JUNK STATUS: WHAT NOW?

IZAK ODENDAAL
INVESTMENT STRATEGIST

A few days after the midnight Cabinet reshuffle in which Finance Minister Pravin Gordhan and his deputy were replaced, S&P Global Ratings cut South Africa's sovereign credit ratings. Foreign currency bonds are now rated BB+, but local currency bonds are still investment grade at BBB-. The outlook on both ratings is negative. Fitch followed suit, cutting both foreign and local currency bonds to BB+, but with a stable outlook. Moody's has postponed its ratings announcement by a month or two. In other words, the much-feared drop to junk status has finally arrived. This is undoubtedly a negative development for South Africa, but there are also several misconceptions around the implications of a ratings downgrade.

What is a credit rating?

Governments borrow money by issuing bonds. The institutions that buy the bonds (banks, pension funds, insurers and asset managers) are therefore lenders. Ratings agencies effectively assess the creditworthiness of the bond issuers (the borrowers). They give an opinion on the ability of the issuer to make interest payments and repay the borrowed amount. These are expressed in a scale where AAA is the borrower with the strongest ability to repay, and C is a borrower that is likely to default (miss interest payments). D indicates a borrower that has defaulted.

This ratings scale is divided more or less in half, with the top half called 'investment grade', and the bottom half 'sub-investment grade' or 'speculative'. Market participants usually refer to the latter as 'high yield' or simply 'junk'.

SOUTH AFRICA'S SOVEREIGN RATINGS

LOCAL CURRENCY

S&P Global	Moody's	Fitch
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
BB+	Ba1	BB+
BB	Ba2	BB
B+	B1	B+
B	B2	B
B-	B3	B-
CCC	Caa	CCC
CC	Ca	CC
C	C	C

FOREIGN CURRENCY

S&P Global	Moody's	Fitch
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
BB+	Ba1	BB+
BB	Ba2	BB
B+	B1	B+
B	B2	B
B-	B3	B-
CCC	Caa	CCC
CC	Ca	CC
C	C	C

Source: Fitch Ratings, Moody's Investors Service, S&P Global Ratings
As at 10 April 2017
C scale is compressed

The ratings agencies have in the past distinguished between bonds issued in local currency, and bonds issued in foreign currency. After S&P's downgrade, South Africa's foreign currency rating is below the junk status cut-off, but our local currency (rand denominated) bonds are still one notch above. In some countries, hard currency (dollars or euros) can be hard to come by, and therefore foreign currency bonds are riskier. Local currency to make interest payments is typically always available from the local central bank as a last resort. In many emerging economies, the domestic savings pool is too small and the bond market is too illiquid to borrow at a decent interest rate. Borrowers then turn to foreign markets or banks where they can borrow on decent terms, but then face exchange rate risk. At a worst case scenario, they can be completely frozen out of global markets (as was the case with South Africa after the Rubicon speech in1985).

However, South Africa's domestic bond market is large and liquid, and Government today has no problem borrowing locally. Therefore, around 90% of the R2.2 trillion outstanding government debt is denominated in rand into the local market. The downgrades will not affect Government's ability to borrow (and roll over existing debt), but the price at which it is done. This is very important.

Why the downgrade?

Ratings agencies care about economic growth, because that is ultimately Government's revenue and, therefore, its ability to service debt mostly comes from taxes which rise and fall with economic activity. S&P's methodology specifically ensures that the country's real economic growth is faster than its population growth. South Africa's population grows around 1.5% per year, meaning that in per capita terms, we have been going backwards. The growth outlook for the coming years has improved, but not enough.

Weak growth and rising government debt has placed downward pressure on our ratings for several years, but the trigger for the latest downgrade was clearly the concern that changes at the Finance Ministry would undermine the hard work done to stabilise Government's debt levels. S&P is also very concerned about the risks of government's guarantees of state-owned enterprises debt.

Will borrowing costs increase?

A lot of the (fairly alarmist) commentary around the ratings downgrade has focused on the impact on interest rates. There are two types of interest rates that matter:

The one we're all familiar with is the prime rate, which banks use to determine mortgage rates (and other loans). The prime rate is 350 basis points above the repo rate set by the SA Reserve Bank (SARB). If the SARB doesn't alter the repo rate, the prime rate won't move. The SARB only changes the repo rate (currently 7%) in response to the inflation outlook. Unless the inflation outlook deteriorates substantially further, hikes in the repo rate are unlikely. The SARB is also unlikely to cut rates given the uncertain environment.

What banks can do is alter the spread between the prime rate and the rate they charge clients. In good times, banks might offer prime-minus loans, while in tough times they will offer prime-plus loans (this will also depend on the creditworthiness of the borrower). The spread can be adjusted for new borrowers, but existing borrowers should be unaffected.

The second type of interest rate is set by the market, but with reference to the SARB's repo rate. These are the yields of bonds and fluctuate in real time depending on the shifting views of market participants on factors like inflation, growth and, yes, ratings. Since Government is the least risky borrower in the local market, its bond yields also serve as a benchmark off which other bonds are priced. Therefore, if the government bond yields rise, the borrowing costs of other companies in the bond market will likely rise too.

But by the same token, South Africa's government bond yields are also priced off the least risky borrower in the global market – the US. US yields serve as reference rates for borrowers in US dollars across the globe. Therefore, think of the US yield as the 'prime rate' and the South African yield as the 'spread' above the prime rate. A ratings downgrade is likely to widen the spread, but whether the yield moves, depends on where US bonds trade. It is therefore not a given that a downgrade will result in higher borrowing costs for the domestic economy.

This spread or premium over US yields is not only determined by investors' perceptions of South African politics and economics. The more important factor is sentiment towards emerging markets. The premium that South Africa will pay did increase over the past few days following the Cabinet reshuffle, but is much lower than it was a year ago when global investors shunned emerging markets. The spreads of our peer group — Turkey, Brazil and Russia — also declined over this period.

The other thing to note about this peer group is that they all have junk status ratings. The global market has long put us in this junk category, and S&P's announcement therefore did not move the dial dramatically in terms of our bond market and the currency.

What is the impact on the economy?

The biggest immediate impact of the ratings downgrade is therefore likely to be on confidence. To invest or expand, businesses must feel confident about the future. Similarly, to make big ticket purchases, households need to feel financially secure. This is where psychology intersects with economics. Surveys confirm that business and consumer confidence was already at recession-like levels even before the recent events. Businesses have therefore chosen to invest abroad instead of in the local economy. The ratings downgrade and uncertain political environment is likely to continue weighing on sentiment.

What is the impact on markets?

Most active investors are forward-looking, and do not wait until there is an announcement to sell. In other words, the risk of a downgrade has largely been priced in. This explains the relatively muted market response. If conditions change, markets will reassess.

The ratings agencies by no means dictate to investors how they should manage portfolios. Some investors who buy bonds have ratings criteria written into their mandates or the regulatory rules they operate under. They will avoid junk status bonds. Others don't, and use the opinion of the ratings agencies as an input into their investment process, along with other information.

Of concern is that a number of large global funds passively track major bond indices, and these indices use credit ratings as criteria. If South Africa is excluded from the index, investors tracking the index will be forced sellers of South African bonds. The main global bond benchmark, the Citigroup World Government Bond Index requires that the local currency rating from S&P and Moody's be investment grade, which is still the case for South Africa. Maintaining a local currency investment grade rating is crucial and should be a priority for the new Finance Minister. The main emerging market bond indices (Citigroup EMGBI, JPMorgan GMBI-EM and Barclays EM Local Currency) have no minimum rating requirements.

In terms of the local equity market, the downgrade hurt bank shares specifically and also other interest rate-sensitive sectors (such as retailers). But the JSE as a whole has held up well since it is dominated by rand-hedge shares. As such, an investment in local equities does provide a fair degree of protection against currency weakness.

Can a country regain its investment grade rating?

Yes, but with difficulty. S&P's own numbers suggest it takes eight years on average to regain an investment grade rating. A recent example is Hungary, who was downgraded to junk in 2011 but upgraded to BBB- late last year due to a much improved economic growth outlook.

An upgrade in South Africa's rating will require evidence of continuity in fiscal policy under the new Finance Minister, specifically the commitment to stabilise Government's debt, tackling the risks to Government's finances from poorly performing state-owned enterprises, and an improvement in economic growth supported by reforms that sustain faster growth over time. We need to achieve these expectations as they are important for the long-term welfare of South Africans, not simply because ratings agencies require it.

Is there life after a downgrade to junk?

Brazil is probably the major emerging market that is most similar to South Africa in terms of its social and economic structure. It was downgraded to junk in September 2015, and another notch in February 2016 (at the height of negative sentiment towards emerging markets and at the bottom of the commodity cycle). Since then, government bond yields have fallen from 16% to 10%, the real has appreciated 30% against the US dollar and the central bank has cut rates. Therefore, a rating change by itself is not the end of the world. It is changes in the economic fundamentals (including growth, inflation, commodity prices) and economic policy that we need to keep an eye on.

OLDMUTUAL WEALTH