South Africa's Sovereign Credit Rating – Should We Care?

Conrad Wood, Head of Fixed Income at ALUWANI shares his views around credit ratings and rating agencies.

One of the key event risks for local investors in 2020 is the potential change in South Africa's sovereign credit rating from Moody's. How we find ourselves in a situation where a small caucus of foreign analysts with a rubber stamp determine the flow of billions of dollars of capital is beyond the scope of this commentary. Even more bizarre is who invented an arbitrary line in the sand where if you are on one side you are "investable" and entitled to a flood of global capital, but if you are on the wrong side of the line, you are an uninvestable pariah, branded with the dreaded "J" for Junk and banished outside the city walls, where no global bond indices would ever dare to wander? We can bemoan the framework of independent credit ratings that has been imposed on us until we are blue in the face. But in reality, the system is so entrenched in investor mandates, financial regulation and credit index methodologies that ratings matter as market participants use them as arbiters of global capital flows.

Why do credit ratings matter?

Now that we have reluctantly made peace with the existence of credit ratings, we need to understand why, as long as they exist, they are important:

1. Access to capital – without a credit rating (preferably a stable and strong one) it is increasingly expensive to attract capital. Global competition for capital flows is fierce and they increasingly move around at the push of a button because they are in financial assets as opposed to bricks and mortar. South Africa is in the unenviable position of having the dreaded, so-called twin deficit syndrome i.e. we have a budget deficit (we spend more than we earn) and we have a current account deficit (more money leaves the country than enters it). Together, the sum of these twin deficits is approaching 10% of GDP or roughly R550bn. To give context to the abyss the country finds itself in, is a South Africa that needs to borrow R1.2bn per day to fund its deficits.

2. Cost of capital – we have established that as a country we borrow a lot and we also spend more than we earn as do most emerging markets. We might as well try and make it as inexpensive as possible. Debt servicing is our most rapidly growing expense currently (faster than education or health). In a few years' time South Africa is forecast to spend 15c of every R1 that we earn on servicing existing debt. Given that our national debt is in excess of R3trn and we add around R300bn to that annually, a 1% change in government cost of borrowing (interest rates) adds about R3bn of interest to the annual debt service bill. Credit ratings invariably impact your cost of capital – In the case of a downgrade in the rating or outlook, the likelihood is for an increase in a country's cost of capital. As a country, we cannot afford ours to get any worse.

What affects credit ratings and in particular what will Moody's look at when reviewing ours?

What does Moody's look at?

As citizens of South Africa, living the daily reality, it is easy to ascribe our personal bias to something like a sovereign credit rating. Everyone has an opinion either way. Thankfully, reality is a little less emotional than that. Below we distil what is a very detailed and robust rating process behind deriving a sovereign credit rating into four high level factors that are overarching to the analysis.

1. **Institutional strength** – are our public institutions that safeguard the constitution as well as set and implement policy strong, independent, protected, reformist etc? This is the "glue" that holds the country together and steers it along a sustainable path.

   Verdict – S.A. is hanging onto an investment grade rating, notwithstanding attacks on the very core of our democracy. SA is leading many of our emerging market peers in this category as the overall strength of our institutional framework remains intact.

2. **Economic growth** – an alarming decline in structural growth and a deficient GDP per capita rate, with little policy reform to change this.

   Verdict – sub-investment grade status.

3. **Fiscal risk / debt sustainability** – an alarming rate of increase in debt, imposing an ever-increasing burden on a low growth, high unemployment economy.

   Verdict – sub-investment grade status.

4. **Ability to absorb shocks / resilience** – this looks at drivers of external vulnerability as posed by hard currency debt, foreign capital flows, foreign exchange reserves, foreign ownership of assets and depth of bond market and floating currency.

   Verdict – S.A. is a leading emerging market peer in this category and comfortably investment grade.

You can see why this is a difficult decision. There are two factors "for" and two factors "against" a rating downgrade. Of course, Moody's will apply weightings to each of the factors in their deliberations. The decision however gets trickier as in addition to the above, there appears to be a healthy dose of qualitative overlay (analyst code for gut feel). Expressed another way, the Model comes to a conclusion but you can do something different if you want. On the back of this we therefore hold the view that it is difficult to predict what a rating agency will do and why so many investors pronounce with conviction their expectation for the rating, only to be proven wrong.

What will happen to markets after the Moody's decision and will investment portfolios be dramatically impacted?

Now we are into the dark art of forecasting and predicting. The biggest challenge in the immediate aftermath of the decision is what action foreign investors take as they are the ones most impacted by a change in a sovereign credit rating as well as what global environment is prevailing at the time (essentially are investors risk weary or not)?. Having said that there will be those that are compelled to liquidate local bond holdings and repatriate ZAR because their mandates do not permit sub-investment grade exposure or their benchmark no longer includes a weighting to South Africa. It is impossible to accurately predict what the total global AUM is that would no longer be allowed exposure, how much of the selling may have been pre-emptively done or hedged and how much time those that would still need to sell are granted to do so. This is where the market consensus number seems to have become $8bn (R120bn) of foreign bond selling.

However, we are not sure that the analysis has much depth to it for reasons already mentioned. Then there will be those investors that are not forced to sell due to more flexible mandates and less benchmark cognisance, but will still make an active investment decision post a downgrade. Our view is that these investors would have largely made a decision already given that the road to a downgrade has been long and well telegraphed with no hurdles put on them from a market access perspective. Putting an optimistic spin on things, one would assume that there is a third group of foreign investors who are benchmarked against High Yield bond indices and as the new "junk" S.A. debuts in those, they may allocate previously untapped capital to our local market, offsetting to a degree that which is running for the exit.

Meanwhile, local investors will be keen spectators on the side-lines, watching developments through a different lens. It will be important for the market how they react as they can either act as shock absorbers for the volatility or exacerbate it by joining the stampede. Our sense is that temptation will be high to relieve foreign sellers of their bonds on their way out as yields of 6% real in the same currency as your liabilities are fairly attractive. If you are a ZAR investor, domiciled in S.A., your own sovereign is certainly not sub-investment grade. The above plethora of investment decision making will play out post the decision and we need to figure out what that means for yields and the currency. Given our scepticism around forecasting, we approach the challenge from a scenario perspective, allocating probabilities to likely outcomes (which we retain the right to change frequently with each new tweet or News headline).

A fitting analogy that comes to mind here is that of a parent- child relationship with Moody's as the disciplinarian parent and South Africa as the rebellious youth. We will use this analogy when assigning and looking at the various scenarios that can potentially play out.

Scenario 1 – probability 5%

Kiss and make up – son, I can see you have learnt from your mistakes and are doing things that show you have changed. I am proud of you, here is an increase in your allowance and why don't you go and play X-box with your friends.

Credit Rating	Remains at Baa3 (investment grade)
Outlook	Stable
Market response	Relief rally, risk premium unwinds
10yr Bond Yield	8.30% (-70 bps)
Yield Curve	Flatter
Total Return from ALBI	+5.25%
Zar	R13.50 /$ (75c stronger)

Scenario 2 – probability 35%

Go to your room and think about what you have done – son, I despair and I am really angry with you. You are proving to be just like the other boys. I want some time to think about what to do. Once I have calmed down and you have shown remorse, I will decide on whether you should be punished further.

Credit Rating	Remains at Baa3 (investment grade)
Outlook	Remains on negative
Market response	Initial rally, which quickly fades
10yr Bond Yield	8.75% (-25 bps)
Yield Curve	Steeper
Total Return ALBI	+1.75%
Zar	R14.00 /$ (25c stronger)

** There is a possible slight variation of this scenario where the outlook is changed from negative to rating watch. This would be less positive for bonds and the rand.

Scenario 3 – probability 60%

How could you – after all I have done for you. You are grounded and have lost all your devices indefinitely. I am tired of talking now and you must face the consequences.

Credit Rating	Ba1 (sub-investment grade)
Outlook	Stable
Market response	Bonds and zar sell-off
10yr Bond Yield	9.50% (+50 bps)
Yield Curve	Steeper
Total Return ALBI	-2.80%
Zar	R15.00 /$ (75c weaker)

** There is a possible variation of this scenario where the outlook remains negative even after the downgrade, implying risk of further moves in the rating. This would exacerbate the already bearish outcomes above.

From the above, you will notice that all-else-being-equal, the impact from Moody's decision sees most of the probable outcomes residing in the marginally positive at best to substantially negative at worst part of the distribution i.e. the pay-off profile is fairly asymmetric and should counsel caution for positioning of investor portfolios. Moody's have announced that the official date for their next compulsory update on the South African sovereign rating will be 27 March 2020. It is worth bearing in mind that they can however pronounce a rating update at any time if they feel the circumstances warrant it. This is particularly relevant because the national budget presentation will take place in late February and is expected to provide the critical information which will crystallise Moody's decision. If this is significant enough, they may feel compelled to pronounce before the formal communication date.