

## Downgrade of South Africa's Foreign Currency Rating and what it means for Investors

On Monday, rating agency S&P Global downgraded its rating of South Africa's **long term foreign currency debt to sub-investment grade**, commonly known as junk. The rating is now at a BB+. They also have a negative outlook, which means that on their upcoming reviews there is the possibility of a further notch downgrade.

**The local currency rating** was lowered one notch to BBB-, which is one notch above sub-investment grade. This also is on a negative outlook. We can expect other rating agencies, i.e. Moody's and Fitch, to follow suit with ratings downgrades.

### What does this mean?

Essentially, a downgrade in the rating is an assessment of the increased risk in government being able to meet its fiscal and growth targets, given what S&P described as "*policy continuity risk*".

Any borrower who has a substandard credit record can expect to be charged a higher interest rate on borrowings. The same rationale extends to the South African government and all state-owned enterprises. The increased risk, as quantified by a rating agency, ultimately means that investors (i.e. lenders) will demand an additional premium (i.e. higher interest rate).

Bond yields on government bonds have been pricing in this additional risk for some time, but on Tuesday morning, the R186 government bond, having closed at a yield of 9% on Monday, fell to a yield of around 9.2% before edging back to around, and indeed below, the 9% level.

The currency also fell from around R13.50/USD at 5pm to over R13.70/USD, strengthening back again in late Tuesday to around R13.55/USD.

In the short term and indeed over the longer term, the mere fact that government has a weaker rating on its debt is a negative for the economy as a whole because the cost of its debt is higher. This additional cost is ultimately paid by taxpayers.

### What does this mean for investors in multi managed, multi asset funds?

We believe that given the level of uncertainty, one of the best options for all investors to consider is a balanced fund. Outlined below is a table reflecting the various asset classes in which the Seed Stable and the Seed Balanced are invested.

Column 2 indicates the overweight or underweight position of the fund. Column 3 indicates the short-term performance (positive, neutral or negative) of Monday's downgrade decision on these asset classes for local investors.

<u>Asset Class</u>	<u>Over/Underweight</u>	<u>Performance Post Downgrade</u>
Local Equity – SA Inc	-	x
Local Equity – Rand Hedge	-	✓
Local Property	+	x
Local Bonds	-	x
Local Cash	+	=
Offshore Currency	=	✓
Alternative - Gold	+	✓
Global Equity	+	✓
Global Bonds	-	✓
Global Cash	=	✓
Global Property	+	✓

Source : Seed Investments – 5 April 2017

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### Some further considerations

The table above reflects that despite the downgrade on the rating, this is not negative for all asset classes. Naturally, as the currency weakens, the result is positive for global investments, range hedge local equities, gold etc.

While the higher cost of debt is negative for taxpayers, for investors the additional interest rate incurred by government on its debt at times more than compensates for the additional risk, and where this is the case, investors would be wise to take advantage. Such was the case for the whole of 2016, where investors in government debt enjoyed a 15.4% gain on their investment. At the same time, foreign investors received a gain as the local currency appreciated from the exceptionally weak January 2016 level.

### Conclusion

Investors have typically done well over the past 3, 5 and even 10 years by investing into a balanced fund, such as the Seed Balanced Fund or a multi asset lower equity fund, such as Seed Stable Fund, which exposes the investor to a range of asset classes.

The same is likely to be true in volatile times that we are facing at present.

Kind regards,

**Ian de Lange**



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### **ADDITIONAL INFORMATION (where applicable)**

Performance has been calculated using net NAV to NAV numbers with income reinvested. Full performance calculations are available from the manager on request.

### **DEFINITIONS (where applicable)**

Annualised Return	Annualised return shows longer term performance rescaled to a 1 year period. Annualised return is the average return per year over the period. Actual annual figures are available to the investor on request.
Highest and Lowest Annual Return	The highest and lowest returns, since launch, for any rolling 1 year period have been shown.