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LOCAL MARKETS AND THE WGBI: MUCH ADO ABOUT NOTHING?

Our analysis indicates that after six months, the impact of a downgrade and subsequent WGBI exclusion is likely to be negligible. Bonds recover first, then the currency and then inflation. The risk, in our view, is that markets normalise much faster than our analysis suggests.

- We expected rand weakness to fade after the MTBPS. But the weakness faded much faster (see Fade the MTBPS weakness and focus on the Fed dated 29 October 2019).
- There may well be a lesson to be learnt from the fast recovery in the rand ahead of a potential Moody's downgrade of South Africa's (SA's) sovereign rating and subsequent World Government Bond Index (WGBI) exclusion of the country's local-currency debt.
- We simulate a potential WGBI exclusion: our simulations show that after six months, the impact of a downgrade and subsequent WGBI exclusion is likely to be negligible. Bonds recover first, then the currency and then inflation. The risk, in our view, is that markets normalise much faster than our analysis suggests.
- Technically, USDZAR support is at 14.70. At this level, the USDZAR has retraced 61.8% of the rally after the MTBPS (see Technical Strategy Note dated 5 November 2019).
- Our fundamental "fair value" range for the currency remains at 14.00-14.50, with a year-end target towards the higher end of this band.

We believe the effect of a downgrade and WGBI exclusion will be transitory

After Moody's revised SA's credit outlook to 'Negative', the impact of a downgrade to non-investment grade on the bond and currency markets is again a key point of focus. It is well known that SA would be excluded from the WGBI and face forced selling of government bonds by foreigners should Moody's downgrade SA to non-investment grade.

To assume that WGBI exclusion would have no impact on local markets would be naïve (even if some of this is already priced in). That said, we believe the negative effect of a downgrade on the currency (and bond yields) will be transitory. We will not be surprised to see the currency back at pre-downgrade levels a few months after the fact.

We crunched the numbers and analysed potential flows (see Credit Insight dated 4 November 2019). Outflow may initially dominate, but this is likely to be offset by inflow at some point:

- Our estimates point to outflow of about USD0.75bn from global funds that track the WGBI (tracker funds).
- Our estimates also point to USD4.3bn of holdings of SAGBs by global funds that benchmark against the WGBI (benchmark funds).
- Assuming a complete liquidation of SAGB holdings of benchmark funds (highly unlikely, in our view), WGBI-related outflow could range anywhere between USD0.75bn and USD5.05bn.
- Note that there has already been net foreign portfolio outflow of USD2.1bn for the YTD from the SA bond market.
- Lastly, we attempted to quantify subsequent inflow following a WGBI exclusion, as SAGBs will be in demand by high-yield (HY) fixed income funds globally. Assuming SA's weight is 1% on average in these portfolios (EM GDP-weighted), inflow could amount to USD1bn; alternatively, assuming a more likely weight of 5% (EM HY GDP-weighted), inflow could amount to USD5.2bn.

As per the above, we believe there is a real probability that subsequent inflow to the local bond market, after a downgrade by Moody's, may negate any outflow almost entirely. However, we think it is more important to have a handle on how asset prices will react to this event.

ANALYST DETAILS
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We simulate a WGBI-exclusion scenario: bond yields recover first, then the currency and then inflation

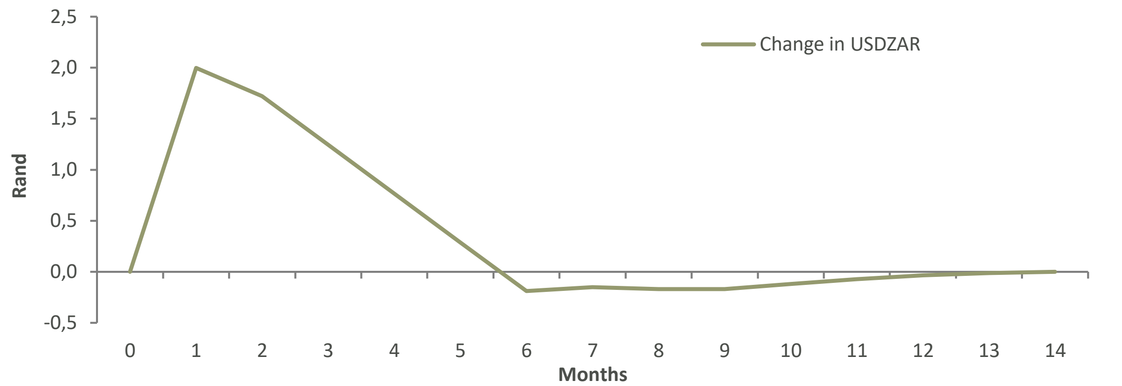
We simulate the impact of bond outflow (and subsequent inflow) on key SA markets. Specifically, we simulate the following impact:

- Outflow of USD2bn or ZAR30bn (net) from SA's bond market in the first month of WGBI exclusion.
- Inflow of USD500m or ZAR7.5bn per month for four months (i.e., USD2bn inflow in total), starting three months after WGBI exclusion.

Rand depreciation is potentially large, but short-lived (Chart 1)

- Our simulation indicates that the rand depreciates by about ZAR2.00 against the USD in the first month on the back of net USD2bn outflow. That is, if the rand trades at ZAR14.50, the currency could move towards the ZAR16.50 mark.
- As inflow returns (as per our assumption of a net USD500m/month starting in month 4 after exclusion), the rand appreciates slowly.
- After about six months, the effect on the rand is negligible.

Chart 1: Rand weakness and strength following initial bond outflow and subsequent inflow after WGBI exclusion

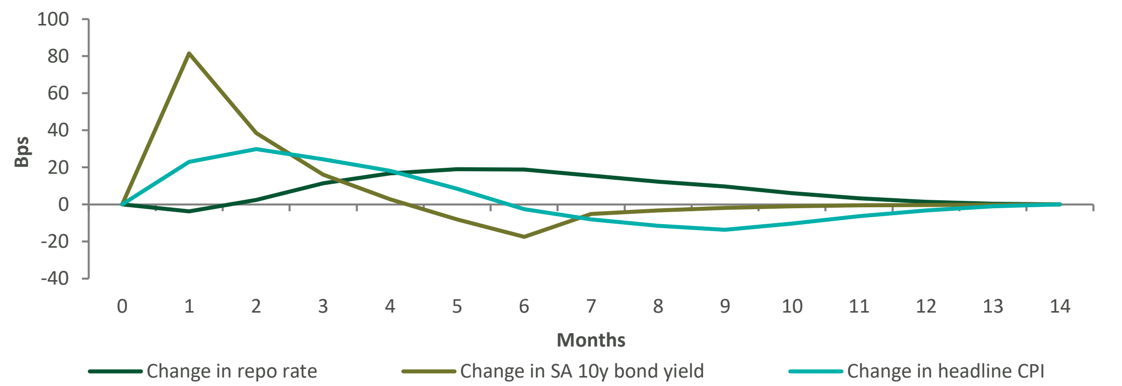


Source: Nedbank CIB Research

Bond yields move rapidly higher, but recover first (Chart 2)

- The 10-year bond yield moves about 80bps higher but recovers almost entirely after three months as foreign inflow to the bond market returns.

Chart 1: Rand weakness and strength following initial bond outflow and subsequent inflow after WGBI exclusion



Source: Nedbank CIB Research

- Headline CPI is about 30bps higher on the back of a weaker currency, with the largest impact after three months. Because of base effects, headline CPI is lower than before after about 10 months.
- The repo rate is about 20bps higher than before following the first six months of exclusion but returns to its original level after 12 months.

In our view, if the SARB continues to look through the first-round effects on inflation and bases its policy decisions rather on the second-round effects on inflation, the SARB could still, in a WGBI-exclusion scenario, cut the repo rate sooner rather than later.

As with the MTBPS, the recovery may be faster than our analysis suggests

We believe SA will lose its last investment-grade rating by a major rating agency in 2H20. This should be of major concern to SA's government, as it signals a continued deterioration in the country's fiscal sustainability and growth outlook.

Despite the deteriorating trend in the country's credit outlook, we expect local markets, including the currency, to recover to pre-downgrade levels within six months of the downgrade. Bonds are likely to recover first, followed by the currency. This recovery in the local market is, to a degree, a function of a global bond yields that remain extremely low.

Local exporters should use this event as an opportunity to buy the rand at attractive levels in the weeks immediately following the downgrade and WGBI exclusion.

Local importers should not panic. They should buy USD ahead of this event (e.g., before the Budget in February next year) or wait patiently for a recovery, which we believe will transpire.

Lastly, we believe the bias lies towards the impact being smaller, not greater, on local markets than our simulations suggest, largely because inflow may well return sooner than we expect.

2019 Macro Calendar

JANUARY

Mo	Tu	We	Th	Fr	Sa	Su
31	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31	1	2	3
4	5	6	7	8	9	10

17th Jan: SA MPC
24th Jan: ECB meeting
22-25 Jan WEF Davos
30 Jan: Fed FOMC

FEBRUARY

Mo	Tu	We	Th	Fr	Sa	Su
28	29	30	31	1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	1	2	3
4	5	6	7	8	9	10

7th Feb: BoE Meeting
7th Feb: SA SONA
13th-14th Feb: UK Mps to vote on Brexit
16th Feb: Nigeria election
20th Feb: SA budget

MARCH

Mo	Tu	We	Th	Fr	Sa	Su
25	26	27	28	1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31
1	2	3	4	5	6	7

1st Mar: End of 90-day trade truce US-China
7th Mar: ECB Meeting
15th Mar: BoJ Meeting
20th Mar: FOMC Meeting
21st Mar: BoE Meeting
28th Mar: SARB Meeting

APRIL

Mo	Tu	We	Th	Fr	Sa	Su
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	1	2	3	4	5
6	7	8	9	10	11	12

10th Apr: ECB Meeting
12-14th Apr: World Bank & IMF meet
17th Apr: Indonesia election
25th Apr: BoJ Meeting
April/May: India election

MAY

Mo	Tu	We	Th	Fr	Sa	Su
29	30	1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31	1	2
3	4	5	6	7	8	9

1st May: FOMC Meeting
2nd May: BoE Meeting
23-26th May: European Parlimentary election
26th May: Belguim election
May-August: South African election

JUNE

Mo	Tu	We	Th	Fr	Sa	Su
27	28	29	30	31	1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
1	2	3	4	5	6	7

6th June: ECB Meeting
19th June: FOMC Meeting
20th June: BoE and BoJ Meeting
28-29th June: G20 Summit

JULY

Mo	Tu	We	Th	Fr	Sa	Su
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	31	1	2	3	4
5	6	7	8	9	10	11

18th July: SA MPC
25th July: ECB Meeting
30th July: BoJ Meeting
31st July: FOMC Meeting

AUGUST

Mo	Tu	We	Th	Fr	Sa	Su
29	30	31	1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	1
2	3	4	5	6	7	8

1st August: BoE Meeting
25-27th Aug: G7 Summit

SEPTEMBER

Mo	Tu	We	Th	Fr	Sa	Su
26	27	28	29	30	31	1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	1	2	3	4	5	6

12th Sep: ECB Meeting
18th Sep: FOMC Meeting
19th Sep: SA MPC
19th Sep: BoE and BoJ Meeting

OCTOBER

Mo	Tu	We	Th	Fr	Sa	Su
30	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31	1	2	3
4	5	6	7	8	9	10

18-20th Oct: World Bank and IMF meet
23rd Oct: SA MTBPS
24th Oct: ECB Meeting
27th Oct: Argentina election
30th Oct: FOMC Meeting
31st Oct: BoJ Meeting, End of term for ECG President (Draghi) and EC President (Juncker)

NOVEMBER

Mo	Tu	We	Th	Fr	Sa	Su
28	29	30	31	1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	1
2	3	4	5	6	7	8

7 Nov: BoE Meeting
22 Nov: S&P/Fitch review SA credit rating

DECEMBER

Mo	Tu	We	Th	Fr	Sa	Su
25	26	27	28	29	30	1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31	1	2	3	4	5

11th Dec: FOMC Meeting
12th Dec: ECB Meeting
19th Dec: BoJ Meeting

Central Bank Meeting
World Summit/ IMF/ Trade war/ Political
Election

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