Economic Update
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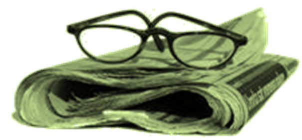

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FINANCIAL SERVICES

South Africa's Credit Rating Downgrade
How will this impact your fund?

Background

South Africa has recently been subject to a period of great political uncertainty since the rather abrupt recall of former Finance Minister Pravin Gordhan from the Treasury "roadshow" and the subsequent dismissal of him and a number of other cabinet members from their posts.

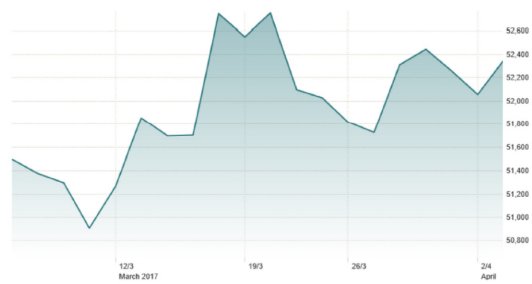
Judging from the reaction of political heavy weights within the ANC, opposition parties and civil society at large, it is clear that the actions of the President have been hugely unpopular.

The events that have been unfolding have already had a significant impact on investment markets. This will in turn impact on retirement fund investment returns, but it is too early at this juncture to accurately comment on the ultimate severity of the impact, save to say that the volatility is most unwelcome.

The segments most impacted are Currency, Equity and Bond markets.

The Rand deteriorated from a low point of R12.31 to the US$ on 27 March 2017 to R13.67 during intra-day trade on Monday, 3 April 2017.

On the equity side, the JSE FTSE All Share has shown surprising resilience in the face of the uncertainty. It dropped from a high of 52,866 on Tuesday, 20 March 2017 to a low of 51,278 on Monday, 27 March 2017. It was trading at a level of 52,300 shortly before noon on Monday, 3 April 2017.



Banks shares have however been hit hard and up to shortly before noon on Monday, 3 April 2017, the Financial Index has lost over 8% from its highest point on 16 March 2017.

The South African Government 10 year (186) bond yields moved from a low of 8.25% to touch a high of 8.96% on Friday, 31 March 2017.

All things considered, initial indications were that the market moves were modest, considering the level of political noise that is created.

This should however be viewed against the backlight of an environment where emerging markets are generally in favour and foreign investor flows into emerging markets are extremely high (or as John Cairns from RMB put it: "The tide of cash flowing into emerging markets is such that it is lifting even half-submerged boats.")

As with most political events that impact markets, it will take time for markets to fully interpret the long-term implications of the recent events.

One of the most concerning was always going to be the position that credit rating agencies would take.

It was widely expected that the latest events would cause them to become increasingly concerned with the South African government's ability to stick to its expenditure targets and to collect budgeted tax revenue in a weak economic environment.

Unsurprisingly Standard & Poor's Global (one of the big three credit rating agencies downgraded South Africa's sovereign credit rating to BB+ (junk status) on Monday, 3 April 2017.

Credit Rating Agencies

A credit rating agency is a company that assigns credit ratings that rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default.

The South African government spends more money than it collects in revenue (predominantly through taxes). To fund this shortfall, the government borrows money by issuing bonds. In exchange for the money that it borrows, it undertakes to pay the lender interest on the amount that has been borrowed and to repay the amount that it has borrowed (the principal debt) at the end of the agreed term.

A country's credit rating expresses the risk that a country will be unable to meet its financial commitments, in terms of repaying interest payments and the debt principal on a timely basis.

The rating agencies utilise various measures that allow them to gauge a country's social, economic and political position in order to determine the probability of a country defaulting on its repayments.

The big three credit rating agencies are Standard & Poor's (S&P), Moody's, and Fitch Group. S&P and Moody's are based in the US, while Fitch is dual-headquartered in New York City and London.

The rating scales of the big three credit rating agencies can be summarized as follows:

Moody's		S&P		Fitch		Rating description
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA–		AA–		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A–	A-2	A–	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB		BBB	F3	
Baa3		BBB–	A-3	BBB–		
Ba1	Not Prime	BB+	B	BB+	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB–		BB–		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B–		B–		
Caa1		CCC+	C	CCC+	C	Substantial risks
Caa2		CCC		CCC		
Caa3		CCC–		CCC–		
Ca		CC		CC		Extremely speculative
		C		C		Default imminent
C		RD	D	DDD	D	In default
/		SD		DD		
/		D		D		

At the end of November 2016 South Africa barely manage to avoid a downgrade from all three credit rating agencies S&P (BBB-), Fitch (BBB-) and Moody's (Baa2).

S&P stated that political events had distracted the country from growth-enhancing reforms, while low GDP growth continued to affect its economic and fiscal performance and overall debt stock, and whilst Fitch left South Africa's credit rating one notch above junk, it dropped its outlook from stable to negative, citing the political turmoil under President Jacob Zuma.

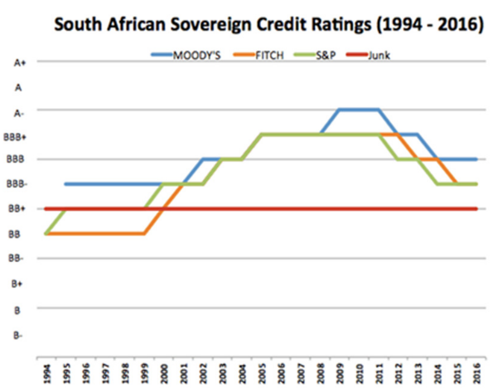
Local vs foreign currency debt ratings

An important distinction of the sovereign credit ratings is that between the foreign currency denominated debt and the local currency denominated debt.

Foreign currency denominated debt is issued in a currency other than the sovereign's own currency (i.e. SA government bonds in US$, yen or euros), while local currency debt is issued in local currency (i.e. ZAR).

It is important to note that it is South Africa's foreign currency denominated debt rating that is in the firing line in terms of a possible downgrade to 'junk status'.

Our foreign currency sovereign credit rating history can be summarized as follows:



Source: National Treasury

South Africa's Foreign vs Local currency sovereign credit ratings as at 31 March 2017 can be summarized as follows:

Long-term Rating		Moody's	S&P	Fitch
Investment Grade	Upper Medium	A3	A-	A-
	Lower Medium	Baa1	BBB+	BBB+
	Lower Medium	Baa2	BBB	BBB
	Lower Medium	Baa3	BBB-	BBB-
"Junk Status"	Sub-Investment Grade	Ba1	BB+	BB+
Outlook		Negative	Negative	Stable

The Downgrade

The ratings agencies were supposed to announce their reviews of the country's status in June 2017, the same month that the ANC gathers in Gauteng for its five-yearly policy conference, and again in December, when the ANC gathers to elect new leadership.

Politics, and the shape and intensity of potential change in this regard, was always going to be a central element for ratings agencies in their determinations of the country's credit status this year.

As outlined above, South Africa was retained on an "edge of junk" rating of BBB- from S&P and Fitch, and a Baa2 from Moody's, which is equivalent to BBB in S&P's and Fitch's terminology.

It therefore comes as little surprise that the political turmoil unleashed by President Zuma's actions during the last week of March 2017 caused the credit rating agencies to move quickly to review their ratings.

S&P, which was only scheduled to review SA's credit rating on 2 June 2017, reportedly had an emergency meeting following President Jacob Zuma's late night Cabinet reshuffle on Thursday, 30 March 2017.

At this meeting, S&P decided to downgrade South Africa's foreign currency credit rating from BBB- to BB+. This rating moves our foreign currency credit rating to Junk Status.

Moody's is scheduled to conduct a similar review on 7 April 2017 and Fitch (who, on Friday, issued a statement warning that Zuma's Cabinet reshuffle "*could result in Fitch reviewing its ratings on the South African sovereign debt*") is expected to also act quickly.

General expectation is that Moody's and Fitch will follow S&P in downgrading our sovereign debt.

Impact of Downgrade

The bottom line is that the downgrade of South Africa's foreign currency debt to 'junk status' will cost South Africa more to borrow money in global markets.

Furthermore, South African consumers are highly indebted and continue to finance their lifestyles through debt and the cost of servicing this debt will become more expensive.

Generally, as seen in past sovereign downgrades, the direct impact is usually felt in the bond and fixed income market through rising interest rates.

A secondary shock will generally be felt in the sovereign's currency, as it weakens against other major currencies. This could also have a negative impact on the equity market as investors deem the sovereign's assets to be more risky.

It is a potentially vicious cycle: if we get downgraded, investors will begin to avoid investing here, the prices of our assets will drop because of the lack of demand for our debt and our shares listed on the JSE, the rand will weaken further, inflation will shoot up and the average South African will have to endure higher costs for goods and higher interest rates.

This is very similar to what happened to Russia at the beginning of 2015, after it too was struggling to make much money selling oil at depressed prices and was subsequently shifted down to junk status by ratings agencies.

Typically, according to research by Rand Merchant Bank, it takes about 7.5 years for a country to recover from a downgrade to junk status.

South Africa's government bonds have already priced in most of the bad news associated with a downgrade. However, it is difficult to say what impact a knee-jerk reaction by investors will have on the bond and fixed income markets. Lower bond yields internationally imply that South African bonds will still remain attractive for investors on a relative basis.

We will only be at the 'end of the road' if South Africa's local currency debt ratings were to become sub-investment grade (i.e. 'junk status') and then only will our bonds be in jeopardy in terms of inclusion in the respective global bond indices.

What should I do?

In times like these, it is important that investors remain focused and unemotional in their decision-making and stay true to their long-term investment goals.

Ensimini remains of the view that funds should have robust long-term investment strategies in place and that whilst short-term events may impact investment markets adversely, fund trustees should maintain their focus on their long-term goals and should take great care when considering what actions to take to compensate for such short-term volatility.

The Ensimini Investment Consulting Team will continue to monitor events carefully and when and / or where action is required, we will provide timeous advice and assistance.

We invite you to contact us should you require any clarity or wish to discuss the potential implications of recent events on your fund's investments with us.

Prepared by:
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