

S&P Investment Downgrade

April 2017



Introduction

The ratings agency, S&P, has downgraded South Africa's foreign currency debt rating by a single notch to non-investment grade. It also downgraded the local currency debt, however this remains within investment grade ratings. The agency has kept the outlook for both debt ratings negative.

The reasons given for the downgrade are largely due to political uncertainty, specifically indicating that the changes made in the cabinet reshuffle and the finance ministry, threaten the outlook for policy continuity, economic growth and fiscal discipline (SOE's and Eskom were highlighted).

There is nothing positive about this outcome, with potentially severe economic implications. The only possible caveat is that it potentially marks a turning point in SA politics.

Downgrade in Perspective

South Africa's foreign currency debt rating as per S&P now sits at a sub-investment grade rating of BB+, while the local currency debt rating sits at BBB-.

The table below shows the current ratings summary post the S&P move and the distinction between Investment Grade (IG) and Sub Investment Grade (sub- IG). SA is still two notches above sub-IG as per Moody's ratings for both local and foreign currency debt and one notch above as per Fitch.

South Africa ratings summary as it stands today (from RMB Morgan Stanley)

South Africa	Moody's	S&P	Fitch
Investment Grade	A3 Baa1 Baa2 Baa3	A3 BBB+ BBB BBB-	A- BBB+ BBB BBB-
Sub Investment	Ba1	BB+	BB+
Outlook	Negative	Negative	Negative
<div>Local Currency Rating</div> <div>Foreign Currency Rating</div>			

Source: Bloomberg, RMB Morgan Stanley Research

Other points which are relevant to note regarding the downgrade include:

- Foreign debt comprises 10% of the total outstanding sovereign debt.
- The local currency rating is more important from the perspective of inclusion in the world government bond index (WGBI), however ratings are not the only factor for inclusion in WGBI.

- Moody's and Fitch will review their ratings in the coming months. The potential additional damage that could be caused would come as a result of 2 rating agencies downgrading our Local debt to below investment grade.
- Our understanding is that for South Africa to be excluded from the World Global Bond Index would require a sub investment grade rating on both Foreign and Local Currency Debt from both S&P and Moody's. Recent events would suggest that this is not impossible, but is not currently the reality.
- From a bond market perspective it is important to note that there is no forced selling as a direct consequence of this move.
- Additional risks and implications of a debt downgrade include a weaker currency, higher inflation, higher interest rates and concomitant lower economic growth.
- The task of restoring credibility and arresting the consequences of a debt downgrade should not be underestimated.

Portfolio Management and Investment Implications

The management of portfolios in non-fundamentally driven markets requires a nimble approach, as gyrations and market dislocations can provide opportunities for investors. Our approach has been to ensure balance in our portfolios, by tilting towards those stocks and asset classes we think are mispriced, but balancing these against the risk of the investment case being derailed by external events. We do not, however, subscribe to the view that South African facing companies are to be avoided at all costs, and offshore, rand hedge exposure is permanently paramount – the economy in SA has always been cyclical, the JSE has high quality and well managed domestic facing companies in which to invest, there are extremely sophisticated and developed capital markets, and at the appropriate times in the cycle has delivered extraordinary returns for investors.

What Next?

We do not know what the political and additional credit rating assessment outcomes may be. The investment environment remains highly uncertain and we feel that it is premature to draw strong conclusions at this juncture. For this reason, we are disinclined to make any knee jerk decisions within portfolios.

We will review portfolios on an ongoing basis to ensure appropriate diversification across asset classes, however we are also of the view that the environment will also present long term investors with opportunities to buy good companies at very attractive valuations.

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