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SA SOVEREIGN CREDIT RATING PREVIEW – MOODY'S

New Politics, New Uncertainties, But Same Old Risk Constraints

Moody's Investors Service reviews South Africa's credit rating this week, in the first of two scheduled reviews for the calendar year. The publication release dates are **23 March 2018** and **12 October 2018**. As a comparison, we show the release schedule for Fitch and S&P below:

Sovereign Rating Release Dates – Fitch Ratings And S&P Global Ratings

- **Fitch Ratings:** No scheduled reviews. The primary analyst is not based in a regulatory jurisdiction that requires the publication of a sovereign rating release calendar. However, we estimate that release dates will fall within a six-month period after the last publication.
  - **Last Rating Review Date:** 23 November 2017
  - **Next Expected Rating Review Dates:** 21-25 May 2018; 19-23 November 2018
- **S&P Global Ratings:** S&P published their "*Calendar Of 2018 EMEA Sovereign, Regional, And Local Government Rating Publication Dates*" on 15 December 2017.
  - **Last Rating Review Date:** 24 November 2017
  - **Next Scheduled Review Dates:** 25 May 2018; 23 November 2018

Moody's has South Africa's Sovereign rating at "Baa3", which is one-notch above speculative-grade. The rating has been on "Ratings Under Review" or "CreditWatch Negative" for the last four months (ie since 24 November 2017), following a lacklustre Medium-Term Budget Policy Statement and amidst heightened political tensions in the run-up to the ruling ANC's 54th Elective Conference. Subsequent to these, the agency has had an opportunity to measure the outcomes of the Elective Conference and review the credibility of the February Budget – neither of which prompted the agency to resolve the "CreditWatch" ahead of its scheduled March 2018 rating review committee meeting. This is a promising sign in our opinion.

Our base-case Scenario: Affirmation at "Baa3", and revised outlook from "Rating Under Review" to "Negative". We think the key credit discussions in the committee will centre around:

1. **Sustainability of National Treasury's fiscal and growth projections.** Will GDP growth come to the party via increased private sector investment underpinned by stronger sentiment? If not, why then is the Sovereign not yet positioning for more austere measures in order to cut debt?
2. **Peer Comparison.** How does South Africa's key credit metrics compare to close peers such as Turkey ("Ba2/Stable") and Hungary ("Baa3/Stable"), and are Moody's relativities still correct?
3. **Transition Timing.** If Moody's does not downgrade the Sovereign now, then what is the new window to watch, and what could the drivers be going forward (Eskom, fiscal slippage by MTBPS, continued policy uncertainty surrounding the mining charter, land expropriation without compensation, and external vulnerabilities as developed market interest rates start to climb)?

We must remember that the disposition of the committee is already a negative one. When it placed South Africa on "CreditWatch Negative" in November 2017, it did so from a "Negative Outlook".

This "Negative Outlook" had been in place since 9 June 2017, at the "Baa3" rating level. The semantics of this is that it signifies a shift from a "1-in-3" to a "1-in-2" probability of a downgrade, or that a downgrade is a foregone conclusion.

Moody's seems to have shown some restraint and opted to wait and see how a fluid situation would settle-down. The market consensus at the moment is that enough may have been done to buy the Sovereign more time (and that Moody's is likely to move back to a "Negative Outlook"). In our opinion, this action would be kicking the downgrade can down the road, and that eventually, over the next 12 months, South Africa's credit may succumb to speculative-grade ratings from Moody's unless GDP growth continues to surprise on the upside.

We think that the Sovereign Committee may have already convened (ordinarily, it can convene any time between Monday and Wednesday). Since Wednesday is a public holiday in South Africa, the Sovereign would need to be officially notified either by Close of Business (COB) on Tuesday, or by market open on Thursday. Under EU regulation, the Sovereign then has 24 hours (ending COB on Friday) to oppose the outcome and take it on appeal or accept it.

- If the Sovereign accepts the outcome, then the publication will be released after all major markets are closed at 22h00 GMT on Friday 23 March 2018, or before markets open the following business day on Monday 26 March 2018.
- If the Sovereign opposes the outcome, then the market would receive a press release after all markets are closed at 22h00 GMT on Friday, or before markets open the following business day. This press release would state that the rating outcome is being reviewed under appeal, and that it would be resolved within a specified timeframe. There would be no rating opinion at this stage. For an appeal to be accepted in the first place, the Sovereign needs to submit new facts to the Committee Chair that it believes are sufficient to change the Committee's decision. This would be an exceptional circumstance and given how transparent public information is in South Africa (as well as the rigour of the rating mission and the committee review process), it is unlikely that new facts would be available and that these would be sufficient to sway the committee's decision. Furthermore, it is not the character of the South African Sovereign to go down this road.

In our opinion, if there is a negative rating action in the offing, then the market may not be positioned for it. Nevertheless, this is not our base-case assumption.

Downgrade Probabilities – We estimate a 43% probability of a downgrade

The committee can either be constituted as a five- or a seven-member committee. Given the complexity of estimating South Africa's credit trajectory, and timing any potential rating transition into speculative grade, we think a larger committee format is likely. The probabilities of a downgrade are actually discrete. One never really can be certain how the final voting might go. However, we show a table of outcomes to illustrate and highlight our estimate.

Table 1: Illustrative Voting Scenarios For South Africa's Sovereign Rating

5-Member Committee		
Likely Outlook Statements	*Voting for a downgrade*	
Stable/Negative Outlook	1/5	20%
Negative Outlook	2/5	40%
Downgrade	3/5	60%
	4/5	80%
	5/5	100%

7-Member Committee		
Likely Outlook Statements	*Voting for a downgrade*	
Stable Outlook	1/7	14%
Stable/Negative Outlook	2/7	29%
Negative Outlook	3/7	43%
Downgrade	4/7	57%
	5/7	71%
	6/7	86%
	7/7	100%

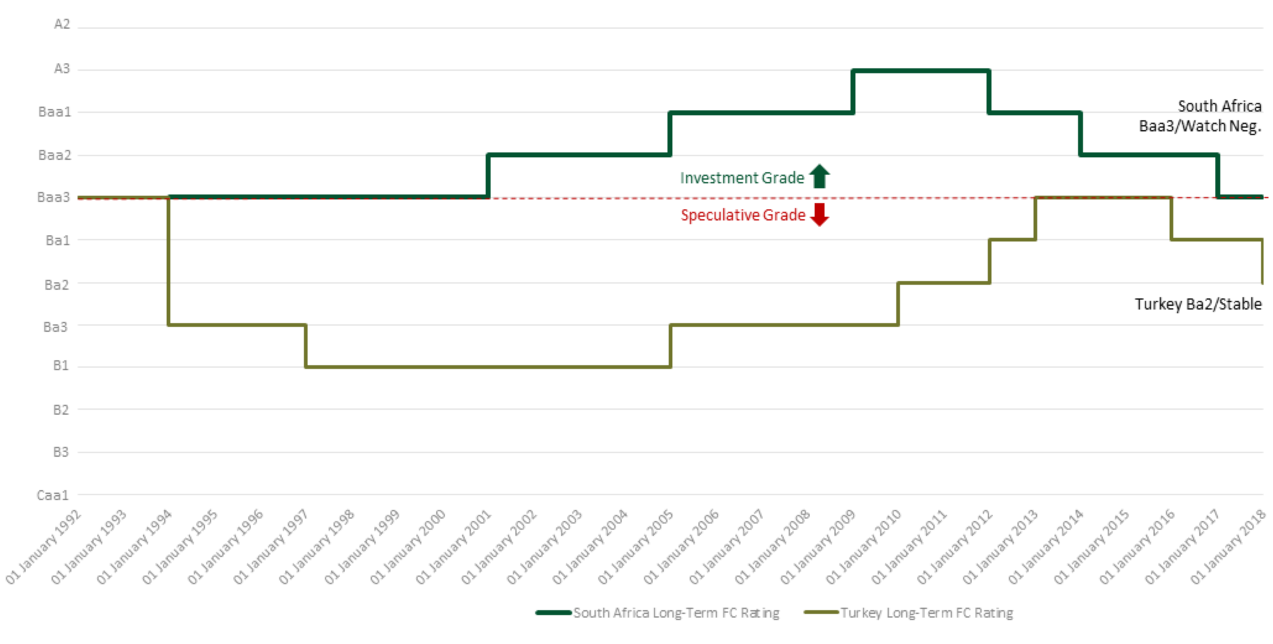
Source: Nedbank CIB

Our core assumption is that those members who voted for a downgrade in the past are unlikely to now have seen fundamental credit metric changes to motivate them to change their view. The metrics were not good at the time of the MTBPS and the Budget, and the Sovereign has only recently managed to salvage some credibility (benefit-of-the-doubt). There has been no fundamental change to the credit direction. For instance, South Africa's net debt-to-GDP ratio is projected to stabilise at about 53%, which is well-above the median range for lower-rated sovereigns in the "Ba-range" (meanwhile South Africa is rated "Baa3"). Those voting members of the Committee that wanted to 'wait and see' are likely to buy the story that South Africa now has better prospects for its structural reform agenda and that the timing of a downgrade might now not be appropriate.

If we look at the case of Turkey (which was downgraded to "Ba2" earlier this month), the Committee 'ran out of patience' with the country. Internal political and geo-political tensions were climbing and fiscal stimulus (supporting high short-term growth rates) comes at a cost to medium-term fiscal balances. The grave concern for the Committee was the widening current account deficit, the low foreign currency reserves (Turkish banks and corporates are largely US dollar funded, with high short-term roll-over risk), and a diminished capacity for the Central Bank to reign-in inflation. All of these could induce a balance of payments crisis, at a time when developed market interest rates are expected to climb.

This might be instructive for South Africa, given that Turkey is a close peer. The leeway South Africa has at the "Baa3" rating might be fast running out – after all credit ratings are all about international comparability. Still, when we compare South Africa's rating history at Moody's to that of Turkey, we find that South Africa's transitions have been more gradual and stable, and that maybe the two-notch difference between the two countries may not be all that unusual in the institutional mind of Moody's.

Chart 1: South Africa vs Turkey – Moody's Long-Term Foreign Currency Rating History



Source: Nedbank CIB, Moody's

Appendix

Table 2: South Africa vs Turkey – Moody's Scorecard Comparison

Rating factors	Sub-factor weighting	South Africa Indicator	South Africa Indicative factor score	South Africa Final factor score	Turkey Indicator	Turkey Indicative factor score	Turkey Final factor score
Factor 1: Economic strength			M+	**MODERATE+**		H+	**HIGH**
Growth Dynamics	**50%**						
Average real GDP growth (2012-2021F)		1.6			4.8		
Volatility in real GDP growth (standard deviation, 2007-2016)		1.9			4.4		
WEF Global Competitiveness index (2017)		4.3			4.4		
Scale of the economy	**25%**						
Nominal GDP (US$ billion, 2016)		294.8			863.7		
National income	**25%**						
GDP per capita (PPP, US$, 2016)		13291			24,986		
Automatic adjustments	**[-3; 0]**	Scores applied			Scores applied		
Credit boom		0			0		
Factor 2: Institutional strength			H-	**MODERATE+**		M	**LOW+**
Institutional framework and effectiveness	**75%**						
Worldwide Government Effectiveness index (2016)		0.3			0.0		
Worldwide Rule of Law index (2016)		0.1			-0.2		
Worldwide Control of Corruption index (2016)		0			-0.2		
Policy credibility and effectiveness	**25%**						
Inflation level (%, 2012-2021F)		5.6			9.2.		
Inflation volatility (standard deviation, 2007-2016)		1.9			1.3		
Automatic adjustments	**[-3; 0]**	Scores applied			Scores applied		
Track record of default		0			-1		
Economic Resiliency(F1xF2)			**H-**	**MODERATE+**		**H-**	**MODERATE +**
Factor 3: Fiscal strength			M+	MODERATE+		H+	HIGH-
Debt burden	**50%**						
General government debt/GDP (2016)		51.3			28.3		
General government debt/revenue (2016)		142.9			82.5		
Debt affordability	**50%**						
General government interest payments/revenue (2016)		11			5.9		
General government interest payments/GDP (2016)		4.0			2.0		

Automatic adjustments	[-6; +4]	Scores applied			Scores applied		
Debt trend (2013-2018F)		0			0		
Foreign currency debt/general government debt (2016)		0			-3		
Other non-financial public sector debt/GDP (2016)		-1			0		
Public sector assets/general government debt (2016)		0			0		
Government financial strength (F1xF2xF3)			**H-**	**MODERATE+**		**H**	**MODERATE+**
Factor 4: Susceptibility to event risk	**Max. function**		M-	MODERATE-		H-	HIGH
Political risk			M-	M-		H-	M
Worldwide voice & accountability index (2016)		0.6			-0.6		
Government liquidity risk			L	L		L-	M
Gross borrowing requirements/GDP		7.3			4.6		
Non-resident share of general government debt (%)		33.7			40.7		
Market-Implied Ratings		Ba1			Ba2		
Banking sector risk			L+	L		M	M
Average baseline credit assessment (BCA)		baa3			ba2		
Total domestic bank assets/GDP		112			105		
Banking system loan-to-deposit ratio		95			119		
External vulnerability risk			L	L		M+	H
(Current account balance + FDI Inflows)/GDP		-2.5			-2.3		
External vulnerability indicator (EVI)		95.3			228.2		
Net international investment position/GDP		7.5			-42.4		
Government bond rating range (F1xF2xF3xF4)			**A3 - Baa2**	**Baa2 - Ba1**		**A3 - Baa2**	**Ba1-Ba3**
Assigned foreign currency government bond rating		**Baa3**			**Ba2**		

Source: Moody's

Worse score compared to South Africa
Better score compared to South Africa
Similar score compared to South Africa

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