20 August 2014

Moody's downgrades SA banks' ratings

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Today sees the release of local CPI inflation numbers for July (consensus: 6.4% y/y; previous: 6.6% y/y). A print higher than consensus could see the curve bear flatten through its implications for monetary policy action. This could further exacerbate the selloff that occurred across the curve early this morning as SAGBs play catch-up with the much weaker rand on the back of the ratings downgrades across the local banking sector by Moody's yesterday.

Moody's downgraded by one notch each, the long-term local currency deposit ratings of South Africa's big four banks: Standard Bank of South Africa (SBSA), Absa Bank Limited (Absa), FirstRand Bank Limited (FirstRand) and Nedbank Limited (Nedbank), to Baa1 from A3. Keeping the door open to further downgrades, the agency also noted that "[a]ll ratings of the above banks and their corresponding long term foreign-currency ratings, as well as those of Investec Bank Limited (Investec), were placed on review for downgrade". According to the agency, "[t]he one notch downgrade of the local-currency deposit and senior unsecured debt ratings reflects Moody's view of the lower likelihood of systemic support from South African authorities to fully protect creditors in the event of need. This updated opinion was prompted, most recently, by the actions taken by the South African Reserve Bank (SARB) in response to the abrupt loss of creditor confidence in African Bank Limited (ABL)". This pertains to inclusion of a bail-in, which the agency negatively assesses as the SARB's "willingness to impose losses on creditors".

Moody's decision to place South Africa's big five banks on review for a downgrade stems from concerns surrounding the current weaker growth environment, "particularly in the context of consumer affordability pressures and still high consumer indebtedness", which the agency believes might materialise in higher credit costs across the banks. This is despite the agency referencing the broad-based resilience that was seen in the banking sector during the economic downturn and the maintenance of solid financial metrics. However, these credit positives were noted as being weighed upon by concerns over "potential asset quality pressure building up in the retail, small and medium enterprise (SME) and corporate loans segment of the banks' portfolios".

Key financial market indicators

Spot		chg	Cross Rates		chg
USDZAR	10.65	0.41%	EURUSD	1.33	-0.33%
EURZAR	14.18	0.08%	GBPUSD	1.66	-0.66%
GBPZAR	17.69	-0.26%	USDJPY	102.92	0.34%
ZARJPY	9.67	-0.07%	AUDUSD	0.93	-0.25%
USDZAR fwd		**chg**	**Commodities**		**chg**
1m	10.70	0.39%	Gold	1295.68	-0.21%
3m	10.81	0.40%	Platinum	1438.25	-0.42%
6m	10.99	0.42%	Copper	6867.50	-0.54%
12m	11.34	0.41%	Brent	101.56	-0.04%
Equities/Risk		**chg**	**US Yields/spreads**		**chg (pps)**
ALSI	51309	-0.41%	US 10 yr	2.41	0.01
VIX	12.21	-0.89%	US 30 yr	3.21	0.01
MSCI World	1735	0.43%	EMBI	297.56	-5.16
MSCI EM	1084	0.69%	SA CDS	176.00	-3.84
Bonds		**chg (pps)**	**Rates**		**chg (pps)**
R 203	7.02	-0.04	3m JIBAR	6.08	0.00
R 208	7.80	-0.01	FRA 3x6	6.22	0.00
R 186	8.25	-0.01	FRA 6x9	6.40	-0.03
R 214	8.93	-0.03	FRA 12x15	6.74	-0.04

Source: Standard Bank Research, Bloomberg

The SA Daily

South Africa | FX & FI

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We believe that the rating actions taken in the banking sector and the intended banking review could have implications for the South African sovereign rating; Moody's considers the local banking sector to be a credit strength in assessing South Africa's sovereign ratings. The agency does have the sovereign on a negative outlook, and rates both the long-term foreign currency and local currency ratings at Baa1. And, while we did not believe that Moody's would resolve the negative outlook on the sovereign at the time that Fitch and S&P were due to release their ratings assessments on South Africa on June 13, Moody's did note that they were updating their 2012 debt figures to 2013. Moody's may release a report at any time because their analyst for South Africa is not based in the EU, which means that an assessment on South Africa is not restricted to a sovereign calendar. The action on the banking system by Moody's could move forward a potential negative rating action on the sovereign.

The local FI market strengthened on balance yesterday, as SAGB yields fell by between 0.50 of a bp and 4.50 bps across the curve. There were a few exceptions, with the yields on the R213 and R2032 remaining unchanged from their prior-day levels at 8.72% and 8.85% respectively, while the yield on the R2030 rose by 1.00 bp to 8.72%. The R2044 saw its yield fall by the largest increment on the day (4.50 bps), to 8.99%, and the yield on the R2048 fell by 4.00 bps to (also) 8.99%. The yield on the R186 fell by the smallest increment, of 0.50 of a bp to 8.25% and the R157 fell by 3.00 bps to 6.58%. The front- and mid-segments of the curve steepened, while the back-end of the curve flattened. The spread on the R186/R203 at the front widened by 3.00 bps to 123.00 bps; the spread on the R213/R186 at the belly widened by a marginal 0.50 of a bp to 47.00 bps; and at the back-end, the spread on the R2048/R186 compressed by 3.50 bps to 73.50 bps. Turnover volumes improved markedly yesterday, to ZAR18.03bn from ZAR13.71bn likely due to interest generated from the nominal government bond auction as significant turnover volumes were recorded in the auction bonds: R2032 (17%); R2037 (15%); and R2044 (13%). The only other bond to record notable trading volumes yesterday, was the R186 (14%).

Non-residents purchased nominal SAGBs on a net basis yesterday for a total of +ZAR796m. Foreign buying was concentrated in the 12+ year segment, with +ZAR1.14bn purchased in this category. Notable purchases in this extended-maturity segment was recorded in the R2032 (+ZAR769m), R2037 (+ZAR363m), R2044 (+ZAR214m), R186 (+ZAR201m) and R209 (+ZAR106m); this was partially offset by net selling in the R2048 (-ZAR225m), R2030 (-ZAR120m) and R213 (-ZAR105m) in this segment. The only other notable transaction on the day was recorded in the R204 in the 3-7 year segment, in which foreigners sold -ZAR209m on the day.

We saw a particularly strong nominal government bond auction yesterday, with robust demand coming through for the bonds on offer. In a replica of last week's offering, ZAR1.00bn was raised in the R2032, ZAR850m was raised in the R2037 and ZAR500m was raised in the R2044. Pricing action was competitive, with all three bonds clearing below market levels. The R2044 recorded a stellar performance for a second week, pricing at 8.97%, 5.00 bps below the market, while the R2032 cleared at 8.845%, 4.00 bps below the market and the R2037 cleared at a yield of 8.945%, 1.50 bps more competitively than the market at the time. Total auction bids rose significantly week-on-week, to ZAR9.05bn from ZAR6.90bn at the previous auction, for an auction bid/cover ratio of 3.9x yesterday. The last time auction bids surpassed the ZAR9.00bn mark was at the beginning of June. The R2032 received the majority of investor bids, with 42% of the auction's bids allocated to the bond. The R2037 received 29% of the auction bids, while the R2044 also received 29%. The R2032 received 54 participant bids, of which 11 were fully allocated, while the R2037 and the R2044 received 41 and 39 bids respectively; the R2037 allocated 11 bids fully, while the R2044 allocated 2 bids fully. Market participants are eligible to take up 100% of their allocations in the R2032 and the R2044 at this Thursday's non-competitive bid auction.

By Asher Lipson and Kuvasha Naidoo

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Local CPI data will be published today. Consensus pegs the July print at 6.4% y/y, lower than the 6.6% y/y reading in June. Base effects are favourable and material, with a 1.1% m/m (sa) increase recorded in July 2013. SBGS economist Kim Silberman sees inflation easing by slightly more than consensus, to 6.3% y/y. The 29c m/m increase in the petrol price translates to a softening of petrol price inflation from 13.4% y/y to 8.3% y/y, given a much larger m/m increase in July 2013. In June, petrol contributed 0.76 percentage points (pps) to the headline figure; this time, it will contribute only 0.43 pps. Food inflation is seen falling from 9.2% y/y in June to 9.0% y/y. Partially offsetting the deceleration in petrol and food inflation, are likely increases in water supply services and funeral services inflation (both are surveyed in July). Upside risks are seen stemming from vehicle price inflation off the back of exchange rate pass-through. Electricity is expected to have increased 7.1% m/m in July – that is, equivalent to the increase in July 2013, leaving electricity inflation flat Y/Y. If we are right regarding a below consensus CPI result, this would be interest rate positive and thus currency market negative.

Notwithstanding a drop in the level of inflation, the SARB's anxiety will be running high so long as the rate remains above the target ceiling. The SARB's inflation profile anticipates a deceleration in the rate of inflation in Q3:14, before resuming an upward trend again to peak in Q4:14 (at a quarterly average of 6.6%). The Bank expects that headline inflation will remain outside the band for an extended period – until Q2:15, according to its July forecasts. The Bank might lower these forecasts to take into account the July hike. At the March meeting – that is, following the January hike of 50 bps - the Bank adjusted its 2015 inflation forecast moderately from 6.0% y/y to 5.8% y/y; it left the peak in Q4:14 and the duration of the target ceiling breach unaltered. The Bank also mentioned in its July Statement that, even when inflation does return to within the target, it expects it to "remain uncomfortably close to the upper end of the target range". In light of this and its view that inflation risks lie to the upside, the Bank is acutely aware that its credibility, and consequently its ability to ensure that inflation expectations remain well anchored, are in a precarious position. We expect CPI inflation to average 6.1%y/y in 2014 and 5.1%y/y in 2015, and – while also expecting a pick-up in Q4:14 – we think that the y/y change might have peaked in June.

The exchange rate was mentioned as "remain[ing] a key factor" in its view that inflation risks remain to the upside. This heightens the sensitivity of policy decisions to exchange rate movements. With the targeted inflation measure likely to remain well above 6.0%, the Bank's 'implicit tolerance' for currency weakness will be running low. It is important to note also that the Bank has previously mentioned that it already sees "indications of some acceleration" in pass-through and, consequently, it might not take much of a push here for the Bank to become acutely concerned. Analysts expect core inflation to hold steady at 5.6% y/y in July. In June core inflation kicked up after remaining at 5.5% y/y for three consecutive months. We anticipate core inflation rose to 5.7%y/y in July, as moderating food inflation felt in the headline measure will not be registered in core.

Today sees the release of minutes of the 29 to 30 July FOMC meeting. As anticipated, the FOMC did not announce any major changes to its policy path at its July meeting. The Committee made a "further measured reduction" in its asset purchases, keeping it on track to wind down the programme completely by the 28 to 29 October meeting – asset purchases will then end in November. However, there were some subtle changes to the July FOMC Statement. The Committee no longer described the unemployment rate as "elevated", merely stating that it had declined further. Nevertheless, most likely to avoid any inference that its view on the labour market had changed appreciably, the Committee added that "a range of labor market indicators suggests that there remains significant underutilization of labor resources." The Committee also removed language describing "inflation persistently below its 2 percent objective" as "pos[ing] risks to economic performance". This time, the Committee described the likelihood of inflation running persistently below 2 per cent as having "diminished somewhat". This could be read as a slightly more hawkish tilt. The minutes will shed further light on the debates that led to these changes. There was no explicit indication in the July Statement regarding the policy normalisation measures that might follow the conclusion of the Fed's bond-buying programme. The minutes of the meeting might be more telling in this regard, particularly if they reveal differing opinions on the Committee as to the appropriate profile for tightening steps. Keep in mind that one Committee member, Philadelphia Fed President Charles Plosser, chose to dissent at the July meeting. He objected to the use of "a considerable time" in providing guidance regarding the appropriateness of keeping the fed funds rate at current levels after the asset purchase programme ends. Plosser felt that such "time dependent" language did "not reflect the considerable economic progress that has been made toward the Committee's goals".

The Fed is not the only central bank to release the deliberations of its last policy meeting today, the BoE does the same earlier in the day. The BoE minutes will be watched by the market for signs that some members are getting twitchy about rates. Quite clearly this could come in terms of a non-unanimous vote, although Steve Barrow (our G10 FIC Strategist) thinks that it will be 9-0 in favour of unchanged policy. Needless to say, if it is anything other than 9-0, the pound will likely rise sharply and the fixed income market (and probably stocks) will sell off. But, even if there's nobody voting for higher rates, the minutes will still be scoured for signs that members are getting closer to pulling the trigger. One difficulty for the market is that the composition of the MPC has changed quite a bit in recent months.

Consensus pegs the first hike in the fed funds rate as occurring in Q3:15. Steve agrees with this view. Pricing in the fed funds futures market appears to be discounting a slightly earlier "liftoff" in Q2:15. BoE is expected to start raising rates in Q1:15 (Bloomberg consensus). With the Fed and the BoE much further along the path towards tightening monetary policy than the ECB and the BoJ, among the majors the rand remains more vulnerable on the USD and GBP axes.

Yesterday's UK CPI reading came in well below consensus, perhaps putting paid to any speculation that BoE tightening might occur already this year. Consumer inflation came in at 1.6% y/y for July, down from 1.9% y/y in June. Expectations were for a milder drop to 1.8% y/y. This release appears to have contributed to sterling weakness yesterday. US CPI was also released yesterday. Both the headline and core readings were in line with expectations at 2.0% y/y and 1.9% y/y respectively. The Fed's preferred measure from a policy calibration point of view is the PCE measure of inflation. This will be released next week Friday. The headline figure stands at 1.6% y/y, with core inflation slightly lower at 1.5% y/y.

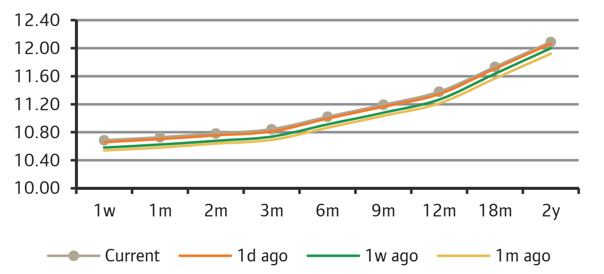
The rand weakened for the third consecutive trading day against the US dollar yesterday, closing at USDZAR10.65, compared with Monday's close of USDZAR10.60. The rand depreciated into a strong performance from the dollar against the major crosses, on the back of a slight (but not unexpected) rise in inflation numbers out of the US yesterday. The dollar strengthened against the euro, the pound and the yen. The biggest move was seen against the pound (-0.7%), owing to slightly lower than expected CPI figures from the UK. SBR's G10 analyst Steven Barrow noted that EURUSD, having found itself at new nine-month lows yesterday, has finally broken free from the stability that we have seen so far this month. The rand depreciated against the dollar, the euro and the yen, while strengthening against the pound. All of the commodity currencies we monitor for purposes of this report depreciated, resonating with softness in commodity prices on the day. The EM currencies we monitor put in a mixed performance on the day. The BRL, INR, TRY and IDR appreciated; the MXN was unchanged, while the THB, HUF, RUB and ZAR depreciated. The rand took up the middle position in the commodity currencies category and ranked last among its EM peers. The rand traded between a low of USDZAR10.5963 and a high of USDZAR10.6633 yesterday. Support from where the rand opened this morning sits at 10.6000, 10.5250, 10.4850, 10.4560 and 10.4000. Resistance levels sit at 10.6500, 10.7200, 10.7700 and 10.8400.

Turning to commodity prices, copper, platinum, gold and Brent fell by 0.5%, 0.4%, 0.2% and 0.04% respectively. The ALSI fell by 0.4%, while the EM MSCI rose by 0.7% on the day. The EMBI spread compressed by 5 bps and the SA CDS 5yr spread compressed by 4 bps. The CBOE VIX index, a volatility proxy for global risk appetite/aversion, fell by 0.9%.

Non-residents were moderate net buyers of local equities (ZAR479 million) and meaningful net buyers of local bonds (ZAR797 million) yesterday. Buying of bonds was seen in the 12+ (ZAR1 141 million) year bucket. Selling was meanwhile seen in the 3-7 (-ZAR254 million), 7-12 (-ZAR57 million) and 1-3 (-ZAR33 million) year segments. Bond yields fell by between 1 bp (R208 and R186) and 4 bps (R203) on the day. The 6x9 and 12x15 FRAs fell by 3 bps and 4 bps, respectively, while the 3x6 FRA was unchanged.

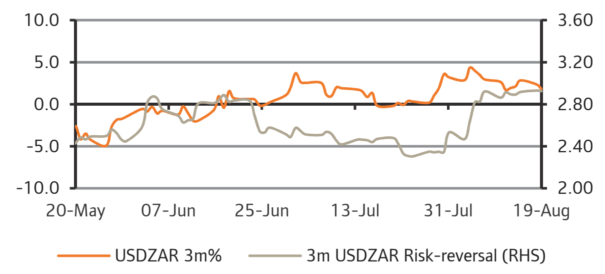
By Bruce Donald, Marc Ground and Varushka Singh

Figure 1: USDZAR forwards



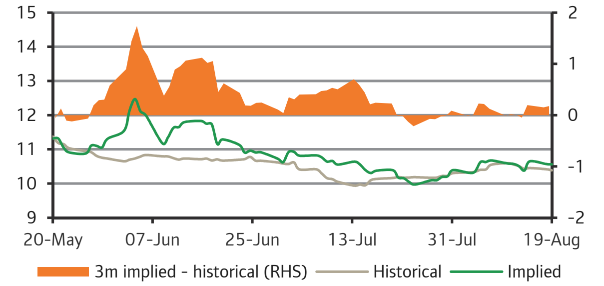
Source: Standard Bank Research, Bloomberg

Figure 2: USDZAR vs risk-reversal



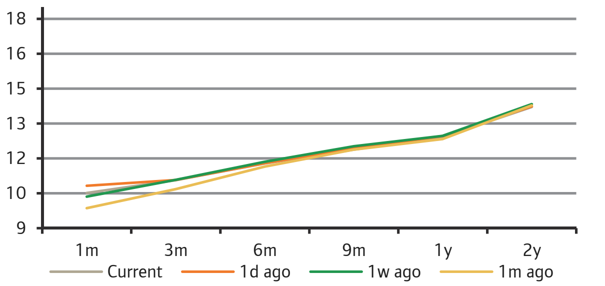
Source: Standard Bank Research, Bloomberg

Figure 3: Implied vs. actual USDZAR volatility



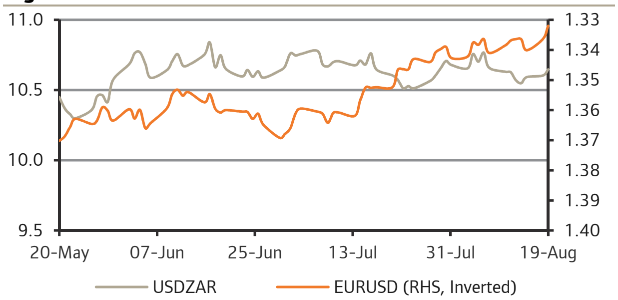
Source: Standard Bank Research, Bloomberg

Figure 4: USDZAR volatility curves



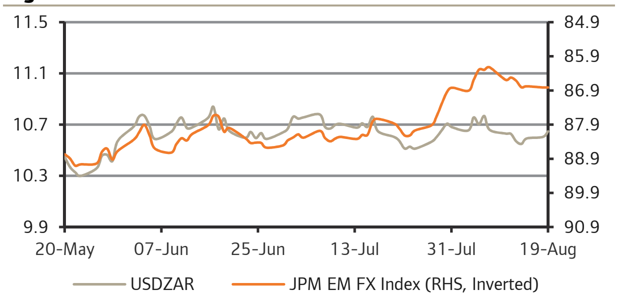
Source: Standard Bank Research, Bloomberg

Figure 5: USDZAR vs. EURUSD



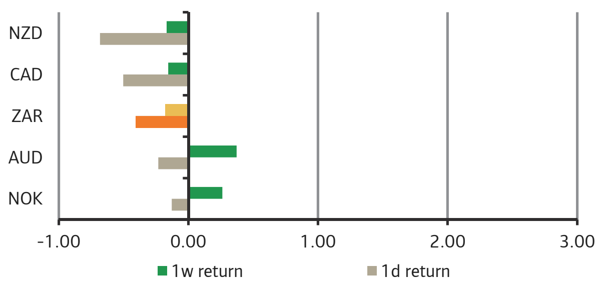
Source: Standard Bank Research, Bloomberg

Figure 6: USDZAR vs. EM FX index



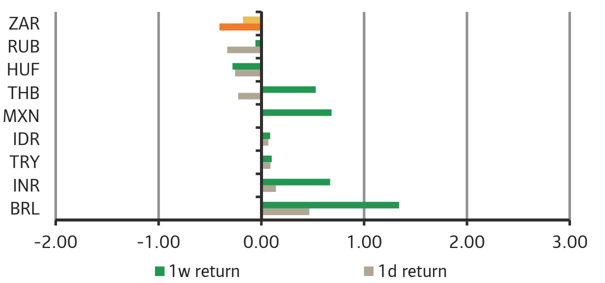
Source: Standard Bank Research, Bloomberg

Figure 7: USDZAR vs. commodity currency performance



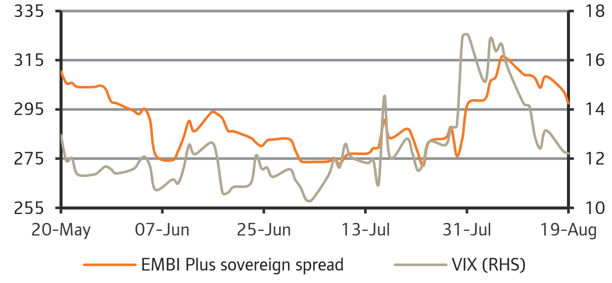
Source: Standard Bank Research, Bloomberg

Figure 8: USDZAR vs. EM currency performance



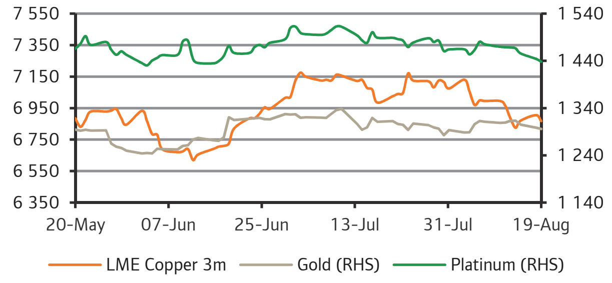
Source: Standard Bank Research, Bloomberg

Figure 9: VIX global risk appetite proxy vs. EMBI



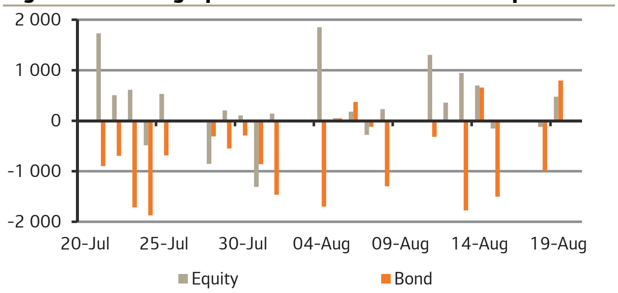
Source: Standard Bank Research, Bloomberg

Figure 10: Commodity prices



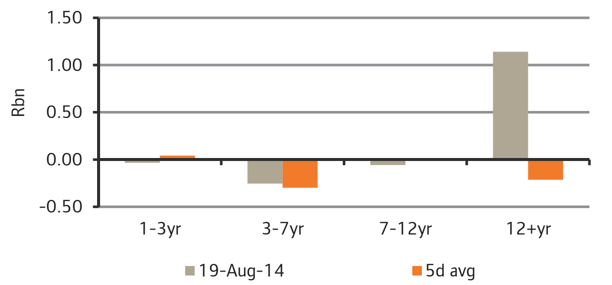
Source: Standard Bank Research, Bloomberg

Figure 11: Foreign purchases of SA bonds and equities



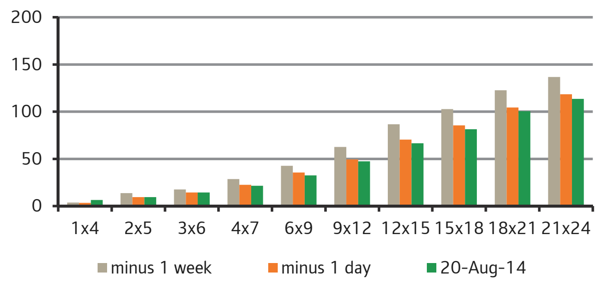
Source: Standard Bank Research, Bloomberg

Figure 12: Foreign purchases of SA bonds by maturity



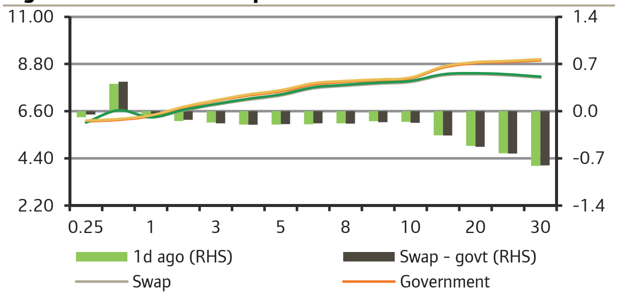
Source: Standard Bank Research, JSE

Figure 13: FRAs less JIBAR



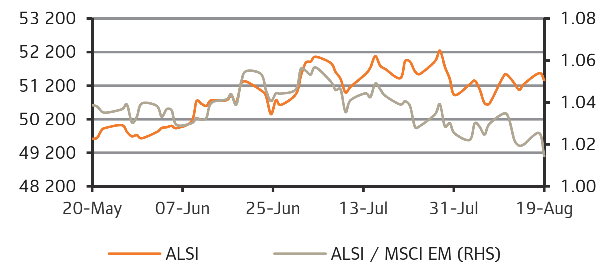
Source: Standard Bank Research, Bloomberg

Figure 14: Bond vs. swap curves



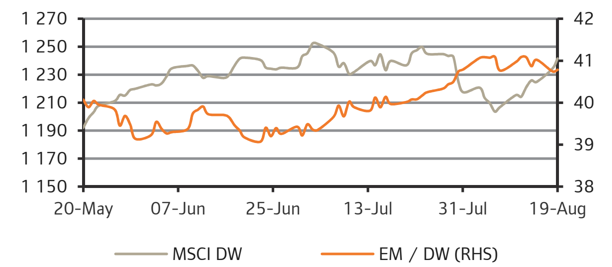
Source: Standard Bank Research, Bloomberg

Figure 15: ALSI vs. ALSI/MSCI EM relative



Source: Standard Bank Research, Bloomberg

Figure 16: MSCI EM vs. MSCI EM/DW relative



Source: Standard Bank Research, Bloomberg

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