Nedbank Corporate and Investment Banking Research: An update on SA and EM CDS spreads

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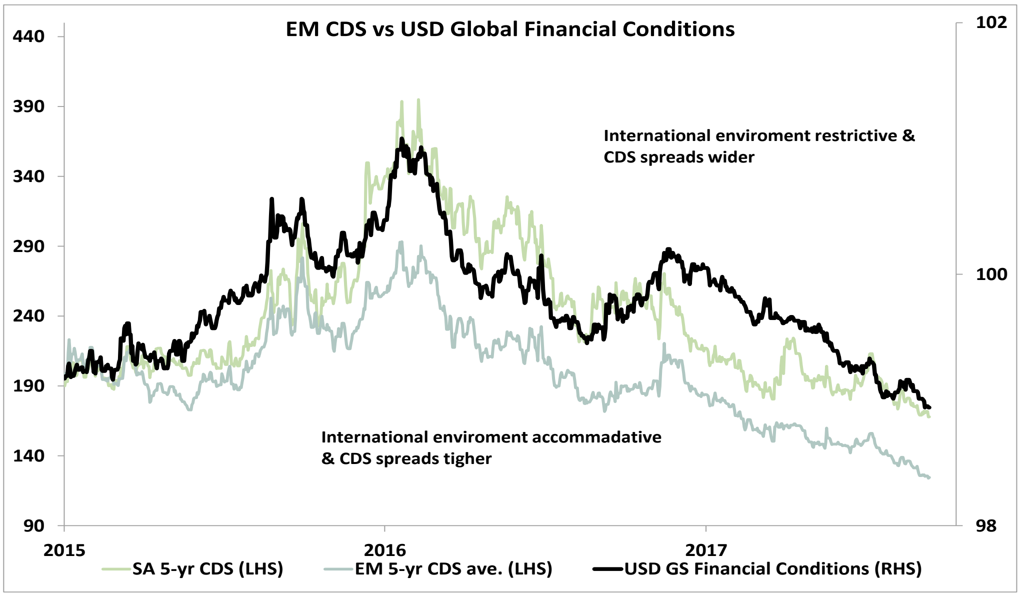
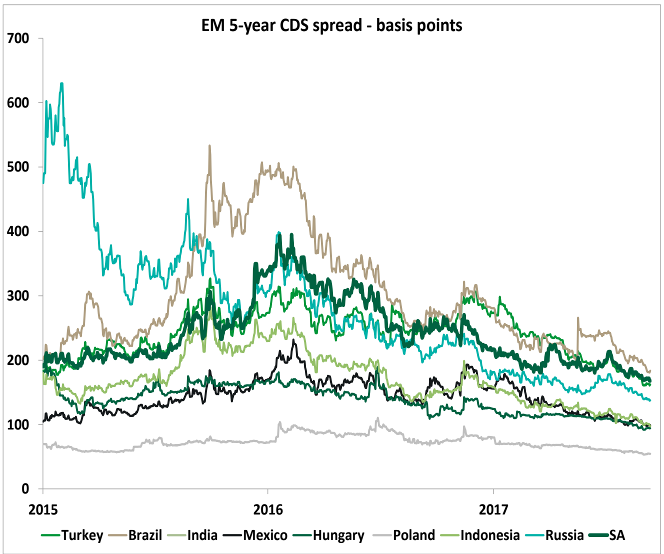
SA's CDS spread compared to EM peers

Chart 1: Easier global financial conditions has been the key driver of lower EM CDS spreads



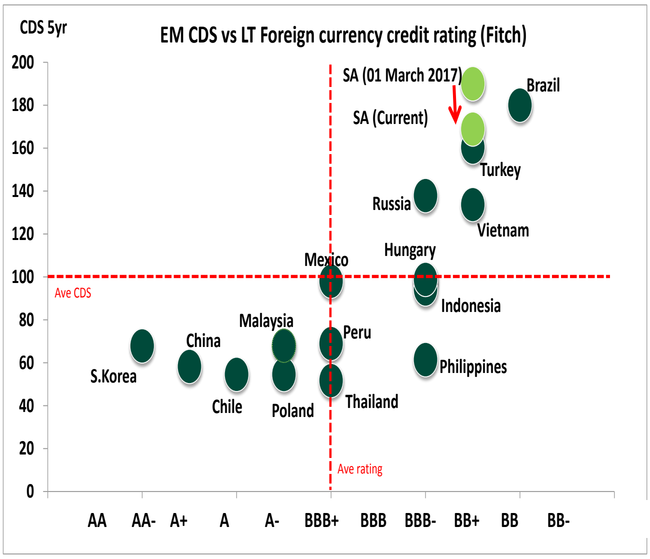
Source: Bloomberg, Nedbank

Chart2: Investor complacency has resulted in falling CDS spreads across the EM universe



Source: Bloomberg, Nedbank

Chart 3: SA finds itself amongst the weakest of EM peers, with an elevated CDS spread and a deteriorating credit outlook



Source: Fitch, Bloomberg, Nedbank

The following are brief notes on SA's CDS spread relative to EM peers, as well as a comparison of the credit ratings

- After Brazil, SA has the highest CDS spread when compared to its closest EM peers. However, EM spreads on average have been trending lower since 2016 and accelerating to the downside YTD. Much of the compression in EM and SA CDS spreads can be explained by the easier global financial conditions as illustrated in Chart 1. The Goldman Sachs Financial Conditions index is an indicator measuring how accommodative or restrictive financial conditions are globally and it can be used as a proxy to gauge risk-sentiment. Hence, despite deteriorating economic fundamentals and rising political uncertainty within EM economies, EM spreads have benefited from the risk-on phase and as a result a build-up of complacency regarding risks within EMs has occurred.
- Currently, local risk premiums remain highly compressed. The CDS spread, local bond yields, and the USDZAR have all declined or strengthened post the downgrades. 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, 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. In our opinion this eventual change in foreign sentiment could be more a result of global factors rather than any particular local development.
- The fact that SA is now in sub-investment grade means that it will take an unprecedented effort and willingness to steer the proverbial ship onto a different course – in our opinion it would take improving confidence levels and implementing structural and SOE reforms, while still maintaining fiscal prudence. Much depends on the MTBPS which should provide more clarity on the government's fiscal path – a move away from the previous course could warrant a downgrade at either the November 2017 or June 2018 credit reviews. We anticipate that both S&P and Fitch will maintain their FC and LC credit ratings and the respective outlooks at the upcoming review/s this year. However, pending the outcome of the MTBPS, Fitch could reduce its outlook to negative from stable in the event of material fiscal slippage. See MTBPS Preview https://www.nedbank.co.za/content/dam/nedbank-crp/reports/MonthyInsights/2017/MTBPS%20Preview_170906.pdf
- Growth is expected to remain benign, while inflation will likely remain below the 6% upper band over the next 12 to 18 months. We anticipate further yield and CDS spread compression up until we reach an inflection point (which may be induced by a change in foreign investor sentiment away from the current yield-seeking behaviour). 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, the rand remains relatively stable through the turbulence of 2017, and domestic demand-pull inflation remains absent. As a result, we believe the SARB will provide two more rate cuts of 25bps each by 1H18 in the current cycle.

SA's local currency credit rating

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	
Baa1		BBB+		BBB+		Lower medium grade
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: Ratings agencies, Nedbank

SA's foreign currency credit rating

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	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	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3 (negative)		BBB-		BBB-		
Ba1	Not prime	BB+ (negative)	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: Ratings agencies, Nedbank

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