ALWAYS BALANCING RISKS

QUARTER 2, 2021

Things were getting better.

The economy was steadily climbing out of the Covid-induced hole, despite the devastating third wave.

In fact, first quarter local economic growth not only exceeded the consensus forecast of 2.5%, but was even better than the most optimistic projection. StatsSA data showed that the economy grew by 4.6% after inflation in the first quarter on a seasonally adjusted and annualised basis. Nonetheless, compared to a year ago, the economy was still 3.2% smaller in real terms, and will still take several quarters to return to pre-pandemic levels. Mining is the only major large private sector that had recovered to pre-Covid levels in real terms in the first quarter, supported by elevated global commodity prices. In other words, South Africa is benefiting greatly from global growth, though household spending is also recovering faster than expected. Household finances have been much more resilient than feared throughout the pandemic, despite the loss of some 700,000 formal sector jobs and even more in the informal sector (which is by nature harder to measure). In simple terms, those who have kept their jobs have done well enough in income and wealth terms to lift total spending. This is good news, but also a stark reminder of inequality and the K-shaped nature of the recovery and the deep-seated inequality in our society. Lower interest rates also support the consumer spending recovery by lowering interest payments.

Nonetheless, consumer confidence remains battered especially among poorer households. This is understandable given the widespread job losses and uncertainties associated with vaccines and lockdowns. The FNB/BER Consumer Confidence Index declined in the second quarter to -13 index points, close to all-time lows.

The better-than-expected economic recovery is helping to address another big vulnerability: government debt. Tax revenues have steadily improved in recent months. Company tax and VAT are well above pre-pandemic levels, while personal income tax revenue, the largest category, has recovered to early 2020 levels. This will reduce pressure on the budget deficit, though it will remain uncomfortably large. Fortunately, the fiscal worst-case scenarios that were spoken about last year – such as debt-to-GDP ratios jumping above 100% – now seem much less likely.

LOOTING SPREE

However, in the short-term, things now seem very uncertain.

The country was hit by a wave of riots and looting in the second week of July. What started out as a political grievance – the arrest of former president Jacob Zuma – quickly descended into anarchy completely disconnected from any cause. Though it happened on a massive scale, it was largely concentrated to Kwa-Zulu Natal and townships in Johannesburg.

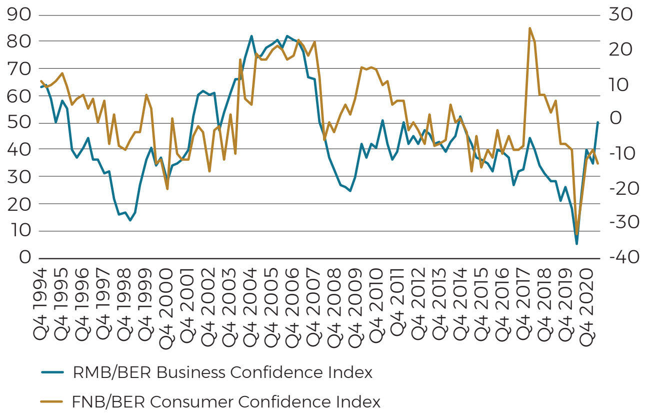
The immediate impact will be declines in retail sales and manufacturing production as well as lost income for the transport and agricultural sectors. It could take several weeks for things to return to normal. Uninsured smaller businesses might have to close for good.

The longer-term impact of these events are unclear as they were still unfolding at the time of writing. Business and investor confidence will take a blow, but the extent of the damage will depend a lot on how government and the broader society respond. As a priority, measures will have to be taken to restore confidence in security forces who were overwhelmed by events despite the best efforts of individual policemen and women. Economic reform - deregulation, cutting red tape and creating space for private investment - will need to be accelerated so that businesses can grow again and create jobs.

RIGHT DIRECTION

Prior to the looting, politics and policy were generally moving in the right direction. President Ramaphosa's unexpected announcement that companies would be allowed to produce up to 100MW of electricity for own use without going through the lengthy licensing process was a big plus. This will not only allow companies to reduce dependence on unreliable and expensive Eskom electricity, but also potentially unlock billions in new investment. The announcement, along with the privatisation of SAA and changes to enable private investment in underperforming ports, can change the narrative around the prospects for the local economy and the government's commitment to making growth-enhancing policy changes. The RMB/BER Business Confidence Index showed a promising jump to 50 index points in the second quarter. For the first time in three years, half the respondents in the survey were positive about business prospects. A proactive response will be needed to ensure this does not plummet again.

Chart 1: Business and Consumer Confidence indices



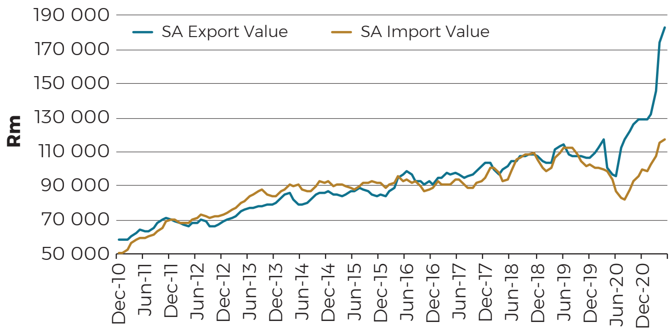
Source: Bureau for Economic Research

THE BIG EXPORT BOOST

The biggest bright spot for the local economy continues to be on the export side, thanks to elevated commodity prices. April and May saw massive trade surpluses of R51 billlion and R54 billion respectively.

This commodity price windfall is pure luck, and not of our own making. It would be foolish to pretend it will always last since commodity prices are cyclical. And it is important that South Africa continues to take steps to improve the business and investment climate to drive long-term growth. There have been some positive developments on this front, but it remains slow going.

Chart 2: South African imports and exports



Source: Refinitiv Datastream

Apart from internal stability, what are the other risks to South Africa's outlook? Since the outlook is largely supported by global factors, the risks lie there as well.

Clearly a sudden reversal in commodity prices would pull the rug out from under us. The surge in export values have come from price increases, not higher volumes. Prices, whether of raw materials or high-end manufacturers or services, are set by the intersection of supply and demand. However, in the case of commodities, supply is slow to respond since it can take years to open up a new mine. So while there is a risk to commodity prices of demand cooling as the initial post-pandemic economic growth surge abates, the bigger risk is if new supply does belatedly come on stream. This is what we saw a decade ago. Just as China's voracious demand for raw materials slowed somewhat, supply grew rapidly as new mining projects (financed with debt) became operational. The result was an epic price collapse and a near-death experience for some of the world's biggest miners like Anglo American. It seems as if they've taken to heart the lesson of the previous cycle, and so far there is reluctance to increase supply. This should support prices. Meanwhile, demand for commodities related to green energy and transport should continue to grow as the necessary transition to carbon neutrality hopefully accelerates.

The other risk is a global tightening of monetary conditions, in particular when the US Federal Reserve eventually starts tightening policy. Though it will carefully signal its intentions, this step does pose risks to emerging markets in particular as we saw during the previous cycle (2013 to 2018). South Africa's large combined twin deficits (current account balance plus fiscal balance) made us a member of the unfortunate 'Fragile Five' grouping back then. However, thanks to the booming exports, South Africa posted a near-record current account surplus in the first quarter which considerably reduces its external vulnerability. And while the fiscal deficit is much larger than in 2013, the recent trends have been encouraging as discussed earlier.

THINKING ABOUT INVESTMENTS

In our strategic asset allocation modelling, we make assumptions about the real long-term expected return of each asset class based on historic data. With the exception of cash, all local asset classes are currently priced to deliver returns above their long-term assumptions. In other words, South African assets have the tailwinds of valuations and a steadily improving macroeconomic backdrop (largely thanks to a supportive global backdrop). This certainly bodes well for the return prospects of our funds.

However, apart from the social, political and economic risks in South Africa, we remind our readers that JSE-listed equities and property are very concentrated asset classes, dominated by a few large companies. There is far greater diversification and better choice overseas, even if one has to pay up for it. On the other hand, in terms of interest-bearing investments, we continue to see more value locally. South African bond yields are simply very high by global standards, already pricing in a lot of bad news.

Therefore we still favour holding a substantial global allocation. It is all about balancing risks and opportunities in line with our promise to always make sure our funds are appropriately diversified.

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