

Market update

Prepared by GTC Investment Analytics

3 April 2020

Scope

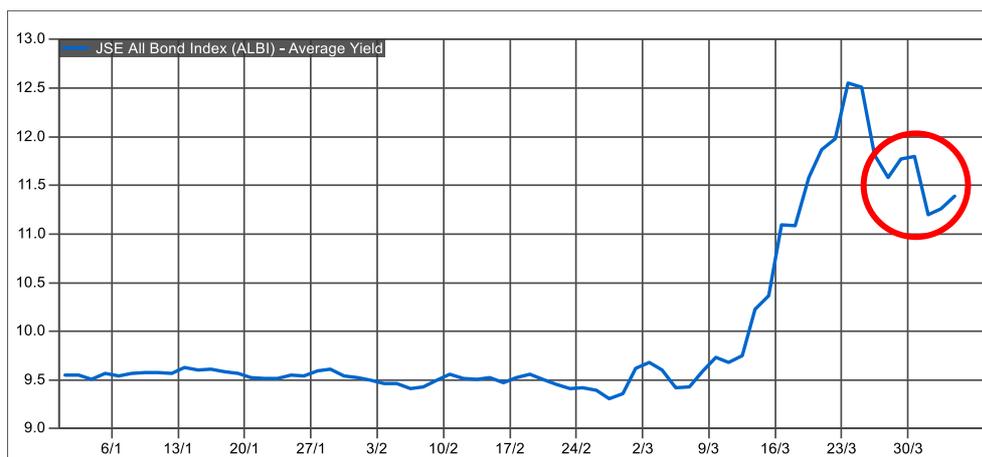
Further to our recently released communications, we aim to continually provide investors with insight into recent investment market developments. This document deals with the recent Moody's downgrade announcement.

What has happened?

Moody's, a global credit ratings agency, lowered their outlook of South Africa's credit worthiness assigning a below investment grade, or junk, status to bonds issued by the South African Government. Moody's is primarily concerned about low economic growth, increased government spending and debt. It was the last of the recognised ratings agencies to downgrade South African bonds to junk status. The downgrade, while long expected by investment markets, comes amidst a global economic crisis driven primarily by the Coronavirus (CoVid19) pandemic which has seen large losses of value in almost all asset classes around the world.

What has the impact been on the markets?

The direct impact of the downgrade on investment markets has been difficult to isolate given the extreme levels of volatility already present due to the impact of the Coronavirus lockdown. The graph below illustrates this:



(Source: GTC Investment Analytics, Factset)

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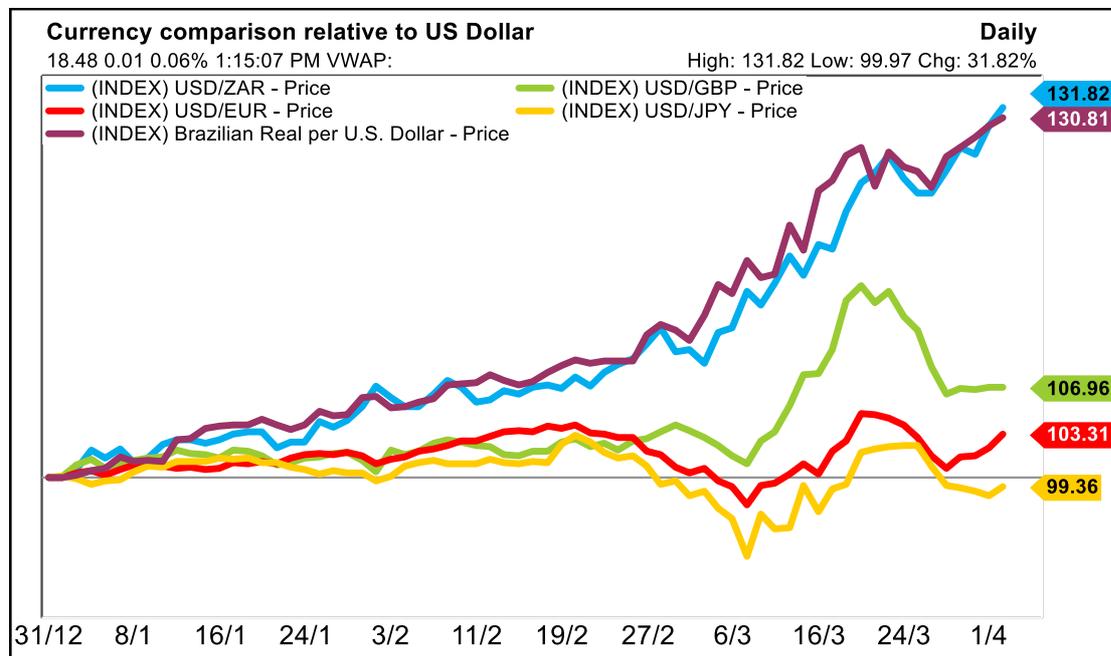
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The blue line shows the average yield of the South African bond market, the JSE All Bond Index (ALBI). A rising line indicates increasing losses for holders of South African Bonds, with a falling line showing a recovery in value.

Much of the fear amongst investors relating to the downgrade was due to the expected selling of our bonds by international investors who in certain cases are prohibited from holding junk bonds. This forced selling was expected to result in large losses in the ALBI which, in reality (at the time of writing) has not materialised.

The announcement of the downgrade occurred late on 27 March and the red circle on the above graph highlights the relatively small reaction in the bond market when compared to the losses suffered since 9 March due to the impact of Covid19. In fact, our bonds have increased in value! This is likely due to two factors. Firstly, while the investment environment remains volatile, with news flow changing daily, the evidence suggests that South African assets had largely already accounted for the downgrade. Secondly, the impact of the downgrade was all but dwarfed into insignificance by the far larger impacts of the Covid19 pandemic.

Some investors point to the loss in value of the South African Rand, currently (at the time of writing) trading at R18.70 to the US Dollar, as evidence that the downgrade has contributed significantly in this environment. Here again, our team's research shows that there are several other factors, mainly related to a shortage of the supply of US Dollars and an increase in the demand for them that is creating enormous pressure on the exchange rate. The graph below compares a number of currencies, including the Rand, to the US Dollar, highlighting the relative strength of the US Dollar.



(Source: GTC Investment Analytics, Factset)

The Dollar has strengthened against the Euro (red), the Pound (green), the Brazilian Real (purple) and the South African Rand (blue) with only the Japanese Yen (yellow) largely flat. The fact that the Rand has weakened against the US Dollar in line with the Brazilian Real, another commodity based emerging market currency, provides evidence that the sell-off in the Rand has largely been driven by the fear based risk off environment that the Covid19 pandemic has created.

What is likely to happen going forward?

The downgrade confirms the current reality of the South African economic environment which most investors already understood to be poor. It does highlight the fact that the money our government needs to borrow to aid our people and companies in weathering this global storm will come at a higher cost due to our lower credit worthiness. This higher cost will provide a further headwind to overcome in improving the situation.

That said recent market activity shows demand for new issuance of South African government bonds with real yields at all-time highs which means that the country will have access to funding which it desperately needs. It also provides comfort that many investors still see South Africa as an attractive investment opportunity.

What should clients do?

The downgrade does not in any way change our message to clients over the past few weeks. There is no requirement for any action on our clients' part, GTC will continue to manage our client's investments along previously communicated principles, adjusting allocations to ensure that the portfolios remain as optimally positioned as possible in this rapidly changing environment.

Yours sincerely

Clive Eggers
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