South Africa: put (firmly) on notice

By Marie Antelme, Economist

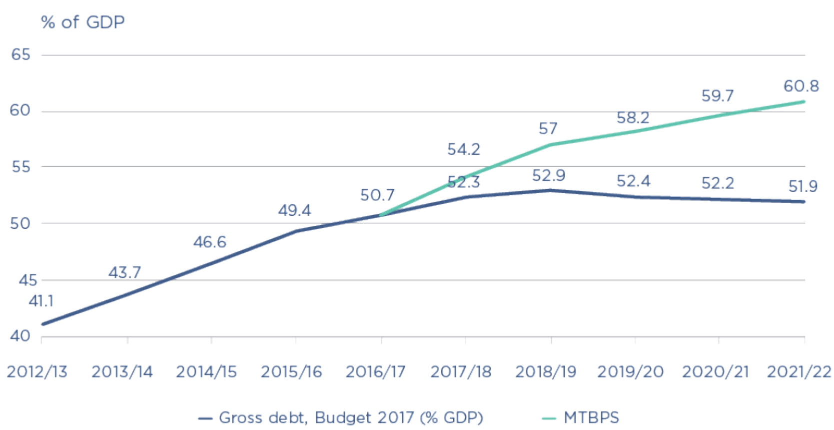
Judging from the muted market reaction over recent days, last week's credit rating decisions were largely priced in. Still, the sting could be in the tail.

Standard and Poor's (S&P) decided to downgrade South Africa's local currency rating to BB+ (the highest junk rating) and its foreign currency rating one notch below to BB, both with a stable outlook. Moody's did not downgrade South Africa's credit ratings, but placed both local and foreign currency on review. Both sit at Baa3, the lowest investment-grade rating. (Earlier, Fitch had affirmed both local and foreign currency ratings at BB+, with a stable outlook.)

The moves were largely expected (except, perhaps, the S&P foreign currency rating downgrade) given the deterioration in fiscal metrics since the Medium-term Budget Policy Statement, and South Africa's persistently low growth rate.

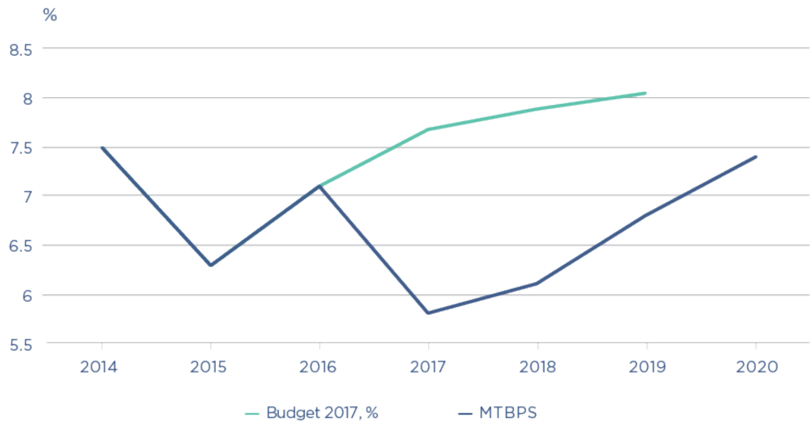
National Treasury now expects GDP growth to be considerably weaker than before. The deficit is forecast to stabilise at -3.9% of GDP over the medium-term framework (compared to a consolidation to -2.6% presented in the February Budget), and gross debt is expected to continue to rise, without stabilising, to 60.8% of GDP by 2021.

SOUTH AFRICA: GROSS DEBT



Source: National Treasury

REVISIONS TO NOMINAL GDP FORECASTS



Source: National Treasury

S&P expects government will introduce measures to arrest public finances deterioration in next year's Budget, but it is not convinced these measures will be enough to remedy the deterioration. Specifically, government spending needs to consolidate and shift from wages to capacity-building infrastructure and new policies aimed at materially boosting confidence and growth need to be introduced to kick-start growth in the near term. Understandably, there is also some caution about government's ability to successfully implement a cohesive strategy when it has failed to do so to date. Another, related, consideration for S&P is that economic policy has become increasingly focused on income distribution rather than on aggregate growth. The agency believes this has undermined confidence and local institutions, while impacting competitiveness. Nonetheless, by moving the outlook to stable, S&P expects credit metrics to remain broadly unchanged next year. If the economy or standards of public governance deteriorate, this will impact its ratings.

Moody's concerns are broadly the same as S&P's. By notifying the market that South Africa is 'on review for downgrade', Moody's is signalling that there has been a deterioration in credit worthiness, but that it is waiting for more or better information before acting. If South Africa is able to demonstrate sufficient commitment to credible corrective fiscal action, Moody's may withdraw the review, and not move.

However, given the short period of time, the political calendar between now and the February Budget, as well as the extent of the deterioration in economic data, it is hard to think that Moody's will ultimately withdraw its position without downgrading the rating further. Moody's has indicated that it will finalise its review of South Africa's credit ratings in the month after the 21 February 2018 Budget.

CURRENT STATUS OF MOODY'S AND S&P CREDIT RATINGS FOR SA

	Moody's	S&P
Investment grade	Baa1 Baa2 Baa3 (local & foreign)	BBB+ BBB
Sub-investment grade	Ba1	BB+ (local) BB (foreign)
Outlook	Ratings review (negative)	Stable
Rating as of	November 2017	November 2017
Next review date	March 2018	22 January 2018

Sources: Moody's, S&P, Citi Research

What next?

S&P's local currency rating downgrade will trigger South Africa's exit from the Barclays Global Aggregate Bond Index (BGAI) by the end of the month. At the time of writing the impact on bond yields and the currency has been negligible, which suggests the exclusion was expected.

There is considerably more uncertainty about the impact on domestic asset prices of a possible exclusion from Citi Bank's World Government Bond Index (WGBI). South Africa has a much larger weighting in that index compared to BGAI. Also, a large group of passive funds track the index, and will be forced to sell off surplus South African assets. (More active funds track BGAI.) WGBI inclusion requires just one of either S&P or Moody's to hold South Africa's local currency rating in investment grade. Should Moody's downgrade, this condition will no longer be met, and South Africa would be excluded from the following month.

History suggests that it takes much longer to regain a lost investment grade rating than to lose it, and even longer to have the requisite rating for re-inclusion in an index such as WGBI. Only a minority of countries that have lost their investment rating over recent decades have succeeded in gaining it back. South Africa's investment grade rating was achieved following many years of hard discipline and tough decisions by the ANC government. The investment grade rating has helped lower the cost of borrowing and enabled the state to provide basic services and welfare grants to the poor and to reduce its debt.

Losing our investment grade rating has negative economic and fiscal knock-ons – it is possible the currency may weaken, prompting higher inflation, higher interest rates and more constrained disposable income. For government, borrowing costs are likely to rise.

The impact on your investment

We are comfortable that our strategies can withstand the worst of the current headwinds. The aim with our multi-asset funds is to build anti-fragile strategies that can withstand unexpected developments – including sharp movements in currencies, inflation and interest rates.

At present, our portfolios remain fully exposed to global assets. Within the South African equity allocation, there is a high allocation to global businesses which derive their earnings from outside of the country. Within fixed interest, we are positioned very defensively, with low duration and very limited exposure to fixed-rate government bonds. We have reasonable property exposure as an alternative to holding fixed-rate government bonds.

History has taught us that our ability to forecast the immediate future is limited. As always, our key focus is on building diversified portfolios of undervalued assets that can withstand shocks, such as those we are currently experiencing.