CABINET PURGE IGNITES DOWNGRADE DECISION

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A lot has been said over the past year in the media regarding the possibility of whether South Africa (SA) will be downgraded to "junk status" by the respective rating agencies, namely Moody's, Standard and Poor's (S&P) and Fitch. An emphasis has been placed on the implications for our stumbling economy, the government, corporates, consumers and what the government is required to do in order to avoid a possible downgrade. Last night, S&P was the first rating agency to make a move following Jacob Zuma's cabinet reshuffle, which was surprising as that they were initially only meant to review SA's credit rating on 2 June 2017. As a result, SA has lost its investment-grade credit rating from S&P for the first time in 17 years. They have reduced our foreign currency rating to BB+ (junk) and our local currency rating to BBB- (still investment grade) with a negative outlook stating that "the downgrade reflects their view that the divisions in the ANC-led government have led to changes in executive leadership, including the finance minister and have put policy continuity at risk". Despite the fact that we have been downgraded on our foreign-currency rating, it is important to realise that these events were driven by politics and that fundamentally, nothing has changed. Furthermore, this article will unpack what a sovereign credit rating is and what "junk status" means for SA and its citizens. Moody's, which currently rates SA two notches above junk status with a negative outlook has placed SA on a downgrade review. Moody's said "changes within a government do not generally signal material changes in a country's credit profile, however, the timing and scope of the reshuffle raises questions over the signal they are sending regarding the prospects for ongoing reforms, the underlying strength of SA's institutional framework, and the fragile recovery in the country's economic and fiscal position". Moody's is expected to publish its review on 7 April 2017, and Fitch could announce its review at any moment but is expected to review on Friday as well.

What is a sovereign credit rating?

A sovereign credit rating expresses the risk that a country will be unable to meet its financial commitments, in terms of repaying interest payments and the debt principal on a timely basis. Essentially, a sovereign credit rating is aimed at providing a relative ranking of a country's overall credit worthiness. Moreover, the respective rating agencies mentioned above utilise various measures that allow them to gauge a country's social, economic and political position in order to determine the probability of a country defaulting on its repayments. Table 1 below depicts the sovereign credit ratings by the respective rating agencies.

Table 1: Sovereign credit ratings

Sovereign credit rating				
Moody's	**S&P**	**Fitch**	**Credit rating meaning**	
Aaa	AAA	AAA	Highest quality	Investment grade
Aa1	AA+	AA+	High quality	Investment grade
Aa2	AA	AA		
Aa3	AA-	AA-		
A1	A+	A+	Strong payment capacity	Investment grade
A2	A	A		
A3	A-	A-		
Baa1	BBB+	BBB+	Adequate payment capacity	Investment grade
Baa2	BBB	BBB		
Baa3	**BBB-**	**BBB-**		
Ba1	BB+	BB+	Likely to fufil obligations, ongoing uncertainty	Sub-investment grade ← JUNK STATUS
Ba2	BB	BB		
Ba3	BB-	BB-		
B1	B+	B+	High risk obligations	Sub-investment grade
B2	B	B		
B3	B-	B-		

Source: Barclays Emerging Market Research

As it stands, Moody's has rated SA as a Baa2 rating which is two notches above sub-investment grade ("junk status"), while S&P and Fitch have rated SA as BBB- which is one notch above "junk status". An important but unappreciated distinction between the sovereign credit ratings is the rating between the foreign currency (FC) denominated debt and the local currency (LC) denominated debt. With respect to SA's total government debt, roughly 10% is issued in foreign currency, while the remaining (90%) is issued in domestic currency.

Distinguishing between our LC and FC debt rating

FC denominated debt is characterised as debt that is issued in a currency other than the sovereign's own currency (i.e. South African issued government bonds in US$, yen or euros), while LC debt is debt that is issued in local currency (i.e. ZAR). Table 2 displays SA's LC and FC debt ratings by the respective rating agencies.

Table 2: South Africa's Local and Foreign currency denominated debt ratings

Local and foreign currency long-term debt rating					
	Moody's	**S&P**		**Fitch**	
	LC&FC	FC	LC	FC	LC
Ratings	Baa2	BB+	BBB-	BBB-	BBB-

Source: Barclays Emerging Market Research

As seen above in Table 2, Moody's has one rating which applies to both the LC and FC denominated debt, while S&P and Fitch distinguishes between SA's FC and LC debt ratings. Moody's rating for SA is two notches above "junk status", and S&P's rating for SA's FC is "junk status", while its rating for SA's LC is one notch above "junk status". Fitch's rating for SA's LC and FC is one notch above "junk status".

What does a downgrade imply for SA and its citizens?

The bottom line for our FC debt being downgraded to "junk status" is that it will cost SA more to borrow money in global markets. Currently, SA has a budget deficit, implying that the government spends more than it earns, whereby the deficit is funded via loans from large international bodies through issuances of South African government bonds. Furthermore, South African consumers are highly indebted and continue to finance their lifestyles through debt and the cost of servicing this debt will become more expensive.

Generally, as seen in past sovereign downgrades, the direct impact is generally felt in the bond and fixed income market through rising interest rates. A secondary shock will generally be felt in the sovereign's currency, as their currency would weaken against major currencies. This could have a negative impact on the equity market as investors deem the sovereign's assets to be more risky.

Concluding thoughts…

SA government bonds have already priced in most of the bad news associated with a downgrade. However, it is difficult to say what impact a knee-jerk reaction by investors will have on the fixed income and equity markets. Lower bond yields internationally imply that SA bonds will still remain attractive for investors on a relative basis. Going forward, the only thing that we can be certain of is that uncertainty will remain. It is important to realise these events have been driven by political events, and that fundamentally, nothing has changed. Investors should not make emotional decisions based on short-term uncertainty and should be disciplined by sticking to their long-term investment plan. As a result, it is imperative to have a well-thought-through diversified portfolio.

Bibliography

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- Fin24
- Moneyweb