Investment Solutions

With Confidence

Credit rating prospects for SA

A presentation by Lesiba Mothata

Chief Economist at Investment Solutions

April 2016

Background

Chief Economist

Work experience:

- Joined Investment Solutions in 2013 as Head of Market and Economic Research;
- Before that, for two years, was at SA Reserve Bank as a risk specialist responsible for the strategic asset allocation of the foreign-exchange reserve portfolio (about $50 billion);
- Prior, spent five years at Investec Bank in the private wealth business as a global macroeconomist;
- Earlier in the career, worked at Nedbank Treasury and Coris Capital (which bought Prodigy Asset Management).

Academic Qualifications:

BCom Honours (Economics): Wits University

MCom (Financial Economics): University of Johannesburg

Capital flows

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Foreign investor perspective

Capital outflows from EMs

About $1.1 trillion has flowed out from Q4.14 to Q3.15

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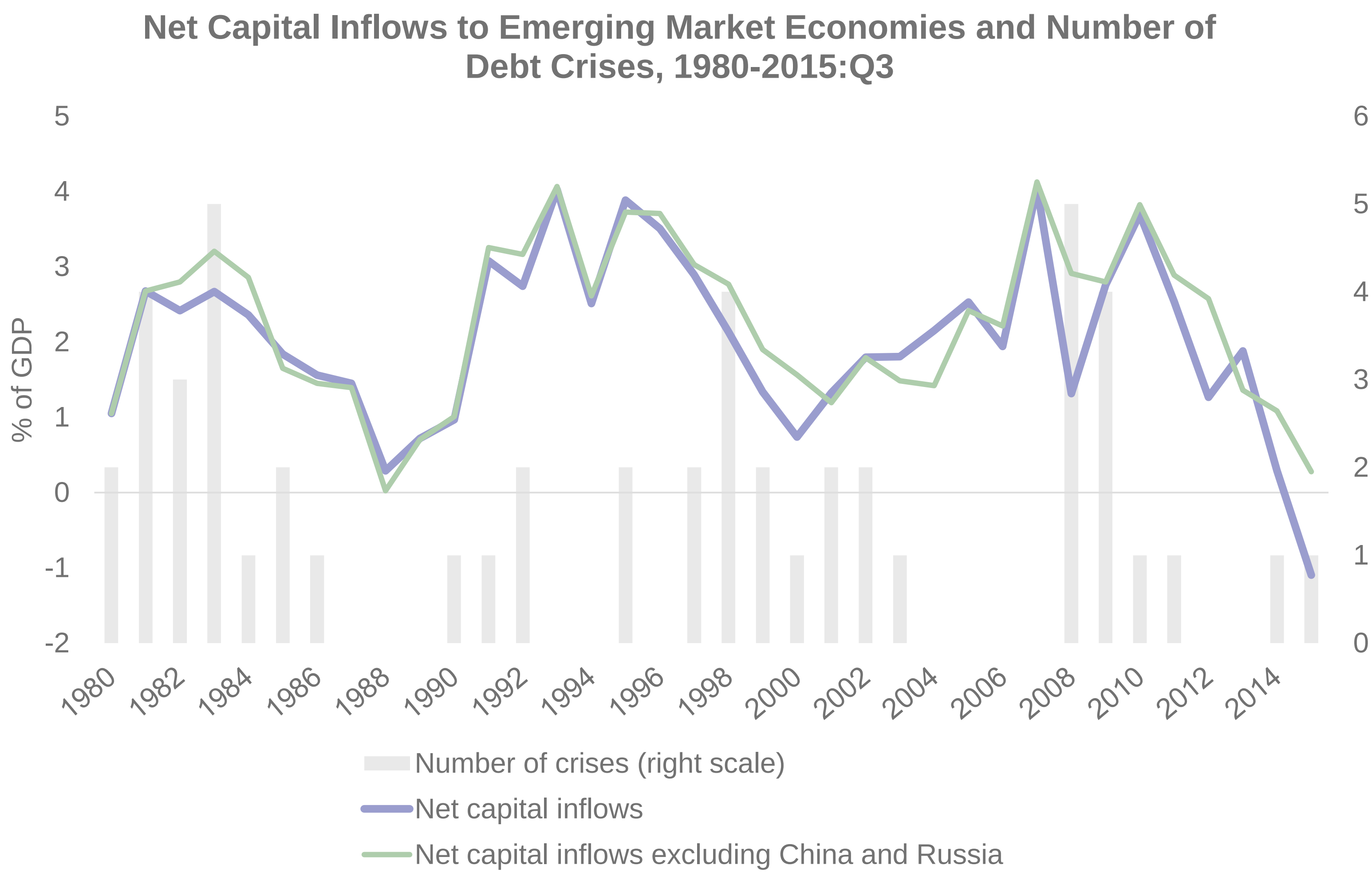
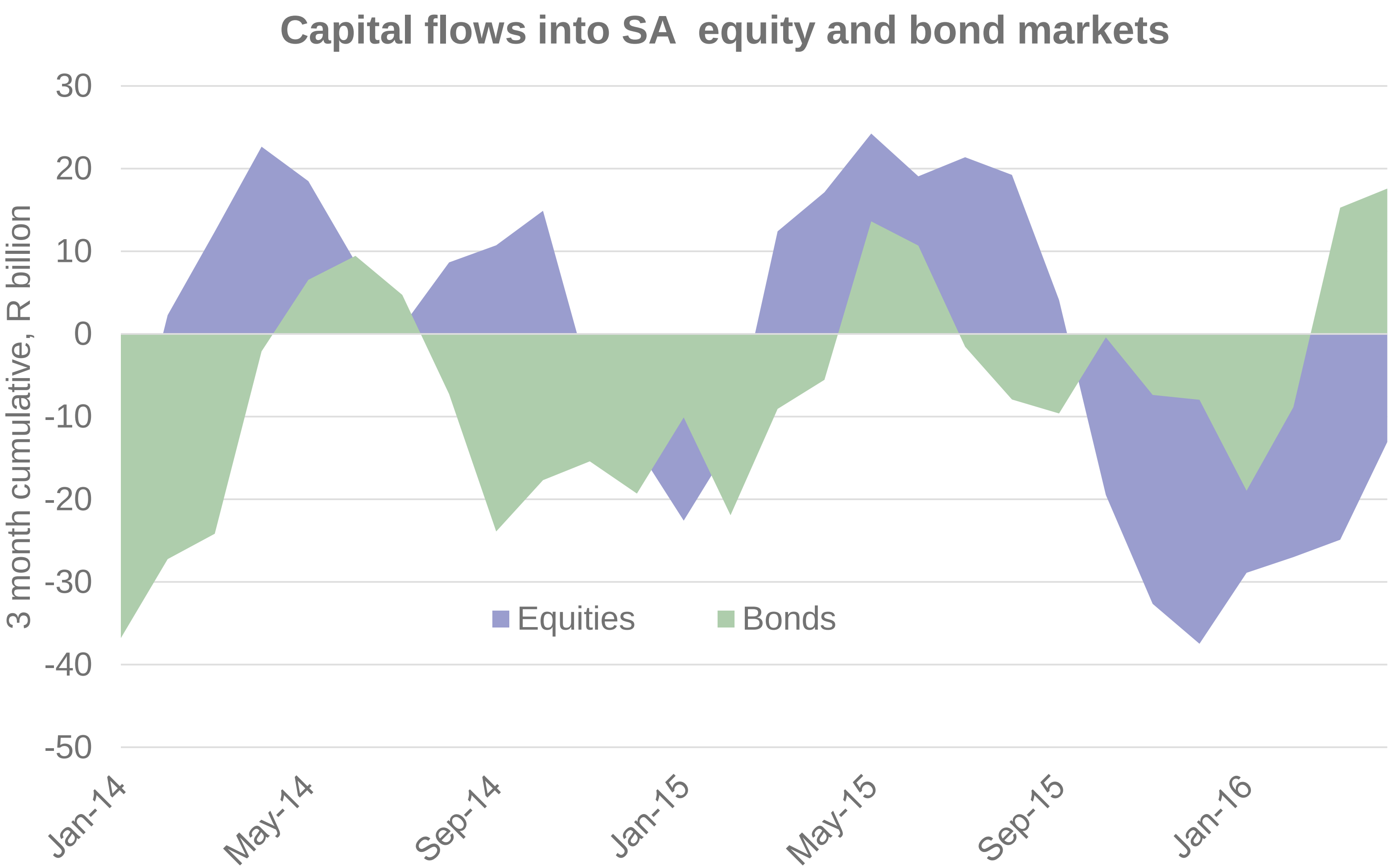


Source: International Monetary Fund, April 2016

Divergence between equity and bond flows

Despite "9/12" bond flows have been robust



Source: I-Net Bridge, April 2016

Debt structure

SA sovereign debt

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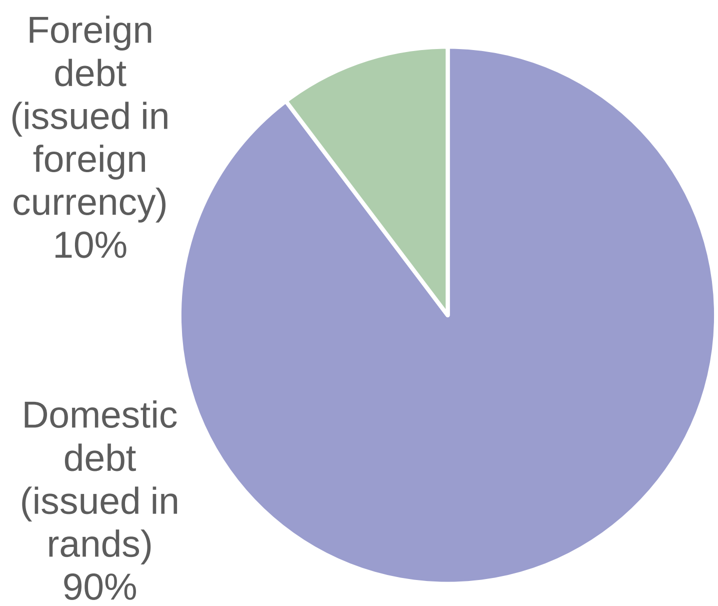
Split of SA sovereign debt



- Debt due at the short-end (about 12 months) is 13% of total
- Longer dated debt is 87%

Total national government debt, R billion

	2015/16	2016/17	2017/18	2018/19
Domestic debt	1 823	2 004	2 180	2 352
Foreign debt	233	230	243	255
Gross loan debt	**2 056**	**2 234**	**2 423**	**2 607**

Source: National Treasury, Budget review, 2016

Investment Solutions survey

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Foreign and local investor perspective

Questions asked

18 institutions (local and global fund managers and brokers)

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South Africa is on the brink of a sub-investment credit downgrade by Standard & Poor's.

1. When do you expect this to take place?
2. What impact of this do you envisage on SA Inc. assets?
3. What about the local currency rating. Does it matter?
4. Is this information priced-in asset prices or not?

Source: Investment Solutions, April 2016

Responses from global managers

Investment Solutions survey

- Compensated to take risk in **maintaining position in SA**.
- Despite being **put on ratings watch**, the rand is up 5.3% year-to-date and the local currency return in Citi WGBI is 6.8%.
- There **hasn't** been a **mass exit** from SA bonds yet, despite negative news.
- **FT is very negative on SA**: *"We do not favour the local currency irrespective on rating versus other EM local currency".*
- **Uneasy to provide** expected timing of the downgrade and in answering whether information is priced-in or not.
- On a **Purchasing Power Parity (PPP) basis**, the ZAR is one of the most **undervalued** currencies in manager's universe.

Source: Investment Solutions, April 2016

Responses from local managers

Investment Solutions survey

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- Most expect junk downgrade in June 2016 (**6 out of 8**).
- Information **fully priced-in asset prices** and expected little impact.
- All **looked at other EM countries** to arrive at little market impact verdict.
- Exclusion from **Citi WGBI far away** (2 yrs +). If it took place, around **R30bn outflows** likely.
- **Duration** in balanced mandates is 2.2 yrs versus ALBI at **6.8 yrs**.

Source: Investment Solutions, April 2016

Responses from brokers

Investment Solutions survey

- Most expect junk downgrade in December, not June (**4 out of 5**).
- Believe a December rating downgrade by S&P is priced in, **but not June.**
- **Adverse market response** likely if June happened. Sell-off not as much as during “9-12”.
- Bond market is pricing a further **3 to 4 downgrades.**
- SA’s **ERP** likely to increase from 8% presently to closer to 9%.
- Also expect about 50bp long bond yield upside which should push up the Cost of Equity by c100bp.
- Expect **cash to be king.**

Source: Investment Solutions, April 2016

Standard & Poor's

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Assessment criteria

Standard & Poor's

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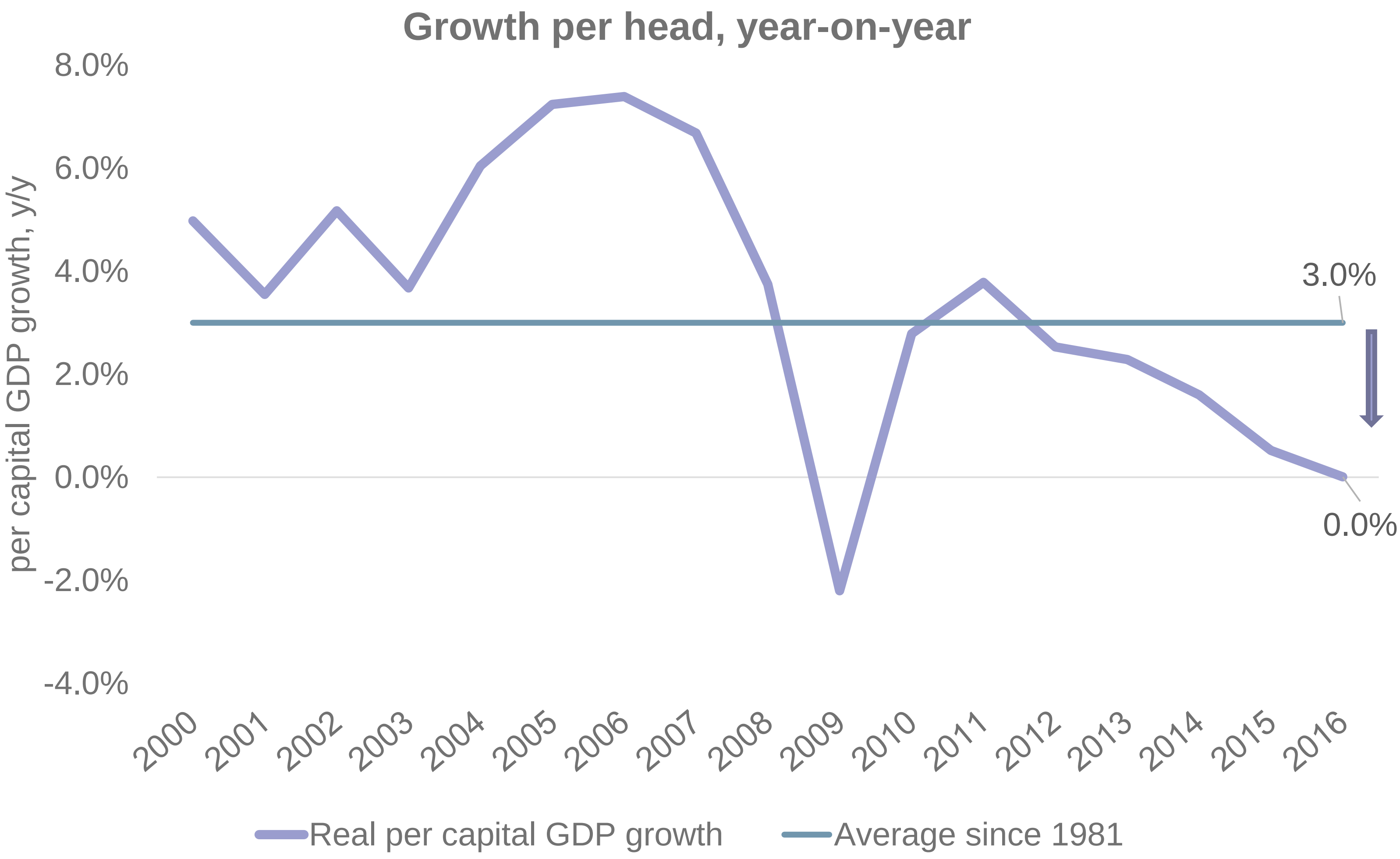
Credit Assessment Criteria

Institutions	Economic	External	Fiscal & Debt Burden	Monetary
(1)	(2)	(3)	(4)	(5)

Source: Standard and Poor's, April 2016

Per capita GDP growth

Slowdown needs to be arrested



Source: International Monetary Fund, April 2016

GDP per capita amongst peers

SA looks a lot like Colombia

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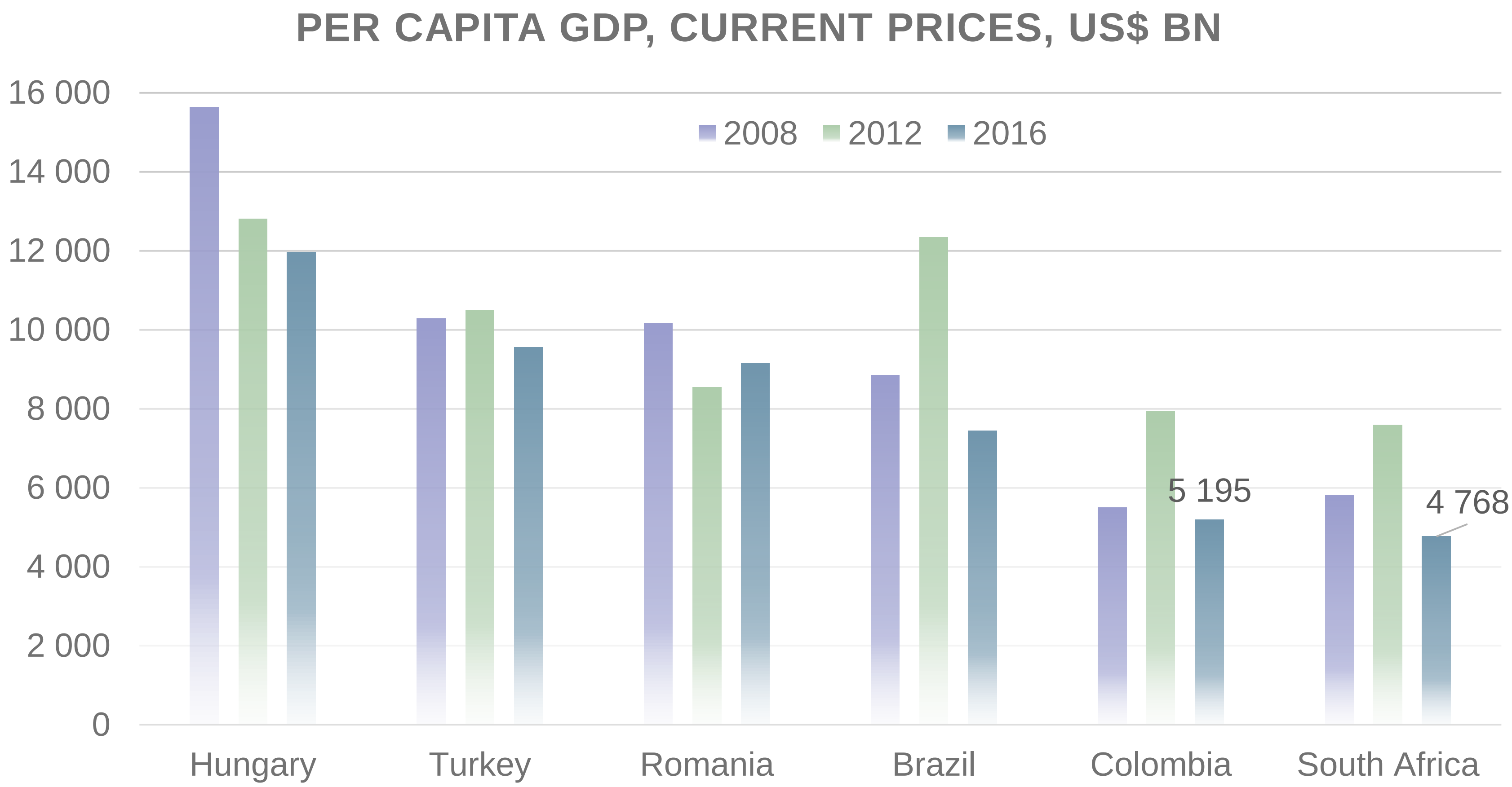
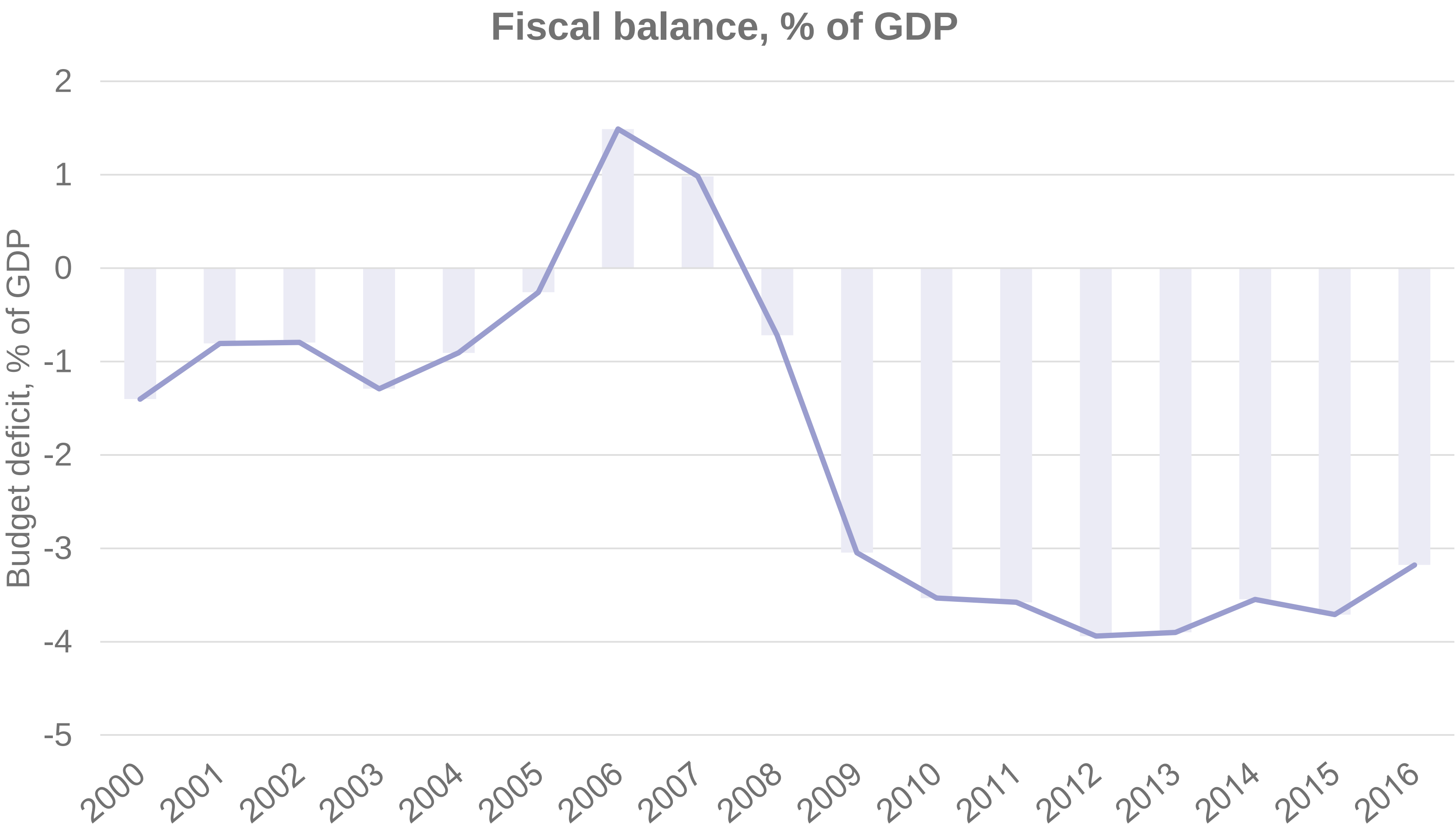


Source: International Monetary Fund, April 2016

Budget deficit as a % of GDP

Post GFC fiscal consolidation too slow



Source: International Monetary Fund, April 2016

State Owned Enterprises (SOEs)

Both public and private firms are struggling to produce value

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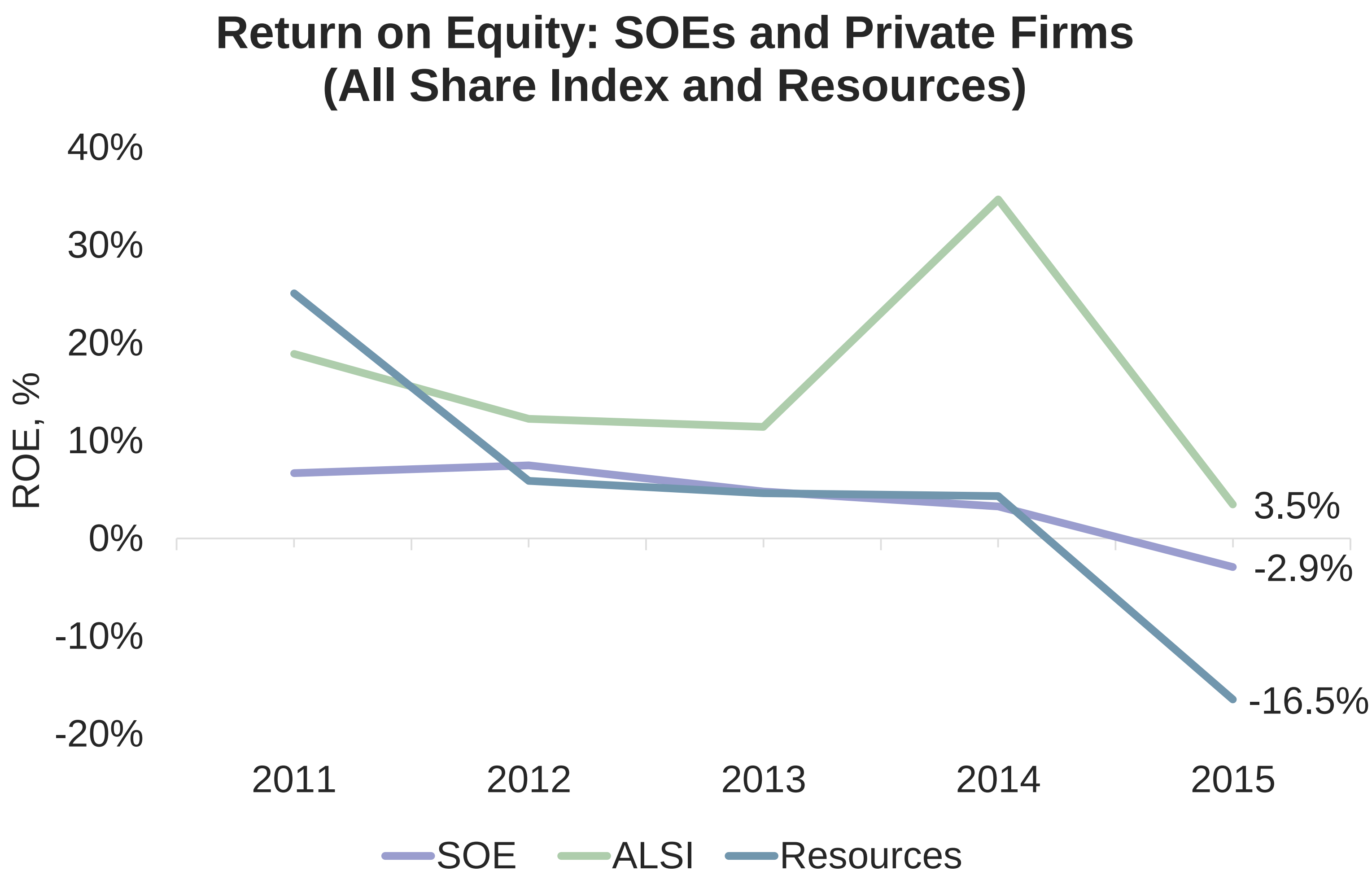

Source: National Treasury, February 2016 Budget Review and Bloomberg

Government guarantees to SOEs

Presidential Review confirms there are 715 in number

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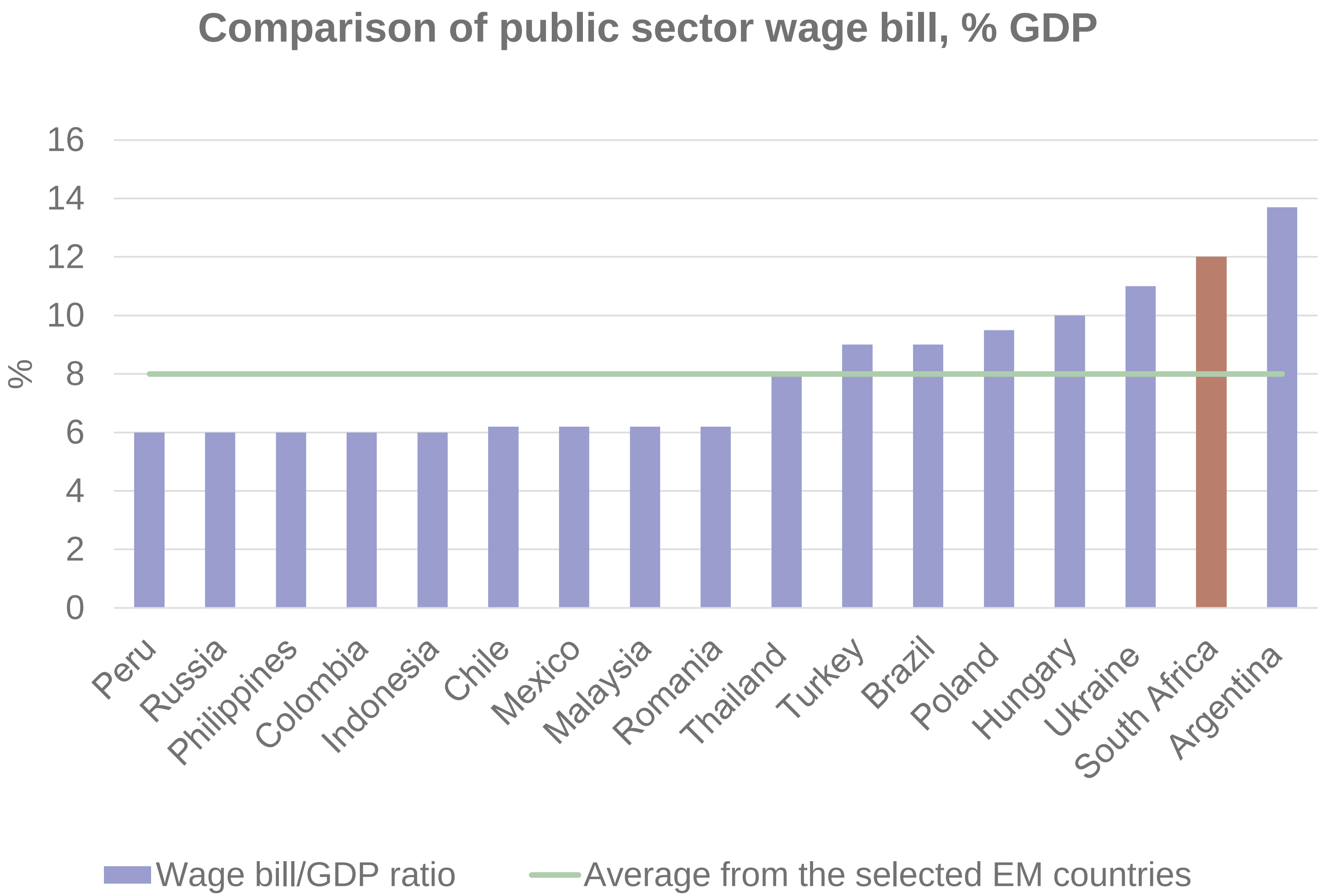
Value of state guarantees on selected SOEs, R bn, 2015/16

SOEs (total)	467	% of total
Eskom	**350.0**	**74.9%**
SANRAL	38.9	8.3%
Trans-Caledon Tunnel Authority	25.8	5.5%
South African Airways	14.4	3.1%
DBSA	14	3.0%
Land Bank	6.6	1.4%
SA Post Office	4.4	0.9%
Transnet	3.5	0.7%
IDC	2.1	0.4%
Denel	1.9	0.4%
SA Express	1.1	0.2%

Source: Presidential Review Committee on State-Owned Entities and National treasury, February 2016 Budget Review

Enlarged public sector wage bill

On the high side relative to other emerging countries



Source: Adopted from the International Monetary Fund, IMF Article IV South Africa 2014 and Investment Solutions

Reduce the debt load

Debt can have perilous effects on the economy

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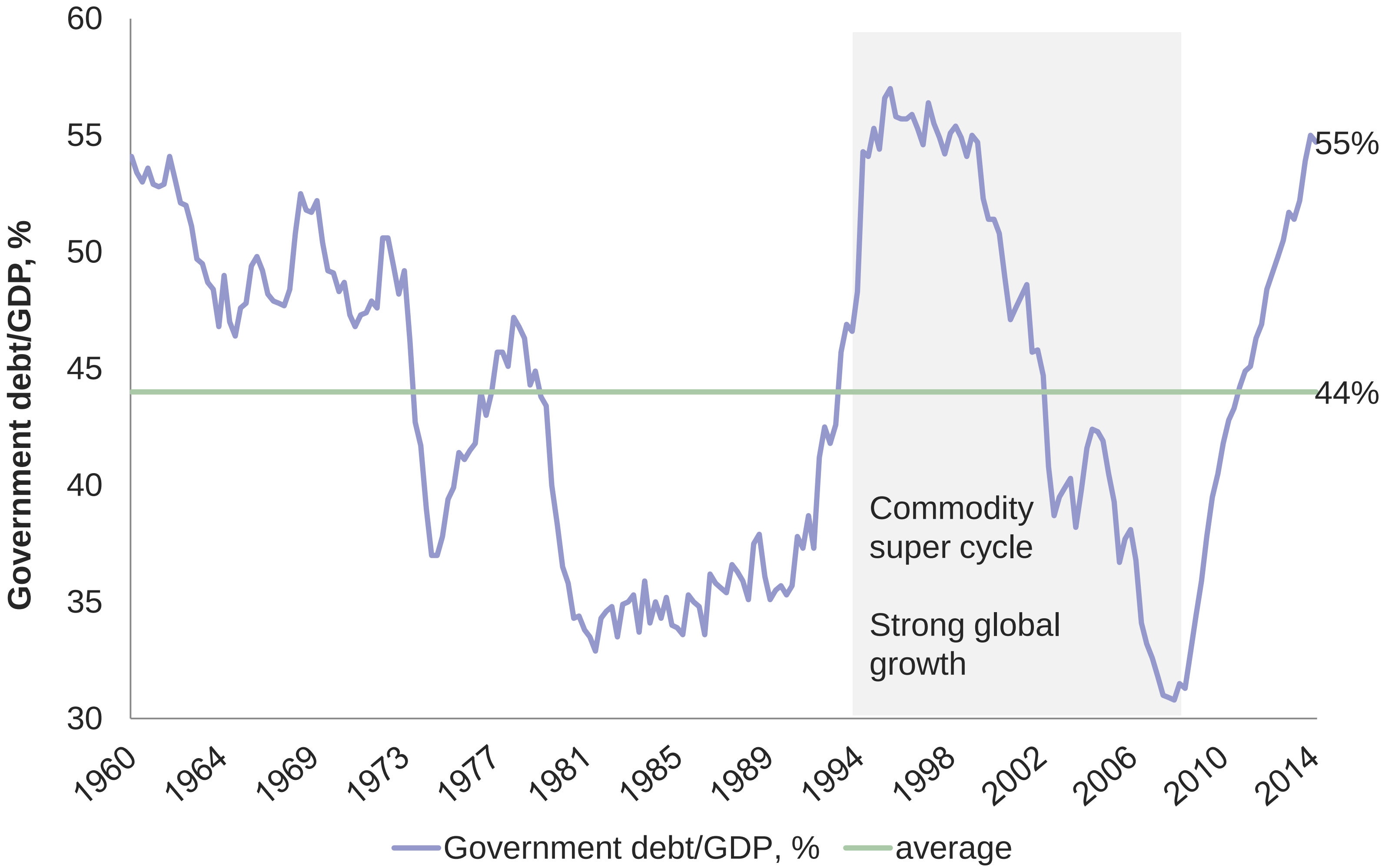

Source: Bank for International Settlements, September 2015

Debt perils

For every rand earned 12 cents paid in interest

	Average growth 2015/16 -- 2015/19
Debt-service costs	11.4%
Social protection	8.1%
Tertiary education	7.9%
Health	7.6%
Basic education	7.4%
Economic affairs	7.2%
Housing	6.7%
Defence	5.9%
Agriculture	4.9%
General public services	-5.4%
Total government expenditure	**7.1%**

Source: National Treasury, 2016 Budget Review

Lessons from other EMs

Policy response function

EMs downgraded into sub-investment grade

Standard & Poor's long term credit rating in foreign currency

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	Date	Rating
South Korea	12/22/1997	B+
Colombia	09/21/1999	BB+
Romania	10/27/2008	BB+
Hungary	12/21/2011	BB+
Brazil	09/09/2015	BB+

Source: Bloomberg

IMF bailout and rating downgrade

Case study

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	Date	Activity	Causes
Colombia	Sep-99	S&P downgrade to BB+ (from BBB-)	Social service benefits and transfers to local government.
	Dec-99	IMF loan US$2.7 billion	
Romania	Oct-08	S&P downgrade to BB+ (from BBB-)	Public sector wage and pension benefits combined with robust credit creation.
	May-09	IMF loan US$16 billion	
South Korea	4th Dec 1997	IMF loan US$35.1 billion	Current account crises, large external debt and contagion in the EM crisis.
	22nd Dec 1997	S&P four notch downgrade to B+ (from BBB-)	

Source: Bloomberg, Investment Solutions, Market and Economic Research, January 2016

Local themes

Time it took to return to investment grade

	Number of years to investment grade
Colombia	**12** (Sep 1999 to Mar 2011)
Romania	**6** (Oct 2008 to May 2014)
South Korea	**1** (Dec 1997 to Jan 1999)
Median	**6 yrs**
Range	**6 – 12 yrs**

Source: Bloomberg, Investment Solutions, Market and Economic Research, January 2016

Columbia's response function

Long & arduous 12 year journey

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START

1. Constitutionally mandated **revenue transfers**
2. Spending **cuts**
3. Tax **hikes**
4. Large **pension liabilities**
5. Higher **interest** & **wages**

MIDDLE

1. Revenue transfers to municipalities **continued**
2. **Additional** tax hikes
3. Pension **reform**
4. **Privatised** state owned banks
5. Large **public debt** (53% from 60% of GDP)

END

1. New laws to **limit** transfers
2. **Incentives** for firms
3. Established a **Sovereign Wealth Fund**
4. **Sound** financial system
5. Public debt (**36% of GDP**)

Source: International Monetary Fund, Article IV Consultation, including notes from the Executive Board Assessment

South Korea’s response function

Fast paced, agile 12 months

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START

1. **Bankrupt** conglomerates
2. No **bailouts**
3. No **guarantees**
4. Hiked **taxes**
5. **Labour** flexibility

MIDDLE

1. High **confidence** levels
2. Fiscal policy **loosened**
3. **FDI** accelerates
4. Set up a **‘bad bank’**
5. Issued $4 bn in **global markets**

END

1. Successful **implementation**
2. Large **capital inflows**
3. **Open** economy
4. **Narrowing** output gap
5. **Daewoo** failed

Source: International Monetary Fund, Article IV Consultation, including notes from the Executive Board Assessment

Hungary's response function

Still on the grind

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START

1. Public debt **67% of GDP**
2. Large stock of **external debt (106% of GDP)**
3. **Undercapitalized** banks
4. Nationalized $14bn of **private pension funds**

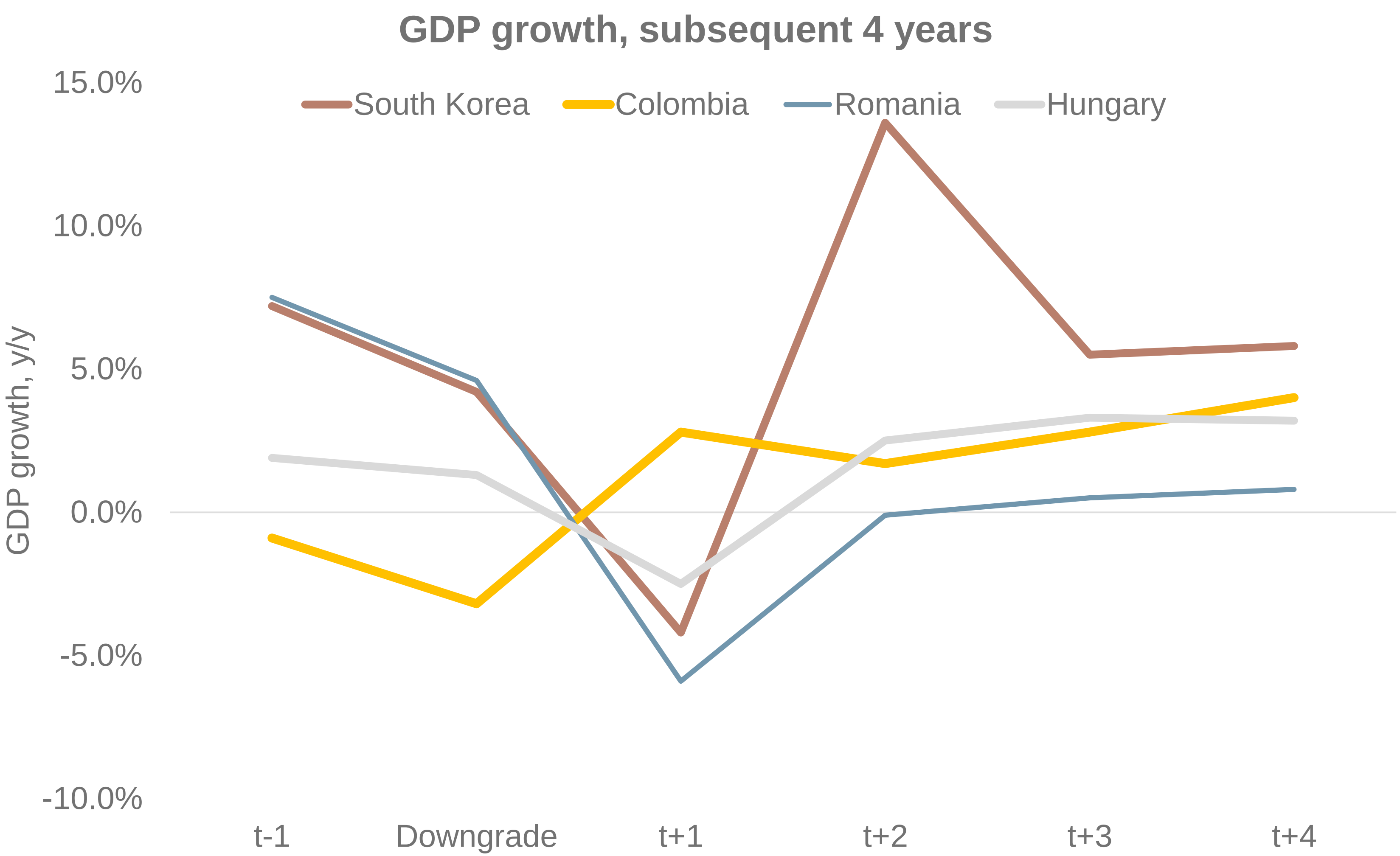
NOW

1. State-owned **MKB Bank** (4^{th} largest) to be privatised **early next year**
2. Monetary policy **easing**
3. Reduction of the **bank levy**
4. Authorities' intents to **downsize the public sector**

Source: International Monetary Fund, Article IV Consultation, including notes from the Executive Board Assessment, Reuters and Bloomberg

Recession profile around junk status

South Korea was heads and shoulders above the rest



Source: Bloomberg, Datastream and Investment Solutions

Lower inflation profile

Accompanied by aggressive policy easing

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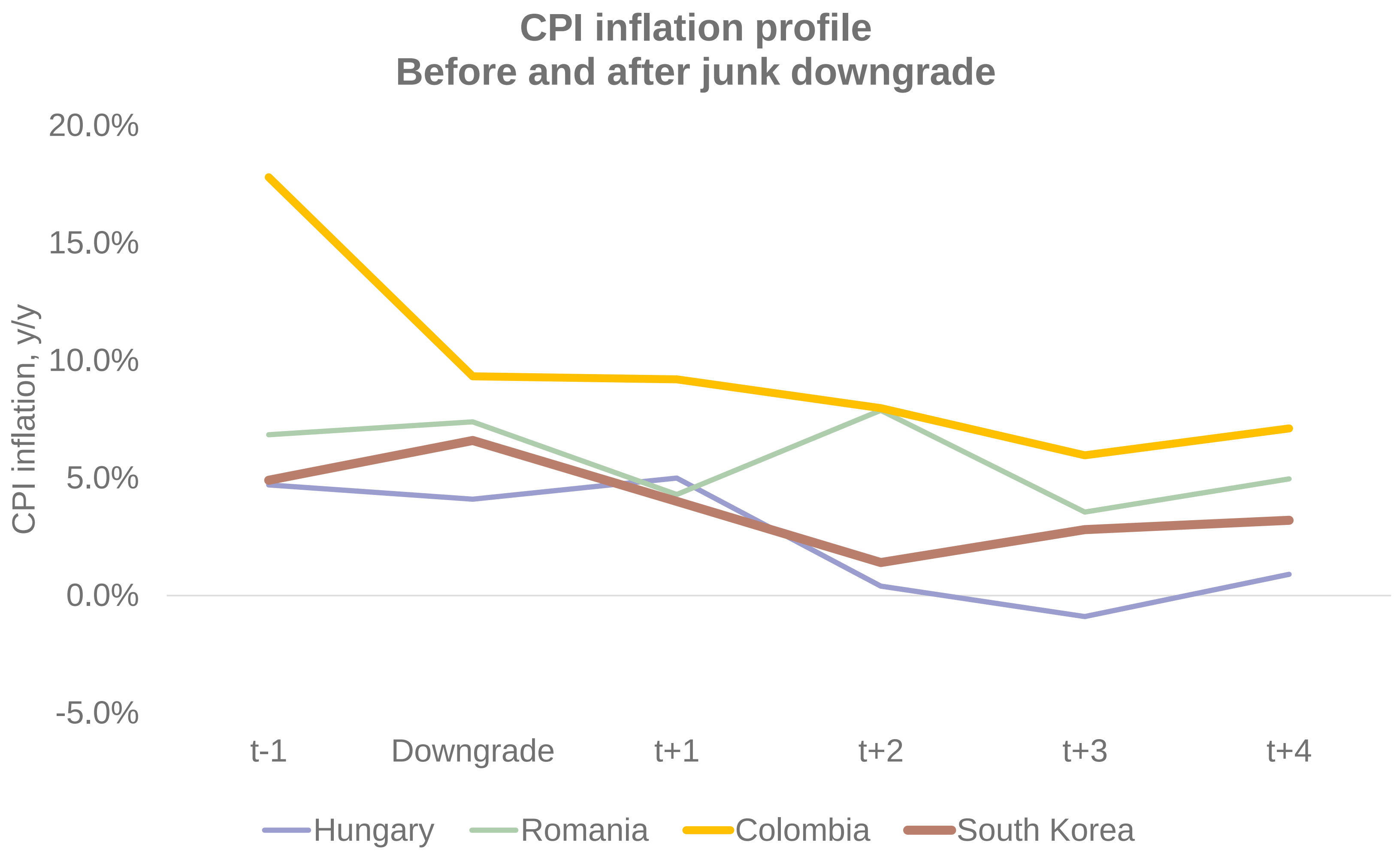


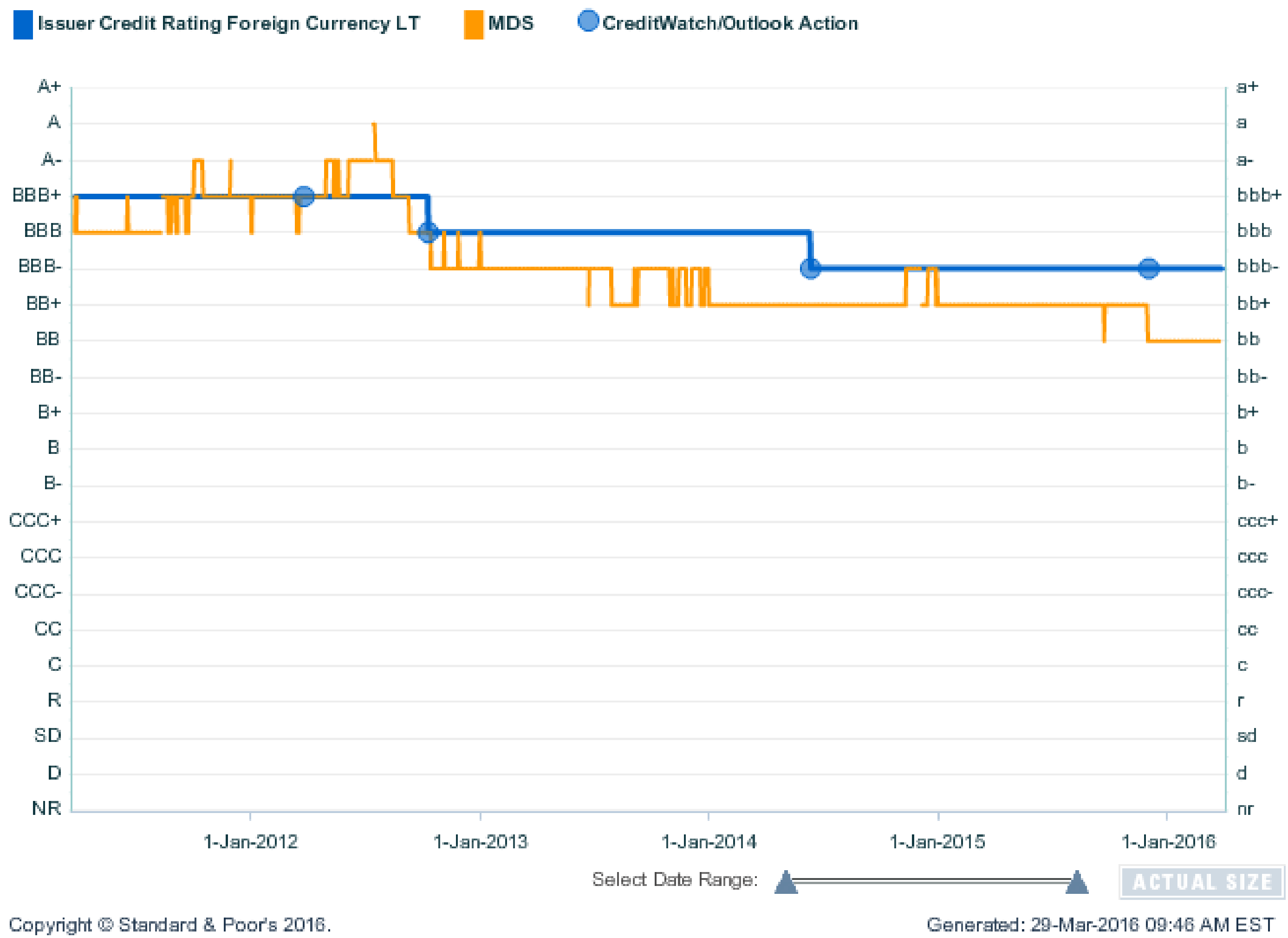
Source: Bloomberg, Datastream and Investment Solutions

Lessons from other EMs

Asset class performance

Implied credit rating calculated from CDS spread

SA = BB (two notches down from BBB-)



Source: Standard and Poor's

Empirical study from the SARB

Junk credit rating experiences

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Sample of **70** countries
Based on **Fitch ratings**
Only **foreign-currency debt**

- Short-end bond yields up **80** basis points
- Long-term bond yields up **104** basis points

Source: South African Reserve Bank, Monetary Policy Review, April 2016

Prior and during downgrades equities struggle

Subsequent year outcome contingent on authorities' response

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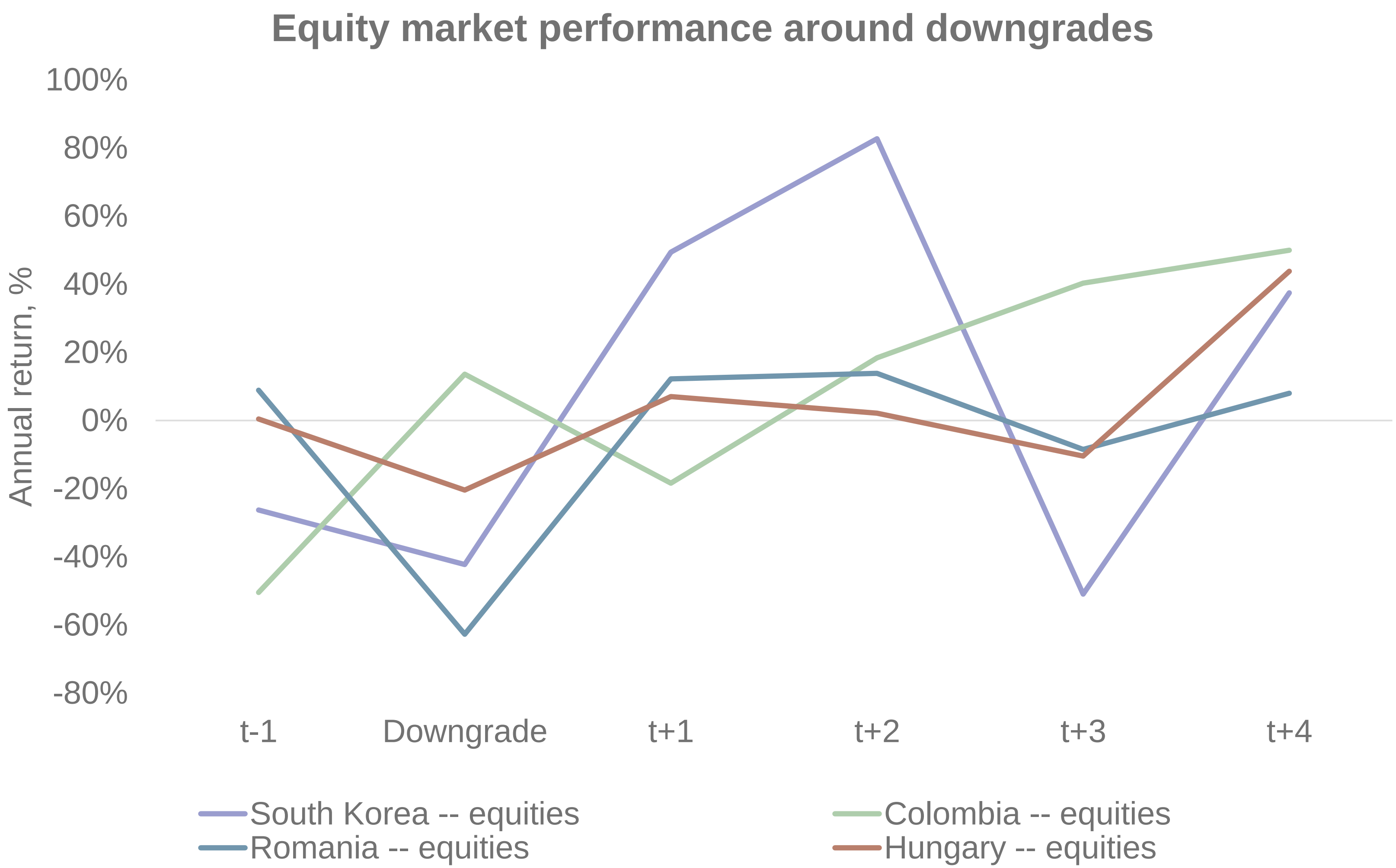

Source: Bloomberg, Datastream and Investment Solutions

Asset class performance around junk

Not a ‘catastrophic sell-off’

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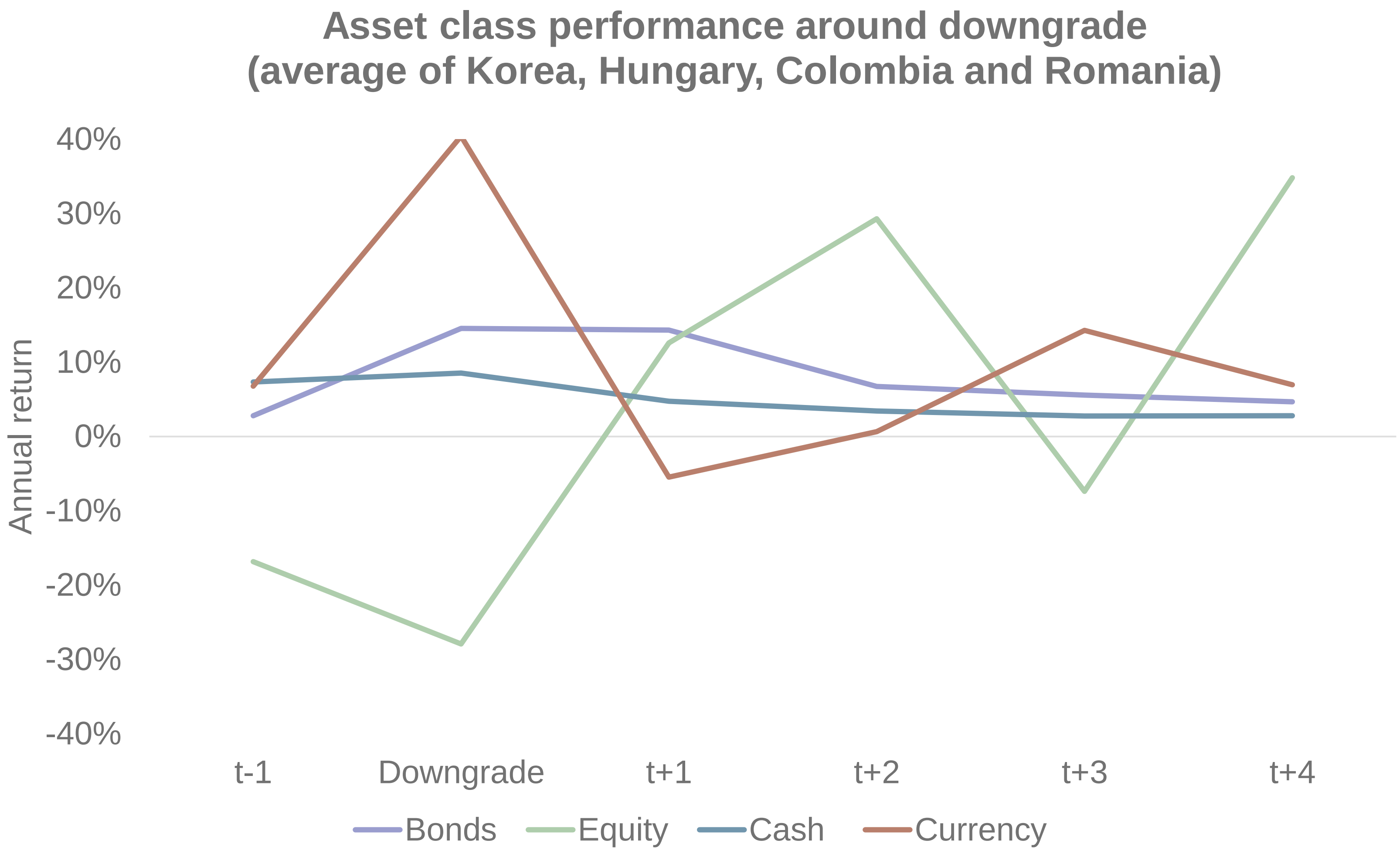

Source: Bloomberg, Datastream and Investment Solutions

Citi WGBI's exit criteria

How does SA stack up?

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	Detail	Comment
1. Market size	US$82 billion	More than double US$25 billion minimum
2. Credit quality	Long-term local currency: Moody's = Baa2 S&P = BBB+	It would take an 'Arab Spring' type outcome to be pushed into junk
3. Barriers to entry	Open and deep financial markets	No visible deliberate policy construct which prohibits foreign investors from replicating the ALBI

Source: Bloomberg, Investment Solutions, Market and Economic Research, April 2016

Where to start?

Answer in SMEs

SMEs

Contribution to total employment

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	SME employment (% total)
China	78
Egypt	74
Mexico	72
Brazil	67
India	67
Ghana	66
Nigeria	60-70
Kenya	>60
United States	51
Russia	51
United Kingdom	40
South Africa	39
Malawi	38

Nigeria has a greater SME content in job creation

Source: World Bank (2005), SMEs across the Globe, http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/SME_globe.pdf

SMEs

Manufacturing

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	SME employment (% total manufacturing)
South Africa	81.5
Ghana	51.6
Zambia	36.6
Kenya	33.3
Tanzania	32.1
Burundi	20.5
Nigeria	16.7
Zimbabwe	15.2

Most of SSA still not industrialized

Source: World Bank (2005), SMEs across the Globe, http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/SME_globe.pdf

Ideas/solutions

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How to avoid junk status?

Turning the tide on the decline

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1. Concede that tax hikes are not the solution to SA's problem
2. Move the correct levers – high multipliers
3. Do innovative things – Global Finance Center
4. Reposition ailing mining towns towards different economic models prioritising SMEs

1. Concede tax hike are not a solution

Tax burden goes beyond the math!

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	Tax-to-GDP ratio	Personal income tax	Corporate income tax	Value-added tax
Germany	36.1	47.5	30.2	19.0
Russia	34.8	13.0	20.0	18.0
Brazil	33.4	27.5	34.0	17.0 - 19.0
UK	32.6	45.0	20.0	20.0
Canada	30.5	49.5	26.3	50.0
Turkey	28.7	35.8	20.0	18.0
Australia	27.5	46.5	30.0	10.0
South Africa	**25.7**	**41.0**	**28.0**	**14.0**
Chile	19.8	39.5	22.5	19.0
China	19.4	45.0	25.0	17.0

"I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."

Winston Churchill

Source: National Treasury, February 2016 Budget Review and https://richardlangworth.com/taxprosperity

2. Moving the correct levers

Focus on high multiplier sectors

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	Domestic output multiplier	Employment multiplier effect
1. Retail and hospitality	1.6	5.3
2. Agriculture	1.7	4.9
3. Construction	1.9	4.9
4. Personal services	1.5	4.1
5. Financial services	1.7	3.1
6. Transport	1.6	2.9
7. Manufacturing	1.4	2.6
8. Mining	1.4	1.6
9. Electricity	1.6	1.4

An additional R1 m spent, generates R1.7 m & creates 5 jobs in the retail and hospitality sector

Source: National Treasury, February 2016 Budget Review

3. Do innovative things

Create a financial centre

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- International Finance Centre;
- From Empire Road, Joe Slovo and M2 including Hillbrow;
- Lower taxes and remove red tape;
- See private capital flock into an area which is an ‘eye saw’;
- Watch investor confidence turn positive;
- Former Governor Tito Mboweni calls it a ‘no brainer’.

Source: Sunday Times, 18 October 2015, a version of Tito Mboweni’s lecture given at the University of the Witwatersrand

4. Build new cities

And reorient ailing mining towns

- Do micro-economic reforms expressed through targeted **economic zones**;
- Refocus economic drivers for **ailing mining towns**;
- **Lower taxes** and remove red tape;
- Create **smart cities** through large scale infrastructure projects;
- Mauritius building **more than half a dozen** new smart cities;

Source: Ministry of Finance Mauritius, 2015/16 Bduget Speech

Conclusion

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Implications for retirement investors

- **Fundamental values in currencies and asset markets play out over a long-term**
- **It is at these points of inflection that investors should stick to the long-term goal in investing even when outcomes in markets could prove to be more volatile**
- **Diversification remain the best investments strategy**