SA Credit ratings this week: Moody's comments on SA

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EXECUTIVE SUMMARY

- In this short note, we provide a brief background of Moody's credit rating of the sovereign, a breakdown of the methodology, recent developments and our expectations going forward. SA growth is expected to remain benign, while inflation will likely remain below 6% over the next 12 to 18 months. The SARB remains concerned about the trajectory of the rand – any flare up of political risks could hamper the rand exchange rate, which may feed through to headline CPI. However, despite this concern, the SARB did begin a loosening cycle in July 2017 as inflation has surprised to the downside and domestic demand-pull inflation remains absent. As a result, we believe that the SARB will provide two more rate cuts of 25bps each by 1H18 in the current cycle.
- Both lower potential growth and a deteriorating fiscal outlook remain credit-negatives in our view. This, combined with a structural reform deficit, would further reinforce the low growth expectation. The lack of private sector investment, a lack of capital mobility within SA and limited political commitment to growth-enhancing structural reform implementation, will probably keep SA on a low growth path, with all of the above a virtuous cycle or a feedback loop.
- The current environment has proven that there is a lack of focus on growth-enhancing policy prioritisation, given the skew in focus to political developments. At the MTBPS we anticipate rising debt levels and a significant revenue shortfall to be among the prominent features, while rising contingent liabilities of SOEs, deteriorating governance levels and deteriorating institutional independence may persist, albeit gradually over the next two years. We are likely to see SA's credit rating fall a further notch by 1H18 (Moody's) to Ba1 (both LC and FC). We believe that a further notch downgrade by S&P will also materialise in this instance, thereby removing SA from the Citi World Government Bond index by the middle of 2018.

Sovereign and Nedbank FC rating

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA		AAA		Prime
Aa1		AA+	A-1+	AA+	F1+	High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	Lower medium grade
Baa1		BBB+		BBB+		
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3 (negative)		BBB-		BBB-		
Ba1		**BB+ (negative)**		**BB+ (stable)**		Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		

Sovereign and Nedbank LC rating

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	Lower medium grade
Baa1		BBB+		BBB+		
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3 (negative)		**BBB- (negative)**		BBB-		
Ba1	Not prime	BB+	B	**BB+ (stable)**	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				Default imminent with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default
/				DD		

Source: Fitch, S&P ratings, Moody's, Nedbank

Source: Nedbank, Moody's, Fitch, S&P

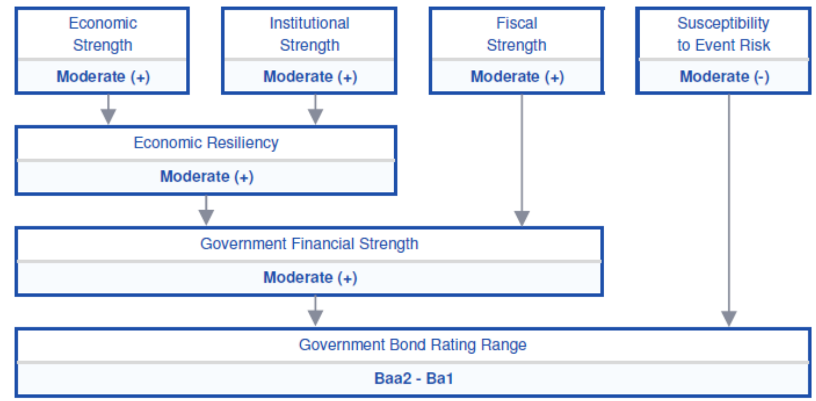
MOODY'S RATINGS METHODOLOGY

USES A COMBINATION OF WEIGHT-BASED AND ALPHANUMERIC SCORES ACROSS VARIOUS SUB-FACTORS

- As a departure point, we briefly outline the Moody's ratings methodology. Moody's sovereign risk analysis uses four broad factors: Economic Strength, Institutional Strength, Fiscal Strength, and Susceptibility to Event Risk. Underlying these broad factors are various sub-factors, which are assigned scores based on a scale. All sub-factors are aggregated after being multiplied by their respective weights.
- The Economic and Institutional strength factors combine into a construct called 'Economic Resiliency'. The scores for the Economic Resiliency and Fiscal Strength are aggregated to obtain a Government Financial Strength indicator. The weight of Fiscal Strength is highest for countries with moderate Economic Resiliency. The rationale is that the creditworthiness of countries with high Economic Resiliency is less susceptible to changes in their debt metrics, whereas the creditworthiness of countries with moderate Economic Resiliency is more sensitive to changes in their Fiscal Strength.
- Lastly, a 'Susceptibility to Event Risk' factor is calculated, with the sovereign credit rating obtained by plotting this against the Government Financial Strength score in the table below.
- A notching between the LC and FC rating is only applied where there is both limited capital mobility and when a government shows a material and observable distinction between its ability and willingness to pay creditors in LC vs FC or vice versa.

Exhibit 1

South Africa's Baa3 Negative sovereign rating is determined by four factors:



Category	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-
Score Range	100 - 85	85 - 80	80 - 75	75 - 70	70 - 65	65 - 60	60 - 55	55 - 50	50 - 45	45 - 40	40 - 35	35 - 30	30 - 25	25 - 20	20 - 1
Mid-Point	92.5	82.5	77.5	72.5	67.5	62.5	57.5	52.5	47.5	42.5	37.5	32.5	27.5	22.5	10.5

* The ranges include the lower number but exclude the higher number, except that the VH+ range is from (and including) 85 to (and including) 100.

Government Financial Strength: Combination of Economic Resiliency (F1xF2) & Fiscal Strength (F3)

Economic Resiliency \ Fiscal Strength	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-	Weight (ER/FS)
VH+	VH+	VH+	VH+	VH+	VH+	VH+	VH+	VH+	VH+	VH	VH	VH	VH	VH	VH-	
VH	VH	VH	VH	VH	VH-	VH-	VH-	VH-	VH-	H+	H+	H+	H+	H+	H	80/20
VH-	VH	VH-	VH-	VH-	VH-	H+	H+	H+	H+	H+	H	H	H	H	H-	
H+	VH-	VH-	H+	H+	H+	H	H	H	H	H-	H-	H-	M+	M+	M	
H	VH-	H+	H+	H	H	H	H-	H-	H-	H-	M+	M+	M+	M	M	70/30
H-	H+	H	H	H	H-	H-	H-	M+	M+	M+	M+	M	M	M	M-	
M+	H+	H	H	H-	H-	M+	M+	M+	M	M	M-	M-	M-	L+	L	
M	H	H-	H-	H-	M+	M+	M	M	M	M-	M-	L+	L+	L+	L	60/40
M-	H	H-	M+	M+	M+	M	M	M-	M-	M-	L+	L+	L	L	L-	
L+	M+	M	M	M	M-	M-	M-	M-	L+	L+	L+	L+	L	L	L-	
L	M	M-	M-	M-	M-	L+	L+	L+	L+	L	L	L	L	L-	L-	75/25
L-	M-	M-	L+	L+	L+	L+	L	L	L	L	L-	L-	L-	L-	VL+	
VL+	L-	L-	L-	L-	L-	L-	L-	L-	VL+	VL+	VL+	VL+	VL+	VL+	VL+	
VL	VL+	VL+	VL+	VL+	VL+	VL+	VL+	VL+	VL+	VL	VL	VL	VL	VL	VL	90/10
VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	VL-	

Alpha-numeric Range: Combination of Government Financial Strength (F1xF2xF3) & Event Risk (F4)

SA

Factor 4: Susceptibility to Event Risk \ Government Financial Strength	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-
	Aaa - Aa2	Aa1 - Aa3	Aa2 - A1	Aa3 - A2	A1 - A3	A2 - Baa1	A3 - Baa2	Baa1 - Baa3	Baa2 - Ba1	Baa3 - Ba2	Ba1 - Ba3	Ba2 - B1	Ba3 - B2	B1 - B3	B2 - Caa
VL-	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL+	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
L-	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L+	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2
M-	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2
M	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3
M+	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3
H-	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B2	B3	Caa1	Caa2	Caa3	Caa3
H	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3
H+	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH-	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3
VH+	A3	Baa1	Baa2	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3

Note: outcomes displayed are the midpoint of the three-notch range, e.g. a Aa1 in the grid above would indicate a scorecard-indicated outcome range of Aaa-Aa2

Source: Moody's, Nedbank

How the Moody's credit rating could evolve in November 2017

RECENT DEVELOPMENTS

The current Moody's credit rating:

- Moody's sovereign risk analysis uses four broad factors: Economic Strength, Institutional Strength, Fiscal Strength, and Susceptibility to Event Risk. SA's credit rating is determined by a matrix which comprises government's financial strength (made up of economic, institutional and fiscal strength) and its susceptibility to event risk. Currently, Moody's assesses the government's financial strength as 'Moderate (+)' and its susceptibility to event risk as 'Moderate (-)', to give us a rating of Baa3.
- Moody's has recently stated a few important observations, relative to its review in June 2017, when it downgraded the sovereign to Baa3, with a negative outlook:
  - SA's Institutional strength has gradually deteriorated.
  - SA's growth outlook has worsened and we are now in a slow growth trap.
  - Rising public debt and the surge in contingent liabilities has meant that the fiscal risk has increased (this is key, in our opinion).
  - The surge in foreign capital inflows into SA's capital markets has meant that SA's susceptibility to sudden events (foreign capital outflows) has risen.
  - Underpinning all of the above is the on-going political event risk, with the ANC leadership conference in December and the National elections in 2019, which is expected to add further strain on the fiscus.
- **Moody's is set to review SA's credit rating on 24 November 2017. Judging by the above comments, we are presented with a few scenarios:**
  - The government financial strength score remains unchanged, but its susceptibility to event risk deteriorates to 'Moderate': This would leave the rating unchanged at current levels.
  - The government financial strength score is lowered to 'Moderate', but its susceptibility to event risk remains unchanged at 'Moderate (-)': This would yield a downgrade to Ba1, with (possibly) the negative outlook maintained.
  - The government financial strength score is lowered to 'Moderate' AND its susceptibility to event risk deteriorates to 'Moderate': This would yield a downgrade to Ba1, with (possibly) the negative outlook maintained.
  - The government financial strength and susceptibility to event risk scores remain unchanged at 'Moderate (+)' and 'Moderate (-)' respectively: This would leave the rating unchanged at current levels.

Scenarios	Best-case	Baseline	Worst-case	Other
Gov. financial risk (Moderate +)	M +	M	M	M +
Susceptibility to event risk (Moderate -)	M -	M -	M	M
Rating (Outlook)	**Baa3 (Neg)**	**Ba1 (Neg)**	**Ba1 (Neg)**	**Baa3 (Neg)**

Alpha-numeric Range: Combination of Government Financial Strength (F1xF2xF3) & Event Risk (F4)

Factor 4: Susceptibility to Event Risk	Government Financial Strength														
	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-
	Aaa - Aa2	Aa1 - Aa3	Aa2 - A1	Aa3 - A2	A1 - A3	A2 - Baa1	A3 - Baa2	Baa1 - Baa3	Baa2 - Ba1	Baa3 - Ba2	Ba1 - Ba3	Ba2 - B1	Ba3 - B2	B1 - B3	B2 - Caa
VL-	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
VL+	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
L-	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
L+	Aa1	Aa2	Aa3	A1	A2	A3	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2
M-	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2
M	Aa2	Aa3	A1	A2	A3	Baa1	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3
M+	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3
H-	Aa3	A1	A2	A3	Baa1	Baa2	Ba1	Ba2	Ba3	B2	B3	Caa1	Caa2	Caa3	Caa3
H	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3
H+	A1	A2	A3	Baa1	Baa2	Baa3	Ba2	Ba3	B1	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH-	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3
VH	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba3	B1	B2	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3
VH+	A3	Baa1	Baa2	Baa3	Ba1	Ba2	B1	B2	B3	Caa1	Caa2	Caa3	Caa3	Caa3	Caa3

SA range

Note: outcomes displayed are the midpoint of the three-notch range, e.g. a Aa1 in the grid above would indicate a scorecard-indicated outcome range of Aaa-Aa2

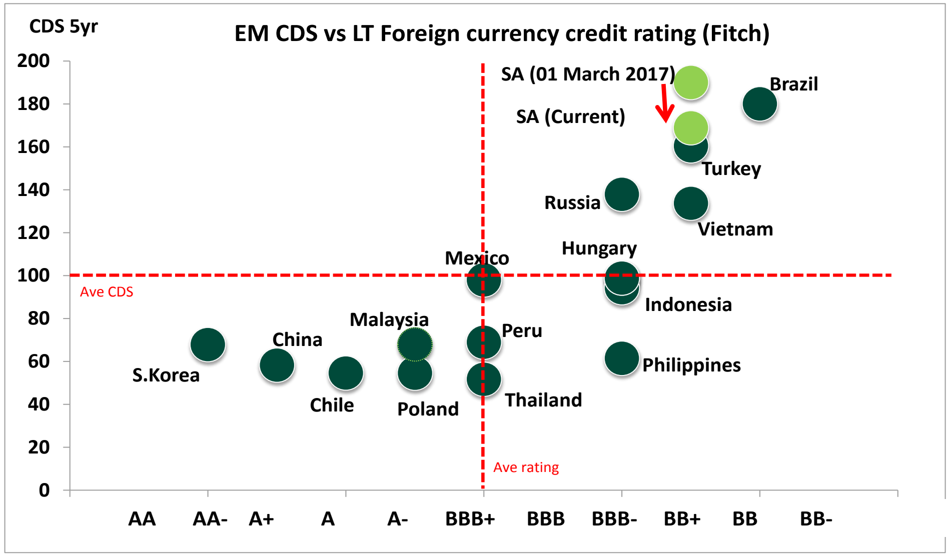
Source: Moody's, Nedbank

EXPECTATIONS

Upcoming review dates	
Moody's	**S&P**
11 August 2017	
24 November 2017	24 November 2017

Source: Moody's and S&P

- Currently, risk premiums remain highly compressed and foreign buying of local bonds remains strong. In our view, this trend may persist due to the yield-seeking, risk-on environment that we find ourselves in. **However, we believe that this will further raise Moody's perception of SA's susceptibility to event risks, as SA's dependence on foreign capital flows rises.**
- A reversal in foreign sentiment in favour of safe-haven assets would likely result in sharp capital outflows due to foreign sentiment being very fickle. This change in foreign sentiment may be more as a result of global factors rather than any particular local development, in our opinion. We have seen some volatility this week, on the back of geopolitical tensions which have spurred demand for safe havens.
- **We believe that Moody's could lower SA's FC and LC credit ratings to Ba1 at the November 2017 review, if the MTBPS signals material fiscal slippage.** This is premised on elevated political risk, a lack of structural reform implementation, a shift in focus to radical economic transformation which may worsen fiscal metrics, rising contingent liabilities which places greater burden on state resources and deteriorating growth metrics, confidence levels and private sector investment. **However, Moody's could choose to wait to evaluate the outcome of the ANC Leadership Conference in December 2017 and review the February 2018 Budget Speech before changing its credit rating.**
- **We are of the opinion that much depends on the MTBPS which should provide more clarity on the government's fiscal path** – a move away from the previous course may warrant a downgrade at either the November 2017 or June 2018 reviews, in our opinion. We favour the latter as we believe that it would be prudent to wait for the February 2018 Budget Speech to gain more clarity (in the case of fiscal slippage). **While there is a risk of a ratings downgrade from both Moody's and S&P in November 2017, we believe that Fitch could reduce its outlook to negative from stable in the event of material fiscal slippage. In either case, we continue to project downgrades before the end of 1H18.**
- Growth is expected to remain benign, while inflation will likely remain below 6% over the next 12 to 18 months. The SARB remains concerned about the trajectory of the rand – any flare up in political risks could hamper the rand exchange rate, which may feed through to headline CPI. However, despite this concern, the SARB did begin a loosening cycle in July 2017 as inflation has declined and domestic demand-pull inflation remains absent. As a result, we believe that the SARB will provide two more rate cuts of 25bps each by 1H18 in the current cycle.



Source: Bloomberg, Nedbank, Standard and Poor's, Fitch

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