MARKET MATTERS

SURPRISES KEEP ON COMING

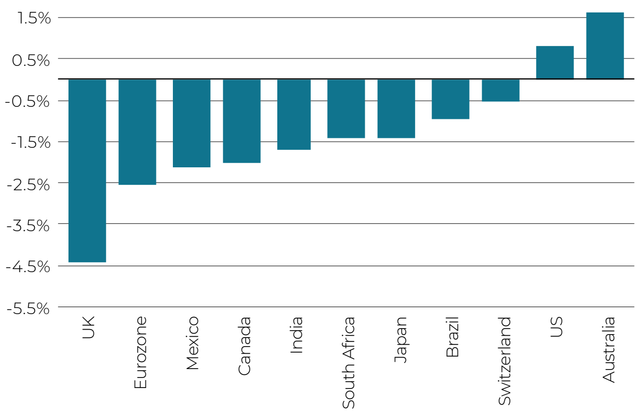
6 SEPTEMBER - 10 SEPTEMBER 2021

South Africa is the country that never stops surprising. Often they are surprises we would rather not have, and sometimes we wish we were not naïve enough to be shocked. The list is long, but recent additions include yet more corruption scandals and more news of government mismanagement and of course the devastating looting and unrest that rocked KwaZulu-Natal and parts of Gauteng in July. But the country delivers positive surprises too. The Springboks beat the British and Irish Lions despite Covid-interrupted preparations, while our Olympians and Paralympians similarly did us proud.

On the economic front, the surprises have been more positive than negative of late. The economy grew by more than expected in the second quarter, according to Stats SA's estimate of gross domestic product (GDP). In real terms (after inflation), the economy expanded by 1.2% from the first quarter. The second quarter of last year was when the hard lockdown brought large parts of the economy to a standstill. From that depressed base, the year-on-year growth rate hit a record 17%.

However, the value of total economic activity is still about 1.4% below pre-pandemic levels in real terms and climbing out the Covid-hole. Of course, it is even further behind if you imagine where the economy would have been if 2020 was just a normal year. Nonetheless, in terms of an incomplete recovery, South Africa hardly stands out. US real GDP was above fourth quarter 2019 levels in the second quarter, as were China and Australia. But the UK was still 4% lower and the Eurozone 2.5%.

CHART 1: DIFFERENCE BETWEEN Q2 2021 AND Q4 2019 REAL GDP, %



Source: Refinitiv Datastream

In nominal terms – not accounting for inflation – the economy is back above pre-pandemic levels. Importantly, the total economy-wide wage bill is larger than in 2019 despite widespread job losses. The inference is that those who kept their jobs have seen their incomes rise. This is an important driver of the recovery in consumer spending.

Total final household spending, the biggest component of economic activity as measured from the spending side, was 2.5% more than in the fourth quarter of 2019. Once inflation is accounted for, it was 1.5% less. This is a better outcome than most would've expected a year or so ago.

Consumer spending also benefits as interest rates remain at five-decade lows. With consumer inflation expected to be around the midpoint of the Reserve Bank's target range over the next two years, interest rate increases will likely be very gradual. They might be somewhat faster if the Reserve Bank Governor Lesetja Kganyago gets his wish of lowering the inflation target to 3%. However, it is government, and not the Bank that sets the target and it is unlikely to change anytime soon.

EXPORT BOOM

Apart from consumer spending, the local economy has massively benefited from exports. Exports are at record levels, and the country has posted trade surpluses for each of the past six quarters. The second quarter trade surplus of R614 billion was the largest on record. This is partly because imports have been slow to recover, but mostly because exports have surged over the past year due to sharp increases in key commodity prices.

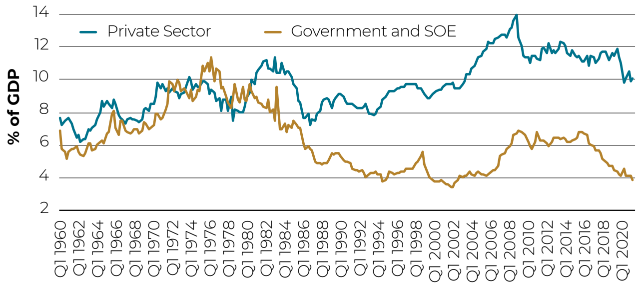
Measured from the start of 2020, rhodium is up 180% in dollars, manganese 150%, coal 90% and iron ore 44%. Palladium and gold are both up 17%.

These price increases were largely a surprise, but the reality is that South Africa's economic history is littered with such external windfalls. However, they never last forever. Already rhodium and iron ore are significantly off their recent peaks and one hears very little about a "commodity supercycle" today unlike a few months ago. For one thing, China's economic growth rate is cooling. However, major global mining companies have been extremely reluctant to expand output for fear of flooding the market and sending prices under water, which is what happened a decade ago. This discipline on the supply side, combined with longer-term demand for key metals used in the transition to green energy suggests that South Africa should continue to benefit from decent commodity prices in the years ahead.

The third leg of a sustained economic recovery – fixed investment – has yet to materially increase.

In real terms, fixed investment (gross fixed capital formation to use the clunky technical term) was still 12% below pre-pandemic levels, and was already weak for some time before Covid. Simply put, investment spending by government and its parastatals peaked in 2016 and then started declining due to a lack of funds. Spending by corporates has been held back by a lack of confidence in the future of the economy and economic policy. Private fixed investment in the domestic economy trended sideways between 2013 and 2019, while South African companies went on a spending spree abroad. The results were mixed at best. In 2020, investment spending predictably collapsed due to the lockdowns.

CHART 2: FIXED INVESTMENT SPENDING AS A PERCENT OF GDP



Source: Refinitiv Datastream

Looking ahead, government investment spending will continue to be hamstrung by funding and capacity constraints, but there is reason to believe that private firms will increase investment.

Firstly, government is opening up space for private participation in areas it previously controlled tightly. Policy changes mean that companies have greater freedom to secure their own electricity supply, while government's latest renewable energy procurement round will require 2 600 MW in capacity to be installed in the next three years. This will be funded and built by private players. Outside of energy, opportunities loom in ports and rail, though the process is still at an early stage. The release of spectrum to expand broadband access and lower costs is tied up in court, but should eventually proceed.

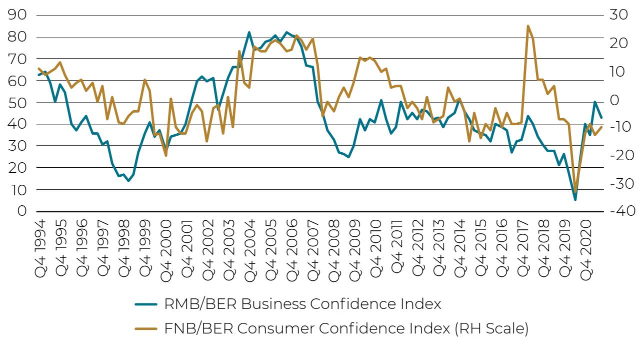
Secondly, elevated commodity prices should boost mining investment, but as noted earlier, mining executives are still wary of overextending their balance sheets. Finally, years of sluggish investment eventually catch up with firms. Inventories run low, systems and equipment need to be upgraded and maintenance can no longer be postponed,

NOT CONFIDENT

Confidence levels remain low, however. While the GDP numbers provide a snapshot of the economy prior to the July unrest, the two long-running confidence surveys from the Bureau for Economic Research give an indication of its impact. The FNB/BER Consumer Confidence Index improved to -10 index points in the third quarter, but remains in net negative territory. The survey measures three components. The outlook for the South African economy was unchanged, which is notable given both the third Covid wave and the unrest. The outlook for household finances increased somewhat, while respondents were much less pessimistic about the appropriateness of buying durable goods. In other words, the survey points to difficult conditions, but an overall resilience.

The RMB/BER Business Confidence Index retreated to 43 index points in the third quarter after surging to 50 in the second quarter. In other words, most executives surveyed were feeling pessimistic about business conditions. However, as with the consumer survey, confidence levels are actually remarkably resilient considering that businesses were faced with Covid-restrictions, looting and the Transnet cyber-attack that disrupted the country's main ports. In particular, confidence in the retail sector increased from 54 to 56 points, the highest level since 2014, even though this was the sector most directly impacted by looting. Similarly, wholesalers also reported positive sentiment though lower than the previous quarter.

CHART 3: BUSINESS AND CONSUMER CONFIDENCE SURVEYS

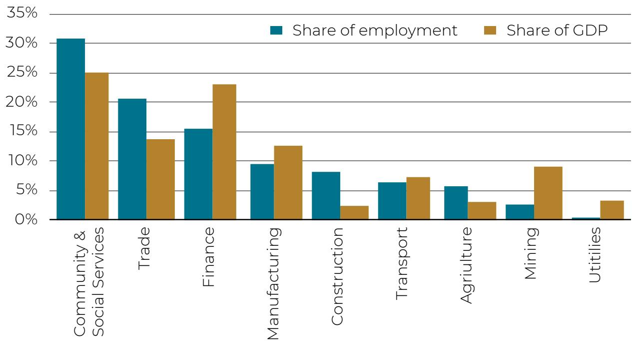


Source: Bureau for Economic Research

Also of note is the confidence levels declined among new vehicle dealers and manufacturers, not because of a lack of demand (the usual culprit) but because of supply constraints. Vehicle dealers in South Africa face the same stock shortages as their global counterparts, while manufacturers also reported problems with the cost and availability of key inputs.

The construction sector continues to struggle, however. In terms of GDP, it was still 20% below pre-pandemic levels in the second quarter, the biggest decline of any sector. Unfortunately, surveyed confidence levels fell even further in the third quarter. This is a pity because construction, along with agriculture, is by far the most labour-intensive industry, if we compare its share of employment with its weight in GDP (chart 4).

CHART 4: SECTOR SHARES OF EMPLOYMENT AND GDP



Source: Stats SA

Fortunately, agriculture is enjoying a bit of a boom with elevated global food prices and good rainfall conditions across most of the country. It has been the best performing sector by some distance since the start of the pandemic.

SO WHAT?

In summary the local economy is benefiting from strong global growth and elevated commodity prices as well as low interest rates. And, of course, the rebound is off a very low base. Therefore, the 2021 growth rate is likely to be very strong, in the region of 5% following the record 6.4% contraction in 2020.

The more interesting question for investors is the medium-term outlook. At what growth rate does the economy settle, once the Covid-related distortions play themselves out? And what is the growth rate that is priced into domestic assets? With a modest improvement in investment levels, it is reasonable to assume that the economy can grow around 2% on average over the next few years. This is unexciting by most standards, but not our own. Growth averaged only 0.8% in the five years prior to the pandemic. This contributed to very disappointing returns from local equities and property, but was by no means the only reason. It also resulted in a rapid increase in government debt, which has put upward pressure on long bond yields. It is also below the population growth rate of about 1.5%, meaning real income per capita declined. Many investors are still anchoring off this pedestrian growth rate, and it still reflects in the prices of many domestic investments.

Happiness, they say, is the difference between reality and expectations. Expectations remain low and sentiment depressed. This increases the odds of an upside surprise. Combined with attractive valuations on South African bonds, equities and property, investors can still expect positive real returns from a diversified portfolio, even though markets have already rebounded substantially.

In closing, however, we should also note that South African markets will continue to take direction from global markets. The JSE suffered the worst week in a while, despite good news on the domestic economic front, as mining shares were lower. Meanwhile ongoing regulatory changes in China continue to weigh heavily on the Naspers share price. Talk about policy uncertainty.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	3 122.0	-1.33%	-0.60%	16.06%	31.84%
United States	S&P 500	US$	4 459.0	-1.68%	-1.41%	18.72%	33.54%
Europe	MSCI Europe	US$	2 074.0	-1.52%	-0.67%	12.72%	26.00%
Britain	FTSE 100	US$	9 721.0	-1.80%	-0.76%	10.10%	26.44%
Germany	DAX	US$	1 753.0	-1.46%	-0.96%	14.38%	20.32%
Japan	Nikkei 225	US$	276.4	4.10%	8.24%	4.06%	26.26%
Emerging Markets	MSCI Emerging Markets	US$	1 309.0	-0.53%	0.00%	1.39%	20.65%
Brazil	MSCI Brazil	US$	1 729.0	-3.62%	-5.98%	-7.84%	12.93%
China	MSCI China	US$	95.8	0.94%	1.94%	-11.60%	0.27%
India	MSCI India	US$	853.3	-0.34%	1.10%	26.41%	50.49%
South Africa	MSCI South Africa	US$	467.0	-3.91%	-3.91%	3.78%	22.25%

EQUITIES - SOUTH AFRICA (TOTAL RETURN 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	64 296.0	-3.13%	-4.64%	8.23%	14.91%
All Share	All Share (Total Return)	Rand	10 327.0	-3.05%	-3.83%	11.44%	18.93%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	26 145.0	-3.61%	-4.92%	12.77%	21.14%
TOP 40/Large Caps	Top 40	Rand	9 304.0	-3.12%	-3.77%	10.21%	16.83%
Mid Caps	Mid Cap	Rand	17 879.0	-2.46%	-4.54%	17.88%	30.05%
Small Companies	Small Cap	Rand	23 434.0	-1.39%	-1.50%	36.47%	63.77%
Resources	Resource 20	Rand	4 588.7	-4.93%	-6.23%	12.29%	16.36%
Industrials	Industrial 25	Rand	16 647.0	-2.01%	-1.89%	5.75%	11.25%
Financials	Financial 15	Rand	8 848.0	-2.49%	-4.41%	17.24%	36.27%
Listed Property	SA Listed Property	Rand	1 495.1	-2.35%	-4.53%	21.55%	46.15%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	545.9	-0.22%	0.02%	-2.30%	0.81%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	813.7	-0.11%	-0.42%	7.22%	13.96%
Government Bonds	BESA GOVI	Rand	803.5	-0.12%	-0.41%	7.14%	13.92%
Inflation Linked Bonds	BESA CILI	Rand	299.1	0.68%	0.78%	10.36%	14.73%
Cash	STEFI Composite	Rand	476.6	0.07%	0.10%	2.59%	3.82%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	72.9	0.43%	1.28%	40.23%	82.30%
Gold	Gold Spot	US$	1 794.0	-0.88%	-1.27%	-5.28%	-7.72%
Platinum	Platinum Spot	US$	980.0	-2.20%	-3.64%	-8.41%	6.41%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.21	1.13%	2.20%	3.38%	18.93%
ZAR/Pound	ZAR/GBP	Rand	19.65	1.02%	1.68%	2.19%	10.18%
ZAR/Euro	ZAR/EUR	Rand	16.78	1.29%	2.19%	6.95%	18.99%
Dollar/Euro	USD/EUR	US$	1.18	0.85%	0.08%	3.56%	0.00%
Dollar/Pound	USD/GBP	US$	1.38	0.27%	-0.22%	-0.94%	-7.45%
Dollar/Yen	USD/JPY	US$	0.01	0.20%	-0.08%	6.39%	3.56%

Source: I-Net, figures as at 10 September 2021

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