PRESCIENT
INVESTMENT MANAGEMENT

SOUTH AFRICAN BOND MARKET WILL OVERCOME THE RATINGS DOWNGRADES

April 2020

Reza Ismail

Portfolio Manager
Fixed Interest Team

South African investors are still absorbing the twin blows of being downgraded by Moody’s into junk territory and, just four days later, the expected Fitch decision to take the South African sovereign debt rating down a further notch into junk territory.

Recently the Governor of the South African Reserve Bank, Lesetja Kganyago, cited the renown German economist, Rüdiger Dornbusch, in his famous economic observation:

“*In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could*.”

It is true that the domestic economy has experienced several body blows in the past few weeks but the impact of the ratings downgrades may not be as severe as expected, as discussed below.

But first it’s worth considering the domestic market context that prevailed when the decisions were taken.

Market reaction

After a series of reprieves over the past two years, Friday March 27, 2020 saw Moody’s become the last of the major credit rating agencies to confer sub-investment grade status to our sovereign government. In truth, the pronouncement was merely a formal confirmation of an event already factored into investor expectations. Security prices are forward-looking assessments, representing a discounted set of future expectations, and as such, financial markets had priced this outcome into bond prices for some time beforehand.

So, what then could have been the reason for Moody’s delaying this pronouncement for the better part of two years? Whilst we don’t presume to know the definitive reasons, we do offer some suggestions as to why notch moves by Moody’s are much more nuanced considerations than what is popularly assumed.

The first and obvious reason for a delay, was that some of the reform areas which were previously highlighted by Moody’s e.g. addressing chronically underperforming and indebted state-owned entities, are no quick-fixes, and needed a reasonable time frame in which to demonstrate purposeful action, or evidence of genuine intent on the part of government.

PRESCIENT INVESTMENT MANAGEMENT (PTY) LTD
Block B, Silverwood, Silverwood Lane, Steenberg Office Park, Tokai, 7945
P.O. Box 31142, Tokai 7966 Tel: +27-21-700 3600 Website: www.prescient.co.za
Executive Directors: Cheree Dyers (CEO) Herman Steyn Guy Toms
Non- Executive Directors: Thabo Dloti Varusha Daljee
Reg No. 1998/023640/07 FSP No. 612

Secondly, what is very under-appreciated is the extent to which Moody's manages sovereign credit ratings as a *cohort* system. That is, similarly, rated sovereign peers should have similar credit attributes. Often overlooked in the writings of gloom, are our pockets of excellence in the form of core institutions such as our central bank and judiciary. Additionally, our deep, liquid and sophisticated capital markets, and our largely rand-based, long-dated sovereign debt are very atypical for an emerging economy. Many of the other sovereigns hovering over junk-status do not have these attractive attributes.

With the exception of growth prospects, most assessment scores for South Africa were very close to (or even better) than what median sovereign scores were for our previous Baa3 category. The decision to place South Africa into Ba1 (the highest junk-rating cohort) also then had to take into account how South Africa would line-up relative to peers in that cohort - the delay could potentially have been because at least for a time, South Africa may have been considered too strong a credit for the Ba1 category relative to other sovereigns.

Moody's ultimately then downgraded SA's sovereign issuer credit rating to reflect "*downside risk to growth and fiscal metrics*", it preserved the negative outlook, which may have been less widely expected. Moody's sees the downside growth risks as "*both immediate and longer term*", given the impact of the coronavirus pandemic and "*persisting domestic impediments*", with "*social and political obstacles to reforms*".

Timing hurt SA

A statement by National Treasury echoed the sentiments of most South African market participants in that the downgrade could not have come at a worse time, albeit that the expectation thereof had long been baked into asset prices. With the entire financial globe grappling with the impact of COVID-19, perceived riskier asset classes such emerging market equities and debt have seen major "flight to safety" outflows.

Outflows from EM debt funds globally hit \$17bn in the seven days to March 25th 2020, according to data from EPFR Global, just a fraction below the prior week's record outflow of \$18.8bn. In the past month, emerging markets have seen a total of \$47.7bn withdrawn from the sector, equivalent to 10.2 percent of assets under management. The exodus has so far erased a third of the \$140bn of net inflows that EM bonds have seen in the past four years, according to Bank of America.

Immediate implications

Moody's is a standalone international credit rating agency, which provides assessments on the creditworthiness of a variety of entities, in addition to credit assessments of sovereigns.

This particular downgrade was consequential in that it triggers SA's exclusion from the FTSE World Government Bond Index (WGBI). South Africa was given somewhat of a reprieve, with the rebalancing of index set for the end of April 2020 (instead of March), given global financial market turmoil.

The FTSE World Government Bond Index (WGBI) is an influential global bond benchmark that tracks the local sovereign debt of 22 countries including South Africa. For a sovereign to be eligible for inclusion the local credit ratings assigned by both S&P and Moody's must be A- and A3 respectively (4 notches above sub-investment grade). A bond will be removed from the index when both of the agencies have downgraded the sovereign's debt to sub-investment grade. In addition to rating requirements, the minimum maturity is one year and the minimum market size for entry is US$50 billion. Furthermore, the market must be fully accessible to foreign investors. South Africa first entered the WGBI (then owned by Citi) in October 2012.

Within the passive funds that track the WGBI, and active discretionary funds that are mandated to only hold investment grade debt (possibly benchmarked against the WGBI), the expectation is that there would be at least some (see later for some assumptions) of the USD 45bn of SAGBs currently owned by foreigners that would be redeemed in the wake of the downgrade and WGBI exclusion.

Why are foreigners important to our bond market?

South Africa had for a time been popularly characterised as being one of the "Fragile Five" economies – along with Brazil, India, Indonesia, and Turkey. These are sovereigns that run both fiscal and current account deficits and share other financial vulnerabilities as well.

With the way economic variables work, since South Africa runs a current account deficit (our imports exceed our exports), it must run a financial account surplus, as the two accounts should sum to zero. This means simplistically that our current account deficit needs to be funded with "imported" savings from the rest of the world, given our chronically low levels of national savings. As such South Africa needs to attract foreign inflows to fund what little investment in capital projects we do make.

In addition to weak capital formation, the past decade has been characterised by a declining real growth profile, and consequently SA has developed an oversized reliance on debt issuance to fund fiscal shortfalls. So, the size and prominence of the bond market has increased significantly over the past decade, and in so doing has magnified the importance of the foreign sector as a funding source. According to data provided by the National Treasury as well as the South African Reserve Bank, foreigners currently own around 37% of South Africa's bond market, up from a mere 14% in 2009.

Why have foreigners invested here in the first place?

The funding balance described above is extremely delicate, and is very under-appreciated because, fortuitously for us, the past two decades have seen emerging market (EM) local currency debt shoot to stardom as an attractive asset class globally.

In 2000, emerging market debt represented just 2% of the global bond universe. Since then the asset class has boomed, accelerating to almost 25% of the global bond universe.

As a countercyclical response to the onset of the Great Recession in 2007, the US Federal Reserve drastically cut the federal funds rate, the conventional monetary policy instrument. Once the federal funds rate effectively hit the zero lower bound at the end of 2008, the Federal Reserve engaged in unconventional monetary policies to provide further stimulus.

This policy, often referred to as quantitative easing (QE), greatly affected the size and composition of the Federal Reserve balance sheet. The main goal was to lower long-term interest rates and thereby, spur economic activity, even as the short-term interest rate was stuck at the zero lower bound.

A positive US QE shock brought down long-term yields in the US, capital flows to emerging market economies accelerated, thereby bidding up their asset prices, strengthening exchange rates and stock prices, and decreasing long-term yields in those countries. The effects on “Fragile Five” countries were particularly pronounced compared to other emerging market economies.

As a consequence, from 2010 to early 2013, the general appreciation in emerging market currencies against the US dollar made investing in EM local currency bonds an attractive proposition for international investors. Concerns about exchange rate risk did not seem to moderate investment into such bonds because of the attractive yield premium.

This was clear a break with the past, when EM local currency bonds had not been able to attract much foreign investment because of fears that EM currencies were inherently unstable or could easily weaken in case sentiment in global markets turned. Some observers saw the early 2010s as the absolution of EM sovereigns from the “original sin”, i.e. the inability of EMs to borrow in their own currencies.

This is set to expand even further as emerging market debt's index representation increases, and bank disintermediation trends continue aligning with developed markets, offering huge opportunities for investors looking to access the asset class.

Broader implications for bond yields

It remains an extremely challenging exercise to disaggregate the US$45bn held by foreigners into that which is:

(a) pure passive WGBI tracker money

(b) active money, potentially benchmarked to the WGBI, but have constrained "investment grade only" mandates

(c) active money, high-yield seeking investors, non-constrained mandates

Only the first two classes of foreign investors mentioned above would need to act based on the downgrade and WGBI exclusion, and some reasonable estimates of the potential outflows in US dollar terms would be in the order of $3bn - $7bn.

Furthermore, amongst the active money segment, it would be challenging to disentangle what proportion of the redemptions already seen in March 2020 (around US$3bn) was related to the general global, coronavirus-induced risk-off sentiment, and how much related to South African idiosyncratic issues, such as weak real economic prospects and the broad expectation of the loss of its investment grade status.

South African bond yields are generally co-integrated with their larger EM peers. However, in the past month there has been a significant de-coupling, with South African yields becoming disproportionately weaker.

When EM debt becomes *in vogue*, South African bonds generally get bought by foreigners as part of an emerging market basket. Another important index for South Africa (as well as its EM peers) is the largest EM local currency bond index, the JP Morgan GBI-EM Global Diversified index. Brazil, Mexico, Indonesia and South Africa each enjoy a substantial 10% weighting in this index. Importantly, the index does not exclude sovereigns when they fall to sub-investment grade.

The larger constituents of the JP Morgan GBI-EM Global Diversified index mentioned above then become "indicators" for foreigners in terms of which EMs matter most. South Africa features very highly on that list.

The implication here is that much of the USD 45bn of foreign held SAGBs might in fact be attributable to foreign investors tracking the JP Morgan GBI-EM Global Diversified index constituents and looking for exposure to the most meaningful EM sovereigns, irrespective of their investment grade status.

Brazil, which has a big weighting in the JP Morgan GBI-EM Global Diversified index and is rated below South Africa at Ba2 by Moody's, has not been investment grade for some time, but still enjoys robust support from foreign capital in their domestic bond market.

Ultimately, once the dust settles, long-term economic parity relationships will re-establish themselves. Rand-denominated long bond yields should offer an investor a base-rate international US dollar yield, in addition to two risk premia: a sovereign risk premium (credit risk compensation for lending to the sovereign government) and a currency risk premium. Both these premia have arguably over-reacted to the confluence of pessimistic sentiment and are highly likely to settle into ranges more aligned to economic parity over time.

We have no doubt that investing in local South African bond yields at current levels will prove a prudent allocation of capital in the fullness of time.

Ends.

About Prescient:

- Prescient Holdings (Pty) Ltd is a diversified, global financial services group with a 21-year track record of providing solutions to our clients in Asset Management, Investment and Platform Administration, Retirement Solutions, Stockbroking and Wealth Management. As at 31 Dec 2019 the group had R98.4 billion client assets under management (AUM) and administered R478 billion client assets (AUA), split between asset admin (R328 billion) and unit holder admin (R150 billion). Prescient has established operating businesses in the following main jurisdictions: Prescient has successfully operated for 21 years in South Africa, 12 years in Ireland & the UK and 6 years in China.
- Prescient Management Company (RF) Pty Ltd (the manager) is approved under the Collective Investment Schemes Control Act (No.45 of 2002). Prescient Investment Management is an authorised Financial Service Provider (FSP 612) under the Financial Advisory and Intermediary Services Act (No.37 of 2002).

PRESCIENT INVESTMENT MANAGEMENT (PTY) LTD
Block B, Silverwood, Silverwood Lane, Steenberg Office Park, Tokai, 7945
P.O. Box 31142, Tokai 7966 Tel: +27-21-700 3600 Website: www.prescient.co.za
Executive Directors: Cheree Dyers (CEO) Herman Steyn Guy Toms
Non- Executive Directors: Thabo Dloti Varusha Daljee
Reg No. 1998/023640/07 FSP No. 612