23 February 2016

The JSE and Junk: what will happen if we get downgraded?

Says Kokkie Kooyman of Denker Capital, our economy is stalling and the risk of a recession is greater than ever. The rand's steep decline of 2015 will significantly increase the cost of living for everyone (specifically fuel, transport and food) while the combination of muted global growth, low business level confidence, drought and persistently low resource prices will result in bankruptcies and higher unemployment levels.

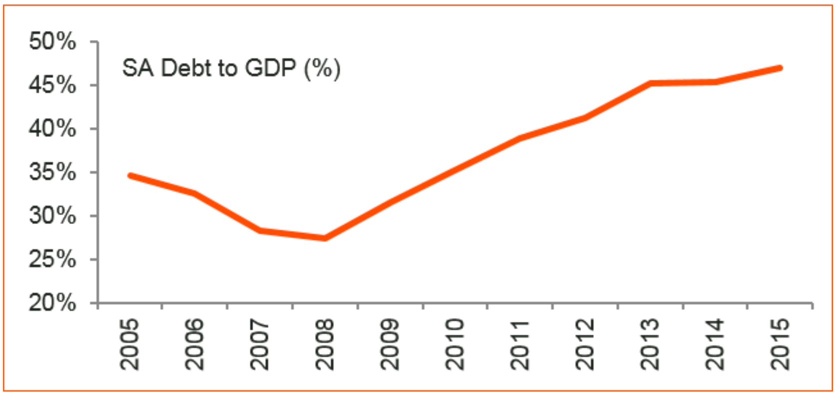
Will our sovereign debt get downgraded?

It is not a "dead cert" that our sovereign debt (and along with it our bank debt) will get downgraded to "junk" or non-investment grade status.

Ratings agencies rate the capacity and willingness of a country/company to repay its debt, and a key factor they look at is debt levels versus future cash flow. A poor or deteriorating growth outlook effects future capacity to repay and is a negative.

SA's 50% debt to GDP ratio level is much lower than that of developed market countries, but SA's high interest rates make a high (and increasing) debt level dangerous. And the rand's fall in 2015 **could push inflation to 7% necessitating continued high interest rates**. The fact that SA also has considerable off-balance sheet debt (Eskom, SAA, etc.) adds to the risk.

On the news of finance minister Nene's dismissal markets immediately re-evaluated SA's ability and willingness to meet future obligations and pushed the interest rate of our sovereign debt higher. This and a shrinking GDP (recession) could keep the **debt/GDP** level on its upward trajectory.



Graph 1: SA Debt to GDP ratio over the past 10 years
(Source: Bloomberg, February 2016, Denker Capital)

Why is it that "developed" countries get away with such high debt levels?

1. Their interest rates are structurally lower and needless to say: at lower interest rates one can afford more debt. This is one of the reasons why keeping inflation low is a key objective of central banks (and the SARB).

2. Perceived low political risk and policy predictability.

Hence the key factors that will determine whether South Africa's sovereign debt will be downgraded are:

- Our prevailing debt levels,
- inflation rate,
- growth rate, and
- trust in the abilities of our political leadership, the Reserve Bank and Treasury.

This week's Budget Speech is critical:

Finance Minister Pravin Gordhan will have to:

- **Reduce/stabilise debt**: Asset sales are necessary plus intervention and control of poorly managed state-owned enterprises like SAA, Eskom, the Post Office, SABC, PetroSA, etc.
- **Reduce the budget deficit (a balanced budget would be ideal but unlikely in the current circumstances)**: Cut government expenditure and increase taxes **but without impacting the country's growth rate** too much.
- **Regain trust in our policy making**: A responsible budget will not be enough. Most important will be whether the cabinet is seen to be fully behind minister Gordhan. Will the president and his cabinet accept the enforced paradigm shift away from a centrally-led economy? And will it be whole-heartedly endorsed and executed?

A balanced budget will be a tough ask:

- Falling tax revenue (lower farming income, lower business profitability, etc.),
- Civil servant salary increases implemented during 2015,
- Promised university fee subsidies,
- Possible drought relief,
- Impact of inflation on government expenditure.

What will the effects of a possible downgrade be on the rand and the JSE?

It seems there are many who believe that South Africa will follow the Brazilian route, believing the rand and the JSE will fall significantly following a downgrade. This view is flawed.

Markets react negatively or positively to **unexpected** events. The extent of such a reaction is driven by:

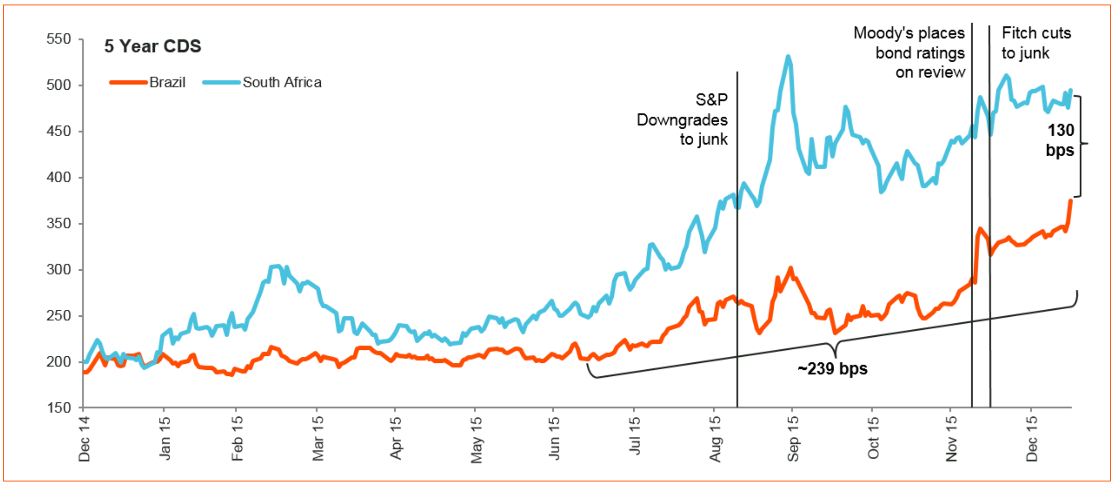
- Valuation levels at the time of the event,
- The extent to which it was expected (corollary to the valuation levels), and
- The extent and impact of the surprise. For example, finance minister Nene's dismissal was totally unexpected and valuation levels were high. Hence the significant impact on the rand, bond markets and JSE when it happened.

A downgrade is seldom a surprise. If we do get downgraded it will be based on what is already known: The weak state of the economy, high debt levels and a lack of confidence in government's decision making and policies.

True, the mandates of most investors in sovereign and bank debt force them to sell their holdings (normally over a 12 month period) which in the short-term has a negative impact and makes future refinancing more difficult. But the markets generally anticipate this before it happens. Brazil is a good example.

Similarities between SA and Brazil in 2015

Brazil experienced a significant recession during 2015 and there are quite a few similarities with the current South African situation, including drought, a shrinking economy, a squeezed consumer and excessive government spending.



Graph 2: 5-year credit default swaps
(Source: FactSet)

The graph shows that Brazil's 5-year credit default swaps (CDS) re-priced by 200 basis points (bps) in the **period leading up to their** downgrade, and only a further 100 bps after the actual S&P downgrade. Most of the bad news was priced in prior to the downgrade. Similarly, our swap rates have already increased by 150 bps. The new budget and risk of further deterioration in our economic prospects (drought, labour unrest, etc.) will be critical to whether our debt re-prices further. A ratings downgrade, should it happen, will simply affirm what we will already know.

The point we are trying to make is this: It is not the rating agencies that will cause the JSE and rand value to fall – it is the budget, its subsequent implementation and further unexpected weakness in the economy that will be the main driver of price changes.

Description	As at 17 Feb 16	% moves measured from this date to 17 Feb 2016		
		30 Nov 15	31 Aug 15	31 Dec 14
JSE All Share	49,786.83	-3.5%	-0.4%	0.0%
S&P 500	1,924.02	-7.5%	-2.4%	-6.6%
Brent Crude	34.76	-18.8%	-32.2%	-37.7%
ZAR/USD	15.29	5.5%	15.3%	32.1%
USD/Indonesian Rupiah	13,501.00	-2.5%	-4.1%	0.0%
USD/Norwegian Krone	8.59	-1.3%	3.3%	15.2%
USD/Turkish Lira	2.96	1.5%	1.7%	26.6%
USD/ Brazilian Real	4.01	2.9%	10.3%	51.4%
(-) = stronger against USD				

Table 1: The rand and the JSE
Source: FactSet, Bloomberg, Denker Capital Research

Table 1 above highlights three interesting points:

- The JSE All Share Index doesn't reflect what is happening inside the country. Despite the events in December (measured in rands), the JSE has outperformed US markets.
- The original effect of the dismissal of finance minister Nene has almost been reversed. Markets look ahead and currently seem to believe that Pravin Gordhan will deliver. Bear in mind, however, that the rand had depreciated by more than 25% during the previous 12 months.
- The Brazilian real declined by more than 40% prior to the S&P downgrade on the back of the recession and political crisis.

The banking sector is typically a better measure and indication of what is happening in an economy. Table 2 below highlights how Brazilian bank share prices (using the Itau, the most conservative bank, as a proxy) fell before the S&P rating downgrade on 15 August 2015, reflecting a severe recession (-4% GDP growth). However, thereafter Itau outperformed its developed market counterparts.

Description	As at 17 Feb 16	% moves in share prices measured from this date to 17 Feb 2016		
		30 Nov 15	31 Aug 15	31 Dec 14
ING Groep (Netherlands)	10.46	-19.5%	-23.4%	-3.5%
Bank of America (USA)	12.51	-28.2%	-23.4%	-30.1%
Itau Banco (Brazil)	24.52	-11.8%	-7.6%	-29.1%
Firstrand (South Africa)	4,751.00	1.0%	-10.2%	-6.1%

Table 2: The flux in Brazilian bank share prices

(Source: Company Financials, Denker Capital Research)

Note: Brazilian government debt was downgraded to junk between 31 Aug and around 15 Dec 2015.

A concern at the moment is that SA bank shares and the rand have retraced most of their December losses (Firstrand, for example, is trading close to where it was on 1 December 2015). Clearly there is a lot riding on Pravin Gordhan's budget. Expectations are high, perhaps too high. Or is the market anticipating something more important?

Table 3 below compares the factors that go into the pot to determine sovereign debt ratings. Each country has a different history and different dynamics which make a simple comparison dangerous. But it does highlight a few interesting similarities.

Country	Population (mill)	GDP (bill)	GDP/ Capita (USD)	Government Debt/GDP	Inflation rate	5 year CD swap rates	GDP Growth 2016F	S&P Credit Rating	Budget Deficit %	Current Account Deficit %	Currency move since Jan '14
South Africa	54	$350	6,483	45.4%	6.2%	3.4%	0.7%	BBB-	-4.1%	-5.4%	45.1%
Brazil	206.1	$2,350	8,177	59.2%	16.1%	4.6%	-3.5%	BB	-10.3%	-3.3%	67.5%
Turkey	75.9	$798	10,515	36.6%	9.6%	3.0%	2.9%	BB+	-1.5%	-4.5%	37.3%
Indonesia	254.5	$888	3,492	56.2%	4.1%	2.4%	5.1%	BB+	-2.5%	-2.1%	10.2%

Table 3: South Africa and its emerging market peers

Note: Due to the debt levels of parastatals not being included the debt/GDP ratio can be misleading

Of the four countries, the South African government has been the strongest believer in a central led "government is best at creating jobs" paradigm. This is a red flag in the eyes of rating agencies. Brazil's recession is worsening (it received a further downgrade this week), whilst Indonesia's sovereign debt has the most positive outlook in terms of an upgrade to investment grade.

Summary

The rand is oversold and undervalued, but without significant policy change South Africa is at risk of losing its attraction as a destination for capital.

Having said that, South Africa has truly world-class management teams. SA corporates are generally ungeared and our banking sector is well capitalised and should come through a possible recession fairly well.

At some stage commodity prices will turn and slow US growth would mean no further US interest rate hikes and a weaker US dollar.

Dividend yields are attractive, but **the consumer and the earnings of consumer-facing companies will face severe headwinds in 2016 due to low growth, high levels of inflation and higher interest rates.**

The recent rand and bank index strength indicates that markets has started anticipating a 2016 budget which will point to a turnaround in government policy. In one budget Pravin Gordhan has to undo a lot of poor policy making hence subsequent support by cabinet is extremely important. Conversely, a failure by cabinet to visibly endorse a good budget could see a significant fall in the rand and consumer dependent shares.

Kokkie Kooyman