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S&P's rating decision explained

S&P Global Ratings affirmed its long- and short-term 'BBB-/A-3' foreign currency and 'BBB+/A-2' local currency sovereign credit ratings of South Africa on 3 June. Their outlook remains negative, reflecting the potential adverse consequences of low GDP growth and signaling that the agency could lower their ratings on South Africa this year or next, if policy measures do not turn the economy around.

At the same time, some economists believe S&P provided South Africa with clear indications on what to focus on to prevent a downgrade in future.

S&P assessment process

Their analysis of sovereign creditworthiness rests on their assessment and scoring of five key rating factors. In its assessment S&P saw South Africa's economic- and fiscal assessments as the two weaknesses out of the five assessment factors. Its monetary assessment was regarded as a strength.

Republic of South Africa Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Weakness
Fiscal assessment: debt burden	Neutral
Monetary assessment	Strength

Source: S&P Global Ratings

Weakness 1: Economic assessment

S&P warned that economic growth is extremely low, with a revised outlook of 0.6% for this year. "On the domestic side, drought and subdued mining and manufacturing output, coupled with structural constraints, remain key negative factors," their assessment notes.

The ratings agency also highlights specific structural measures which South Africa needs to focus on to place our economy on a firmer footing and to maintain an investment-grade rating. These include, amongst others, the provision of a reliable energy source, a more flexible labour environment, policies which aim to instil greater business confidence and enhances relations in the mining-sector as well as better cohesion of the executive branch. The agency gave the country six months to turn the economy around and has warned that continued political instability is also a threat.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Economic indicators (%)										
Nominal GDP (bil. ZAR)	2 748	3 020	3 245	3 539	3 797	4 043	4 336	4 653	5 016	5 423
Nominal GDP (bil. US$)	375	416	395	367	350	317	275	291	314	339
GDP per capita (US$000s)	7.4	8.1	7.5	6.9	6.5	5.8	4.9	5.1	5.5	5.8
Real GDP growth	3.0	2.9	2.5	2.8	1.7	1.2	0.6	1.5	1.8	2.1
Real GDP growth per capita growth	1.5	1.4	1.0	1.2	0.1	(0.5)	(0.9)	0.0	0.3	0.6
Real investment growth	(3.9)	5.5	2.6	7.0	1.5	2.5	0.3	1.3	1.5	1.5
Investment / GDP	19.5	19.7	20.0	21.1	20.8	20.7	20.7	21.1	21.5	21.5
Savings / GDP	18.0	17.5	15.0	15.4	15.4	16.6	16.4	17.0	17.3	17.0
Exports /GDP	28.6	30.5	29.8	30.9	31.3	31.0	30.5	31.8	32.4	32.7
Real exports growth	7.7	3.6	0.7	3.6	3.3	2.5	3.8	3.9	3.4	3.0
Unemployment rate	24.9	24.8	24.9	24.7	25.1	25.9	25.4	26.1	25.9	25.9

Source: S&P Global Ratings

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Weakness 2: Fiscal assessment

On the fiscal side, the government is showing stronger resolve to reduce fiscal deficits, with targets of 3.2% of GDP this year, 2.8% in 2017, and 2.4% in 2018, S&P's reports states.

"However, the treasury's annual change in general government debt in the past has tended to be higher than the reported deficit by at least 1% of GDP in the past five years."

Although less than a tenth of the government's debt stock is denominated in foreign currency, non-residents hold about 35% of the government's rand-denominated debt, "which could make financing costs vulnerable to foreign investor sentiment, exchange rate fluctuations, and rises in developed market interest rates."

S&P also views South Africa's contingent liabilities as limited. According to the agency the government faces risks from nonfinancial public enterprises with weak balance sheets, which may require more government support than the agency currently assumes.

They further estimate current account deficits will average 4% of GDP (or 12% of current account receipts) over 2016-2019 due to the size of the current account deficit, weak domestic demand, and some export response from the mining and auto manufacturing sectors.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fiscal indicators (% general government)										
Balance/GDP	(4.3)	(3.7)	(4.2)	(3.8)	(3.6)	(3.9)	(3.2)	(2.9)	(2.6)	(2.4)
Change in debt/GDP	6.8	6.5	5.5	6.2	5.6	6.5	4.4	4.2	3.9	3.7
Primary balance/GDP	(1.9)	(1.1)	(1.5)	(1.0)	(0.6)	(0.7)	0.2	0.6	1.0	1.1
Revenue/GDP	27.8	27.9	28.0	28.5	29.0	30.3	30.5	30.9	31.3	31.5
Expenditures/GDP	32.0	31.6	32.2	32.3	32.6	34.1	33.8	33.8	33.9	34.0
Interest /revenues	8.7	9.1	9.7	10.0	10.4	10.6	11.2	11.3	11.4	11.4
Debt/GDP	36.0	39.3	42.1	44.8	47.4	51.0	51.9	52.5	52.6	52.3
Debt /revenue	129.8	141.0	150.5	157.2	163.5	168.5	169.9	170.2	167.9	166.1
Net debt /GDP	29.9	32.8	36.4	39.6	42.4	46.1	47.4	48.3	48.6	48.6
Liquid assets /GDP	6.2	6.6	5.7	5.2	5.0	4.9	4.5	4.3	4.0	3.7

Source: S&P Global Ratings

Strength: Monetary assessment

Not all is doom and gloom, with S&P viewing South Africa's monetary assessment as a strength. According to their report the country continues to pursue a floating exchange rate regime.

"The South African Reserve Bank (SARB) does not have exchange rate targets and does not defend any particular exchange rate level. It consequently forgoes expending reserves to lean against market sentiment. We assess the SARB as being operationally independent and its policies as credible. It uses an inflation-targeting framework for its monetary policy. The bank also uses open market operations to manage liquidity, including sterilizing its purchases of foreign exchange inflows. The repurchase (repo) rate is the bank's most important monetary policy instrument."

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Monetary indicators (%)										
CPI growth	4.3	5.0	5.6	5.7	6.1	4.6	6.5	6.0	5.4	5.4
GDP deflator growth	6.4	6.8	4.8	6.1	5.5	5.2	6.6	5.7	5.9	5.9
Exchange rate, year-end (ZAR/US$)	6.63	8.14	8.50	10.49	11.58	15.11	16.00	16.00	16.00	16.00
Banks' claims on resident non-gov't sector growth	6.1	5.6	10.6	6.0	9.0	11.0	8.0	8.0	8.0	8.0
Banks' claims on resident non-gov't sector/GDP	78.7	75.7	77.9	75.7	76.9	80.1	80.7	81.2	81.4	81.3
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	2.5	2.8	3.5	3.9	4.6	5.9	4.0	4.0	4.0	4.0
Real effective exchange rate growth	15.6	(2.1)	(5.4)	(10.5)	(6.4)	0.5	N/A	N/A	N/A	N/A

Source: S&P Global Ratings

Conclusion

S&P's long-term local currency sovereign rating on South Africa is two notches above the long-term foreign currency sovereign rating.

"This is because we believe that the sovereign's flexibility in its own currency is supported by the SARB's independent monetary policy, a large and active local currency fixed-income market, and a prudent fiscal policy."

However, low GDP growth is putting South Africa's economic metrics at risk and could eventually weaken the government's social contract with business and labour. Rising political tensions are also accentuating vulnerabilities in the country's sovereign credit profile, S&P highlighted.

"Still, energy sector improvements will likely reduce some of the economic bottlenecks and pending finalisation of labour and mining reforms could engender a positive confidence shock. On the fiscal side, the government is showing greater resolve to reduce fiscal deficits at a faster pace than we expected."

Therefore S&P latest rating is supported by their assumption that South Africa will experience continued broad political institutional stability and macroeconomic policy continuity.

"We also take into account our view that South Africa will maintain fairly strong and transparent political institutions and deep financial markets. The ratings are constrained by the need for further reforms, low GDP growth, volatile sources of financing, structural current account deficits, and sizable general government debt."

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Bottom line

For market commentators to say that we need a growing economy to avoid a downgrade is too vague a statement. We first have to look at specific measures to get the economic outlook changed to positive, or at least stable. The two most important factors are:

1. Government desperately needs to restore business confidence through more business friendly policies.

2. We desperately need a stronger and stable exchange rate through stronger investor confidence to curb higher inflation and interest rates.

However, investors in the PSG Wealth Solutions should be assured that they are in good hands:

- Their financial planning is done by the best financial planners available in South-Africa.
- The investment process allows for tailor made solutions that align the investment objective with their investment goals.
- The investment portfolios are managed by the best portfolio managers in South-Africa, as well as offshore. We actively align our portfolios to protect against current risks, and to benefit from both current and expected future conditions.

To view the full S&P report click here.