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South Africa's credit downgrade by Moody's

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On the evening of Friday the 27th, Moody's lowered South Africa's country credit rating to sub-investment grade (commonly referred to as "junk") and maintained a negative outlook.

The rating agency cited a deterioration in SA's fiscal strength and "structurally very weak growth" for its decision. It now estimates that SA's debt burden will reach 91% of GDP in the 2023 fiscal year. Moody's also observed that progress on structural reforms had been limited and the restoration of full capacity to SA's electricity system will take "some years to complete," which contributed to its decision.

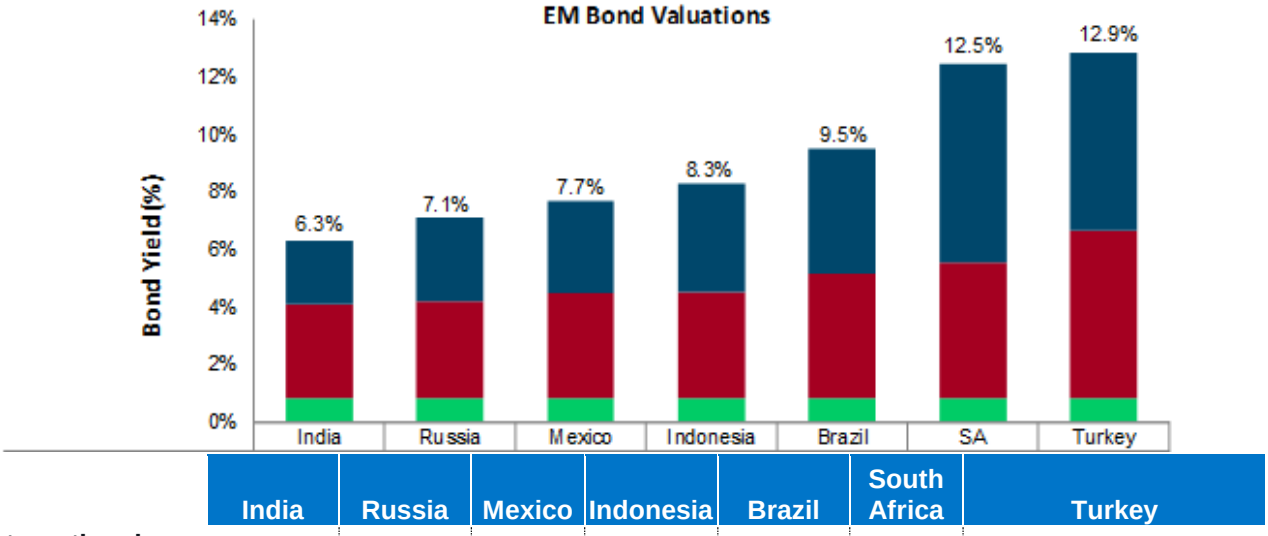
Ahead of the decision, Moody's had been the only major rating agency to maintain an investment grade rating. Fitch and S&P both downgraded SA's rating to sub-investment grade in 2017.

As a result of this downgrade, South African government bonds will automatically be excluded from the major FTSE World Government Bond Index (the "WGBI"). South Africa's current weighting in the WGBI is 4.43%. This means that the government bond market will probably experience further capital outflows, as funds whose mandates require them to hold only investment grade bonds will be forced to sell South African government bonds. It is difficult to know for certain what the magnitude of such forced redemptions will be, but estimates range from about $2.8 billion to as high as $11 billion.

Importantly, however, FTSE Russel, which administers the WGBI, has postponed the official removal of South Africa from the index for at least a month. This is due to the unusual problems with liquidity in the fixed income market and increased volatility due to the economic and humanitarian crisis brought about by the COVID-19 virus. FTSE Russel reported that South Africa would therefore remain in the WGBI, even in the event of a downgrade by Moody's, until the end of April.

The South African government has reacted with great concern. Treasury, in a statement, said the downgrade would add to the prevailing financial market stress as the country battles to contain the spread of the coronavirus and expected interest rates to increase as a result. In fact, Finance Minister Tito Mboweni has even voiced the possibility of South Africa approaching the International Monetary Fund and the World Bank to help with funding to deal with South Africa's current economic crisis.

While it was not unreasonable, in the circumstances, to have expected Moody's to delay its rating review at the current time, South Africa's deteriorating fiscal position and structural and power-generation challenges have been well-known for many years. This has led many market participants to surmise that most, if not all, of the negative consequences of an eventual downgrade had already been priced into South Africa's bond yields long before Moody's decision on Friday. The chart below, drawn last week before Moody's announcement, illustrates the point, demonstrating the very high yield of South African 10-year government bonds (12.5%) last week, and how it compared to other countries, indicating a similar or higher yield than countries with a sub-investment grade rating.



	India	Russia	Mexico	Indonesia	Brazil	South Africa	Turkey
International Rating - Foreign Currency	BBB-	BBB-	BBB+	BBB	BB-	BB	B+

Source: Prescient Investment Management ("Prescient"), March 2020

With all this in mind, we have canvassed some of our highly-rated fixed income managers for their view, which we discuss below.

Prescient

Fixed Income market conditions before the downgrade

Prescient observed that, in the weeks leading up to the downgrade, there had been unprecedented illiquidity in the fixed income markets, as global markets tumbled and as investors rushed for cash. Credit markets stopped trading largely and the RSA bond market bore the brunt of the selloff in fixed income assets given their better liquidity. The net result was that RSA yields spiked, with long-dated bonds trading above 13%, or inflation plus c. 8.5%. Even in an outlier scenario of future inflation of 7.5%, the yields would be inflation plus c. 5.5%.Inflation linked bond yields also rose to above inflation plus c. 6%.

In the meantime, the interest on cash is about 5%, and so the difference between the short end of the duration curve (bonds that will mature immediately) and the long end of the duration curve (bonds that will mature in 10 years or more) is extremely large, or in fixed income parlance, the fixed income yield curve is extremely steep.

The likely outcome of the downgrade

The bottom-line is that the downgrade will mean a higher cost of capital for South Africa (investors demand a higher interest rate to lend to a more risky entity). Yields have been driven to these abnormal levels because of the extreme events in the markets and because of all the issues around liquidity locally. Since South Africa will likely be excluded from the WGBI 1 May, this creates significant uncertainty about potential flows in the month of April. Therefore in the short term, volatility and higher rates are possible. However, this does not necessarily mean higher yields permanently from here.

For Prescient, it is more important to look at valuations and risk:

- In an inflation environment of 6% or below, regardless of volatility and possible higher yields in the short term, buying longer-dated bonds at these levels and locking in these high yields above inflation will provide a great investment return over the term of the bond, just as real returns (returns above inflation) on cash approach zero.

- If an investor is concerned that all these events will lead to a weaker currency and higher inflation, inflation linked bonds provide certainty of real returns, risk-free, if held to maturity (it is important to note here that the price of inflation liked bonds will still move over time in reaction to market movements, but if held to maturity will provide the real return stipulated).

- In a scenario where ultimately market panic recedes somewhat and there is progress with the COVID-19 virus, bond yields could drop extremely quickly (within days). The opportunity to lock in high yields for the long term will then be gone. South Africa cannot afford long term real rates of this type of yield and an extremely steep yield curve indefinitely. They are unsustainable. Either the economy weakens even further, inflation goes up with a weak currency, and the real rate reduces, or there will be changes brought about externally (e.g. by the IMF) or internally by government, to loosen monetary policy (QE), reduce debt, stimulate the economy and therefore force yields down

Positioning of Portfolios

For Prescient, the obvious answer is to buy inflation linked bonds at inflation + c. 6%, as this is the return required to fund one's pension fund risk-free (unless the doomsday scenario eventuates of South Africa ultimately defaulting on bond payments). However, for a fund that has a benchmark-cognizant mandate and therefore must hold the majority of its assets in nominal bonds, a combination of some ILBs and long-dated nominal bonds is sensible.

Risks and Opportunities

In Prescient's view, the fundamentals of our economy do not justify a c. 13% yield on our long-dated bonds when the US's 10 year yield is under 1%. The illiquidity and panic in the markets have driven this. When liquidity returns globally and the search for yield resumes, yields are likely to be a lot lower - even with the junk rating.

More immediately, credit risk is significant. In Prescient's assessment, credit yields have yet to be priced correctly, given the illiquidity in the market. In the longer term, rising debt and South Africa's fiscal situation is clearly a great risk. Eventually appropriate reforms must be enacted, or the currency will fall, and inflation rise.

Policy Response

The Reserve Bank is engaging in QE action and support for the banking system, albeit slowly. The insurance industry and asset management industries require stability and liquidity to operate effectively. Prescient would hope that Monetary and Fiscal support is forthcoming and that active QE polices seen in the developed world would be applied here too. Illiquidity risk translates to solvency risk, if not addressed. So far there does not appear to be a solvency issue, but corporate and state entities will require funding facilities to operate in these times.

Sanlam Investment Management (SIM)

Fixed Income market conditions before the downgrade

The budget which the finance minister delivered on 26 February was relatively well received, with the bonds rallying on the day of the speech. The sell-off which followed in the first few days after the budget presentation was because the market realised that there was significant implementation risk associated with limiting the increase on the wage bill, but that the government had come to this realisation was an important first step in correcting the budget.

At the beginning of March, we started to witness increasing cases of Covid-19 infections outside of a few hotspots of Wuhan, South Korea, Italy and Iran. Stock markets started to fall as more and more isolationist measures were adopted in country after country. As the crisis spread and financial markets reacted by indiscriminately selling risky assets, Emerging Market bonds experienced massive redemptions. Emerging Portfolio Fund Research (EPFR), which tracks fund flows into EM portfolios, reported that the four weeks to the 18th of March had experienced a total of $30.7 billion of outflows. This was the largest outflows on record for a four-week period.

Therefore, in large part, the spike in yields was driven by selling of bonds to meet client redemptions. This was exacerbated by the lack of buyers domestically - the support for the bond market from local investors has not been what one would have expected, as many local market participants have also sold bonds. The result has been the credit market experiencing a liquidity crunch and the yields of government bonds spiking even higher.

The likely outcome of the downgrade

On a probability-weighted basis, SIM views the likely outcome of the downgrade in the immediate, near and medium-to-long term as follows:

	Base Case (55%)	Bull Case (20%)	Bear case (25%)
Near term	Yield up modestly 10-yr @ 12.25%	Yield unchanged 10-yr @ 11.60%	Re-test recent high 10-yr @ 13.25%
Medium to Long term	10-yr @ 10.25%	10-yr @ 9.50%	10-yr @ 13.25%
Shape of the curve	Curve flattens	Curve flattens	Curve flattens
Major assumption Short term	Liquidity remains scarce USD/ZAR 18.3	Liquidity remains scarce USD/ZAR 17.75	Liquidity remains scarce USD/ZAR 19
Major assumption Long-term	CPI averages 5.25%	CPI averages 4.5%	CPI averages 5.25%

As with the other managers that we have engaged with post the downgrade, while yields may move higher in the short term, SIM assigns greater probabilities to a reduction in yield over the medium- to long term.

Positioning of portfolios

As of Friday, the duration of the various bond mandates managed by SIM was slightly greater than the All Bond Index (ALBI), i.e. the bonds had a slightly higher maturity overall. This was driven by SIM's analysis that the current 10-yr yield of 11.66% is higher than their assessment of long-term fair value. SIM plans to add duration, but at a slow, measured

pace, as yields move higher in the short term. This will be dependent on being able to create liquidity by selling shorter-dated credits.

Risks and opportunities

SIM views the major risk to their fairly optimistic view to be that the lockdown in South Africa is extended for several months and the economy contracts by more than 3%.

In addition, they are of the view that South Africa needs to undertake structural reforms as quickly as possible and table a new budget, which takes into account a global recession and difficulties of financing large deficits.

They also consider there to be a risk that credit spreads widen by about 50 basis points, but they do not expect the domestic credit market to function efficiently and for credit spreads to widen appropriately for some time, as liquidity remains a challenge. However, they note that the credit bonds of South African companies that have issued bonds offshore, for example in dollars, have re-priced and these credit spreads have widened significantly. SIM considers this to be an excellent investment opportunity.

Policy response

Structural reform to repair South Africa's debt and fiscal problems remains an urgent requirement, but has been slow in being implemented by government. The ability for Treasury to support the economy is limited, but SIM expects the Reserve Bank will cut rates and be prepared to look through possible inflationary effects to achieve monetary stimulation.

Terebinth Capital (Terebinth)

Fixed Income market conditions before the downgrade

The local fixed income market has been trading in a fairly well-defined range for the better part of 3 years, with the ALBI's yield varying from c. 8% to 10% over this period.

The reason for this 'steady' state of affairs could mainly be ascribed to foreign portfolio support as the fiscal situation in South Africa continued to deteriorate. Barring a brief period in 2018, termed "Ramaphoria" at the time, bond issuance in South Africa has been placing pressure on the yield curve (as creating a greater supply of bonds, by issuance, means that to balance this supply with demand, the yield has to remain attractively high).

The first 8 weeks of 2020, from a local fixed income perspective, could actually be described as a positive period for this market, including a surprise Monetary Policy Committee interest rate reduction, a market-friendly State of the Nation address, culminating in a surprisingly innovate National Budget tabled on 27 February 2020. At this stage the local reaction to the Covid-19 crisis was not evident in the local market yet, with bond yields actually rallying sharply into the Budget, while they also 'only' experienced an 8% drawdown, this despite a 16% drawdown for the S&P 500 into month-end.

With the Budget positively surprising in the sense that no increases in taxes were announced, no increase in issuance and a plan announced to consolidate the deficit, assumptions grew that a rating downgrade in March might be averted. Liquidity in the market during this phase was as per normal, with valuations only slightly below fair value (but an improving fiscal plan announced perhaps explaining the strength).

However, following the inception of the COVID-19 crisis, we have seen a collapse in the yield curve, most likely driven by indiscriminate selling to meet redemptions during one of the most severe periods for liquidity seen in the local market.

The reason for the 450 basis point sell-off in long bonds (the R2037 traded from a best level of 9.59% on the last day of February to a worst level of 14.08% on 24 March) can be attributed to various factors laid out below:

- Month-end rebalancing as China entered the GBI-EM index and South Africa downsized at the same time;
- Various global investment funds selling out of global bonds due to stop-losses being triggered in early March;
- Risk systems in global hedge funds forcing indiscriminate selling;
- Possibly banks closing their proprietary (on-balance sheet) trading desks and cutting positions indiscriminately;
- The regulatory burden of banks having to hold capital leading to a cash squeeze and finding the environment extremely challenging in providing liquidity as Primary Dealers in an environment of massive selling and little buying of bonds;
- An extremely high volume of selling by investors generally at the very moment that all the above factors were in effect; and
- A general dry-up of cash in the system as a result of the use of derivatives (futures) to achieve bond exposure, resulting in further selling.

The likely outcome of the downgrade

In Terebinth's analysis, there is a 50% probability that the immediate reaction to the downgrade will be weaker currency, bonds and equities. It can be expected that the SARB will introduce liquidity into the market on various fronts, which could settle markets during the day/week.

Terebinth considers there to be a 25% probability that the selling of bonds accelerates, with foreigners not waiting for the 30 April WGBI exit deadline. Under this scenario, yields and the rand trade to fresh low levels, with local equities risking a further 20% downside. Given foreign holdings are relatively concentrated in duration holdings, the curve would steepen again.

Finally, there is a 25% probability that the worst is behind us already, given that the market has anticipated a downgrade for close to two years. In this instance, barring a small overnight reaction, bonds may stabilise (especially if the SARB supports the market), while the rand may strengthen from an undervalued rate.

Positioning of portfolios

Terebinth has reduced exposure to credit and property over the past year and added offshore exposure both to the US Treasury market as well as direct FX hedges. They also sold their positions in inflation-linked bonds during the recent rally as they are particularly negative on the outlook for the ILB market.

They continue to counterbalance credit risks through active portfolio management strategies, while anticipating lower interest rates, and navigating very trying markets and liquidity conditions.

Risks and opportunities

Terebinth assigns as their base case a 50% probability that there is a global recession and South Africa enters a deep recession, with the lack of fiscal levers forcing the fiscal deficit wider and higher debt to GDP. National Treasury ("NT") will have to increase bond issuance dramatically. NT is already very well aware of the importance to reduce yields at the long of the yield curve. Unfortunately, their biggest dilemma is in fact short-term liabilities which will mature soon. With a dollar bond maturing soon, and the SARB already committed to support the bond market, Terbinth expects yields to find some support in coming days, perhaps from higher than current levels.

Given the demand shock in the oil market, the SARB has ample room to lower interest rates. Terebinth has a long-held view that inflation will surprise materially to the downside and so they see no reason why the SARB should delay announcing lower interest rates, and therefore expect interest rates to drop to at least 4% in coming weeks. Terebinth's bear case, which they think has a probability of 25%, is in the context of the deepest recession since the 1930s, with global growth forecast to fall from 3.4% to -1%. In this environment, the risk is of a second global flair-up of the virus. The difference between 2008/09 and 2020 in terms of market impact is the pace and magnitude of response by authorities around the world to the crisis. It is therefore possible that the market may bottom out before the economy does. On the local front, presenting a bear scenario is easier and will likely revolve around the risk of another shut-down. The currency in particular will be at risk in this instance.

In the bull case, to which Terebinth ascribes a 25% probability, global stimulus of unprecedented proportions puts a floor under markets, reviving sentiment. Locally IMF emergency assistance, SARB bond buying, and local investor repatriation of funds and buying would then support markets. This would result in the currency stabilising, despite deep further interest rate cuts, and foreign and local investors purchasing bonds and equities, leading to a sharp recovery.

Policy response

Terebinth hopes that the SARB will understand the need to cut interest rates aggressively to manage a massive supply and demand imbalance, as well as the other effects of the COVID-19 virus shock.

Bond issuance is expected to increase from c. R7bn to at least R11bn in weeks to come, while South Africa will exit the WGBI at the end of April. In addition, the risk of further downgrades by S&P and Fitch looms large. The SARB might therefore be required to underwrite at least the next few months' bond auctions as well as the effects of the WGBI exit, in order to support the market and provide sufficient liquidity.

Given the economic impact of the COVID-19 virus on the South African economy, it is likely that South Africa will need to ask for support from the IMF or other International Finance Institutions.

Terebinth notes that eighty countries have so far approached the IMF for emergency funding. However, the biggest impediment to the IMF deploying the $1 trillion at its disposal is that in lending, it needs to ensure that the borrowing country's debt is sustainable. The IMF cannot lend to a country knowing that doing so would make its debt unsustainable. Given the mayhem in financial markets and the large increases in fiscal deficits and debt that are likely to ensue, it is unlikely that debt can be assessed to be sustainable for many countries where financing needs will be large - even with very benign assumptions (such as global interest rates remaining close to zero for an extended period). Thus, the IMF can likely only deploy a fraction of the $1tn without diluting its lending norms, which could easily call into question the institution's seniority among all creditors.

Coronation Fund Managers (Coronation)

Fixed Income market conditions before the downgrade

Bonds, next to cash and bank deposits, are the most liquid portion of a portfolio. Therefore when cash is required, this is the natural source. Given the magnitude of the sell-off and in order to meet redemption requests and margin calls, investors have liquidated government bonds to meet these requirements. In addition, foreign selling, in anticipation of a deteriorating economic backdrop and a sell-off in global credit markets and general risk aversion, led to an acceleration in the liquidation of South African government bond positions. SA is one of the most liquid bond markets in the world and, as such, would be one of the first markets foreign investors would utilise in order to generate cash to meet margin calls and in anticipation of redemptions. This volume of indiscriminate selling led to a rise in SA bond yields and steepening of the yield curve.

Locally, in expectation of the slowdown in growth as a result of the COVID-19 virus crisis, banks have held back cash in order to support their corporate client base through a period where very many of them will struggle to meet their funding and operational requirements. This entails withdrawing liquidity from the interbank funding market, which hence puts pressure on funding rates for bond positions. Banks are the major intermediaries in the bond market and, with short-term funding rates increasing, it reduces their ability to operate as market makers, leading to widening in bid/offer spreads and the dysfunctional behaviour that we saw in the bond market in the previous week.

The South African Reserve Bank (SARB) reacted initially by cutting rates, but then a few days later by injecting liquidity into the local market through allowing term (up to 1y) funding of bond positions at rates marginally above the repo rate, buying domestic government bonds in the bond market to support the functioning of the bond market and reducing capital requirements for banks so that they maintain high levels of liquidity through the crisis.
Yields reduced slightly after the Reserve Bank action, and are less elevated than at the peak of the crisis.

The likely outcome of the downgrade

For the bear case to materialise, one would need to see a complete breakdown in market liquidity and volatility for yields to remain heightened for an extended period of time. In these trying times, it is very likely that these materialise in the very short term, but current measures put in place by the SARB allows them to take steps to ease the pressures over the medium to long term.

The bullish case would materialise if the number of infections from the COVID-19 virus levels out more quickly, a vaccine is found, or global market volatility starts to subside.

However, it is very difficult to attach probabilities to scenarios, given how fluid many of the input variables currently are, and by implication, it means trying to pinpoint market levels under these scenarios is a near-impossible task.

Nevertheless, Coronation's expectations are that over the shorter term, the rand will weaken by up to 5% and bond yields will rise anywhere from 50 - 100bp, due to the downgrade and current market conditions. However, one must be aware that foreign outflows accelerated to about R50bn this month and the downgrade was already expected before the crisis began. In addition, the FTSE has allowed any re-weighting changes to only occur at the end of April (as opposed to the end of March), which should provide some relief, although it will not stop selling pressure over April.

Valuations on South African government bonds are attractive, as they trade at yields double current cash rates (and probably even more in the near future as we expect the SARB to reduce rates further), are 10% above Developed Market bonds, and have been hit by a wave of selling that rivals that seen in the 2008/2009 Global Financial Crisis.

Coronation would therefore expect in the medium to longer term that yields settle at levels that are lower than current. With respect to the currency, the fall in the oil price has given South Africa a terms of trade boost and the rand is trading at significantly weaker than fair value. Coronation would expect the rand (depending on how global risk appetite evolves) to at worst remain unchanged over the longer term, if not have a slightly stronger bias.

Positioning of portfolios

Coronation currently views as very attractive a yield of 10.5% - 11.5% on 5 -10 year nominal bonds, and 5.5% - 6% on 5 - 10 year inflation-linked bonds. The credit bonds of South African companies that have issued bonds offshore, for example in dollars, has repriced significantly and one can therefore buy well-priced credit in offshore markets at spreads that are at multiples of the local market. Coronation views this as an attractive opportunity. However, given volatility and liquidity in the current market, Coronation is proceeding in a cautious manner when adding more nominal and inflation-linked South African government bonds and offshore credit to the portfolios.

Risks and opportunities

Coronation views the major risk in local markets to be a significant repricing in local credit. Given the level of repricing that we have seen in global credit markets, not only in global names but also in South African names that trade in offshore markets, current levels of local credit spreads seem incorrect. There is a risk of a significant re-price in local credit spreads as redemptions come through and there is forced liquidation of local credit. Up until now, this has been confined to government bonds given their more liquid nature, but in the weeks or month to come, this is very likely to permeate through the local credit markets.

Coronation sees opportunities in government nominal and inflation-linked bonds. Although listed property has sold off massively, given the poor growth outlook and the risk of dividend suspension in this sector, they are being cautious and selective in purchasing property stocks.

Policy response

Low growth and the risk of corporate failures should weigh more on government's response as opposed to the downgrade. As such, Coronation believes the SARB will continue to reduce interest rates by 100 basis points over the next 6 - 9m, and has already announced tools to facilitate a more orderly functioning of bond markets and increase liquidity in the financial system.

Government is in a difficult position, given the current state of finances, and this latest growth downturn will mean that the deficit widens (in line with the rest of the world) to 9%. Thus far, assistance from the UIF to support SMEs and individuals through this period has been the only government pledge. It is also likely that there is increased spending by government post/during the COVID-19 outbreak to soften the growth downturn and foster a recovery.

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