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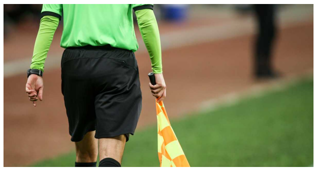
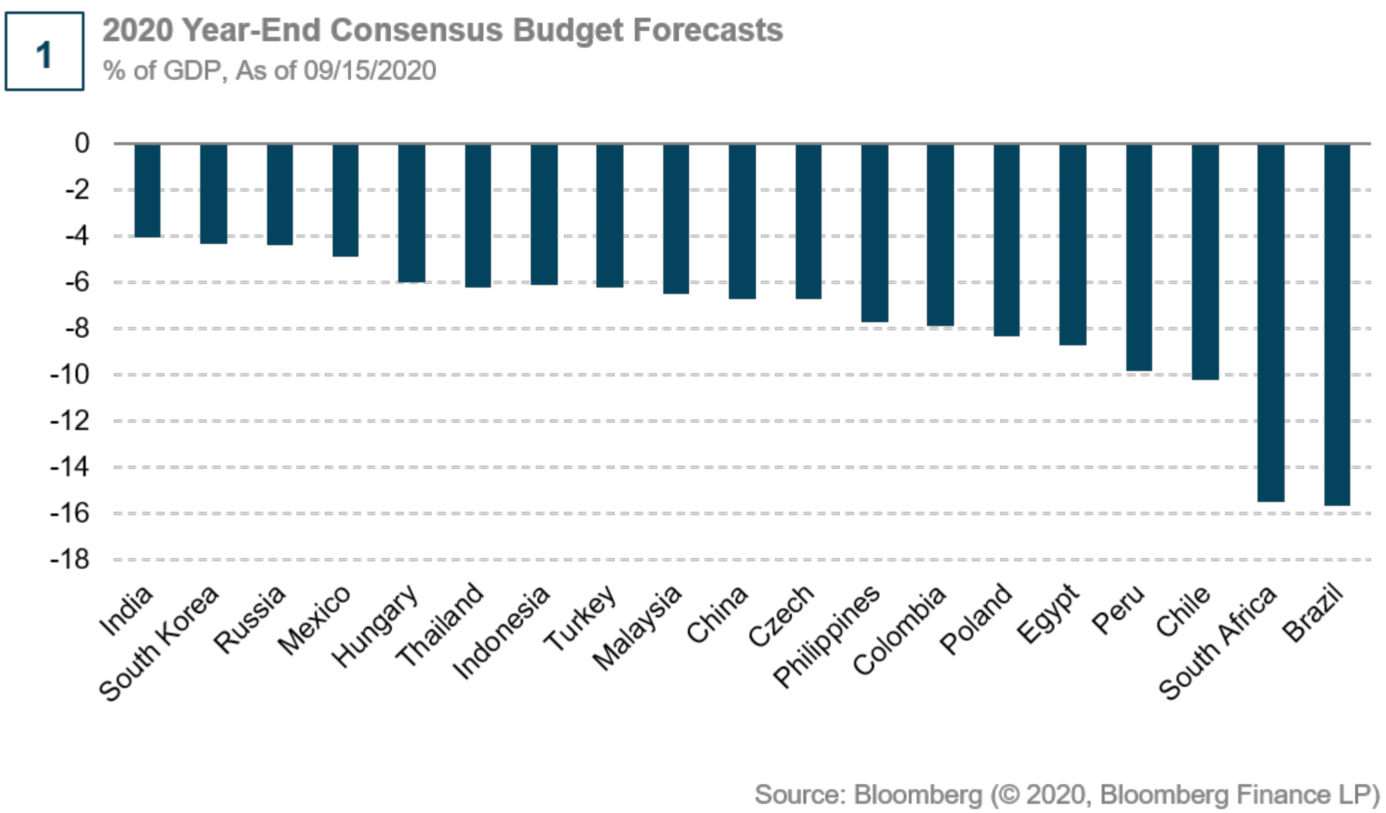


When to Call Time on Brazil and South Africa

Countries around the world have responded to the economic downturn by implementing fiscal stimulus. This intervention has led to a deterioration of fiscal finances everywhere. However, even by these relative standards, Brazil and South Africa look particularly dismal. Both countries are running fiscal deficits in the mid-teens (see Chart 1). Debt-to-Gross Domestic Product (GDP) in both countries is approaching 90%. Growth prospects are also quite bleak, which should push debt loads for these BB-rated sovereigns even higher over time.



Politicians need to make some tough choices in the years ahead. The only silver lining is that both countries can muddle through for some time still. Their debt stock is mostly denominated in local currency, external debt is termed out, and the domestic banking systems are well capitalized and liquid.

The debt mix enables these countries to use their currencies to weaken and act as a rebalancing lever for the economy. In South Africa, only 12% of the debt is in hard currency, and the next large external debt maturity is not until May 2022 when $1 billion USD of principal is due. In Brazil's case, less than 4% of the debt is in foreign currency. One risk for Brazil is its reliance on floating-rate debt, which allowed the country to reduce the weighted-average cost of debt to 7% currently, down from 14% in late 2015. However, in an eventual rate-hike cycle, the risks of this debt could be significant.

Since their downgrade to high yield, Brazil and South Africa have become less attractive to foreigners that often have credit rating constraints. Luckily for both countries, the domestic banking systems remain very liquid and willing to finance the sovereign. In Brazil, private-owned banks have found few attractive lending opportunities amid a recession. As loans mature, they have reinvested that cash in sovereign bonds. Bank holdings of sovereign debt have doubled to over $800 billion USD from approximately $400 billion USD. In South Africa, bank holdings of sovereign paper have also begun to increase and, at roughly 8% of assets, have plenty of room to grow. Large domestic pension fund systems are also likely to remain willing buyers of sovereign debt.

Significant Market Anomalies Remain

The tradeoff between long-term solvency concerns with limited short-term liquidity constraints has introduced significant market anomalies. In Brazil, the market prices an aggressive rate-hike cycle over the next two years despite record low inflation. In South Africa, the yield curve is more than twice as steep as any historical comparables. As negative as things look, the risk premia embedded in assets seems excessive at this point.

But Markets May Be Forced to Call Time

To be clear, having some leeway to finance fiscal deficits does not excuse these sovereigns from postponing tough political decisions. In a recent review of sovereign defaults, Moody’s emphasized that high debt-to-GDP ratios are neither a necessary nor sufficient condition for sovereign default. Of 42 sovereign defaults since 1997, only 33% occurred because of high debt burdens. However, 36% of defaults were caused by political and institutional weakness. Presidents Bolsonaro and Ramaphosa have some runway left, but not much. Both leaders face elections in 2022, at which point markets may well call time.

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