

Junk Status: Facing the realities of a potential downgrade

There has been widespread media coverage and speculation regarding South Africa's (SA) credit rating and the likelihood of a downgrade to "junk status". But what does "junk" actually mean and how will it impact SA savers and investors? In this article, we look at what a credit rating is, why SA is facing a further downgrade and what that could mean for South Africa and the various investment opportunities in the market.

Credit Ratings: What are they and why do they exist?

There are three main global credit rating agencies: SP Global Ratings (SP), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch). A credit rating attempts to provide an indication of a debtor's ability to pay back debt (i.e. how likely is it that both the interest payments on a loan and the initial loan amount will be paid on time). Not being able to repay a loan (or any part thereof) is called a default and the rating agencies are trying to identify the likelihood of default – the lower the rating, the higher the likelihood of default.

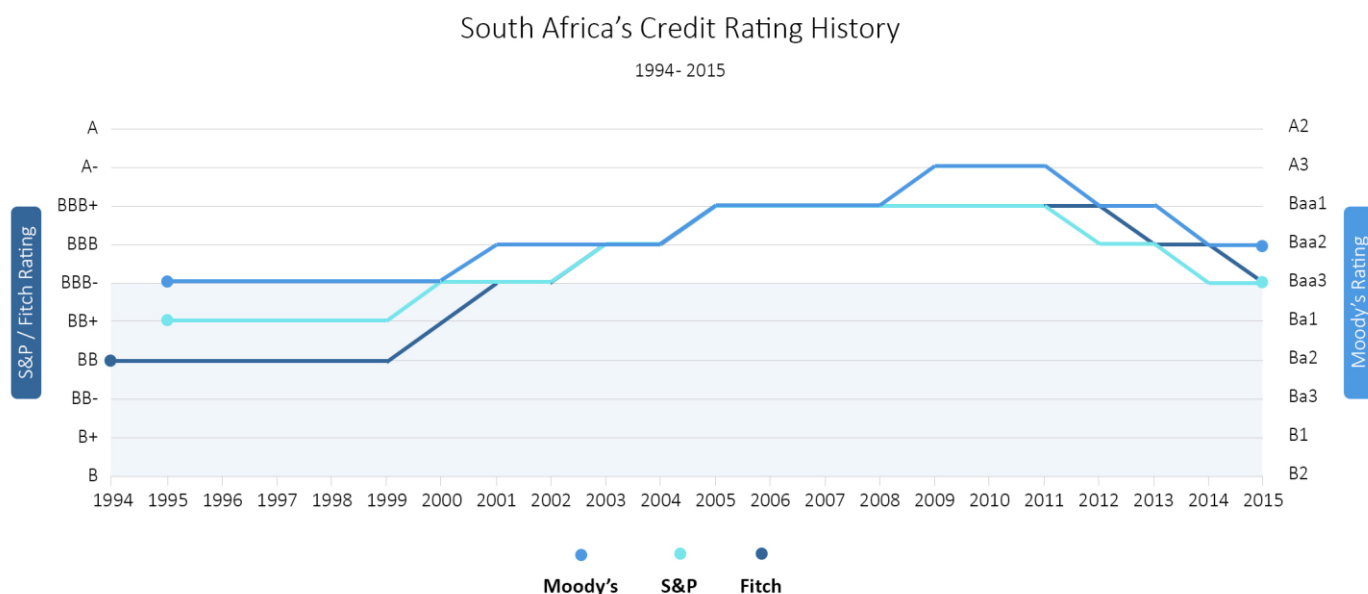
The agencies use different notations for the various ratings (which adds to the confusion) – the table below sets out the various rating definitions.

Moody's	S&P	Fitch	Rating description		
Aaa	AAA	AAA	Prime	Investment-grade	
Aa1	AA+	AA+	High grade		
Aa2	AA	AA			
Aa3	AA-	AA-			
A1	A+	A+	Upper medium grade		
A2	A	A			
A3	A-	A-			
Baa1	BBB+	BBB+	Lower medium grade		
Baa2	BBB	BBB			
Baa3	BBB-	BBB-			
Ba1	BB+	BB+	Non-investment grade speculative	Non-investment grade aka high-yield bonds aka junk bonds	
Ba2	BB	BB			
Ba3	BB-	BB-			
B1	B+	B+	Highly speculative		
B2	B	B			
B3	B-	B-			
Caa1	CCC+	CCC	Substantial risks		Non-investment grade aka high-yield bonds aka junk bonds
Caa2	CCC		Extremely speculative		
Caa3	CCC-		Default imminent with little prospect for recovery		
Ca	CC				
Ca	C	DDD	In default		
C	D			DD	
/		D			

In addition to the rating, the agencies will also provide an indication of the direction in which they see the rating heading. If their opinion is that the credit rating is likely to worsen going forward they will put it on negative watch, and similarly if they believe there is likely to be an improvement, they would indicate the trend as positive.

Credit rating of South African government bonds

The debtor in this case is the SA government and the loans are SA government bonds. In determining the credit rating, the agencies are effectively forming an opinion on the likelihood of the SA government defaulting on the terms of the loans provided to them by investors. The chart below shows the history of credit ratings for SA foreign denominated debt since 1994:



As can be seen in the chart, the rating agencies don't always agree: while all three rating agencies do still regard SA foreign denominated government bonds as investment grade, SP have given the lowest possible investment grade rating (BBB-) and put it on negative watch while Moody's rates it Baa2 (on a negative watch) which means it still has another rating tier to go before "junk".

There is general consensus in the market and amongst economists that SA foreign denominated government bonds will be downgraded to "junk" status at some point this year by SP (i.e. a move to BB+), and Moody's will move the rating to Baa3, their lowest investment grade rating. SP review the rating every 6 months with the next review in June and then again in December – the question seems to be less about whether a downgrade will happen rather more about whether it will be June or December.

However, it is important to distinguish between different types of debt issued by the SA government – they issue debt both in local and foreign currency. The rating agencies consider these separately (as shown in the table below).

SA ratings	Foreign long -term debt	Local long -term debt	Outlook
SP	BBB-	BBB+	Negative
Moody's	Baa2	Baa2	Negative
Fitch	BBB-	BBB	Stable

For both SP and Fitch, the rating of local currency SA government debt is higher than the foreign currency debt (which is often the case due to higher risk associated with currency). SP would need to drop the credit rating 3 levels to move local currency SA debt to "junk". So all the discussion and debate around the potential downgrade to junk this year applies to the SA government debt issued in foreign currency (approximately 10% of the total debt).

Why the potential downgrade?

In simple terms, South Africa is facing a downgrade for two reasons:

1. Slow growth – along with the rest of the world, SA faces lower levels of growth than forecast (and these forecasts continue to fall). There are a multitude of reasons for the slowdown including depressed commodity prices and reduced global demand for commodities, but also a lack of willingness to invest with all the current uncertainty around government policy.
2. Fiscal outlook – effectively this relates to the ability of the country to control spending given the tax base so that excess spending does not need to be covered by issuing more debt. With low growth and high unemployment, tax revenue is under pressure and spending on benefits is rising. The government's target to limit gross debt to 50% of GDP is going to be very difficult to achieve.

All of this is not helped by concerns around the independence of the Treasury and the South African Reserve Bank. The long held belief of the international community in the strength of this independence was severely tested late last year with the "Nenegate" debacle. Political upheaval, which has led to calls for President Jacob Zuma to resign, is compounding the economic risks.

As a result rating agencies are expressing a concern that the ability for SA to meet future loan repayments is deteriorating. They will be looking very closely as to whether SA is able to control its spending (and ideally reduce it) while implementing government policy to spur growth. Cutting spending in an election year is going to prove challenging.

What impact would the downgrade have?

There are two main impacts of a downgrade:

1. Reduction in Foreign Investment:

- Large foreign institutional investors (included pension funds, hedge funds and asset managers) will in many cases not be allowed to invest in any asset with a "junk" rating (prescribed by their investment policy/guidelines). This means they will not invest in SA bonds or they will sell their existing investments.
- For index or passive investors, they invest in line with an index and will often use the World Government Bond Index (WGBI) for global bond funds. The index will exclude any "junk" status bonds. However, the local currency denominated SA debt is included in the WGBI (not the foreign currency debt which is facing the downgrade). Therefore, if the country loses its investment-grade rating on its foreign currency debt, the local currency debt is not impacted and it will not force widespread selling from rand-denominated South African government debt by the passive managers.
- However, despite the higher credit rating on local currency debt, there is potential for a knock on effect and for investors to sell down their rand denominated bonds as well.

2. Cost of borrowing:

- A lower credit rating implies that there is more risk associated with buying the debt. As a result investors demand a higher return on that investment (i.e. the yield needed is higher to attract investors). Therefore, a downgrade would raise the cost to the SA government (and SA companies) of borrowing money. Effectively more tax revenue will need to go towards paying higher interest on debt. We already run at a budget deficit in SA (i.e. we spend more than we earn using debt to make up the difference) so this higher cost of borrowing will enhance the deficit.
- This higher "cost of borrowing" makes capital more expensive (and less accessible for SA companies) which generally has a knock on effect of reduced investment and growth.
- The foreign denominated debt of SA corporates will also be under the spotlight and it is likely that their corporate credit ratings will also be downgraded (resulting in higher costs of refinancing)

These impacts will then impact the price of SA assets most notably SA bonds and corporate credit. Yields on SA fixed income have risen materially over the past 6 months and the view of many asset managers is that the impact of a downgrade is already priced in (if not entirely then to a significant degree). In other words if the downgrade did go ahead, the view is that yields would not be materially impacted as the negative news is already anticipated in the price of bonds.

There is also the potential for knock on effects to the currency on the back of foreign outflows and an indirect impact on the equity market driven by the economic uncertainty and risk perception of investors.

On the positive side it appears the threat of the downgrade is driving constructive dialogue between government and business in SA which has been sorely lacking for a number of years now, and there is an increased focus on curbing government spending by Minister Gordhan. Regardless of whether it is too little, too late to avoid a downgrade, both of these developments will start to move the economy in the right direction.

30 April 2016

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	1.7%	8.9%	-0.2%	5.6%	0.2%	14.4%	13.4%	12.8%	15.2%
FTSE/JSE SA Listed Property	ZAR	2.0%	15.7%	4.8%	12.2%	6.6%	12.4%	19.4%	16.7%	16.9%
SA All Bond Index (ALBI)	ZAR	1.9%	3.8%	0.2%	8.5%	1.7%	3.2%	7.7%	7.6%	7.5%
SA Cash Index (SteFI)	ZAR	0.6%	1.7%	3.4%	2.2%	6.7%	6.0%	5.8%	7.3%	0.6%
Balanced Benchmark ²	ZAR	0.9%	5.2%	1.6%	4.0%	5.0%	13.6%	14.2%	12.6%	7.1%
SA Inflation (1 month lag)	ZAR	0.8%	2.9%	3.5%	2.9%	6.3%	5.5%	5.6%	6.3%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	1.4%	7.0%	-2.1%	0.5%	-6.1%	4.4%	3.8%	2.0%	16.6%
Emerging Markets Equity (MSCI EM)	USD	0.5%	13.7%	-0.1%	6.3%	-17.9%	-4.6%	-4.6%	2.4%	23.7%
Global Bonds (Barclays Global Bond Index)	USD	1.3%	6.4%	6.1%	7.3%	4.8%	0.8%	1.5%	4.3%	5.7%
Global Cash	USD	0.0%	0.1%	0.2%	0.1%	0.3%	0.2%	0.2%	1.4%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	1.7%	8.9%	-0.2%	5.6%	0.2%	14.4%	13.4%	12.8%	15.2%
Global Equity (MSCI World)	ZAR	-2.3%	-4.6%	0.6%	-8.0%	11.4%	21.6%	21.0%	11.0%	13.5%
Emerging Markets Equity (MSCI EM)	ZAR	-3.1%	1.4%	2.6%	-2.7%	-2.6%	11.1%	11.2%	11.5%	15.6%
COMMODITIES										
Gold (US Dollars)	USD	3.8%	16.2%	10.8%	21.2%	6.8%	-4.7%	-3.5%	7.1%	19.2%
Gold (Rands)	ZAR	0.1%	3.6%	13.8%	10.9%	26.7%	11.0%	12.5%	16.7%	21.9%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	-3.6%	-10.8%	2.7%	-8.5%	18.6%	16.4%	16.6%	8.9%	16.4%
Rand / GBP Pound	ZAR	-1.7%	-7.9%	-2.6%	-9.0%	13.1%	14.1%	13.6%	6.6%	14.5%
Rand / Euro	ZAR	-3.1%	-5.6%	6.5%	-3.5%	21.2%	11.1%	10.7%	7.9%	13.9%

Spot Rates

30-Apr-16		8-May-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US\$	Rand	14.73	14.65	12.13	6.75	6.13	3.98
Rand/GBP	Rand	21.21	21.09	17.97	10.84	10.64	6.08
Rand/EUR	Rand	16.96	16.70	13.14	9.58	7.46	4.73
Rand/Aus \$	Rand	10.96	11.26	9.29	6.99	4.41	3.11
Libor 6m \$	US\$	0.91	0.90	0.40	0.46	5.14	N/a
Prime	Rand	10.50	10.50	9.25	9.00	10.50	18.50
Repo Rate	Rand	7.00	7.00	5.75	5.50	7.00	N/a
All Bond Index Yield	Rand	9.00	9.01	8.15	8.89	9.44	13.86
Gold (\$/oz)	US\$	1,288.50	1,232.65	1,183.24	1,432.36	583.65	395.35
Palladium	US\$	604.00	569.00	729.00	766.00	332.00	139.00
Platinum	US\$	1,080.50	977.50	1,142.50	1,766.50	1,060.00	408.25
Oil (Brent Crude) \$	US\$	45.25	40.05	55.84	117.38	66.17	19.14
SA Inflation	Rand	N/a	6.30	4.00	4.10	3.40	6.30

data provided by Profile Data Analytics and INET BFA