# The downgrade will add to challenges for South African investors

## Old Mutual Corporate Consultants commentary

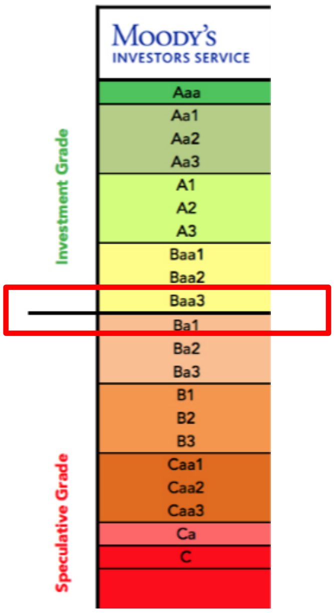
MARCH 2020

CORPORATE
CONSULTING

DO GREAT THINGS EVERY DAY

**In a move that was widely expected, Moody's cut South Africa's debt to sub-investment grade on Friday night, 27 March 2020. Both the local and foreign currency denominated debt ratings were cut from Baa3 to Ba1. Moody's also retained their negative outlook.**

Their statement highlighted South Africa's "continuing deterioration in fiscal strength and structurally very weak economic growth".




**In summary, the potential impacts on investments may include:**

- Higher cost of government borrowing, leading to lower expenditure and/or higher taxes
- Rand weakening, leading to higher inflation
- Higher bank cost of borrowing, leading to higher interest rates for South Africans
- Removal from Citigroup's World Government Bond Index (WGBI), leading to bond outflows by foreign investors but possible inflows from other investors with less restrictive mandates
- Reduction in defined benefit funds' liabilities due to higher assumed discount rates
- Weaker economic activity, which is generally negative for shares, but offset by any foreign earnings and rand weakness
- Possibly all overshadowed by impact of COVID-19

## What does the downgrade mean for South Africa?

To understand the downgrade and what it means for South Africa, it's necessary to understand counterparty risk. **Counterparty risk is the risk that one of the parties involved in a transaction fails to meet their obligation**. The higher the risk, the higher the interest rate a lender will demand to lend the money. Investing in bonds involves lending money to a government or a company. When doing so, an astute investor will want to assess the likelihood of getting back their money, including any interest on the loan. This requires an assessment of counterparty risk. The rating agencies perform a valuable service for investors by rating the creditworthiness of entities (governments or companies) who are active in bond markets globally.

Moody's is one of three major global credit rating agencies – the others being S&P and Fitch. Moody's has now followed the other two rating agencies in judging that South Africa's government is less likely to be able to repay its debts in future.

In simple terms, this can be compared to a person seeking a loan from a bank. With a good credit score the individual might get a loan at an interest rate of 10% p.a. If the person then returns for another loan but their credit score has worsened, the bank will view them as a higher risk in terms of repayment of the loan. The bank may grant them the new loan but at a higher interest rate, say 11% p.a. The individual's loan repayments will therefore be much higher leaving them with less money for their other living expenses.

The same impact will be felt by South Africa and, by extension, its corporates and citizens. South Africa has been spending more money than it earns from taxes. The government needs to borrow money to fund this shortfall. Governments borrow using bonds. The next time South Africa issues a bond, the credit rating on the bond will be sub-investment grade according to all three agencies and this is likely to lead investors to demand a higher interest rate. Paying more interest will mean even less money available for education, wages, the police force, healthcare, social grants, infrastructure and other government expenses. This might in turn lead to higher taxes, which will stifle the economy even further.

Another impact of the downgrade to sub-investment grade is that South Africa's government bonds will be removed from Citigroup's World Government Bond Index (WGBI), which consists only of bonds issued by countries with investment grade ratings. This index is the benchmark used by many global bond portfolios with substantial assets invested in them. The managers of these portfolios, and any others with investment-grade only mandates, will be compelled to sell South

African bonds to comply with their investment mandates. In his response to the downgrade announcement, Finance Minister Mboweni commented: "Non-residents currently hold approximately 37% (R800 billion) of the total domestic government bonds and the number is expected to substantially decline with the combined impact of COVID-19 and the downgrade." A small piece of luck is that COVID-19 has led to a decision to postpone the regular rebalancing of the index from April to May so we will have another month in the index. This is merely a brief postponement of the inevitable sales by many global bond investors.

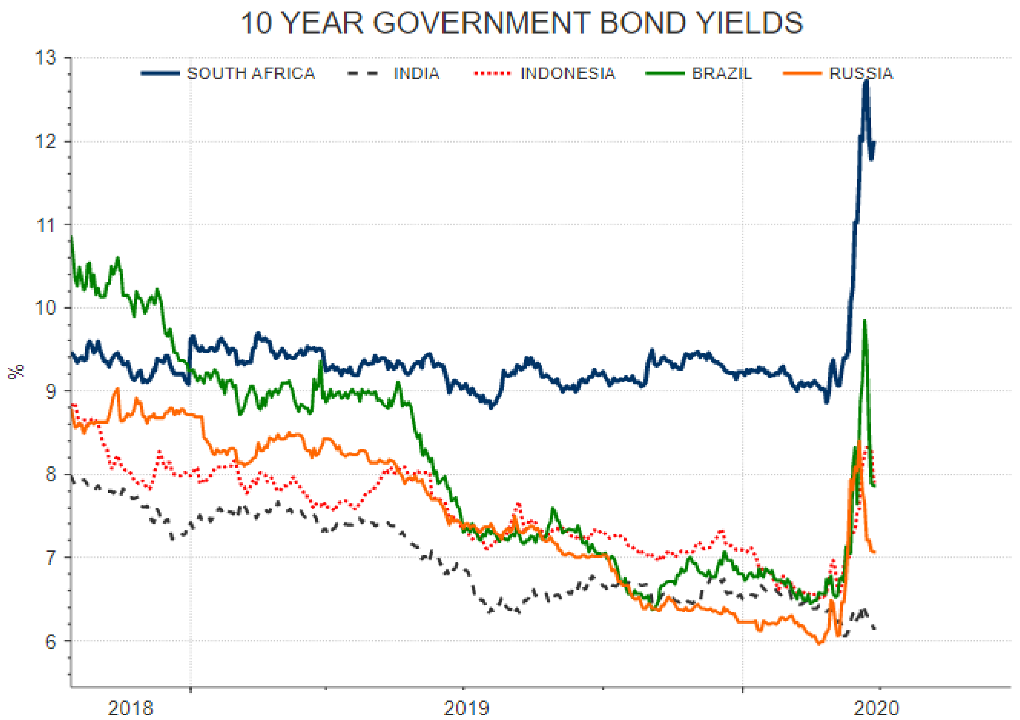
Although investors with investment-grade only mandates will be sellers of South African bonds, other investors with less restrictive mandates will be potential buyers. South Africa was previously clinging onto the bottom rung of investment grade but was by no means the most attractive option within this universe. However, in the sub-investment grade universe, South African bonds are likely to be very attractive on a risk-adjusted basis meaning that demand might be quite strong.

## WHAT IMPACT DOES THIS HAVE ON MEMBERS OF RETIREMENT FUNDS?

**As always it's difficult to predict the impact of an event like this on different types of investments. This is why it's essential to ensure that the investment strategy you use for your retirement savings is well-diversified and designed with the long term in mind.**

Some possible impacts:

- **The downgrade has been anticipated for some time and because investments are forward-looking, it has been largely priced in by investors. Priced in** means that the prices i.e. the interest rates being demanded for the bonds, already reflect the lower creditworthiness. This can be seen by comparing the interest rates on our bonds to other countries who are already in sub-investment grade. Refer to the graph that follows. Two things are clear:
    1. Prior to COVID-19, the interest rates on the bonds of South Africa's emerging market peers had been reducing relative to South Africa's
    2. COVID-19 has had a dramatic impact on all emerging market bonds (the spike upwards on the right) and even more so on South Africa's.




Source: Refinitiv Datastream/Old Mutual Multi-Managers

- However, **the extent to which the downgrade is priced in is somewhat limited.** This is because some investors, notably those who track the World Government Bond Index, have been compelled to hold South African bonds to align to the index constituents. The actual date on which the bonds are officially removed from the index will thus see further selling pressure, which is likely to negatively affect prices.
- **The downgrade is likely to put pressure on the rand**, both immediately as some active investors sell in advance of the index re-balancing, and again when South Africa's bonds are officially removed from the index.
- **A weaker rand generally drives up inflation.** This is because South Africa is a net importer of many goods, with the possible exception of commodities. Higher US dollar prices thus affect inflation. South Africa is also a net importer of oil so a weaker rand results in a higher oil price in rands and hence a higher fuel price. As all goods need to be transported a higher oil price leads to higher transport costs and hence prices for these goods. This leads to higher inflation. Fortunately, COVID-19 and the recent price war between Saudi Arabia and Russia have resulted in a sharp drop in oil prices so this might cushion any impact from a weaker rand.
- **Higher inflation is also likely to push up interest rates** as the SARB is forced to act to manage inflation according to its inflation-targeting mandate. This adds to the upward pressure on interest rates from the downgrade itself.

- **Although shares may be negatively impacted** as investors fret about the impact of a downgrade on economic activity, **there are various other factors at play:**
    1. After the significant COVID-19 induced falls experienced over the last few weeks, shares are pricing in a lot of bad news so further falls are likely to be muted.
    2. Banks are likely to be negatively affected as they are also downgraded (linked to the downgrade of the country), the interest rates they pay then increase and they then pass this onto their customers.
    3. A large proportion of the earnings of South African listed companies are now earned offshore and a weak rand might boost these earnings and hence support the share prices of these companies.

The downgrade has been looming over us since S&P downgraded South Africa to sub-investment grade in 2017. The actual downgrade has come at a time when we are in lockdown in an effort to curb the spread of COVID-19. The dramatic global economic implications of the COVID-19 crisis are likely to overshadow the downgrade and may delay or distort the potential impacts described above. One of the implications is that South Africa is likely to be just one among many countries to be downgraded. On a relative basis, the effects might thus be limited.

**Long-term investors, like those saving for retirement, don't need to panic. A well-diversified investment strategy with exposure to shares, property, bonds and cash, both in South Africa and globally, will certainly experience some ups and downs. Staying calm, contributing diligently every month and leaving skilled asset managers to steer the portfolio is the best strategy to achieve a sound retirement outcome.**

## OTHER IMPACTS FOR RETIREMENT FUNDS?

**For defined benefit funds the impact of a downgrade will be felt in the assumptions underlying the calculation of their liabilities.** The key feature of the determination of the liabilities is the discount rate that the statutory actuary uses to determine the current value of all future payments the fund will need to make to members. The higher the discount rate the lower the value of liabilities. The discount rate is set by the actuary with reference to the interest rate on government bonds. The increase in the interest rate on bonds arising from the downgrade is likely to result in higher discount rates in actuarial assumptions. Assuming that inflationary impacts remain muted as a result of the oil price decline, and that salaries increase only marginally ahead of inflation, this will result in a decrease in the value of liabilities.

CORPORATE
CONSULTING

## CONCLUSION

The downgrade is undoubtedly bad news for South Africa, its corporates and its citizens. However, the country has been in sub-investment grade territory before and managed to build its way up to investment grade. This can be done again. This will require South Africa to address the structural issues holding back its economy – urgently fix the Eskom crisis, sort out the education system, address the inflexibility of the labour market and high public wages, invest in infrastructure and tackle unemployment and inequality. The leadership shown by our President during the current COVID-19 crisis is inspirational and has the potential to serve as a catalyst to get all South Africans working towards a prosperous future. Let's not waste this crisis.

**Produced by Old Mutual Corporate Consultants.** For more information contact your Old Mutual Corporate Consultant or visit www.oldmutual.co.za/OMCC and visit www.oldmutual.co.za/mindspace for more articles on a range of relevant topics.

Copyright © 2020 Old Mutual. All rights reserved.

This document is owned and produced by Old Mutual Corporate Consultants (OMCC). No part of it may be reproduced in any form or by any means without OMCC's written permission. While every effort has been made to ensure the accuracy of information contained in this document, OMCC, Old Mutual and its directors, officers and employees provide no representation or warranty, express or implied, regarding the accuracy, completeness or correctness of information contained in this document and as such, OMCC and Old Mutual do not accept responsibility for any loss or damage suffered by a person as a result of reliance on the information contained herein.

Old Mutual Corporate is a division of Old Mutual Life Assurance Company (South Africa) Limited, Licensed Financial Services Provider.