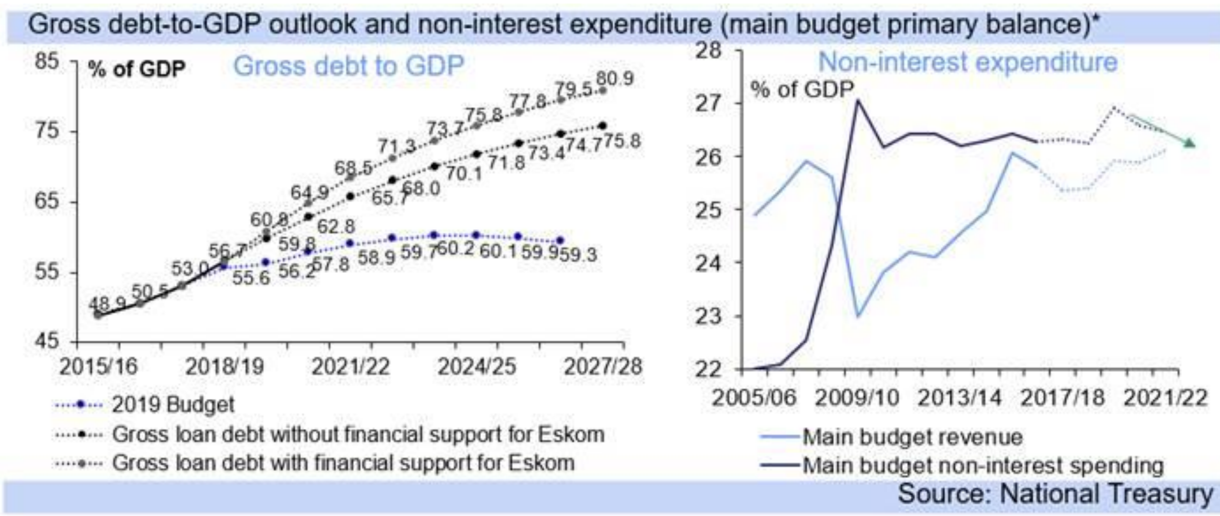
Investec

SA Economics

Credit Rating

Friday 21 January 2020

Why a credit watch from Moody's is unlikely to be implemented for SA at its country review in March, (or even before then), even if the Budget next week does not materially improve over the 2019 MTBPS



- South Africa's Budget next week Wednesday (26th) is being seen as a make or break budget, which will either keep SA's debt to GDP projections fairly similar, if slightly lower to those of the 2019 MTBPS which prompted Moody's placing SA on a negative outlook, or less likely, see a material lowering of the debt projections.

- However, to lower the debt projections, expenditure will need to be cut. Revenue projections were cut substantially in the 2019 MTBPS due to a material deterioration in the economic growth outlook, while expenditure projections were not, escalating instead. Consequently debt projections rose substantially.

- An inflation adjusted increase is likely to be aimed for public sector and SOE employees, but the high political tensions in SA that have log-jammed the implementation of many structural reforms to date, likely also mean that it will be difficult to affect only inflation adjusted increases, with government flip flopping over this before.

- Additional expenditure allocated to Eskom to keep it afloat has also been a drain on Government finances. Earlier this month it looked like Cosatu had formulated a plan to rescue Eskom, by halving its debt, and if this has been accepted, would have resulted in a lowering of the debt trajectory, and likely avoided a downgrade.

- South Africa is currently on a negative outlook from Moody's, which implies that with around eighteen months the country could be downgraded following 2019's MTBPS revisions for gross debt to 71% of GDP by 2022/23 (from closer to 60% in the 2019 MTBPS), and to 81% by 2027/28 (from 59.3% in the 2019 MTBPS).

- For SA to return to a stable outlook, SA's government debt projections would need to be lowered all the way back down to essentially those in the 2019 Budget (see graph above), which showed an expected debt trajectory supporting a stable ratings outlook from Moody's.

- SA will either return to a stable outlook, remain on a negative outlook or be downgraded after next week's Budget. While there are some concerns SA will receive a credit watch, we believe this is very unlikely. A credit watch can be used when a credit situation is very fluid and so changing, and the outcome is very uncertain.

- A credit watch can also be implemented when additional information is needed before a rating decision, due to the entity likely moving away from an expected trend. However, the information in next week's Budget will be very in depth, transparent and extremely detailed and so a credit watch will also likely not be needed.

- With little possible in three months after the Budget to turn around the projected debt and deficit picture a ratings watch would likely be just a signal of an unavoidable, impending credit rating downgrade, and as such the agency could by the very same token just effect the actual downgrade to sub-investment grade instead.

- Furthermore, Moody's country review of South Africa is on 27th March, which gives the rating agency over a month to digest the Budget, which is ample time - credit watches tend to be only for short periods, typically up to three months. There is no rationale for one to be expected, unless a new event is imminent.

Local Currency – Long term			
	S&P	Moody's	Fitch
Brazil	BB-	Ba2	BB-
Russia	BBB	Baa3	BBB
India	BBB-	Baa2	BBB-
Turkey	BB-	B1	BB-
Mexico	A-	A3	BBB
South Africa	**BB+**	**Baa3**	**BB+**
China	A+	A1	A+
Nigeria	B	B2	B+
Kenya	B+	B2	B+
Namibia	NR	Ba2	BB
Ghana	B	B3	B
Botswana	A-	A2	NR
Mozambique	B-	Caa2	CCC
Zambia	CCC+	Caa2	CCC
Ethiopia	B	B1	B
Rwanda	B+	B2	B+
Uganda	B	B2	B+
Angola	B-	B3	B
Dem. Rep of Congo	CCC+	Caa1	NR
			Source: Bloomberg

SA's credit ratings

South Africa – S&P Ratings		South Africa – Fitch Rating		South Africa – Moody's	
03/10/1994	BB	22/09/1994	BB	14/10/2004	Baa2
20/11/1995	Upgraded to BB+	19/05/2000	Upgraded to BB+	11/01/2005	Upgraded to Baa1
25/2/2000	Upgraded to BBB-	27/06/2000	Upgraded to BBB-	16/07/2009	Upgraded to A3
07/05/2003	Upgraded to BBB	05/02/2003	Upgraded to BBB	27/09/2012	Downgraded to Baa1
01/08/2005	Upgraded to BBB+	25/08/2005	Upgraded to BBB+	06/11/2014	Downgraded to Baa2
12./10/2012	Downgraded to BBB	10/01/2013	Downgraded to BBB	09/06/2017	Downgraded to Baa3
13/06/2014	Downgraded to BBB-	04/12/2015	Downgraded to BBB-		
03/04/2017	Downgraded to BB+	07/04/2017	Downgraded to BB+		
24/11/2017	Downgraded to BB				

Source: Bloomberg

- That is, little further game changing information is expected to emerge three months after the Budget or three months after Moody's 27th March country review on SA. The agency would have more then enough time by 27th March to decide whether SA should remain on a negative outlook.

- Besides insufficient information, an entity is typically also placed under credit watch when it has seen a significant change in performance (as opposed to one being expected) and the rating impact has not yet been assessed, that is there has not been a decision from the rating agency yet on it.

- The last criteria is when there is a change in the grouping the entity falls into, and a rating change could occur as a consequence in the short-term. Imposition of a credit watch typically means that there is a 50/50 chance of a rating change – but we maintain our view a credit watch is unlikely for SA on the Budget alone.

- A credit watch can be either negative or positive, but in SA's case a negative credit watch is likely after the budget. A positive credit watch would only occur if SA was in line for a credit rating upgrade and for some reason there was a real rush to implement it.

- The potential for an upgrade is currently unlikely, as there is over a month between the Budget and Moody's end-March review, which once again gives the agency enough time to finish its computations and decide on retaining the negative outlook, imposing a stable one or even just outright downgrading SA's credit rating.

- A negative credit watch also does not mean that a rating downgrade is inevitable, whereas a negative outlook does, unless the entity returns to a stable outlook. For SA, a rating downgrade is inevitable, unless SA returns to a stable outlook by returning to the debt projections of the 2019 Budget.

- Moody's recently revised its forecast of SA's GDP growth to "0.7% in 2020 and 0.9% in 2021", stating "(o)ur sub-1% projections reflect our view that the pace of economic activity will remain subdued, well below the country's potential, over our forecast horizon."

- Moody's adds that it "attribute(s) the persistent economic weakness to lacklustre domestic private-sector demand — both household spending and investment — and the detrimental impact of widespread power outages on the manufacturing and mining activity."

- "The steady rise in the unemployment rate since 2018, which now stands at 29%, reflects the difficulties in absorbing the growing labour force. Slow growth of economic activity is hampering the rate of jobs creation." "South Africa's economy remains stuck in low gear".

- South Africa's risks continue to stack up, as high political tensions hold-up the implementation of key policy reforms. Next week's budget is likely to show the fiscal deficit for 2019/20 at 6.1% (from 5.9%) of GDP, due to a revenue shortfall, with expenditure not expected to come in lower than projected, nor significantly higher.

Economic Scenarios: note downside currency updates

Extreme Up case 1%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	11.50	10.30	9.50	8.60	7.90	7.60	7.40	7.10
Repo rate (end rate)	6.00	6.00	5.75	5.75	5.50	5.50	5.25	5.25

Fast, sustainable economic growth of 5-7% y/y. Change in political will with growth creating economic reforms that structurally lift private sector investor confidence and fixed investment. Global growth boom (including commodities), Trump protectionism removed, SA export and domestic growth boom lifts employment and incomes, poverty eventually eliminated. Property rights strengthened, individuals obtain title deeds in EWC without disruption to economy. Fiscal consolidation, credit rating upgrades to A grade.

Up case 7%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	13.00	11.50	10.00	9.95	9.90	9.70	9.65	9.45
Repo rate (end rate)	6.25	6.25	6.25	6.00	6.00	6.00	6.00	6.00

Persistent growth of 3–5%, higher probability of extreme up case. Better governance, growth-creating reforms (structural constraints overcome), greater socio-economic stability, strengthening in property rights, individuals obtain title deeds in EWC without disruption to economy and can leverage and obtain credit. High business confidence and fixed investment growth, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle, 'trade war' subsides. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base case 39%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	14.50	14.80	14.70	14.45	14.00	14.05	14.55	14.15
Repo rate (end rate)	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25

Annual growth approaches 2.0% y/y by 2022. Rising confidence and investment levels over the five-year forecast period. SA retains one investment grade (Moody's) rating on its local currency long-term sovereign debt in 2019 and 2020 on a negative outlook. Avoids severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand to trend growth. Limited impact of EWC (expropriation without compensation) to abandoned, unused, labour tenets and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy.

Lite (domestic) Down case 38%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	15.50	16.50	16.80	16.10	15.80	15.90	15.70	15.30
Repo rate (end rate)	6.75	7.25	7.25	7.25	7.25	7.25	7.25	7.25

SA is rated sub-investment grade by Moody's but substantial repair avoids further marked downgrades. Business confidence depressed, rand weakness, significant load shedding and weak investment growth until substantial repair effected. V shaped, credit-rating-downgrade related recession. However, a neutral to risk-on global financial market environment (the international environment is that of the base case) lessens the impact of the rating downgrade. Potentially combined with a modest expropriation of some private commercial sector property without compensation, with modest negative impact on economy.

Severe down case 15%

	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
USD/Rand (average)	16.00	17.50	18.50	19.80	19.50	18.90	18.50	18.00
Repo rate (end rate)	7.00	7.75	8.50	9.25	10.00	10.00	9.50	9.00

Continued global sharp economic slowdown resulting in a global recession, on a marked escalation of the US-China trade war – may include a global financial crisis. May also include severe escalation of US Middle East military conflict. A significantly more severe recession occurs in SA than in the lite down case, marked rand weakness, may eventually include widespread services load shedding and strike action. Potentially combined with expropriation of private sector property (title deeds not transferred to individuals) without compensation – severe negative impact on economy. SA rated sub-investment grade from all three key agencies, with further rating downgrades occurring.

Note: Event risk begins Q1.20. Source: Investec, Iress historical data

- The 2019 MTBPS said "to restore … public finances to a sustainable position … will mainly involve a range of expenditure reductions, … particularly on the wage bill, will be required to narrow the deficit and improve the composition of spending."

- "Growth in the public-service wage bill needs to decline to reduce the pressure on goods and services and infrastructure. The wage bill accounts for 46 per cent of tax revenue in 2019/20, primarily because of above-inflation increases in average remuneration over the past decade."

- In the recent SONA the President said that "(w)e are engaged with labor and other stakeholders on measures to contain the public wage bill and reduce wastage." However, it is unlikely that expenditure projections will be cut back sufficiently to allow debt projections to return to those of the 2019 Budget (see graph directly below).

- “Significant tax increases over the past several years leave only moderate scope to boost tax revenue at this time. Given the size of the required adjustment, however, additional tax measures are under consideration. To reduce future transfers, a sustainable plan for state-owned companies is required.”

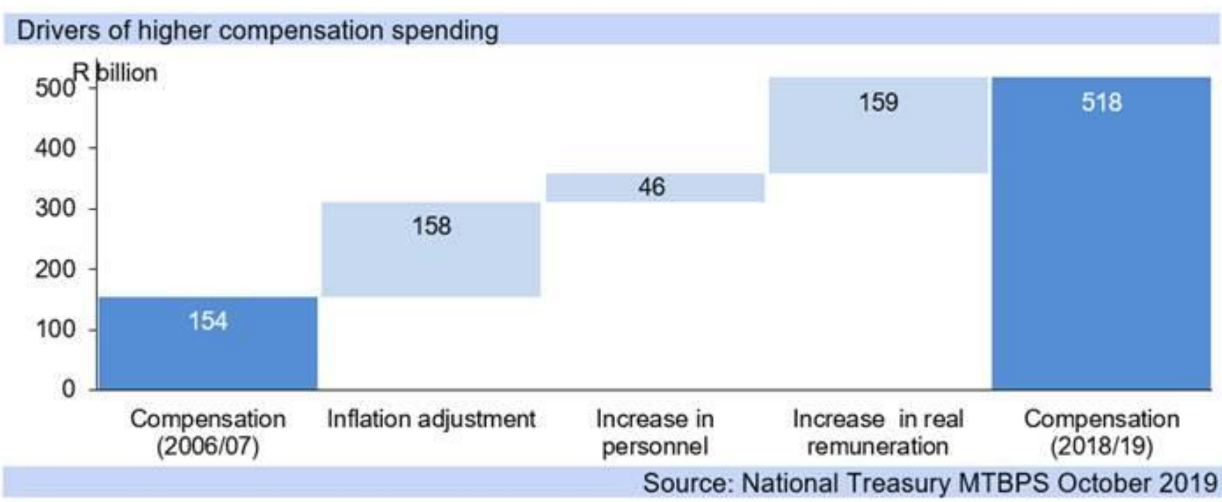
- We do not think there will be a VAT increase in the Budget next week. Rising unemployment in SA, very weak economic growth and the fragile state of household finances have meant that consumer spending has been under significant pressure, with extremely low real salary and wage increases.

- Raising VAT in the current environment would not be prudent in the economic sense - higher taxation has been one of the key reasons for the deterioration in economic growth over the past decade (the 2010s - 2010 to 2019), and consumers are financially restrained as a result, leading to poor performance from some corporates.

- Hiking VAT would worsen the situation, and also give rise to social discontent, where political tensions are already high, and are holding-up the implementation of key policy reforms in SA. Fiscal drag may be used to raise around R12bn or more from taxation, while expenditure on government's side really needs to decrease.

- Fiscal drag is used to garner in more tax by failing to adjust income tax rates for higher inflation, resulting in the devaluation of income by inflation not being accounted for, and income earners are then charged higher taxation in real terms by the brackets not shifting. This garnered in a substantial amount last year of R12.8bn.

- Top tier marginal income tax rates could rise by about 1%. The revenue shortfall for 2019/20 should be significantly less than the revised revenue projections for the 2019 MTBPS of -R52.5bn, as a weaker economic trajectory was factored in for the MTBPS for 2019/20.



- Economic growth of 1.2% y/y was expected in the 2019 MTBPS for 2020 (down from 2.0% y/y previously), and consensus is closer to 0.8% y/y now for 2020, which will likely see some further downwards adjustment to the economic growth forecast for South Africa this year and in the next few.

- In its “Global Macro Outlook 2020-21 (February 2020 Update)” Moody’s warned that the outbreak of “(c)oronavirus … has diminished optimism about prospects of an incipient stabilization of global growth this year.”

- “With the virus continuing to spread, it is still too early to make a final assessment of the impact on China … and the global economy. We have revised our global GDP growth forecast down, and we now expect G-20 economies to … grow 2.4% in 2020, a softer rate than last year, followed by a pickup to 2.8% in 2021.”

- “Our baseline assumes the outbreak will cause disruption in Q1 economic activity. Under our baseline forecast, the spread of the coronavirus will be contained by the end of Q1, allowing for resumption of normal economic activity in Q2.”

- “At present, China's economy is by far the worst affected. … The effects on the global economy could compound if the rate of infection does not abate and the death toll continues to rise, because supply chain disruptions in manufacturing would become more acute the longer it takes to restore normalcy.”

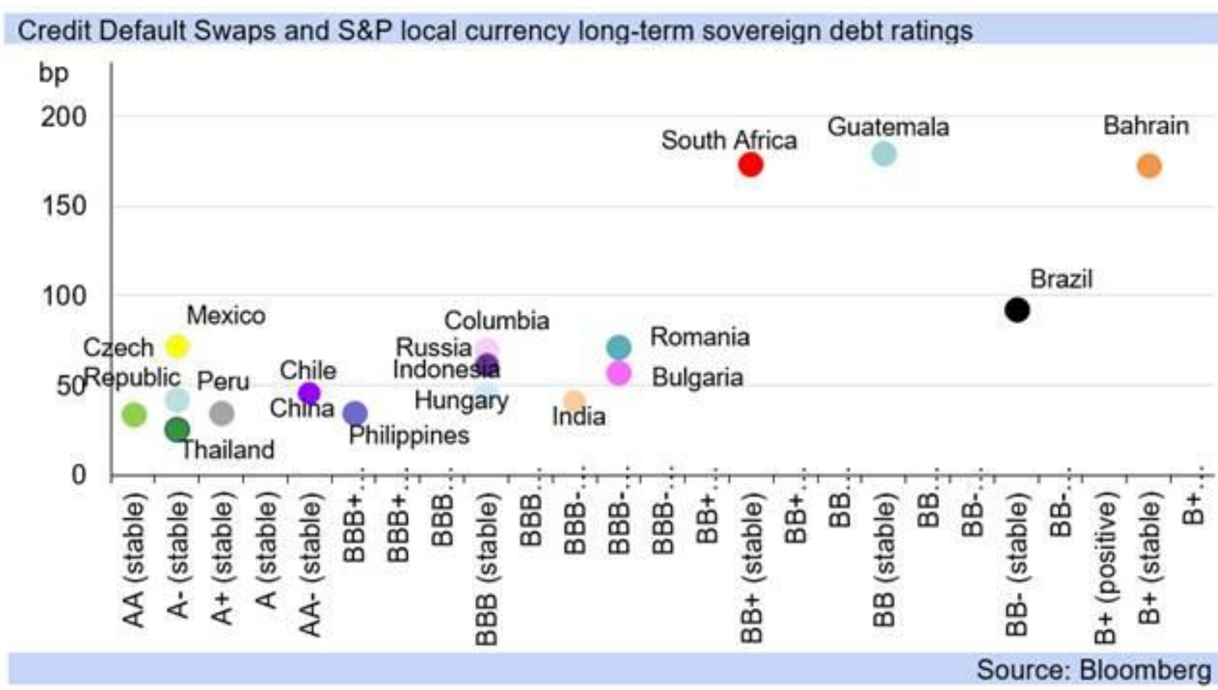
- “We have reduced our growth forecast for China to 5.2% in 2020 and maintain our expectation of 5.7% growth in 2021. The outbreak will primarily hurt China’s economy by lowering discretionary consumer spending on transportation, retail, tourism and entertainment.”

- Until the hard data begins comes out for the global PMIs and other data prints for February and March, the quantified effect of Covid-19 on industrial production globally will remain unclear, particularly the effect on the global supply chain. Even then, data into Q2.20 will be needed to assess the impact on countries’ 2020 growth.

- By the end of 2019, signs were emerging of some stabilisation in global growth, particularly in the trade and manufacturing sectors, with the Phase One trade deal boosting confidence, leading to expectations that knock-on trade effects would see SA economic growth recover this year, and so incomes via this export led growth.

- However, the expected contraction in China’s industrial production in Q1.20 will cause a slowdown in the Chinese economy in that quarter, likely lowering its growth for 2020. This would impact global growth, negatively affecting exports to China. This in turn will likely negatively affect SA growth, exports and incomes.

- That is, slower global growth will negatively impact SA’s economic growth ability, as SA is a small open economy, and so would weaken the growth outlook for 2020 even further than the 0.8% y/y growth rate we forecast. This would further exacerbate SA’s weakness in its government finances.



- Moody's adds that "(t)he South African Reserve Bank('s) … policy interest rate … now stands at 6.25%, 75 basis points below the high in the current cycle of 7.0% in mid-2016 … monetary policy, which is primarily focused on meeting the central bank's inflation target objective, remains tight."

- "As a result, the value of the rand in real trade weighted terms has held up even as the economy has decelerated sharply … . However, the real policy rate exceeds 2%, well above the real GDP growth rate. In other words, real interest rates remain high, constraining the pace of real economic activity."

- A downgrade from Moody's would elevate money market rates and bond yields, as it is the last agency still to hold SA on investment grade, and the downgrade would be to sub-investment grade. This would place significant upwards pressure on the repo rate and upwards pressure, or a higher risk premium, on SA's bonds.

- Indeed the credit default swaps already reflect the increased likelihood of SA being rated sub-investment grade. The Reserve Bank adds that the "higher South African premium creates upside pressure on rates, which is difficult to ignore. Lower risk would create space for lower rates."

- The credit default swaps currently price SA at sub-investment grade, while the yield on SA's ten year benchmark government bond is around 9.0% from close to 6.0% in 2013, as successive credit rating downgrades were factored in, and occurred.

- The plans outlined to stabilise public finances (cut expenditure) in the 2019 MTBPS, if they are adopted in the 2020 Budget, would somewhat reduce the possibility of a Moody's credit rating downgrade. Fiscal restraint is key in next week's Budget, with expenditure cuts necessary.

- The tax-to-GDP ratio is already around its 2007/08 peak of 26.4 per cent, while the tax buoyancy ratio is not projected at a robust ratio in the MTEF. Looking forward, we project the fiscal deficit at 6.2% of GDP in 2020/21, after 2019/20's 6.1%, and 6.0% in 20/22, 5.9 in 22/23% and 23/24 at 5.5%.

- We expect the gross debt to GDP ratio to see a lower peak than in the 2019 MTBPS, although adding Eskom debt to government's balance sheet would clearly not allow for this. While it is not certain if this transfer of likely 50% of Eskom to SA's balance sheet will occur at some stage, there are not many other options currently.

- "Moody's has already said South Africa's "(g)overnment proposal to more than double support to Eskom is credit negative … because it would be an additional drain on fiscal resources." The MTBPS saw assistance rendered to Eskom, and the Budget may well see more.

- Eskom is not able to service its own debt, the South African economy is not able to absorb huge tariff increases without growth plummeting further and "no clear strategic turnaround plan agreeable to all stakeholders has emerged yet, fuelling risks for the government of having to provide additional support."

Credit ratings

	S & P	Moody's	Fitch	R & I
Investment grade	AAA	Aaa	AAA	AAA
	AA+	Aa1	AA+	AA+
	AA	Aa2	AA	AA
	AA-	Aa3	AA-	AA-
	A+	A1	A+	A+
	A	A2	A	A
	A-	A3	A-	A-
	BBB+	Baa1	BBB+	BBB+
	BBB	Baa2	BBB	BBB
	BBB-	Baa3	BBB-	BBB-
Speculative grade	BB+	Ba1	BB+	BB+
	BB	Ba2	BB	BB
	BB-	Ba3	BB-	BB-
	B+	B1	B+	B+
	B	B2	B	B
	B-	B3	B-	B-
	CCC+	Caa1	CCC	CCC+
	CCC	Caa2	CC	CCC
	CCC-	Ca3	C	CCC-
	CC	Ca	RD	CC
	C	C	D	C
	D	WR	WD	
	NR		PIF	

Source: Bloomberg

Foreign Currency – Long term

	S&P	Moody's	Fitch
Brazil	BB-	Ba2	BB-
Russia	BBB-	Baa3	BBB
India	BBB-	Baa2	BBB-
Turkey	B+	B1	BB-
Mexico	BBB+	A3	BBB
South Africa	**BB**	**Baa3**	**BB+**
China	A+	A1	A+
Nigeria	B	B2	B+
Kenya	B+	B2	B+
Namibia	NR	Ba2	BB
Ghana	B	B3	B
Botswana	A-	A2	NR
Mozambique	CCC+	Caa2	CCC
Zambia	CCC+	Caa2	CCC
Ethiopia	B	B1	B
Rwanda	B+	B2	B+
Uganda	B	B2	B+
Angola	B-	B3	B
Dem. Rep of Congo	CCC+	Caa1	NR

Source: Bloomberg