PSG Wealth

SA sovereign rating downgrade

3 April 2017

Contents

1 | Review results - S&P Global Ratings 3 April 2017

S&P downgraded foreign currency rating to BB+

Long-term local currency rating also downgraded to 'BBB-' from 'BBB'

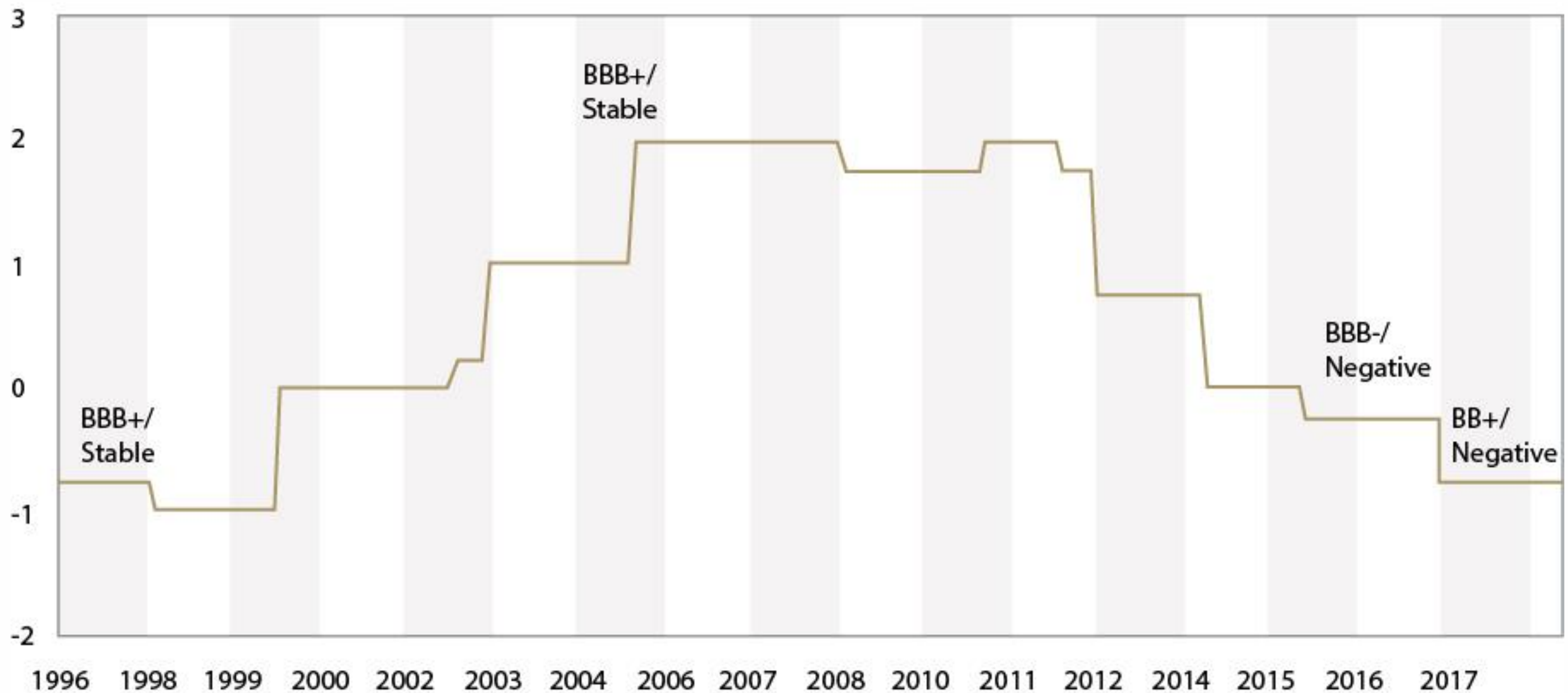
- S&P cut our long-term foreign currency rating from BBB- to BB+ on political and institutional uncertainty
- S&P rationale for lowering currency rating:
  - In our opinion, the executive changes initiated by President Zuma have put fiscal and growth outcomes at risk
  - We assess that contingent liabilities to the state are rising
  - The negative outlook reflects our view that political risks will remain elevated this year, and that policy shifts are likely, which could undermine fiscal and economic growth outcomes more than we currently project

- S&P decision of 3 April falls in our base case
  - Albeit sooner than expected

SOURCE: S&P Global Ratings

South Africa's ratings history

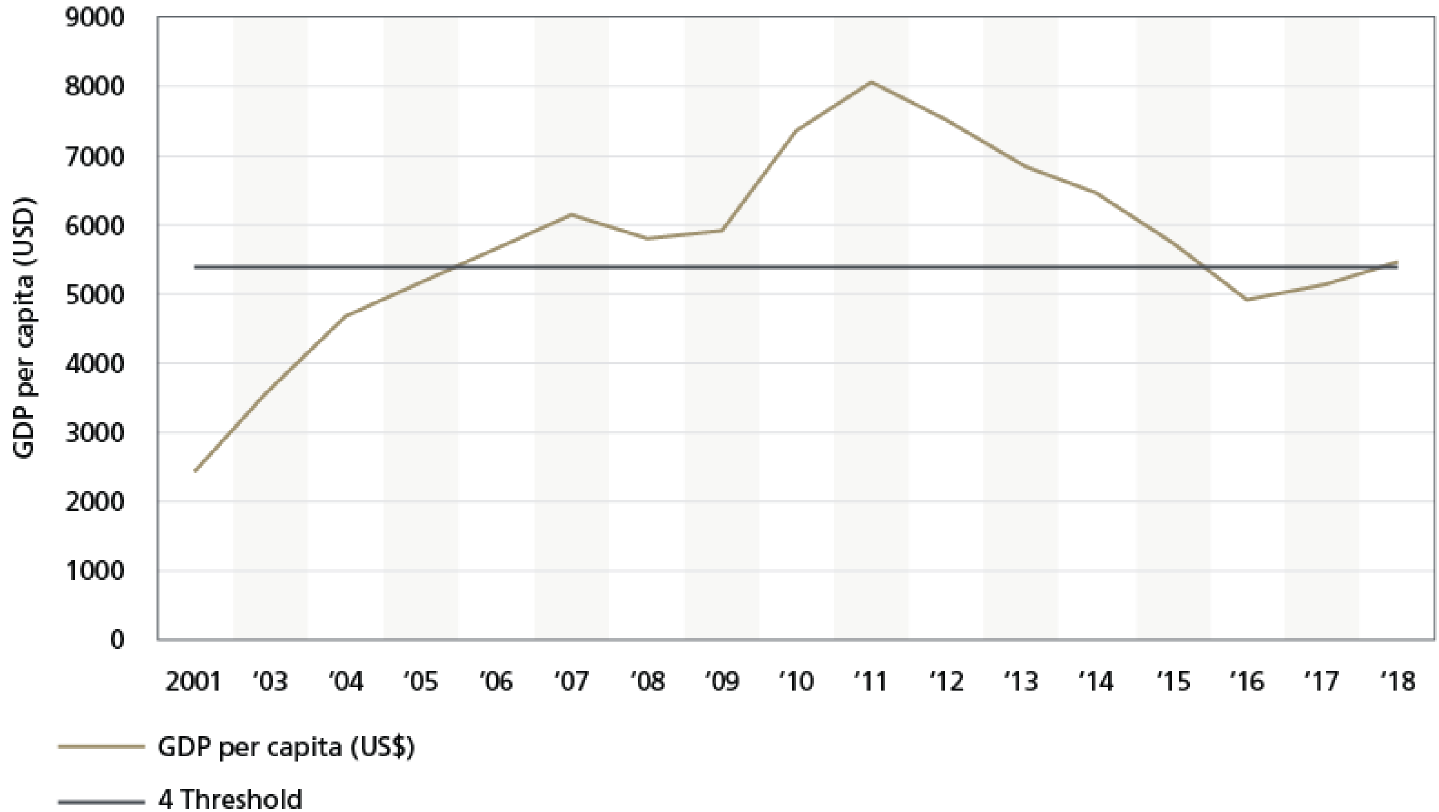
Last time SA was non-investment grade during 1999



SOURCES: PSG Wealth research team, S&P Global Ratings

Wealth levels are declining due to low GDP

Growth and rand weakness in recent years



SOURCES: PSG Wealth research team, S&P Global Ratings

From an economic perspective

…the following happens when a sovereign a downgraded to ‘junk’

- Government may struggle to raise funding for projects
- Yields on bonds should move higher to compensate investors for additional sovereign risks
- This increases governments’ cost of capital
- Added pressure on national budget, and ultimately taxes
- Corporate financing cost will also increase
- This places pressure on earnings and growth
- The rand already weakened sharply on downgrade news
- Further rand volatility likely to continue

2 | Rating factors

Republic of South Africa ratings score snapshot

Key rating factors	Jun-16	Dec-16	Apr-17
Institutional assessment	Neutral	Neutral	Neutral
Economic assessement	Weakness	Weakness	Weakness
External assessment	Neutral	Neutral	Neutral
Fiscal assessment: flexibility and performance	Weakness	Weakness	Weakness
Fiscal assessment: debt burden	Neutral	Neutral	Weakness
Monetary assessment	Strength	Strength	Strength

SOURCE: S&P Global Ratings

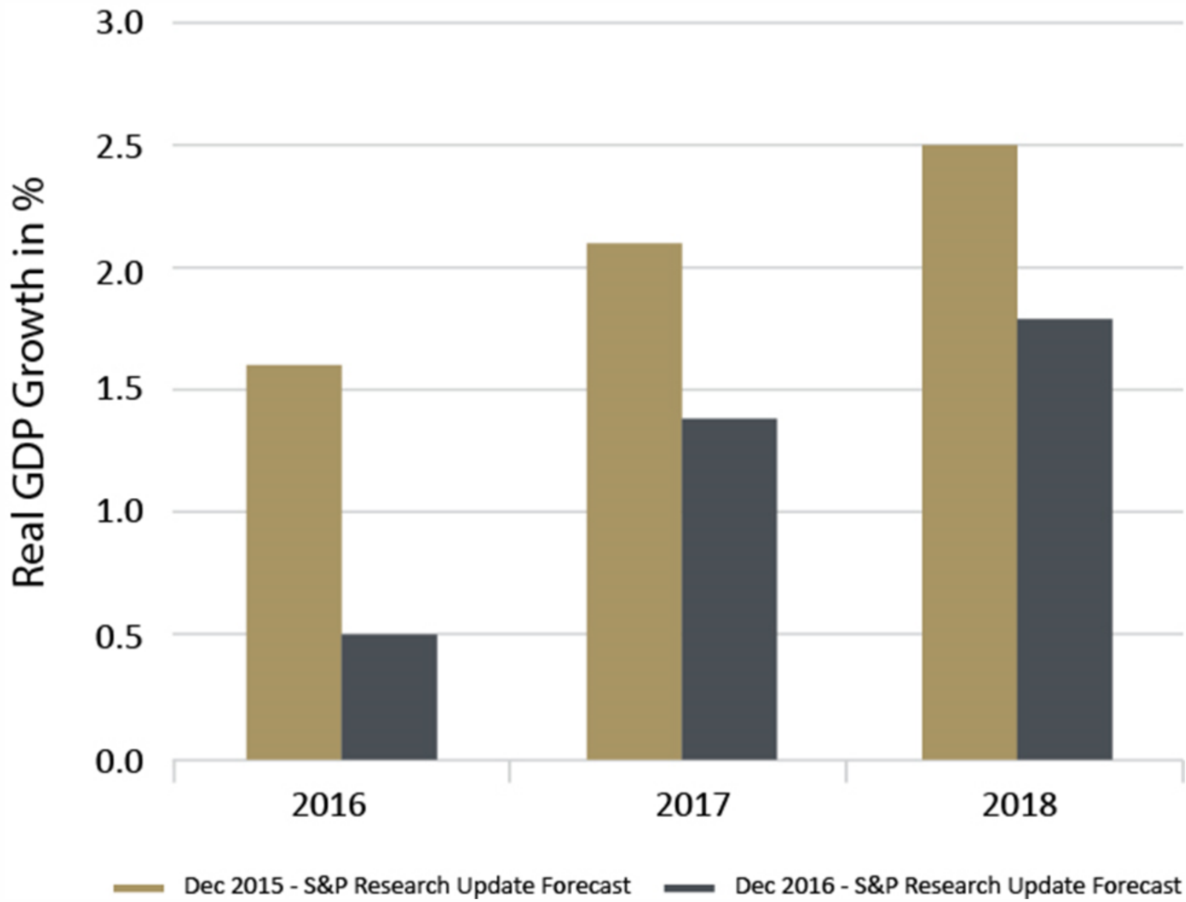
Institutional assessment (Neutral)

S&P affirms SA has strong democratic institutions

- South Africa has a strong democracy with independent media and reporting
- S&P believes SA will maintain institutional strength, particularly regarding the judiciary. This provides checks and balances and accountability where the executive and legislature has appeared less willing to do so
- The government has set up a commission into minimum wages, which has provided a starting point for negotiations with business and labour unions
- However, political tensions are still high
- Tensions and contestations to increase in run up to ANC’s December 2017 elective conference
- This could weigh on investor confidence and exchange rates, and potentially affect government policy direction
- Domestic capital markets are well developed

Economic assessment (Weakness)

The negative outlook reflects a weaker-than-expected real GDP growth



SOURCE: Treasury, Reserve Bank, IMF, S&P Global Ratings, PSG Wealth research team

External assessment (Neutral)

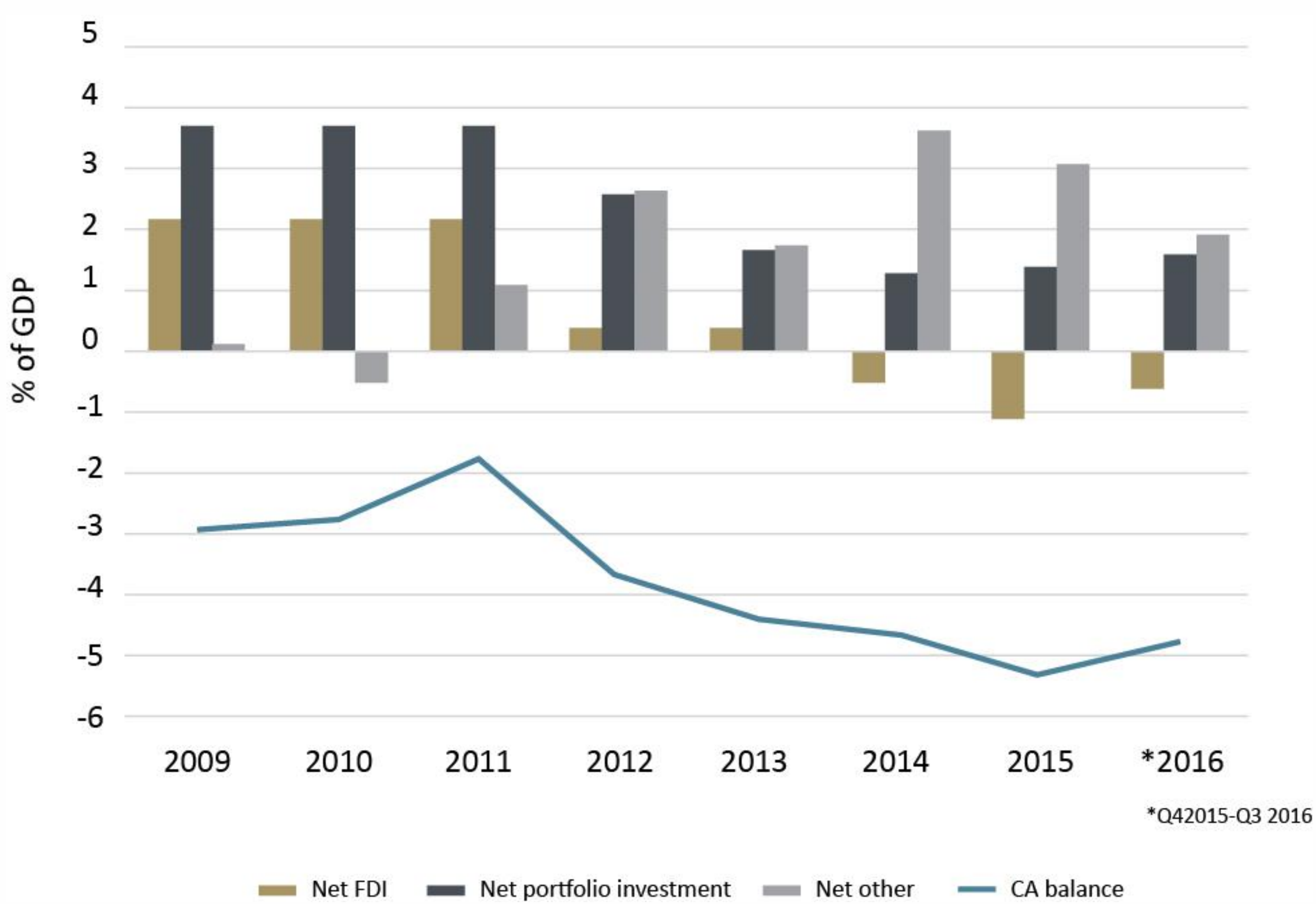
SA’s gross external financing needs are large

- Averaging over 100% of current account receipts (CARs) plus useable reserves
- However, they are declining because the current account deficit is narrowing
- The trade deficit (surplus in 2016) has seen contraction, but given the small recovery in oil prices (oil constitutes about one-fifth of South Africa's imports) S&P sees the trade balance weakening again
- S&P also sees weaker domestic demand and a notable increase in exports from the mining and manufacturing sectors, along with a slower pace of increase in imports

Source: S&P Global Ratings

External assessment (Neutral)

The shift in current account funding over time



Source: S&P Global Ratings

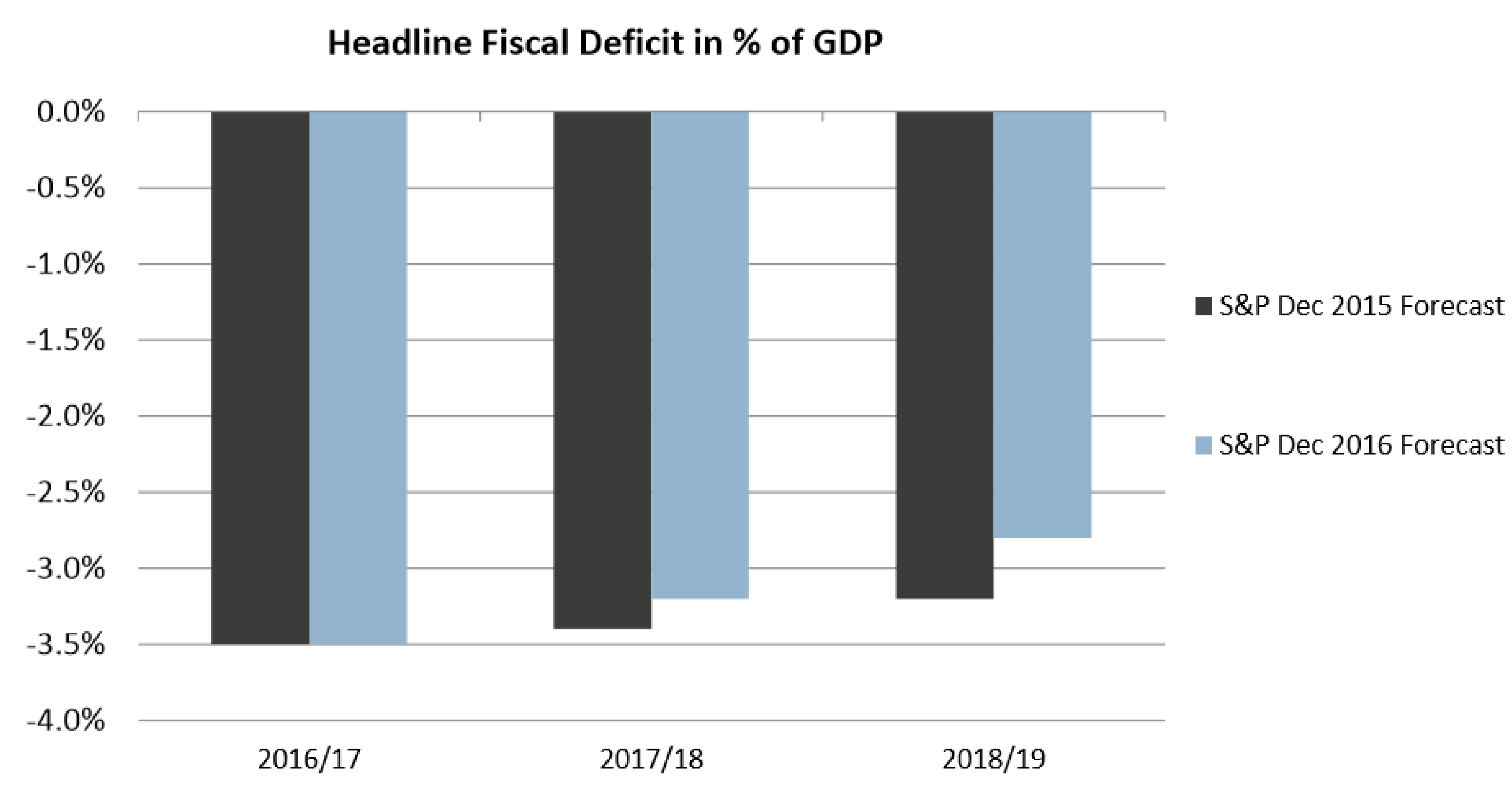
Fiscal assessment: flexibility and performance (W?)

Real exports growth likely to be slow

- S&P expects:
  - Real exports growth to be slow over 2017-2020
  - Compressed import growth amid currency weakness and the subdued domestic economy
  - Estimate current account deficits will average close to 4% of GDP over 2017-2020

Fiscal assessment: flexibility and performance (W?)

Fiscal forecasts suggest stabilisation may be near?



Source: S&P Global Ratings

Fiscal assessment: debt burden (W)

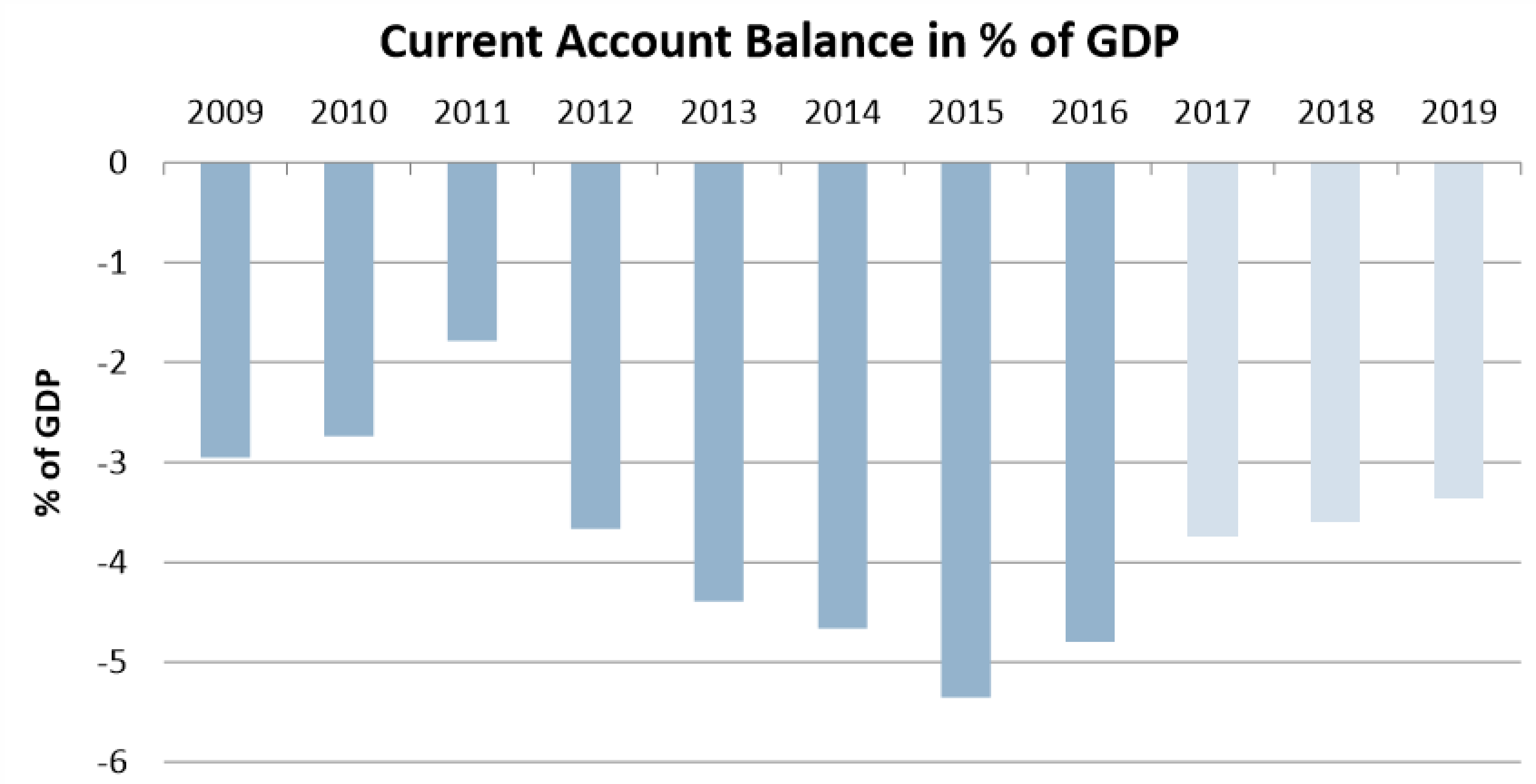
From ‘Neutral’ in December to ‘Weakness’ in April

- SA depends on resident and non-resident purchases of rand-denominated local currency debt to finance its deficits
- S&P estimates the change in general government debt will average 4.2% of GDP over 2017-2020
- On a stock basis, general government debt net of liquid assets increased to about 48% of GDP in 2017 from about 30% in 2010
- S&P expects it will stabilise at just below 50% of GDP in the next three years
- Less than one-tenth of government's debt stock is denominated in foreign currency
- However, non-residents hold about 35% of government's rand-denominated debt
- This could make financing costs vulnerable to foreign investor sentiment, exchange rate fluctuations, and rises in developed market interest rates.
- S&P projects interest expenses will remain at about 11% of government revenues this year

S&P Global Ratings

Fiscal assessment: debt burden

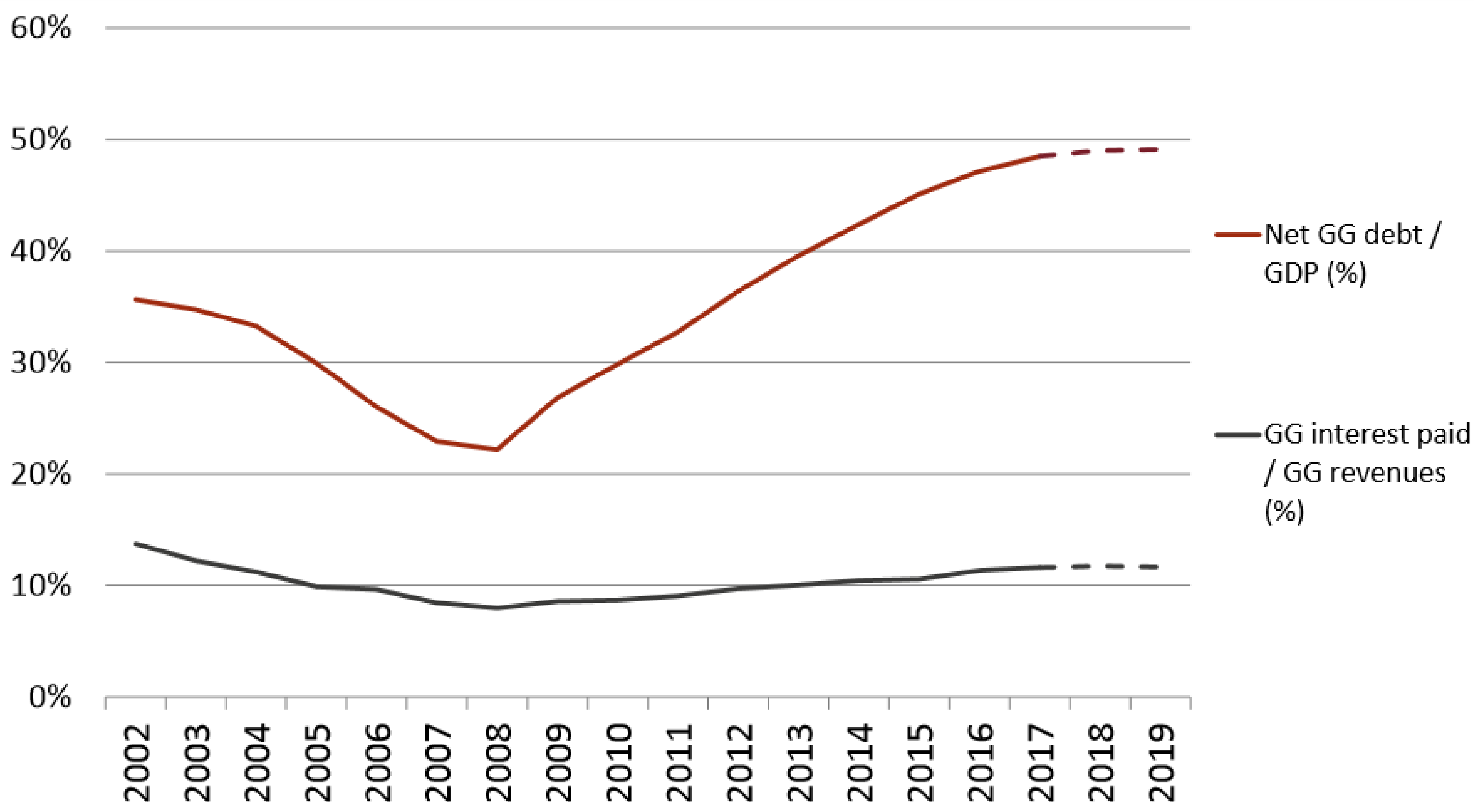
The current account deficit is structural, albeit on a declining trend



S&P Global Ratings

Fiscal assessment: debt burden

Debt levels have been rising substantially post-crisis



Source: S&P Global

Fiscal assessment: debt burden

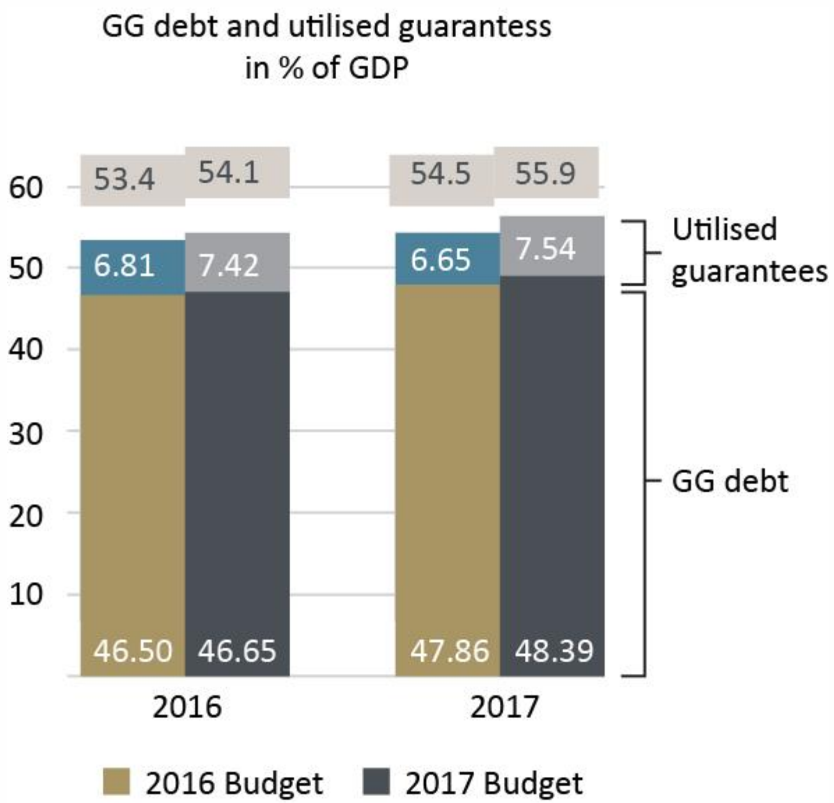
South Africa's contingent liabilities

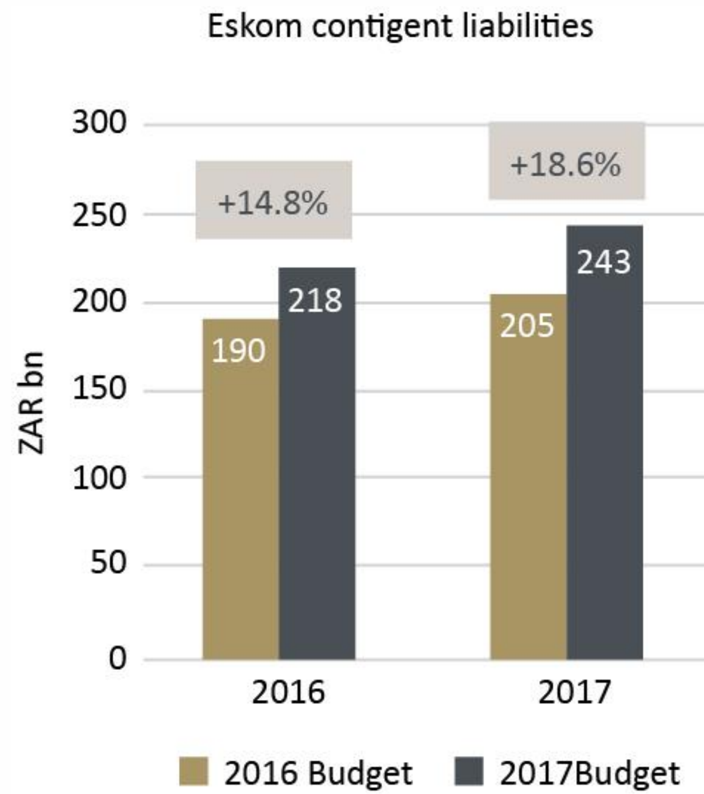
- S&P views this as additional pressure point
- S&P’s assessment reflects the increased risk that non-financial public enterprises will need further extraordinary government support
- S&P expects guarantee utilisations will reach R500 billion in 2020, or 10% of 2017 GDP
- The utilisations are dominated mainly by Eskom (BB-/Negative)
- Eskom benefits from a government guarantee framework of R350 billion (US$25 billion) about 7% of 2017 GDP.
- S&P estimates Eskom will have used up to R300 billion of this framework by 2020

Source: S&P Global Ratings

Fiscal assessment: debt burden

Rising contingent liabilities: The Eskom challenges

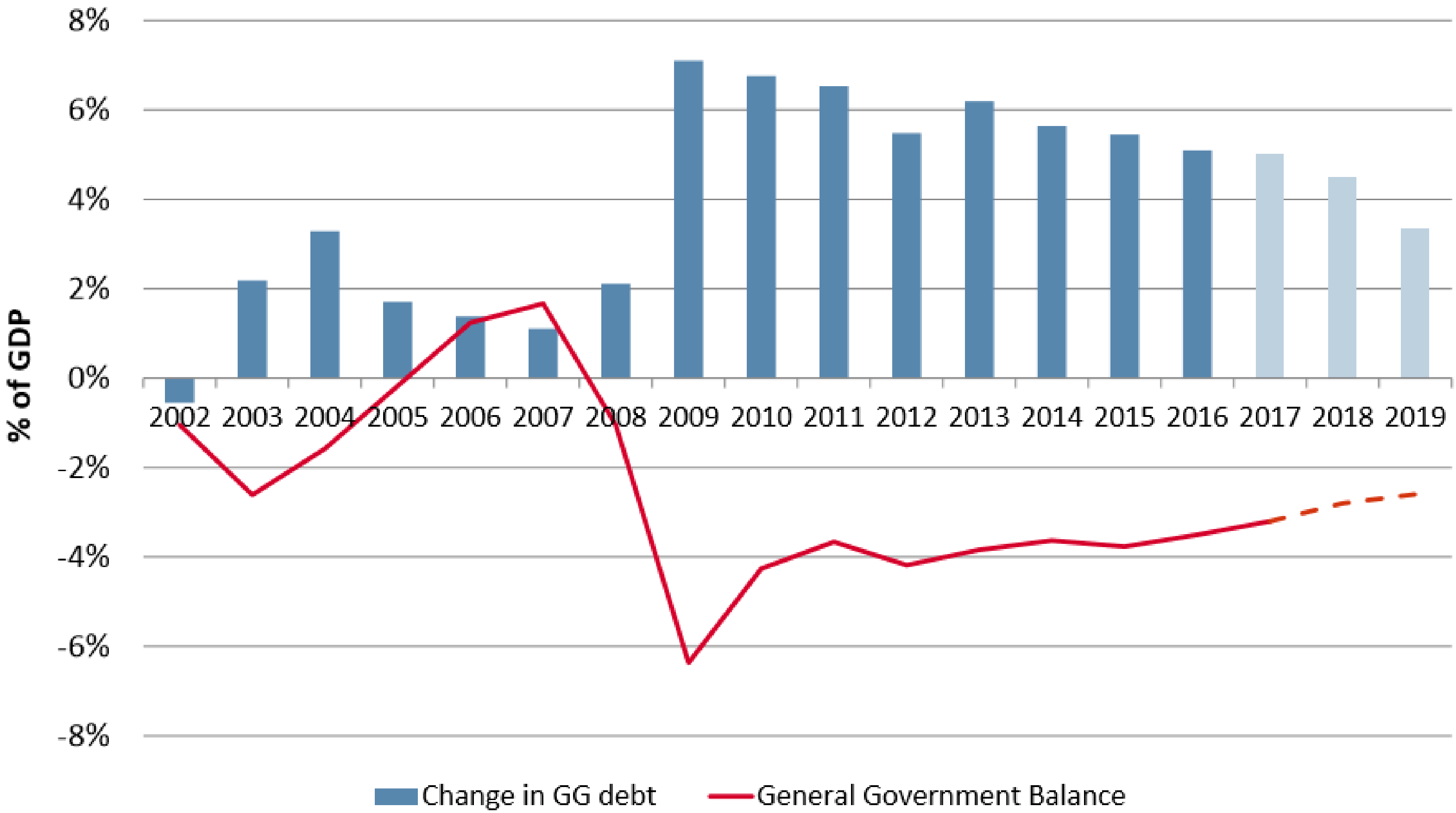




Source: S&P Global Ratings

Fiscal dynamics - What consolidation risks does S&P see?

Post-crisis fiscal consolidation is gradual



Source: S&P Global Ratings

Monetary assessment

SA continues to pursue floating exchange rate regime

- S&P considers SA's monetary policy flexibility
- Its track record in achieving price stability is an important credit strength
- SARB does not have exchange rate targets and does not defend any particular exchange rate level
- S&P sees the SARB as operationally independent, with transparent and credible policies
- The repurchase rate is the bank's most important monetary policy instrument
- Absent large currency depreciations, S&P expects inflation will fall back below 6% this year and remain in the target range of 3%-6% over their three-year forecast horizon

S&P's outlook remains negative

Reflects view of elevated political risk which will hamper growth

- S&P view:
  - Divisions in the ANC-led government led to changes in the executive leadership, including the finance minister
  - This has put policy continuity at risk
  - Increased the likelihood that economic growth and fiscal outcomes could suffer
  - The ratings action also reflects our view that contingent liabilities to the state, particularly in the energy sector, are on the rise, and that previous plans to improve the underlying financial position of Eskom may not be implemented in a comprehensive and timely manner
  - Higher risks of budgetary slippage will also put upward pressure on South Africa's cost of capital, further dampening already-modest growth

- "We could revise the outlook to stable if we see political risks reduce and economic growth and/or fiscal outcomes strengthen compared to our baseline projections." – 3 April 2017

3 | Our base case

Our base, bear and bull case

	BEAR	BASE	BULL
	Downgrades continue - Local currency to 'junk'	Ratings remain as is - Outlook changes to stable on back of slow-paced growth	S&P changes outlook from negative to positive
	40%	50%	10%
IMMEDIATE	• Rand depreciates beyond 3 standard deviations from purchasing power parity (PPP)	• Domestic markets sell-off • Bond yields shoot up • Rand appreciates between 2 and 3 standard deviations from purchasing power parity (PPP)	• Market sentiment improves • Equity and bond markets rally • CDS spreads decline • Rand strengthens to below 2 standard deviations from purchasing power parity (PPP)
NEAR	• Rand recovers some initial losses to below 3 standard deviations from the PPP mean • Mixed results in equity markets • Bond yields move higher	• Rand recovers some initial losses to below 3 standard deviations from the PPP mean • Mixed results in equity markets, that causes stock pickers with active management strategies to outperform	• Rand continues to strengthen as cost of capital is reduced in light of lower sovereign risk and uncertainty • Equity returns surprise to the upside as sentiment continues to improve • Bond yields move lower
LONG TERM	• Rand strengthens to below 2 standard deviations from the PPP mean as inflation differential fundamentals overpower sentiment over the long term • Equity returns outperform inflation and cash, as asset class, fundamentals overpower sentiment over the long term	• Rand strengthens to below 2 standard deviations from the PPP mean as inflation differential fundamentals overpower sentiment over the long term • Equity returns outperform inflation and cash, as asset class, fundamentals overpower sentiment over the long term	• Equity returns continue to outperform inflation and cash

SOURCE: PSG Wealth research team

4 | How does South Africa compare to its EM peers?

Credit ratings of EM peers

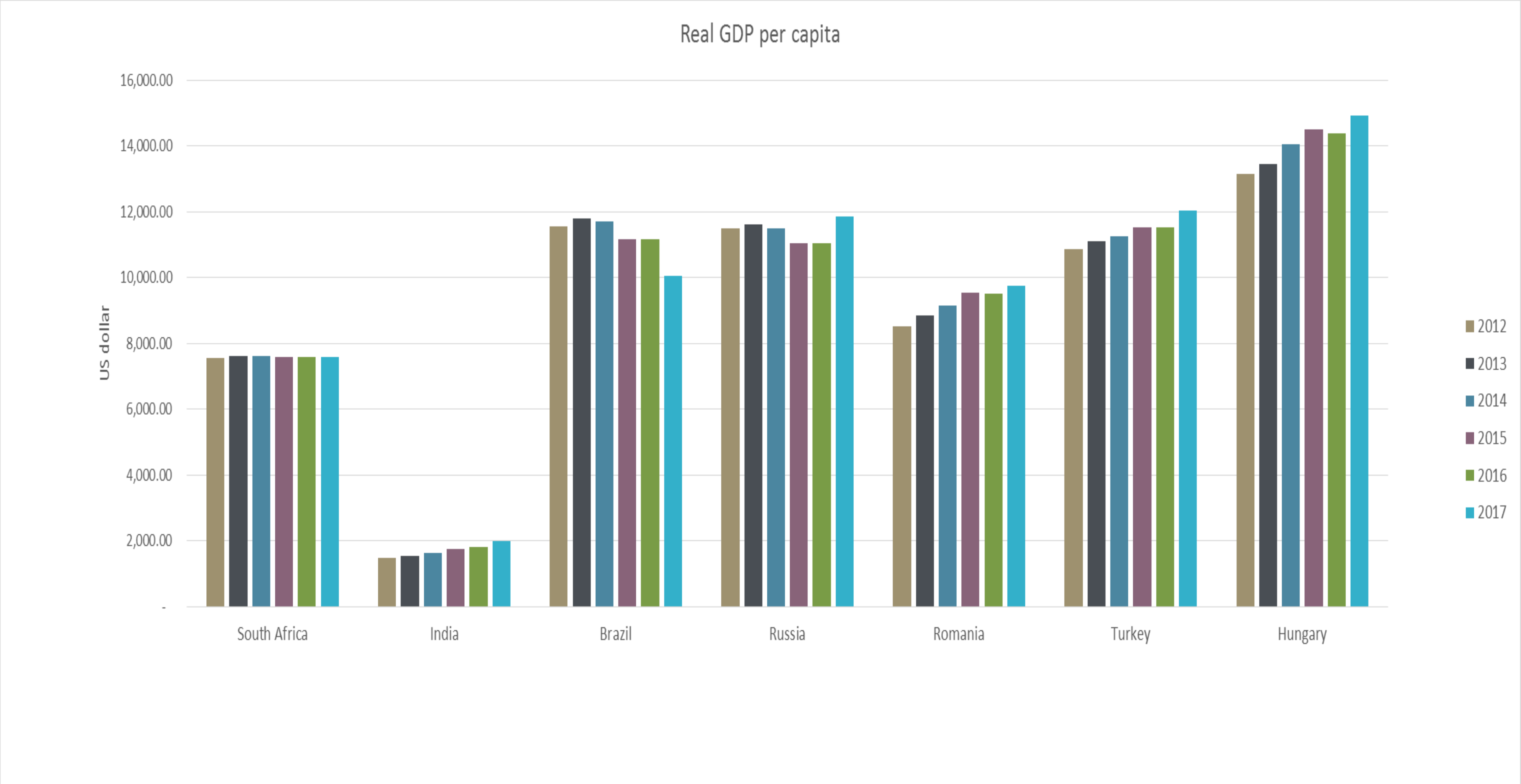
EM countries ratings at risk since 2014

	Fitch ratings	S&P Global Ratings	Moody's ratings
South Africa	BBB- (Dec 15 downgrade) Negative outlook (Nov 16)	BB+ (Apr 17 downgrade) Negative oulook (Dec 15)	Baa2 (Nov 14 downgrade) Negative outlook (May 16) Rating unchanged (Nov 16)
Brazil	BB (May 16 downgrade) Negative	BB (Feb 16 downgrade) Negative	Ba2 (Feb 16 downgrade) Stable
Russia	BBB- (Jan 15 downgrade) Stable	BB+ (Mar 17 downgrade) Positive	Ba1 (Feb 17 downgrade) Stable
Turkey	BB+ (Jan 17)	BB (Jan 17)	Ba1 (Mar 17)
Romania	BBB- (Apr 15)	BBB- (Apr 15)	Baa3 (Dec 15)
Hungary	BB+ (Apr 15)	BBB- (Sept 16)	Baa3 (Nov 16)
India	BBB- (May 16)	BBB- (Apr 15)	Baa3 (Apr 15)

- Global growth dynamics have weighed on domestic growth metrics
- Coupled with significant currency weakness
- Currency weakness lower impact on South Africa versus peers
- Brazil has lower weighting of foreign currency denominated debt
- Remains its relative strength

SA per capita GDP…

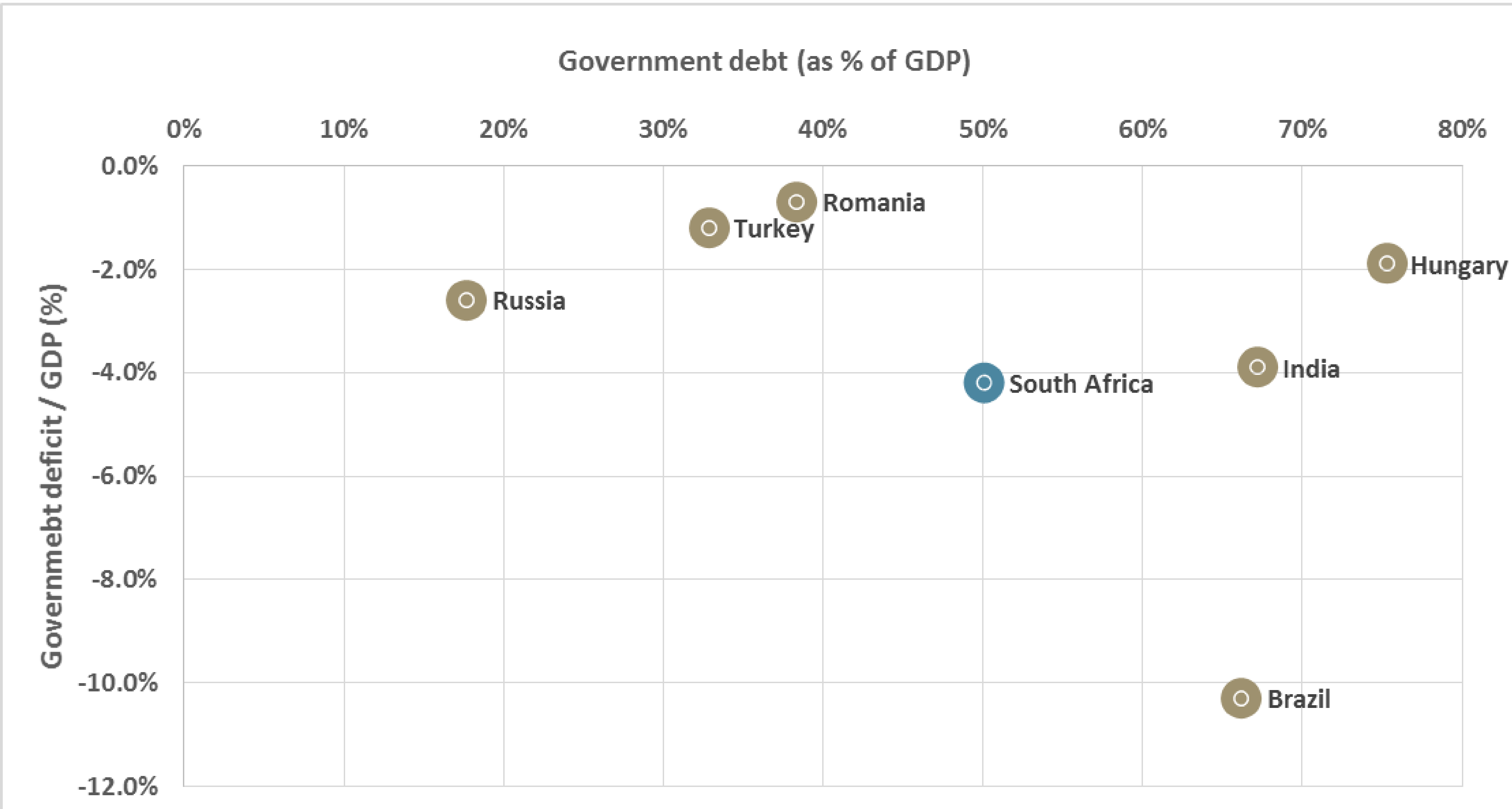
Lower than most EM market peers



SOURCES: WorldBank, Trading Economics, Bloomberg, PSG Wealth research team

Debts and deficits of EM peers

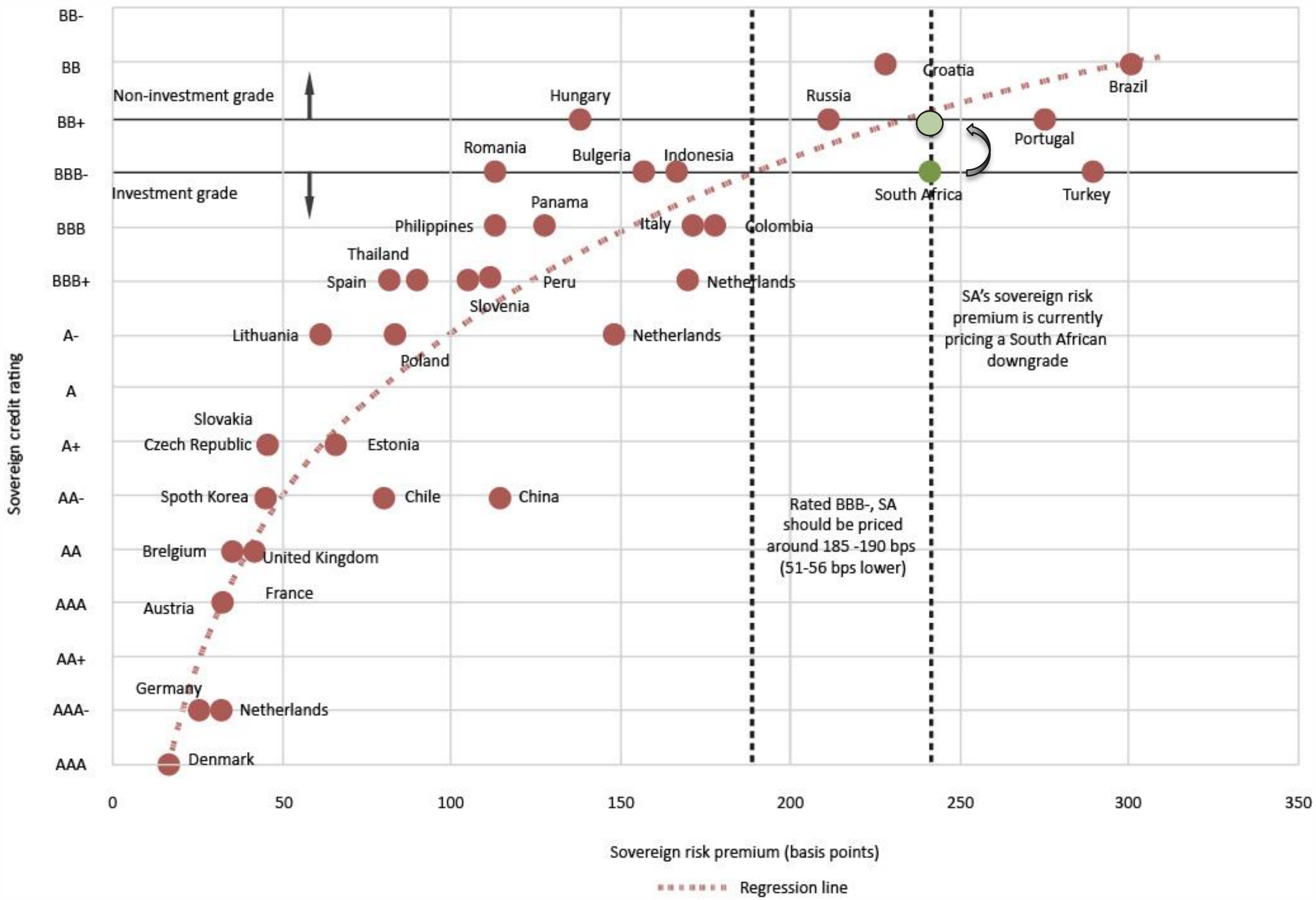
SA government debt at 50% of GDP



SOURCES: Trading Economics, PSG Wealth research team

South Africa's credit risk premium

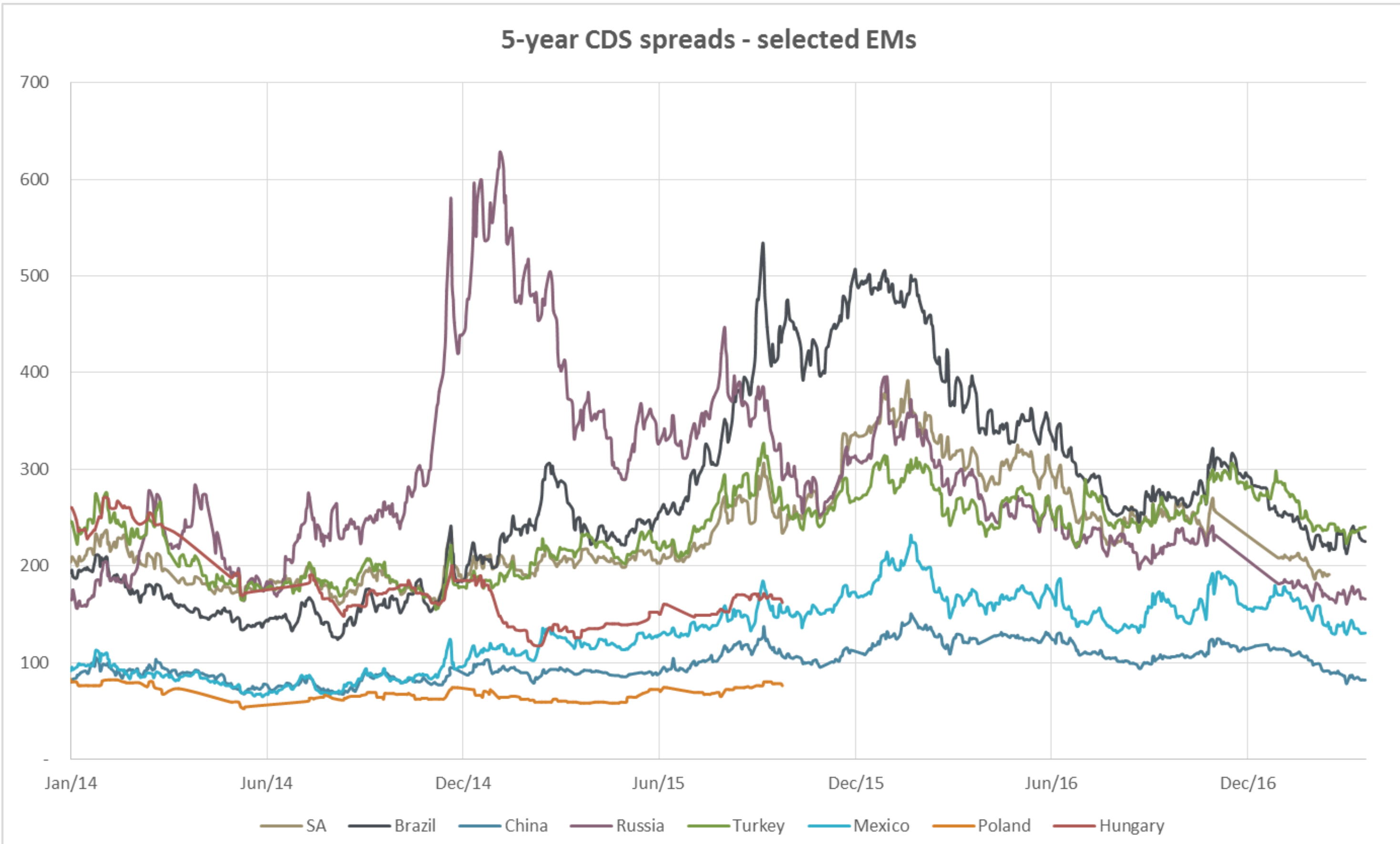
In April 2017 changed from 'BBB-' to 'BB+'



Source: Bloomberg

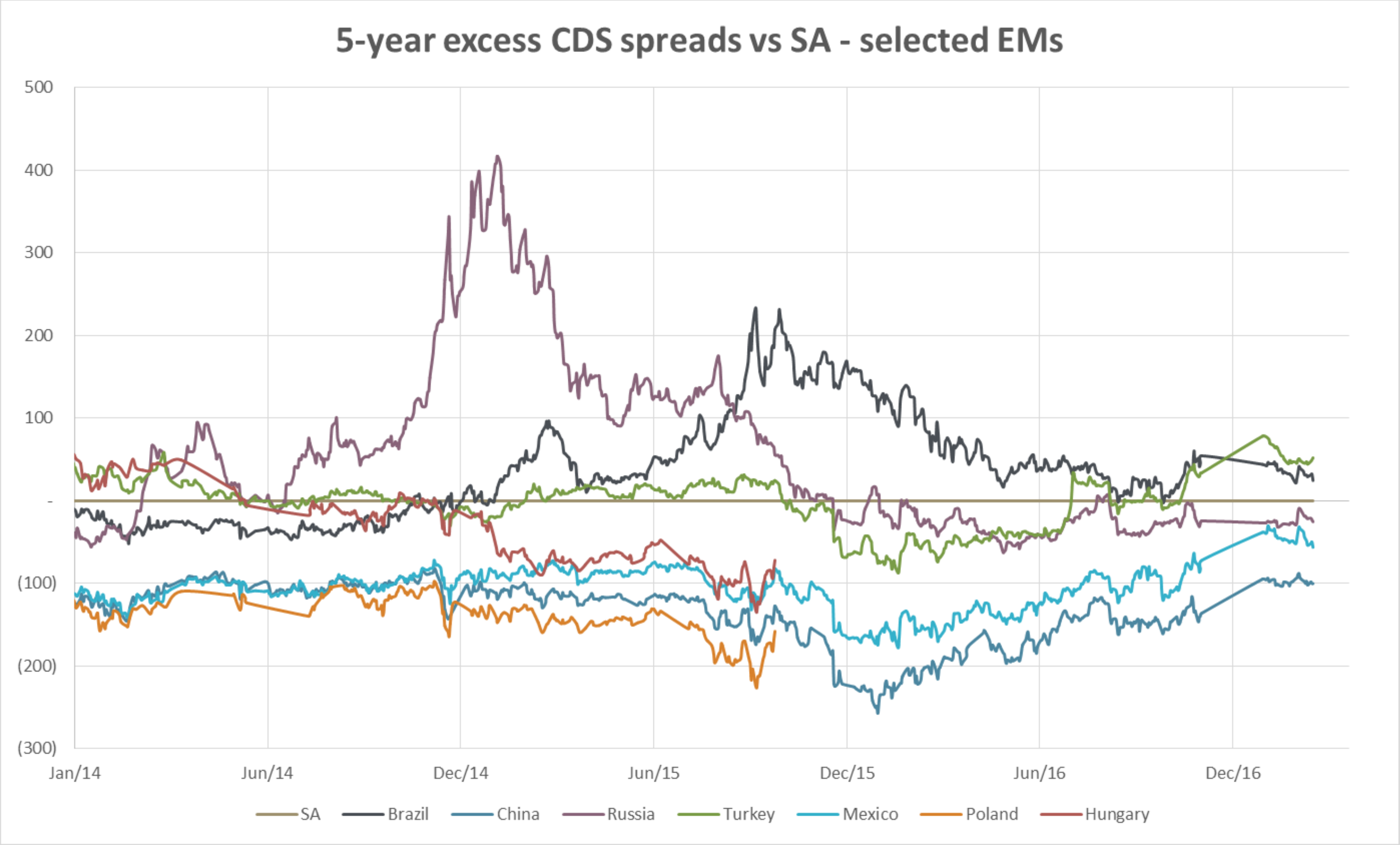
Credit default swap (CDS) spreads

CDS spreads seem stretched for SA



SOURCES: PSG Wealth research team, Bloomberg

CDS spreads continued

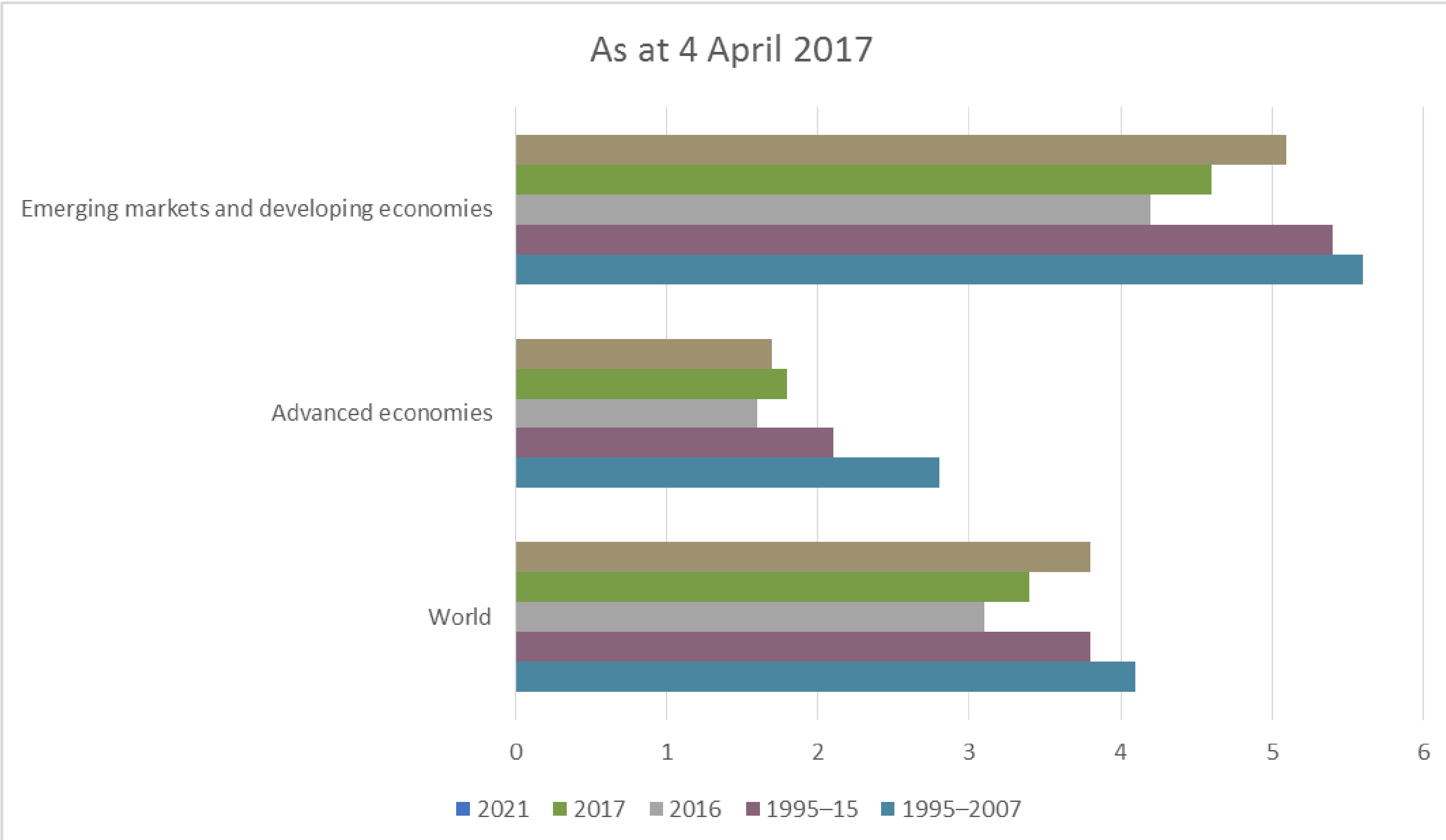


SOURCES: PSG Wealth research team, Bloomberg

5 | Global growth challenges

Global challenges

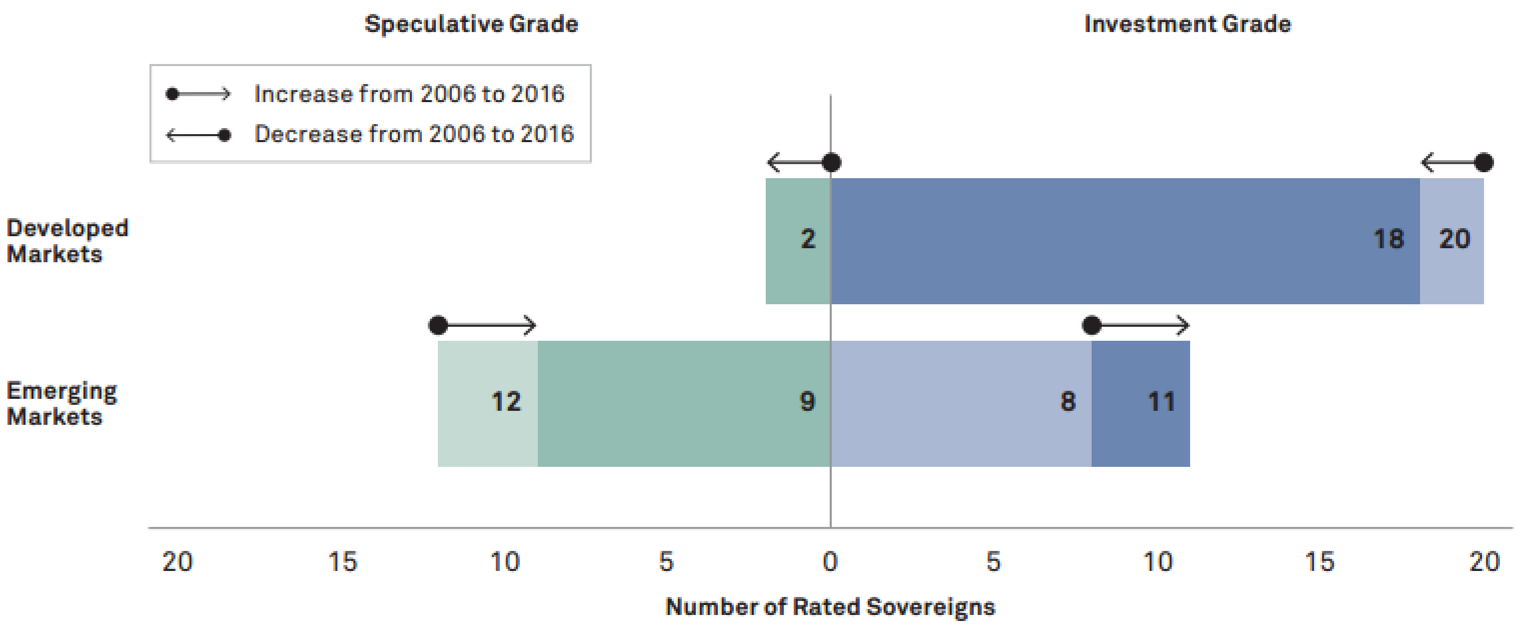
Global growth projected to recover to 3.4% in 2017 after slowing to 3.1% in 2016



SOURCES: IMF

Ratings have started to converge

Emerging and developed market ratings have become somewhat similar



Top 20 Developed Markets: United States, Japan, United Kingdom, Italy, France, Germany, Spain, Canada, Belgium, Netherlands, Australia, Austria, Israel, Portugal, Sweden, Ireland, Finland, Denmark, Switzerland, Greece

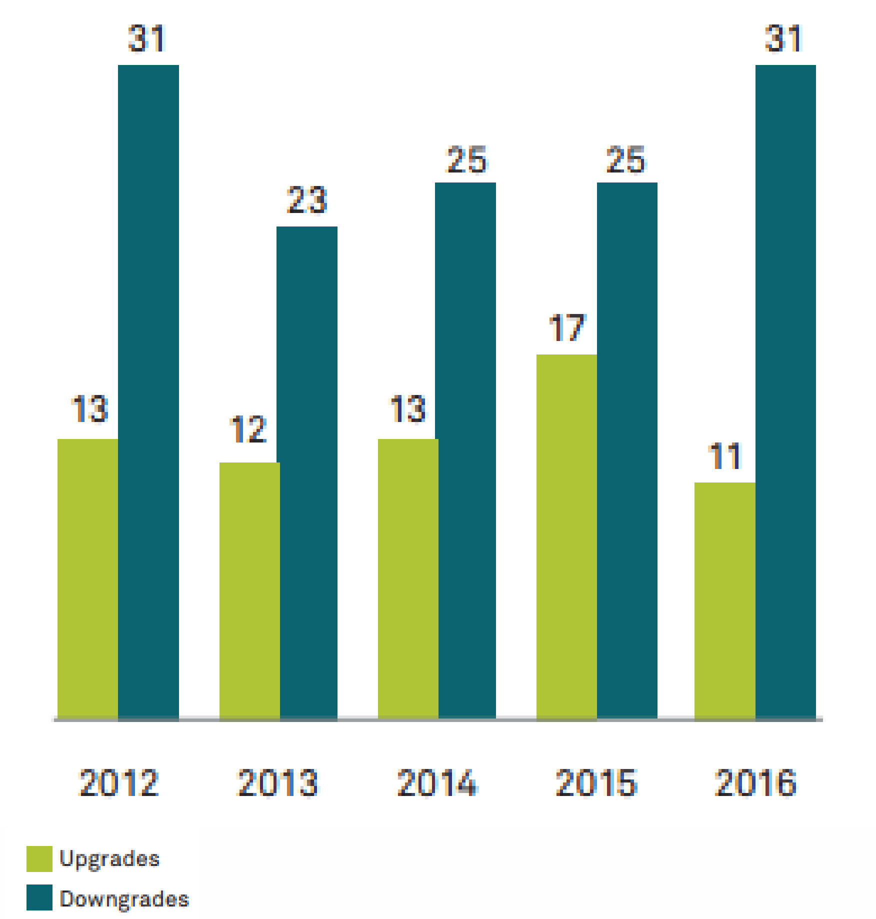
Top 20 Emerging Markets: Argentina, Brazil, China, Colombia, Egypt, Hungary, India, Indonesia, Lebanon, Malaysia, Mexico, Morocco, Pakistan, Philippines, Poland, Russia, South Africa, Thailand Turkey, Venezuela

SOURCE: S&P Global Ratings

- When comparing the ratings of the 20 largest (by outstanding commercial debt) developed market sovereigns with the top-20 emerging markets, the latter still trail the former
- But emerging markets have been gradually catching up during the last decade

Ratings trend points downwards globally

On average S&P upgraded one sovereign a month, while more than two sovereigns were downgraded a month



- Upgrade/Downgrades from 2012 – 2016
- Negative outlooks currently outnumber positive outlooks by a margin of four to one
- Expect the negative trend to continue

Source: S&P Global Ratings

6 | Outlook for markets

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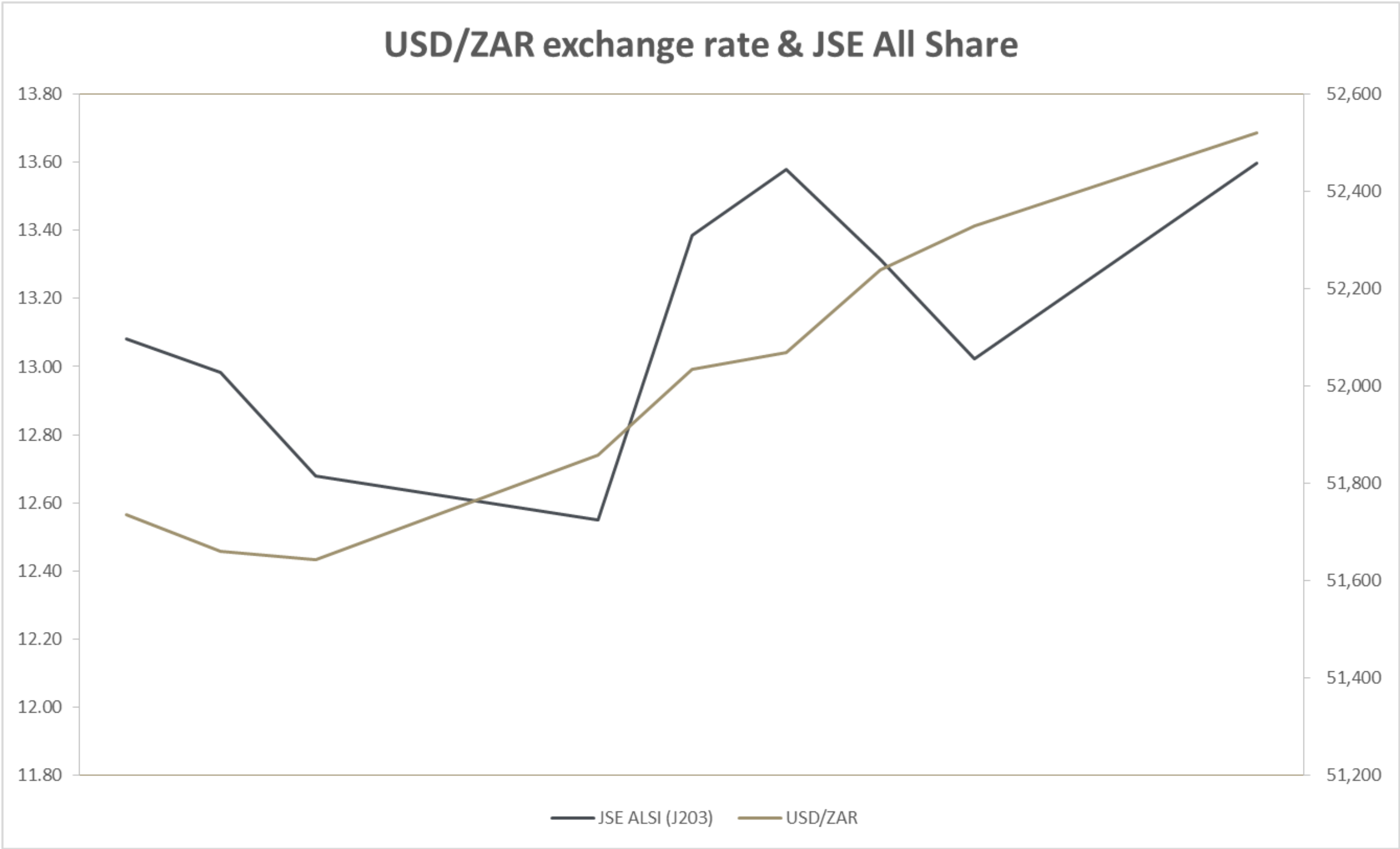
Market reactions after S&P decision

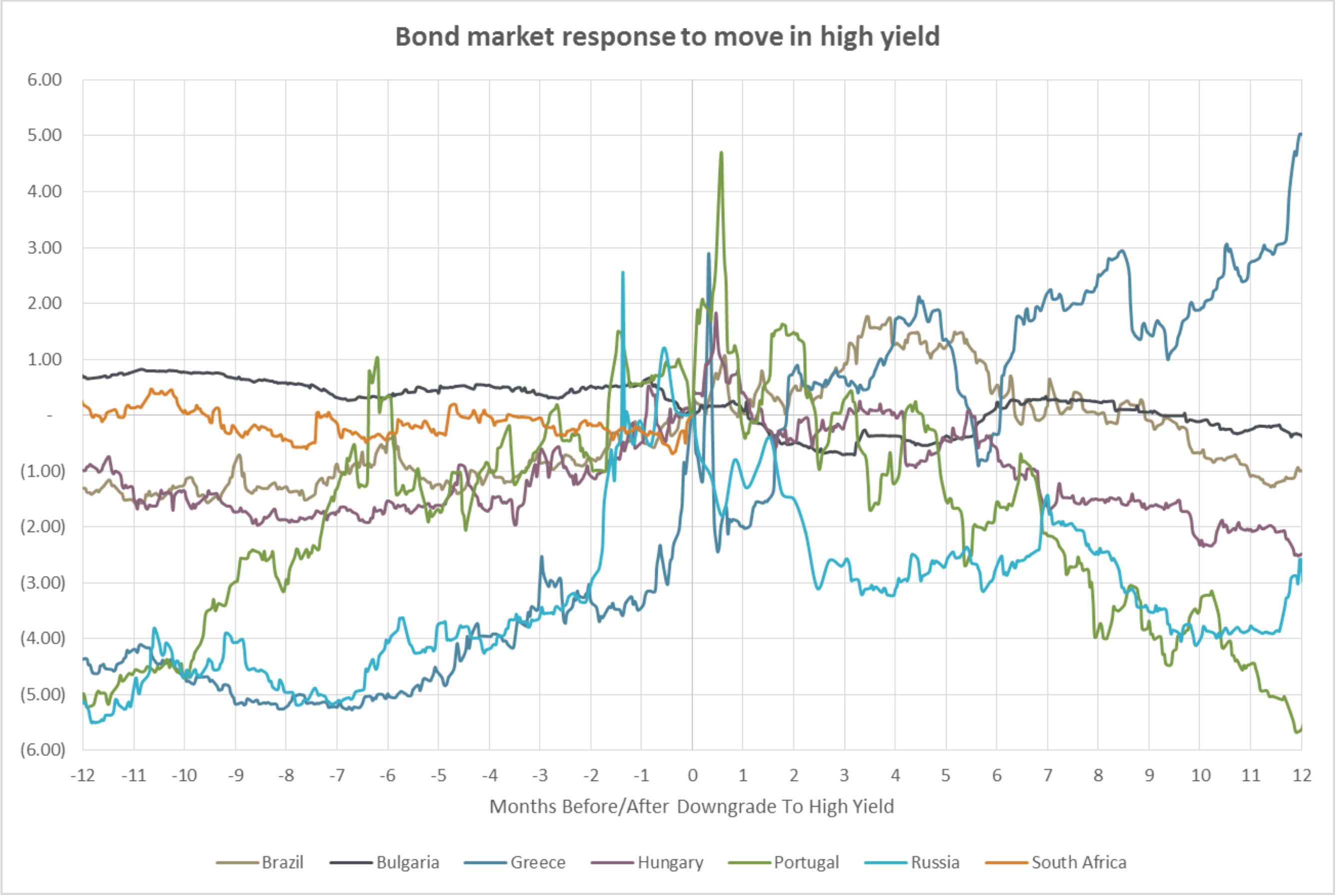
The ALSI and rand movement from 24 March to 3 April 2017



SOURCE: PSG Wealth research team, Oanda

Bond market response to

…a downgrade



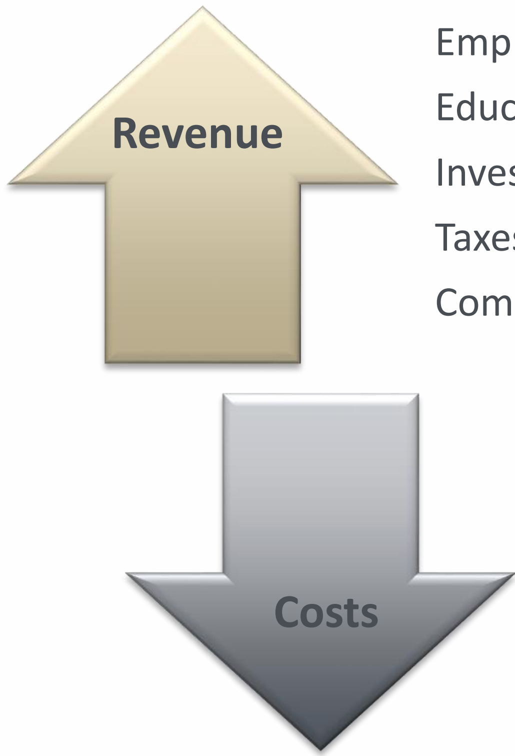
SOURCES: PSG Wealth research team, S&P Global Ratings, Bloomberg

7 | Bottom line

Bottom line

From an economic perspective

- A lot of work ahead (ratings just affirm what new)



Employment

Education

Investment

Taxes

Commodity prices and agriculture

Financing costs

Contingent liabilities

Spending for growth

Bottom line

From an investment perspective

- Don't make emotional investment decisions. It rarely ends well for investors.
- Review your financial plan and your risk appetite
- If your financial plan makes sense and your investments are allocated to reflect your risk appetite and long term objectives, leave the rest to the guys who work with markets daily.

- Clients should take comfort in the fact that:
  - Their financial planning is done by the best financial planners available in South Africa
  - We have award winning processes and products
  - Our investment experts are rated amongst the top nationally and internationally

Bottom line

From an investment perspective

Date From:	28-Mar-17	30-Mar-17	3 Apr-17	1-Jan-17	5-Apr-12
Date To:	4-Apr-17	4-Apr-17	4-Apr-17	4-Apr-17	4-Apr-17
	Since Pravin Gordhan recall from UK	Since cabinet reshuffle	Since Ratings downgrade	YTD	5 Year
PSG Wealth Creator FoF D	2.23	1.04	0.74	4.47	12.36
PSG Wealth Moderate FoF D	2.45	1.51	0.60	4.29	12.33
PSG Wealth Preserver FoF D	1.46	1.00	0.37	3.17	10.48
PSG Wealth Income FoF D	0.11	0.06	0.07	2.47	8.02
PSG Wealth Enhanced Interest D	0.15	0.10	0.04	2.04	6.53

Source: PSG Multi Management, Morningstar

8 | Frequently asked questions

Why did S&P not wait till 2 June 2017?

- Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation.

"In this case, the reasons for the deviation are the heightened political and institutional uncertainties that have arisen from the recent changes in executive leadership."

– S&P downgrade notice of 3 April 2017

What is constraining GDP growth?

- Political uncertainty and SA's pace of economic growth remain rating weaknesses
- GDP growth continues to be negative compared to other EM peers on a per capita GDP basis
- S&P says, "While the government has identified important reforms and supply bottlenecks in SA's highly concentrated economy, delivery has been piecemeal in our opinion. The country's longstanding skills shortage and adverse terms of trade also explain poor growth outcomes, as does the corporate sector's current preference to delay private investment, despite high margins and large cash positions."
- Domestic factors constraining GDP growth
  - Electricity supply constraints
  - Labour issues in the real sectors
  - Weather patterns
  - Weak business confidence (low investment)
  - Policy implementation challenges
- S&P has revised down our real GDP growth assumptions for 2016 to 0.5%; 1.4% for 2017; 1.8% for 2018
  - last June they forecast 0.6% for 2016 and 1.5% for 2017

Source: S&P Global

Frequently asked questions and answers

1. Now that SA has been downgraded, what is the likely impact on the local economy?

From an economic perspective the government may struggle to raise funding for projects. Yields on bonds will have to move higher in order to compensate investors for the additional sovereign risks, which increases the governments' cost of capital which will place additional pressure on the national budget, and ultimately taxes. In addition, corporate financing cost will also increase, which places pressure on earnings and growth. From a market perspective, bond yields have already moved higher to price in the sovereign risk increase.

2. What does junk status really mean?

It means that the perceived probability of defaulting on the capital loan repayment is higher than that of investment grade bonds. In return of taking additional risk, investors will demand greater compensation, ie higher yields. This cost will be directly borne by government and corporates, but ultimately passed on to consumers and shareholders.

3. Who would be able to invest in SA now that we reached junk status?

The country remains open for investment to anyone who is unaffected by investment mandate constraints. Some mandates of pension funds or unit trust portfolios are required to invest in investment grade instruments only. These investment vehicles will no longer be able to invest in these bonds, and finance will have to be obtained through other investors with more liberal mandates.

4. What type of investors are we likely to see enter our local bond market?

Investors with higher risk appetites willing to take on additional sovereign risk for additional compensation for doing so.

5. Would a junk status rating affect consumers/everyday South Africans?

Yes, most definitely. Yields on bonds will have to move higher in order to compensate investors for the additional sovereign risks, which increases the governments' cost of capital which will place additional pressure on the national budget, and ultimately taxes. In addition, corporate financing cost will also increase, which places pressure on corporate earnings and economic growth.

6. Did you anticipate that SA will reach junk status?

We previously communicated that "The market is currently pricing in a strong possibly of a downgrade."

7. How could SA improve its rating from here?

Our two main concerns are the current account and the fiscal budget. We need to improve on our relative attractiveness in order to attract investment. We need to increase or export to import ratio, and get a firmer grip on our fiscal spending. Economic growth will go a long away towards increasing spending power, but ultimately we will simultaneously have to cut spending and increase revenue in order to make swift work of recovering investment grade status.

8. Is it the end of the world now that SA reached junk status?

It has serious implications for both investors and consumers. It poses a massive challenge to all South Africans and we cannot afford to be complacent regarding the impact, nor lacklustre in our efforts to turn things around.

At the same time, a diversified portfolio of assets will deliver mixed results in reaction to the downgrade. Bonds' capital value will be under pressure, but at the same time more attractive yields will be on offer. Offshore investments will benefit from a weaker currency, offsetting some the losses in bank, retailers, and property investments.

Our product positioning was very well diversified in anticipation of tougher both political and economic investment climate. We anticipate that poor sentiment will dominate markets over the short term, which may well offer some attractive investment opportunities.

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