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Challenging Conventional Wisdom
NEWSLETTER

Monthly Newsletter – April 2017

JUNK AND THE PRESIDENT

A Note from Theo and Warren

The headlines over the last few days have been alarming, starting with the firing of Pravin Gordhan and then our unfortunate downgrade to "junk" status by the credit rating agency, S&P. We suspect the other agencies will follow suit shortly and expect the media reaction to be equally disturbing.

After the events of December 2015, when Zuma fired Nhlanhla Nene as finance minister, we learnt some valuable financial planning lessons that are being implemented in this current crisis. First, we must acknowledge that this is a crisis for South Africa and false optimism could lead to some costly financial decisions. Similarly, we should also realise that the situation is not as bad as some commentators are indicating.

Here are some of the principles we are following to navigate our way through this current crisis:

- **Take time to make big decisions:** Markets tend to overreact to surprise events, we should be careful of making big decisions in the heat of the moment. Rather take time to digest the impact of the news, allow markets to stabilise and then make a long-term rational decision.

- **Consume news carefully and consider multiple sources:** Unfortunately, social media is clogged with fake news and unsubstantiated rumours. If you are lured into checking the news and social media every five minutes, you are likely to be overwhelmed with noise. This can be exhausting and will limit your ability to make rational decisions. Rather limit your consumption of news, which will give you time to reflect and help you to separate the real news from the hype. Be wary of trusting news on social media; rather use trusted news outlets.

- **Major moves in the rand or JSE might correct within months:** This is not a prediction, but we have studied other countries that have been downgraded and many of them have seen a recovery in their stock market and currency in the 12 months after a downgrade. If political events in SA turn positive, there might be a substantial recovery in investment markets.

- **Try scenario planning rather than a one solution approach:** We do not subscribe to the view that there is only one outcome to our current situation. In our view, there are a few different scenarios that might unfold from here. In some instances, even very poor outcomes in the short term might be positive in the long run. As one example, if the Zuptas do take over Treasury and spend recklessly on the nuclear deal, and the Zupta grouping win in the ANC elective conference in December, our economy might face even worse headwinds for the next 24 months. However, this will certainly increase the odds of a loss for the ANC in the general election in 2019.

It is worth noting that the rand was at current levels at the start of 2017 i.e. R13.70 to the USD. Similarly, the JSE was at a level of 50 600 and it is now at 53 000. In other words, the rand has not moved since the start of the year and the stock market is up – after the downgrade.

This is not an attempt to paint a positive picture of these events but rather to show that markets don't necessarily react the way we anticipate in times of distress. Investors should increase their offshore allocation when the rand is below R13.50 to the USD. This is what we advised when the rand was at R17.00 to the USD and we maintain this view now.

In summary, it is far too early to turn off the lights in this country, there is no doubt we are in trouble and action needs to be taken to rectify the situation. However, if the right people take the right action, the turnaround could be as swift as the decline has been.

JUNK STATUS AND WHAT DOES IT MEAN FOR US ALL?
S&P Global Ratings has lowered its long-term foreign currency sovereign credit rating on South Africa to 'BB+' from 'BBB-'. This places the rating below investment grade. The agency also lowered the long-term local currency rating to 'BBB-' from 'BBB', which is still investment grade. The outlook on both ratings was kept at negative, suggesting that S&P could revise the country's credit rating lower at a future date should the fiscal parameters deteriorate significantly.

Although the market has been pricing in a potential downgrade for some time, it reacted negatively. The rand has weakened noticeably against the major currencies, and was trading at R13.75 to the dollar on Monday evening, down from R12.40 the previous Monday. The 10-year (R186) bond yield has moved from a low of 8.25% early last week to touch a high of 9.15% on Monday evening.

S&P made an unscheduled downgrade announcement on Monday evening. The move followed last week's Cabinet reshuffle in which President Jacob Zuma replaced previous Minister of Finance and his deputy, Pravin Gordhan and Mcebisi Jonas respectively, with Malusi Gigaba and Sifiso Buthelezi.

The downgrade to sub-investment grade will likely lead to some sell-off of rand-denominated government bonds and therefore lead to an increased cost of funding for corporates, parastatals and government. Four-and-a-half years ago, SA's government bonds were included in the highly influential Citibank World Government Bond Index (WGBI), leading to large inflows as investors who track the WGBI assumed exposure to SA. Inclusion in the WGBI is based on a country's local currency rating, not its foreign currency rating. South Africa's local currency rating is rated higher than that of SA's foreign currency rating. S&P's latest domestic currency debt rating for South Africa is at the lowest level of investment grade, at BBB-.

Investors in SA bonds who are benchmarked against the WGBI can still hold these instruments as long as the local currency rating is investment grade. SA could only be excluded from this index if both Moody's and S&P downgraded the country's local currency to below investment grade. Some large institutional investors would then have to sell off exposure to SA debt because their fund mandates prohibit holding sub-investment grade bonds. Most of South Africa's debt is issued in local currency with SA's foreign currency debt only making less than 10% of total issued debt.

Moody's Investors Service, which rates the nation at two levels above sub-investment grade with a negative outlook, is due to publish its review on April 7. However, on Monday Moody's put South Africa on review for a downgrade. Fitch is due to review South Africa's rating in late May or early June, but it could also decide on an unscheduled review now.
Source: Stanlib

- Theo and Warren

MARKET COMMENT – GLOBAL PORTFOLIOS

The bouncy ride in US stocks over the last month reminded us of two market truths:

1. Market forecasting can be a substantially futile exercise.
2. US presidents and politics have relatively limited scope to sustainably impact markets.

It's one thing for Trump to stand on a podium waving an inflationary chainsaw; it's quite another for the US political system to agree to it. Thus while markets initially cheered the growth intentions of his policy soundbites, implementing them is quite another story. US governance has checks and balances that may be frustrating in some areas, but this prevents them from just willy-nilly doing something dotty (like buying a Russian nuclear power station for instance).

Historically even the most substantial US political events (or even constitutional crises) tend to have relatively limited impact. The largest would probably be Watergate (Oct 1973 to Aug 1974), which had a peak to bottom of about 30%, but that happened to coincide with a recession that only wrapped itself up by March 1975.

Thus, although the US trade officials at the last G20 meeting saw a commitment to "resist all forms of protectionism" come out of the draft statement, it amounted to bickering rather than trade war. Trump's bark is apparently a lot worse than any bite he could actually deliver. This combined with the bogging down attempts to reform healthcare in congress shows that Trump has a long way to go before he actually is effective as a politician.

In the meantime, rising US rates combined with a slowing GDP growth rate (substantially aggravated by a stronger dollar) suggest that US equities could find themselves coasting sideways for a while.

Accordingly in SwissQuote direct offshore portfolios we continue to have a relatively light exposure to US equities. We tend to have over-exposures where equity valuations are either relatively low against their bond markets and central bank rates (such as Japan and parts of Europe) or contextualised against better economic growth prospects (such as many emerging markets).

- Warwick Lucas, chief investment officer, Galileo Asset Managers