Moody's downgrade

How will it affect me?

All three major rating agencies have now downgraded South Africa's sovereign credit rating to "junk", meaning that we as a country will fall out of the FTSE World Government Bond Index. The term "junk status" refers to countries with debt rated below that of investment grade – this debt is sometimes referred to as "high yield".

Here are direct ways in which it will impact the average South African.

1. How are markets likely to react?

Based on historical reactions by investors to other emerging markets downgraded to junk status, much of the bad news is typically priced in by the market in advance of the announcement. South Africa is unlikely to be an exception, although we would still expect to see markets spike (bond yields upwards, equities downwards) in the days following such an announcement.

The local market spikes may actually represent good buying opportunities. However, this would need to be viewed within the context of the rapidly deteriorating global economic backdrop in the wake of COVID-19 which, incidentally, also presents opportunities if one takes a longer view.

2. Cost of government debt

The cost of raising further funds in the global and domestic bond market will increase due to a greater level of "credit risk".

To compensate for this risk, a higher return needs to be paid. The SA government will therefore need to issue debt at a higher interest rate (yield), increasing their future interest rate payments.

The higher portion of the annual budget allocated to interest payments will reduce the amount available for other items such as hospitals, education and infrastructure.

3. If market rates suddenly increase, will this affect my house mortgage lending rate?

There is no direct link between bond rates as traded in the open market (which we expect will briefly spike higher following the downgrade announcement) and the lending rates as set by the commercial banks, which are a product of the Repo rate as determined by the South African Reserve Bank.

For those folks who like to get into the technical aspects however, one could argue that in the event of a simultaneous strong sell-off of the Rand (as we have seen recently) – particularly if there are substantial inflationary pressures which are brought to bear (currently absent however) – the SA Reserve Bank could opt to increase rates which would in turn translate into higher lending rates for clients.

The likelihood of this is low, even with the current rand weakness. In addition, the low oil price helps to mitigate these issues.

In summary, if bond rates in the open market increase due to a downgrade, it is extremely unlikely that we will see increases in mortgage rates. On the contrary, mortgage rates should decline given the recent Repo rate cuts by the SA Reserve Bank.

4. Forced selling

Global bond funds and index tracking funds which are limited to holding investment grade bonds will in time need to sell their SA bond holdings due to the "junk" or non-investment grade status. Conversely, it should be noted that there are large amounts of global funds that hold junk bonds and would thus become buyers of SA government bonds. This will result in an inflow into the country. Time will tell how much these flows will offset each other.

Outflows may put downward pressure on the Rand causing it to weaken. This has an impact on the price of goods that we then import as it makes them more expensive.

5. Concluding comments

It certainly is no surprise that this Moody's downgrade was announced. Markets have been anticipating it for many months now – and finally the event has happened.

Other emerging markets like Brazil, Russia and Hungary felt the brunt of their downgrade pressure in the run-up to the downgrade event. Although the market did invariably react post the downgrade announcements to "junk" or sub-investment grade, the impact was typically acute yet relatively short-lived.

While the short-term market reaction might be material, this is likely to be transient in isolation (currently the COVID-19 outbreak and its economic impacts are substantially more material).

The impact of the downgrade in isolation on consumers is likely to be very limited. Furthermore, personal lending rates should not be impacted directly, nor will the downgrade warrant any drastic asset class changes by clients compared to their long-term asset allocation requirements.

6. Our advice

Our fund managers will take advantage of the various opportunities that present themselves when the time is right, whether that be through higher yielding bonds or significantly discounted equities. Their focus is on your long term success and so should yours. Do not undermine your Investment Strategy by irrationally selling out of your portfolio and moving into cash. Emotion is one of the biggest destroyers of wealth.

Our advice remains unchanged. Do not get swept up in short term market negativity. Stick to your plan no matter how uncomfortable it is at the moment and focus on your long terms goals.