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Fundamental Fixed Income

Market update: is South Africa losing sight of true north?

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South Africa downgrade – intense political instability weighs on economic performance and policy.

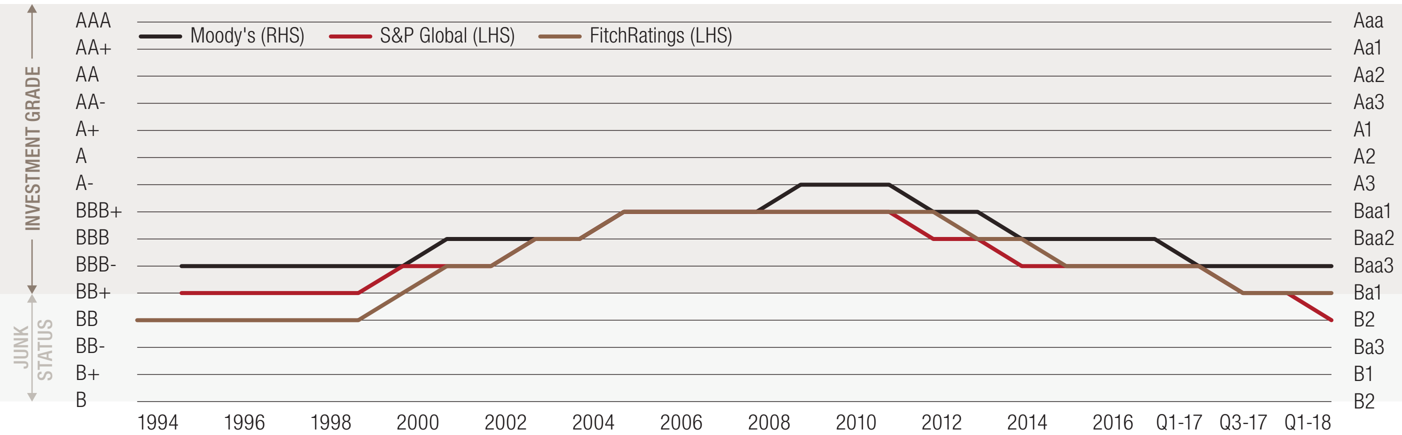
South Africa's slide into sub-investment grade territory by S&P reaffirms the need for continuous monitoring of sovereign credit metrics. Rating pressures persist as Moody's put the country on negative watch, signalling the risk of another downgrade.

An unsurprising downgrade

Political uncertainty in South Africa has been rising for a number of years. It took a turn for the worse in late March, when President Zuma fired the well-respected Finance Minister Pravin Gordhan as part of a broader government reshuffle, in an effort to gain more direct control over the Treasury.

These developments triggered early rating actions from S&P and Fitch. On 3 April, S&P downgraded South Africa's sovereign rating to BBB- from BBB (local currency debt) and to BB+ from BBB- (foreign currency debt). S&P cited concerns about "the economic outlook and fiscal outcomes," amid renewed political uncertainty. Fitch followed suit on 7 April, downgrading both the local and foreign currency ratings to BB+ from BBB-. Then more recently, the disappointing October budget presentation that revealed a significant deterioration in the fiscal outlook led S&P to also lower its local currency sovereign rating by another notch, to BB+ in November. Moody's is the only agency that maintains an investment grade rating for the country but it also signalled concern in November placing South Africa's Baa3 ratings on review for downgrade.

Figure 1 – Rating evolution



Source: Bloomberg.

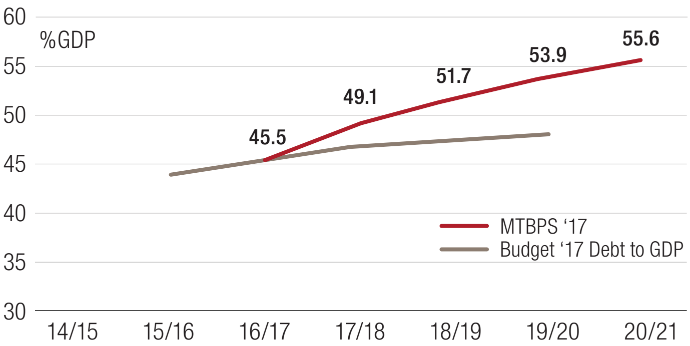
South Africa is losing sight of its true north due to political uncertainty

Since the start of Zuma's Presidency, South Africa's economic performance has declined steadily, prompting a wave of rating downgrades. In contrast, during the Mandela and Mbeki presidential years in the nineties, the country enjoyed a stellar revival and its debt climbed out of junk status. However, since the "Zanufication" of the ANC, the country has faced a multitude of issues at the political, economic and social level. Academic research indicates these problems should not be viewed in isolation. For example, in its paper "How Does Political Instability Affect Economic Growth?" the IMF concludes that political instability significantly reduces economic growth.

In South Africa there is abundant evidence of this phenomenon taking hold. The lack of structural reforms; regulatory uncertainty (especially in the mining sector); corruption in state-owned enterprises; and a lack of competition are just some examples of the deficiencies that plague the SA economy, all of which were also acknowledged in the South African government's latest Medium Term Budget Policy Statement Speech (MTBPS). Indeed, the speech given by Finance Minister Malusi Gigaba on the 25 October did not appease rating agencies and investors as it directly acknowledged many of the well-known structural issues while falling short of providing credible solutions.

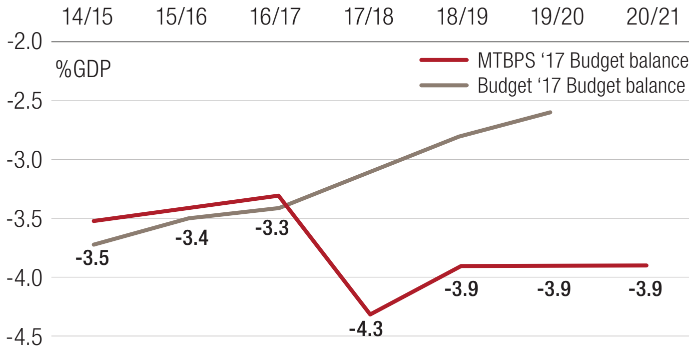
The October mini budget showed that the South African government is no longer forecasting a stabilisation of the debt projection. The outlook of the net debt to GDP ratio is forecast to balloon to 55.6% by FY 20/21 as illustrated in the Figure 2. This reflects large upward revisions in the Treasury's consolidated government deficit forecast, to 4.3% of GDP (1.2pp worse than in the February budget) this year with little tangible improvement in the next few years as shown in Figure 3. However, it is important to note that the MTBPS did not contain any new policies to correct the fiscal situation; those decisions having been left for the Budget in February 2018 and after the election of the new ANC leader.

Figure 2 – Net debt to GDP



Source: National Treasury, Nomura.

Figure 3 – Budget balance (consolidated basis)



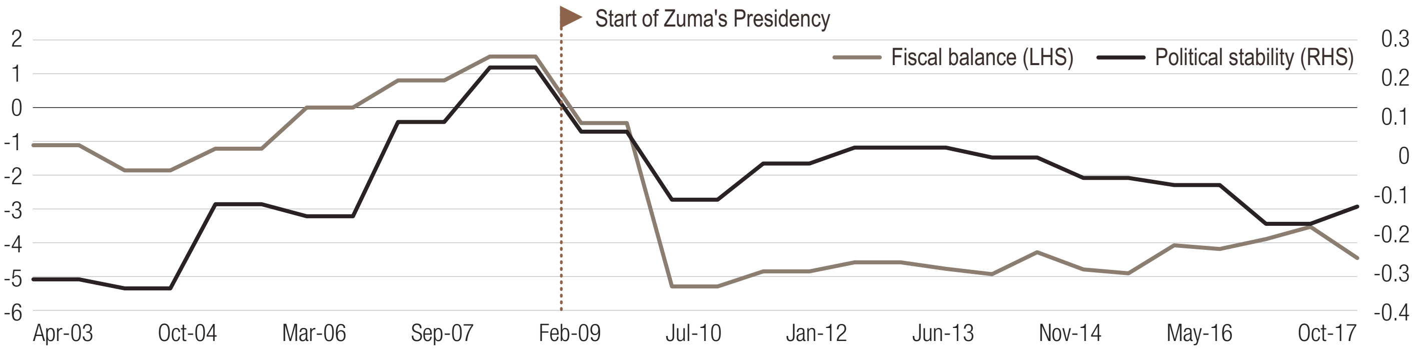
Source: National Treasury, Nomura.

The deteriorating fiscal outlook and structural concerns have weighed on business confidence and held back investment, resulting is sub-par economic growth. Annual GDP growth has been on the decline over the past four years and GDP per capita actually shrank over the past two years.

Alongside the poor management of the government finances, stalling economic growth has been the main culprit for South Africa's deteriorating fiscal situation.

The World Bank political indicator (-2.5 weak; 2.5 strong) shows that political stability started to fall markedly in 2009 when Jacob Zuma was sworn in as president of South Africa, as illustrated below in the figure 4. The graph also shows that the turning point in the political indicator coincided with a sharp and sustained deterioration in the fiscal deficit.

Figure 4 – Fiscal balance and political stability



Source: World Bank/IMF.

A light at the end of the tunnel, perhaps?

At the 54th ANC Elective Conference scheduled for 16-20 December, the new political leadership will be elected and the tone for the future policy framework will be set. Cyril Ramaphosa is the front-runner versus Nkosazana Dlamini-Zuma, according to the branch nomination process. A Ramaphosa victory could herald the dawn of a new political era, with an acceleration of some of the badly-needed reforms.

The ANC Conference will be a key event. Moody's will also scrutinise the 2018 budget, due to be released next February to assess the willingness and ability of the authorities to remedy some of the most immediate concerns, particularly with respect to fiscal policy. If also Moody's were to strip South Africa's local debt of its investment-grade status, the country would be excluded from Citi's World Government Bond Index, and this could trigger further forced selling to the tune of USD 10 billion (about 3% of GDP), in our view, putting intense pressure on the current account – presently in a deficit of USD 8.4 billion.

Implications for investment approaches

We believe that recent events in South Africa highlight the importance of considering a country's economic fundamentals in a fixed income portfolio. A fundamentals-based approach to portfolio construction can seek to provide a more meaningful – and less risky – allocation, as each country is treated on the basis of its own merits, rather than on its level of outstanding debt. Our fundamentals-based approach leads us to an underweight position in South Africa within an emerging local currency bond portfolio on the back of weak fundamentals and with the aim of carefully managing risk.

IMPORTANT INFORMATION