momentum
investments

The Macro Research Desk

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Ratings reprieve, but S&P echoes concerns over political interference

S&P lowers local currency rating, but leaves foreign currency rating intact at BBB- with a negative outlook

Although S&P Global Ratings left SA's foreign currency rating unchanged at BBB- with a negative outlook, the agency noted that financing needs had surprised negatively exceeding previous expectations, while a low 'gross domestic product (GDP) growth path has exacerbated SA's economic (per capita wealth) and fiscal performance. Moreover, S&P reiterated concerns highlighted by Moody's and Fitch Ratings regarding the political situation in SA. In its view, recent politically motivated events have detracted from the progress on growth-enhancing reform implementation and could further negatively affect the direction of government policy. S&P has, in Momentum Investments' opinion, issued SA with a warning to prioritise growth in a politically challenging environment by lowering the two-notch gap between SA's local and foreign currency ratings. S&P's latest ratings action has left SA's local credit rating at BBB, warning that a further reduction in fiscal flexibility, which is currently ranked as a weakness (see table 1), could result in a further notch downgrade to the local rating.

Table 1: Peer comparison of ratings score

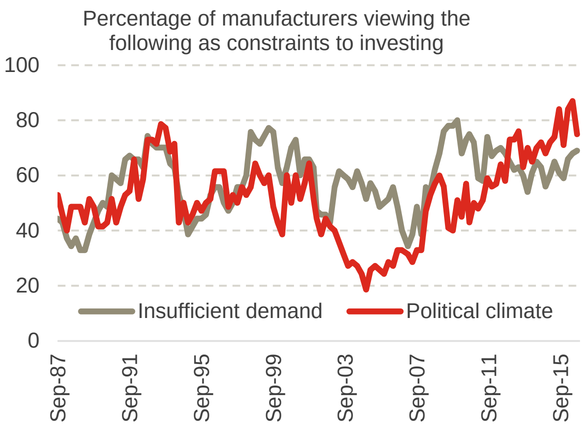
Key rating factors	SA	Brazil	India	Russia	Turkey
Institutional assessment	Neutral	Neutral	Neutral	Weakness	Weakness
Economic assessment	Weakness	Weakness	Weakness	Weakness	Neutral
External assessment	Neutral	Neutral	Strength	Strength	Weakness
Fiscal assessment (flexibility and performance)	Weakness	Weakness	Weakness	Neutral	Strength
Fiscal assessment (debt burden)	Neutral	Weakness	Weakness	Strength	Strength
Monetary assessment	Strength	Neutral	Neutral	Neutral	Neutral

Source: S&P, institutional assessment = policymaking (predictability), political shocks, accountability and transparency of policymakers, external assessment = external liquidity and international investment position, monetary assessment = credibility and ability to fulfil mandate

Poor growth fundamentals and slow reform momentum leave SA's economic score ranked as a weakness

S&P attributes the current weak growth environment to a persistent skills shortage, adverse terms of trade (SA's export prices relative to import prices) and a delay in private fixed investment spend notwithstanding high corporate margins and large cash positions. According to the Bureau of Economic Research (BER), businesses remain reluctant to invest domestically given elevated policy uncertainty (see chart 1).

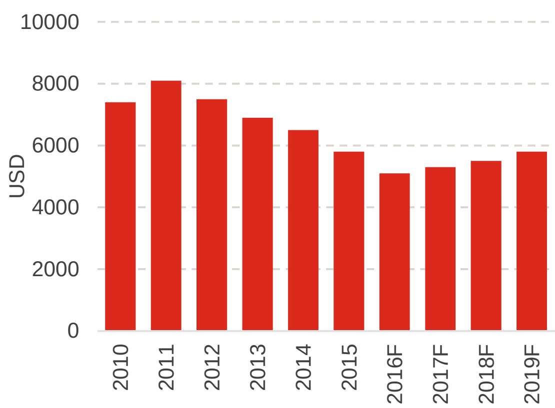
Chart 1: Constraints to investing domestically



Source: BER, Momentum Investments, data up to third quarter of 2016

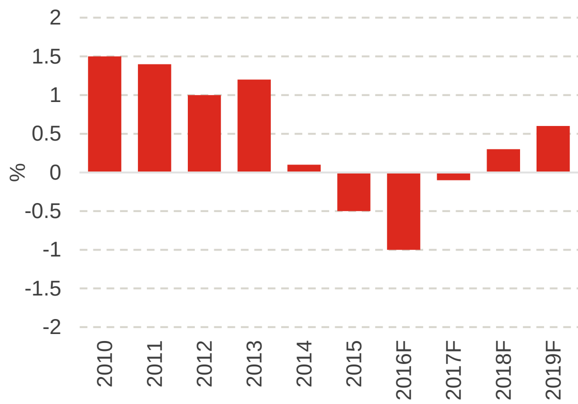
S&P has downwardly revised its growth forecasts marginally from 0.6% in 2016 and 1.5% in 2017 to 0.5% and 1.4%, respectively, broadly in line with those of Treasury and Fitch. This is likely to leave SA's real GDP per capita at US$5,300 by 2017 (see chart 2) and growth in real GDP per capita in positive territory in 2018 (see chart 3). The ratings agency cited global growth and SA's terms of trade as key risks to SA's growth outlook.

Chart 2: Real GDP per capita



Source: S&P, Momentum Investments

Chart 3: Growth in real GDP per capita



Source: S&P, Momentum Investments

S&P noted that despite government identifying necessary reforms and supply-side bottlenecks, not enough progress had been seen to rectify growth headwinds. It suggests that the delivery of structural reform has been "piecemeal" and more needs to be done to instil investor and business confidence to boost SA's muted growth trajectory. Although the Mineral and Petroleum Resources Development Act (MPRDA) is likely to be enacted soon, S&P envisages that issues around the mining charter could drag out over the next year.

S&P acknowledged advances made on the minimum wage debate, secret strike balloting and the handing over of more power to the labour tribunals, but made the point that the delivery on labour market reforms remains slow. On a positive note, S&P anticipates little strike action in the next while, given the multi-year wage agreements in place in the gold and platinum mining sectors.

While reforms enforcing a higher level of governance at the state-owned enterprises (SoEs) are viewed as a positive, S&P maintains that broader structural reform at SoE level is unlikely to be implemented in the short term.

Table 2: S&P's ratings review

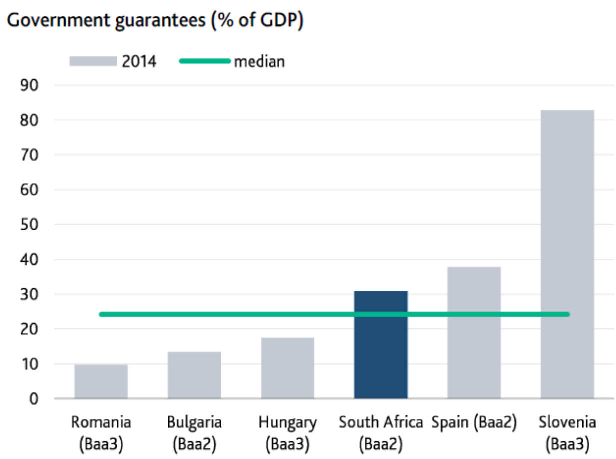
Outcome	Sovereign • Stable at BBB- (negative outlook on hold since December 2015) Local • Downgraded to BBB (from BBB+)
Reasons behind outcome (foreign currency rating unchanged)	• Well-developed domestic capital markets • Commitment to gradual fiscal consolidation ➔ tight expenditure ceiling, but can accommodate unforeseen expenditure pressures • Independent Reserve Bank • Institutions have remained strong (for example judiciary keeps executive and legislature in check) • Independent media reporting
Triggers for potential negative ratings action	• Disappointment in GDP ➔ continued decline in average wealth levels • Political interference threatening macroeconomic policy continuity and weakening institutions • Higher-than-expected net debt levels and contingent liabilities (previously stipulated that this must not exceed 60% of GDP) • Reduction in fiscal flexibility ➔ could lead to a further lowering of the local currency rating
Triggers for potential positive ratings action (revision of outlook to stable)	• Policy implementation ➔ boosting confidence ➔ accelerating growth
Preventing an upgrade	• Need for further reforms • Low GDP growth • Vulnerability to foreign financing of external deficits • Structural current account deficit • Sizeable government debt

Source: S&P

Contingent liabilities viewed as limited

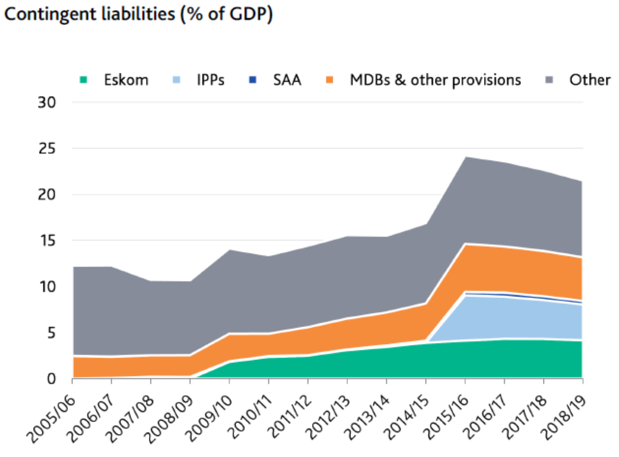
Given the weak state of many SoE balance sheets, S&P cautioned against the need for further government support, highlighting Eskom, SA National Roads Agency (SANRAL) and SA Airways (SAA) as key risks. In its review of SA's sovereign rating, Moody's suggested that SA's share of government guarantees as a percentage of GDP ranked slightly higher than similarly rated peers (see chart 4), recognising the steep rise in contingent liabilities since the global financial crisis (see chart 5).

Chart 4: SA government guarantees high in comparison



Source: Moody's

Chart 5: Sharp rise in contingent liabilities' share of GDP



Source: Moody's

Government's response to the ratings reviews

Treasury acknowledges the need to fast track structural reforms and has committed to building a foundation for faster growth in collaboration with business, labour and civil society. It pointed out that government policy continues despite rising political noise, which in S&P's view could remain a challenge in the run up to the African National Congress (ANC) National Executive Committee (NEC) elective conference in December 2017.

Political interference a threat to the credit ratings outlook

Despite government's commitment to fiscal consolidation, weak economic growth and ongoing political tensions threaten SA's growth and fiscal performance. Policymakers have been given some breathing room to implement structural reforms viewed as necessary to lift SA's growth path higher, allowing for an improvement in overall living standards. Since the peak in the commodity cycle in 2011, living standards, as measured by real GDP per capita, have fallen in line with lower commodity prices. This trend underscores the extent to which SA's growth model has remained reliant on the commodity cycle in the absence of much-needed reforms in the labour, mining and public enterprise sectors in particular.

A downgrade to sub-investment grade could still, in Momentum Investments' opinion, be on the cards, should real economic activity disappoint further or political instability derail policy continuity in SA. In response to Moody's and Fitch's reviews, Treasury warned against the dangers of a sub-investment grade status, explaining that it could translate into higher interest payments, a weaker rand, a higher cost of living, reduced fiscal space to address escalating spending pressures and subdued confidence, ultimately translating into low investment and weak job creation.

For SA to lose its spot in indices such as the Citi World Government Bond Index, the long-term domestic currency rating would need to be lowered into sub-investment grade by Moody's and S&P. Momentum Investments does not view this as an immediate concern for SA, given that the local currency rating is still two notches away from sub-investment grade on Moody's and S&P's rankings (see table 3).

Table 3: SA's sovereign rating by the three key rating agencies

	S&P	Fitch	Moody's
Investment grade	A3	A3	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1

Source: S&P, Moody's, Fitch, pink = foreign currency rating, blue = local currency rating