MARKET COMMENTARY

The month of May saw Russian Markets fall following news that the European Union is likely to renew sanctions against the country in July. Germany led the European Markets closing the month up by 2.23% following a revival in domestic consumption and construction activity. Brazilian Markets were down by -11.22% after efforts to impeach current President have all but failed. The Indian BSE closed the month up 4.15% following better than expected data from the US coupled with news of a possible rate hike in July. The JSE followed suit and ended the Month up by 1.84%. However, the Rand didn't fair too well following news of the South Africa's possible downgrade in June and the possible of arrest of Finance Minister Pravin Gordhan.

PWM ADVISORS
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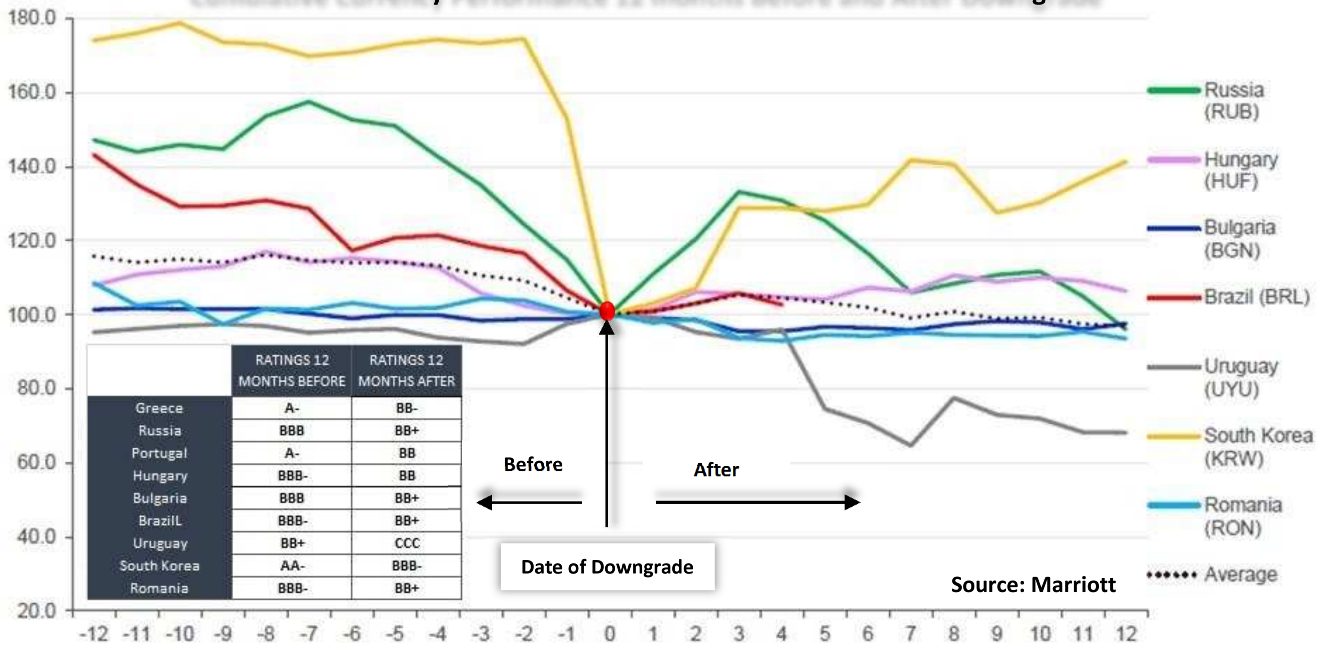
YEAR TO DATE: 31 MAY 2016

SA	7.57%	CASH	2.95%
PROPERTY	8.35%	BONDS	6.93%
INDIA	2.11%	RUSSIA	8.62%
CHINA	-5.02%	BRAZIL	11.81%
INDONESIA	4.44%	GERMANY	-4.47%
LONDON	1.41%	USA	2.08%

NO SA RATINGS DOWNGRADE! WHEW!

SA breathed a collective sigh of relief on the 3rd of June 2016, when S&P confirmed that the current credit rating for SA will remain at BBB- , with a negative outlook. Following this, Fitch also affirmed their current rating of BBB- on the 8th of June. The Rand responded from R 15.57 /US$ on 2nd June to R 14.73 by the 8th of June (a gain of 5.5% in 4 trading days). On Monday the 13th of June, the Rand was trading at R 15.22 – not far from its pre-downgrade level. So what does this tell us? It simply illustrates that any possible downgrade is already reflected in the currency, and that the currency market believes that the December 2016 still carries the threat of a downgrade.

Cumulative Currency Performance 12 months Before and After Downgrade



	RATINGS 12 MONTHS BEFORE	RATINGS 12 MONTHS AFTER
Greece	A-	BB-
Russia	BBB	BB+
Portugal	A-	BB
Hungary	BBB-	BB
Bulgaria	BBB	BB+
BrazilL	BBB-	BB+
Uruguay	BB+	CCC
South Korea	AA-	BBB-
Romania	BBB-	BB+

CURRENCY OBSERVATIONS

It is clear that most countries' currencies depreciate in anticipation of a downgrade. South Korea, Russia and Brazil fell the most from 12 months prior and up to the downgrade date.

The average (dotted line) currency depreciation from 12 months prior to date is -18%, interestingly, 12 months post downgrade – the currency on average remains flat (no significant depreciation!). In some cases, it actually appreciates e.g. South Korea, Brazil, and Hungary.

It's only where the downgrade was much harsher than expected, e.g. Uruguay – where the currency had further depreciation after the downgrade. Uruguay moved from BB+ into CCC which is a significant jump into very risky territory.

Countries with downgrades from BBB to BB+ example Bulgaria, Brazil, Russia, and Hungary have shown that the currencies stabilise after downgrade and in some instances even improve. These downgrades are similar to SA, where it was expected that SA will move from BBB- to BB+.

The fantastic appreciation in the South Korean Won 12 months after downgrade was due to the swift actions by its Government to reform the economy, and regained its investment grade within 12 months.

The Rand's movement is attributable to 3 basic influences – 1. The prospect of higher interest rates in USA (pure US$ strength) 2. The political cloak and dagger game that prevails between the knights in shining armour (Pravin) and the dark forces of state capture (Fiscal risk); 3. Credit Ratings downgrade for SA (fiscal and political risk).

Most topical in SA, are the latter 2 – and in this newsletter we tackled the prospect of a RATINGS DOWNGRADE and its effect on currency. In our analysis we presented the cases of 7 countries who have had downgrades, and examined the effect on their currencies 12 months prior to the actual date of downgrade, and 12 month post the downgrade. The exercise yielded some interesting observations!

VERDICT:

The Rand, at its current level (R 15.22), is already reflecting the risk of a credit ratings downgrade in December 2016. It has depreciated 22% in the last 12 months up to 13th June 2016 , higher than the average of -18% in our analysis above – but this could be due to the political issues and pure US$ strength. There is no need to panic and make hasty manoeuvres based on the fear that "the Rand will blow out and hit R 30 in a couple of years" due to a ratings downgrade.

Just as SA might slip into a downgrade – it can very well climb out of it. A credit ratings downgrade is not cast in stone. One must appreciate the fact that commodity prices are at extreme lows, which has had the most impact on our country's finances. The political issues surrounding fiscal discipline and state capture have just added to the problem. So to improve our credit rating or to avert a future downgrade, we need improved commodity prices and Pravin Gordhan to win the battle.

I will not be surprised to see the Rand improving after December 2016, and a return to R 13.50 to the US$ by December 2017 should not be ruled out! It simply requires improved commodity prices (which will reflect positive world growth and therefore more fund flows out of US$ and into emerging markets) + sound and swift policy action to reform the SA economy and state finances.

Expect the Rand to trade sideways until December 2016, unless we have radical political change at the top, coupled with better outlook for world growth.

Viren B. Garach