Possible Moody's Ratings Action - A Quick Take

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Date: February 2020

Much had been written since late 2018 about a possible rating action by Moody's Rating Agency (Moody's). In this article, we hope to give the reader better insights into Moody's, and rating agencies as a whole, and the potential impact of credit rating changes.

What exactly is the hype about Moody's?

This is nothing new, really. Moody's is one of the three major international rating agencies (the other two are Standard & Poor's and Fitch). These rating agencies issue a credit rating to bond issuers (at a fee). Their client base ranges from private sector firms to countries, like the Republic of South Africa. The credit rating is basically a reflection of the rating agency's estimate of the default probability of the borrower. The higher the rating (AAA) the lower the default risk and vice versa. In determining the rating, the agency takes into account a myriad of factors, including mostly macroeconomic and financial variables, as well political risk. Most investors tend to at least partially base their investment decision (which would include the pricing of these bonds) on these "independent" ratings.

In some cases, mandates require investors to invest in bonds with a so-called investment grade rating only, where the lowest investment grade rating is BBB- (or Baa3 in the case of Moody's). In the case of the Republic of South Africa, Moody's is the only rating agency that is still rating the country as such. The other two agencies have downgraded South Africa to a sub-investment rating of BB+ for local currency denominated debt. Moreover, for inclusion in certain global bond indices, a minimum investment rating of BBB- is required.

Graph 1: Sovereign credit rating scale

Moody's	S&P	Fitch	
Aaa	AAA	AAA	Prime
Aa1	AA+	AA+	High grade
Aa2	AA	AA	
Aa3	AA–	AA–	
A1	A+	A+	Upper medium grade
A2	A	A	
A3	A–	A–	
Baa1	BBB+	BBB+	Lower medium grade
Baa2	BBB	BBB	
FC Baa3 LC	BBB–	BBB–	
Ba1	BB+ LC	FC BB+ LC	Non-investment grade (speculative)
Ba2	FC BB	BB	
Ba3	BB–	BB–	
B1	B+	B+	Highly speculative
B2	B	B	
B3	B–	B–	

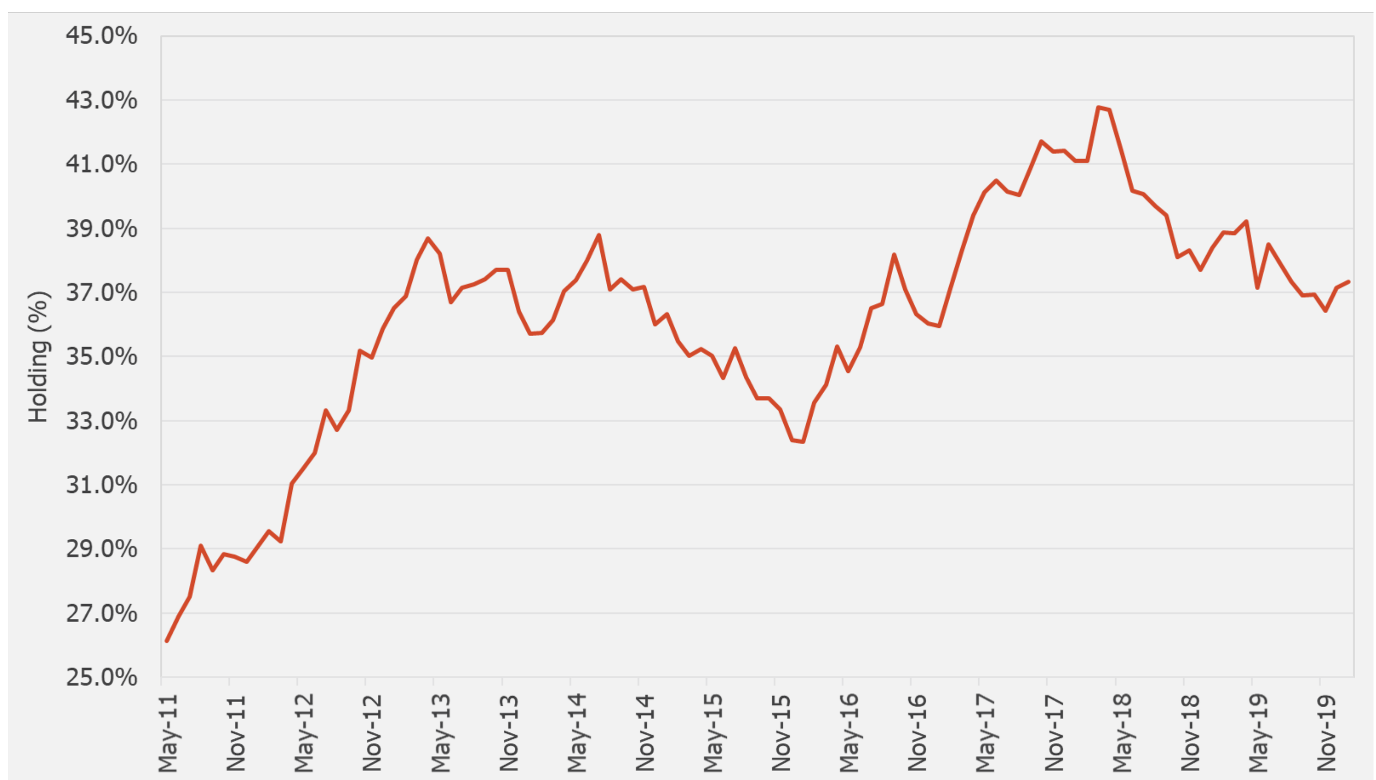
FC = SA Foreign currency sovereign rating; **LC** = SA Local currency sovereign rating

Source: Futuregrowth

Why is this so "newsworthy"?

The widespread and lingering concern is that Moody's will finally "see the light" and follow the other two rating agencies, which will cause the country to lose its last investment grade rating. This, in turn, will force passive or benchmark driven global investors to sell rand denominated South African government bonds that they currently hold in their portfolios. At the time of writing, foreign investors owned about 37% of South African government bonds. This equates to roughly R800 billion. That said, it is important to note that not all of it is actually owned by passive or index tracking investors. A significant portion of emerging market bonds, including those issued by South Africa, is owned by the so-called "unconstrained" foreign investors. These investors are not constrained by credit ratings, indices and other limitations, but would base their investment decisions on their internal fundamental analysis and relative valuation. Even so, it is reasonable to assume that some selling may either pre-empt (the active investors) or follow (the passive managers) the rating change.

Graph 2: Foreign ownership of rand denominated bonds issued by the RSA government (nominal and inflation-linked)



Source: SA National Treasury, Futuregrowth

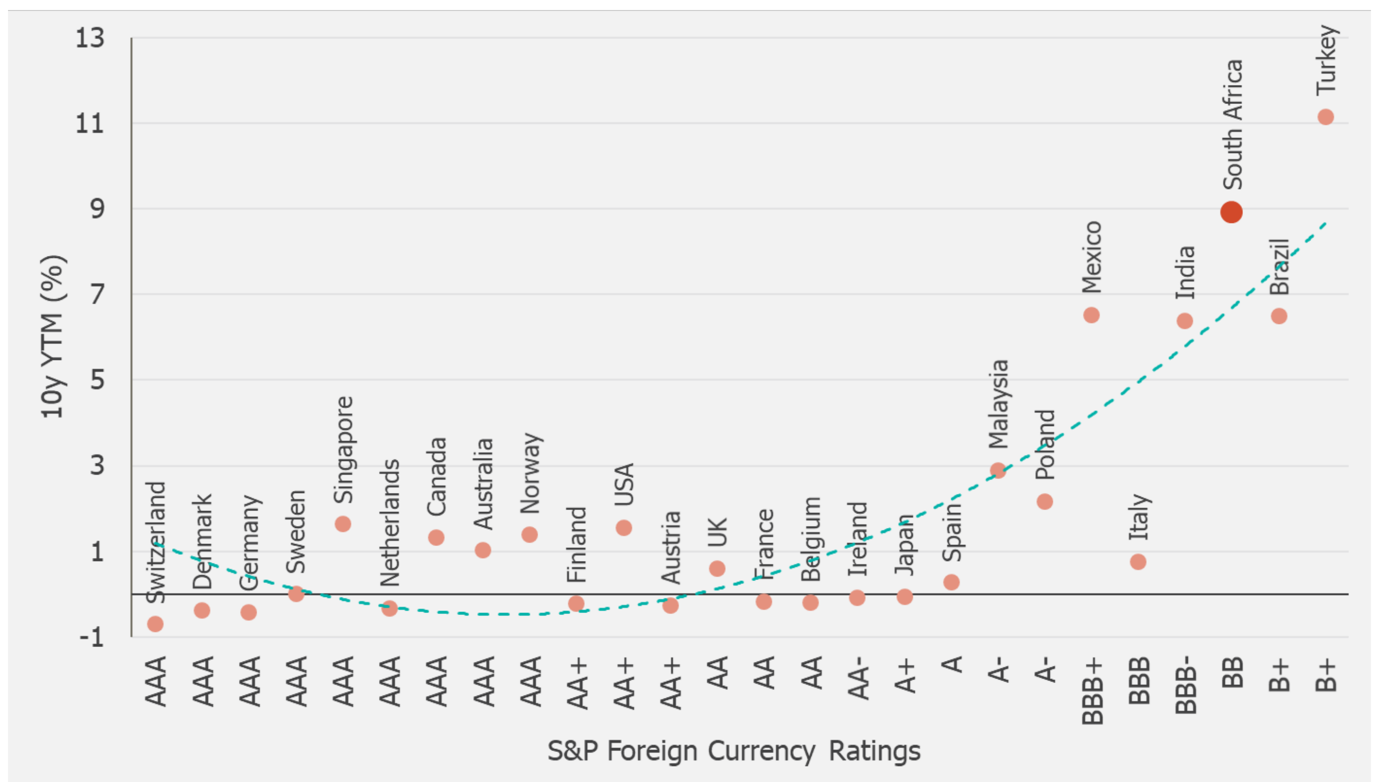
How newsworthy is a possible Moody's downgrade really?

It most certainly is not fresh news, since the possibility has been telegraphed way in advance. Of course, the element of uncertainty is whether the agency will actually act on the negative outlook or surprise most by once again holding off, the way they have done over the past year or so. We would refrain from guessing the outcome. Suffice to state that, in our view, the agency is behind the curve and should have acted already.

More interesting is the way markets are currently priced. It comes as little surprise that both US dollar- and South African rand-denominated government bonds have been trading as sub-investment graded debt for a while (see Graph 3 below). It follows that markets should not be surprised by a downgrade, as a fair amount of the "bad' news has been discounted and may at least in terms of this be trading close to fair value.

That said, most of the time markets tend to overreact and thus trade around fair value estimates. So, with this in mind, we cannot overlook the probability that bond yields may still spike in response to an actual downgrade and thus cheapen more.

Graph 3: Local currency denominated 10-year treasury yields and S&P credit ratings

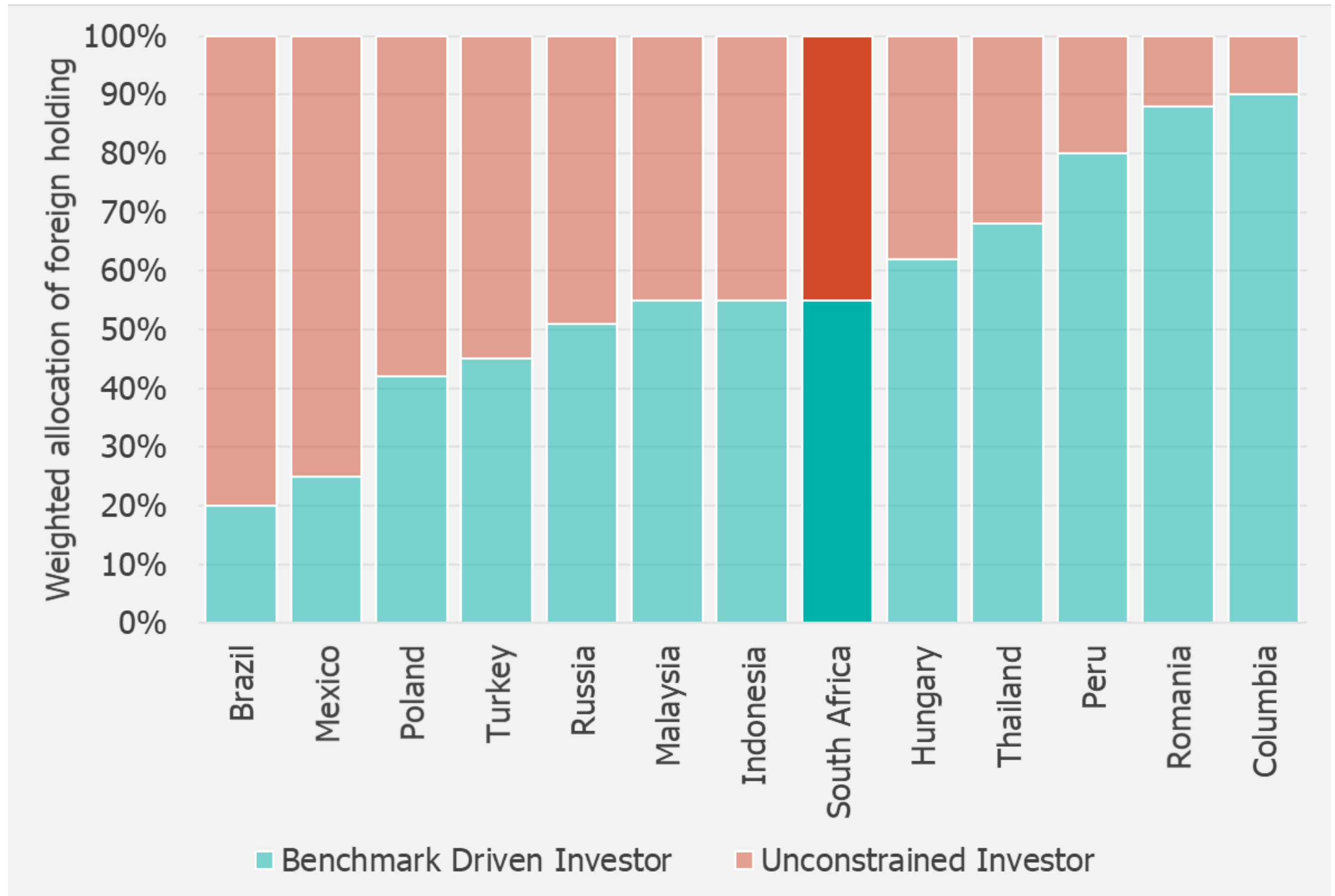


Source: Bloomberg, Futuregrowth

Is this incorporated into our investment view and strategy?

Indeed it is. Our investment philosophy at Futuregrowth is never to rely on the input from official rating agencies but to allow our fundamental analysis to lead us to our own conclusions and, in this case, our ratings. In this sense, our investment theme and strategy have incorporated concerns about sustained fiscal slippage and its impact on the country's sovereign credit worthiness for more than two years. From a valuation perspective, various indicators point to the probability that a fair amount of this fear is already in the price. We also have to consider other drivers, such as very depressed global bond yields, strong disinflationary forces and a repo rate that is unlikely to increase any time soon. The steep slope of the nominal bond yield curve is another indicator of how much bad news had been discounted for. Sitting on the fence (on cash) thus implies an opportunity cost the investor can ill afford.

Graph 4: Foreign ownership of emerging market local currency bonds



Source: IMF, Futuregrowth

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