The Macro Research Desk

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Fitch downgrades SA to junk status, but outlook revised to stable

Following the lead of Standard and Poor's Global Ratings (S&P), Fitch downgraded SA's foreign currency rating to junk

Similar concerns led Fitch Ratings agency to downgrade the country's long-term foreign and local currency ratings by one notch from BBB- (investment grade) to BB+ (junk status). Unlike S&P, Fitch has, however, revised the outlook on SA's rating to stable, from a negative outlook previously. Fundamentally, weakened standards of governance and a poorer outlook on SA's public finances have prompted negative ratings actions from the two ratings agencies.

The triggers behind Fitch's negative ratings action

Fitch downgraded SA in light of the following:

Potential change in economic policy direction

Fitch specifically alluded to the changes at the finance ministry, noting that this could in itself result in an adverse change in the direction of economic policy in SA.

Efforts to reform governance across state-owned enterprises (SoEs) under threat

Given that the former Minister and Deputy Minister of Finance spearheaded an overhaul of the governance measures at SA's SoEs, the reshuffle poses a threat to the progress already made in this regard. As a result, further potential financial demands by SoEs on government's balance sheet poses a threat to debt consolidation.

The Financial Mail reported earlier in the week that SA's SoEs have drawn down 65% (up from 55% a year ago) of their total available R478 billion worth in government guarantees. S&P fears that SoEs may need an additional R200 billion in government support in the next three years, which would increase government's exposure to SoEs to c.R500 billion by 2020 (which equates to around 10% of SA's projected GDP in 2017, using S&P's conservative growth estimates).

Unaffordable nuclear project may be given the green light and accelerated under new energy and finance portfolio heads

Fitch highlighted that the dismissal of a previous finance minister (Nhlanhla Nene) was preceded by "differences over the country's expensive nuclear programme".

It expects the new leadership in government's energy and financial portfolios to accelerate the nuclear programme. This implies that government would have to raise its guarantees to energy utility Eskom, which has been appointed as the procurer of the nuclear project.

Fiscal consolidation may not be prioritised

Fitch questions whether fiscal prudence will be exercised to the same extent as it was under the previous administration, in light of the President's renewed focus on radical economic transformation, particularly in an environment where growth is likely to be lower given the additional blow to business and consumer confidence. Moreover, departments at Treasury could be pressured by an increase in demands for additional spending. At 53% of the gross domestic product (GDP), general government debt already ranks higher than the typical BB-rated country (51%).

Cabinet reshuffle has undermined SA's growth prospects

Although a high degree of policy uncertainty was already baked into Fitch's real GDP growth forecasts at the last ratings review in December 2016, it believes the recent reshuffle will further damage SA's investment climate and has raised the risk of downside surprises to its growth forecast of 1.2% in 2017 and 2.1% in 2018.

SA's strengths still include a flexible exchange rate and a low reliance on foreign funding

Fitch acknowledged the narrowing in SA's current account deficit ratio from 4.4% of GDP in 2015 to 3.3% in 2016, suggesting that this, together with a freely floating exchange rate, would contain pressures should external financing dry up. It also noted that at 11.3% of debt, SA's reliance on foreign-currency denominated debt remains low.

SA's new BB peer group

Fitch stated that many of SA's economic indicators are in line with the BB median-rated country. While the latest available governance indicator information from the World Bank suggests SA governance is more or less in line with a BBB-rated country, Fitch believes the reshuffle and concerns highlighted in the public protector's report on state capture may have knocked SA down the rankings.

Positive ratings triggers

An improvement in governance standards (leading to a revival in confidence and growth), a substantial improvement in SA's fiscal deficit and debt ratios and/or an improvement in SA's net external debt ratio could, according to Fitch, result in a positive ratings action.

Negative ratings triggers

A further upward revision in SA's debt profile, a rise in contingent liabilities, stagnant growth in response to persistent uncertainty and/or a threatening rise in SA's net external debt ratio could prompt Fitch to embark on a further negative ratings action.

SA's immediate ratings outlook

RMB Morgan Stanley points out that this downgrade (see chart 1) has triggered the exit criteria of the Barclays United States (US) Aggregate and Global Aggregate indices. It estimates an outflow of around US$1 to 2 billion in the next month. RMB Morgan Stanley also suggested that the Global Bond Index – Emerging Markets Global

Diversified Investment Grade Index could be affected by around USD0.5 to 1.5 billion. For SA to exit the Citi World Government Bond Index, S&P and Moody's would need to cut the local currency rating to sub-investment grade. Earlier this week, Moody's rating agency announced it had placed SA's sovereign credit rating on review (which could take up to 30 to 90 days to resolve) for downgrade as a result of the "abrupt change in leadership of key government institutions". Momentum Investments expects Moody's to follow through with a downgrade, at this stage attributing a higher probability to a one-notch rather than a two-notch downgrade.

Chart 1: SA's sovereign ratings

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
Outlook	Negative	Stable	Negative

Local currency rating
Foreign currency rating

Source: S&P, Moody's, Fitch, Momentum Investments

Investment implications of ratings downgrades

The likely broad investment implications of the S&P and Fitch downgrades to SA's sovereign ratings depend on the subsequent response of the broader African National Congress (ANC) leadership to the ratings actions.

If there are positive political and economic policy responses forthcoming from within the ANC (the so-called 'wake-up-call' scenario Momentum Investments highlighted previously), favourable political developments and policy adjustments could eventually result in a return to investment territory within a couple of years. As such, a 'wake-up-call' scenario is likely to be accompanied by a period of rand strength, once perceived-favourable political and policy responses are effected, with local asset classes expected to outperform global asset classes (including commodity exchange-traded funds) in such an outcome, *ceteris paribus*. More specifically, local government bonds and listed property should perform particularly well, with locally focused equities outpacing global-driven shares.

In contrast, should there be a denialist response from within the ANC and government to the recent ratings downgrades, accompanied by ongoing factionalism, patronage and fiscal slippage, there is likely to be a trend of continual ratings downgrades in coming years (the 'slippery-slope' scenario). Such a scenario would likely entail ongoing rand weakness, with global asset classes outperforming local asset classes, while local cash and equities (particularly those shares with large global revenue bases) should outperform local fixed-income investments.

Sticking calmly to long-term investment plans within an outcomes-based framework enhances Financial Wellness

While human nature favours strong reactive behaviour to system shocks, radical changes to investment portfolios in response to developments that have uncertain long-term implications are likely to destroy wealth. History has shown that despite the regular occurrence of shocks in financial markets, the optimal wealth-maximising strategy for investors over time has been to calmly stick to well-constructed financial plans and stay invested throughout short-term volatility. In Momentum Investments' view, the diametrically different implications for financial investments, depending on the response from the ANC leadership to South Africa's ratings downgrade to junk (the 'wake-up-call' compared to 'slippery-slope' scenarios), can best be managed when investors have well-diversified portfolios with exposure to a wide range of asset classes that will each behave differently depending on the outcome. Hence, collectively minimising the volatility of the portfolio during uncertain times and making the investment experience less stressful. In this regard, the outcome-based investment philosophy adopted by Momentum Investments provides a framework and process that inherently have

diversification embedded as a central principle in the approach to portfolio construction. As a result of this diversification, different asset classes and investments will either benefit or have an adverse experience depending on how markets react and which scenario transpires. The outcome-based investment philosophy therefore represents a prudent approach to provide a robust investment experience through the current economic and political uncertainty. Furthermore, as custodians of Momentum Investments' clients' savings, the company continually looks for potential attractive risk/reward opportunities in asset classes that might be forthcoming from any investment price weakness to enhance the long-term return potential of portfolios, hence, enhancing the long-term financial wellness of its clients.

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