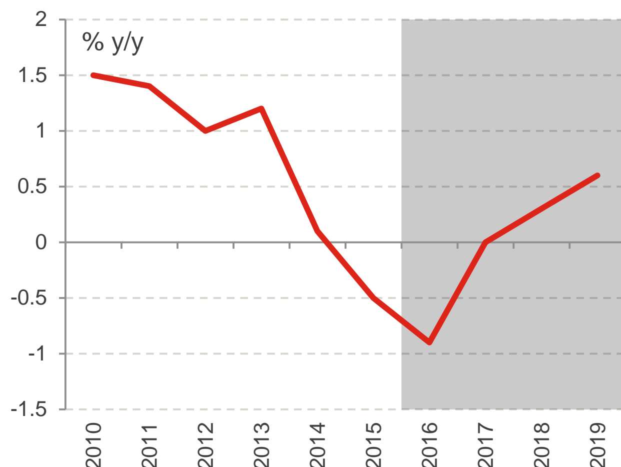
Chart 1: Real GDP growth estimates



Source: National Treasury, S&P, Bloomberg, Momentum Investments

S&P estimates that growth in real GDP per capita will decline by 0.9% this year following a contraction of 0.5% in 2015. Flat growth is expected in 2017, gradually increasing to 0.6% in 2019 (see chart 2). S&P warns that socioeconomic implications of muted growth in real GDP per capita measures could shift policy towards increased intervention and income redistribution at the cost of GDP growth.

Chart 2: Steady decline in real GDP per capita since 2010



Source: S&P, Momentum Investments

Table 1: Summary of S&P's mid-year review

Outcome	• **Sovereign:** Rating stable at BBB- (negative outlook remains) • **Local:** BBB+ affirmed
Reasons behind outcome	• Government showing greater resolve to reduce fiscal deficits at a faster pace • Energy sector improvements • Pending finalization of labour and mining reforms • GDP downgrades largely due to cyclical factors ➔ expect terms of trade and weather patterns to improve
Positives	• Strong democracy with independent media reporting • Strong institutions (Public Protector, Judiciary, monetary + fiscal authorities) • Government showing stronger resolve to reduce fiscal deficits
Triggers for potential positive ratings action	• Policy implementation leading to an improvement in business confidence and encouraging higher levels of private fixed investment spend
Triggers for potential negative ratings action	• Further GDP disappointments leading to a further decline in GDP per capita • Political tensions and interference affecting government's policy framework • Inconclusive labour (prolonged strikes + less flexible labour laws) + mining sector (mining code ➔ sensitive negotiations regarding Black Economic Empowerment) reform • Additional funding required by state-owned enterprises with weak balance sheets (Eskom + Sanral + SAA) • Net government debt + government guarantees > 60% of GDP over forecast period

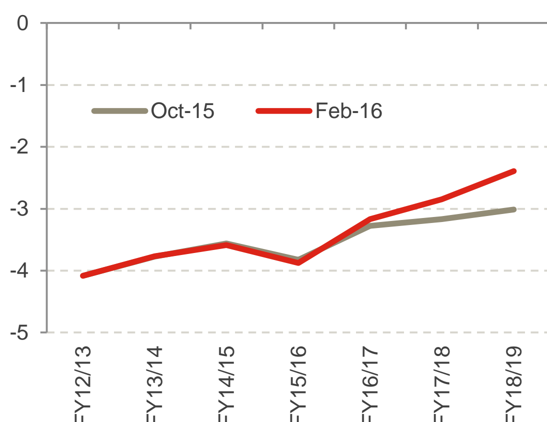
Source: S&P

SA's local currency rating gap at risk

SA's local currency rating was affirmed at BBB+, ranking two notches higher than the foreign rating thanks to an independent and credible South African Reserve Bank (SARB), prudent fiscal policy, a large and active local currency fixed-income market and a floating exchange rate regime which limits expending reserves to protect the value of the currency, However, S&P warned that a reduction in fiscal flexibility could lead to a narrowing of the two-notch gap between the local and foreign currency debt rating.

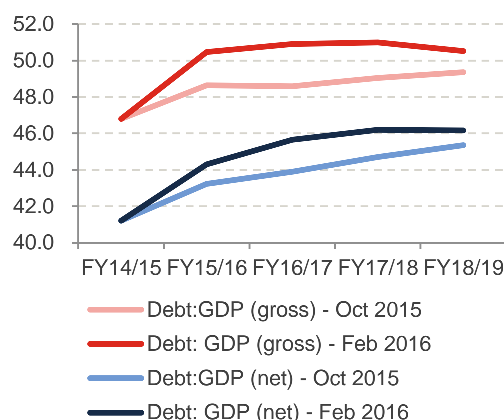
With Treasury projecting a narrowing in the government budget deficit from 3.9% in FY15/16 to 2.4% in FY18/19 and a stabilisation in the gross debt to GDP ratio at 50.5% in three years' time (see chart 3 and 4), government will have to demonstrate a commitment to decreasing spending and increasing the tax base in a growth-friendly manner to achieve these targets. In our view, a low-growth environment and further likely downgrades to Treasury's growth forecasts of 0.9% in 2016 and 1.7% in 2017 will continue to threaten the outlook for SA's fiscal flexibility and performance score (currently scored as a weakness) and ultimately SA's debt burden score (currently rated as neutral).

Chart 3: Government budget balance (as % of GDP)



Source: National Treasury, Momentum investments

Chart 4: Government debt balance (as % of GDP)



Source: National Treasury, Momentum investments

Treasury acknowledges that the next six months are critical

Treasury responded to S&P's review by saying that government will act in concert with labour and business to insure that confidence is restored in order to boost both local and foreign investment. They aim to remove obstacles prohibiting a faster acceleration in employment and will undertake fiscal and regulatory reforms.

Consequences of low growth could lead S&P to downgrade SA this year or next

Although SA averted a rating downgrade to junk status at S&P's mid-year review, we are not out of the woods as yet. The current rating assumes that SA will continue to experience broad political stability and macroeconomic policy continuity. The rating agency has however highlighted potential disruptions associated with the upcoming local government elections in August later this year and the ANC's elective conference in December 2017. Moreover, S&P has cited a lack of progress on structural reform, low GDP growth, SA's reliance on volatile portfolio flows to close the current account gap and a sizeable government debt burden as key risks to the current rating and has indicated an intention to lower SA's rating into sub-investment grade this year or next if SA fails to implement the necessary measures to turn the economy around. While key labour market reforms (including the secret strike ballot and national minimum wage) may still be announced before the end of the year, the outcome of the proposed amendments to SA's mining legislation (with respect to the mining charter and the Mineral and Petroleum Resources Development Act in particular) and broader state-owned enterprise reform may take longer.

If government commits to reducing the bloated public sector wage bill by constraining employment additions and curbing wasteful expenditure through cracking down on corruption, the trajectory of structural expenditures will improve. Acting on a number of proposed economic reforms, in the labour and mining sector, in particular, will cultivate higher rates of economic growth, allowing SA to grow its way out of a potential debt crisis. Moreover, addressing the challenges that face vital state-owned enterprises are key in unlocking a higher growth potential in SA. Although a rating agency can generally keep a negative outlook for between 12 and 24 months before acting, rising political tensions in a low-growth environment raises the risk of buckling under socialist demands and endorsing policy measures that could damage SA's investment climate, posing a significant threat to SA's sovereign rating outlook as early as December this year (year-end review set to take place on the 2nd of December 2016).

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