Silver linings amongst SA's rating downgrade clouds

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In the months leading up to March 2020, among the biggest issues on the minds of SA investors was the threat of ratings agency Moody's following the lead taken by Standard & Poor's (S&P) and Fitch, and downgrading our sovereign country rating from Investment Grade to Non-Investment Grade (i.e. junk status).

As we now know, 'junking' our sovereign rating was a decision they eventually felt compelled to make, for a range of reasons including a deteriorating fiscus, rising levels of government debt, electricity supply constraints, ailing SOEs and persistently weak economic growth. Yet, inconceivably, this preoccupying development has been overshadowed by the global Covid-19 pandemic, compounding the volatility of local and global markets, and giving South African investors an even bigger headache. But every cloud has a silver lining … doesn't it?

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SA rating assessed

The function of credit agencies, such as Moody's, Fitch and S&P, is to assess the creditworthiness of sovereign countries around the world and ascribe ratings that reflect their level of confidence in each country's ability to honour its debt obligations. The lower the rating, the higher the perceived risk and hence a higher compensation or yield is required by investors. For South Africa, this higher required yield was fairly reflected in pricing prior to the downgrade.

Beyond the psychological implication of being demoted to Junk, the downgrade has triggered South Africa's exclusion from World Government Bond Indices. The timing was unfortunate as it coincided with the Covid-19 pandemic unfolding globally and emerging markets in general (including South Africa) experienced extreme capital outflows as foreign investors took refuge in safe haven assets.

These are unprecedented times - at least as far as the pandemic is concerned - but it is worth remembering that South Africa has been on the downgrade road before… and recovered.

Peaking in 2008

It was only after the end of apartheid that South Africa received its first credit rating and, for five years, our sovereign country rating was deemed Non-Investment Grade, until all three major credit agencies upgraded SA to Investment Grade in February 2002. After that - as the result of a period of good economic growth, government's strong commitment to fiscal consolidation, good governance and policies that promoted the ease of doing business - our sovereign country rating was consistently upgraded until the pinnacle was reached, in 2008, with an A+ rating from Moody's.

Since then, SA has gradually tip-toed back down the ratings, taking two decades to make the transition back to Non-Investment Grade status. The claw-back to Investment Grade will require significant and sustained improvement. It took Indonesia 19 long years but South Korea, in contrast, managed it in just less than 2 years and, while South Africa's efforts will no doubt be constrained by the impact of Covid-19, we can be hopeful that it is doable.

Junk status repercussions

Inevitably, there are serious long-term consequences to being 'junked'. The most obvious is that the SA government will be faced with higher borrowing costs which will crowd-out budget allocations set aside to fund other pressing needs.

Another negative consequence relates to the pool and type of capital that SA can access. Globally, the size of the Investment Grade market is much larger than the Non-Investment Grade market, hence shrinking the pool of capital that SA can access. Also, the type of capital invested in Investment Grade assets is much more stable and long term in nature than that invested in Non-Investment Grade, which tends to be volatile and more susceptible to changing investor sentiment.

Unfortunately, there's also likely to be a fallout for SA corporates who - despite their underlying fundamentals - might face their own downgrades because of the major ratings agencies' policies that limit a corporate issuer's ability to be rated above its sovereign country rating.

Reasons to believe in silver lining

So, where is the silver lining? Clearly, the picture is far from pretty, but SA is not about to become an investment wasteland and there are several reasons for believing that.

- **Foreign currency denominated debt:** Among the key reasons countries in emerging markets find themselves downgraded to 'junk' is their inability to pay foreign currency debt but there is widespread understanding that South Africa is not at risk of defaulting. About 90% of our total government debt is rand-denominated which should buffer us from higher debt cost and the effects of a highly volatile local currency, although we do acknowledge that the R500bn stimulus package will add strain (as it will for every other country taking similar action).

- **Institutional strength:** South Africa has a well-functioning, stable financial sector and deep liquid capital markets; the Reserve Bank is well regarded for its sound monetary policy framework and focus on preserving financial stability; and our fully-funded state pension fund and asset management industry (with AUM of close to R2.5 trillion) gives us a potential source of funding in local currency. (NB We are not alluding to 'prescribed assets' here which is another, highly contentious matter.)

- **The resurgence of strong leadership:** While 'Ramaphoria' may have proved transient, the impressive response of President Cyril Ramaphosa and his team to the Covid-19 crisis has attracted praise around the world. Then there is the unprecedented cross-party cohesion and widespread support from business, labour and citizens, and the emphatic way in which the private sector is stepping up to play its part via the newly created Solidarity Fund. Of course, rebuilding our country will require us to sustain and strengthen this new-found unity but, right now, it is good to see that perceptions of SA are (justifiably) on the rise again.

- **Long overdue structural reforms could become a reality:** As the saying goes, no crisis should be wasted. Catastrophic circumstances really can be the breeding ground for great reform and perhaps, without the pressure to 'protect' our Investment Grade, the SA government may now take the opportunity to make some of the extraordinary decisions needed to kick-start our economy. With the deep scars the Covid19 pandemic is expected to leave, structural reform is more imperative than ever and, finally, South Africans have reason to be hopeful that our leaders will take the bold action that's so urgently needed.

So, with all that has transpired recently, we would like to sound a note of caution against making dramatic portfolio changes due to panic.

Looking after your nest eggs

With the unfolding economic fall-out, the rand has devalued to levels considered highly over-sold but, as one of the more liquid and volatile emerging market currencies, it does tend to over-react. But, once the crisis du jour passes, it typically returns to fair value, leaving investors who rushed their portfolios offshore with gains substantially eroded.

Currently, our fixed income market offers attractive real yields that can help savers to maintain their purchasing power. And, while growth assets have generally failed to generate inflation-beating returns, the significant declines across our local equity and property markets, mean valuations have become attractive too. So, we would caution investors that, while cash may be "king" at the start of a crisis, hoarding it could come at the risk of missing out on significant opportunities.

In this time of uncertainty, that's all we've got: the sliver of a silver lining and a fighting spirit. Now is not the time to take our gloves off. ●

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