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The Macro Research Desk

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No ratings bargains for South Africa on Black Friday

Highlights

- **Fitch leaves South Africa's (SA) rating unchanged**
- **Moody's rating kept steady, but country placed on review for downgrade**
- **Standard and Poor's (S&P) lowers SA's foreign and local currency ratings by one notch**
- **SA is vulnerable to additional negative ratings action should further disappointments on growth and fiscal outcomes materialise or governance standards deteriorate further**
- **A more positive than expected outcome in politics, coupled with progress on economic and fiscal reforms, could tilt the currently negative ratings bias the other way**

One notch downgrade by S&P, while Moody's placed the country on review for downgrade

Two out of the three key rating agencies left SA's sovereign credit rating on hold. Fitch Ratings affirmed SA's long-term foreign and local currency debt ratings at BB+ and maintained a stable outlook.

Similarly, Moody's kept its Baa3 rating for SA intact at its recent review, but it placed the country on review for downgrade given weaker growth prospects, "material budgetary revenue shortfalls" and a further escalation in government's debt ratio relative to the gross domestic product (GDP).

S&P, on the other hand, justified a downgrade to SA's foreign currency rating from BB+ to BB, leaving the outlook at neutral. Although only 56% of economists anticipated a cut in S&P's ratings, according to RMB Morgan Stanley, the effect on the domestic currency was limited, following an initial spike, suggesting the downgrade was largely priced in.

All three rating agencies warned SA's institutional strength is deteriorating. It would be ratings negative should the country no longer adhere to the Constitution and rule of law, or if independence and credibility of key institutions, including the SA Reserve Bank (SARB) or National Treasury, are comprised.

All three agencies suggested a further disappointment on growth or fiscal outcomes (including additional outlays to SA's state-owned enterprises (SoEs)) could trigger additional negative ratings action.

In contrast, all three agencies commended SA on its monetary flexibility, deep capital markets and improving external position. S&P noted central government debt was predominantly denominated in rands, with only 10% denominated in foreign currency, reducing SA's external vulnerability.

Key risks to SA's ratings posed by the fiscal outlook

S&P and Moody's alluded to the rigidity of SA's public sector wage bill. The public sector wage bill has increasingly crowded out other areas of more useful expenditure, raising the importance of a reasonable compromise between government and civil servants.

This year, public sector wage negotiations are taking place against tepid economic growth and a heavily constrained fiscus. The acting director-general of the Department of Public Service and Administration recently noted in Parliament that the cost of meeting this year's civil servant wage demands amounted to R282 billion. Public sector workers have started their negotiations between 10% and 12%, while their demands for housing allowances have increased from R1 200 to R2 500. This compares unfavourably to the budgeted annual average 7.3% increase for the next three years, as indicated by National Treasury.

Moreover, free tertiary education poses a risk to the fiscus. The Inter-Ministerial Committee on Higher Education Funding recommended technical education and training costs must be subsidised fully by the state. These additional costs have been estimated at a cumulative R23 billion in the next three years. It also recommended R50 billion in surplus Unemployment Insurance Fund (UIF) receipts be used to improve the infrastructure at the Technical and Vocational Education and Training (TVET) colleges.

According to RMB Morgan Stanley, a full drawdown of these funds would represent a 1% decline in fiscal revenues in fiscal year 2018/19.

The rating agencies warned government might have to provide additional support to SoEs as moderate contingent liabilities materialise. S&P noted it anticipates an increase in appropriations to Eskom, given its very weak financial position.

Lastly, the financial risk associated with the nuclear build programme lingers. At the time of the October 2017 Medium Term Budget Policy Statement, Finance Minister Malusi Gigaba intimated that the country could not afford a nuclear build programme. However, more recently, the finance and energy ministers stated in Parliament that nuclear remains a part of SA's energy mix and the country would purse the nuclear build programme at a pace and scale the government could afford.

The most recent Cabinet reshuffle stirred concerns over the appointment of David Mahlobo to the energy portfolio, given his alleged links with Russia. At present, it is highly unlikely Eskom will be able to absorb the nuclear project with its current approved guarantees, implying a substantial ramp up of guarantees to the power utility if the project is undertaken. As such, should the controversial nuclear build programme be pursued, there will be major negative ramifications for SA's fiscal and overall debt profile.

Comparison of the key ratings reviews

	Fitch	Moody's	S&P
Outcome	• Ratings kept on hold at BB+ • Outlook remains stable	• Ratings kept on hold at Baa3 • Placed on review for downgrade (review period likely to extend to the February 2018 national budget)	• Foreign currency rating lowered to BB from BB+; local currency rating lowered to BB+ from BBB- • Outlook remains stable
Reasons behind outcome	• Favourable government debt structure • Deep local capital markets • Flexible exchange rate can absorb external shocks • Outcome of the ruling party's elective conference in December 2017 remains key to further ratings decisions	• Economic and fiscal challenges are more pronounced • Slower growth prospects and rising poverty • Revenue shortfalls • Sticky wage bill • Further rise in borrowing costs • Challenges to fiscal consolidation • Measures to address additional fiscal pressures not addressed in budget • Halting progress on structural reform exacerbated by "unclear and shifting" policy objectives	• Further deterioration in economic outlook and public finances • Expected real GDP per capita growth averaging at negative 0.7% between 2015 and 2018 • "Rigid wage-setting mechanisms" • Incorrect focus on redistribution, rather than growing the economy • Erosion in external competitiveness • Even with offsetting fiscal measures, public finances are unlikely to stabilise in near term • Overall public sector debt (including contingent liabilities of SOEs) estimated at 71% of GDP in 2017 • **Stable outlook** reflects the potential for political instability to subside after December 2017
Triggers for negative ratings action	• Weaker fiscal outlook • Faster increase in debt	• Faster debt accumulation → risks posed by concentrated contingent liabilities to SOEs • No longer adhering to the constitution or rule of law • Fiscal measures to address funding gaps lack credibility • Lack of structural reforms • Doubt over the independence of core institutions (National Treasury and SARB)	• Further deterioration in economic and fiscal metrics relative to forecasts (expects real GDP growth of 0.7% in 2017 and 1.0% in 2018, while the fiscal deficit is expected to average close to 3.6% of GDP up until 2021) • Increased threat to independence of the SARB

Triggers for positive ratings action			
	• Positive direction for policy outcomes following the December 2017 elective conference • Potential fiscal consolidation measures • Firmer growth recovery should confidence improve after December 2017	• Ratings would be confirmed at the current level should a positive policy response emerge • Positive developments in the political economy foster growth and an investor-friendly environment	• Firmer growth or better fiscal outcomes compared to base case • Subsiding risks to deterioration in external funding sources • Economic reforms introduced to create jobs, increase competitiveness and boost growth

Source: SARB, Momentum Investments

SA's sovereign ratings outlook and investment implications

SA's ratings outlook could take on a more positive bias should the new leadership ushered in at the December 2017 elective conference boost confidence by implementing structural reforms needed to halt the rot at SA's SoEs, improve competitiveness and boost growth. However, if structural reforms are not forthcoming and if offsetting fiscal measures in the February 2018 national budget do not stabilise, SA's fiscal and debt outlook, further negative ratings action is more than likely by Fitch and Moody's in particular.

According to RMB Morgan Stanley, SA's sovereign bonds will now be excluded from the Barclays Global Aggregate Bond Index. It estimates up to US$1.5 billion in passive outflows, based on Turkey's experience and the size of the SA bond market.

For now, SA remains in the Citi World Government Bond Index (Citi WGBI). RMB Morgan Stanley projects a potential US$5 billion in outflows should SA be excluded from this index. An exclusion from the Citi WGBI would be triggered by Moody's dropping its rating by one notch, so that the local currency rating for S&P and Moody's are rated as sub-investment grade (see table 2).

Citi notes that while buying into the index inclusion might have been staggered, the exit door could be crowded. Re-entry into the index will be difficult to achieve. The Citi WGBI requires a minimum credit quality of A- by S&P and A3 by Moody's for the country's local currency rating (four notches above junk status).

While it is debatable how much of the ratings downgrade news is already reflected in financial markets, it is reasonable to expect that there will be at least some negative market reaction to the news. As such, rand-hedge investments can reasonably be expected to outperform in a ratings downgrade scenario. These include global asset classes and the local equity market (due to the latter's dominance by foreign-driven earnings). In contrast, local fixed-income-related investments (bonds and listed property) are likely to suffer during a ratings downgrade period.

Table 2: SA's sovereign ratings

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
	BB	BB	Ba2
Outlook	Stable	Stable	Negative

Local currency rating
Foreign currency rating

Source: Fitch, Moody's, S&P, Momentum Investments

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