PRUDENTIAL **INSIGHTS**

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# Now That We're Junked, Where To From Here?

ARTICLE SUMMARY


- Deteriorating economic conditions, elevated political uncertainty and ever-rising contingent liabilities from State-Owned Enterprises (SOEs), coupled with the lowest-ever post-democracy business and consumer confidence, all conspired to deliver South Africa's first "junk" (below investment grade) credit rating in April 2017 by S&P Global Ratings. More downgrades followed from other agencies.
- As seen in other countries facing similar ratings trajectories, our bonds, currency and other credit instruments have already sold off substantially, pricing in the risk of further downgrades, and subsequently recovered.
- While capital inflows to countries that have been downgraded do slow following downgrades, the degree of outflows is very much dependent on other countries' relative attractiveness, among factors.

- Bonds have reacted as expected to the November downgrade, initially selling off and subsequently rallying. We see current yields (as of year-end 2017) as still moderately attractive – now fairly valued at around 8.5% (a real yield of 2.5%) compared to their long-term fair value real yield of 2.25%.

Given the extensive coverage of the various ratings agencies and downgrades over the last two years, we are all well-acquainted with the reasons for South Africa's downgrade into "junk" or high-yield bond territory:

- Slow economic growth making it nearly impossible for the government to meet its revenue targets (and thus maintain its fiscal targets and reduce the budget deficit);
- Decreasing per-capita growth exacerbating the strain on the fiscus;
- Poorly run SOEs putting further strain on the government's balance sheet and increasingly, as in 2017, on the fiscus, such as SAA's R5 billion bailout in September;
- Low prices for commodity exports making it difficult to reduce the trade deficit, making South Africa dependent on volatile capital flows to finance this deficit; and
- Greater policy uncertainty and political risk on the back of corruption allegations in government, changing leadership at Treasury and divisions within the ANC.

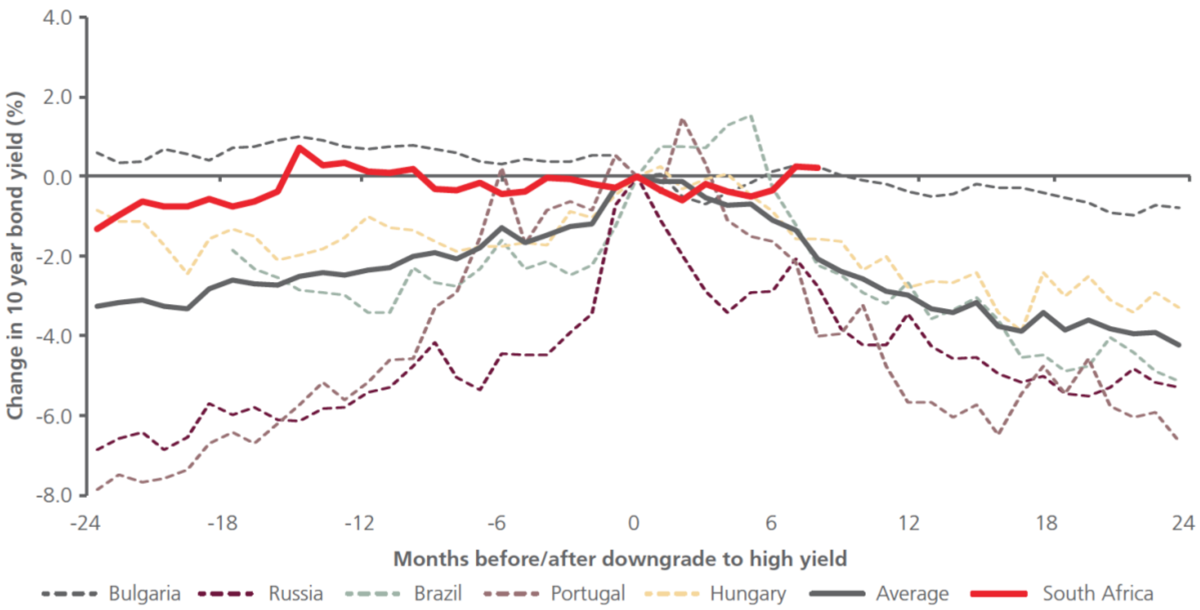
There are of course many other factors that the ratings agencies consider when making their assessment. For more details on their methodologies, see, for example, S&P's "Guide to credit rating essentials" on its "understanding ratings" page at www.spratings.com.

It's important to stress that South Africa's experience in being downgraded due largely to macroeconomic underperformance is not unique: a study by the IMF looking at sovereign rating drivers between 2007 and 2010 found that by far the three leading factors causing sovereign downgrades were public finance, debt and macroeconomic/growth conditions.

## IMPACT ON SA INVESTORS

So what does this mean for investors? In a separate report, we evaluated the impact of downgrades to “junk” status on bond yields, equity markets, currencies, GDP growth, etc. in several countries. In broad conclusion, we found that markets are forward-looking, with most of the negative impact taking place prior to the downgrade and peaking when the downgrade is delivered. In bond markets in particular, all the markets we investigated (with the exception of Bulgaria), actually had lower bond yields a year on from the downgrade. In Graph 1 we can see, reading from left to right, bond yields rising (weakening) in each country in the months ahead of an actual downgrade to junk status, which takes place at point “0” on the horizontal axis. Bond yields then subsequently fall (strengthen) in the months following the downgrade. The average experience across the countries we studied is shown by the solid grey line – where we can see that in the average country, bonds retraced all of their pre-downgrade yield rises within12 months.

**Graph 1: Bond market response to downgrade to high-yield**




Source: Bloomberg

The South African experience has been slightly different to date. The red line in Graph 1 illustrates how our bond yields rose (weakened) in anticipation of the downgrade, with the peak in yields occurring in December 2015 following the shock dismissal of Finance Minister Nene – about 15 months prior to our downgrade in April 2017 (shown at point 0). Bond yields subsequently fell (rallied) ahead of the actual downgrade.

Since the downgrade, however, our experience has been clouded by several significant events which caused considerable bond market volatility. For example, more bond weakness stemmed from the very poor Medium-Term Budget Policy Statement (MTBPS) in November, but yields strengthened in November in the wake of the credit rating reprieve from Moody's and in December's "Ramaphosa rally". This shorter-term volatility masks a remarkably strong performance from the All Bond Index for the year as a whole, with a total return of 10.2% in 2017.

## CAPITAL FLOWS

One factor we haven't discussed is the impact of a downgrade on capital flows – sales and purchases of assets by foreigners. In general, the data show that although capital inflows to countries that have been downgraded do slow following downgrades, the degree of outflows is very much dependent on other countries' relative attractiveness, among other factors. Given the quality of country-level flow data, it's quite difficult to distinguish the effects of the actual downgrade announcement on a country's bond and equity flows from the normal flows. However, the literature we reviewed on the flow dimension to sovereign ratings found that the response to ratings changes is asymmetric: sovereign downgrades are strongly associated with outflows of capital from the downgraded country, but improvements in a country's rating are not associated with any discernible inflows.

Moreover, flows around downgrades are consistent with a "flight to quality" phenomenon. Put slightly differently, these flows are consistent with flows that take place in a "risk-off" environment, when international investors are noticeably tilting their portfolios to hold more "safe assets" such as those from other countries that are perceived as safer than the downgraded country.

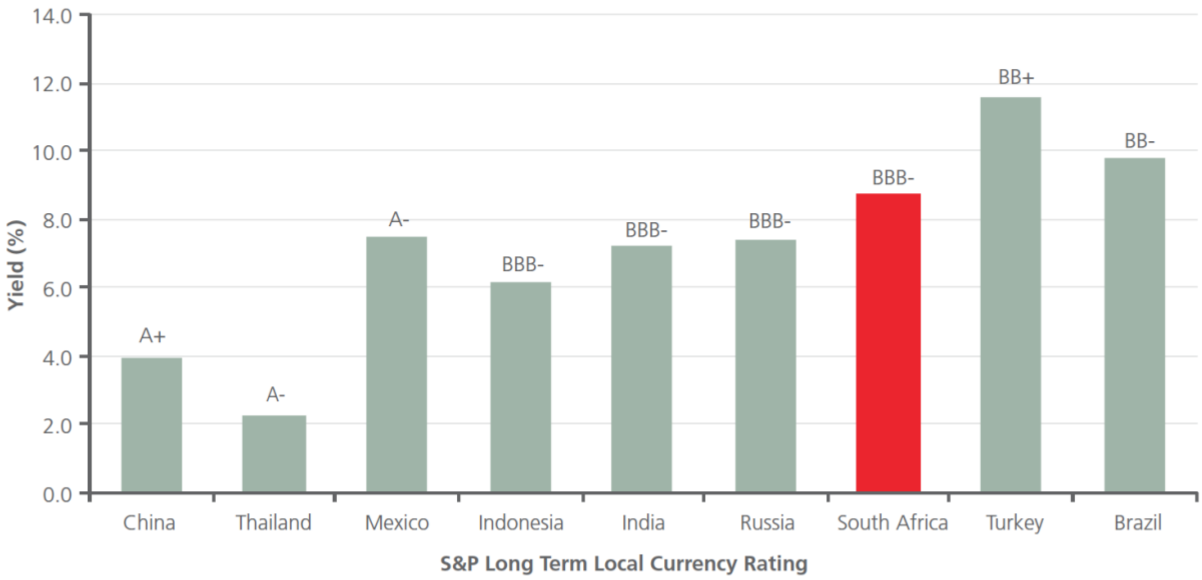
Another interesting feature of a seminal study into equity flows by Gande and Parsley found that the level of corruption in the country has a discernible effect on the flows associated with ratings changes: the lower the level of perceived corruption, the lower the responsiveness of flows to ratings changes, i.e. the smaller the outflow. Thus good governance plays a mitigating factor in the outflows due to ratings downgrades.

**HOW ARE WE LIKELY TO FARE IN 2018?**

Considering that financial markets tend to be forward looking and incorporate expectations and information, we would argue that we have already seen the bulk of the reaction to the initial downgrades, which is already reflected in interest rates, bond yields, equity market prices and the exchange rate. Forward rate agreements (FRAs) are now discounting a more benign interest rate path over the next 12 months, due partly to an improving inflation outlook. However, this could become a steeper hiking cycle if more downgrades follow due to further unexpected deterioration in our macroeconomic performance, such as slower-than-expected GDP growth or a wider government budget deficit such as that reflected in the MTBPS. The latter would lead to further bond weakness.

Currently, the market consensus expects South Africa to deliver pedestrian GDP growth of 1.3% in 2018 and 1.7% in 2019. Inflation is expected to remain fairly supportive and average 5.1% in 2018 and 5.3% in 2019, having averaged 5.3% in 2017. Given this backdrop, government bond yields at around 8.50% for the 10-year bond currently seem fairly valued. The 2.5% real yield (above inflation) on offer is only slightly above the long-term fair value of 2.25%. However, despite the strong rally to due to positively perceived political developments at the ANC's December elective conference, SA government bond yields still compare favourably to similarly rated global emerging market peers, and therefore still represent good value for global investors looking to deploy their capital in emerging markets.

**Graph 2: SA bond yields offer value vs peers**




Source: Bloomberg, local currency credit ratings and 10-year local government bond yields

Graph 2 highlights this, showing how our 10-year government bonds, at over 8.0% as of the end of 2017, offer higher yields than some countries with the same credit rating, like India, Indonesia and Russia. Going into 2018, we are moderately overweight SA bonds in Prudential's client portfolios and multi-asset unit trusts such as the Prudential Balanced and Inflation Plus Funds, reflecting our view that they fairly compensate investors for the risk involved.