Investec

SA Economics

Credit Rating

Friday 22 November 2019

SA is facing a country review from Standard & Poor's tonight, which will likely see the outlook on SA's BB+ rated debt dropped to negative

South Africa – S&P Ratings	
03/10/1994	BB
20/11/1995	Upgraded to BB+
25/2/2000	Upgraded to BBB-
07/05/2003	Upgraded to BBB
01/08/2005	Upgraded to BBB+
12./10/2012	Downgraded to BBB
13/06/2014	Downgraded to BBB-
03/04/2017	Downgraded to BB+
24/11/2017	Downgraded to BB

South Africa – Fitch Rating	
22/09/1994	BB
19/05/2000	Upgraded to BB+
27/06/2000	Upgraded to BBB-
05/02/2003	Upgraded to BBB
25/08/2005	Upgraded to BBB+
10/01/2013	Downgraded to BBB
04/12/2015	Downgraded to BBB-
07/04/2017	Downgraded to BB+

South Africa – Moody's	
14/10/2004	Baa2
11/01/2005	Upgraded to Baa1
16/07/2009	Upgraded to A3
27/09/2012	Downgraded to Baa1
06/11/2014	Downgraded to Baa2
09/06/2017	Downgraded to Baa3

- South Africa is expected to see a key credit rating decision from Standard and Poor's tonight. S&P already rates SA on subinvestment grade, at BB+ local currency, and we expect the agency will deliver a negative outlook on SA's local currency rating, and quite possibly on its BB scored foreign currency rating too.

- S&P has said it "could lower the ratings if we were to observe continued fiscal deterioration, for example due to higher expenditure pressures, the crystallization of contingent liabilities, if economic performance structurally weakened, or if external financing pressures mounted."

- In addition it has added that it "could also consider lowering the ratings if the rule of law, property rights, or enforcement of contracts were to weaken significantly, undermining the investment and economic outlook." However, we continue to expect a switch to a negative outlook(s), not an outright rating(s) downgrade(s) yet.

- The downward trend in economic growth since 2011, from 3.3% y/y to likely 0.5% y/y this year has added to the rationale for the rating downgrades SA has experienced from S&P since 2012, and indeed from Moody's as well, and from Fitch since 2013.

- S&P says specifically that its "ratings on South Africa are constrained by the weak pace of economic growth, particularly on a per capita basis, as well as its large and rising fiscal debt burden, and sizable contingent liabilities."

- It has noted in particular that "structural impediments remain high "to improving the economic growth environment, and that "reform … (e)fforts will focus primarily on cutting costs, slimming ministerial head-counts, improving state-owned enterprises, and tackling graft."

- "Overall reform efforts are likely to be lacklustre and unlikely to be significant enough to drive strong GDP growth." With growth likely to be 0.5% y/y this year, instead of closer to the 1.5% y/y expected at the start of this year, weakening economic growth is likely to be one reason for instituting a negative outlook tonight.

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-
Sub-investment 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

- S&P has also identified that "the government will likely continue to shy away from difficult and contentious issues such as widespread staff retrenchments in state-owned enterprises, and tackling the labour unions." The outcome of the current SAA strike, will also be key in this regard for S&P's assessment next year.

- Clearly the outcome of the wage negotiations at other SOEs will also be key to S&P's outlook on SA's ratings, and so too to the ratings themselves, as will be the outcomes of the actual public sector wage negotiations. S&P is likely to wait for these, just dropping the outlook to negative in the meantime.

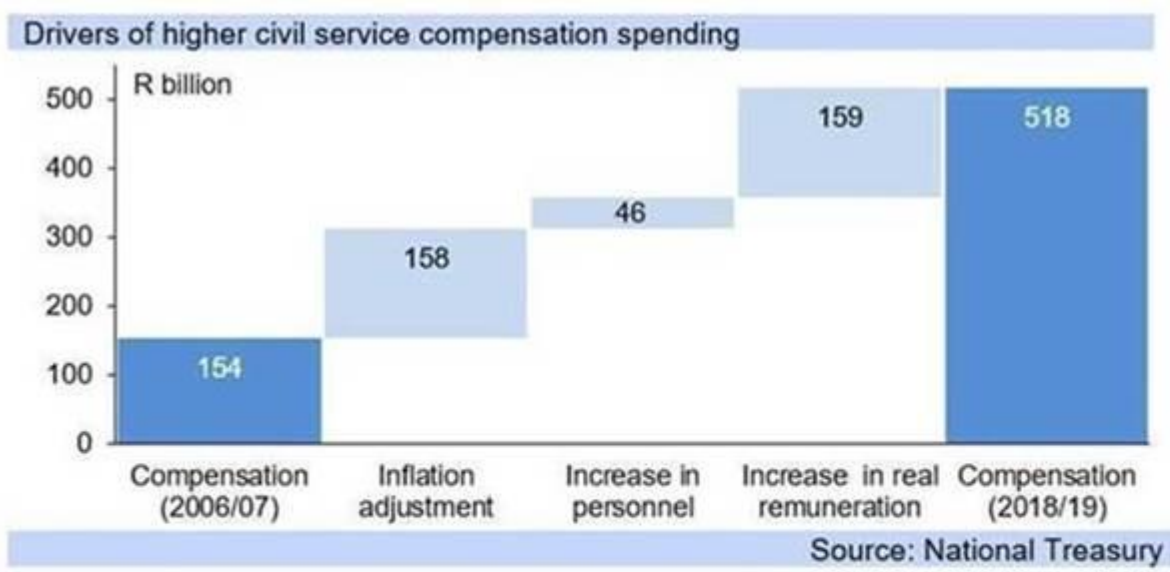
- The recent 2019 MTBPS has identified a number of key areas in which to reduce expenditure and stabilise public finances, in particular saying "(t)his will require reductions to wage bill growth. Tax measures are also being considered."

- "Additional measures, 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 final adjustments will be announced in the 2020 Budget."

- "These measures require difficult decisions that will affect the economy and the distribution of public resources. The short-term costs, however, are outweighed by the need to ensure sustainable public finances for decades to come, ensuring intergenerational fairness."

- Substantial, above-inflation rolling salary and wage increases for public sector service employees have also added to the huge escalation in debt (which is borne by future generations) this decade. Quelling the growth in this current expenditure area is key as above inflation increases are no longer affordable.

- Failure of a social compact to limit public sector employees to salary and wage increases at, or below, CPI inflation will clearly imperil the ability of South Africa to achieve its fiscal target as per the 2019 MTBPS, and so avoid credit rating downgrades from S&P, and also from Moody's and Fitch in 2020.



- On the positive side S&P has said "(t)he ratings are supported by the country's monetary flexibility, well-capitalized and regulated financial sector, and deep capital markets, alongside moderate external debt, in particular low levels of external debt denominated in foreign currency."

- While this provides an argument to retain SA on its current rating, the agency nevertheless warns this would be insufficient as it could still "lower … the ratings if the rule of law, property rights, or enforcement of contracts were to weaken significantly, undermining the investment and economic outlook."

- Formal clarity from government on EWC (expropriation without compensation) is likely end-Q1.20. The outcome of this policy adopted by the ANC at its 2017 elective conference will be key to SA's credit ratings, and so S&P will also likely wait until next year before making any decisions other than on ratings outlook(s).

- S&P has previously noted that "(a)lthough the president has stated that any expropriation would follow due process and that agriculture should not be damaged, such reform has worried some investors." This has also impacted business confidence as both foreign (and domestic) direct investors worry over capital outlays.

- S&P does clarify that "(n)evertheless, we expect land and property expropriation will move slowly with deals subject to the courts' scrutiny and the rule of law and enforcement of contracts remaining in place", but the investor climate has been negatively affected by the lack of formal clarity to date on EWC."

- S&P adds on to this contentious issue that its "view reflects our consideration of the checks and balances embedded within South Africa's institutional framework, which includes a constitutionally independent judiciary." We expect the institution of negative outlook(s) as opposed to rating(s) watch(es) tonight.

- South Africa's business confidence has remained depressed this decade on average, and indeed this year and last as well, worsening as lack of clarity over EWC drags on, quelling much of the potential growth in FDI from the private sector, nationally and internationally.

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	Ba1	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

- Overall however, what is key for credit rating agencies is the assessment of the actual creditworthiness of the sovereign, i.e. its likely ability to repay its debt, which is ranked by the rating agencies in terms of its rating metrics - South Africa is already in the speculative, not investment grade category from S&P.

- In May 2019, S&P said it had "revised our general government deficit projection to 4.5% of GDP for fiscal 2019/2020 ending March 2020, and 4.2% on average for 2019-2022." It will now need to revise these projections further for this year, and the next few, supporting at least the institution of negative outlook(s).

- It also previously said in May "(w)e estimate that the annual change in net general government debt (which reflects the government's net funding requirements), will average 4.7% of GDP per year over 2019-2022. We therefore now expect debt stabilization to be more gradual than we had previously forecast."

- Additionally, at that time it highlighted that "(w)e project that government debt (net of liquid assets) will increase to around 56% of GDP in the fiscal year ending March 2023 and that debt-servicing costs, measured by the ratio of interest to revenues, will increase to just above 13% of revenues."

- Furthermore, "(w)hile the government breached its self-imposed expenditure ceiling in 2019/2020, we expect it will keep trying to limit slippage. There may also be some slight revenue upside tied to improving economic growth in 2020-2022." All of the agency's views on SA's fiscal condition in May will now need to be revised.

- The deteriorated fiscal position, and projected government finances metrics in the 2019 MTBPS (which occurred in October) versus the 2019 Budget (which took place in February) all clearly argue for some action from S&P, if only on the outlooks of the credit ratings.

- A negative outlook(s) on the sovereign's debt rating(s) indicates that the rating(s) will be downgraded within a period (potentially around eighteen months) if the outlook(s) does(do) not return to stable. S&P will likely outline tonight, after markets have closed, what these criteria will be that would enable a stable outlook.

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	Ba1	BB
Ghana	B	B3	B
Botswana	A-	A2	NR
Mozambique	SD	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

- Should SA fall to a lower sub-investment grade rating(s) from S&P – that is drop down the scale from BB+ to BB on its local currency long-term debt rating, and from BB to BB- on its foreign long-term debt currency rating, it will drop lower in the speculative category, that is the double B rankings.

- While the speculative category is not outright 'junk', or the substantial risk of the C grade categories, speculative grade increases market volatility for South Africa's financial indicators somewhat, particularly lower rankings of speculative grade such as BB and BB-. The single B category is highly speculative.

- In particular, such a ratings deterioration would likely cause significant currency, bond yield and a number of other financial indicators' volatility when global financial markets switch between risk on and risk off sentiment and vice versa (a lowering or rise in risk aversion).

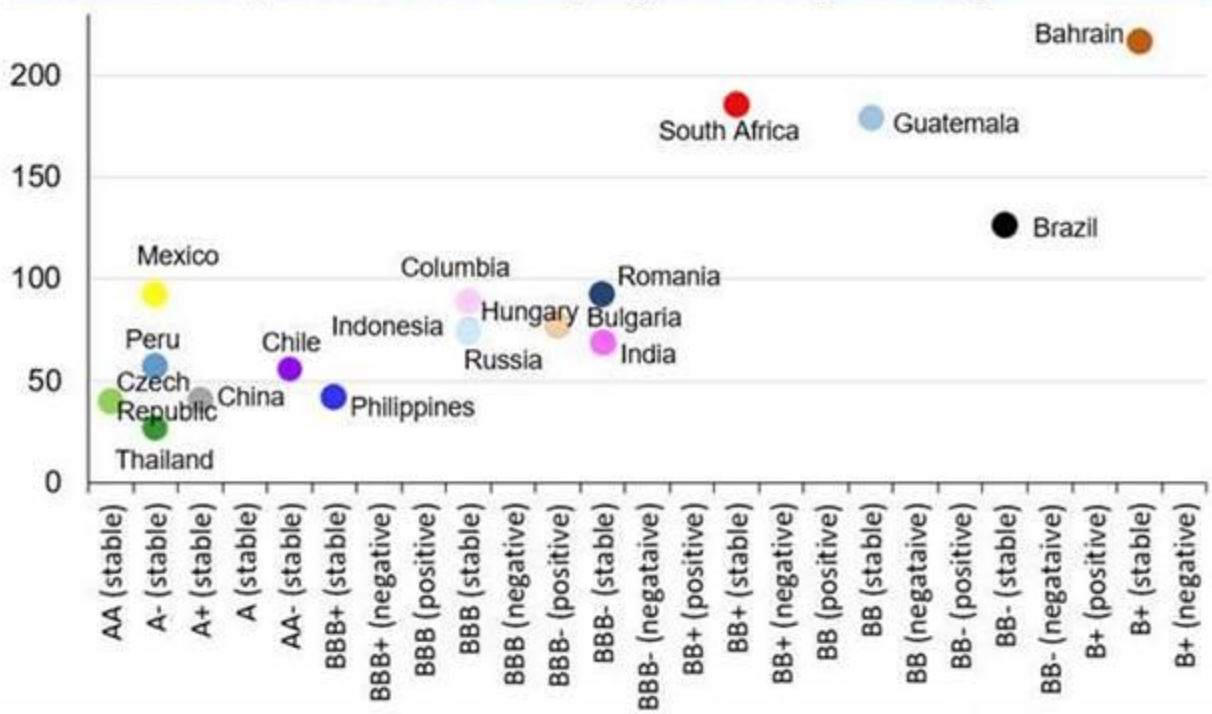
- A uniform sub-investment (speculative) grade sovereign long-term credit rating profile for South Africa from the three key agencies has largely been priced into SA's financial indicators, as reflected by the CDS (credit default swaps), but a continued decline down through the credit ratings has not been.

- Losing its current credit ratings from S&P and receiving lower quality ratings would still be problematic for South Africa, as it would definitely place some upwards pressure on SA's borrowing costs, and so also make fiscal consolidation for SA more difficult, thereby increasing the likelihood of even further ratings downgrades.

- Higher borrowing costs, that is higher yields on government debt, reflect lower prices of SA government debt as rating downgrades negatively affect the perceived quality of sovereign debt (that is a sovereign's ability to repay its debt) and so the price purchasers are willing to pay.

- A vicious cycle can then ensure. SA's government has already borrowed money for current expenditure, which includes civil servants remuneration and the interest costs on servicing its debt, exacerbating the risk of a debt trap crisis.

Credit Default Swaps and S&P local currency long-term sovereign debt ratings



Source: Bloomberg

- Consequently, National Treasury is aiming for a primary balance (revenue equating non-interest expenditure) during the Medium-Term Expenditure Period (MTEF) by 2022/23, and indeed 2021/22 would already provide evidence of whether this fiscal target can be achieved, with fiscal performance over 2020/21 also key.

- The 2019 MTBPS also therefore proposes “a fiscal target: a main budget primary balance, excluding financial support for Eskom, by 2022/23. This will require reductions to wage bill growth. Tax measures are also being considered.”

- “Spending reductions amounting to R49.5 billion over the next two years have been identified, and noninterest expenditure growth is limited to CPI inflation in the outer year. Nevertheless, total spending increases in the current year and in 2020/21, mainly due to financial support for Eskom.”

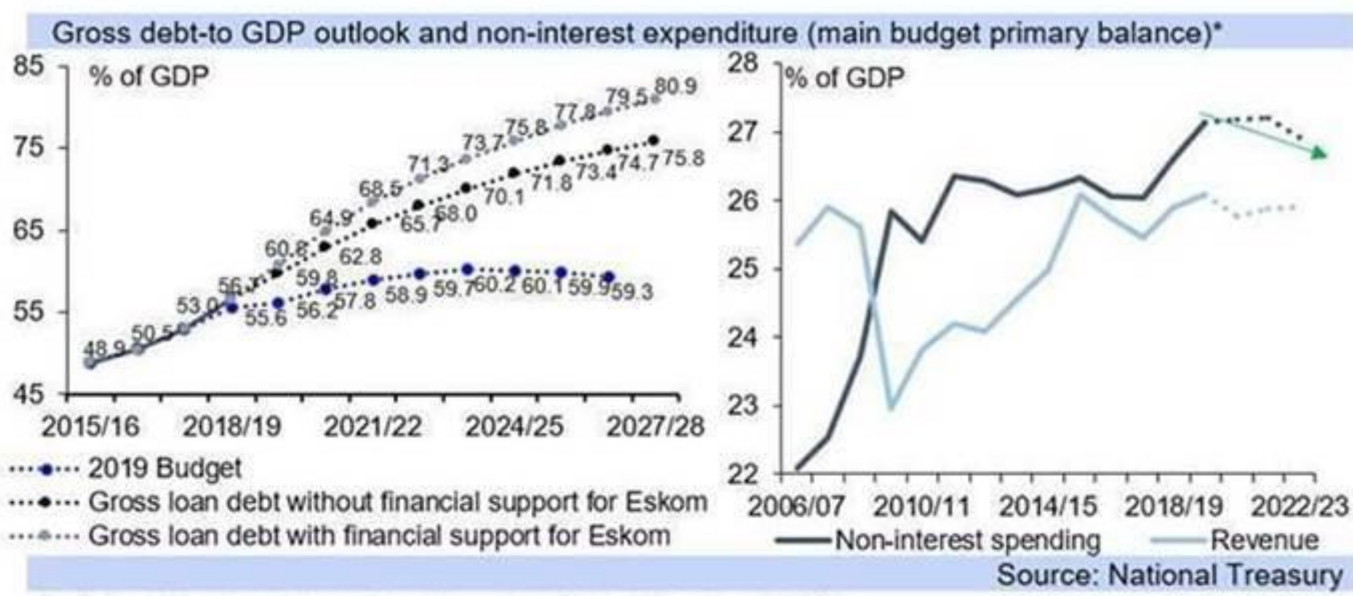
- The MTBPS aims “(t)o stabilise the debt-to-GDP ratio over the coming decade, large additional measures are needed. … (to achieve the MTBPS projections)… (r)elative to the 2019 Budget, … (of the) … main budget non-interest spending increase(ing) by R23 billion in 2020/21 and decreases by R8.2 billion in 2021/22.”

- Furthermore, “(s)pending additions include financial support for Eskom and the reversal of estimated savings from compensation measures and the reorganisation of government, which were announced in the 2019 Budget.”

- Fiscal restraint is key, with expenditure cuts necessary as “following several years of tax increases, revenue options are constrained.” The tax-to-GDP ratio is close to its 2007/08 peak of 26.4 per cent, while the tax buoyancy ratio is not projected at a robust ratio in the MTEF.

- The MTBPS also said “(t)he 2019 Budget included R10 billion in tax increases for 2020/21. The tax policy measures to raise this amount will be announced in the 2020 Budget.” We expect failure to adjust for bracket creep will account for the majority of this collection, with possibly a top marginal tax rate increase.

- Clawing “back some of the revenue shortfall through reductions to departmental baselines and slower spending growth in the outer year of the medium-term expenditure framework (MTEF)” is projected. But the MTBPS calculates that “(a)lone, these reductions are insufficient.”



*Excluding Eskom financial support and transactions in financial assets and liabilities

- S&P noted in May already this year that “government's debt burden is sizable and contingent liabilities are substantial”, and that “contingent liabilities as sizable. This reflects the increased risk that South Africa's large nonfinancial public enterprises (NFPEs) sector”.

- It was concerned then that “Eskom in particular, could require further extraordinary government support than currently provisioned. In addition, plans to improve the underlying financial position of Eskom and other NFPEs with weak balance sheets may only deliver results over time.”

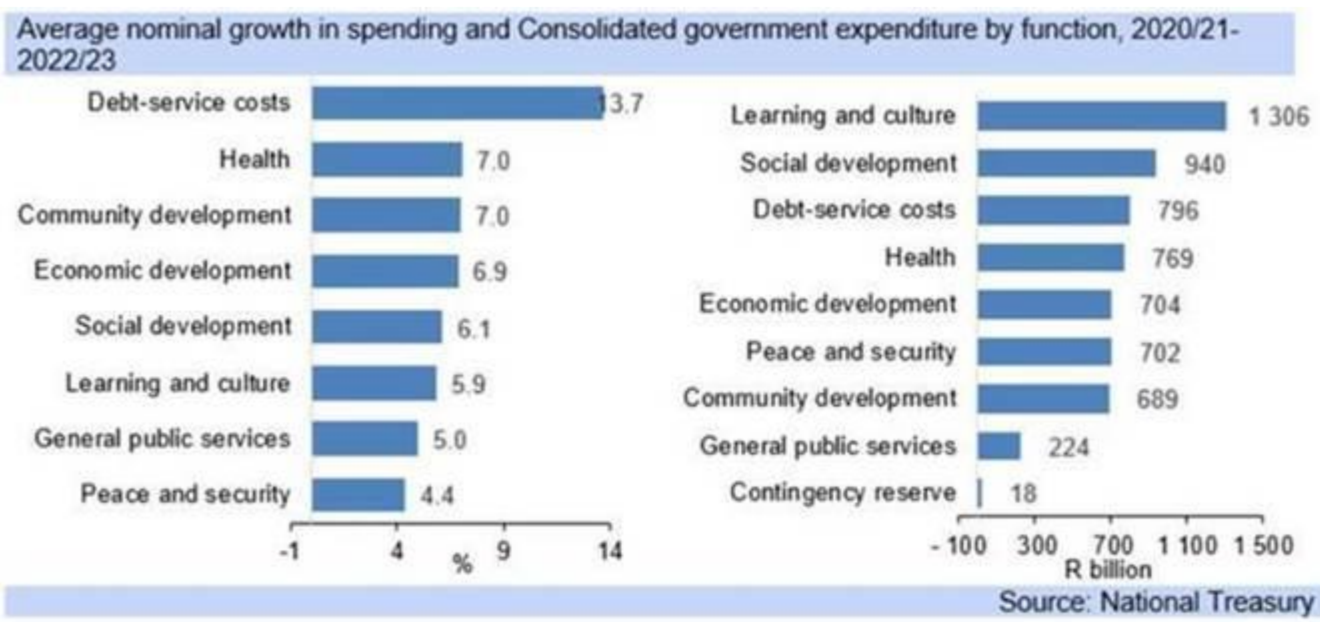
- Furthermore, it “estimate(s) overall public-sector net debt at around 75% of GDP in 2019, including the debt of central and local governments and of public sector companies.” “Eskom's financial issues and mismanagement have long weighed on the government and escalated further this year”.

- This was exacerbated by “extended power cuts and the need for further liquidity support. In the 2019/2020 budget the government announced a support package for Eskom of about South African rand 23 billion annually over three years, equivalent to about 0.4% of estimated GDP in 2019.”

- With little tangible on the Eskom debt and security of electricity supply front to allay the rating agency’s concerns, other than Eskom now only receiving loans going forward instead of bailouts it was essentially treating as income, S&P will remain concerned on this front.

- S&P was already alarmed in May this year that “(f)rom 2019/2020 onward, continued slow revenue growth tied to low GDP growth, significant spending on wages , and financial support for Eskom and other state-owned-enterprises will remain the main constraints to fiscal consolidation.”

- Furthermore, “(w)e view contingent liabilities as sizable. This reflects the increased risk that South Africa's large nonfinancial public enterprises (NFPEs) sector, and Eskom in particular, could require further extraordinary government support than currently provisioned.“



- "In addition, plans to improve the underlying financial position of Eskom and other NFPEs with weak balance sheets may only deliver results over time. We estimate overall public-sector net debt at around 75% of GDP in 2019, including the debt of central and local governments and of public sector companies."

- S&P has said "(e)lectricity shortages in the first quarter of the year as a consequence of operational issues in the power-parastatal Eskom, alongside weakness in mining and manufacturing, dented performance in most sectors and will weigh on growth."

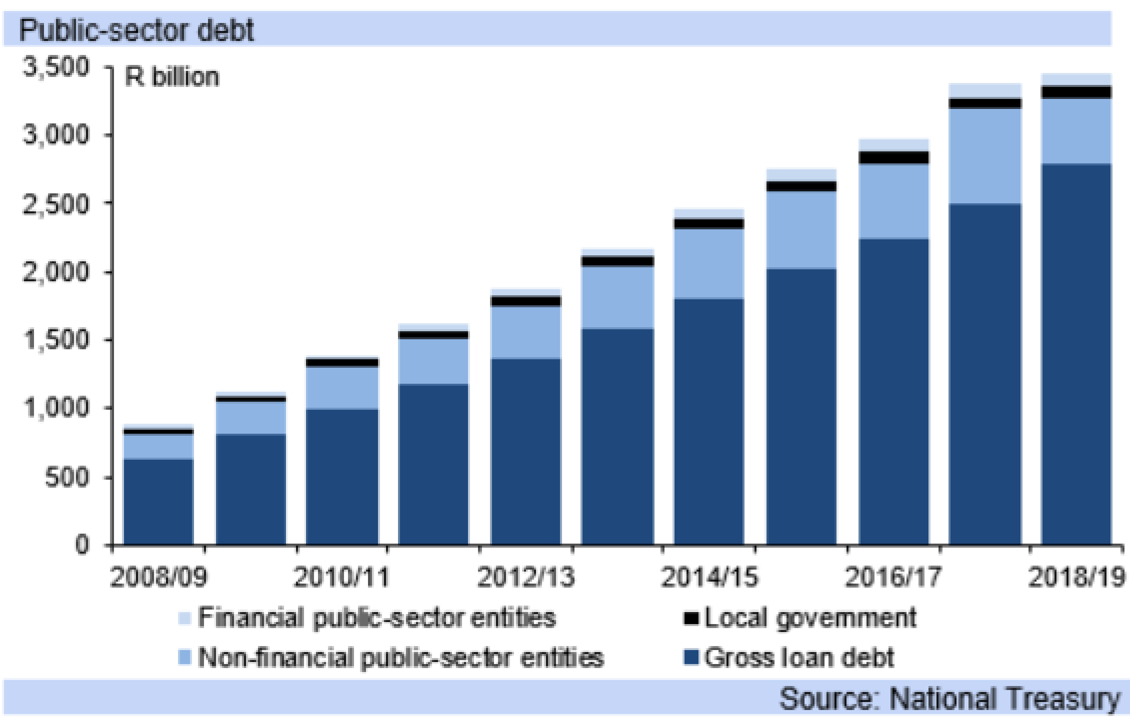
- "We have revised down our forecast for 2019 to 1.0%. However, we anticipate that the implementation of reforms in 2019 should boost investment and growth slightly. As such, we expect the economy to recover slowly in the medium term and average 1.9% over 2020-2022."

- "Nevertheless, this is still close to 0% on a per capita basis. S&P also evinces concern that "South Africa .. still fac(es) significant unaddressed challenges related to high levels of poverty, unemployment, and economic inequality".

- "We estimate South Africa's GDP per capita at close to US$6,200 in 2019, down from US$6,400 in 2018." South Africa performs poorly against its rated peers on a GDP per capita front, which is also an important metric into its rating assessment.

- S&P has flagged that "(d)espite unemployment remaining very high, at an estimated 27%, the public sector received an above-inflation pay hike last year, while heavy unionization in key sectors such as mining creates an insider-outsider labor market that is inflexible and further constrains GDP growth."

- On the positive front S&P does recognise that "South Africa's government debt is overwhelmingly denominated in rand, with only about 12% denominated in foreign currency. This shields the government debt from exchange-rate shocks."



- “(N)onresidents hold 39% of the government's rand-denominated debt as of April 2019, down from 43% a year ago. While the large presence of international investors in South Africa's debt markets helps improve liquidity and can lower the government's cost of funding”.

- However, “it also means the economy is vulnerable to global emerging market sentiment and global interest rate movements.” Indeed, during global financial market risk-off, the negative impact on the country’s currency, bond yields, short-term money market rates and other indicators can be quite pronounced.

- “While the current account deficit is relatively small by historical standards, its financing remains vulnerable to changes in investor sentiment … predominantly funded through volatile portfolio and other investment inflows … (which) can be susceptible to changes in foreign investor sentiment and emerging market appetite.”

- “(G)ross external financing needs are large, at 109% of current account receipts plus usable reserves in 2019, and we expect it to remain high through 2022. The sizable external financing needs partially reflect the short-term external debt of the financial sector--predominantly trade finance facilities and deposits from multinational companies. “

- Globally, the current environment risk aversion levels are not elevated as they were in 2018, with some notable periods of risk on this year. In risk on, the market impact of rating or outlook downgrades is likely more muted than in risk-off. Sentiment in global financial markets has a material impact on the outcome.

- Another noted S&P positive is that “the financial sector is largely profitable and well capitalized, although small banks have recently been hit by governance issues. Banks continue to rely on concentrated short- and medium-term wholesale funding from nonbank financial institutions, since retail savings are low.”

- Our expected case is for S&P to drop the outlook on SA’s sovereign credit rating(s) to negative, but not downgrade SA’s credit rating(s) this year. Next year, much will depend on whether the agency believes that government can achieve the repair proposed in the 2019 MTBPS, with the 2019 Budget key in this regard.

Economic Scenarios: - note updated table

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Extreme	Rand/USD (average)	14.01	14.38	14.69	11.50	10.30	9.50	8.60	7.90
Up case	Repo rate (end rate)	6.75	6.75	6.50	6.00	6.00	5.75	5.75	5.50

1% 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%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.01	14.38	14.69	13.00	11.50	10.00	9.95	9.90
	Repo rate (end rate)	6.75	6.75	6.50	6.25	6.25	6.25	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, Trump protectionism reduce significantly. Stabilisation of credit ratings, with ultimately credit rating upgrades.

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Base	Rand/USD (average)	14.01	14.38	14.69	14.65	14.15	14.45	14.65	14.00
case	Repo rate (end rate)	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.50

40% Annual growth approaches 2.0% y/y by 2021. 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 land, labour tenets land and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy.

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Lite	Rand/USD (average)	14.01	14.38	14.69	15.80	16.50	16.30	15.50	15.15
(domestic)	Repo rate (end rate)	6.75	6.75	6.50	6.75	7.25	7.25	7.25	7.25

Down case 37%

SA is rated sub-investment grade by Moody's but substantial repair avoids further marked downgrades. Business confidence depressed, marked 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 limited impact on economy.

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Severe	Rand/USD (average)	14.01	14.38	14.69	16.10	18.50	19.50	20.00	19.25
down	Repo rate (end rate)	6.75	6.75	6.50	7.00	7.75	8.50	9.25	10.00

case 15%

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. SA rated sub-investment grade from all three key agencies, with further rating downgrades. A significantly more severe recession occurs in SA than in the lite down case, marked rand weakness, eventually widespread services load shedding and strike action. Expropriation of private sector property (title deeds not transferred to individuals' and so nationalisation) without compensation – severe negative impact on economy.

Note: Event risk begins Q4.19. Source: Investec, Iress historical data