Seed Weekly

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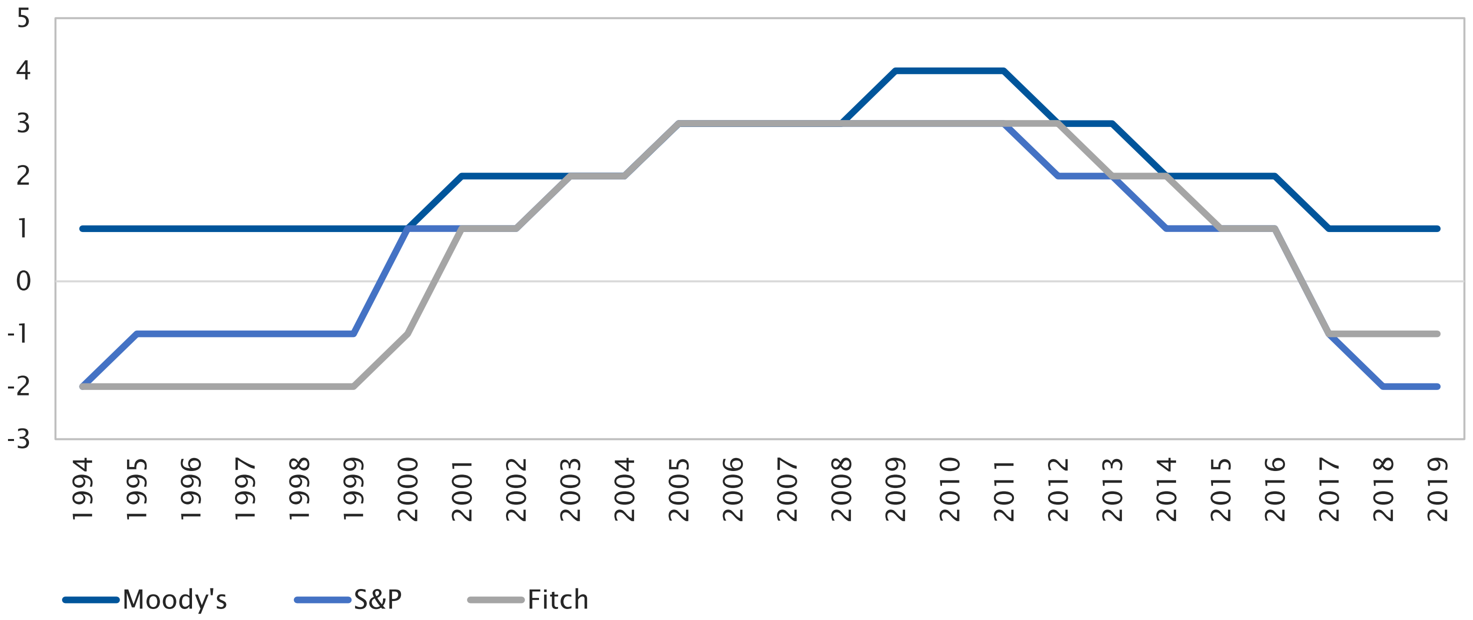
South Africa's Sovereign Credit Rating

South Africa's Sovereign Credit Rating has been a key topic of discussion in recent years. For a protracted period of time the country's economy has been weak, worsened by institutional decline and increased political risk. This led a series of downgrades by major ratings credit ratings agencies, eventually culminating in a sub-investment grade rating (speculative/junk) by two of the agencies - Fitch and Standard & Poor's (S&P). As shown in **Chart 1** (below), while Fitch and S&P have downgraded to junk status, Moody's has kept the rating investment grade for 25 years.

Chart 1: South Africa's Sovereign Credit Rating (Level Above/Below Sub-Investment Grade)



Source: Bloomberg (November 2019)

The reluctance to downgrade to junk status by Moody's has surprised market participants given the economy's dire position. In its latest review, Moody's kept the rating investment grade but changed the outlook to negative on the risk of continued deterioration in finances - a possible precursor to a downgrade. However, it begs the question why Moody's has afforded us more time. The ratings agencies follow fairly similar methodologies and, understanding the subtle differences in what the respective methods imply, helps to answer this question.

Broadly, S&P and Moody's consider similar factors, namely the economy, institutional strength, fiscal position and the susceptibility to event risk. S&P's methodology places more weight on the strength and stability of the issuer and, therefore, tends to reflect a view on the probability of default. As such, the ill-timed cabinet reshuffle that saw the finance minister and his deputy unceremoniously relieved of their duties in 2017 was the last straw before a prompt downgrade to junk. With weak economic fundamentals and heightened political risk, the strength and stability of the issuer had been severely weakened, thus increasing the probability of default.

The Moody's methodology, on the other hand, places more weight on institutional and political factors that underpin the willingness to repay debt, reflecting a view on expected losses. This not only focuses on the increased probability of default, but also looks at the severity of losses for investors based on the willingness and capacity to repay debt. Previous statements by Moody's have highlighted the risks, but also stressed positives as exemplified by the country's resilience, strong core institutions, a solid financial sector and the low level of foreign currency liabilities for the government and broader economy.

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Another aspect to look at is the long-term nature of credit ratings. Moody's has in the past alluded to the fact that there is a necessary trade-off between rating accuracy (instantaneous) and stability of the rating. A long-term perspective tries to filter out cycle fluctuations. If economic conditions deviate from past averages, a through-the-cycle rating may over- or under-estimate credit quality.

S&P's ratings calibration promotes greater stability in higher ratings than lower ratings, meaning there is more movement lower rated issuers. As illustrated in **Table 1** (below) historic data indicates that investment grade issuers have above 90% chance of maintaining the rating or bettering it, and less than 5% chance of a downgrade to junk the following year. Chances of an upgrade or downgrade are higher at sub-investment grade level.

Table 1: Sovereign Foreign Currency Average One-Year Transition Rates (1975-2018)

%	Rating One Year Later								
	AAA	AA	A	BBB	BB	B	CCC/CC	SD	NR
Rating as of 1st of Month									
AAA	96.6	3.3	0.0	0.0	0.1	0.0	0.0	0.0	0.0
AA	2.5	93.3	3.0	0.3	0.3	0.0	0.0	0.0	0.5
A	0.0	3.7	90.7	5.0	0.4	0.0	0.0	0.0	0.2
BBB	0.0	0.0	5.3	89.3	4.7	0.5	0.2	0.0	0.0
BB	0.0	0.0	0.0	6.3	86.5	6.0	0.6	0.5	0.1
B	0.0	0.0	0.0	0.0	5.2	87.7	3.0	2.8	1.2
CCC/CC	0.0	0.0	0.0	0.0	0.0	29.1	29.3	41.6	0.0

Source: S&P Annual Sovereign Default and Rating Transition Study (2018)

In conclusion, ratings represent a forward-looking view on creditworthiness and migrate in line with a change in view on credit conditions or expectations. As such, market commentators view South Africa's downgrade to junk as inevitable. However, there still is a possibility it can be avoided, given Moody's focus areas. Much rests on the ability of the government to stop fiscal deterioration, a turn in economic growth prospects and the maintenance of sound institutions. We continue to hold thumbs.

Kind regards,

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