



The impact of a greylisted status on the SA economy and financial markets

Highlights

- When the global Financial Action Task Force (FATF) places a jurisdiction under increased monitoring (ie the grey list), it means that the country is actively working with the FATF to address apparent strategic deficiencies in its regimes designed to tackle financial crimes.
- In our view, much of the responsibility for the weakening of South Africa's (SA) criminal justice system lies with the previous administration, during which period, the capacity of SA's tax authority, intelligence agencies and crime-fighting and law enforcement bodies were eroded.
- SA was given until November 2022 to prove it was remedying the country's structural deficiencies when it comes to anti-money laundering and countering the financing of terrorism. However, a plenary vote of the FATF members has determined that SA has failed to demonstrate satisfactory progress on these remedial actions, resulting in the country being greylisted on 24 February 2023.
- Aside from technical factors, the decision to greylist SA was contingent on the FATF's judgement of government's political willingness to achieve sufficient progress in addressing the concerns highlighted in their report.
- Although global empirical studies show mixed results on the impact of a greylisting event on a country's capital flows, being greylisted could further impair the economy's links to the global financial system, raise SA's cost of capital and create an additional disincentive for offshore companies to deal with SA.
- Nevertheless, with global themes likely to be a larger determinant of the outcome for SA financial markets, local idiosyncrasies, such as a greylisting event, may be overshadowed by sticky global inflation, the direction of global monetary policy and the lingering risk of recession in key markets. Moreover, it can be argued that a compendium of negative SA-specific factors has already been incorporated by local and global investors into elevated risk premia for SA asset classes, as reflected in cheap valuations.
- In any event, we remain steadfast in our view that a well-diversified investment portfolio as encapsulated in our outcome-based investing philosophy provides the best possible protection against any unforeseen global or idiosyncratic market events that may cause short-term instability. Furthermore, history has shown that staying invested throughout any market turbulence has been the superior strategy for long-term returns.
- Momentum Metropolitan Holdings Limited gives its full co-operation to ensure we participate in efforts to lessen the impact of greylisting on SA.
- Regardless of the greylisted status, we believe this yellow card warning should serve as a wake-up call for SA policymakers, regulators and law enforcement agencies to intensify efforts to convince the country's international

counterparts it is worth their effort to maintain relationships in the interim as SA continues to build a more robust legal and compliance framework to remain competitive on the global stage.

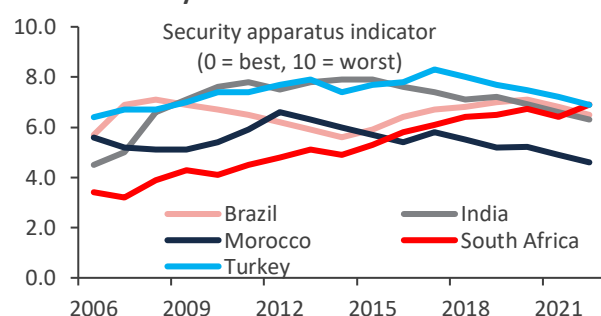
The global watchdog for money laundering risks raised red flags in 2021

The FATF was founded in 1989 by an intergovernmental forum, consisting of the seven largest advanced economies, to formulate policies to curb money laundering and subsequently combat terrorist financing. When the FATF places a jurisdiction under increased monitoring (ie the grey list), it means that the country is actively working with the FATF to address apparent strategic deficiencies in its regimes designed to tackle financial crimes.

The SA government has been aware of the stakes since October 2021 when the FATF released the findings of its Mutual Evaluation Report (based on a site visit between 22 October and 12 November 2019) to Cabinet, following its assessment of the country's ability to investigate and prosecute financial crimes. The report illuminated under-addressed money laundering risks and insufficient monitoring of terrorist financing risks in SA.

In our view, much of the responsibility for the weakening in SA's criminal justice system lies with the previous administration, during which period, the capacity of SA's tax authority, intelligence agencies and crime-fighting and law enforcement bodies were eroded. Subsequently, the Fund for Peace noted a deterioration in SA's ranking of its security apparatus in contrast to an improving trend for our emerging market counterparts (see chart 1).

Chart 1: Security threats on the rise



Source: Fund for Peace: Fragile States Index, Momentum Investments

The FATF noted that SA's law enforcement agencies lacked the skills and resources to proactively investigate money laundering and terrorist financing cases linked to narcotics, corruption and tax offences. Moreover, while large banks were found to have adequate mitigating measures in place, supervision and compliance monitoring remained inadequate for SA's smaller financial institutions and designated non-financial businesses (including estate agents, motor vehicle dealers and legal practitioners). In addition, it was found that opaque ownership structures in SA created an opportunity to disguise the proceeds of unlawful activity. While the FATF acknowledges the existence of SA's financial intelligence framework, it suggests a lack of resources to proactively follow through on criminal investigations to trace and recover assets.

SA was given until November 2022 to prove it was remedying the country's structural deficiencies when it comes to anti-money laundering and countering the financing of terrorism. A plenary vote of the FATF members has nevertheless determined that SA has failed to demonstrate satisfactory progress on these remedial actions and as such the country has been assigned a greylisted status.

Although Intellidex notes that Pakistan's greylisted status between 2012 and 2015 triggered a cut in economic growth of between 1% and 2% and projects that in a worst-case scenario more than 3% can be shaved off growth in SA, we believe there will be less of an impact on macro dynamics in SA should a clear plan be forthcoming to reverse the greylisted status, given the experience in Turkey, Botswana, Mauritius and the United Arab Emirates. Moreover, sovereign rating agencies are more likely to move on SA's macro fundamentals rather than allowing for a greylisting event to act as the sole determinant of the rating outcome. The February 2023 national budget outlined a debt relief package for Eskom, based on a set of conditionalities, while the budget outcomes show

restraint on the expenditure side and a commitment to prudent fiscal policymaking. In spite of severe energy outages, these remedial factors should help keep SA's sovereign rating steady at current levels. Additionally, plans by Treasury to address the eight areas of strategic deficiencies, related to the effective implementation of SA's anti-money laundering laws, by 'no later than the end of January 2025' indicates a high level of commitment by government to raise the standard of compliance in as short a time as possible.

Being greylisted could nevertheless further impair the economy's links to the global financial system, raise SA's cost of capital and create an additional disincentive for offshore companies to deal with SA, on top of inept network industries, inflexible labour markets, energy shortages and policy uncertainty.

Although most global investors take the FATF watchlist seriously and it could hamper access to trade and financial systems, we view this as an unlikely event. Investment opportunities in the country could also be dampened following this decision. In line with perceived poor corruption scores and increased regulatory red tape (associated with enhanced monitoring and lengthier transactions), SA's ranking on the (now discontinued) World Bank's Ease of Doing Business indicator would likely have deteriorated further from its 84th position from 190 countries (and sixth best in Africa, underperforming Mauritius, Rwanda, Morocco, Kenya and Tunisia). Nonetheless, Treasury argues that increased monitoring would have little impact on the costs of doing business with SA given that there are no items on the action plan that link to preventative measures in the financial services sector.

According to SGB Securities, evidence from global empirical studies show mixed results on the impact of a greylisting event on a country's capital flows. A May

2021 paper from the International Monetary Fund, *The Impact of Graylisting on Capital Flows: An Analysis Using Machine Learning*, suggests that capital inflows decline on average by 7.6% of gross domestic product (GDP) when a country is greylisted. The results also suggest that foreign direct investment (FDI) inflows dip on average by 3% of GDP, portfolio inflows decrease on average by 2.9% of GDP and other investment inflows fall by an average of 3.6% of GDP. Nevertheless, the range between countries remains wide and SGB Securities argues that, at some stage, investors would be reacting to the weakening fundamentals of the country and not necessarily the greylisting status of the country.

Morgan Stanley previously highlighted the changes to Regulation 28, allowing for a higher offshore allocation limit, as a bigger implication for capital markets and estimates a R550 billion to R800 billion outflow in a worst-case scenario. Nonetheless, in our view, SA fund managers are likely to shift toward a higher offshore allocation over a gradual timeline, particularly given the relative attractiveness of SA asset classes relative to more expensive global asset classes at present.

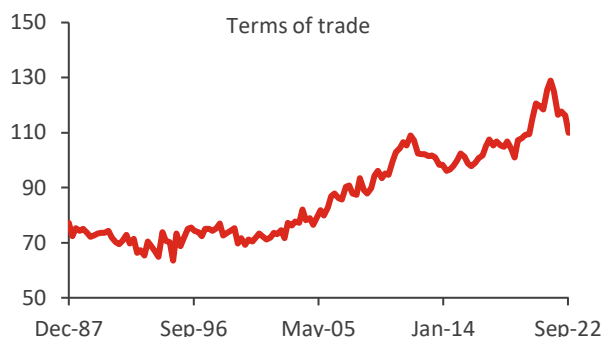
Should this worst-case scenario on Regulation 28 changes materialise, we are of the opinion that the Reserve Bank would act more aggressively to stem the rise in inflation (particularly if there are signs of inflation persistence, ie broad-based pressures) but would also be more cognisant of growth. The sacrifice ratio suggests that much higher interest rates to tame inflation from our base case interest rate view (another 25 basis-point hike in March 2023) becomes less effective to combat inflation but has a larger negative impact on growth. This would factor in the Reserve Bank's deliberations on the interest rate outcome.

Global themes are larger drivers of SA's economy and asset classes

Based on a fair value calculation using the real effective exchange rate, we view the rand as being around 5.2% undervalued. However, in our view, the local unit is likely to remain on the backfoot in the near term given

lingering global recession risks and a softening in the terms of trade for SA (see chart 2 below).

Chart 2: SA's terms of trade still elevated but has rolled over from its peak



Source: Bloomberg, Momentum Investments

Nevertheless, as we approach the latter part of 2023, markets may likely start discounting future cuts in interest rates in the US. At that point in the cycle, the US Federal Reserve may shift its focus to ailing growth as

Not your typical grey area

While an actual greylisting should amplify economic pressures and raise the regulatory burden in SA, arguably, investors have been well aware of the backsliding in SA's rule of law, institutional degradation and allegations of corruption and state capture.

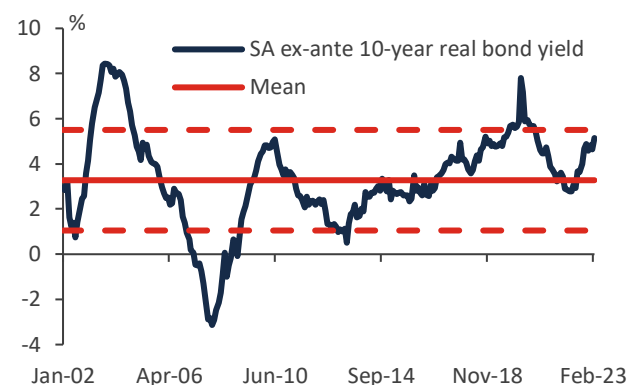
As such, local asset prices may already capture some degree of risk incorporating a greylisting, with the actual event merely rubber-stamping well-known problems.

For instance, it can be argued that the cheapness of the SA bond market, as reflected in consistently high SA real yields in global comparative terms and relative to its history in recent years (see chart 3), as well as the cheapness of SA equity market valuations (see chart 4), imply that a compendium of negative SA-specific factors (including the greylisting threat) has already been incorporated by local and global investors into elevated risk premia for these asset classes.

inflation starts coming down more consistently in reaction to previous monetary tightening. This would likely trigger a reversal in capital flows out of the US and into EMs/riskier assets (shifting from a risk-off into a risk-on period) and we could see the rand benefit from this stronger overarching theme, notwithstanding what is happening with our local dynamics at the time.

Moreover, we expect growth in China to rebound from around 3.5% this year to around 5% next year on a quicker reopening of the economy from stringent lockdown regulations and thanks to meaningful government support measures to shore up the ailing property sector. Better growth in China in 2023 should be supportive of commodity prices and provide a further benefit to the local currency from current oversold levels.

Chart 3: SA real bond yield

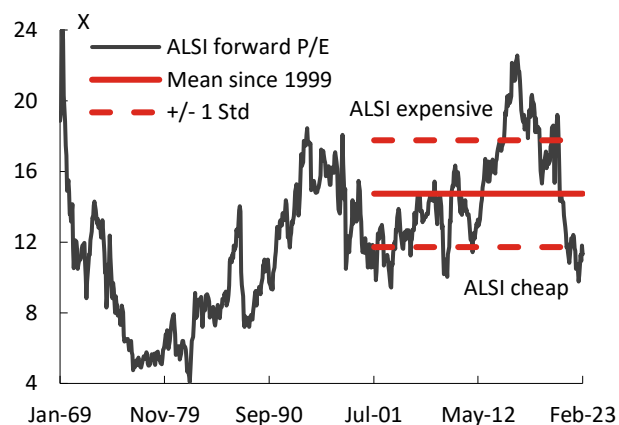


Source: IRESS, Momentum Investments

Moreover, we believe that sticky global inflation, the direction of global monetary policy and the lingering risk of recession in key markets will dominate global capital flows. With global themes likely to be a larger determinant of the outcome for SA's asset classes, local idiosyncrasies, such as a greylisting, may be overshadowed. In any event, we remain steadfast in our view that a well-diversified investment portfolio as encapsulated in our outcome-based investing philosophy provides the best possible protection against any unforeseen global or idiosyncratic market events that may cause short-term instability.

Furthermore, history has shown that staying invested throughout any market turbulence has been the superior strategy for long-term returns.

Chart 4: SA equity market forward P/E



Source: IRESS, Momentum Investments

At its last plenary sitting of 2022, the National Council of Provinces passed two bills aimed at preventing SA from being greylisted, including the General Laws Amendment Bill and the Protection of Constitutional Democracy Against Terrorist and Related Activities Amendment Bill, which were designed to collectively

address 16 out of 20 deficiencies in SA's anti-money laundering /counter-terrorism financing laws. Moreover, the Financial Intelligence Centre Act was amended to expand the list of accountable institutions, which also took effect in December last year.

Aside from technical factors, the decision to greylist a country depends on the FATF's judgement of a government's political willingness to achieve sufficient progress in addressing the concerns highlighted. Unfortunately, SA failed on a number of measures used by the FATF to assess effectiveness in implementation. Nonetheless, regardless of SA's greylisted status, we believe this yellow card warning should serve as a wake-up call for SA policymakers, regulators and law enforcement agencies to intensify efforts to convince the country's international counterparts that these grey skies are merely passing clouds and it is worth their effort to maintain relationships in the interim as SA continues to build a more robust legal and compliance framework to remain competitive on the global stage.

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