Investec

Economic outlook 2017 – 2022: South Africa's economic growth likely to remain below that of both sub-Saharan Africa and world growth

2nd Quarter 2017

12th May 2017

Figure 1: Summary, % real growth rates	2016	2017	2018	2019	2020	2021	2022
GDP (real, %)	0.3	0.8	1.3	1.6	1.8	2.0	2.2
HCE (real, %)	0.8	1.2	1.3	2.3	2.3	2.2	2.4
GCE (real, %)	2.0	0.9	0.0	0.4	1.1	1.1	1.2
GFCF (real, %)	-3.9	-0.9	0.0	1.7	3.2	2.6	3.0
GDE (real, %)	-0.7	0.9	0.9	1.7	2.1	2.2	2.3
Export (goods & non-factor services) - (real, %)	-0.1	4.3	4.0	3.7	5.5	5.1	4.3
Imports (goods & non-factor services) - (real, %)	-3.7	2.1	3.1	4.1	6.1	5.6	5.6
Balance: Current Account - (% of GDP)	-3.3	-2.8	-3.4	-3.0	-3.4	-3.5	-3.8
							Source: SARB, Investec

Incoming data for H2.17 is evidencing that while sub-Saharan Africa continues to experience subdued growth on the commodity price effect, globally economic activity is picking up, but structural impediments in many sub-Saharan countries, South Africa included, will limit the lift gained from the (modest) global upswing. While commodity prices have recovered to some extent, many commodity exporters are reported to be finding commodity price levels still insufficient and government debt levels have been rising, particularly in sub-Saharan countries where this has increased uncertainty and so negatively impacted investment. South Africa suffered from a contraction in investment last year, and government gross debt has escalated from 22% of GDP in 2008/09 to 45.7% of GDP in 2016/17. Uncertainty has risen too on the political and economic policy front with SA currently seeing its key credit ratings split between investment grade (IG) and sub-investment grade (SG). Moody's and S&P have SA local currency (LC) long-term sovereign debt (LSD) on investment grade, while Fitch has it on SG. SA's foreign currency (FC) LSD is IG from only Moody's, while Fitch and S&P have it on SG. This three/three split will likely persist after Moody's country review of SA, as the agency is expected to move its LC and FC LSD ratings down by only one notch (still IG). SA bonds would then not fall out of the WGBI, with likely little further impact on the rand from this source this year. However, with country reviews from Fitch and S&P twice a year at least, and the possibility of ratings changes between scheduled reviews, the possibility of further downgrades cannot be

Figure 2: Sub-Saharan Africa: Real GDP growth									
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Sub-Saharan Africa	**7.0**	**5.0**	**4.3**	**5.3**	**5.1**	**3.4**	**1.4**	**2.6**	**3.5**
Of which:									
Oil-exporting countries	9.2	4.7	3.9	5.7	5.9	2.6	-1.4	0.9	2.0
Of which: Nigeria	11.3	4.9	4.3	5.4	6.3	2.7	-1.5	0.8	1.9
Middle-income countries	6.9	4.5	4.3	4.7	4.6	2.7	0.5	1.8	2.8
Of which: South Africa	3.0	3.3	2.2	2.5	1.7	1.3	0.3	0.8	1.6
Low-income countries	7.2	6.9	4.5	7.2	6.8	5.6	4.4	5.2	5.6
World economic growth	**5.4**	**4.2**	**3.5**	**3.4**	**3.5**	**3.4**	**3.1**	**3.5**	**3.6**
									Source: IMF, World Economic Outlook database

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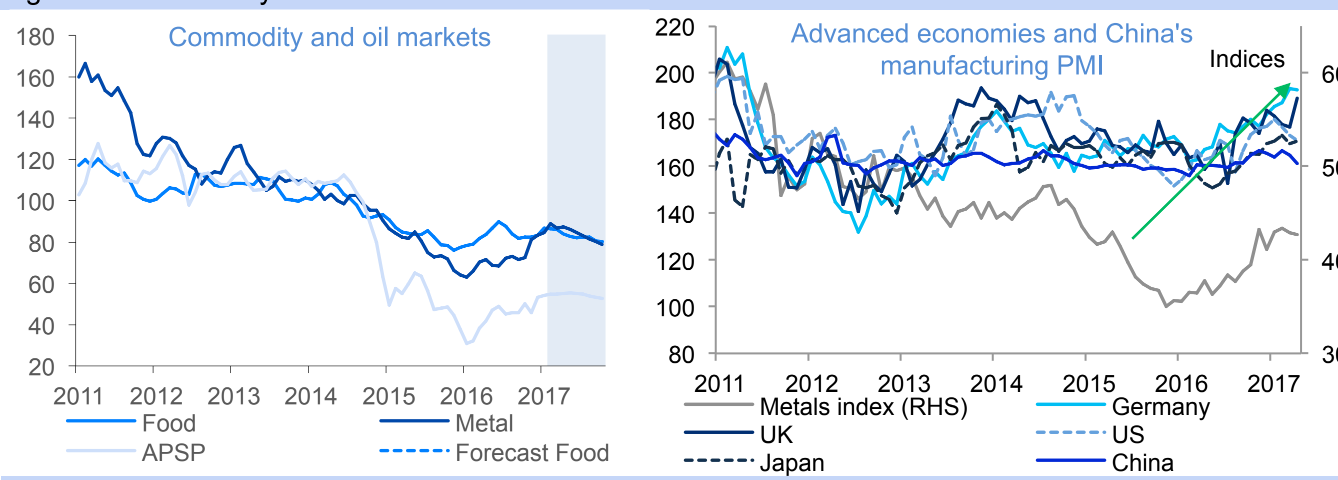
Figure 3: Consumption Expenditure	2016	2017	2018	2019	2020	2021	2022
HCE, total (real, %)	0.8	1.2	1.3	2.3	2.3	2.2	2.4
HCE as % of GDP	60.6	60.9	60.9	61.2	61.5	61.7	61.8
Unemployment rate (%)	26.9	27.4	27.8	28.2	28.5	28.5	28.9
Population (million)	55.0	55.4	55.9	56.3	56.7	57.0	57.4
Employment growth rate (%)	0.3	0.0	0.6	0.3	0.6	0.8	0.2
Compensation of employees (%)	7.8	6.3	7.8	8.8	9.3	9.6	9.6
GCE as % of GDP	20.6	20.6	20.3	20.1	20.0	19.8	19.6

Source: Investec, SARB

excluded, which has heightened uncertainty. We ascribe a 35% weighting to this down case of further credit rating downgrades (see "Risk update", 9th May 2017, website address below), and a 35% weighting to the expected case detailed on page one. With the WGBI holding a large amount of SA's LC (local currency) LSD (long-term sovereign debt) the rand could weaken substantially if this Citibank fund has to sell its South African bonds (LC LSD), given the large size of its holdings. The rand and bond yields were to a significant extent shielded from April's credit rating downgrades by the strong risk on in financial markets as foreign investors were heavy purchasers of EM debt globally. Looking forward for the rand, much will depend on the global cycle, with the domestic currency at high risk of volatility, and weakness in particular from further credit rating downgrades and/or a risk-off global environment.

Expansionary fiscal policy in the US is still expected to drive growth, while the European recovery continues, with manufacturing activity and trade improvements of 2016 still noted globally, and indications that this persisted into H2.17 (see figure 4). The feed through into investment and imports is expected to

Figure 4: Commodity and oil markets and advanced economies PMI's



Source: IMF WEO April 2017 and Bloomberg/Economist

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*APSP = average petroleum spot price

Figure 5: Monetary Sector	2016	2017	2018	2019	2020	2021	2022
Repo Rate (year-end: %)	7.00	7.00	7.25	7.25	7.25	7.25	7.25
Prime Overdraft Rate (%)	10.50	10.50	10.75	10.75	10.75	10.75	10.75
SA rand bond (%)	9.02	8.81	8.71	8.69	8.79	8.91	9.00
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

persist, strengthening global economic activity. However the slowdown in China and moderation in commodity prices has impacted emerging market growth, with only a modest pick-up expected. In sub-Saharan Africa a lift in growth is expected as well (see figure 2), with SA's pick-up in growth more modest. Commodity prices are generally expected to rise this year and next, but only modestly, and not reaching the heights of 2011 (see figure 4).

In this modest global growth environment (see figure 2), with only a gentle upward trend in commodity prices, commodity exporters cannot expect a substantial boost to economic growth from this source. Rising government debt levels will need to be reined in, with SA receiving a credit rating downgrade this year on its escalation in debt to GDP since 2009 in a declining growth environment (with substantial contingent liabilities on its balance sheet from the guarantees to its state owned entities). The credit rating downgrade is not expected to precipitate an interest rate hike this year, with the impact on the rand and bonds proving limited in the global risk-on period. The FRA curve is flat to down this year while the US is expected to hike by two to three 25bp increments in 2017. CPI inflation is expected to moderate in SA this year, and

Figure 6: Interest rates

FOMC interest rate expectations

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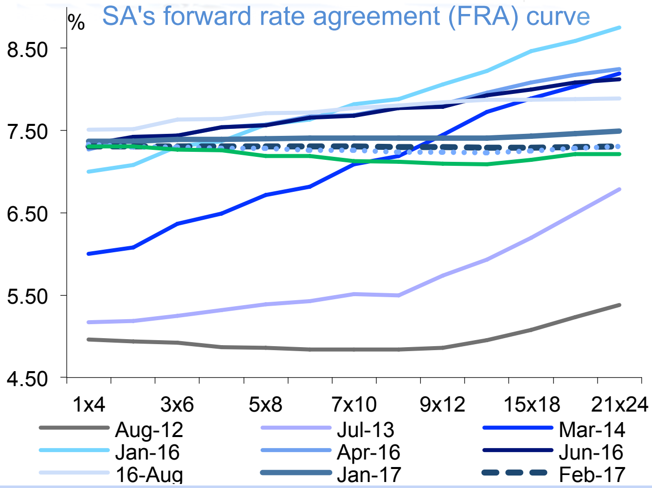

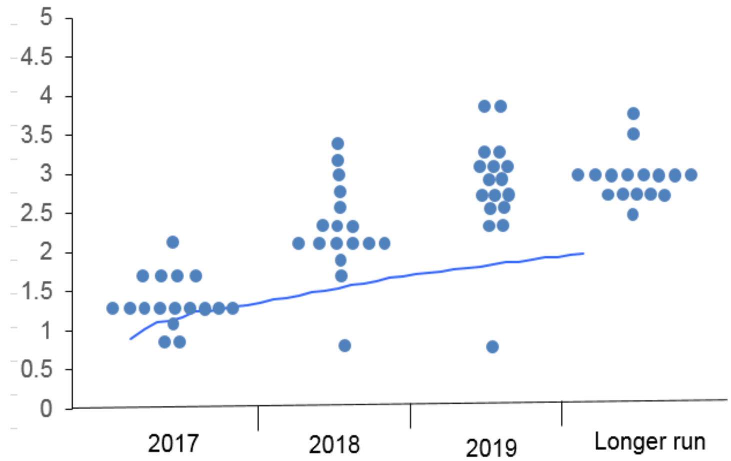

Source: Reuters, Federal Reserve Bank

Figure 7: Inflation	2016	2017	2018	2019	2020	2021	2022
Consumer Inflation (Av: %)	6.3	5.6	5.3	5.4	5.5	5.6	5.5
(year-end: %)	*6.7*	*4.9*	*6.0*	*5.4*	*5.4*	*5.5*	*5.5*
Producer Inflation (Av: %)	7.1	5.2	5.4	5.5	5.3	5.4	5.5
(year-end: %)	*7.2*	*4.8*	*6.1*	*5.2*	*5.4*	*5.2*	*5.8*
Salary & wage increases (%)	7.9	6.9	7.0	7.1	7.2	7.3	7.3

Source: Investec, SARB, Statistics SA

next year as food prices moderate and demand pressures remain weak in the economy as economic growth remains below trend until 2022.

The fall in fixed investment (GFCF) in South Africa in 2016 (see table 1) was driven by state owned entities and the private sector, with growth in government investment slowing down sharply. The IMF says "(r)ising public sector debt is becoming a cause for concern in sub-Saharan Africa … the ratio of public debt to GDP has increased … to an average of 42 percent of GDP in 2016 (and a median of 51 percent). This is the highest value since many countries received debt relief in the 2000s under the Heavily Indebted Poor Countries/Multilateral Debt Relief Initiative." SA's fiscal constraints have led to lower investment growth for government and SOE's, with the bulk of state expenditure focused on social services and civil servant remuneration, while the country continues to run a primary deficit. At 46% of GDP SA's debt to GDP ratio is similar to the debt to GDP ratio inherited by the ANC tripartite alliance in 1994 with the advent of democracy, when the fiscal deficit for national government was close to 7% of GDP. At that time SA's credit ratings were sub-investment grade. The IMF notes "prudent fiscal policies play a special role in

Figure 8: Inflation and the consumer

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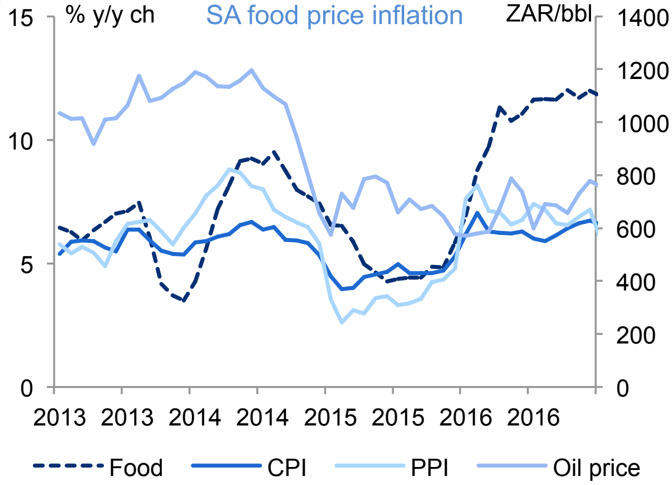
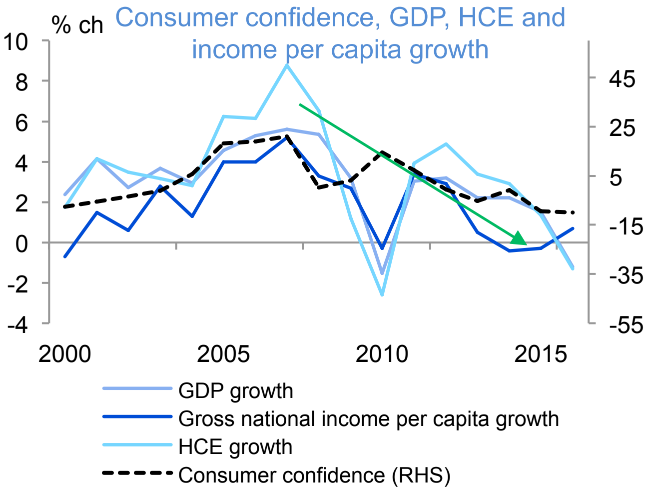




Source: Stats SA, SARB

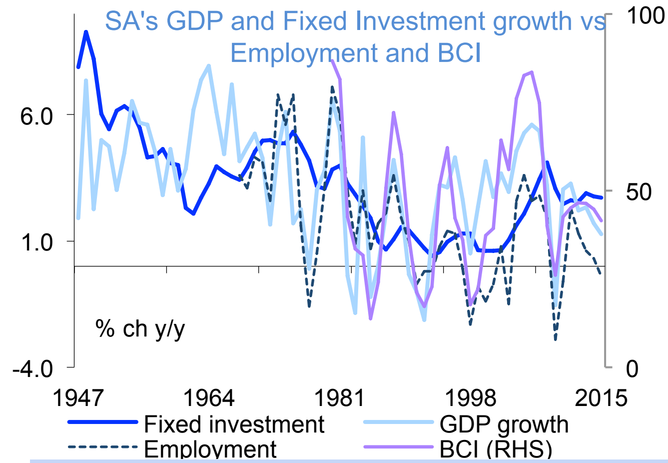
Figure 9: Gross Fixed Capital Formation	2016	2017	2018	2019	2020	2021	2022
GFCF, total (real, %)	-3.9	-0.9	0.0	1.7	3.2	2.6	3.0
GFCF as % of GDP	20.0	19.7	19.4	19.4	19.7	19.8	20.0
Private sector (real, %)	-6.0	-0.8	0.1	2.7	4.2	3.1	3.3
Government (real, %)	-0.3	-1.1	-0.1	0.1	1.5	1.8	2.4
Non-residential GFCF (real, %)	-6.6	-0.9	0.2	2.7	4.3	3.1	3.3
Residential buildings (real, %)	-2.4	-0.3	-0.3	2.9	3.8	3.4	3.8

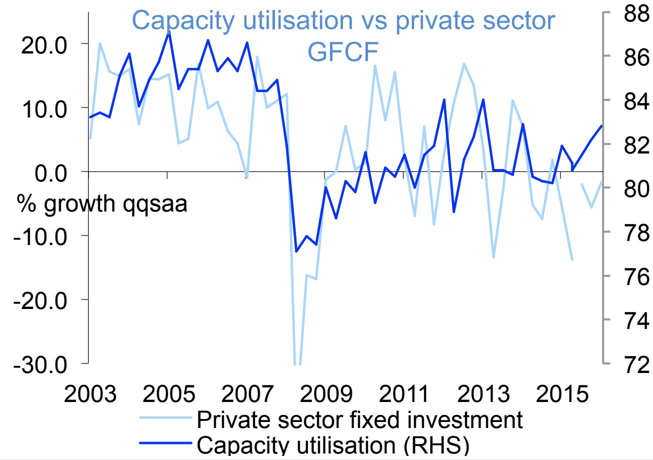
Source: Investec, SARB

sustaining growth spells in sub-Saharan Africa: a better fiscal balance significantly increases the chance that a growth spell will continue, while conversely, a higher debt burden can accelerate its end. …In particular, … a lower debt-to-GDP ratio tend to prolong growth spells in the (sub-Saharan African) region." The IMF adds currently that "(w)eakening commodity exports, the ensuing sharp slowdown in economic activity, and the build-up of government payment arrears to contractors are all restricting private firms' capacity to service their loans to various degrees across the region."

Business confidence has essentially remained at depressed levels since 2009, with an average of 59% of business dissatisfied with business conditions. The close link to fixed investment has shown a contraction in private sector investment over the period. Heightened uncertainty, reflected in poor confidence levels leads to lack of investor appetite, as does anaemic domestic demand. Industrial production is expected to be weak, but positive over the forecast period of 2017 to 2021 Consumer confidence has been very weak over the period, with gross national income per capita falling in real terms in 2016, both of which have subdued real household consumption expenditure (HCE), and so GDP growth.

Figure 10: Fixed investment





Source: SA Reserve Bank, BER, Stats SA

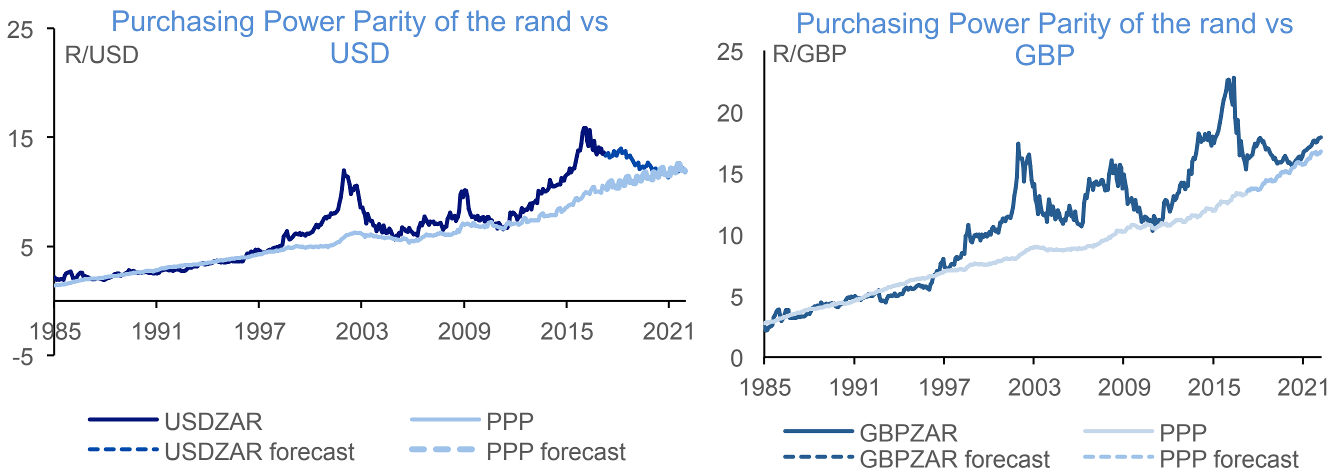
Figure 11: Exchange Rates: averages	2016	2017	2018	2019	2020	2021	2022
USD/ZAR	14.68	13.37	13.41	12.38	11.79	11.91	12.38
GBP/ZAR	19.92	17.22	18.13	17.06	16.44	16.80	17.57
EUR/ZAR	16.26	14.64	15.52	14.62	14.09	14.56	15.35
ZAR/JPY	7.33	8.19	7.88	8.49	9.02	8.98	8.65
GBP/USD	1.36	1.29	1.35	1.38	1.40	1.41	1.42
EUR/USD	1.11	1.10	1.16	1.18	1.20	1.22	1.24
USD/JPY	109	110	106	105	106	107	107

Source: Investec, IRESS

With Moody's still to review SA's country credit LC and FC ratings, but likely to keep them IG, it will be December's country reviews which could have a ratings impact on the rand, unless further political disturbances this year promote another round of downgrades. A more gradual trajectory than previously is likely in the return to PPP, given the recent downward trend in credit ratings. The rand could therefore reach PPP in 2020, where PPP valuation will then be closer to R11.50/USD. Loss of another investment grade local currency long-term sovereign credit rating would delay the return to PPP further, while loss of all investment grade local currency long-term sovereign credit ratings would mean the rand would be unlikely to return to PPP. Unless otherwise stated all views in this document are of the baseline case.

South Africa has lost growth momentum, with the economy in a downward growth trend over the past several years. Economic growth of around 1.0% y/y is insufficient to prevent further credit rating downgrades, particularly if government debt to GDP ratios do not fall and there is insufficient SOE reform. The agencies also point to concerns on GDP per capita and the possibility of future government policies undermining economic or fiscal strength - the latter weakening business confidence.

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



Source: IRESS, Investec

Figure 13: Sub-Saharan country credit ratings – local currency long term

	S & P	Moody's	Fitch
South Africa	BBB-	Baa2	BB+
Angola	B	B1	B
Botswana	A-	A2	NR
Burkina Faso	B-	NR	NR
Cameroon	B	B2	B
Democratic Republic of Congo	B-	B3	NR
Republic of Congo	B-	B3	CCC
Ethiopia	B	B1	B
Gabon	NR	B1	B+
Ghana	B-	B3	B
Kenya	B+	B1	B+
Lesotho	NR	NR	B+
Nigeria	B	B1	B
Malta	A-	A3	A
Mozambique	B-	Caa3	CC
Namibia	NR	Baa3	BBB-
Rwanda	B	B2	B+
Uganda	B	B2	B+
Zambia	B	B3	B

Source: Bloomberg

Note: Ratings of BBB- and above are investment grade

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Figure 14: Sub-Saharan country credit ratings – foreign currency long term

	S & P	Moody's	Fitch
South Africa	BB+	Baa2	BB+
Angola	B	B1	B
Botswana	A-	A2	NR
Burkina Faso	B-	NR	NR
Cameroon	B	B2	B
Cape Verde	B	NR	B
Democratic Republic of Congo	B-	B3	NR
Republic of Congo	B-	B3	CCC
Ethiopia	B	B1	B
Gabon	NR	B1	B+
Ghana	B-	B3	B
Kenya	B+	B1	B+
Lesotho	NR	NR	B+
Nigeria	B	B1	B+
Malta	A-	A3	A
Mozambique	na	Caa3	na
Namibia	NR	Baa3	BBB-
Rwanda	B	B2	B+
Uganda	B	B2	B+
Zambia	B	B3	B

Source: Bloomberg

Note: Ratings of BBB- and above are investment grade

Figure 15: Credit ratings

S & P	Moody's	Fitch
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA

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Investment grade	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Speculative grade	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC+	Caa1	CCC
	CCC	Caa2	CC
	CCC-	Ca3	C
	CC	Ca	RD
	C	C	D
	D	WR	WD
	NR		PIF

Source: Bloomberg

Figure 16: Economic Scenarios

		Q1.17	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18
Extreme up	Rand/USD (average)	13.22	13.45	11.30	10.60	9.50	8.70	8.20	7.90
Case 1%	Repo rate (end rate)	7.00	7.00	6.75	6.50	6.00	5.50	5.00	5.00

Fast, sustainable growth of 5-7% y/y plus. End of threat to private sector property rights, pro

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private sector business (capitalist) policies bring certainty to investor climate, business confidence booms, employment rises markedly. Global growth (including commodity boom) and SA export boom that substantially lifts employment and incomes, eventually eliminating poverty. Credit rating upgrades occur, interest rate cuts. Currency appreciation shock.

		Q1.17	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18
Up case **10%**	Rand/USD (average)	13.22	13.45	12.60	12.50	12.40	11.90	11.50	11.20
	Repo rate (end rate)	7.00	7.00	7.00	6.50	6.50	6.50	6.00	6.00

Persistent economic growth of 3-5% on domestic economic reforms (structural constraints are overcome), strong global growth and upwards commodity cycle. Better governance, retreat from the threat to private sector property rights. Stabilisation of credit ratings on fiscal consolidation. Rand strengthens back toward PPP (reach PPP by 2020).

		Q1.17	**Q2.17**	**Q3.17**	**Q4.17**	**Q1.18**	**Q2.18**	**Q3.18**	**Q4.18**
Base line case **35%**	Rand/USD (average)	13.22	13.45	13.25	13.55	13.85	13.65	13.25	12.90
	Repo rate (end rate)	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.25

Trend growth rate of 2.0% y/y, reached by 2022. Recent downgrades subdue confidence, growth somewhat, structural constraints. Rand structurally weaker 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.

		Q1.17	**Q2.17**	**Q3.17**	**Q4.17**	**Q1.18**	**Q2.18**	**Q3.18**	**Q4.18**
Down case **35%**	Rand/USD (average)	13.22	13.45	16.90	18.00	19.00	19.50	19.00	18.50
	Repo rate (end rate)	7.00	7.00	7.75	8.00	9.00	9.50	10.00	10.50

All three key agencies rate SA's sovereign foreign **and local** currency long-term debt sub-investment grade. Higher borrowing costs increase the cost of repaying debt, increase the chance of further credit downgrades. Upwards pressure on interest rates, rand weakness on loss of investor confidence, inflation shock, SA portfolio assets sold, capital exits, business confidence and investment depressed. Government's capacity for expenditure reduced, including existing social welfare grants. Significant strike action. Global growth slow down.

		Q1.17	**Q2.17**	**Q3.17**	**Q4.17**	**Q1.18**	**Q2.18**	**Q3.18**	**Q4.18**
Extreme down case **19%**	Rand/USD (average)	13.22	13.45	17.00	21.00	22.30	24.00	25.50	27.00
	Repo rate (end rate)	7.00	7.00	8.50	10.50	14.00	16.50	18.00	21.00

State bankruptcy (failed state) - lack of funds to pay social grants and civil servants wages, civil unrest and civil war. Persistent electricity, water, government services outages. Full loss of private sector property rights under nationalisation but majority of capital already exited under formal private sector disinvestment. Business confidence at record low. Persistent depression – L shaped. Downward spiral of a debt trap results in debt default, and so sovereign debt restructure and haircuts on sovereign debt.

Note: Event risk begins Q3.17 **Source:** Investec, IRESS

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