GLOBAL BRIEF

Third Quarter | 2016

Editorial comment

Another eventful three months on the South African economic landscape has passed. The SA Rand has been one of the best performing currencies over this quarter, strengthening against all major currencies and recovering some of the losses made since the beginning of the year. The municipal elections went well with a better than expected outcome – no doubt boosting business confidence from very fragile levels and regaining some faith in the SA economy. A further interest rate hike has been avoided and inflation numbers have also been inspiring with a somewhat better economic outlook and even positive growth numbers now being predicted for the year ahead.

Unprecedented unrest currently experienced at SA universities, growing concern over the management and future financial viability of State Owned Entities and the likelihood of a credit downgrading in December this year are, however, factors weighing in on short to medium term progress. The JSE All-share index for equities was slightly down over the past quarter and with all the above, the remainder of the year could be challenging as well. As we enter into this last quarter of 2016, we would like to give our clients the assurance that we are, as ever, managing risk through these cycles to ensure preservation and growth.

As from this edition, the GLOBAL BRIEF will cover general financial planning subjects that we believe could be of value to you while investment portfolio matters will be covered by a separate FIRSTGLOBAL ASSET MANAGEMENT quarterly report.

The FIRSTGLOBAL Team

Time is running out to disclose your offshore assets

Carl Roothman | Non-executive director: First Global Asset Management | CEO: Sanlam Investments - Retail

D-day is drawing near for South African taxpayers with undisclosed offshore assets

The new global standard for the Automatic Exchange of Information (AEOI) means that from 2017, SARS will have automatic access to information on assets held by South African taxpayers in most other countries. This means that, if you have any undisclosed offshore assets or receive an offshore income, it's crucial that you take corrective action to avoid harsh penalties as well as possible prosecution.

You have until March next year to voluntarily disclose offshore assets and income

In the National Budget delivered on 24 February, Finance Minister Pravin Gordhan announced that non-compliant taxpayers will have the opportunity to voluntarily regularise their tax and exchange control affairs with minimal penalty. You can do this by participating in the proposed Special Voluntary Disclosure Programme (SVDP), which will run within a limited window period from 1 October 2016 to 31 March 2017. Applications for the programme may be made on a 'no-name approach' basis or in a representative capacity.

If you participate, you may be granted a number of tax and exchange control reliefs

The exact details of the reliefs are still under debate as part of the draft bill. The table below, however, provides a general overview of the tax and exchange control relief measures that will be granted to successful applicants:

Tax relief	Exchange control relief
Only 50% of the amount you used to buy offshore assets (also called 'seed money') before a certain date will be included in taxable income and subject to normal tax.	You will be granted administrative relief from owning unauthorised offshore assets.
You won't pay tax on any investment returns earned on offshore assets before 1 March 2010.	You may still have to pay a levy of 5% or 10% of the market value of your offshore assets as at 29 February 2016, subject to certain restrictions.
You won't pay tax on interest on tax debts resulting from seed money or returns from offshore assets before 1 March 2010.	If you don't participate in the SVDP but make a full disclosure directly to the Financial Surveillance Department of the South African Reserve Bank (FinServ) after the SVDP window period, you will still pay a settlement ranging from 10% to 40% of the market value of your offshore assets.
No understatement penalties will be levied.	
You will be exempt from criminal prosecution for a tax offence by SARS.	

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We recommend that you get professional advice if you have any undisclosed offshore assets

In the months leading up to 1 October 2016, we encourage you to get all your documentation in order and to get advice and guidance from tax professionals. It's also important to be aware that there are certain restrictions to who may apply for the SVDP. For example, if you are aware of any pending or current audits or investigations against you relating to foreign assets or foreign taxes specifically, you cannot participate in the SVDP. Ask a tax professional if you are not sure whether any restrictions will apply to you.

Investors who are found to be non-compliant following the SVDP will face the full force of the law. Do the right thing while you have the opportunity – and protect yourself and your wealth.

If you don't have access to a tax professional, start with contacting your financial adviser. If your adviser does not offer speciality tax services, they will be able to refer you to a tax professional.

What if SA is downgraded?

Melville du Plessis | Portfolio manager: SIM Fixed Income | Sanlam Investments

Six ways it could impact your wallet

Credit rating agencies assign credit ratings to borrowers such as sovereign nations, companies and banks. The credit rating reflects their assessment of creditworthiness – the probability that a borrower will be able to honour its financial obligations on the dates agreed. In the case of sovereign nations, it takes into account both quantitative factors, such as fiscal sustainability, and qualitative factors, such as perceived political risks and the policy environment.

Ratings of at least a BBB- are viewed as investment grade, while credit ratings of BB+ and lower are non-investment grade or junk bonds. These are borrowers who have a higher probability of not repaying their debt on time. Understandably, investors want compensation (in the form of higher interest rates) for handing over money to non-investment grade borrowers due to the higher chance of a renegotiation of loan terms or of non-payment (a default).

When talking about a downgrade of South Africa's credit rating, we need to distinguish between local currency and foreign currency ratings. The majority of the SA government's debt obligations are denominated in local currency (rand), with only around 10% of borrowings in foreign currency. SA's local currency debt is currently balancing on a precipice with all three major credit rating agencies – Moody's, Fitch and S&P – currently assigning BBB- to BBB+ to local and foreign currency credit ratings. Moody's and S&P still have negative outlooks attached to their rating, which means there is potential for a downgrade but it is not inevitable. Fitch has a stable outlook on their rating, meaning it is unlikely they will adjust their credit rating over the next one- to two-year period, barring unforeseen events.

If one or more of these agencies do announce a downgrade to junk status within the next year, how would that affect you?

1 Your worldwide buying power

The South African rand has sold off substantially to levels far beyond where we see fair value, at present between one and two standard deviations cheaper compared to where purchasing power parity levels indicate it should trade. In the case of a rating downgrade, continued rand weakness is likely. This means that your rands will continue to be worth less than a year ago. Expect overseas travel and imported products to remain more expensive than you are used to. If, however, you have already taken money offshore years ago, there's some good news. This will now, after the currency weakening, be worth much more in rands than the capital you transferred to your offshore bank account. Or at the very least you should have retained your global buying power.

It is not only the cost of imported goods that would be affected by a downgrade. The impact on SA state owned enterprises (SOEs) could also be detrimental to consumers of local electricity and other services. The main SOEs all rely on external funding. Funding spreads (the interest rate premium above SA government bonds) of these entities have roughly doubled over the last three years. If SA government bond yields increase further then this could lead to a material increase in borrowing costs for these entities, which most likely would be passed on to the consumer or taxpayers in one form or another.

2 The interest on your bank savings

If a credit rating downgrade does, in fact, lead to continued rand weakness, higher import prices could increase the local consumer inflation rate, leading to more monetary policy tightening by the SA Reserve Bank, i.e. higher interest rates. This is great news for pensioners or anybody else living off the capital in a bank account, provided the interest rates their banks offer beat inflation after tax.

3 Your home loan and property value

If a credit downgrade causes continued currency weakness and inflationary pressure, leading to the Reserve Bank raising the repo rate, the repayments on your home loan will also increase.

Higher interest rates are generally not the friend of property values. With higher interest rates and bond repayments, buyers become more reticent, lowering demand for property, thereby stunting the growth in property values.

On the other hand, a weaker rand could encourage the number of foreign property buyers, boosting property market valuations, particularly in key areas which tend to attract foreign buyers. But it is difficult to predict the overall direction of property prices.

4 Your bond portfolio

Our country's credit rating is not the most important driver of the yield on government bonds; it is rather a reflection of the underlying fundamentals of a country. Financial market dynamics and policy considerations, such as fiscal and monetary policy, are much more important over the longer term. Bond yields are influenced by inflation expectations, the credibility of monetary policy and the sustainability of fiscal policies. In fact, historically there has been at best limited correlation between SA's credit rating and the yield on the government's bonds.

We have seen substantial inflows of international capital into SA government bonds since the 2008 global financial crisis. Financial repression has resulted in developed market yields trending to zero and below, resulting in a global search for yield and inflows of capital to countries with higher yields, such as SA. Roughly a third of SA local currency government bonds are now owned by foreign investors.

Downgrades of SA's credit rating could indeed lead to the outflow of capital from SA government bonds, but the impact this event would have on SA asset prices is more limited than most anticipate – and importantly a less material concern than other factors, such as policy considerations, political uncertainty and fiscal sustainability. For example, SA government bonds de-rated due to political turmoil during December 2015. It was one of the worst months on record for local bonds with 10-year yields trading above 10% for only the third time in 12 years.

The loss of investor confidence in SA after December 2015 has was not subsequently restored: government bond yields and the rand continued trading weaker during 2016 compared to the previous year leading up to the event. This has increased debt service costs and also influenced monetary policy actions with two policy rate hikes following during the first quarter of 2016. This is an unwelcome outcome especially since SA has not benefitted from the global lower yield environment since 2008 – in fact, SA government bonds are now trading at higher levels than at the end of 2007 and at their widest levels above developed market yields in more than a decade.

By taking a closer look at previous episodes of sovereign nations being downgraded to junk status it can be seen that financial markets start pricing in the probability of the event – or more importantly the deteriorating economic fundamentals – between 12 to 36 months in advance of an eventual credit rating downgrade. Bond yields typically increase in the 18 months leading up to a downgrade, while policy rates can increase substantially in a very short period on the back of currency weakness and accompanied inflationary pressures.

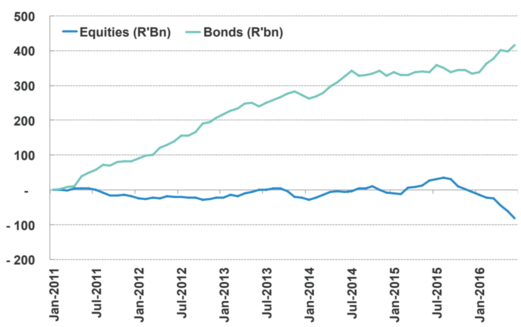
SA assets are already pricing in a substantial amount of downside. SA government bonds and credit default swap (CDS) spreads imply a rating gap of between 2 to 4 notch downgrades, suggesting a fair amount of bad news is already priced in. However, this is not too different from the ratings gap of most other countries with either a negative outlook on their credit rating or a BBB category rating. SA government bonds are currently pricing in around 7% expected inflation, which is substantially higher than the historic realised inflation rate over various periods, as well as the historic expected inflation breakeven. Further weakness in SA government bonds is possible, however there is still a margin of safety priced in.

5 Your share portfolio

Equity markets are typically very weak in the two to three years leading up to a credit rating downgrade, with the subsequent performance varying substantially between countries.

The impact on the SA **equity market** should be unpacked due to a number of reasons. Firstly, foreigners currently own around 40% of the free float of locally listed equities. Although this was also increasing during the last few years, it has been at a much slower pace, seeing as the inflow of international capital into SA asset classes over the last few years has been predominantly towards local bonds, whereas local equities have not witnessed as much appetite from international investors:

Foreign owners' cumulative inflows into SA bonds and equities (R'bn)



Source: Sanlam Investments, Barclays Capital, UBS, JSE, Bloomberg, National Treasury | Aug 2016

Secondly, roughly two-thirds of SA listed companies' earnings are generated abroad. Of the larger companies listed on the Johannesburg Stock Exchange, almost half are dual listed shares (companies which also have listings on international stock exchanges) and local share prices are thus tied to the exchange rate, while a further quarter of listed companies are rand hedge shares (companies with foreign earnings and which benefit from a weakening of the rand). This leaves only around a quarter which are truly locally orientated shares. Rand hedge and dual listed shares would be somewhat insulated from currency weakness, while rand leverage shares (companies with a foreign earnings base and local cost base) may even benefit.

The locally orientated companies which would be most vulnerable in the event of a downgrade would be interest rate sensitive sectors such as some retailers, industrials and financials and companies whose earnings are sensitive to the performance of the local economy.

However, these sectors are trading at a discount to the rest of the market – they have been underperforming the rest of the SA equity market, in particular towards the end of 2015 as the currency weakness played to the strength of dual listed and rand hedge shares while local interest rate sensitive shares were under pressure. As such there is already a significant amount of bad news priced into these shares (as much as at the height of the 2008 global financial crisis) and thus a relatively higher margin of safety in the event of a downgrade.

Also, in the event of a downgrade and an increasing interest rate environment SA's banking sector is well capitalised with relatively strong balance sheets to withstand adverse shocks.

6 Your listed property portfolio

SA listed property has been one of the best performing asset classes and its continued strength has made this asset class more vulnerable. Given the sensitivity of this sector to interest rates, an increase in bond yields combined with negative investor sentiment could lead to weakness in listed property counters. Property counters with locally orientated portfolios will be most susceptible to negative investor sentiment, while those that have diversified their portfolios offshore will be more insulated from a currency and sentiment point of view, although their valuations are more stretched than the property counters which have kept their investments local.

But, could anything good come from a downgrade?

One could only hope that a credit downgrade (or the looming threat thereof) would create even greater urgency among the public and private sector to address the issues that concern rating agencies: the economic growth outlook; stabilisation of government debt ratios; political stability and the strength of South Africa's institutions; reliable sources of energy; labour reform; and regulatory policies that serve to attract investment activity in the country rather than deter it. The successful implementation of credible and successful policies that stimulate broad based economic growth is necessary to stabilise debt ratios and reduce rising tensions in the country.

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