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WAITING FOR RECOVERY AFTER THE SHOCKS

South Africa's real annual economic growth rate averaged 2.6% between 2010 and 2013. This was hardly exciting, but probably in line with the economy's inherent or potential growth rate, the rate determined by its social and political institutions, infrastructure, knowledge base and productive capacity. However, from early 2014 the growth rate plunged, hitting -0.6% in the first quarter of 2016.

What happened?

The economy was hit by a number of shocks almost simultaneously:

- Global commodity prices started declining from 2011, but the plunge accelerated from 2014 onwards. For instance, the price of platinum, one of SA's most important exports, fell from $1 865 per ounce in mid-2011 to $1 479 in mid-2014, but then almost halved to $820 per ounce in January 2016. Falling commodity prices had a negative impact on mining production, exports, government's tax revenue and the share prices of mining firms. Related sectors such as transport, construction and manufacturing were also very negatively affected.
- Load shedding was a further blow to energy-intensive mining and manufacturing sectors (and also small businesses who couldn't afford generators).
- Prolonged strikes hit the platinum, automotive and metals sectors in 2014.
- The rand collapsed from a post-global financial crisis peak of R6.80 per US dollar to R16.90 per dollar in January 2016 along with other emerging market and commodity currencies. While a weaker currency is welcomed by exporters, it had a negative impact on sentiment. Import prices also rose, but in the end not by as much as one might have otherwise expected (unlike previous episodes of currency weakness, consumer inflation never breached the 6% upper-end of the Reserve Bank's target range on a sustained basis, limiting upward pressure on interest rates).
- An El Nino-related drought, the worst in decades, hit agricultural in large parts of the country.
- The drought also forced South Africa to become a net grain importer at a very weak currency, resulting in a food price surge.

At the same time, as the economy experienced these disruptions, the ability of policymakers to cushion the blow evaporated. On fiscal policy side, Government embarked on a process of gradually reducing the budget deficit. In response to the global financial crisis, Government increased borrowing to support the economy. This was appropriate at the time, but by 2013 there was pressure from investors and ratings agencies to stabilise the debt-to-GDP ratio (including a downgrade in 2014). On the monetary policy side, the SA Reserve Bank responded to a deteriorating inflation outlook (primarily due to actual and feared rand depreciation) by increasing the repo rate from 5% in January 2014 to 7% currently. There were also a number pf policy own-goals, which worsened matters, including:

- the beleaguered mining sector had to deal with regulatory uncertainty.
- instead of benefiting from the weak rand, tourism was hampered by tightened visa requirements.
- the respected Finance Minister Nhlanhla Nene was surprisingly and inexplicably fired in December 2015.

The combination of all this has also seen a further credit ratings downgrade hang over the economy like a sword of Damocles, further depressing business and consumer sentiment. Indices of business and consumer confidence compiled by the Bureau for Economic Research (BER) are both at levels usually seen in recessions. This lack of confidence means firms and individuals are reluctant to make long-term spending decisions, like buying furniture or a new car or investing in a new factory. In fact, a feature of the past two years is the rapid pace at which South African companies made acquisitions abroad in search of better growth.

What was the impact on investments?

Largely as a result of Nene's axing, 2015 was one of the worst calendar years for bonds in the past two decades. The yield on the R186 government bonds rose from 8% to 9.6% during the course of 2015, hitting a high of 10.4% immediately after the Nene news broke (bond prices move inversely with yields). Other interest rate-sensitive assets such as bank shares also suffered serious declines.

The JSE All Share index returned around 20% since the start of 2014 (7% annualised), but this hid a large divergence between sectors. The JSE Resources index lost 25% over this period, while the JSE Industrials index with its large weighting to rand-hedge global consumer stocks returned 30%.

The weak rand also boosted returns from offshore investments. Our Strategies were at maximum allowable offshore exposure throughout this period.

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Why are the prospects improving now?

GDP growth improved in the second quarter of this year, and for the first time in many years, growth forecasts are being upgraded instead of downgraded. The data we have for the third quarter so far suggests that growth in the second half of the year will still be subdued, but the medium-term outlook has improved. A shock isn't permanent, and as the impact fades, prospects improve. Already, a number of positive developments can be noted:

- Commodity prices have stopped falling, and have firmed somewhat. A return to pre-2011 prices is not expected, but as long as prices do not fall further, mining can grow again off a low base.
- The drought is still persisting in some regions, while easing in others. It might take a few years for agricultural output to return to normal, but the sector should return to growth (off a low base soon). Grain prices have already declined to levels seen a year ago.
- There has been no load shedding in over a year and Eskom is optimistic that it can maintain electricity output without disruption, partly as a result of new generation capacity coming on stream.
- The exchange rate has stabilised at a level that is still weak enough to be supportive of exporters, import-competing business and tourism (which also benefits from an easing of the visa restrictions). But the fact that the rand is firmer since the start of the year limits further sustained upward pressure on inflation and interest rates. In fact, inflation is expected to decline next year to around 5%, which means that real household income growth should improve.
- Interest rate increases since early 2014 subtracted around 1% from household income in the form of higher debt repayments. This is unlikely to be repeated as interest rates are close to peaking and there has been little growth in household debt.

No one expects a boom

No one expects a boom, but growth forecasts still appear very pessimistic. The International Monetary Fund recently projected growth of 0.1% in 2016 and 0.8% in 2017. As noted upfront, the potential growth rate of the economy – the rate at which it can grow without overheating and bumping into resource constraints — is probably between 2% and 3% (some estimates, such as the SARB, puts it closer to 1.5%). It doesn't take too much imagination to see the economy return to those sorts of growth rates, in the absence of further shocks. Uncertainty around the position of Finance Minister Gordhan, could also have a renewed negative impact on sentiment. However, positive shocks can also occur, for example the halving of the oil price from mid-2014 onwards which was very helpful. There is no inherent reason why the news will always be bad. The historian CW de Kiewiet noted in 1941 already that "South Africa has advanced politically by disasters and economically by windfalls". Not much has changed.

Windfalls will not raise the economy's potential to 5% and beyond, however. That would require substantial reforms to increase competition, make the labour market more flexible and improve the efficiency of the state. It will also need large-scale investments in education, infrastructure and technology. These are long-term undertakings and progress so far is mixed at best. However, at least for the shorter term, there are reasons to be more optimistic.

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