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MARKET MATTERS

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FISCAL FOLLIES AND PHOENIXES

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OLD MUTUAL MULTI-MANAGERS

This year's Budget Speech takes place in a temporary dome erected in a Cape Town parking lot. The traditional venue, Parliament, was severely damaged in a January 2022 fire. At the time, its smouldering ruins seemed an apt metaphor for a country facing massive challenges from all sides. The pandemic left a massive hole in the economy and government's already-shaky finances. Sentiment was still very poor after the July 2021 riots and with seemingly no end in sight to ongoing loadshedding. Russia would soon launch its attack on Ukraine, leading to a global surge in food and fuel prices, and ultimately interest rates. Although the jump in other commodity prices, notably coal and rhodium, provided a temporary economic reprieve, South Africa was unable to fully capitalise because of crumbling rail and port infrastructure.

A lot has changed since then, globally and domestically. Locally, the government of national unity (GNU) has committed itself to economic reform and delivered some early wins. On the international front, three key developments stand out. Firstly, global interest rates surged, and though they have peaked and are declining unevenly across major economies apart from Japan, it appears they are unlikely to return to pre-pandemic ultra-low levels. This is also true of the short-term rates set by central banks and longer-term market rates. At the beginning of 2022, the global benchmark 10-year US government bond yield was trading at 1.7%, having averaged 2% over the prior decade. Today it is around 4.5%, in the middle of a broad trading range of 4% to 5% over the past two years, with no sign of breaking lower any time soon.

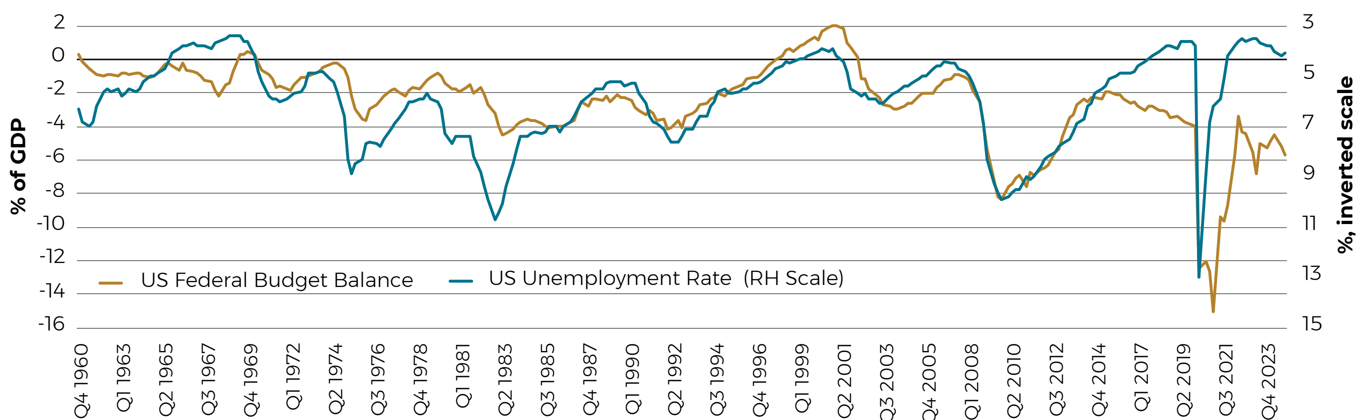
Secondly, there is a debate over the extent to which these elevated borrowing costs reflect worries over long-term fiscal health. However, it is clear that fiscal sustainability in many major economies is a hot topic again. This is particularly the case in the US, but budget fights in France and Germany late last year cost prime ministers their jobs.

The American fiscal outlook matters most, since it issues the global reserve currency and the country's bonds are central to the global financial system. It was

worrying even before Donald Trump's re-election as president. As chart 1 shows, budget deficits, the difference between annual government spending and tax revenue that must the funded through borrowing, tend to rise and fall with the economic cycle. (Since fiscal numbers tend to be large, they are usually expressed as a ratio of national income, otherwise known as gross domestic product. This also allows for comparisons across countries or over time.)

In recessionary conditions, when unemployment rises, the government borrows more as tax revenues decline and support measures kick in. This provides an important 'automatic stabiliser' to the economy at a time when the private sector is on its knees. During the economic upswing, the government should ideally rein in its borrowing to create fiscal room to respond to the next downturn. From 2015 onwards, however, under both Democrat and Republican presidents, the deficit did not contract even while the economy expanded and unemployment declined. Projections from the nonpartisan Congressional Budget Office show that the deficit will hover around 6% of GDP over the next decade if fiscal policy remains unchanged.

CHART 1: US BUDGET DEFICIT AND UNEMPLOYMENT RATE



Source: LSEG Datastream

But it is unlikely to remain unchanged, mainly because an extension and expansion of Trump's 2017 tax cuts is still on the cards. This will likely lead to even larger deficits. Large deficits in turn compound into a growing stock of debt, a process that is accelerated by the higher interest rates noted above. The US government will spend an estimated $880 billion on interest payments this year, a number that will only rise with higher bond yields and ongoing borrowing. The CBO projects that interest payments will hit 4% of GDP by 2035, a record, though still below the 5% of GDP that the South African government currently pays to creditors.

The Committee for a Responsible Federal Budget, a Washington-based think tank, estimates that Trump's tax plans would add between $5 trillion and $ 11 trillion to the federal debt over 10 years if not offset by spending cuts or other sources of revenue. This would raise the debt-to-GDP ratio to between 130% and 140% of GDP by 2035, compared to a baseline projection of 118%.

DOGE-BALL

Trump has appointed billionaire Elon Musk to run a Department of Government Efficiency (DOGE) to cut wasteful government spending. DOGE has already wielded an axe but won't necessarily be able to achieve sufficient savings. Most spending by federal spending is on social security, health, and defence, and interest, areas usually too politically sensitive to touch. In contrast, the shuttering of USAID, the overseas development agency, shocked many but will only save $40 billion or less than 1% of federal government spending. Many USAID-sized agencies would need to be closed to offset the tax cuts, and the collateral damage would be significant.

The other hope is that tariffs will raise a lot of tax revenue, but if they work as intended, tariffs will discourage imports and with it, tax income. Therefore, there seems to be no plausible scenario where US government debt does not rise meaningfully over the next decade. To be clear, the US doesn't have a debt problem as much as it has a prioritisation problem. Its tax-to-GDP is much lower than most other rich countries.

A NEW WORLD

The third big change is in the global political and geopolitical landscape. Talk of 'multipolarity' and the world splitting into different economic blocs, which increased in recent years, accelerated after the Russian invasion. There has been an increasingly inward turn in economic policy, with more support given to domestic industrial capacity, particularly in sensitive sectors like batteries and microchips. Trump's return adds additional complexities, because it threatens to undermine the US relationship with allies as much as with adversaries. So far, his tariff plans seemingly hurt Canada more than China, while Europe has been warned it will be next.

Trump has also attacked South Africa, superficially because of domestic transformation policies, but the underlying reason is probably unhappiness that Tshwane's foreign policy priorities have long clashed with Washington's. If South Africa wasn't hosting the G20 this year, it might have flown under the radar. But now it faces the possibility of losing duty-free access to the US market under AGOA, while further tariffs cannot be ruled out. This would be negative for its economy, though not catastrophic, since about 8% of South Africa's exports go to the US. The knock to broader investment sentiment remains to be seen.

UNDER PRESSURE

All of this means that South Africa is under greater pressure than ever to get its own fiscal and economic house in order given an uncertain geopolitical environment, and backdrop of higher global borrowing costs. The fact that government debt levels look set to keep elsewhere doesn't imply that South Africa has room to do the same. The government already spends 20 cents out of every tax rand on interest payments, a number that grows annually, leaving less money to spend elsewhere. Worse, it became a self-fulfilling prophecy where markets questioned the government's creditworthiness and charged it higher rates, compounding the interest burden and further reducing perceived creditworthiness.

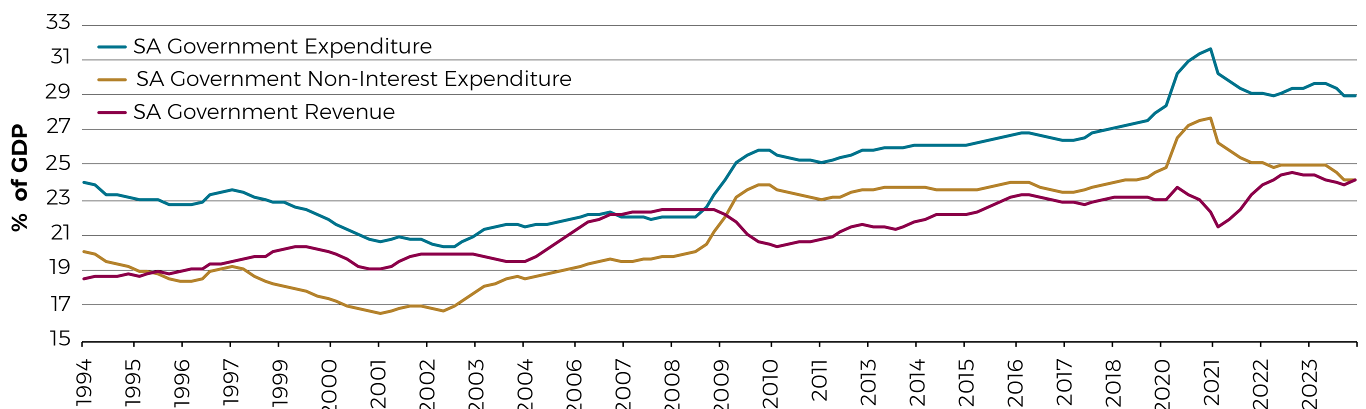
The way out of this is credible fiscal consolidation (reduced borrowing) and growth-enhancing economic reforms. This week's Budget Speech is likely to stick to this message, which is very important, but delivery is what counts most.

The progress in fiscal consolidation to date has been mixed. Budget projections are made three years into the future, and for most of the past decade, economic growth tended to disappoint relative to the forecasts. For instance, the 2022 Budget projected that the economy would grow by 2.1%, 1.6% and 1.7% respectively in 2022, 2023 and 2024. The actual numbers were 1.9% in 2022, and 0.6% in 2023, while 2024 will likely end up being less than 1%.

Disappointing growth leads to disappointing tax revenue collections. There is limited room for tax rate hikes, since the government already takes a large slice of national income (see chart 2). There will be the usual increases of sin taxes and probably the fuel levy, as well as a stealthy increase in personal income tax by not fully adjusting the brackets for inflation (known as bracket creep). Changes to income tax and VAT rates are unlikely, though there were reports in the weekend papers of this being discussed. Higher tax rates might be inevitable in future if current fiscal consolidation efforts fail.

Meanwhile, spending pressures have been relentless, from social security to student funding to SOE bailouts. These pressures aren't going away. One of the key things investors will look out for this week is whether there will be support for Transnet, which is struggling to meet interest payments on its R130 billion debt pile. Similarly, municipalities owe various utilities billions of rands. An expanded social safety net is still on the cards, while the National Health Insurance looms further in the distance. More immediately, the taxpayer will probably have to pick up the tab for the withdrawal of US funding, while a new public sector wage agreement will have to be accommodated as it is slightly larger than projected.

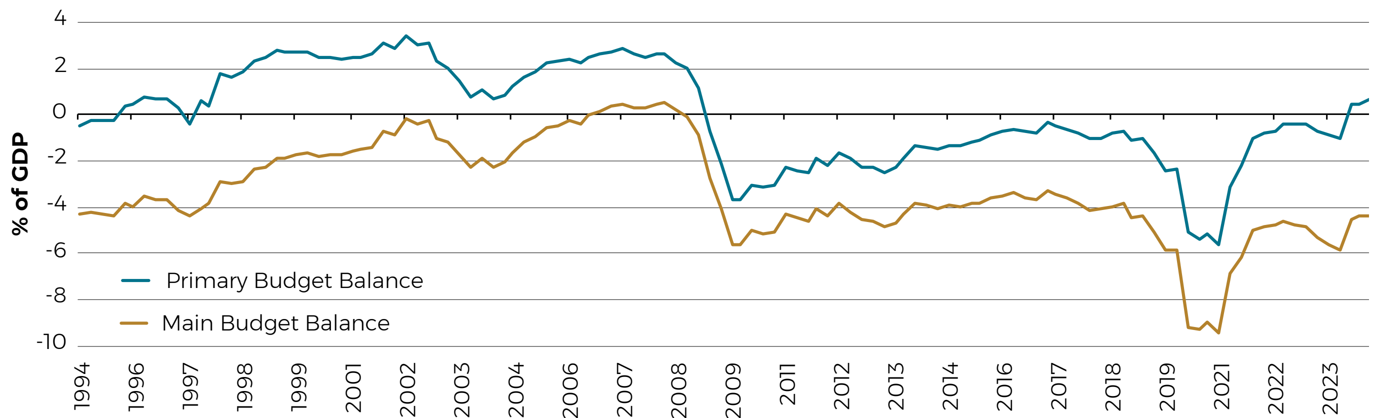
CHART 2: SOUTH AFRICA GOVERNMENT SPENDING AND REVENUE



Source: LSEG Datastream

But there has been some progress on the spending side. Treasury has achieved a primary surplus for the first time since 2008, meaning that non-interest spending is now less than tax revenues. As a share of GDP, it is back to pre-Covid levels. The budget deficit therefore consists entirely of interest payments. If this trend is sustained, the government debt-to-GDP ratio will start bending lower. It will require ongoing political will in the face of demands for increased spending from various quarters. However, giving in to those demands without offsetting cuts elsewhere will only lead to further increases in the interest burden.

CHART 3: SOUTH AFRICA BUDGET BALANCE



Source: LSEG Datastream

Could Musk's slash-and-burn approach help here? There is waste to eliminate, no doubt, but doing a DOGE in South Africa will hurt on a macro and a micro level. At the macro level, deep spending cuts will weaken the economy, for instance if many public servants lose their jobs. This will ultimately reduce tax revenues. At the micro level, indiscriminate cuts risk undermining important government work. Many government programmes will benefit from more investment, for instance in digitisation, not less.

The best thing the government can do to stabilise its finances is to carefully prioritise spending. The zero-based budgeting approach, which was mooted several years ago but seemingly never implemented, would be a start. Secondly, the government must accelerate efforts to make it easier to do business and that can unlock private capital in infrastructure spending. The Budget Speech is likely to include more detail on these infrastructure initiatives, in particular.

Faster economic growth would boost tax revenues and lower borrowing needs. It would also raise the denominator of debt-to-GDP ratios. It will take a few years, but we are grinding our way towards a stabilisation of the debt ratio. If so, the reward will be credit ratings upgrades, and a rerating in the bond market.

A major reconstruction of Parliament is underway. Rather than just rebuilding the damaged buildings, substantial alterations will re-emerge, Phoenix-like, as a modern and fit-for-purpose seat of South Africa's democracy. Here too, is a potential metaphor for a country that is trying to rebuild its economy and with it, fiscal sustainability. But as anyone who's ever undertaken a construction project knows, it often takes longer than anticipated.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	3 899.0	1.72%	1.62%	5.15%	19.38%
United States	S&P 500	US$	6 115.0	1.48%	1.22%	3.96%	22.28%
Europe	MSCI Europe	US$	2 217.0	3.40%	3.60%	10.68%	11.52%
Britain	FTSE 100	US$	10 991.0	1.87%	2.25%	7.46%	15.57%
Germany	DAX	US$	2 013.0	5.06%	5.12%	14.37%	27.57%
Japan	Nikkei 225	US$	257.1	1.05%	0.09%	1.30%	2.68%
Emerging Markets	MSCI Emerging Markets	US$	1 125.0	1.53%	2.93%	4.65%	12.61%
Brazil	MSCI Brazil	US$	1 367.0	3.09%	3.48%	16.14%	-18.44%
China	MSCI China	US$	73.0	7.38%	12.50%	13.21%	41.30%
India	MSCI India	US$	949.0	-3.32%	-3.86%	-7.33%	-0.22%
South Africa	MSCI South Africa	US$	478.0	1.70%	5.52%	11.16%	28.15%

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	88 717.0	1.42%	3.21%	5.50%	21.51%
All Share	All Share (Total Return)	Rand	16 234.0	1.42%	3.21%	5.60%	26.03%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	39 678.5	1.09%	2.81%	5.44%	25.37%
TOP 40/Large Caps	Top 40	Rand	14 639.0	1.67%	4.07%	7.47%	26.18%
Mid Caps	Mid Cap	Rand	25 245.0	-0.65%	-0.34%	0.40%	22.34%
Small Companies	Small Cap	Rand	42 474.0	0.12%	0.54%	-4.09%	29.48%
Resources	Resource 20	Rand	5 570.3	1.78%	4.75%	23.51%	33.23%
Industrials	Industrial 25	Rand	27 672.0	3.50%	5.18%	6.29%	24.86%
Financials	Financial 15	Rand	15 486.0	-0.91%	1.37%	-1.38%	25.00%
Listed Property	SA Listed Property	Rand	2 366.1	1.61%	0.82%	-1.53%	22.47%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government Overall (USD Unhedged)	S&P	US$	74.8	0.29%	0.88%	1.26%	-0.59%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 107.3	0.00%	-0.01%	0.43%	18.66%
Government Bonds	BESA GOVI	Rand	1 090.5	0.00%	-0.01%	0.43%	18.57%
Inflation Linked Bonds	BESA CILI	Rand	375.9	0.11%	0.13%	-0.20%	8.20%
Cash	STEFI Composite	Rand	600.4	0.15%	0.29%	0.95%	8.39%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	74.7	0.11%	-1.66%	-0.35%	-8.85%
Gold	Gold Spot	US$	2 881.0	0.77%	3.00%	10.13%	44.85%
Platinum	Platinum Spot	US$	1 000.0	0.30%	-3.19%	9.29%	12.61%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.36	0.28%	1.70%	2.63%	3.77%
ZAR/Pound	ZAR/GBP	Rand	23.11	-1.25%	0.17%	2.25%	3.59%
ZAR/Euro	ZAR/EUR	Rand	19.28	-1.39%	0.32%	1.41%	6.03%
Dollar/Euro	USD/EUR	US$	1.05	-1.90%	-1.33%	-1.43%	1.90%
Dollar/Pound	USD/GBP	US$	1.26	-1.48%	-1.48%	-0.68%	0.11%
Dollar/Yen	USD/JPY	US$	0.01	0.58%	-1.01%	-3.12%	1.13%

Source: I-Net, figures as at 14 February 2025

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