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Executive Summary

There has been much speculation for some time that South Africa could be downgraded by Moody's to sub-investment grade or "junk", despite a recent reduction in the likelihood of the actual full downgrade announcement occurring on 1 November as many anticipate. The Moody's rating has been pertinent in that it is the only one of the three major ratings agencies that has not yet downgraded SA's foreign rating.

In the brief overview below we examine the perceived risk of a downgrade and pertinently also briefly discuss what the likely potential impact (if any) would be on end consumers and clients.

Introduction

A South African ratings downgrade has been hotly debated for quite some time and largely anticipated (and priced in) by markets. In our in-house quarterly macro overview we started to review this possibility and its potential impact as early as January 2016. We looked at how other emerging markets such as Brazil, Russia and Hungary felt the brunt of their downgrade pressure in the run-up to the downgrade event. Whereas the market did invariably react post the downgrade announcements to "junk" or sub-investment grade, the impact was typically acute yet relatively short-lived (see *"2IP Investment Committee Meeting Q1 2016, page 124"*).

Fast forward to 2019 and both S&P and Fitch have delivered the abovementioned downgrades, whereas the market has both nervously and keenly awaited the completion of the ratings agencies trifecta in Moody's final deliberation, which has provisionally been scheduled for 1 November. Should this downgrade – technically by two further notches – to sub-investment grade occur, many market participants have argued that the resultant exclusion of SA bonds from global bond indices would result in bonds sales of up to \$2bn. While this posited figure is indeed very significant, economists have also pointed out that these same bonds may then also be purchased, albeit likely to a lesser extent, by other sub-investment grade funds and investors searching for yield during the current global low- and negative rate environment.

As it stands at the moment however (partly owing to how long Moody's has delayed their announcement) there is actually a strong school of thought which has emerged which speculates that the full downgrade may not happen on 1 November 2019, despite the spate of recent negative economic data which has been released for South Africa in terms of GDP growth, unemployment and budget shortfalls. The market seems to believe that there is therefore an increased likelihood that Moody's may very likely (or at worst) simply place SA on "negative watch" – the typical precursor to a downgrade – without actually following through on the downgrade itself.

Regardless of the above and for the balance of this article, we will examine what the effects on the man in the street might be should the downgrade actually occur.

So if a SA downgrade occurs – how are markets likely to react?

As previously eluded to and also looking at how investors have historically reacted to other emerging markets when they have been downgraded to junk, much of the bad news is typically already priced in by the market in advance of the announcement occurring. South Africa is unlikely to be an exception, although we would still expect to see markets spike (yields upwards, equities downwards) in the days following such an announcement.

As we have actually stated in our commentary on a few occasions, depending on the state of the global economy, the aforementioned local market spikes may actually represent good buying opportunities, although this would need to be viewed within the context of the global economic backdrop.

If market rates suddenly increase, will this affect my house mortgage lending rate?

There is no direct link between bond rates as traded in the open market (which would almost certainly spike higher in the event of a downgrade announcement) and the lending rates as set by the commercial banks, which is a product of the Repo rate as determined by the South African Reserve Bank.

As such if market rates happen to increase due to a downgrade it is extremely unlikely that we will see even near similar increases in mortgage or retail lending rates.

For those folks who like to get into the technical aspects however, one could argue that in the event of a simultaneous strong sell-off of the Rand – particularly if there are substantial inflationary pressures which are brought to bear (currently absent) – then the SA Reserve Bank could opt to increase rates independently of the above, which would in turn translate into higher lending rates for clients. This is by no means a certainty however.

Why don't we simply “reduce risk” and move all clients into cash?

Whereas we often hear clients positing this as a solution there are several reasons why this might be a very bad idea and why one needs to be very careful in understanding the risk of doing this. Most clients need to achieve substantive real-returns over the longer term (which cash typically always underperforms over any meaningful investment period) and as such one might actually be placing clients in greater risk by moving to cash, not less.

For clients whose long-term return objectives are very close to inflation only, the risk of moving into cash is not as material. However for clients who are targeting a long-term return of CPI+3% or higher, a wholesale or material move to cash could pose a very real risk to their ability to achieving their long-term return objectives. This is only further exacerbated when one looks at the research of how badly clients typically time the markets. By far the majority, if not almost all clients, typically not only go into cash at inopportune times (e.g. after a market sell-off event has occurred), but then also wait too long to reinvest back into risk assets, which undermines their long-term investment goals.

Last but not least, recall also that we mentioned that the market moves resulting from a downgrade announcement are typically relatively short-lived (in the absence of a deteriorating global growth backdrop).

Whereas it might be prudent to tilt portfolio exposures more defensively should it become clearer that the downgrade event will occur (and only assuming that markets have not already again priced this in), this is not currently the default consensus.

How will an increase in market rates resulting from a downgrade affect South Africa and SA multi-nationals?

Whereas private mortgage rates are not likely to be affected at all directly, there is however potentially an impact on future borrowing costs for corporates and government (or any entities that rely on the bond market to raise capital), should market rates remain elevated for any significant period. In this scenario it would increase future funding rates both for government, parastatals and for corporates. In the case of government it would manifest in the higher interest rates they would need to pay to make our bonds attractive to investors, whereas in the case of corporates it would similarly increase their cost of capital and flow through to an eventual reduction in profitability.

Conclusion

Whereas it seems very likely that Moody's may put SA on "negative watch" as of 1 November, the likelihood of an outright rating downgrade to "junk" is less likely right now. That said, should the ratings downgrade to sub-investment grade occur, historic data from other emerging markets that have undergone similar transitions (and local experiences such as "Nenegate" at the end of 2015) indicate that while the short-term market reaction might be material, this is likely to be transient in the absence of other external negative factors.

Furthermore, personal lending rates should not be directly impacted, nor should any pre-emption of a downgrade (potentially already being priced into markets) necessarily warrant any drastic asset class changes by clients compared to their long-term asset allocation requirements.

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