

OLD MUTUAL MULTI-MANAGERS MARKET MATTERS

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BUDGET BLUNDER DOESN'T BODE ILL



IZAK ODENDAAL

OLD MUTUAL MULTI-MANAGERS

On Tuesday last week, American astronomers announced that a sizeable asteroid named 2024 YR4 has a 3% chance of colliding with Earth in December 2032. While 3% doesn't sound like much, it is the highest ever calculated probability of such a collision according to a New York Times report. The asteroid could flatten a city with a direct hit, though the projected path at this stage is over the ocean. This is a roundabout way of making two points about Wednesday's Budget Speech that was cancelled at the very last minute. Firstly, postponing a big event like the Budget caused inconvenience, but is not the end of the world. Being hit by a large asteroid would be. At any event, the Budget Speech will now take place on 12 March.

Secondly, scientists can make these sorts of very precise projections of celestial objects far into the future because they are governed by the laws of physics. Processes that are governed by political logic are inherently unpredictable. So, while the postponement of the Budget was unexpected, nothing should really be unexpected in the realm of politics. Just witness everything coming out of the Trump administration over the past month (more on this next week).

As it happened, Wednesday was also the fifth anniversary of the day financial markets first awoke to the reality that the novel coronavirus was not going to be contained to China. On 19 February 2020, global equity markets started a decline that would only bottom out a month later after a 33% drawdown. The rand fell from R15 per dollar to almost R19. The 10-year South African government bond yield spiked from 9% to 12% before retracing the losses over subsequent months.

Covid-19, as the disease came to be known, reshaped global politics and economics, and fiscal policy in particular. A big deal, in other words. A bit like a meteor striking out of the darkness. Nowhere was this truer than in South Africa, which went into the pandemic with a weak economy and strained government finances and still imposed one of the strictest lockdowns.

Economies in lockdown could not generate much tax income, while government spending on healthcare and social support increased sharply across the world. Moreover, since debt levels are expressed as a ratio of national income (GDP) to allow for comparisons across time and between countries, the weaker denominator worsened the ratios. South Africa's debt ratio jumped by 23 percentage points of GDP between 2019 and 2024, one of the largest increases internationally as

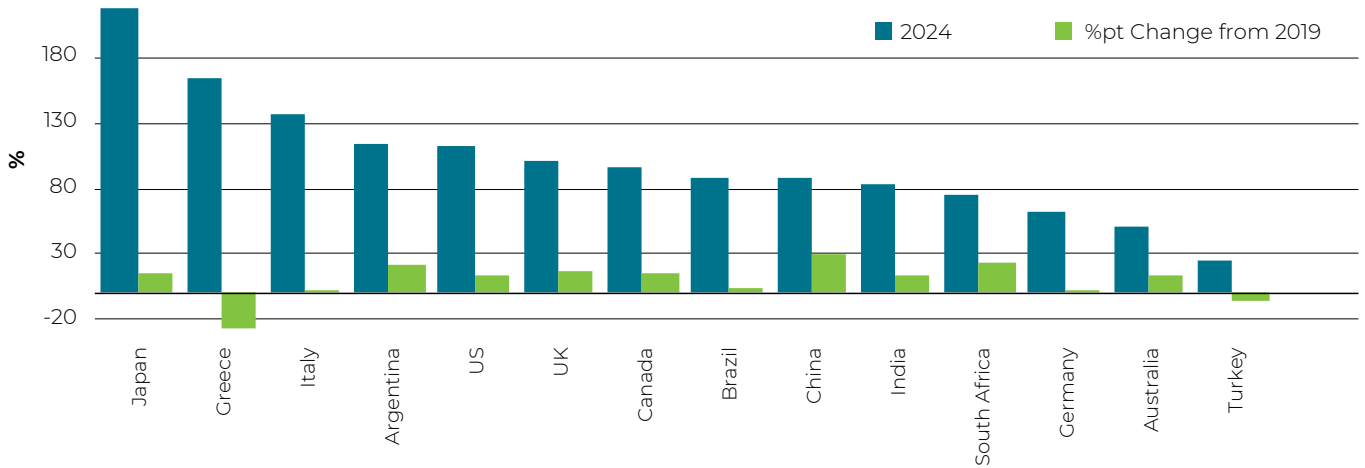


Chart 1 shows. South Africa is clearly not highly indebted by global standards. Rather, it is the rapid increase in debt since 2010 and particularly since 2020 that is worrying.

Of course, one cannot blame Covid entirely for South Africa's current precarious fiscal position. In particular, the country's

large state-owned enterprises have been a bottomless pit for taxpayers while also failing to deliver the key services they exist for, hobbling the economy in the process.

CHART 1: GOVERNMENT DEBT-TO-GDP RATIOS, %



Source: International Monetary Fund

HIGHER-FOR-LONGER

The stop-start shock Covid delivered to global supply chains contributed to a surge in prices, which was compounded by Russia's invasion of Ukraine, another unexpected shock (Saturday was the third anniversary). The result was that inflation rates jumped to levels last seen in the early 1980s across the developed world. Interest rates eventually followed a similar path. There is no indication of a return to the pre-Covid, post-financial crisis period of ultra-low interest rates, especially not as inflation uncertainty has increased with the various tariff threats. A bit worryingly, recent inflation data in the US and UK showed an uptick even before any tariffs have taken effect. It is too soon to ring the alarm bells, but it does mean that the US Federal Reserve is justified in pausing its rate-cutting cycle to assess how things play out, while the Bank of England will also proceed cautiously.

Higher-for-longer global interest rates might be one of the biggest legacies of the pandemic. By definition, it means borrowers, including governments, need to think carefully about taking on more debt.

South African interest rates are not particularly high relative to pre-pandemic levels, but high relative to economic growth. The government borrows around 9%, while nominal economic growth is hovering around 5%. Tax revenue will grow more or less in line with nominal economic growth over time, assuming a steady tax-to-GDP ratio. This gap between interest rates and growth, sometimes expressed as $r > g$ by economists, renders borrowing unsustainable, since debt compounds faster than the income needed to service it. It sits at the core of South Africa's fiscal challenge. Since the government cannot directly control economic growth or the interest rate at which it borrows (that is determined by the bond market), it must focus on reducing its borrowing requirement. This is euphemistically called 'fiscal consolidation' but is necessarily painful since it relies on some combination of higher taxes or less spending.

NO EASY CHOICES

Unfortunately, South Africa has no easy choices left. All we can ask for is that the difficult choices are made wisely. From investors' point of view, it would have been positive if Treasury was prepared to take the politically unpopular step of raising VAT rates by two percentage points. The fact that the Cabinet was not sufficiently briefed now appears clumsy but it's not sinister. The pushback against the VAT increase means that Treasury must return to the drawing board. Importantly, however, at issue is not the principle of fiscal consolidation, but rather how best to achieve it.

A VAT rate increase may or may not be in the final Budget Speech on 12 March. If not, some of the increased proposed spending – on infrastructure, social grants, education and health – would have to be trimmed back. Now that the market has seen the draft projected deficits, it is likely to respond negatively to wider deficits in the final Budget.

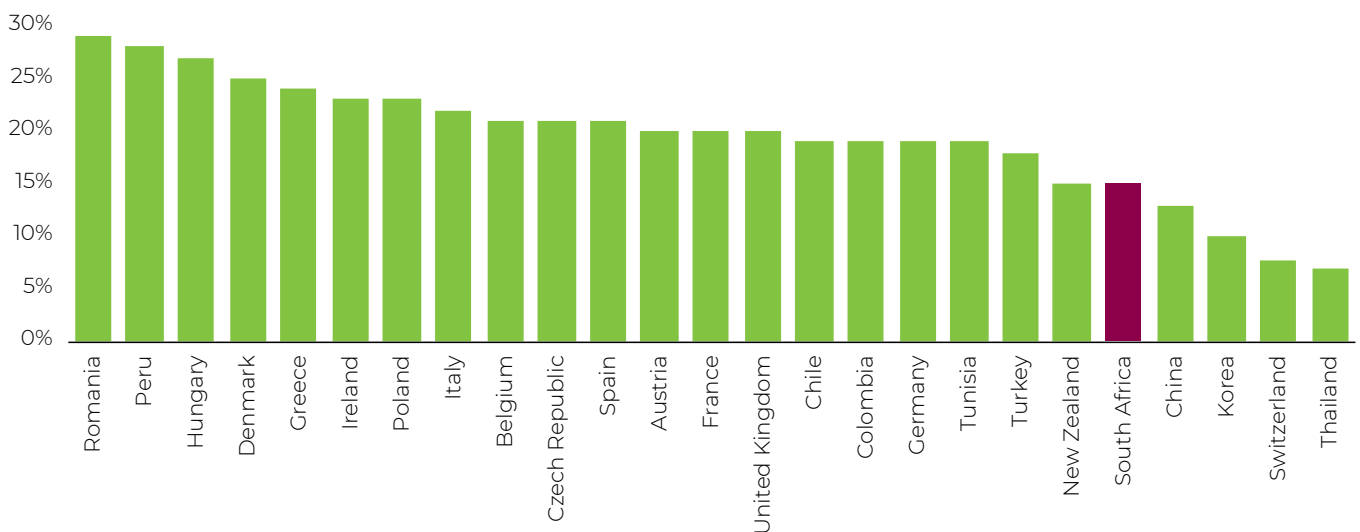
If there is a VAT increase, perhaps 1% instead of 2%, the economy is at least on a sounder footing to be able to absorb it due to the significant decline in loadshedding, this weekend's blackouts notwithstanding, and lower interest

rates. The benefit of VAT is that it is applied broadly and does not distort economic incentives the way income taxes can. The drawback is that it is a regressive tax, in the sense that rich and poor alike pay the same rate, but the impact on low-income households would have been offset somewhat by zero-rating a broader basket of goods and granting above-inflation social grant increases.

A VAT increase would raise consumer inflation, but the Reserve Bank will view it as a temporary bump and focus on potential second-round impacts instead. It shouldn't change the interest rate outlook, which at this stage largely depends more on what happens internationally than domestically.

There are few alternatives to raising more revenue. While South Africa's VAT rate is on the low side by global standards, its personal income tax rates are relatively high and imposed on a narrow base of individual taxpayers. South Africa's company tax rate is also quite high by global standards, and the international trend has been for lower company tax rates.

CHART 2: VALUE ADDED TAX RATES ACROSS COUNTRIES



Source: International Monetary Fund

Given high levels of inequality, a wealth tax could still be considered, but it is easy to overestimate how much revenue it will generate since it will be administratively complex, and the super-rich are globally mobile. It is better, as the SARS Commissioner has indicated in the past, to improve compliance with existing tax law.

Overall, however, South Africa's tax-to-GDP ratio of 28% is closer to that of rich countries than developing economies, with New Zealand's ratio at 33% while Mexico's is 17%. This suggests that the economy is nearing the limits of how much it can be taxed, particularly given that most taxpayers probably feel they don't get quality public services in return for handing their hard-earned rands over to SARS.

Ultimately, sustained faster economic growth is the best way to boost tax revenues, without raising the tax-to-GDP ratio.

The draft Budget Speech reiterated the need to grow the economy, particularly through crowding in private investment in infrastructure spending. This emphasis, along with necessary regulatory changes, is likely to remain in the final Budget. Along with the slow grind towards a smaller deficit and less borrowing, Treasury is also rightly trying to gradually tilt the composition of government spending away from consumption (salaries) towards investment. We'll need to wait a few weeks for the details.

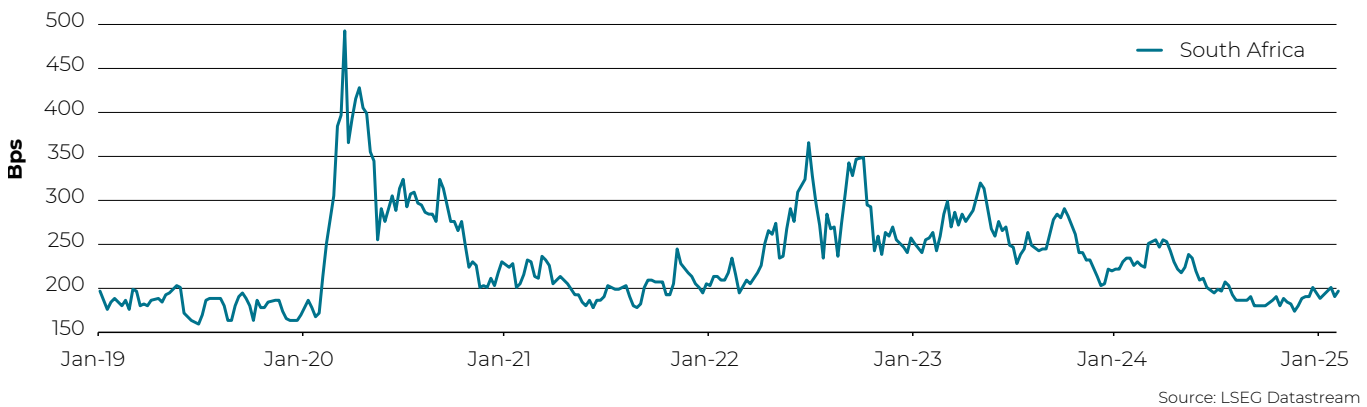
BONDING

In terms of investment implications, the Budget is of course most directly relevant to the bond market, though the rand was also briefly weaker after the cancellation of the speech. South African bond yields remain well above any reasonable assumption of future inflation, especially if the Reserve Bank eventually gets its way and shifts to a 3% target.

The government’s perceived creditworthiness can be assessed by dollar credit default swap spreads, since these

do not factor in currency or inflation components. These remain elevated, pointing to concerns over fiscal sustainability, but have declined since 2022. It will probably take more evidence of delivery to drive these spreads lower, and ultimately, credit ratings higher. These spreads are also priced in a global context and tend to rise with periods of international market stress, as in 2020.

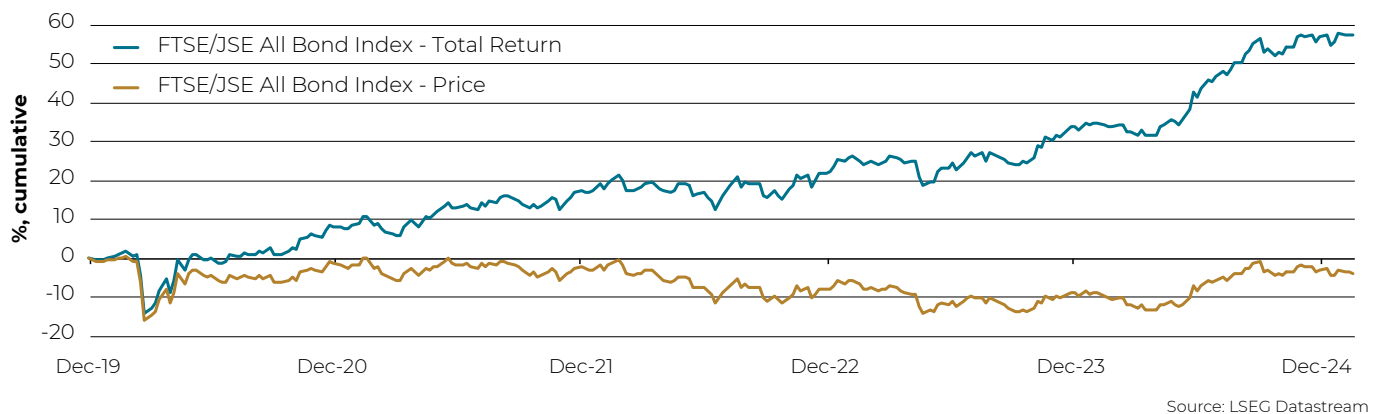
CHART 3: 5-YEAR US\$ CREDIT DEFAULT SWAP SPREADS



Despite all the fiscal drama of recent years, including multiple ratings downgrades and the sharp drawdowns of 2020, South African government bonds have delivered decent real returns for investors, but this is entirely due to the fact that bonds pay a high level of interest (or coupons). In terms

of price terms, it has been going nowhere slowly (though 2024 saw a bounce in bond prices, which boosted total returns to 17% for the year). Chart 4 shows the difference between price returns and total returns, including interest.

CHART 4: JSE ALL BOND INDEX RETURNS



In summary, three things to remember. One, the Budget postponement caused some uncertainty, but the rand ended the week stronger than it started, so the market reaction was only briefly negative. There is no reason to question the GNU’s commitment to fiscal consolidation in principle. Adjusting to coalition politics needs to happen at all levels, including in the Budget process, but it is democracy in action. Secondly, while fiscal consolidation can still be delayed by a number of factors, South African bonds offer attractive real returns in the context of a diversified

portfolio where other assets can offset some of those risks. Thirdly, the global environment will remain very important, particularly as international bond markets digest the outlook for inflation and changes in trade policies. While South Africa has scored its fair share of own goals over the years, it is usually global shocks that cause the real damage to markets, as we saw during Covid (let’s hope extraterrestrial shocks never occur). All of this means that cool heads are as important, if not more important as always.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 843.0	-1.44%	0.16%	3.64%	17.45%
United States	S&P 500	US\$	6 013.0	-1.67%	-0.46%	2.23%	20.69%
Europe	MSCI Europe	US\$	2 212.0	-0.23%	3.36%	10.43%	9.07%
Britain	FTSE 100	US\$	10 939.0	-0.47%	1.77%	6.95%	12.96%
Germany	DAX	US\$	1 993.0	-0.99%	4.07%	13.23%	24.02%
Japan	Nikkei 225	US\$	259.8	1.96%	1.14%	2.36%	2.03%
Emerging Markets	MSCI Emerging Markets	US\$	1 147.0	1.96%	4.94%	6.70%	12.34%
Brazil	MSCI Brazil	US\$	1 326.0	-3.00%	0.38%	12.66%	-23.40%
China	MSCI China	US\$	75.8	3.85%	16.83%	17.57%	41.61%
India	MSCI India	US\$	950.9	0.20%	-3.66%	-7.14%	-2.27%
South Africa	MSCI South Africa	US\$	482.0	0.84%	6.40%	12.09%	27.85%

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	88 914.0	0.22%	3.44%	5.73%	21.75%
All Share	All Share (Total Return)	Rand	16 270.0	0.22%	3.44%	5.83%	26.27%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	39 678.1	0.00%	2.81%	5.44%	25.38%
TOP 40/Large Caps	Top 40	Rand	14 715.0	0.52%	4.61%	8.02%	26.58%
Mid Caps	Mid Cap	Rand	24 986.0	-1.03%	-1.36%	-0.63%	20.35%
Small Companies	Small Cap	Rand	42 313.0	-0.38%	0.16%	-4.45%	30.83%
Resources	Resource 20	Rand	5 358.0	-3.81%	0.76%	18.80%	28.04%
Industrials	Industrial 25	Rand	28 190.0	1.87%	7.15%	8.28%	27.93%
Financials	Financial 15	Rand	15 599.0	0.73%	2.11%	-0.66%	24.04%
Listed Property	SA Listed Property	Rand	2 378.6	0.53%	1.35%	-1.02%	24.79%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	74.8	0.06%	0.95%	1.32%	-0.71%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 104.6	-0.25%	-0.26%	0.18%	16.40%
Government Bonds	BESA GOVI	Rand	1 087.8	-0.25%	-0.26%	0.19%	16.34%
Inflation Linked Bonds	BESA CILI	Rand	380.0	1.09%	1.22%	0.89%	9.03%
Cash	STEFI Composite	Rand	601.3	0.15%	0.44%	1.10%	8.38%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	74.4	-0.41%	-2.07%	-0.76%	-10.33%
Gold	Gold Spot	US\$	2 934.0	1.84%	4.90%	12.16%	44.82%
Platinum	Platinum Spot	US\$	975.0	-2.50%	-5.61%	6.56%	10.42%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.36	0.01%	1.70%	2.63%	3.07%
ZAR/Pound	ZAR/GBP	Rand	23.19	-0.34%	-0.17%	1.90%	3.10%
ZAR/Euro	ZAR/EUR	Rand	19.21	0.36%	0.67%	1.77%	6.56%
Dollar/Euro	USD/EUR	US\$	1.05	0.00%	-1.33%	-1.43%	2.86%
Dollar/Pound	USD/GBP	US\$	1.26	-0.37%	-1.84%	-1.05%	-0.26%
Dollar/Yen	USD/JPY	US\$	0.01	-1.99%	-2.97%	-5.05%	-0.67%

Source: I-Net, figures as at 21 February 2025

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