Sanlam

Economic Overview for Business Owners

September 2016

Does South Africa deserve junk status?

South Africa's sovereign debt rating is firmly back in focus in the lead-up to the Medium Term Budget Policy Statement, due to be read on 26th October 2016. Concern over this is justified. All else equal, sovereign debt rating downgrades imply higher borrowing costs for all domestic borrowers. This includes state-owned enterprises, which increases the cost of providing infrastructure and raises service tariffs.

In June this year Standard and Poor's (S&P) credit rating agency affirmed South Africa's long-term foreign currency bond rating at BBB- (one notch above junk status) and its long-term local currency bond rating at BBB+ (three notches above junk status) and maintained its negative outlook on the rating. The latter is an indication that the agency expects to downgrade the rating, unless measures to ensure a decisive shift towards long-term fiscal sustainability are implemented. This would include improving the governance and financial performance of state-owned enterprises (SOEs), given the considerable guarantees extended by the central government on SOE debt. Meanwhile, S&P is expected to review the country's rating in December 2016, although it may conclude the review earlier.

Rating agencies look at a number of variables to determine a sovereign debt rating. Of these the potential GDP growth of the economy, trends in per capita income, the country's external balance (notably the current account balance), the level of external debt, the fiscal balance and changes in the domestic debt ratio appear to be especially important. Further, an economy's development status is considered. Relatively more developed economies, typically those with high per capita income levels, tend to have stronger ratings. In addition, institutional strength (including sound rule of law and protection of investor rights) contributes positively to ratings decisions. Finally, it is also helpful if there is no history of default.

This is a fairly extensive list and different rating agencies ostensibly place different weights on each factor. But a cursory glance at the mean levels of a number of these factors, across a range of countries, suggests that South Africa is, indeed, at risk of being assigned a sub-investment grade rating. Our GDP per capita level is declining, potential growth is low, we have been running a relatively large current account deficit, the government's Main Budget deficit remains wide, policy uncertainty has escalated over the past year and the economy does not count amongst the most developed economies.

However, the rating agencies have not downgraded South Africa's debt to junk (at least not yet). In my view, this, to a large extent, reflects the strength of institutions such as the National Treasury and the South African Reserve Bank.

The Treasury has built a solid track record in recent years of sticking to its expenditure ceiling (although expenditure has been rising relative to GDP, given the underperformance of the economy). Moreover, its intent and willingness to stabilise the debt ratio and return government's finances to long-term sustainability are clearly illustrated in the actual and projected decline over the next three years in the primary budget deficit.

2/…

On its own, the determination of the Treasury is insufficient to sustain the sovereign debt rating in investment grade territory. But there is some potentially good news. The current account deficit shrank from 5.3 per cent of GDP in 1Q16, to 3.1 per cent of GDP in 2Q16. Moreover, the advance in real GDP recovered from an outright fall of 1.2 per cent annualised in 1Q16, to an increase of 3.3 per cent annualised in 2Q16. GDP growth is unlikely to sustain this pace in 3Q16, but given the nascent increase in South Africa's terms of trade, the better trade data and the possibility of an improved *relative* performance from agricultural production, a recovery in real economic activity, albeit tepid, appears to be on the cards by 2017. Moreover, inflation is expected to peak in late 2016, before slowing through next year. This augurs well for the short-term interest rate outlook. Maybe, just maybe, this helps South Africa stave off the drop to junk status.

But here's the thing, even if South Africa's foreign currency debt is downgraded to junk, Credit Default Swap (CDS) spreads indicate in mid-September 2016 the market had already priced in sub-investment grade status broadly in line with countries such as Brazil, Turkey and Russia. Of course, unanticipated events, for example more aggressive tightening by the US Federal Reserve than currently expected or heightened domestic economic policy uncertainty, could change the outlook. Also, one assumes that the policy response will be appropriate should a downgrade occur, failing which further downgrades may be priced in. But this is not predictable.

The point is that South Africa is already paying for the expectation of junk status. Borrowing costs are already higher than they would have been. And, arguably, the Rand is weaker than it would have been (implying the same goes for inflation and implicitly, short-term interest rates). This leaves the possibility of a pleasant surprise should the confluence of relatively better news noted above be sustained, thus preventing what appears to be inevitable. Here's hoping that is the case.

Written by Arthur Kamp, Investment Economist, Sanlam Investment Management