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CAPITAL

MARKET VIEW

South Africa's Creditworthiness Deteriorates

South African President Jacob Zuma announced a cabinet reshuffle on the 30th March 2017. Included in the cabinet reshuffle was the then Finance Minister Pravin Gordhan, who was highly regarded by the local business community and international investors. The sacking of Gordhan means that South Africa has had four different Finance Ministers in the past sixteen months.

Ratings

Credit ratings issued by three major global rating agencies are usually relied upon by global investors when choosing debt securities to invest in, namely Standard and Poor (S&P), Fitch and Moody's.

There are different scales used by the rating agencies to assign credit ratings to debt issuances, but broadly the scales are split by investors between investment grade and non-investment grade (junk). Investment grade debt for S&P and Fitch are issuances with a credit rating of BBB- and above and investment grade debt for Moody's are issuances with a credit rating of Baa3 and above.

Rating Agency Responses to Cabinet Reshuffle

S&P

As a consequence of South Africa's cabinet reshuffle, the following Monday, S&P downgraded South Africa's foreign currency debt rating from BBB- (lowest investment grade notch) to BB+ (highest junk rating) with a negative outlook. The fact that S&P placed a negative outlook on South Africa rating indicates that there may be another rating cut if things worsen in South Africa.

S&P reduced its credit rating on South Africa's local currency debt from BBB (second lowest investment grade rating) to BBB-.

In its reasons cited for downgrading South Africa's debt rating, S&P stated that the Finance Ministry is now part of political machinations and that puts policy continuity at risk. Due to the political atmosphere S&P felt that the fiscal deficit was going to occupy a lower priority and lead to fiscal slippage.

Fitch

On Friday, the same week, Fitch downgraded South Africa's local and foreign currency bonds from BBB- to BB+ with a stable outlook. The reasons cited by Fitch are that recent political events, including a major cabinet reshuffle, will weaken standards of governance and public finances.

Moody's

Moody's released a statement that it has put South Africa's bond rating on review for a downgrade. Moody's indicated that the decision to initiate a review for downgrade was prompted by the abrupt change in leadership of key government institutions.

Implications for South Africa**Fund Flows**

Mandate rules for some international institutional investors indicate that either they hold debt which is rated investment grade by S&P or by at least two of the three major rating agencies.

This signifies that there will likely be an outflow of international funds from South Africa as investors sell-off South African sovereign debt which now does not meet their investing rules.

The outflow of funds has so far not been significant due to South Africa's local currency debt still holding an investment grade rating from S&P and Moody's. Most of South Africa's debt, approximately 90%, is denominated in local currency. Should Moody's reduce South Africa's local currency debt rating to junk, it would trigger a significant exodus of funds from South Africa. This review process typically takes 30-90 days.

South African Exchange Rate

As funds leave South Africa, the Rand will come under pressure and depreciate versus developed market (DM) currencies. A weaker Rand will place upward pressure on inflation through more expensive imports and result in higher central bank interest rates in order to stem outflow of funds. The higher central bank interest rates will filter through to higher

interest rates on credit extended to businesses and households.

Implications for Botswana**Inflation**

The South African Rand makes up 45% of the Pula basket and hence weakness in the Rand will lead to weakness in the Pula. This will increase the costs of imports which would push up inflation. However due to the SDR being 55% of the Pula basket, the Rand will also weaken against the Pula, thereby limiting the import inflation to Botswana. Most of Botswana imports emanate from South Africa.

Government Revenues

SACU Revenue makes up a substantial portion of government revenues and is denominated in Rand. If the Rand weakens significantly against the Pula, the revenue earned from SACU in Pula terms will also reduce putting further strain on the government's fiscal budget.

Implications for our investments

We believe that the deterioration in South Africa's creditworthiness, although it has accelerated slightly, is still far from warranting a two-notch downgrade from Moody's as some in the market fear. The comparisons to Brazil's two notch reductions in February 2016 are very premature as Brazil's economic and political situation was significantly more severe. Rather, we think the uncertainty is over the outlook which we expect to remain negative.

We currently have reasonable exposure to Emerging Market (EM) assets for our global funds. This includes South Africa equities. We are still seeing robust sentiment for our holdings and the general SA equity market despite the country being immersed in politics.

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