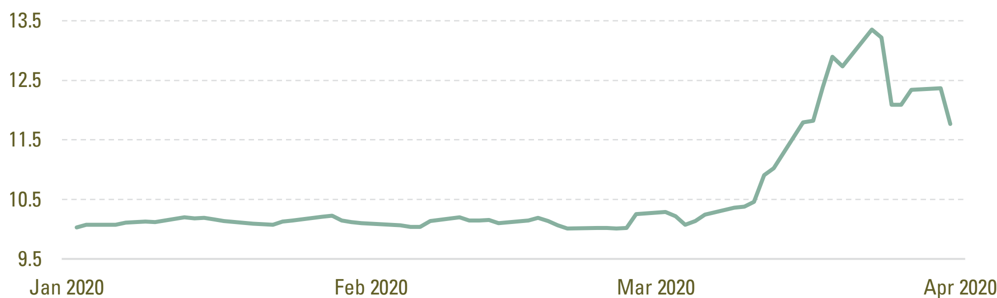
The South Africa Ratings Downgrade

Will More Sovereigns Follow?

The writing has been on the wall for a South Africa credit rating downgrade for quite some time, as Moody's continually deferred its country review. South Africa was unofficially given a grace period by the ratings agency to allow current President Cyril Ramaphosa to tackle deeply entrenched structural problems: rampant corruption, a nearly 30% unemployment rate, and fiscally bloated state-owned enterprises (SOEs) such as Eskom. Weakness in commodity markets only compounded issues for South Africa. In order to maintain its own credibility, and address the negative impact deteriorating global growth could have on South Africa, Moody's relegated the country's credit rating to below investment grade on March 27—a decision that fell in line with existing ratings from S&P and Fitch. Moody's also continued to maintain a negative outlook for the country. Yet, in the first two days of trading after the downgrade announcement, South African 30-year government bonds have rallied substantially (see **Figure 1**).

Figure 1 South Africa 30-Year
As of 3/31/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

This rally highlights a few positive aspects for South Africa:

- The South African Reserve Bank remains credible and independent. Investors remain confident that the central bank will utilize the proper policy tools to address any sharp economic downturn related to COVID-19. For example, the central bank has initiated a modest quantitative easing (QE) program.
- Outstanding South African debt is relatively longer-duration relative to other emerging market issuers, and the country's financial institutions are able to step in and purchase the bonds should liquidity become an issue.
- The downgrade may force President Ramaphosa to finally implement some of those difficult and unpopular decisions to improve the country's fiscal position.
- The worst news—*including the anticipated downgrade—was already priced into the bonds. The market really took this news in stride. Now that the downgrade is out of the way, investors are ready to start purchasing these bonds again.*

An 11.5% yield is certainly attractive, though we are not currently assessing this downgrade as a buying opportunity. Rather, we have materially reduced our bond and rand exposure over the last year. Now, we are working with clients to determine whether they want to continue holding the position in the likely event South African bonds will be excluded from the FTSE World Government Bond Index. *Most importantly, the South Africa downgrade raises the question of whether other emerging markets or oil-centric countries may be vulnerable to sovereign credit ratings downgrades.*

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For Institutional Investors Only

While our positioning in South African bonds was marginal, many of our Global Fixed Income strategies maintain significant exposure to Mexican Bonos, and to a lesser extent, Brazilian government bonds. The sovereign credit ratings for all three countries are shown in **Figure 2**.

Figure 2 Sovereign Credit Ratings by Agency
As of 3/31/2020

Country	Moody's Rating	Fitch Rating	S&P Rating
South Africa	Ba1	BB+	BB
Mexico	A3	BBB	BBB
Brazil	Ba2	BB-	BB-

Source: Bloomberg (© 2020, Bloomberg Finance LP) and Verisk Maplecroft

Ultimately, we believe that different stories are at play in Mexico and Brazil, though eventually these countries—as well as most emerging markets—could be at the mercy of a coronavirus-related economic downturn.

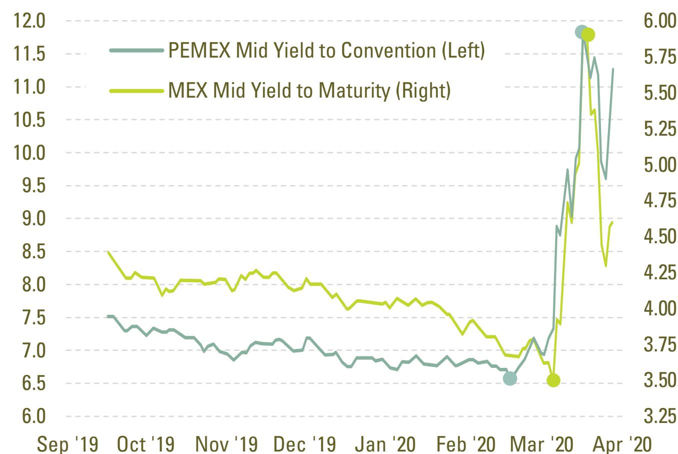
MEXICO & PEMEX

Similar to Eskom, Petróleos Mexicanos (Pemex) has been the proverbial albatross around the neck of Mexico's fiscal position and Mexican Bonos valuations, as the oil SOE's bonds trade as quasi-sovereigns. On March 26, S&P downgraded Mexico's sovereigns due to concern over Pemex, with its own bonds lowered to a C+ rating. While the precipitous decline in crude oil prices and related supply glut are significant headwinds to Pemex and the overall industry, there are signs of support for the SOE:

- Like many private sector corporates, Pemex has some liquidity levers to pull this year, such as a $7B revolver.
- The bonds do not have financial covenants and maturities have been pushed out.
- The government increased equity in the company and has reduced the SOE's tax burden. Despite party lines, President Andrés Manuel López Obrador (AMLO) has continued to lend support to Pemex.
- Pemex has hedged part of its production and is flexible in reducing its capital expenditures this year.
- From a valuation perspective, Pemex 30-year bonds are trading 684 basis points (bps) over Mexican Bonos with the same duration. In our opinion, these yields are very attractive for an SOE, which is why we continue to hold them in addition to the sovereigns (see **Figure 3**).

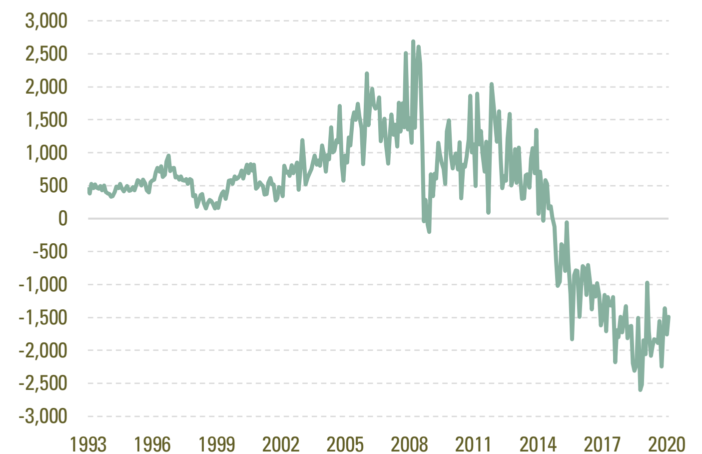
While the downturn in crude oil prices will affect Pemex and the broader industry, Mexico remains a net importer of the commodity. It may take several quarters for this benefit to flow through to industrials and consumers, but it should eventually bode well for the broader economy (see **Figure 4**).

Figure 3 Pemex and MBonos Yields to Maturity
As of 3/30/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 4 Mexico Foreign Trade, Trade Balance & Oil Products
$M USD, As of 2/29/2020



Source: Macrobond

CURRENT ACCOUNTS

Mexico also has a very modest current account balance as a percentage of GDP—aided by its trade balance—while the budget currently remains balanced—a surprise to the upside from the AMLO administration (see **Figure 5**).

OUR POSITIONING

These factors support our bond position, as do our proprietary bond models that signal that Mexican Bonos remain undervalued. We have treated the peso and Bonos as the relatively liquid proxy for emerging markets, which remains pertinent during these periods of extreme risk aversion and volatility. Nevertheless, there should be challenges to Mexico's outlook, fiscal position, and external balances. Many developed market economies may be in the middle stage of the COVID-19 outbreak, with emerging markets only beginning to grapple with the effects of the virus. Many emerging markets, including Mexico and Brazil, simply do not have the policy firepower to implement as generous of a fiscal stimulus package as the U.S.

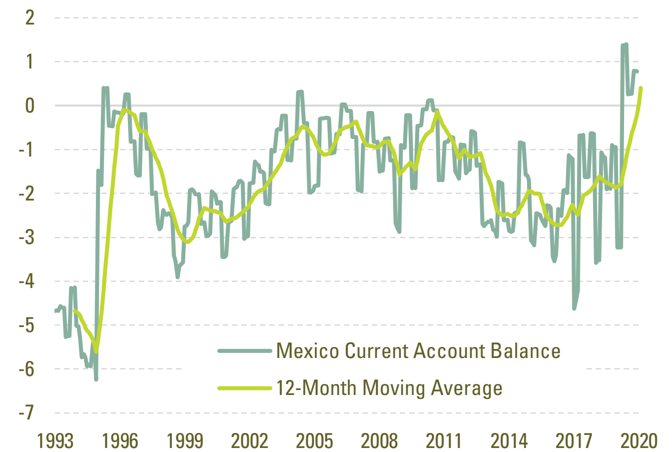
However, we believe their central banks have the capabilities and integrity to continue easing and providing liquidity to financial conditions. Like most emerging markets, Mexico and Brazil have substantial dollar-denominated foreign reserves. Recent Federal Reserve programs like the swap line and repo facilities will help central banks like the Banco de México and Banco do Brasil address their dollar funding needs. Yet, foreign reserves are only one part of their external balances. The global economic downturn will inevitably impact export-reliant economies like Mexico and Brazil. We think the stages of recovery from the COVID-19 outbreak in other key regions and countries could potentially help the export- and commodity-centric economies.

LINKS TO A POTENTIAL ECONOMIC RECOVERY

While the overall percentage of Mexican exports to the U.S has decreased over time, domestic industrial production has a positive correlation to the U.S. ISM New Orders/Inventories. Therefore, the recovery in U.S. sentiment and spending should be reflected in Mexico's industrial activity (see **Figure 6**).

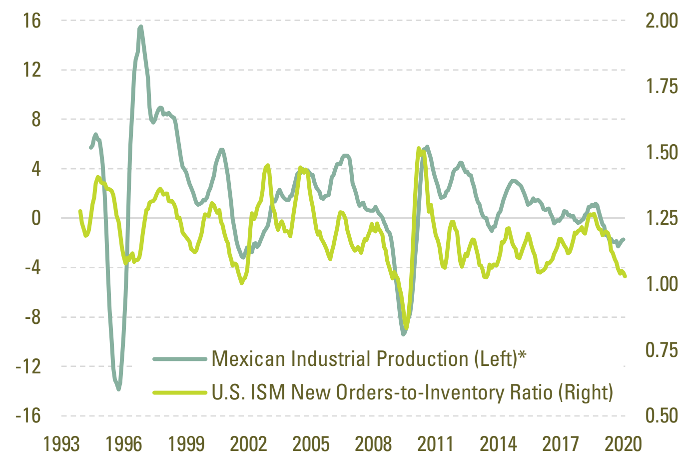
In the same vein, Brazilian GDP growth has historically moved in line with Asia import activity. We believe parts of Asia may be in the later stages of the COVID-19 recovery and could aid export activity in Brazil (see **Figure 7**).

Figure 5 Mexico Current Account Balance
% of GDP, As of 2/29/2020



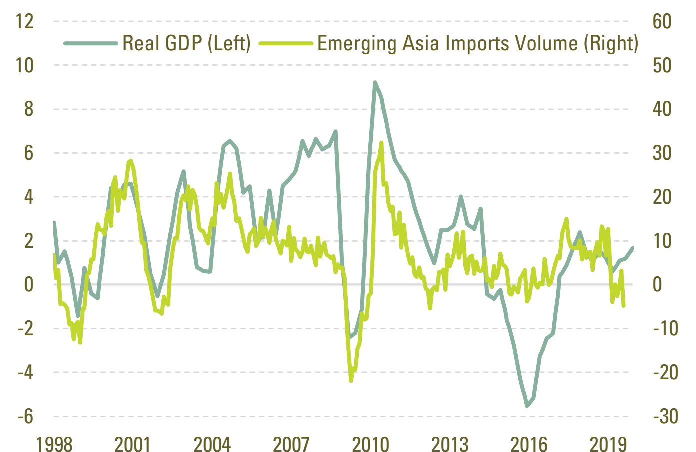
Source: Macrobond

Figure 6 Mexico Industrial Production and U.S. ISM Order
Annual % Change, As of 2/29/2020



*Shown as a 6-month moving average
**Shown as a 6-month moving average, advanced by 6 months
Source: Macrobond

Figure 7
Annual % Change, As of 12/31/2020



Source: Netherland Bureau of Economic Analysis, Advanced 3 Months

IS THE WORST PRICED INTO BOND VALUATIONS?

Economic indicators such as industrial production, PMIs, and exports have deteriorated over time for Brazil, Mexico—and more broadly around the world—as the Chinese economy came to a halt due to the coronavirus outbreak. Weaker data has largely been priced into sovereign bonds, and as more countries become ensnared with the effects of the virus, we could see further deterioration. We likely will maintain our positioning even as fiscal and trade positions deteriorate in order to avoid forced selling, but more importantly because economies like Mexico and Brazil should benefit from recoveries in the U.S. and Asia, respectively. With Mexico fresh off its own ratings downgrade, perhaps agencies will extend grace periods to many governments as they implement policies to counteract the negative effects of the virus. Furthermore, the presidential administrations in Mexico and Brazil have made some difficult and unpopular choices to placate investors, whereas South Africa had not. While we do not expect South Africa to create a domino effect of sovereign downgrades, we think extreme pessimism is priced into the bond market.

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