Ratings downgrades and our equity positioning

If the cap fits, wear it – actions come with consequences

Even though President Zuma's cabinet reshuffle last week effectively made rating downgrades far more of a certainty in our minds, it still came as a surprise when S&P **downgraded South Africa's foreign credit rating** by one notch last night to "junk status" (BB+), ***ahead of their scheduled June review***.

The S&P rating agency also **left their outlook on *"negative*"**, to reflect that "political risks will remain elevated this year and that policy shifts are likely, which could undermine fiscal and economic growth outcomes", more than currently expected. This implies further potential downgrades, particularly as concerns remain regarding the rising contingent liabilities of State Owned Enterprises (SOEs).

Situation is dire but not critical … yet

S&P's recent downgrade is only on South Africa's ***foreign credit rating***. South Africa would face a far more material impact were the rating agencies to downgrade our ***domestic creditrating*** to "junk status". Domestic South African government bonds (which make up approximately 90% of our debt) experienced significant investment flows after our inclusion in the World Government Bond Index (WGBI) in 2012, which requires an "investment grade" rating for a country's domestic credit rating.

Exclusion from the influential WGBI would require our ***domestic credit*** rating to be downgraded to "junk status" by both S&P (currently one notch above "junk") and Moodys (currently two notches above "junk"). For now, South Africa's domestic credit rating remains higher rated than our foreign credit rating, however, the rating agencies' negative outlooks place our domestic credit ratings at risk.

So what are the consequences?

Essentially one of the key consequences is the increase in interest payable on government debt, which will in turn put pressure on government funding, increasing pressure for even higher tax collection, which will come out of the pockets of corporates and consumers. This will weigh on investment and savings, which only further lowers the trajectory of economic growth.

Portfolio positioning

From our perspective, the reaction of the currency to the foreign credit rating downgrade, and the consequent strong upward move in the price of rand-hedge shares, reinforces our view that the long-held rand-hedge and quality bias of our portfolios represents a prudent stance in terms of both managing political risk and retaining exposure to other markets that are growing at a faster pace than South Africa, as we seek to generate long-term compounded returns for our clients.

Our investment stance is strengthened further by these events as prolonged political uncertainty seems inevitable.