Effects and outlooks of the credit rating downgrade

By Nazmeera Moola, Head of SA Investments at Ninety One

In a not unexpected move, Moody's downgraded South Africa's sovereign credit rating to one notch below investment grade at Ba1. They also kept South Africa's outlook as negative, indicating the risk of a further downgrade within the next 18 months.

As a result of this move, South Africa will no longer from part of the FTSE World Investment Grade Bond Index (WGBI) from 1 May 2020. Fortunately, there will be no rebalancing at end March. This should provide some time for the current market volatility to settle.

WHAT PROMPTED THE DOWNGRADE?

Moody's rating methodology is reliant on four factors:

1. **Economic strength (baa3).** Despite persistently weak economic growth over the last decade, South Africa retained an investment grade score on this metric, mainly due to the relatively large and diversified economy and low volatility in GDP growth.
2. **Institutions and governance strength (baa2).** This score also remained high, due to strong institutions, reasonable political leadership and the strong central bank.
3. **Fiscal strength (b1).** This metric has been repeatedly lowered over the last two years. Using only their quantitative methodology, Moody's scores South Africa's fiscal strength as two notches below investment grade. They then add a further two-notch downward adjustment due to the negative trajectory of South Africa's debt ratios. Notably, they see debt service costs taking up 17.5% of all tax revenues in 2021. The result is a fiscal strength score that is four notches below investment grade.

4. **Susceptibility to event risk (baa).** This last (and most important metric) has been South Africa's saving grace in the Moody's methodology. The combination of low liquidity risk due to limited foreign currency borrowing and a long-term structure of government debt, deep local savings pools, and a well-regulated banking system, have bolstered South Africa's rating. Unfortunately, the combination of weak growth and COVID-19 left Moody's make a one-notch downward adjustment to banking sector risk to consider the difficult operating environment that SA banks will be facing.

The combination of the fiscal and banking sector concerns drove the rating downgrade. Working through their methodology, it does appear that without the adjustment for the banking system, a downgrade may not have been forthcoming. Therefore, COVID-19 has played a material role in the decision to downgrade.

While COVID-19 may have provided the last straw that broke the camel's back, the haystack comprises the persistent deterioration in South Africa's growth outlook and the resultant fiscal deterioration over the last decade.

Going forward, Moody's noted that to remove the negative outlook, they would need increasing assurance that government debt will stabilise comfortably below 90% of GDP.

WHAT HAPPENS IN THE NEXT FEW WEEKS AFTER THE DOWNGRADE?

Following the loss of South Africa's last investment-grade rating, it would be easy to conclude that there is no solution to South Africa's fiscal deterioration. However, a debt trap is not inevitable. On 24 February 2016, Brazil lost its last remaining investment grade rating. Surprising to many, Brazil's bonds did not sell off dramatically after this was announced.

Brazil's five-year credit default swap (CDS, which is effectively the cost of buying insurance on Brazilian debt) peaked at 493bps on 16 February 2016 – eight days before the downgrade. By early September 2016, the CDS was at 250bps. Brazil's CDS bottomed at 94bps on 21 February 2020, before surging in recent weeks. On Friday, it traded at 270bps – still well inside South Africa's equivalent CDS of 405bps, despite being two credit notches weaker.

Looking at the local bonds, Brazil's 10-year local currency bond peaked at 16.8% on 21 January 2016. By early September, the yield was down to 12%, and on 28 February 2020, the yield was at an all-time low of 6.6%.

Initially, Brazil's bonds rallied as the uncertainty was removed from the system. It is possible that some of the same dynamic occurs in South Africa. Unfortunately, while Brazil's downgrade occurred in the emerging market sell-off of late 2015/early 2016, current conditions are much worse. The market environment created by the COVID-19 pandemic may not allow a similar "relief rally."

Fortunately, last week Wednesday the South African Reserve Bank (SARB) announced that they would be buying bonds in the secondary market to ensure there was sufficient liquidity to allow the market to function. Since that announcement, the SARB has emphasised that this is not quantitative easing and they will not be monetising debt, as they will not be purchasing bonds directly from the Treasury. However, we would expect the Bank to be ready to provide liquidity if it is required next week.

This is the mechanism that we expect South Africa to use in the short-term to deal with downgrade. Given the wide spectrum of potential market outcomes next week, it is reassuring that the institution is led by a Governor who has spent almost three decades interacting with financial markets. Lesetja Kganyago is also currently chair of the International Monetary and Financial Committee (IMFC) – and will be very well versed with the actions other countries are taking around the world.

WHAT IS THE MEDIUM-TERM OUTLOOK?

When conditions are moving so fast, it is dangerous to make unequivocal predictions. However, we think that any changes to either exchange controls or prescribed assets are unlikely. There is no need for exchange controls as South Africa is not facing massive pressure on its balance of payments at this point. Prescribed assets would result in the forced liquidation of equities by South African pension funds in a weak equity market, which could result in a balance of payments crisis.

Beyond the initial rally as the overhang of a prospective downgrade was removed, Brazil's cost of borrowing continued to decline in the four years following their loss of investment grade. The reasons were a few tangible policy shifts.

Firstly, Brazil removed their largest fiscal overhang by implementing a large-scale overhaul to their pension system. This took years to finalise – with the final bill approved on 24 October 2019. However, as the market became confident about their commitment to progress on this issue, the government increasingly gained the benefit of the doubt. South Africa has two sources of significant fiscal risk: the public sector wage bill and Eskom. The first they began to address with the unilateral decision to implement a zero wage increase in the fiscal year starting 1 April 2020. After a decade of excessive wage increases and many private sector workers facing the prospect of no wages through the current lockdown, that is entirely reasonable. They now need to stay the course. The second requires the stabilisation of Eskom's debt dynamics.

Secondly, Brazil implemented an expenditure cap. South Africa has an expenditure ceiling – but this needs to be overhauled, and perhaps linked to revenues if there are several years of revenue shortfalls.

By curtailing expenditure, Brazil has managed to stabilise debt-to-GDP around 70% - well below the 90% predicted in 2016. South Africa needs to take similar action.

WHAT CAN SOUTH AFRICA DO TO SUPPORT GROWTH IN 2020?

Most importantly, South Africa needs to implement structural reforms to boost growth. In the short term, the economy needs stimulus. In a joint statement the IMF's Managing Director, Kristalina Georgieva, and the IMFC chair Lesetja Kganyago noted that in the current unprecedented situation, "priority should be afforded to targeted fiscal support to vulnerable households and businesses to accelerate and strengthen the recovery in 2021."

This is what South Africa needs in the short term. The UK announced a support package of 13% of GDP. The EU and the US are providing similar solutions. They have the luxury of issuing bonds at 0% – therefore big surges in their debt-to-GDP ratios are sustainable. South Africa does not have this luxury. The solution is to access multilateral funding through institutions like the IMF, World Bank or BRICS Bank to facilitate a relief package in South Africa that supports jobs, households and small businesses in particular.

There is also room for the SARB to cut interest rates further – by around 150bps-200bps. Given the plunge in oil prices, even with an exchange rate of R17.50/US$, we expect CPI to average 3.3% in 2020. The current repo of 5.25% leaves the Bank with room to cut 200bps before short-term real rates go to zero.

The ultimate solution is the implementation of the structural reforms South Africa has long been talking about, opening the grid to private sector electricity provision, making it easier for skilled workers to get visas, and selling spectrum. Over a 24-month period, these measures could boost South Africa's growth rate, induce private-sector investment, increase tax revenues, and stabilise the fiscal dynamics. The President has shown his ability to mobilise the country in a crisis to save lives – now he has to use the crisis to create long-term growth and save the economy.

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For a detailed description of these risks, and other risks that are relevant to the portfolio, please refer to the CIS risk disclosure document, available on the website **www.discovery.co.za**.

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Collective Investment Schemes (unit trusts) are generally medium to long-term investments. The value of participatory interests (units) or the investment may go down as well as up. Past performance is not necessarily a guide to future performance. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending (i.e. borrowing and lending of assets). The manager does not provide any guarantee, either with respect to the capital or the return of a portfolio. Any forecasts and/or commentary in this document are not guaranteed to occur. Different classes of participatory interests apply to these portfolios and are subject to different fees and charges. A schedule of all fees and charges, inclusive of VAT and maximum commissions, is available on request from us or from your financial adviser. Forward pricing is used.

Redemptions
The collective investment scheme may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. The ability of the portfolio to repurchase, is dependent upon the liquidity of the securities and cash of the portfolio. A manager may suspend repurchases for a period, subject to regulatory approval, to await liquidity, and the manager must keep the investors informed about these circumstances.

Yields
The yield for bond, income and money market portfolios is historic and is calculated quarterly.

Prices
The latest prices and TERs are published daily in the Business Report (South Africa's National Financial Daily) and are made available on our website **www.discovery.co.za**.

Performance fees
Performance fees are not levied on the portfolios.

Performance returns
Lump-sum performance returns are being quoted. Income distributions, prior to deduction of applicable taxes, are included in the performance calculations. NAV to NAV figures have been used for the performance calculations, as calculated by the Manager at the valuation point defined in the deed, over all reporting periods. Investment performance calculations are available for verification upon request by any person. Reinvestment of income is calculated on the actual amount distributed per participatory interest, using the ex-dividend date NAV price of the applicable class of the portfolio, irrespective of the actual reinvestment date. The performance is calculated for the fee class. The individual investor performance may differ, as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. The rate of return is calculated on a total return basis, and the following elements may involve a reduction of the investor's capital: interest rates, economic outlook, inflation, deflation, economic and political shocks or changes in economic policy. Annualised returns are period returns re-scaled to a period of one year. This allows investors to compare returns of different assets that they have owned for different lengths of time. All period returns greater than one year have been annualised. Returns for periods less than one year have not been annualised. A cumulative return is the aggregate amount an investment has gained or lost over time, independent of the period of time involved. Actual annual figures are available to the investor on request. Illustrative investment performance is for illustrative purposes only.

Valuations and transaction cut-off times
Pricing date is daily, except weekends and public holidays. Valuation point is at 16h00 on each pricing date, except at month-end, where it will be at 17h00. Offers to repurchase participatory interests must be received by 16h00 on each pricing date.

Additional information
For additional information on the portfolio, refer to the following documents, available on our website, from your financial adviser, or on request from the manager, free of charge.
- Application forms
- Annual report
- Fee schedule
- Quarterly General Investor Report

Complaints and conflicts of interest
The complaints policy and procedure, as well as the conflicts of interest management policy, are available on our website **www.discovery.co.za**. Associates of the manager may be invested within certain portfolios, and the details thereof are available from the manager.

Closure of the portfolio
The manager has the right to close certain portfolios to new investors, in order to manage them more efficiently, in accordance with their mandates.

Contact details
CIS Manager
Discovery Life Collective Investments (Pty) Ltd, registration number 2007/008998/07, 1 Discovery Place, Sandton, 2196, www.discovery.co.za. The manager is registered as a manager of collective investment schemes, in terms of the Collective Investment Schemes Control Act. The manager, through Discovery Holdings Limited, is a member of the Association for Savings and Investment South Africa (ASISA).

Trustee
Standard Chartered Bank (Johannesburg Branch), registration number 2003/020177/10, 2nd Floor,115 West Street, Sandton, 2196, P O Box 782080, Sandton, 2146, www.standardchartered.com/za. The trustee is registered as a trustee of collective investment schemes, in terms of the Collective Investment Schemes Control Act.

Investment Manager of the Discovery Aggressive Dynamic Asset Optimiser Fund of Funds, Discovery Conservative Dynamic Asset Optimiser Fund of Funds, and the Discovery Moderate Dynamic Asset Optimiser Fund of Funds

Riscura Invest (Pty) Ltd, registration Number 2009/015999/07, FSP number 40909, Monclare Place corner Campground & Main Road, Claremont, Cape Town, P O Box 23983, Claremont, 7735, 021 6736999.

Investment Manager of all other portfolios
Investec Asset Management (Pty) Ltd, registration number 1984/011235/07, FSP number 587, 36 Hans Strijdom Avenue, Foreshore, Cape Town, 8001, www,investecassetmanagement.com, 0860 110 161.

The investment managers are authorised financial services providers (FSP), as discretionary FSPs, in terms of Section 8 of the Financial Advisory and Intermediary Services Act (FAIS). This information is not advice, as defined in FAIS. Please be advised that there may be representatives acting under supervision.