Communiqué

Monthly
South Africa
December 2017

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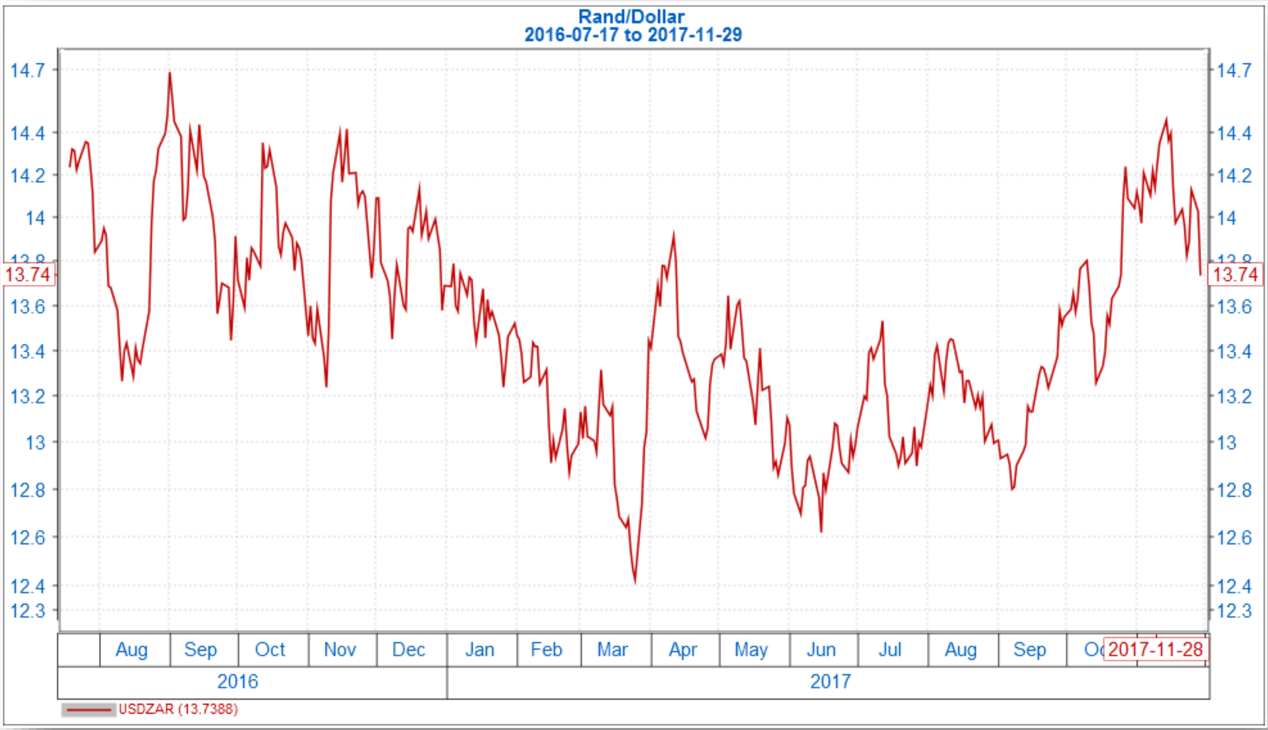
South Africa in 2018

Following the recent agency downgrades and the upcoming ANC elective conference, we decided this month to focus on South Africa.

It's only in April 2018 that SA could fall from investment to sub-investment grade from all three key rating agencies, depending on Moody's move.

S&P Global Ratings downgraded the country's long term local currency sovereign debt rating to junk status. South Africa's government debt in local currency is now one notch into sub-investment grade at BB+ from our previous BBB- rating. The long term foreign currency debt was also dropped by one notch to deeper into junk status from BB^+ to BB. The rand and bond market reacted negatively following the announcement with the rand weakening by 2% but has since recovered. The overall effect was rather mild.

The rand recovered sharply after the downgrades due to "risk-on" sentiment



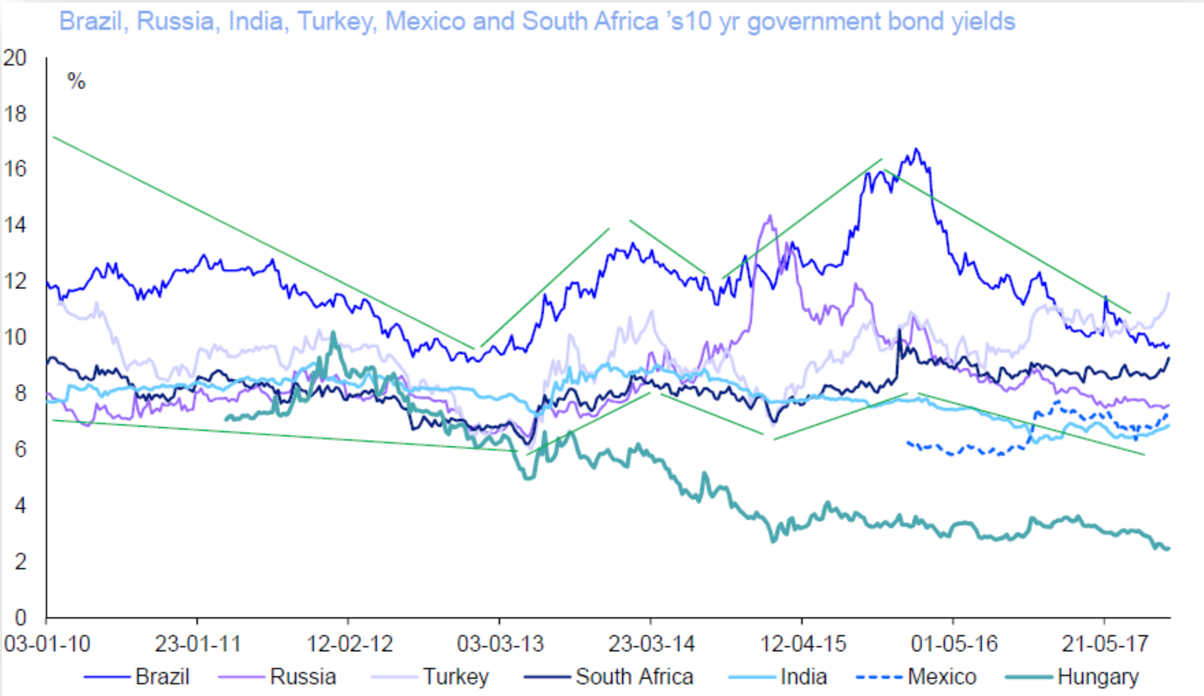
Source: Iress

Moody's indicated a 90 day reprieve placing its rating "on review" until the ANC elective conference in December 2017. It further noted that they could not conclude their view until the size and composition of the 2018 budget gets released in February 2018. Moody's is currently the only agency that has an investment grade rating on our long term sovereign debt. They did however state that they would downgrade if our "economic, institutional and fiscal strength continue to weaken" or if "measures to address funding gaps over the next two years lacked credibility or that the lack of progress with structural reforms effort would result in an environment not conducive to investment and growth"

Following S&P's decision to downgrade they noted "economic decisions in recent years have largely focused on the distribution – rather than growth – of national income. As a consequence, South Africa's economy has stagnated and external competitiveness has eroded".

The mild reaction by our market was largely due to global financial markets being in a "risk-on" phase meaning that emerging markets in general have been experiencing strengthening currencies and bond yields. Yields on most emerging markets tend to move in the same direction in general within a "risk-on" or "risk-off" environment. The large yield differential between emerging markets and developed markets currently supports higher appetite for risk and the search for yield given low inflationary expectations (and rising interest rates) in developed markets.

Emerging Market bond yields – move together



Source: Investec

The bottom line is that downgrades raise the cost of funding and it becomes more expensive for a government to borrow money which reduces the amount available for housing, healthcare, education and social grants.

In the event of a downgrade by Moody's, a definite outcome will be the exclusion of local bonds in key indices such as Barclays BGAI and Citi Banks's World Government Bond Index which will cause bond yields to rise and the currency to weaken. The inflationary impact could force the SARB to hike rates which will likely further harm the current fragile growth environment. This might lead to further downgrades accompanied by more rate hikes and higher inflation. A vicious circle then. It's important to emphasise that approximately 40% of our sovereign issuance is held by foreigners so large capital outflows remain a key risk factor.

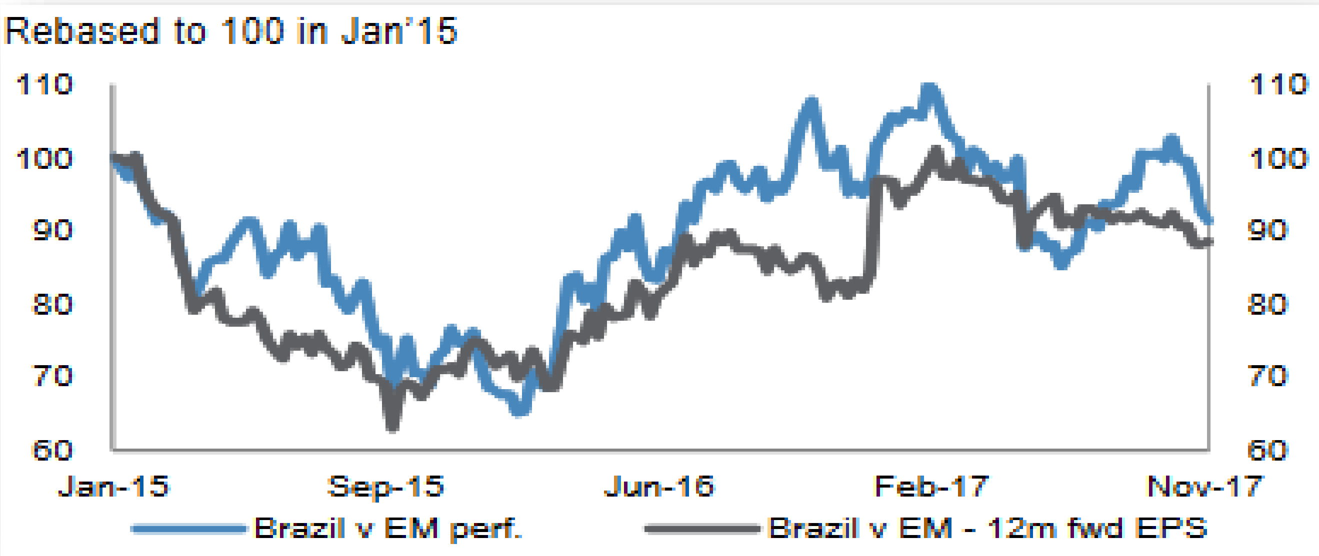
Ask any economist or investor how they see South Africa in 2018 and they will almost certainly respond by stating it all depends what will happen at the ANC conference in December. Expectations are that the outcome of the conference will have a profound impact on the country's future.

A Ramaphosa victory will likely be viewed as a silver bullet to jump start the economy and the country's future whereas a Dlamini-Zuma victory will be viewed as a doomsday scenario with the country slipping into further economic chaos accompanied by on-going corruption and non-performance.
The outcome is of importance as there has been significant building of cash resources on corporate balance sheets which could be unleashed rapidly to stimulate economic growth.

Due to the uncertainty, many locally orientated listed shares have been experiencing weakness for some time due to foreign selling. Local investors have remained overweight in companies earning a large portion of profits from offshore markets. One can therefore expect significant outperformance from locally based stocks if Ramaphosa gets the nod. Shares that stand out are banks and retailers.

While SA domestic stocks appear cheap, we are not expecting any meaningful recovery in consumer spending. However, it's worth noting that post expectations of a political shift in Brazil, the stock market there started outperforming other emerging market indices significantly in dollar terms. Should we get a more market friendly outcome in December, we can expect local stocks to start pricing in a more favourable economic outlook accompanied by multiple expansion.

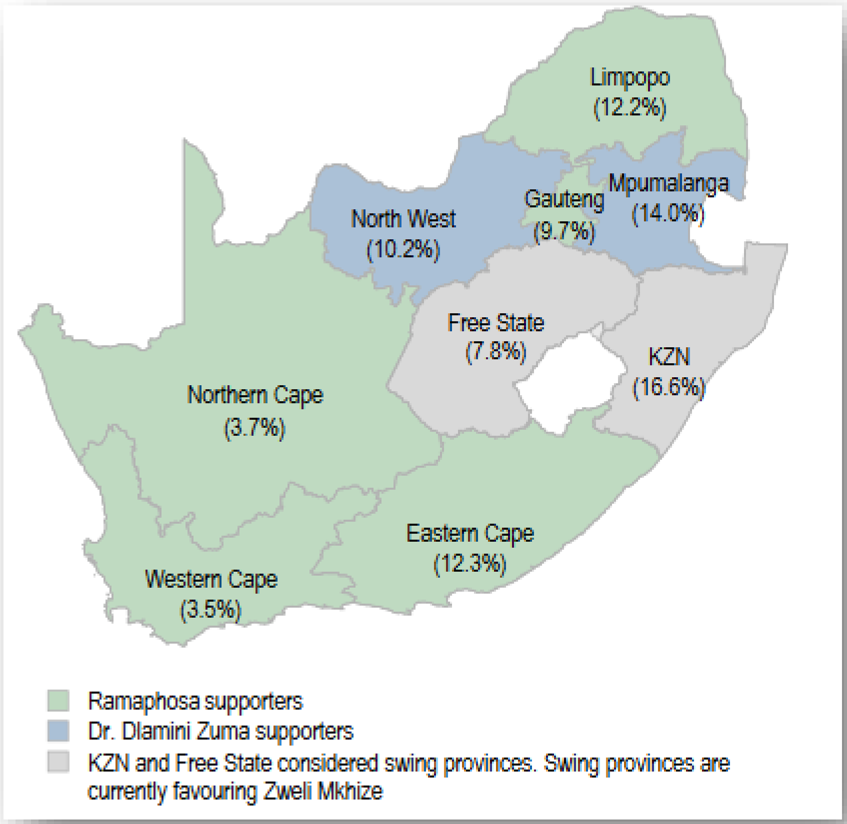
MSCI Brazil vs. Emerging Markets in $. Performance vs. earnings per share



Source: JP Morgan

While there is a great need for greater focus on unity within the ANC, we sense that most branches are focussed on getting their preferred candidates elected. A failed conference due to infighting or disputed results will cause huge damage to the ANC and every effort will be made to avoid this. Recent ANC nominations suggest Ramaphosa in an early lead but the situation remains fluid.

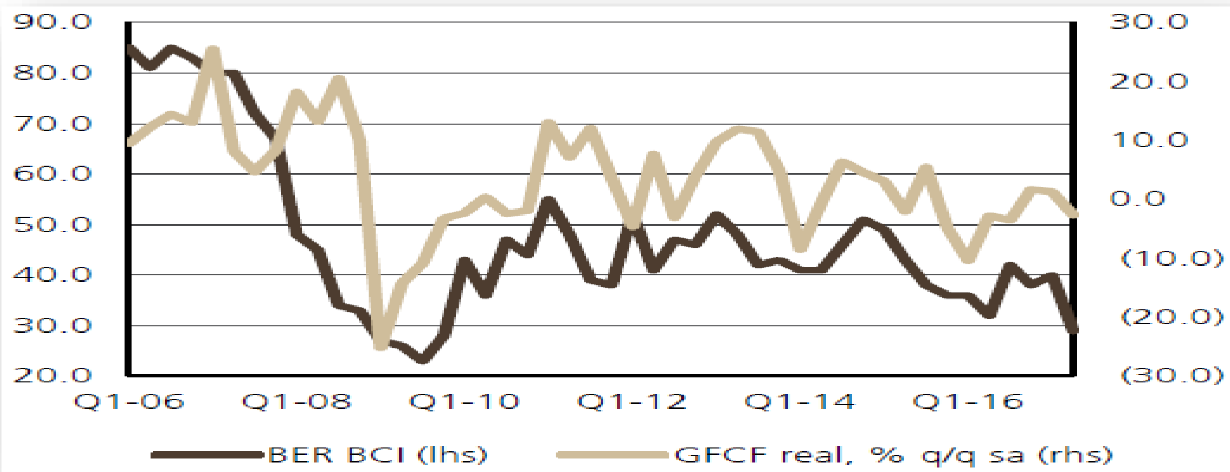
ANC provincial representation



Source: JP Morgan

The most crucial issue about economic activity, which will hopefully improve after the ANC conference, is the lack of private sector investment growth since the fourth quarter in 2014 – hence the record cash levels on balance sheets. Cash reserves in the JSE's largest 50 companies have increased from R242bn to R1.4-trillion between 2005 and 2016. A rebound in business confidence will be needed to reignite spending by corporates. Economists at UBS estimate that if confidence improves to the historical average of 50 from 37 in the third quarter of 2017 it would add 0.8% to 1% additional GDP growth. No recovery in confidence will likely cause GDP to linger at the 1% level in 2018 at best.

Fixed investments and confidence – not looking good



Source: UBS Global Research

IMARA Asset Management SA

To conclude:

- It's only in April 2018 that SA could fall from investment to sub-investment grade from all three key rating agencies, depending on Moody's move
- S&P Global Ratings downgraded the country's long term local currency sovereign debt rating to junk status. The market and currency reaction was rather muted.
- In the event of a downgrade by Moody's, a definite outcome will be the exclusion of local bonds in key indices such as Barclays BGAI and Citi Banks's World Government Bond Index which will cause bond yields to rise and the currency to weaken
- A Ramaphosa victory at the December ANC conference will likely be viewed as a silver bullet to jump start the economy and the country's future whereas a Dlamini-Zuma victory will be viewed as a doomsday scenario
- The most crucial issue about economic activity, which will hopefully improve after the ANC conference, is the lack of private sector investment growth since the fourth quarter in 2014 – hence the record cash levels on balance sheets
- We expect significant outperformance from locally based stocks if Ramaphosa gets the nod. Shares that stand out are banks and retailers

This will be our final communiqué for 2017.

Sincerely

<u>Chris Botha</u>