MOODY's DOWNGRADE COMMENT
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NEDGROUP INVESTMENTS

MOODYS DOWNGRADES SOUTH AFRICA

Moody's announced last night that they are ***cutting South Africa's sovereign credit rating to Ba1 From Baa3***. The outlook remains negative. This means that the country now has a ***sub-investment grade rating***. All three major rating agencies now have South Africa rated as sub-investment grade, meaning that we as a country will fall out of the FTSE World Government Bond index.

Fitch and S&P, the two other key global rating agencies both downgraded South Africa to "junk" status during 2017.

The word "junk" status refers to countries whose debt is rated below that of investment grade – it is sometimes referred to as "high yield."

Factors that affect a countries Sovereign Credit Rating

Rating agencies do not per se measure the health of a country's economy, rather what they assess is a governments ability to honour debt commitments. These measures take certain economic factors into account which could be seen as indicators of a country's future economic prospects.

Some of the key factors that rating agencies will look at are:

- Political stability;
- Level of national debt;
- Debt interest payments as a percentage of GDP;
- When does the national debt mature (various timelines);
- Annual economic growth forecasts.

They look at all of the above components as a collective – which in turn paints a picture of the current and expected future state of the countries economy and financial position.

What were the reasons for the downgrade?

Moody's largely cited the deterioration in South Africa's fiscal strength and structurally very weak economy as the basis for their decision. This was not unexpected, as in November 2019 Moody's had already stated their worry and concern about SA's growing debt-to-GDP ratio which was rising rapidly.

Moody's also noted that the untimely event that the world and South Africa is facing with the COVID-19 virus only makes matters worse and will make it even more difficult to put effective policy responses in place given the countries already tight economic position. SA has record high levels of unemployment, the SA economy had its second technical recession in just two years during the last quarter of 2019 and is expecting a further negative second quarter in 2020 based on the global lockdown due to the corona virus.

It noted that SA was entering a period of much slower global economic growth due to COVID-19 in a weak position, with not much ability for government to implement policies to assist in weathering the storm.

They also noted that the pace of "structural reforms" in the economy had been "very limited" and was way slower than they had hoped. They acknowledged that some progress had been made to encourage job creation and increase competition but nothing that they considered a "step-change" for the economy. Issues like the uncertainty about property rights, the strength and rigidity of the trade unions, ESKOM and a long-term plan on the countries power generation were all cited as areas where no real material progress had yet been finalised.

What does this mean to South Africa?

Cost of debt

The cost of raising further funds in the global and domestic bond market will rise. The cost at which one raises capital is directly linked to one's "credit worthiness", and the lower the global rating agencies rate a country – the greater the level of "credit risk" is placed on the country. As a result – to compensate for this greater risk a higher return needs to be paid. As such the SA government will need to issue debt at a high interest rate (yield), thereby increasing their future interest rate payments. This will add further pressure on the budget where interest payments already make up a significant portion. Moody's estimate that by 2023 the countries total debt burden may reach a level of 91% of GDP.

Forced selling

Global bond funds and index tracking funds who are limited to holding investment grade bonds will in time need to sell their SA bond holdings due to them now having "junk" or non-investment grade status. SA bonds will be removed from the FTSE World Government Bond Index, and all index trackers will be forced to sell their holdings. Non-residents currently hold around 35% (R600 billion) of total domestic bonds. Conversely however, it should be noted that there are large amounts of global funds that hold and invest into junk bonds and they would thus become buyers of SA government bonds. This will result in an inflow into the country. Time will tell how much these flows will may offset each other.

Inflation and the SA exchange rate

Currently SA's inflation is well within the target range of Treasury and is around 4.4%. Historically with downgrades one has seen a short-term decline in the countries exchange rate, very often then followed within 3-6 months by a recovery. A weaker exchange rate would result in the price of imported goods increasing including the price of petrol (which is priced in USD) – thereby putting upward pressure on prices to the consumer and a rise in inflation. This would then result in the Reserve Bank traditionally having to raise interest rates in order to curb inflation – thereby pushing up the cost of borrowing and debt to consumers (as an example, home bond payments would rise).

Notwithstanding the above it should be noted we are in a somewhat different scenario. Over the past month with the outbreak of COVID-19 we have already seen:

- SA Reserve Bank drop rates by 100bps;
- The price of oil has slumped from $55 a barrel to around $25. This will keep petrol prices lower and curb inflation pressures;
- Inflation is currently well under control in SA. There is pressure on unions and government to reign in real wage increases;
- The Rand has weakened 18% YTD to the USD on the back of a possible downgrade and a risk off environment across all emerging market economies with the corona-virus lockdown;
- Globally and in SA material fiscal policy stimulus packages have been announced to help support the various global economies, small and medium businesses and those workers who have lost jobs over this period.

It is impossible to predict exactly what will happen going forward, but in all likelihood much of the downgrade has already been priced into the SA bonds (as reflected by current bond yields), into the ZAR exchange rate and into annual GDP growth forecasts. Trying to differentiate between movements caused by the downgrade (largely expected and priced in) and movements caused by the corona virus and its economic impact (largely unexpected and unknown) is very difficult.

Government response

The SA government released a brief statement – with Finance Minister Tito Mboweni stating, "to say we are not concerned and trembling in our boots about what may be coming in the weeks and months ahead is an understatement.". He stated that the government remains fully committed in both the short and medium term to address structural economic reforms, stimulate economic growth, tackle the labour market and focus on fixing ailing state owned enterprises.

It should also be noted that the SA Reserve Bank has demonstrated a good track record in implementing credible and effective monetary policy and maintaining financial stability in the country and across the financial system.

Concluding comments

It certainly is no surprise that this Moody's downgrade was announced. Markets have been anticipating it for many months now – and finally the actual event has happened. There will no doubt be some knee jerk reactions in some parts of the market and the currency, but we feel the vast majority of it would already have been priced in. South Africa is not the first nor will it be the last country to be downgraded and in time we hope to get back to investment grade status.

The key concern is that it places the government and Treasury under added pressure with its constrained budget to allocate its spending and annual budget. The economy is fragile already and governments ability to put stimulus packages together will be made more difficult. It also cannot raise the tax burden on individuals, who are already paying significant levels of personal income tax. It is now time for government to speed up key economic reforms and to create the best possible environment to stimulate economic growth. BUT first, it has the key task of tackling the spread of COVID-19 and protecting the health of its citizens.

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