# Economic outlook 2017–2022: Strengthening global growth outlook spurs risk-on; SA growth remains dissociated from the global trend

Fourth quarter 2017

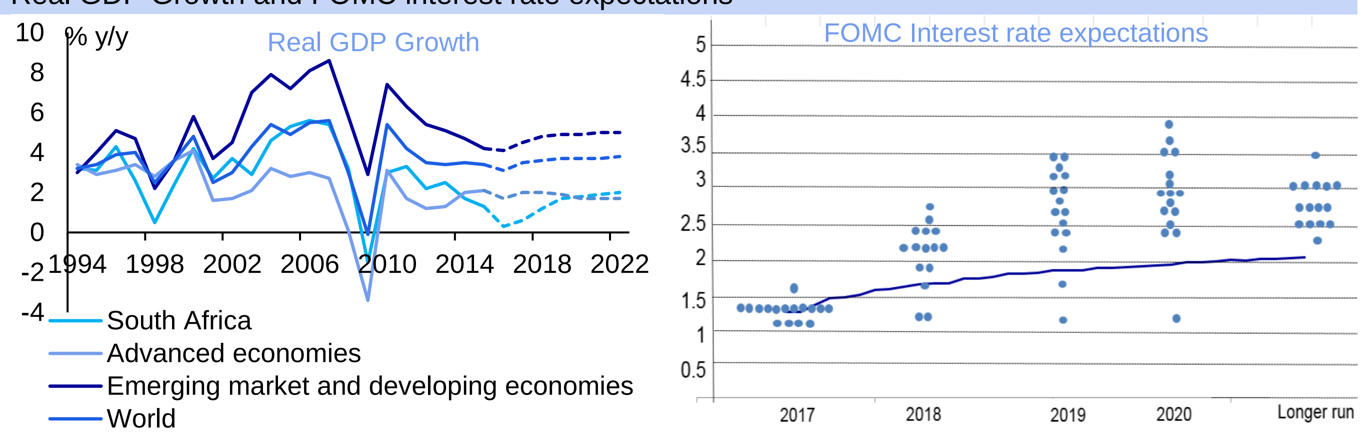
9th October 2017

| Summary, % real growth rates | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| GDP (real, %) | 0.3 | 0.6 | 1.2 | 1.7 | 1.8 | 1.9 | 2.0 |
| HCE (real, %) | 0.8 | 1.1 | 1.4 | 1.9 | 2.0 | 2.1 | 2.2 |
| GCE (real, %) | 2.0 | 0.5 | 0.0 | 0.4 | 1.1 | 1.1 | 1.1 |
| GFCF (real, %) | -3.9 | -0.8 | 0.3 | 1.1 | 2.9 | 2.3 | 3.4 |
| GDE (real, %) | -0.7 | 1.0 | 1.0 | 1.5 | 1.8 | 2.0 | 2.2 |
| Export (goods & non-factor services) - (real, %) | -0.1 | 3.6 | 4.4 | 4.9 | 6.1 | 5.2 | 5.0 |
| Imports (goods & non-factor services) - (real, %) | -3.7 | 3.0 | 2.7 | 4.6 | 6.2 | 5.3 | 5.6 |
| Balance: Current Account - (% of GDP) | -3.3 | -2.5 | -2.8 | -2.8 | -3.1 | -3.4 | -3.4 |

Source: SARB, Investec

The global economic outlook of a continued synchronized upswing has supported markets, along with expectations of a slow pace of monetary policy normalisation in advanced economies on restrained inflation. Equity markets have reached new highs, with volatility subdued, and global risk-on remains a feature as the lengthy bull market persists. Emerging markets (EM) have seen strong foreign portfolio inflows on meaningful interest rate differentials, while low bond yields (and volatility) in Advanced Economies (AE) have supported global bourses. The risk of a financial crisis is being debated, not least due to the growing time-period since the last one (we ascribe a 19% probability to a severe global financial crisis over the next five years, with lower immediate probability but rising to 19% by 2022 - see "Risk update" of 8th September 2017, website address below), while household debt levels are climbing along with those of non-financial corporates. Indeed, the Bank of International Settlements (BIS) highlights that the "number of companies rated A or better has fallen especially sharply, while the share of worst-rated (C or lower) companies has increased." A higher interest rate environment (higher debt service payments) risks increased corporate stress, particularly if economic growth slows following monetary tightening. Under such a scenario, expectations of weaker global economic growth would likely follow, and so market risk-off could ensue. A correction (or even a substantial period of market risk-off) with a global economic slowdown on the down

Real GDP Growth and FOMC interest rate expectations




Source: IMF and Federal Reserve Bank (SA GDP forecast Investec)



Annabel Bishop • Investec Bank Limited • Tel (2711) 286 7188 • email: ambishop@investec.co.za •
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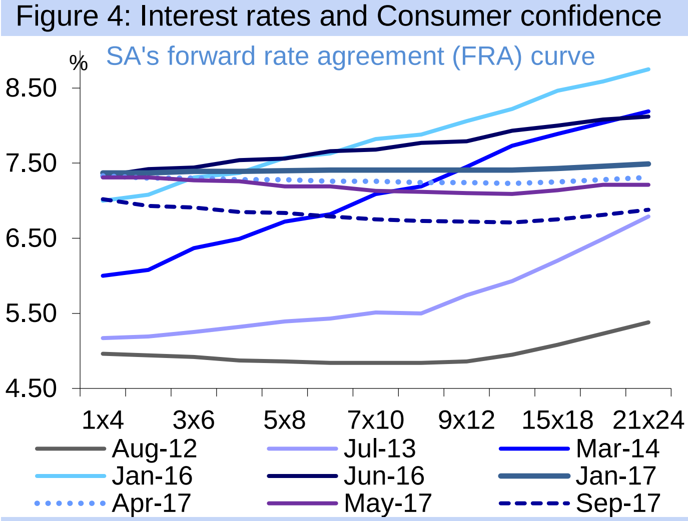
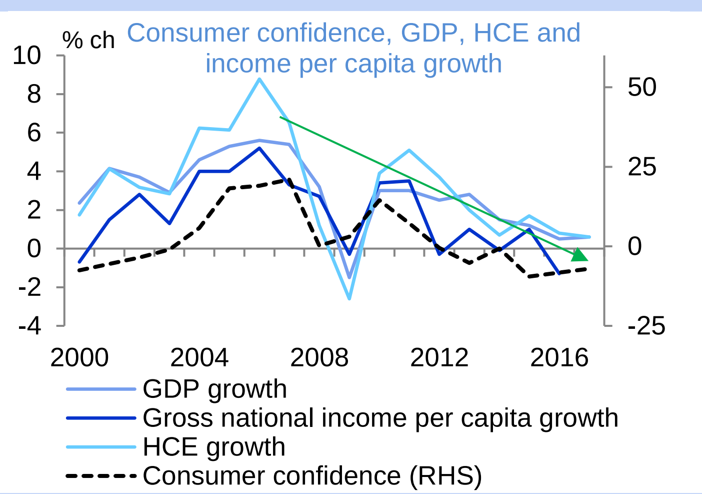
| Figure 3: Monetary Sector | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| Repo Rate (year-end: %) | 7.00 | 6.50 | 6.50 | 6.50 | 6.75 | 7.00 | 7.00 |
| Prime Overdraft Rate (%) | 10.50 | 10.00 | 10.00 | 10.00 | 10.25 | 10.50 | 10.50 |
| SA rand bond (%) | 9.02 | 8.77 | 8.50 | 8.40 | 8.60 | 8.50 | 8.65 |
| US Fed funds rate | 0.5-0.75 | 1.25-1.50 | 2.00-2.25 | 2.75-3.00 | 2.75-3.00 | 2.75-3.00 | 2.75-3.00 |
| UK Bank rate | 0.25 | 0.25 | 0.25 | 0.50 | 1.00 | 1.50 | 1.50 |

Source: Investec, SARB, IRESS

case of a steeper than anticipated hike in global interest rates between 2017 and 2022, is more likely (we ascribe a 35% probability - see figure 13), than the 19% ascribed probability of a global financial crisis and global recession. All other tables (figures 1, 3, 5, 7, 9 and 11 are forecasts of the expected case, which also has a 35% probability as per figure 13). The US is expected to raise interest rates by about 1.50% in its dot-plot trajectory, with markets anticipating a lower outcome of potentially a 75bp lift (see figure 2). The Federal Reserve Bank's FOMC is likely to be cautious in its rate hike trajectory due to growth and financial stability risks, while the outgoing Chair, Janet Yellen, could be replaced with a more dovish incumbent. The BIS reports that corporate credit spreads are low and covenant standards have eased, while "(t)he global volume of outstanding leveraged loans, as recorded by S&P Global Market Intelligence, reached new highs … (and) … the share of issues with covenant-lite features increased to nearly 75% from 65% a year earlier. Covenant-lite loans place few to no restrictions on the borrowers' actions and as such might signal a less discriminating attitude on the part of lenders while potentially fostering excessive risk-taking on the part of borrowers. According to Moody's, the covenant-lite share in the high-yield bond market also increased, while covenant quality declined to the lowest levels since Moody's started to record these numbers in 2011." The BIS also worries that "a growing share of firms face interest expenses exceeding earnings before interest and taxes … The share of such firms has risen especially sharply in the euro area and the United Kingdom".

Figure 4: Interest rates and Consumer confidence




Source: Reuters, Stats SA, SARB



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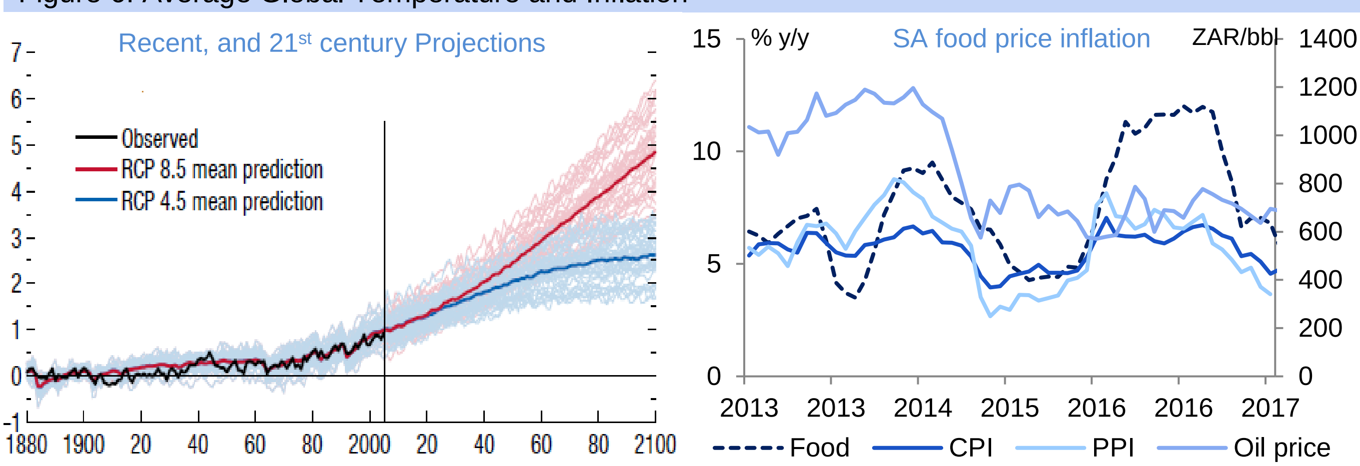
| Figure 5: Inflation | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| Consumer Inflation (Av: %) | 6.3 | 5.2 | 5.1 | 5.4 | 5.5 | 5.6 | 5.5 |
| *(year-end: %)* | *6.7* | *4.4* | *5.8* | *5.4* | *5.4* | *5.5* | *5.5* |
| Producer Inflation (Av: %) | 7.1 | 4.8 | 5.3 | 5.6 | 5.3 | 5.4 | 5.5 |
| *(year-end: %)* | *7.2* | *4.7* | *5.1* | *6.1* | *5.1* | *5.8* | *5.2* |
| Salary & wage increases (%) | 5.8 | 6.9 | 7.0 | 7.3 | 7.3 | 7.4 | 7.6 |

Source: Investec, SARB, Statistics SA

Equity markets and a number of non-financial corporates remain vulnerable globally to rising bond yields, and so market risks of a sharper global interest rate hike trajectory than currently factored into the markets.

On the domestic front, despite the expected normalisation of global interest rates, South Africa recently entered a shallow interest rate cut cycle which assisted the JSE, along with the lift in global bourses. The heavy weight that politics has in South Africa, and in particular the perceived frequent, conflicting political and economic policy proposals, especially populist ones, is seen to have negatively impacted sentiment, and so investment. Since 2015 South Africa experienced a net outflow of foreign holdings of SA equities as risks have been perceived to be heavily tilted to the downside. SA's repo rate is expected to see another 25bp cut this year, at the remaining MPC meeting (23rd November), although there is almost an equal chance of the cut failing to materialise as this current MPC's historical inclination to hawkishness is likely not far below the surface. The January 25bp cut in the repo rate we have penciled in is also at similar risk of failing to materialise. Inflation has been modest globally, and this could persist into next year, alongside rising global growth. However, SA will likely see CPI inflation bottoming before the start of the MPC's inflation targeting period of six to twelve/eighteen months, which in November 2017 will run from May/June 2018 out into 2019. In this inflation targeting period (which the SARB will base its interest rate decision on) CPI inflation is likely to lift back to 5.5% y/y and then remain around this long-run average inflation rate over the

Figure 6: Average Global Temperature and Inflation




Source: Stats SA, IMF, SARB



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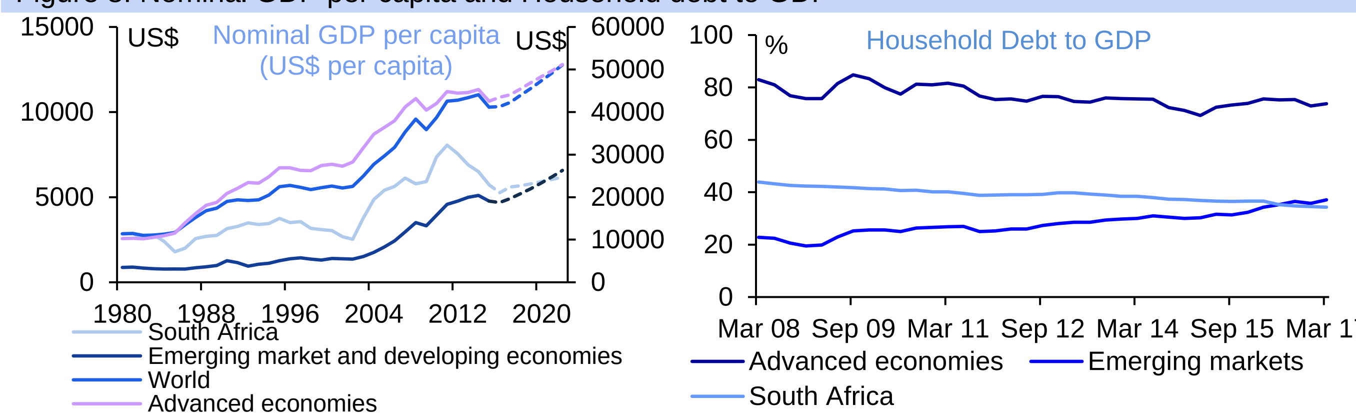
| Figure 7: Consumption Expenditure | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| HCE, total (real, %) | 0.8 | 1.1 | 1.4 | 1.9 | 2.0 | 2.1 | 2.2 |
| HCE as % of GDP | 60.6 | 60.9 | 61.0 | 61.1 | 61.3 | 61.4 | 61.5 |
| Unemployment rate (%) | 26.7 | 27.7 | 28.7 | 29.1 | 28.6 | 28.8 | 29.0 |
| Population (million) | 56.0 | 56.7 | 57.4 | 58.1 | 58.7 | 59.4 | 60.0 |
| Employment growth rate (%) | 0.4 | 0.3 | -0.1 | 0.4 | 1.5 | 0.5 | 0.7 |
| Compensation of employees (%) | 8.2 | 5.7 | 7.7 | 9.7 | 9.7 | 9.7 | 9.9 |
| GCE as % of GDP | 20.6 | 20.5 | 20.3 | 20.0 | 19.9 | 19.7 | 19.6 |

Source: Investec, SARB

forecast period. The remainder of this year, and the first quarter of 2018, will see the last of the beneficial effects of drought alleviation in key areas of the country filter through, while a significant electricity tariff increase is due mid-2018, and further substantial increases are expected further out, as well as from other administered prices such as water tariffs. The IMF finds that “(g)lobal temperatures have increased at an unprecedented pace over the past 40 years, and significant further warming could occur, ... (Furthermore) … increases in temperature have uneven macroeconomic effects, with adverse consequences concentrated in countries with relatively hot climates, ... (where) … a rise in temperature lowers per capita output, in both the short and medium term, by reducing agricultural output, suppressing the productivity of workers exposed to heat, slowing investment, and damaging health”. The IMF adds “the speed at which the climate has changed over the past 30–40 years appears to be unprecedented in the past 20,000 years…(see figure 6). … Most scientists agree that global temperatures are set to rise further, at a scale and pace very much dependent on our ability to restrain greenhouse gas emissions, the central cause of global warming … . Extreme weather events, such as heat waves, droughts, and floods, are likely to become more frequent, and sea levels will rise.” The IMF concludes “empirical evidence suggests that countries with better-regulated capital markets, higher availability of infrastructure, flexible exchange rates, and more democratic institutions recover somewhat faster from the negative impacts of temperature shocks. Higher temperatures also constrain growth in hot regions of emerging market and developing

Figure 8: Nominal GDP per capita and Household debt to GDP




Source: IMF, BIS

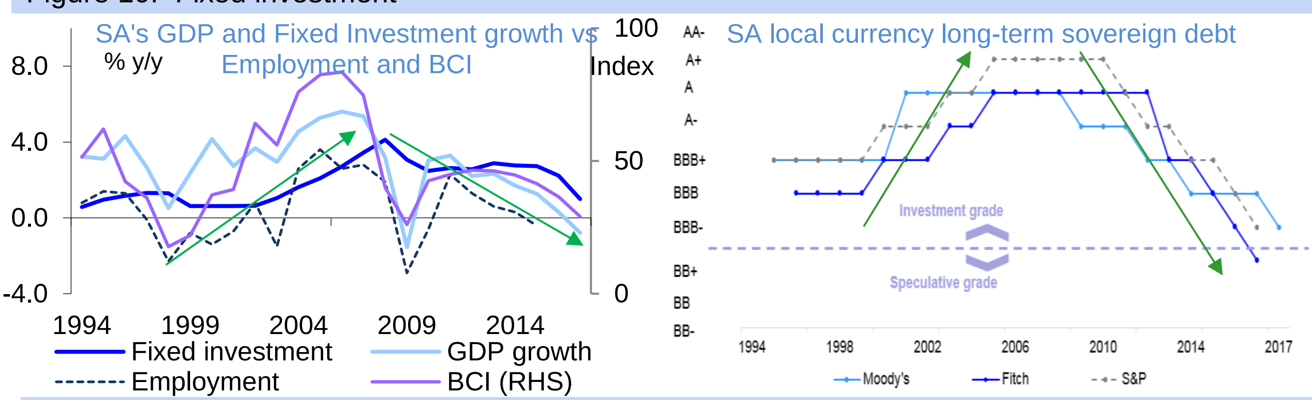
| Figure 9: Gross Fixed Capital Formation | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| GFCF, total (real, %) | -3.9 | -0.8 | 0.3 | 1.1 | 2.9 | 2.3 | 3.4 |
| GFCF as % of GDP | 20.0 | 19.7 | 19.5 | 19.4 | 19.6 | 19.7 | 20.0 |
| Private sector (real, %) | -6.8 | -1.6 | 0.8 | 2.6 | 3.8 | 3.1 | 3.4 |
| Government (real, %) | 0.9 | 0.4 | -0.5 | -1.1 | 1.5 | 0.9 | 3.4 |
| Non-residential GFCF (real, %) | -7.6 | -1.9 | 0.8 | 2.4 | 3.8 | 3.0 | 3.3 |
| Residential buildings (real, %) | -2.4 | 0.3 | 1.2 | 3.6 | 4.0 | 3.6 | 3.9 |

Source: Investec, SARB

economies significantly more than in hot regions of advanced economies, which corroborates the importance of development in reducing vulnerability. …The temperature increase projected by 2100 under a scenario of unmitigated climate change implies significant economic losses … . Under the conservative assumption that weather shocks have permanent effects on the level, rather than the growth rate, of per capita output, model simulations suggest that the per capita GDP of a representative low-income country would be 9 percent lower in 2100 than it would have been in the absence of temperature increases, with the present value of output losses amounting to more than 100 percent of current GDP when discounted at the growth-adjusted rate of 1.4 percent. … Adaptation strategies that reduce specific climate change effects and risks, such as targeted infrastructure projects, adoption of appropriate technologies, and mechanisms to transfer and share these risks through financial markets, could also be part of the toolkit for reducing the economic damage caused by climate change." For South Africa, the risk is additional as the economic growth path has weakened structurally while the population continues to expand meaningfully, which, combined with the other risks highlighted, places SA in danger of ultimately becoming a low income economy, if the low economic growth trend is not reversed.

South Africa's deterioration in its government finances since 2009, and the concomitant poor fiscal health of many major state owned entities, has required assistance from the government purse, placing pressure

Figure 10: Fixed investment




Source: SARB, Stats SA, Rating Agencies

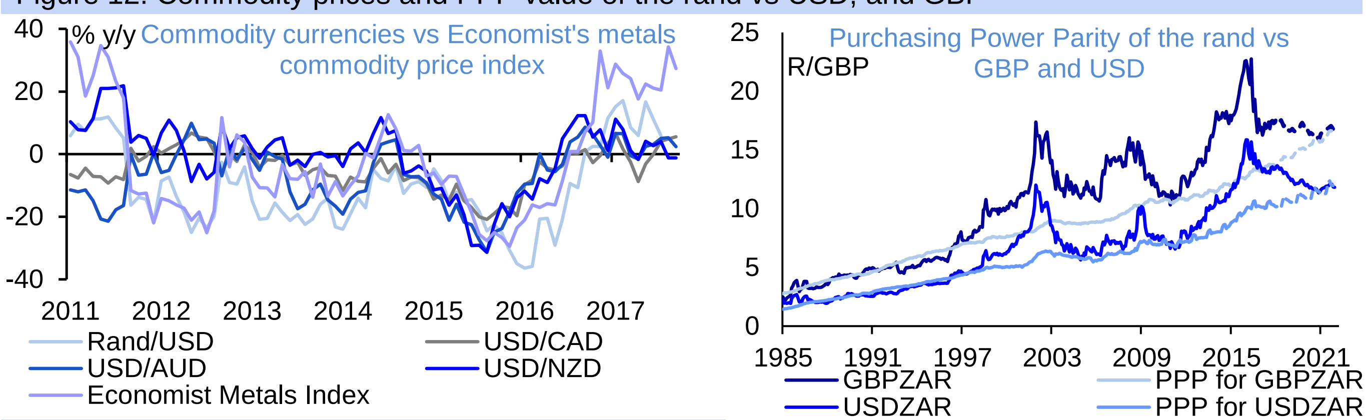
| Figure 11: Exchange Rates: averages | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| USD/ZAR | 14.68 | 13.25 | 13.21 | 12.28 | 11.73 | 11.86 | 12.28 |
| GBP/ZAR | 19.92 | 16.90 | 17.25 | 16.85 | 16.36 | 16.73 | 17.43 |
| EUR/ZAR | 16.26 | 14.73 | 15.29 | 14.50 | 14.01 | 14.50 | 15.22 |
| ZAR/JPY | 7.33 | 8.37 | 8.02 | 8.56 | 9.07 | 9.02 | 8.72 |
| GBP/USD | 1.36 | 1.28 | 1.31 | 1.37 | 1.40 | 1.41 | 1.42 |
| EUR/USD | 1.11 | 1.11 | 1.16 | 1.18 | 1.20 | 1.22 | 1.24 |
| USD/JPY | 109 | 111 | 106 | 105 | 106 | 107 | 107 |

Source: Investec, IRESS

not only on inflation, but also on SA's credit ratings (see figure 10). Rapidly rising country debt levels, particularly including the debt of the State's entities such as SAA, have led to concern from the rating agencies, and the October (25th) Medium-term Budget Policy Statement (MTBPS) will likely be closely watched in this regard for the country's debt and deficit forecasts. Our risk scenarios place a 54% weighting on the downgrade of SA's sovereign debt to sub-investment grade over the next five years, with a rising probability to 54% by 2022. The rand and domestic bond yields were to a significant extent shielded from this year's tranche of credit rating downgrades by the strong risk on in financial markets as foreign investors were heavy purchasers of EM debt globally. Net foreign purchases of R55.9bn have occurred year to date, with strong net foreign sell-off of domestic equity holdings.

The rand has traded in a tighter range in 2017 than it has done in some other years, ranging between a high in the year to date of R13.99/USD, R16.17/EUR, R18.32/GBP and a low of R12.30/USD, R13.29/EUR R15.32/GBP, with the lower volatility of the domestic currency likely having proved helpful to the JSE. In Q4.17 the rand has weakened to date due to USD strength on expectations of slightly higher US interest rates than previously factored in by the markets. Higher US interest rates than expected could lead other global interest rates to ultimately also move higher than currently factored into the markets. Looking forward for the rand, much will depend on the global growth and commodity cycle, with high risks of both

Figure 12: Commodity prices and PPP value of the rand vs USD; and GBP




Source: IRESS, Investec



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Figure 13: Economic Scenarios

| | | Q3.17 | Q4.17 | Q1.18 | Q2.18 | Q3.18 | Q4.18 | Q1.19 | Q2.19 |
|---|---|---|---|---|---|---|---|---|---|
| Extreme up Case **1%** | Rand/USD (average) | 13.15 | 11.70 | 10.60 | 9.50 | 8.60 | 7.90 | 7.60 | 7.40 |
| | Repo rate (end rate) | 6.75 | 6.50 | 6.00 | 5.50 | 5.00 | 5.00 | 5.00 | 4.50 |

Fast, sustainable economic growth of 5.0-7.0% y/y plus. SA sees change in political will with growth creating economic reforms in line with global norms that structurally lift private sector investor confidence and so fixed investment. Global growth boom (including commodities), SA export and domestic growth boom lifts employment and incomes to the degree that poverty is eliminated. Fiscal consolidation, credit rating upgrades to A grade ultimately, interest rate cuts.

| | | Q3.17 | Q4.17 | Q1.18 | Q2.18 | Q3.18 | Q4.18 | Q1.19 | Q2.19 |
|---|---|---|---|---|---|---|---|---|---|
| Up case **10%** | Rand/USD (average) | 13.15 | 12.60 | 12.20 | 11.80 | 11.50 | 11.20 | 10.50 | 10.55 |
| | Repo rate (end rate) | 6.75 | 6.50 | 6.50 | 6.25 | 6.25 | 6.00 | 5.50 | 5.50 |

Persistent economic growth of 3.0 – 5.0%, with growing probability of extreme up case thereafter. Better governance, growth creating economic reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability. This lifts business confidence and so private sector fixed investment growth rises to double digits, fixed investment inflows occur, resulting in faster GDP growth and fiscal consolidation. Strong global growth and commodity cycle. Stabilisation of credit ratings, with ultimately credit rating upgrades.

| | | Q3.17 | Q4.17 | Q1.18 | Q2.18 | Q3.18 | Q4.18 | Q1.19 | Q2.19 |
|---|---|---|---|---|---|---|---|---|---|
| Base line case **35%** | Rand/USD (average) | 13.15 | 13.45 | 13.60 | 13.40 | 13.05 | 12.80 | 12.45 | 12.10 |
| | Repo rate (end rate) | 6.75 | 6.50 | 6.25 | 6.25 | 6.25 | 6.50 | 6.50 | 6.50 |

Trend growth rate of 2.0% y/y, reached by 2023. Suppressed confidence and weak investment. Rand structurally weaker on downgrades so slower return to PPP (by 2020). SA retains two investment grade (IG) ratings on its local currency (LC) long-term sovereign debt this year. Sedate global monetary policy normalisation – avoid severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand.

| | | Q3.17 | Q4.17 | Q1.18 | Q2.18 | Q3.18 | Q4.18 | Q1.19 | Q2.19 |
|---|---|---|---|---|---|---|---|---|---|
| Down case **35%** | Rand/USD (average) | 13.15 | 16.00 | 18.00 | 19.00 | 19.50 | 18.50 | 17.80 | 16.90 |
| | Repo rate (end rate) | 6.75 | 7.00 | 7.50 | 8.25 | 9.00 | 10.00 | 10.50 | 10.50 |

SA's foreign and local currency long-term debt sub-investment grade, increased chance of further credit downgrades. Marked rand weakness, confidence and investment measures depressed. Government's capacity for expenditure reduced, including social welfare grants. Faster than expected global monetary policy normalisation, global sharp economic slowdown (commodity slump), and substantial period of risk-off (SA V shaped recession).

| | | Q3.17 | Q4.17 | Q1.18 | Q2.18 | Q3.18 | Q4.18 | Q1.19 | Q2.19 |
|---|---|---|---|---|---|---|---|---|---|
| Extreme down case **19%** | Rand/USD (average) | 13.15 | 17.00 | 19.00 | 21.00 | 22.80 | 24.00 | 25.50 | 26.00 |
| | Repo rate (end rate) | 6.75 | 8.00 | 10.00 | 13.00 | 15.50 | 17.00 | 19.00 | 22.00 |

State bankruptcy, and so the path to a failed state. Credit ratings drop to junk, sovereign debt default, debt restructure. Lack of funds to pay public sector employees' wages and social grants, persistent government services outages, civil unrest/war. Partial loss of commercial private sector property rights under state custodianship. SA economic depression, global economy falls into recession, global financial crisis.

**Note:** Event risk begins Q4.17 Source: Investec, IRESS

volatility and weakness, while further credit rating downgrades are a real risk to the domestic currency.



Annabel Bishop • Investec Bank Limited • Tel (2711) 286 7188 • email: ambishop@investec.co.za •
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