BUDGET: DARK CLOUDS AND SILVER LININGS

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Finance Minister Tito Mboweni took to the podium in Parliament last week amid a national sense of dread. So why do we care so much about the annual Budget Speech? It matters because of four key elements.

Firstly, it sets out government's spending plans for the next three years. This includes not only the total planned amount, but also the mix of spending between different departments and the different spheres of government, and importantly, between current and capital spending.

Secondly, it sets out how much revenue government expects to raise over the three year-period, and from which sources, including the various types of direct and indirect taxes.

Thirdly, the difference between spending and revenue is the budget balance. If it is in deficit, government will have to borrow to make up the shortfall. Governments often run budget deficits and the annual borrowing cumulates into the government's total debt stock. Debt and deficits are usually expressed as a percentage of national income to make comparisons easy over time and across countries.

Finally, the Budget Speech this year was an opportunity for the Finance Minister to set out any major economic policy initiatives to address the country's challenges of low growth and high unemployment. Treasury is also the line department responsible for the financial sector and therefore makes policy announcements specific to financial services.

WHO CARES?

Therefore, different people care about the Budget for different reasons. Civil servants might care most about spending allocations to their particular department or agency. Taxpayers and consumers are typically mostly concerned about changes to tax rates. Economists and investment analysts will focus on the debt and deficit numbers and policy changes impacting the economy. Whether it was a "good" or a "bad" Budget will therefore depend on your perspective.

SUPPORT FOR ESKOM TO KEEP THE LIGHTS ON

Looking at these four elements in turn, the spending side still shows growth of about 2% in real terms over the next three years. It is therefore not an austerity budget, although the spending growth is unevenly distributed over this period. However, there is an important shift in the mix of spending. To help Eskom meet the interest payments on its massive R475 billion debt pile, the government will provide R23 billion a year. (If funded by tax increases, this would be the equivalent of a 1% hike in the VAT rate each year.) It will not absorb Eskom's debt, and the restructuring of Eskom and unbundling into three separate entities will continue. Private investors will be able to take a stake in the new distribution entity, which is a very positive step.

To fund this support for Eskom, R50 billion in spending cuts over three years elsewhere were announced, including trimming the bloated public sector wage bill through natural attrition and making allowance for early retirement. In this way, the Government Employee Pension Fund (GEPF) indirectly carries some of the cost of the Eskom bailout. The fact that the government is prepared to reduce the size and cost of the civil service for the first time since the 1990s is significant, since it will occur in the face of union opposition.

SHORTFALL

On the revenue side, government once again collected less tax revenue than expected in the fiscal year that ends in March. For the last few years, the weak economy has persistently delivered less revenue than anticipated. More recently, this has been compounded by operational problems at SARS. Most of the R42 billion shortfall in the current fiscal year is due to VAT refunds. There were however no major tax changes announced to compensate for this, with government taking the view that taxpayers cannot be squeezed further. Hikes in the VAT rate last year and the personal income tax rate in 2015 did not deliver a revenue boost and further increases in headline rates might be counterproductive. More effective, and stealthy, is to allow inflation to raise some more revenue by pushing taxpayers into higher tax brackets. Relief for this so-called fiscal drag was the lowest in 20 years, only R1.2 billion, while not increasing the medical tax credit will save the government R1 billion.

WIDER DEFICIT AND RISING DEBTS

The deficit number spooked the market initially, and the rand fell 2% as the headlines came out. The deficit for the current year will be higher than expected at 4.2% of GDP and will rise to 4.5% next year before declining to 4%. Put simply, the deficit will remain stuck at around 4% for the foreseeable future, despite promises over the years to reduce it. As a result, the government debt-to-GDP ratio will rise to 60% over the next few years. Although this number is not high in a global context, the International Monetary Fund (IMF) has warned that emerging markets like South Africa should not have debt ratios above 60% as they are prone to shocks that require a fiscal cushion. The fact that the government has been unable to stabilise the debt ratio is the biggest risk to our credit rating.

The market would have cheered the reduction in the public sector wage bill, which is widely seen as unsustainable, if it wasn't for the fact that the savings have to be redirected to bail out Eskom. Then again, if it hadn't been for the Eskom crisis, the cuts might never have taken place, certainly not before an election. That is the one positive of a crisis: it does focus policymakers' minds.

On the fourth element of the Budget - policy changes - there were a few encouraging steps. Perhaps more noticeable is what was not announced, There was no mention of prescribed assets or any other populist measures or pre-election giveaways. The planned reconfiguration of the electricity sector by unbundling Eskom and introducing more competition is positive. The emphasis on crowding in private sector money when it comes to infrastructure spending and working with the private sector in general is very welcome, but words must be translated into action. It helps that Minister Mboweni seems set to stay on in his post. While the Budget will not hurt economic growth in the short term by maintaining reasonable growth in government spending and ensuring that Eskom remains a going concern, it also does not contain anything that suggests economic growth will accelerate. Indeed, the Treasury's own forecasts are muted, pointing to growth of 1.5% in 2019, rising to only 2.1% in 2021.

IMPLICATIONS FOR INVESTORS

Though domestic growth is rising, it is still low in a global context. This will provide some support for domestically focused JSE-listed companies, but not much. Overall, the JSE is dominated by global companies and will therefore follow global market trends. Global and local equities are attractively priced though and should provide decent returns for investors. There were no tax changes to alter the return expectations from any asset class.

The bond market is clearly most exposed to a Budget Speech surprise, since the Budget sets out how much government plans to borrow from the bond market. In other words, it impacts the potential supply of bonds. A flood of bonds could push prices down and yields up, but this is not automatic. Perceptions of future interest rates, growth and inflation matter a lot.

Inflation in January was lower than expected, declining to 4% year-on-year. Though the big petrol price cut contributed, underlying inflationary pressures are still very weak. Food price inflation also remains lower than anticipated at only 2.3% year-on-year. Both food and fuel inflation can be expected to rise in coming months. In the case of food, we've seen maize prices jump 30% due to dry conditions in the key planting areas. Some of this will filter through to the consumer level in the next few months. Fuel prices are set to rise, with a combination of a weaker rand, higher global oil prices, increases in the fuel levy and Road Accident Fund levy, and the new carbon tax. But whether this will push up overall inflation will depend on whether companies can push up selling prices. Recent evidence suggests they are still unable to do this given competitive pressures. Inflation is gradually and structurally grinding lower, which is what the SARB wants to see. This is good for bonds over the longer term, despite the more immediate ratings risk.

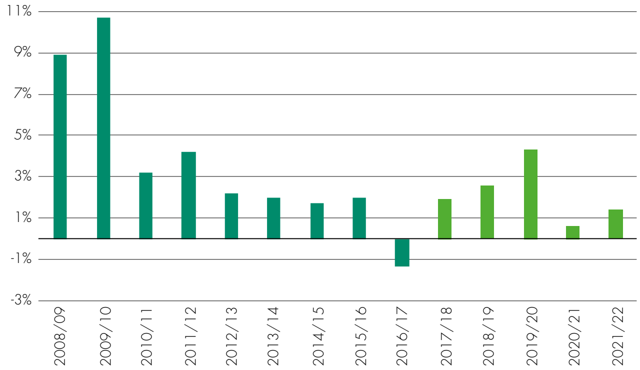
Only Moody's still maintains an investment grade rating for South African local currency bonds. If they were to downgrade us, it would mean exclusion from the FTSE World Government Bond Index (WGBI). Although many investors fear that the subsequent capital outflows would result in a crippling collapse of the rand and surge in bond yields, it is highly unlikely, since money tracking the WGBI represents only one source out of many when it comes to foreign buyers of our bonds. There are also domestic buyers. 2018 saw R70 billion in foreign net selling, and yet yields only moved slightly. Moody's will make a ratings announcement next month, but could wait until after the election to gauge progress on Eskom's restructuring and other reforms. Ultimately, a credit rating is only one piece of information that investors rely on.

The rand's primary driver has always been global conditions, with local politics and policy secondary. Should the fiscal situation deteriorate substantially further, the local currency is likely to bear the brunt, which will boost the rand values of global investments. However, sentiment towards emerging markets and the direction of the US dollar will probably matter more over time. The US Federal Reserve (Fed) is in 'patient' mode given an uncertain global economy and subdued inflation and this takes pressure off emerging market currencies. Put slightly differently, Fed Chair Jerome Powell has a greater ability to move the rand than Tito Mboweni does.

GOING FOR BROKE?

Finally, the question many have been asking, or are too afraid to ask: Is the country on the path to bankruptcy? According to research by the IMF into governments' assets as well as debts, the South African government has a positive net wealth. But it needs to sweat those assets more effectively. Therefore, it is unlikely that we'll go bust, leaving aside the question of whether a country that borrows in its own currency can go bankrupt at all. But clearly with interest payments eating up a bigger share of the Budget year after year, the current situation cannot be allowed to continue. Government cut its debt levels and interest bill substantially between the mid-1990s and mid-2000s. It can do it again, but we need political resolve and faster economic growth.

CHART 1: REAL GROWTH IN GOVERNMENT NON-INTEREST SPENDING, %

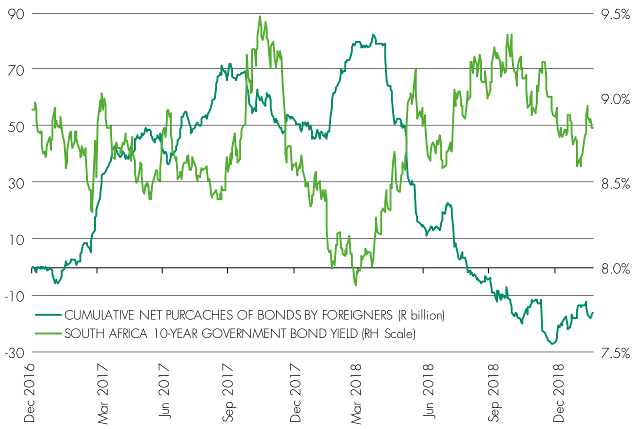


Source: StatsSA

CHART 2: SA GOVERNMENT GROSS DEBT TO GDP RATIO, %

Source: National Treasury

CHART 3: NET PURCHASES OF SA BONDS AND 10-YEAR BOND YIELD



Source: Refinitiv

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 087.0	0.97%	2.91%	10.77%	-1.42%
United States	S&P 500	US$	2 793.0	0.61%	3.29%	11.41%	3.29%
Europe	MSCI Europe	US$	1 619.0	1.25%	2.27%	8.95%	-10.01%
Britain	FTSE 100	US$	9 371.0	0.47%	2.57%	9.16%	-7.40%
Germany	DAX	US$	1 222.0	1.50%	0.83%	0.79%	-15.78%
Japan	Nikkei 225	US$	193.6	2.32%	2.52%	3.21%	-4.94%
Emerging Markets	MSCI Emerging Markets	US$	1 059.0	2.72%	0.86%	9.63%	-11.82%
Brazil	MSCI Brazil	US$	2 230.0	-0.62%	-2.53%	14.71%	-4.37%
China	MSCI China	US$	81.1	4.39%	3.75%	15.23%	-14.04%
India	MSCI India	US$	543.7	1.19%	-0.61%	-2.57%	-6.74%
South Africa	MSCI South Africa	US$	475.0	3.71%	-4.81%	6.74%	-24.36%

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	55 993.0	2.50%	3.39%	6.17%	-3.72%
All Share	All Share (Total Return)	Rand	8 216.0	2.50%	3.40%	6.29%	-0.62%
TOP 40/Large Caps	Top 40	Rand	7 275.0	2.65%	3.71%	6.53%	0.06%
Mid Caps	Mid Cap	Rand	15 978.0	2.33%	1.89%	4.27%	-5.32%
Small Companies	Small Cap	Rand	17 871.0	0.57%	-2.46%	-0.47%	-14.37%
Resources	Resource 20	Rand	3 013.6	3.18%	8.89%	11.93%	35.74%
Industrials	Industrial 25	Rand	13 004.0	2.41%	3.72%	4.74%	-11.21%
Financials	Financial 15	Rand	9 752.0	2.52%	-1.87%	4.76%	-1.84%
Listed Property	SA Listed Property	Rand	1 950.2	1.40%	-3.02%	5.93%	-2.73%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	483.9	0.36%	-0.47%	1.05%	-0.54%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	646.9	1.03%	-0.70%	2.18%	3.13%
Government Bonds	BESA GOVI	Rand	640.5	1.05%	-0.74%	2.20%	2.60%
Corporate Bonds	SB JSE Credit Indices	Rand	102.7	0.56%	-0.30%	0.82%	-20.53%
Inflation Linked Bonds	BESA CILI	Rand	256.2	-0.37%	-0.56%	1.09%	1.09%
Cash	STEFI Composite	Rand	415.1	0.14%	0.43%	1.04%	7.26%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	66.9	0.97%	9.72%	23.94%	1.41%
Gold	Gold Spot	US$	1 327.0	0.45%	0.53%	3.59%	0.38%
Platinum	Platinum Spot	US$	841.0	4.34%	2.81%	6.05%	-14.88%

CURRENCIES

ZAR/DOLLAR	ZAR/USD	RAND	13.99	0.61%	-5.35%	2.54%	-16.68%
ZAR/Pound	ZAR/GBP	Rand	18.27	-0.77%	-4.98%	0.27%	-10.95%
ZAR/Euro	ZAR/EUR	Rand	15.86	0.17%	-4.37%	3.82%	-9.41%
Dollar/Euro	USD/EUR	US$	1.13	0.00%	1.33%	1.50%	8.85%
Dollar/Pound	USD/GBP	US$	1.31	-1.26%	0.35%	-1.95%	7.25%
Dollar/Yen	USD/JPY	US$	0.01	0.19%	1.67%	0.99%	3.69%
Dollar/Yen	USD/JPY	US$	0.01	0.65%	1.48%	0.80%	4.08%

Source: I-Net, figures as at 22 February 2019

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Money supply and credit growth
- Producer inflation
- Trade balance
- Absa Purchasing Managers' Index

US

- Building permits and housing starts
- House prices
- Q4 GDP growth

EUROPE

- Eurozone credit growth
- Eurozone economic sentiment
- Eurozone inflation

JAPAN

- Industrial production
- Retail sales
- Unemployment
- Retail sales

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