Investment Research

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Emerging markets: the next shoe to drop

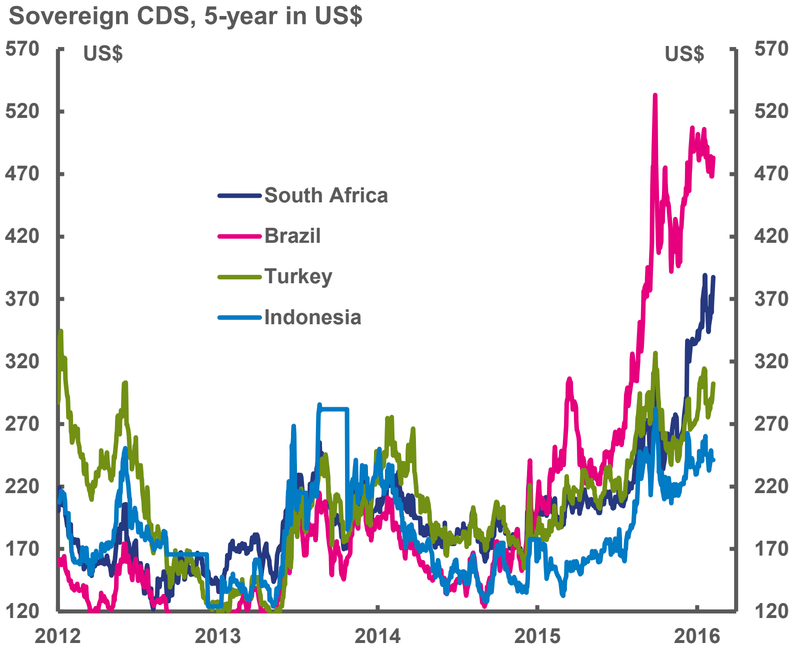
South Africa candidate for junk status, Turkey not immune

Key points

- South Africa has received a lot of attention as evident in the 5-year CDS, which rose at a speed resembling that of Brazil, and soon surpassed the likes of Turkey.
- Both Turkey and South Africa are facing high net foreign liabilities and rising political risks as Brazil did. Yet, South Africa is more exposed to falling commodity prices and a weaker China than either Brazil or Turkey.
- South Africa's recalcitrant fiscal policy resembles that of Brazil, whereas Turkey's fiscal discipline stands in stark contrast.
- Lack of fiscal consolidation in South Africa's 2016 budget could trigger a downgrade. Turkey's downgrade could be triggered by a rise in political risk or fears about central banks' credibility.
- The downgrade to junk is the most likely for South Africa, while a more dovish Fed would postpone the downgrade particularly for Turkey.
- A downgrade to junk by two rating agencies would spur portfolio outflows as South Africa and Turkey would drop out of the JP Morgan Emerging Markets Bond Index Global Diversified Investment Grade.

Exhibit 1

Sovereign Credit Default Swaps (CDS) on the rise



Source: Bloomberg and AXA IM Research

INVESTMENT MANAGERS

Christmas hangover

Global markets jolted at the beginning of the year on concerns over global growth and the ability of China to avert a hard landing. Disappointing real GDP growth data for the fourth quarter 2015 in the US, falling energy prices and concerns over China spurred more risk aversion towards emerging markets (EMs) in general and EM commodity exporters in particular. EMs with high imbalances, large trade exposure to China and a large share of commodities in total exports got hammered the most. The political environment remains unsettled in many of these economies. Political uncertainty has made ratings agencies more vigilant. The downgrade of Poland by Standard and Poor's by one notch to BBB+ on 15 January based on political risk factors is alarming.

South Africa (Moody's: Baa2, negative; S&P: BBB-, negative and Fitch: BBB-, stable) and Turkey (Moody's: Baa3, negative; S&Ps: BB+, negative and Fitch: BBB-, stable) top the list for potential downgrades to junk. Their credit default swaps (CDS) ascended at a rate similar to Brazilian 5-year CDS in the run up to its downgrade to junk in mid-December 2015. The purpose of this note is to illustrate that South Africa is more similar to Brazil than Turkey and subsequently, more likely to be downgraded to junk by rating agencies in 2016. A more dovish Fed would reduce the downgrade probability, particularly for Turkey.

Political risk is high

South Africa and Turkey have several things in common with Brazil, a country that recently lost its investment grade status and is facing a presidential impeachment. All of these countries are experiencing a political crisis that is unsettling international investors and impedes budgetary execution. High political risk implies a high risk premium required by investors.

Following the November 2015 runoff general elections and the landslide victory of AKP[1], Turkey is confronted with terrorist attacks in major cities. The struggle with the outlawed Kurdish PKK[2] continues as the ceasefire lifted during the summer in an attempt to polarise public opinion and lure the popular vote from Kurd-friendly political parties has not been restored. Also, the political debate over constitutional amendments fuel further political uncertainty. The downing of a Russian air fighter at end December 2015 brought attention to the country's foreign policy and raised tensions.

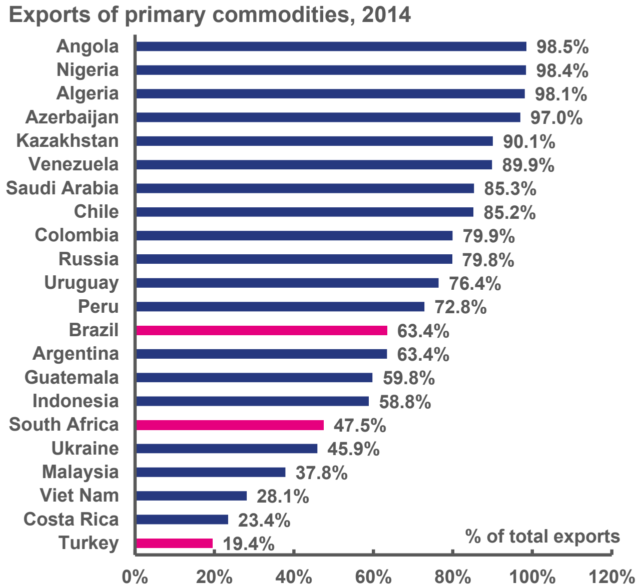
South Africa is heading to local elections scheduled for 18 May and 16 August 2016, fuelling political uncertainty and impeding much-needed fiscal consolidation. In an attempt to lure the popular vote, the government decided to introduce an expensive 3-year public wage deal in 2015, funded by the contingency reserve. The latter had been earmarked for the stabilisation of public debt. Political developments at end-2015 unsettled the markets of South African assets as the respected Finance Minister Nele was removed and a relatively unknown MP was appointed, triggering short-term volatility. Shortly afterwards, the government backpedalled and appointed Pravin Gordhan who held the post in 2009-2014.

Commodity exposure

South Africa is significantly more exposed to commodity prices than Turkey, either directly or indirectly via the trade with commodity exporters. South Africa's primary commodity exports stand at 48% of total exports, or 12.3% of GDP (*Exhibit 2*). South Africa is more exposed to falling commodity prices relative to Brazil for which primary commodity exports equal 63% of total exports or 8% of GDP. Hence, the South African economy is less differentiated from commodities relative to that of Brazil. In Turkey primary exports stand only at 19% of total exports, or 4% of GDP, signalling that it is the least directly exposed to commodity prices.

Exhibit 2

Directly exposed to commodities



Source: United Nations Conference on Trade and Development (UNCTAD) and AXA IM Research

Even indirectly, Turkey has a fairly limited exposure to falling commodity prices via trade with commodity exporters. Iraq, itself a commodity exporter, is Turkey's second most important trading partner as Turkey ships 7% of its total exports there. Russia, also a commodity exporter, is Turkey's seventh most important trading partner (*Exhibit 3*). Turkey ships less than 20% of its total exports to commodity exporters, while its export base is fairly diversified into commodity and non-commodity exporters.

Moreover, South Africa is more exposed to China than Turkey, increasing its sensitivity to exogenous factors. China is in the process of reforming its economy towards a lower but more sustainable growth rate, while opening up its capital account. South Africa ships 24% of its exports to China alone, Brazil ships 18% and Turkey 2%.

[1] Turkish Justice and Development Party
[2] Kurdish Worker's Party

Exhibit 3
Indirectly exposed to commodities via trade with commodity exporters

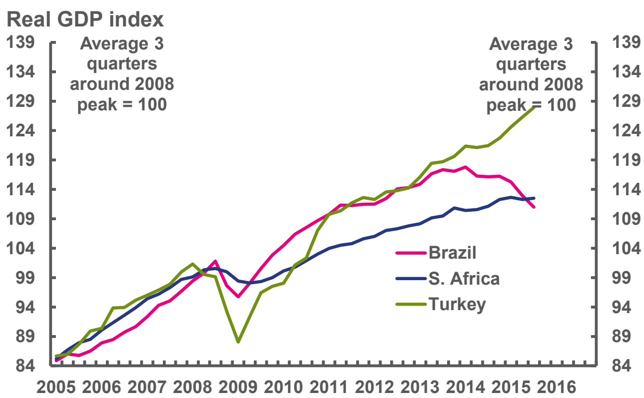
Source: UNCTAD and AXA IM Research

Similar economic performance

The three economies are very similar in terms of their banking systems. Non-performing loans are around 3% of total loans across the three countries. The banking system is considered well capitalised with the Tier I capital adequacy ratio at about 12% for each. The soundness of the banking system is observed when the leverage built up following the global financial crisis was the most pronounced in Brazil and the least in South Africa.

Economic recovery after the 2013 market tantrum has reversed in Brazil and stalled somewhat in South Africa(*Exhibit 4*). Supply-side bottlenecks increased inflation and eroded the purchasing power of households. Recovery resumed in Turkey, though, as the country entered a long election period (public spending increased ahead of the elections in order to support growth).

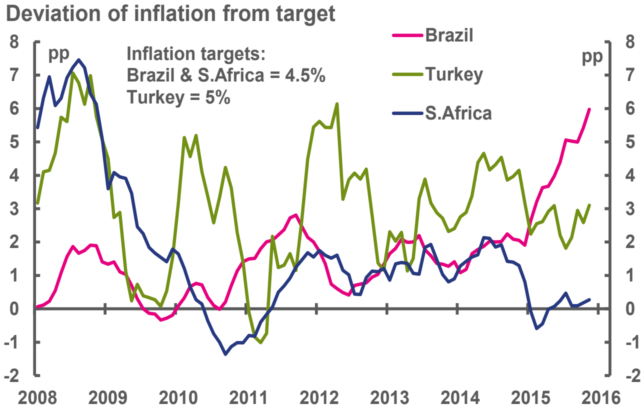
Exhibit 4
Stalling growth in South Africa



Source: Datastream and AXA IM Research

Inflation overshot the inflation target, particularly in Turkey and Brazil. We see in *Exhibit 5* that inflation is currently almost 6 percentage points (pp) above the inflation target in Brazil, while it overshoots the target by 3pp in Turkey. In South Africa, it is almost on target. The differences in the inflation gap is attributed to the pass-through of currency depreciation to headline inflation as Brazil and Turkey have the highest pass-through rate among EMs, while for South Africa it is low. Also, the three countries are confronted with high food prices caused by droughts (South Africa and Brazil) and the spike in demand (Turkey). Going forward, inflation is likely to accelerate in Turkey after the 30% increase in minimum wages is expected to add 1.5pp to inflation, according to the central bank. It's impact to growth is debatable given that it may force employers to substitute the more expensive labour force in the formal sector with the least expensive workers in the informal economy. In that case the unemployment rate and the precautionary saving would increase at the cost of economic growth and fiscal revenue performance.

Exhibit 5
High deviation of inflation from target



Source: Datastream and AXA IM Research

Both South Africa and Turkey have seen their currencies depreciate versus the dollar by double digit rates: the ZAR was down by 34%yoy in 2015 and the TRY by 25%yoy. For comparison, the BRL has depreciated by 49%yoy while the IDR by 11%. In fact, the depreciation of ZAR and TRY was the highest among BBB- rated countries. Since end 2015, the ZAR has traded at levels well below its pre-2013 market tantrum level, for the first time below those of the TRY, signalling how alarmed investors are about South Africa. Unsurprisingly, current account deficits narrowed the most in 2015 relative to a year earlier as the depreciation narrowed the trade deficit[3].

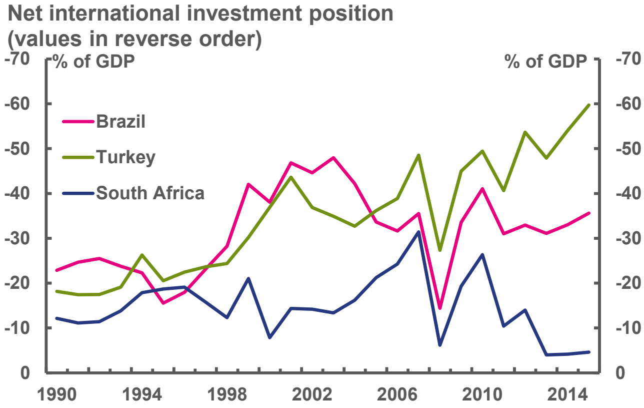
South Africa and Turkey, as Brazil, have sizeable net foreign liabilities that expose them to the strengthening of the dollar as the Fed normalises monetary policy. It is not a coincidence that the three economies were included in the pool of the fragile five currencies in the eve of the 2013 market tantrum episode, as they witnessed the highest depreciation because of their high external financing needs. We note in *Exhibit 6* that Turkey has the

[3] ZAR: South African rand, TRY: Turkish lira, BRL: Brazilian real, IDR: Indonesian rupiah

highest net foreign liabilities touching 60% of GDP, while South Africa has the lowest. The net foreign investment position deteriorates continuously, particularly in Brazil and Turkey.

Exhibit 6

Elevated foreign liabilities

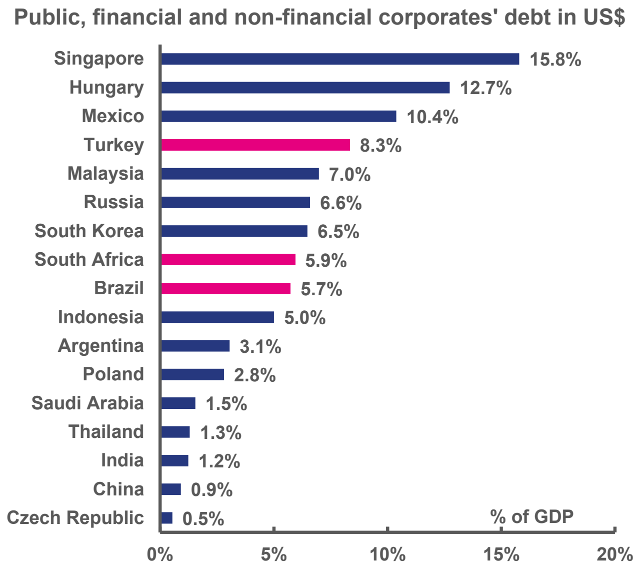


Source: Institute of International Finance (IIF) and AXA IM Research

Servicing foreign liabilities will become more challenging as the Fed turns the screws on global liquidity. Portfolio investors are lured by the prospect of high and secure yields provided by US treasuries and thus flee EMs. Already, weekly data implies that portfolio outflows are in acceleration mode in the three economies considered. The ensuing currency depreciation challenges the ability of dollar indebted economies to service debt. Dollar denominated debt is elevated in Brazil, South Africa and Turkey at 5.7%, 5.9% and 8.3% of GDP, respectively. For comparison, the gross external debt/GDP stands at 30.4% for Brazil, 40.5% for South Africa and 50.8% for Turkey. The higher the dollar denominated debt, the greater the currency pressure due to the Fed's policy. *Exhibit 7* shows that this is particularly true for Turkey.

Exhibit 7

High dollar-based debt

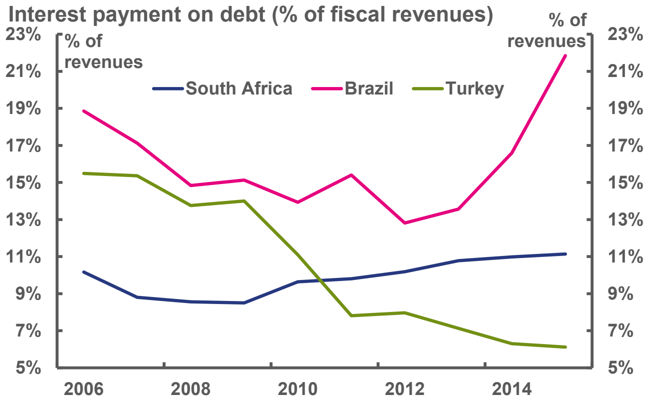


Source: IIF and AXA IM Research

According to our research, [4] EM commodity exporters are confronted in the current setting with higher yields relative to their non-commodity EM exporters. Falling commodity prices imply that the terms of trade, proxied by the ratio of unit value of exports to the unit value of imports, are falling. When this happens, yields rise. Hence, commodity exporters see their yields increase not only because of the looming Fed tightening, but also because of falling commodity prices. Brazil and South Africa are very similar in that regard as they are both commodity exporters. We observe in Exhibit 8 that public debt affordability is declining particularly in South Africa and Brazil, as the ratio of interest payments to fiscal revenues increases due to the rise in the cost of money. Turkey fares better than Brazil and South Africa due to its fiscal discipline and its low public debt. [5]

Exhibit 8

Deteriorating debt affordability



Source: International Monetary Fund and AXA IM Research

Potential triggers for a downgrade

A downgrade of South Africa could be triggered following the announcement of the government budget for 2016, which will be presented to the parliament on 24 February. Any deviation from stabilising public debt and cutting the government deficit (budget deficit at 4% of GDP with gross public debt at 50% of GDP in 2015) could trigger a sovereign downgrade. Some tweaks are to be expected to taxation, while wages would be more controllable after the 1% above the Treasury's inflation forecast increase spanning the next three years that has been agreed already. Raising taxes as part of the fiscal consolidation would be problematic though, as the February announcement of the budget would come just a few months before local elections. Hence, the popular vote would be less favourable to the ruling African National Congress party's candidates.

Political risk due to the debate concerning the looming constitutional amendments over the executive powers of the President of the Republic of Turkey could trigger a downgrade to junk. The next presidential elections are scheduled for 2019 and the new constitution should be in place well in advance. Also, national security risks

[4] Davradakis, M., "EMs: riding the commodities' roller coaster", AXA IM Research, 15 January 2016.

[5] Public debt in 2015 stood at 32% of GDP in Turkey versus 48% in South Africa and 70% in Brazil.

cannot be excluded as long as the country continues its anti-ISIS[6] foreign policy and the ceasefire with the PKK is not restored. Furthermore, monetary policy credibility may be questioned by ratings agencies as long as the central bank refrains from raising interest rates in order to support the currency. Admittedly, though, the risk of a downgrade to junk is more pronounced for South Africa than Turkey as the downgrade trigger is more tangible for the former than the latter.

Impact on sovereign bond indices

Downgrade to junk by two ratings agencies would be sufficient to force Turkey and South Africa out of the basket considered for the compilation of the JP Morgan Emerging Markets Bond Index Global Diversified Investment Grade (EMBIG IG), a popular index having a total market capitalisation of US$209bn. Turkey has a weight in the index twice as high as that of South Africa (*Exhibit 9*).

Exhibit 9

Large portfolio debt outflows in the pipeline

Source: Bloomberg and AXA IM Research

If we assume that South Africa is downgraded to junk, sovereign debt securities of US$8.5bn (4.1% of EMBIG's market cap) would be either recycled to other EMBIG IG constituents or repatriated due to de-risking of their foreign investment holders. In both cases, South Africa would register higher bond portfolio outflows. For comparison, South Africa's debt portfolio outflows stood at US$600mn (12-month trailing sum) at end January 2016.

If portfolio investors, instead, would decide not to reinvest the proceeds from selling the South African sovereign debt securities in the EMBIG IG and not to invest in debt securities issued by other EMBIG IG constituents, total EM portfolio debt outflows would increase by US$8.5bn. Turkey's downgrade to junk would produce portfolio debt outflows of US$17bn, where Turkey's total portfolio debt outflows stood at US$7.3bn (12-month trailing sum) at end January 2016. Downgrades of both Turkey and South Africa, which could cause foreign portfolio investors to repatriate the proceeds from selling their sovereign debt exposure to both, resulting in significant EM portfolio debt outflows.

A more dovish Fed could postpone downgrades

In the event that the Fed does not deliver more than a single rate hike, if any, in 2016, markets would respond more friendly towards risky assets. EMs with large net foreign liabilities and current account deficits would experience less currency pressures as the unwinding of portfolio flows reverses. The Fed's more dovish tone following the December 2015 rate hike was reinforced by the ECB's dovish rhetoric for more easing by March 2016 and the Bank of Japan's unexpected deposit rate cut to negative, which triggered some portfolio inflows to EMs. The Institute of International Finance reports that flows turned positive at end-January 2016. Although it may be a short-lived respite in portfolio flows to EMs, it is an indication of how conducive to EM portfolio flows a more dovish monetary policy stance by developed economies' central banks is.

More dovish monetary policy at the centre of the global monetary policy, the US, would reduce the likelihood of a sovereign downgrade of Turkey and South Africa. In that setting, net foreign liabilities could be funded more comfortably, while currencies could depreciate less. Less depreciation, in turn, could ease pressure to Turkey and South Africa's monetary policy to raise rates in support of local currencies and fight inflation. Economic activity could improve resulting in higher fiscal revenues and better budgetary outcomes.

Turkey could benefit more than South Africa in this scenario as it has a higher passing through of foreign exchange changes to headline inflation. Also, Turkey relies more on portfolio flows in order to finance its net foreign liabilities, which are higher than those of South Africa. The latter would still have to deliver a credible fiscal consolidation agenda in the 2016 budget, when Turkey's fiscal house is in order.

[6] Islamic State of Iraq and Syria

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