# IN THE DARK AHEAD OF THE BUDGET SPEECH

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

Nothing highlighted – and highlight is perhaps an unfortunate word in this context - the central focus of this week's Budget as clearly as the return of load-shedding.

Eskom's operational and financial woes pose a massive risk to the local economy. Therefore, almost nothing Finance Minister Mboweni says this week will matter as much as any detail on Eskom's future, particularly how much the government is prepared to spend on supporting it. The unbundling of Eskom into generation, transmission and distribution entities – announced in the State of the Nation Address - is a useful first step, but does not by itself solve any problems. The timeline of the unbundling is also unclear, particularly since it faces stiff union opposition.

How did we get here? In simple terms, Eskom borrowed enormous amounts of money to fund the construction of two of the world's largest coal-fired power plants, Kusile and Medupi. With both being way over budget and years behind schedule, Eskom has not been able to generate revenue to service that debt. Megaprojects typically run over time and over budget, as demonstrated by Sasol's announcement last week that the completion date of its new US ethanol cracker has again been pushed out.

Corruption and mismanagement have also been a factor in its underperformance, but there is a deeper structural reality: Eskom's entire cost base is too high, particularly employee costs. Eskom's board has noted that the company is overstaffed by a third. (The World Bank went further and estimated that it is two-thirds overstaffed.) Moreover, power utilities globally face what is known as the 'utility death spiral': technological advances increasingly allow consumers to 'defect' off the grid, meaning that costs have to be spread over a smaller customer base. The remaining customers face steep tariff increases to make up for lost revenue, and then have an even greater incentive to defect. This is an issue for Eskom too, whose total output, and hence its sales, is less than it was a decade ago. Electricity available for distribution was 16 522 gigawatt hours in December, the same level as in 2003.

## ELECTRIC SHOCKS TO THE ECONOMY

Eskom's crisis poses three broad risks to the local economy. Firstly, reliable energy supply is essential for economic activity, and it is not as if the economy is booming to begin with. Last week Stats SA reported that fourth quarter numbers for key sectors and growth in manufacturing and retail sales were positive, although muted, but mining was negative, impacted by load-shedding late last year. If the current power outages persist, it can dent first quarter growth too. It can also further damage business confidence and future investment.

Secondly, tariff increases raise the cost of living and the cost of doing business. Eskom has applied for 15% increases for the next three years, coming on top of a doubling of tariffs in real terms over the past decade. It is extremely rare for consumers to be asked to bail out a company – imagine Sasol pushing up chemical prices to fund its new project - but that is what you get with monopolies.

Thirdly, it is increasingly likely that the government will have to absorb at least some of Eskom's debt, which increases the risk of credit ratings downgrades and rising borrowing costs. Government has very little fiscal space to bail Eskom out. To do so means either crowding out other much-needed investments, or borrowing more.

Eskom has asked for a R100 billion bailout, which it is unlikely to get at this stage. Government has previously promised that any further assistance to state-owned enterprises (SOEs) will be deficit neutral (i.e. not result in additional borrowing). It can probably scratch around for R10 billion to R20 billion to help Eskom cover interest payments. But more than that will probably have to wait until Eskom's restructuring is further advanced. Moody's, the only agency that maintains an investment grade rating for South Africa, has noted that government support for Eskom will only be neutral for the rating outlook if measures are also taken to cut costs and stabilise Eskom's finances.

## ON THE HOOK

Apart from direct assistance to Eskom, the government also guarantees up to R350 billion of Eskom's total debt of R420 billion. This means that if Eskom fails to pay its creditors, the government – and therefore taxpayers – will be on the hook. The South African government already has gross debt of R2.5 trillion, which amounts to 56% of nominal gross domestic product. In October this ratio was projected to rise to 58% over the next three years. As a stark contrast, the 2017 Budget projected that the debt ratio would peak at 52%. That rosy picture feels a lifetime away, but was sketched merely two years ago.

Absorbing Eskom's debt would push the debt ratio above 60%, a level that is considered a red line by some. South Africa's government debt ratio is not unusually large in the global context, but the problem is the trajectory. It jumped by almost 30% points since 2009, and continues to rise. The government has reduced its debt ratio before, from almost 50% in 1994 to 26% in 2008, through a combination of belt-tightening (running primary surpluses) and a strong economy in the early 2000s, which led to a surge in company tax income. It can be done, but requires political will and some luck.

At the macro level, the government has been reasonably disciplined on the spending side, sticking to the self-imposed expenditure ceiling. The bigger problem has been that disappointing economic growth and problems at SARS in recent years have resulted in persistent tax revenue undershoots. The gap between spending and revenue – the budget deficit – has to be borrowed. The government has deliberately not closed the deficit too quickly by hiking taxes or slashing spending, since such 'austerity' measures would severely hobble the economy. Its approach has been to gradually narrow the deficit, which is correct in principle, though in practice has not achieved much. The deficit remains stuck around 4% of GDP, and it is hard to see it narrow much in the next few years unless the economy picks up speed.

## NOT UNIQUE

South Africa is not unique in its budgetary problems. In the 2010 State of the Union Address, then-US President Obama announced that it was time for the government to tighten its belt, even though unemployment was still above 9% and the US debt ratio was at 80%. Between 2010 and 2013, a global obsession with debt and deficits caused premature fiscal tightening in the US and Europe that set back the global recovery. The mood has shifted. In the 2019 State of the Union, President Trump did not mention debt or deficits once, even though his tax cuts are pushing the deficit towards 5% of GDP and the debt ratio to around 100%. This despite a very strong economy and low unemployment rate that would normally be associated with a smaller deficit.

While the content of South Africa's Budget might make for scary reading, the budgeting process is clear and sensible, and indeed is routinely rated among the top countries globally in terms of transparency according to the Open Budget Index. (Only New Zealand scored better in the latest version.)

The US also has a particularly dysfunctional way of drawing up and approving budgets. The federal government shut down for more than a month recently because the two chambers of Congress and the White House couldn't agree. In the end, a temporary budget was passed to reopen the government for 15 days. Fortunately, last week saw a final deal approved that will fund the government for the remainder of the fiscal year. It included additional money for border security, but not specifically for Trump's border wall with Mexico.

The crucial difference between South Africa and the US (and most of Europe) is that borrowing costs in the US and Europe are historically low, and lower than national income growth. US nominal economic growth is around 5% and long-term borrowing costs only 3%. It makes sense for the US government (and even more so in Europe) to borrow to fund long-term investments that will pay for themselves, such as infrastructure upgrades. Unfortunately, it instead used much of its fiscal space to fund tax cuts for corporations and wealthy individuals. South African nominal growth is 7% and long-term bond yield 9%. The arithmetic is as brutal as it is simple. Hence it is crucial to stabilise the growth in borrowing.

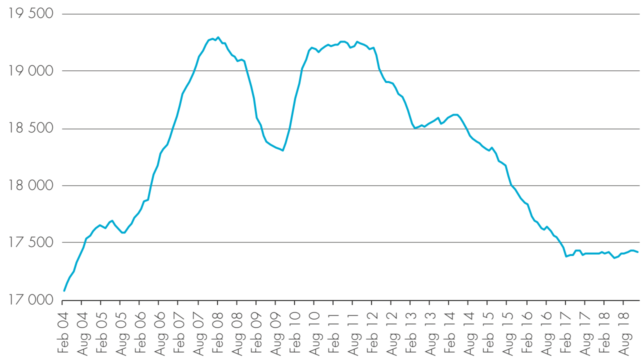
## INVESTMENT IMPLICATIONS

From an investment point of view, the importance of the Budget Speech is often overstated, though it can impact sentiment in the short term. The rand weakened sharply last week as the Eskom crisis gripped headlines, but other emerging market currencies also weakened in the face of a stronger dollar. The rand's primary driver has always been global conditions, with local politics and policy secondary. Should the fiscal situation deteriorate substantially – which we don't expect – the local currency is likely to bear the brunt which will boost the rand value of global investments.

For most South Africans, JSE-listed companies will be the main component of the portfolio, and these are priced in a global context. At an index level, these companies earn more income abroad than at home. Unless there is a change to company, dividend withholding or capital gains tax rates – which seems unlikely - the return outlook from local equities is unlikely to be affected by the Budget, and remains reasonable.

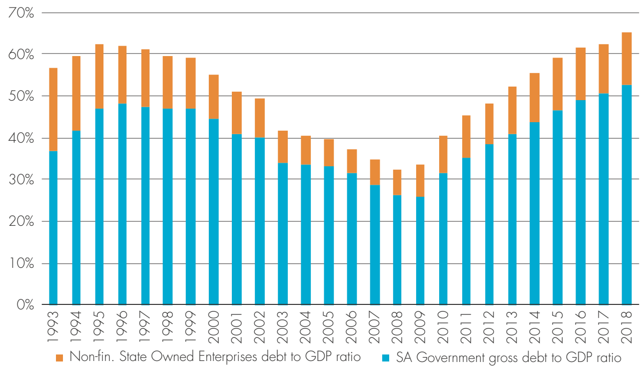
The bond market is clearly most exposed to a Budget Speech surprise, and bonds sold off last week (again, along with other emerging markets). But South Africa's fiscal challenges, including the Eskom risks and the slide into junk status are not new and therefore largely priced in already. A positive surprise could see bonds rally. As much as we are in the dark (literally and figuratively) with regards to Eskom's future, we caution against making knee-jerk portfolio changes in response. Maintaining appropriate diversification remains the best approach.

**CHART 1:** ESKOM OUTPUT, GIGAWATT HOURS, SMOOTHED



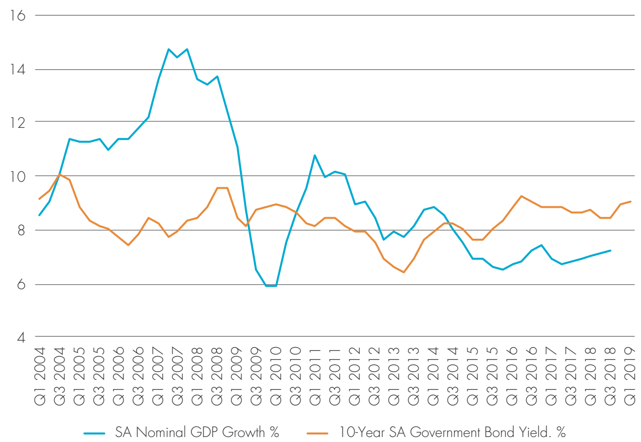

Source: StatsSA

**CHART 2:** SOUTH AFRICAN GOVERNMENT AND SOE DEBT TO GDP RATIO %




Source: National Treasury

**CHART 3:** SOUTH AFRICA ECONOMIC GROWTH AND GOVERNMENT BORROWING COSTS, SMOOTHED.




Source: Refinitiv Datastream

# INDICATORS

**EQUITIES - GLOBAL**

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Global | MSCI World | US$ | 2 067.0 | 2.28% | 1.92% | 9.71% | -3.00% |
| United States | S&P 500 | US$ | 2 776.0 | 2.51% | 2.66% | 10.73% | 1.65% |
| Europe | MSCI Europe | US$ | 1 599.0 | 2.43% | 1.01% | 7.60% | -11.31% |
| Britain | FTSE 100 | US$ | 9 327.0 | 1.91% | 2.09% | 8.64% | -8.56% |
| Germany | DAX | US$ | 1 204.0 | 3.17% | -0.66% | -0.70% | -17.36% |
| Japan | Nikkei 225 | US$ | 189.2 | 2.12% | 0.19% | 0.87% | -6.44% |
| Emerging Markets | MSCI Emerging Markets | US$ | 1 031.0 | -0.48% | -1.81% | 6.73% | -14.30% |
| Brazil | MSCI Brazil | US$ | 2 244.0 | 2.51% | -1.92% | 15.43% | -2.22% |
| China | MSCI China | US$ | 77.7 | -0.46% | -0.61% | 10.38% | -17.38% |
| India | MSCI India | US$ | 537.3 | -2.52% | -1.78% | -3.71% | -11.04% |
| South Africa | MSCI South Africa | US$ | 458.0 | -2.55% | -8.22% | 2.92% | -28.77% |

**EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)**

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| All Share (Capital Only) | All Share (Capital Index) | Rand | 54 628.0 | 2.60% | 0.87% | 3.59% | -8.24% |
| All Share | All Share (Total Return) | Rand | 8 016.0 | 2.60% | 0.88% | 3.70% | -5.28% |
| TOP 40/Large Caps | Top 40 | Rand | 7 087.0 | 3.08% | 1.03% | 3.78% | -4.95% |
| Mid Caps | Mid Cap | Rand | 15 614.0 | 0.66% | -0.43% | 1.89% | -9.49% |
| Small Companies | Small Cap | Rand | 17 770.0 | -2.33% | -3.01% | -1.03% | -15.15% |
| Resources | Resource 20 | Rand | 2 920.7 | 6.28% | 5.53% | 8.48% | 26.70% |
| Industrials | Industrial 25 | Rand | 12 698.0 | 3.29% | 1.28% | 2.28% | -15.45% |
| Financials | Financial 15 | Rand | 9 512.0 | -0.65% | -4.29% | 2.18% | -5.63% |
| Listed Property | SA Listed Property | Rand | 1 923.4 | -3.68% | -4.36% | 4.47% | -7.22% |

**FIXED INTEREST - GLOBAL**

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| US Aggregate Bond Index | Bloomberg Barclays | US$ | 482.2 | -0.35% | -0.83% | 0.68% | -1.39% |

**FIXED INTEREST - SOUTH AFRICA**

| DESCRIPTION | INDEX | CURRENCY | Index Value | Week | Month-to-date | Year-to-date | 1 Year |
|---|---|---|---|---|---|---|---|
| All Bond | BESA ALBI | Rand | 640.4 | -1.60% | -1.71% | 1.14% | 4.54% |
| Government Bonds | BESA GOVI | Rand | 633.8 | -1.67% | -1.77% | 1.14% | 3.77% |
| Corporate Bonds | SB JSE Credit Indices | Rand | 102.2 | -0.23% | -0.86% | 0.26% | -20.59% |
| Inflation Linked Bonds | BESA CILI | Rand | 257.2 | -0.40% | -0.18% | 1.47% | 3.46% |
| Cash | STEFI Composite | Rand | 414.6 | 0.14% | 0.29% | 0.90% | 7.26% |

**COMMODITIES**

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| Brent Crude Oil | Brent Crude ICE | US$ | 66.3 | 6.80% | 8.67% | 22.76% | 1.98% |
| Gold | Gold Spot | US$ | 1 321.0 | 0.53% | 0.08% | 3.12% | -2.51% |
| Platinum | Platinum Spot | US$ | 806.0 | 0.75% | -1.47% | 1.64% | -19.88% |

**CURRENCIES**

| DESCRIPTION | INDEX | CURRENCY | INDEX VALUE | WEEK | MONTH-TO-DATE | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|---|---|---|---|
| ZAR/Dollar | ZAR/USD | Rand | 14.08 | -3.31% | -5.89% | 1.95% | -17.45% |
| ZAR/Pound | ZAR/GBP | Rand | 18.13 | -2.70% | -4.25% | 1.05% | -9.65% |
| ZAR/Euro | ZAR/EUR | Rand | 15.89 | -2.89% | -4.52% | 3.66% | -8.55% |
| Dollar/Euro | USD/EUR | US$ | 1.13 | 0.00% | 1.33% | 1.50% | 10.62% |
| Dollar/Pound | USD/GBP | US$ | 1.29 | 0.42% | 1.64% | -0.69% | 9.40% |
| Dollar/Yen | USD/JPY | US$ | 0.01 | 0.65% | 1.48% | 0.80% | 4.08% |

Source: I-Net, figures as at 15 February 2019

OLDMUTUAL

**HELPLINE** +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

# ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

# THE WEEK AHEAD

## SOUTH AFRICA

- Budget Speech
- Consumer inflation

## US

- Flash Markit Purchasing Managers' Index
- Durable goods orders

## EUROPE

- Germany ZEW Economic Sentiment Index
- Flash Markit Purchasing Managers' Index

## CHINA

- Vehicle sales

## JAPAN

- Trade balance
- Inflation



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