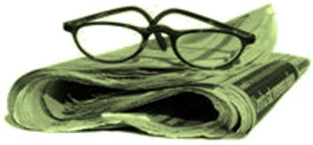
# Economic Update
# Issue 2017.11



## IMPACT OF LATEST RATINGS DOWNGRADE BY S&P GLOBAL ON SOUTH AFRICAN BONDS

### Background

After heightened expectations and much anxiety, the long wait for global ratings agencies Moody's and S&P Global to update their credit review on South African debt reached to a pinnacle. On Friday evening, S&P Global downgraded local currency as well as foreign currency debt by one notch each, meaning South Africa's local currency debt (BBB- to BB+) now also stands at non-investment grade like its foreign currency debt (BB+ to BB). Moody's on the other hand, maintained their rating but placed South African debt on downgrade watch.

The jury is out whether further downgrades to non-investment grade will follow early next year. Nevertheless, a few key points below summarise the impact of S&P Global's downgrade on Friday as well as the possible effects further downgrades by Moody's:

- The immediate effect of Friday's downgrade by S&P means some estimated $3.7 bn of SA bond exposure is estimated to be cut from The Barclays Global Bond indices on Thursday evening this week.
- As SA is excluded from global bond indices, there will be excess supply issues for the local bond market. The SA bond market could enter a period where bonds offer relative value to Emerging Markets peers until the selling abates or is absorbed.
- The Citibank World Government Bond index (WGBI) exclusion will only occur once Moody's downgrades SA debt to junk. If this were to occur, significantly more exposure to SA bonds would then be cut.
- SA sovereign risk premium has priced in junk status already.
- Emerging Markets flows are critical. If Emerging Markets bonds remain an attractive asset class, this will continue to support SA bond yields and result in a muted move in yields in the face of downgrades. If Emerging Markets flows reverse, all Emerging Markets bond market yields will likely rise and SA bonds will be exposed to index exclusion and Emerging Markets outflows.

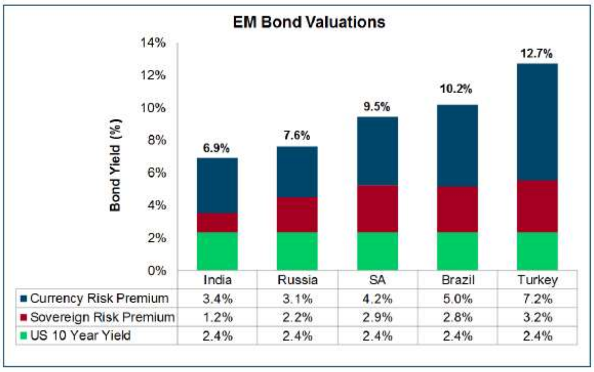
### Comparing SA Bonds against other Emerging Markets

The South African bond market remains resilient in the face of ongoing credit downgrades by ratings agencies. This may be explained in part by the comparative Sovereign Bond Yields of other Emerging Markets.

The graph below compares the Interest Rate Parity of South Africa with a number of its Emerging Market peers.

Interest Rate Parity is:

**US base rate**
**+**
**Sovereign risk premium (yield demanded over and above US yields for default risk)**
**+**
**Currency risk premium (yield demanded for holding bonds in local currency).**




| | India | Russia | South Africa | Brazil | Turkey |
|---|---|---|---|---|---|
| Domestic Rating - Local Currency | AAA | AAA | AAA | AA | AA+ |
| International Rating - Local Currency | BBB- | BBB- | BB+ | BB | BB+ |
| International Rating - Foreign Currency | BBB- | BB+ | BB | BB | BB- |

The SA sovereign risk premium is in line with Brazil and Turkey which both currently have junk status. SA bond yields should therefore not, all other things being equal, move up significantly on Friday's downgrades. Only if the market starts to expect additional downgrades would the relative risk premia likely change.

SA yields are lower than Turkey and Brazil essentially because the market attaches a lower currency risk premium to the Rand. This is premised on a strong central bank that has been successful in managing inflation under 6% whereas for Brazil and Turkey this has not been the case.

## Conclusion

SA bonds appear fairly priced and reasonable value against its Emerging Market peers. As bonds are excluded from the indices following downgrades, they may exhibit relative weakness on excess supply and we would expect to see active investors in Emerging Market funds enter the market.

The key risks for SA bonds are:

- Waning of the overall appetite for Emerging Market Bonds.
- Deterioration of SA's fiscal metrics that could lead to further credit rating downgrades.
- Intervention of the South African Reserve Bank Central bank intervention.

At the current price the Bond Market offers an opportunity to Provident Funds to lock in some real return.

**Sources:**
**Bloomberg**
**Prescient Investment Managers**



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