Economic review and outlook

Q3 2018

Annabel Bishop
Tel: (2711) 286 7188
annabel.bishop@investec.co.za
http://www.investec.co.za/research-and-insights/economy/economic-research-v1.html

Introduction

Introduction: global growth continues to strengthen, and …

Over half of the world's economies are experiencing faster economic growth on the back of an improvement in trade and investment (as per World Bank data), while unemployment in key developed economies (US, Japan, Europe) is declining. Developed economies' monetary policy is generally accommodatory, and is not expected to be tightened, but return to neutral levels instead as inflation pressures are expected to emerge.

However, global market risk-off has escalated as the transition to neutral US interest rates has become more advanced. A number of EM interest rate hikes are now occurring, essentially to increase the attractiveness of interest rate differentials between emerging markets and developed economies. South Africa is unlikely to see any further interest rate cuts in the current risk-off period.

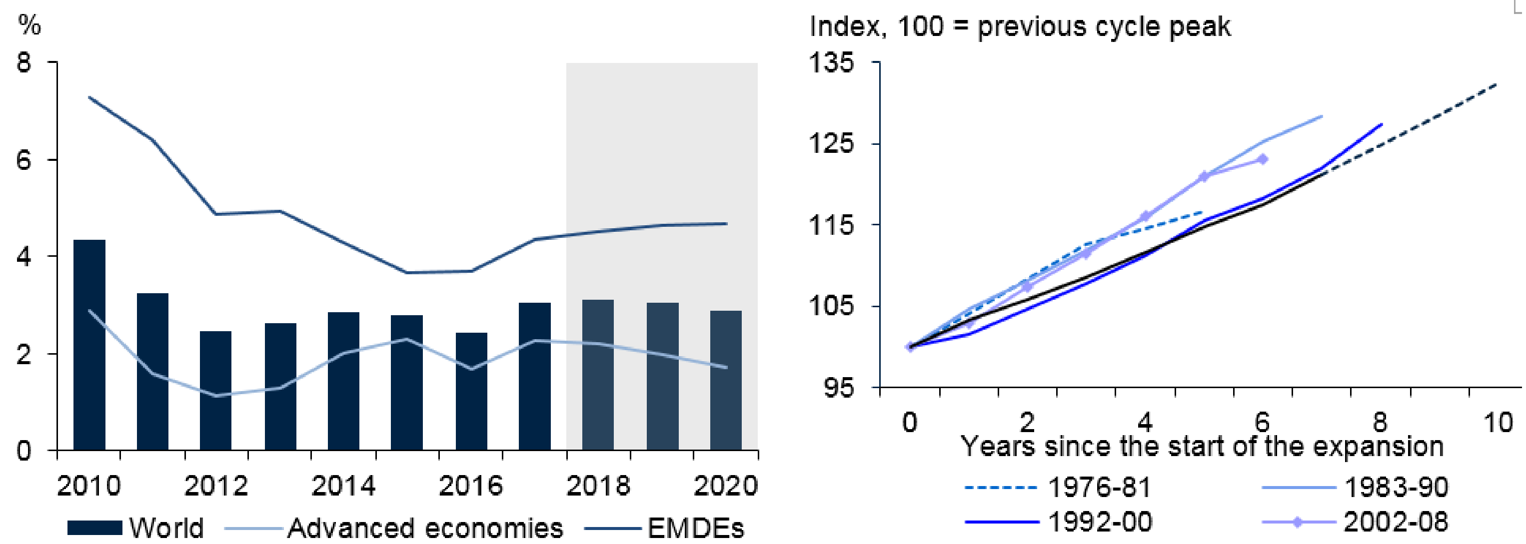
South Africa saw three quarters of growth averaging 2.8% y/y last year, up from 0.6% y/y the year before, on the recovery from severe drought and the rise in global growth, and so in the commodity cycle. While Q1.18 saw GDP fall by 2.2% qqsaa, such a weak GDP outcome is not generally expected to be sustained into Q2.18 (i.e. a recession materialize) as Q1.18's contraction was largely due to base effects following strong growth at the end of 2017.

South Africa has seen its competitiveness and institutional strengths deteriorate substantially in the past few years, as has its credit ratings, to an average of sub-investment grade from the three key credit rating agencies. The governance of the SOEs and state institutions also deteriorated substantially in the past several years, as did the health of government finances, depressing business confidence over the entire period. Real household income growth and the efficacy of corporate boards also deteriorated and corruption proliferated. The IMF warns that economic growth in SA will not lift beyond 2% in the absence of resolving uncertainties surrounding land expropriation without compensation and outstanding structural reforms.

Unless otherwise stated all views in this document are of the baseline (expected) case – all forecasts are subject to changes – please see disclaimer.

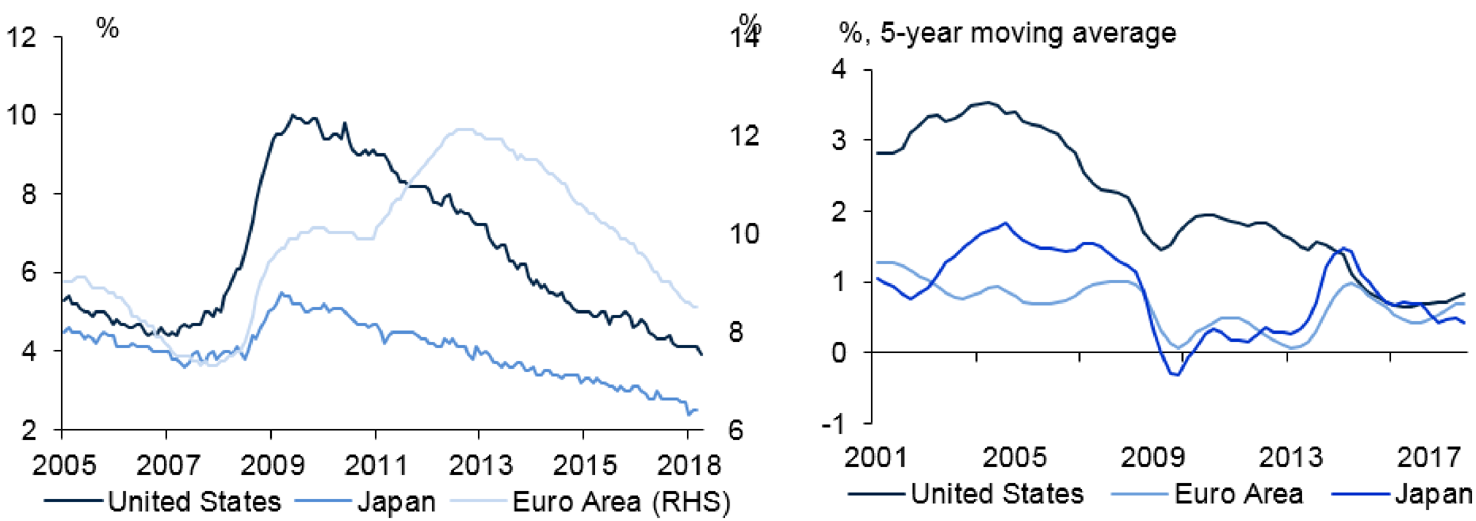
… unemployment decline, particularly in advanced economies, while ...

Global growth and Global GDP during expansion periods



Source: World Bank Global Economic Prospects June 2018

Unemployment rate and productivity growth in major advanced economies

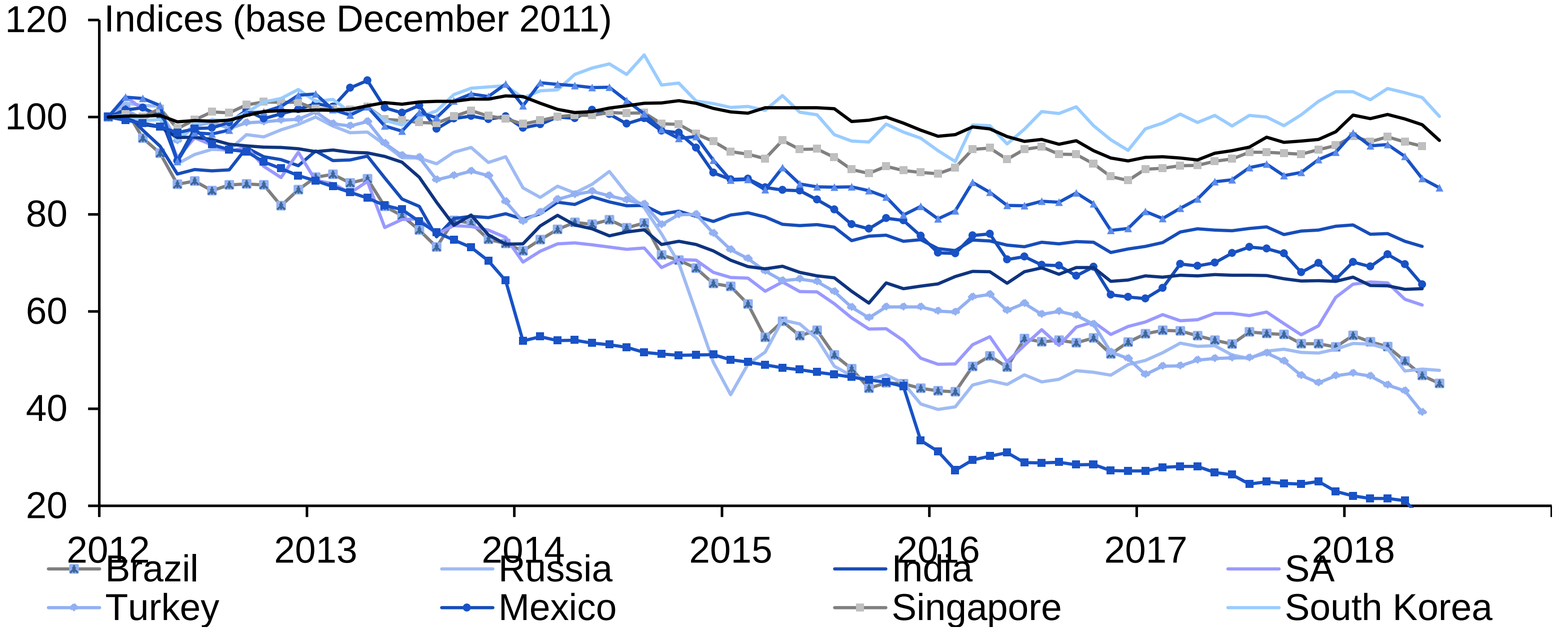


Source: World Bank Global Economic Prospects June 2018

… increased global risks are seeing weakness for emerging market (EM) currencies, as ...

- The rand recently weakened materially in Q2.18 on the surge in global risk-off (including this year's market recalibration to expected higher US interest rates), as foreigners sold a substantial amount of SA's portfolio assets.
- Emerging markets in general experienced marked portfolio outflows, causing their currencies to weaken, but for the rand this weakness was particularly marked, following substantial portfolio inflows in Q1.18, which were then more than reversed.
- Furthermore, the rand is very liquid, and SA's deep, sophisticated financial markets also make the rand an attractive proxy for EM currency sell-offs.
- The domestic currency will remain vulnerable to global investor sentiment for the rest of the period.

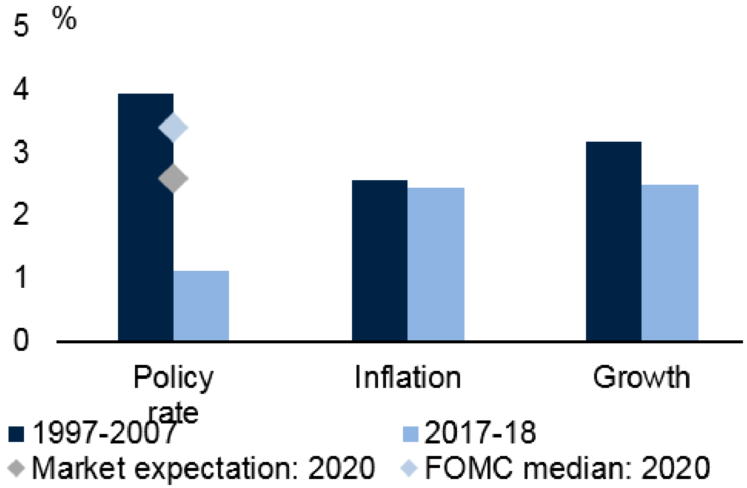
Volatility index for emerging market currencies

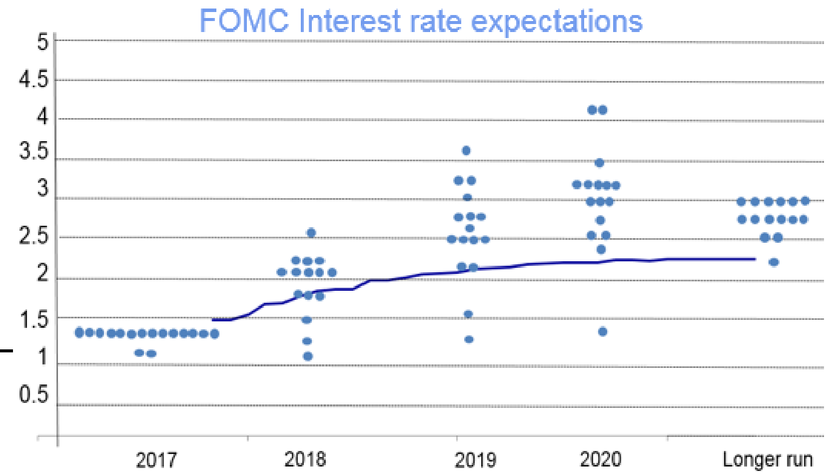


Source: Iress, Investec

… expected higher inflation prompts interest rate increases in the US.

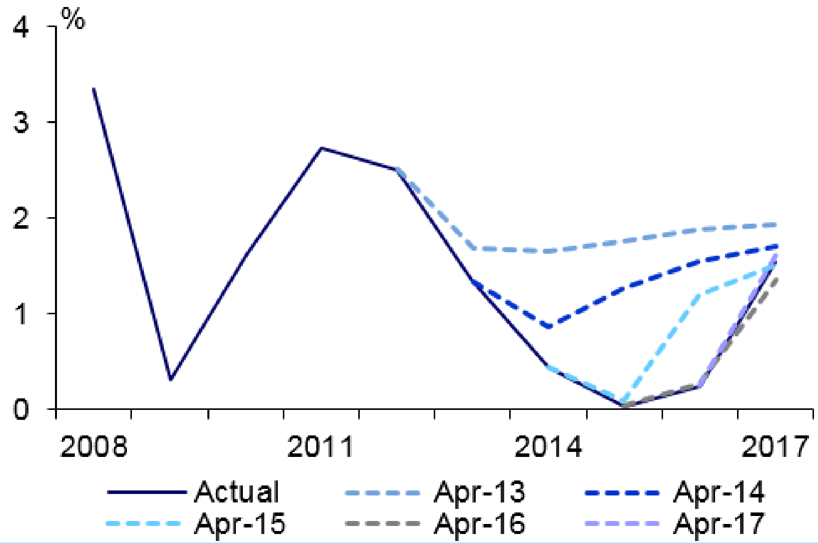
US policy interest rates, inflation and growth and FOMC interest rate expectations

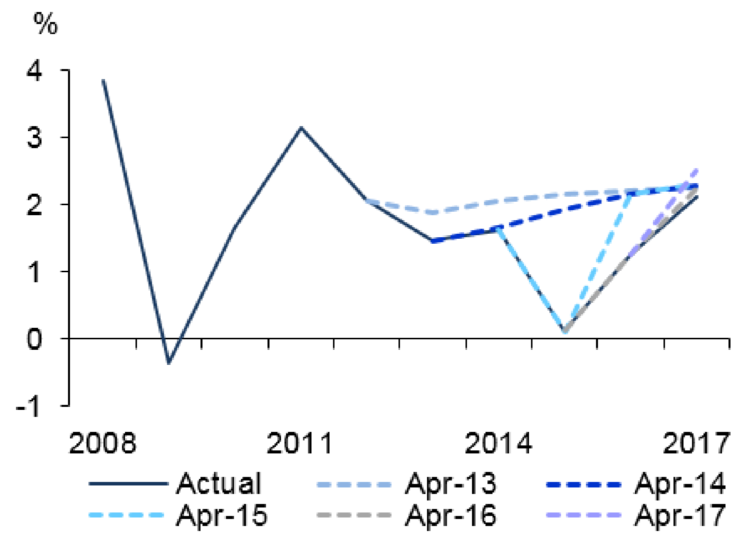




Source: World Bank Global Economic Prospects June 2018 and US Federal Reserve Bank

Euro area consensus inflation forecasts (graph on left) and U.S. consensus inflation forecasts





Source: World Bank Global Economic Prospects June 2018

However, SA's economic growth remains insufficient and unemployment high.

- South Africa got off to a weak start in 2018, as GDP growth contracted by -2.2% qqsaa in Q1.18, (quarter on quarter, seasonally adjusted, annualised) leading to concerns of a recession.
- While a recession is not expected, Q2.18 has also got off to a weak start, with industrial production contracting by close to -11% qqsaa for the three months to May.
- Additionally, in Q2.18 business confidence fell towards 2017's average of 35 (2017 was the worst year since 2009), which is reflective of the impact that the weakening of SA's fundamentals from 2009 to end 2017 has had, and still has.
- The damage to business confidence has not yet been repaired, while recent sharply higher petrol prices, rand weakness, broad scale substantial consumer tax increases and the announced, but still not explained, EWC (expropriation without compensation) have contributed to lower confidence levels in Q2.18.
- Lower confidence indicates a likely lower GDP growth outcome for 2018.
- We have lowered our GDP growth forecast for 2018, to 1.4% y/y, from 1.8% y/y.

Summary, % real growth rates	2017	2018	2019	2020	2021	2022	2023	2024
GDP (real, %)	1.3	1.4	1.9	2.2	2.4	2.6	2.8	2.9
HCE (real, %)	2.2	2.0	2.0	2.5	2.7	2.9	3.0	3.0
GCE (real, %)	0.6	1.2	1.3	1.3	1.4	1.4	1.4	1.4
GFCF (real, %)	0.4	0.8	1.5	3.5	3.3	3.9	4.6	4.6
GDE (real, %)	1.8	2.0	1.8	2.4	2.6	2.9	3.0	3.1
Export (goods & non-factor services) - (real, %)	-0.1	3.3	3.8	6.3	5.7	5.1	5.2	5.1
Imports (goods & non-factor services) - (real, %)	1.9	3.2	3.3	6.5	5.7	5.1	5.2	5.1
Balance: Current Account - (% of GDP)	-2.5	-3.4	-2.9	-2.9	-3.0	-3.0	-3.0	-3.1
Imports as % of GDP	30.3	30.8	31.3	32.5	33.6	34.4	35.2	36.0
Exports as % of GDP	29.3	29.8	30.4	31.6	32.6	33.4	34.2	34.9

Economic Scenarios – note updated probabilities

Extreme Up case **1%**		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
	Rand/USD (average)	11.96	12.65	10.75	10.00	9.50	9.00	8.60	7.90
	Repo rate (end rate)	6.50	6.50	6.00	5.50	5.25	5.00	5.00	5.00

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 (individuals obtain title deeds to land they live on (EWC) without disruption to economy). Fiscal consolidation, credit rating upgrades to A grade.

Up case **10%**		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
	Rand/USD (average)	11.96	12.65	11.15	10.70	10.50	10.50	10.30	10.25
	Repo rate (end rate)	6.50	6.50	6.25	6.00	5.50	5.50	5.25	5.25

Persistent growth of 3.0 – 5.0%, higher probability of extreme up case. Better governance, growth creating reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability, individuals obtain title deeds to land they live on (EWC) without disruption to economy. High business confidence, fixed investment growth in double digits, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base line case **45%**		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
	Rand/USD (average)	11.96	12.65	13.20	12.70	12.50	12.30	12.35	12.25
	Repo rate (end rate)	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00

Annual growth rate of 2.0% y/y reached by 2019, 3.0% y/y by 2024. Higher confidence and investment levels than past decade, limited impact of EWC/expropriation without compensation (to abandoned and unused land of government and agricultural sector – individuals are new owners and receive title deeds). Rand structurally stronger, returns to PPP by 2020. SA retains one investment grade (Moody's) rating on its local currency 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.

Down case **30%**		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
	Rand/USD (average)	11.96	12.65	15.00	15.90	17.00	17.90	18.60	19.60
	Repo rate (end rate)	6.50	6.50	7.00	7.50	8.00	8.50	8.50	8.50

Partial expropriation of (certain groups') private commercial sector property (including productive land) without compensation, plus wide scale land grabs, title deeds not transferred to individuals. Confidence and investment depressed, marked rand weakness, significant strike action and load shedding. SA sub-investment grade, increased chance of further credit downgrades. Faster than expected global monetary policy normalisation, global sharp economic slowdown (commodity slump), escalation of US-China trade war, short global financial crisis (SA V shaped recession).

Extreme down case **14%**		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
	Rand/USD (average)	11.96	12.65	15.50	17.00	19.00	21.00	22.80	24.00
	Repo rate (end rate)	6.50	6.50	8.50	10.50	14.00	16.50	18.00	21.00

Wide scale expropriation of private sector property (assets and land) rights without compensation with state as custodian. Credit ratings junk & sovereign debt default - state bankruptcy/failed state. Partial to no payment of public sector employees' wages and social grants, persistent government services outages and rolling mass strike action, civil unrest/war. Global economy falls into recession, severe global trade war, severe lengthy global financial crisis, SA economic depression.

Note: Event risk begins Q3.18. Source: IRESS

SA’s institutional rakings

Institutional rankings: a marked decline in recent years …

South Africa has a high level of institutional soundness compared to the other sub-Saharan African counties, but not compared to its own rankings of a few years ago. The World Economic Forum's Global Competitiveness Survey rates SA's strength of its auditing and reporting standards, regulation of its securities exchange (JSE) and soundness of banks in the 30s and 40s in the world, although these rankings were in the top ten a couple of years ago.

SA's banking sector is currently ranked 37th globally, with deep, liquid sophisticated markets and consistent, sound budgetary policies that allow South Africa to be a key contributor to the global bond market. However, in 2016 SA was ranked in the top ten in the world.

Also a few years ago SA had uniform investment grade ratings from the three key credit rating agencies (Fitch, S&P and Moody's), but currently SA sovereign credit ratings are rated at the last rung of investment grade by Moody's, and sub-investment grade by the other two key agencies. Fiscal deterioration spanning 2009 to early 2017 steadily lowered SA's credit ratings.

This year the International Budget Partnership's latest Open Budget Index ranks SA jointly 1st among 88 countries. Newly elected President Ramaphosa is committed to fiscal consolidation, faster, inclusive growth, and the repair of SOE finances (without further drain on government's balance sheet), and so the economic growth outlook has consequently brightened.

However, it will take a number of years to unwind the institutional weakness that has pervaded SA, specifically requiring substantial repair in the governance of the SOEs and state institutions, as well as restoring investor confidence, real household income growth and the efficacy of corporate boards, and eliminating corruption.

… has weakened SA's economic growth potential, and so outlook, …

SA still has some competitive strengths, including:

- Relatively strong, capable world class private business sector
- Prudent monetary policy
- Relatively sound banking sector
- Fiscal policy consolidation planned
- Well managed JSE and strong foreign interest in SA listed equities
- Incubated a large number of companies to large scale, international level
- SA part of global automotive supply chain
- Mineral rich, endowed country, potential significant gas and oil reserves
- World-class private sector education and private sector healthcare
- Tourism opportunity for employment, particularly as SA is a youthful population

... despite the strong growth in the global economy. SA now needs to …

- Financial market development: 44 out of 137 countries (12^{th} 2016)
  - 25 Financing through local equity market (1^{st} 2016)
  - 46 Regulation of securities exchanges (2^{nd} 2016)
  - 32 Availability of financial services (6^{th} 2016)
  - 37 Soundness of banks (8^{th} 2016)
  - 48 Affordability of financial services (21^{st} 2016)
  - 62 Ease of access to loans (32^{nd} 2016)
  - 66 Venture capital availability (47^{th} 2016)
  - 69 Legal rights index (63^{rd} 2016)

- Market size: 30 out of 137 countries (29^{th} 2016)
  - 30 Domestic market size index (27^{th} 2016)
  - 30 GDP (PPP$ billions) (29^{th} 2016)
  - 36 Foreign market size index (36^{th} 2016)
  - 83 Exports as a percentage of GDP (94^{th} 2016)

Source: Global Competitiveness Report 2017-2018

… repair its institutions or risk sinking into a lower GDP per capita …

- Business sophistication: 37 out of 137 countries (29th 2016)
  - 30 Extent of marketing (48th 2016)
  - 24 Willingness to delegate authority (94th 2016)
  - 38 Control of international distribution ((27th 2016)
  - 29 State of cluster development (33rd 2016)
  - 42 Local supplier quality (28th 2016)
  - 40 Production process sophistication (31st 2016)
  - 46 Local supplier quantity (17th 2016)
  - 46 Value chain breadth (25th 2016)
  - 58 Nature of competitive advantage (33rd 2016)

- Innovation: 39 out of 137 countries (38th 2016)
  - 29 University-industry collaboration in R&D (57th 2016)
  - 32 Company spending on R&D (54th 2016)
  - 30 Capacity for innovation (51st 2016)
  - 42 Quality of scientific research institutions (38th 2016)
  - 49 PCT patents, applications/million pop. (26th 2016)
  - 100 Availability of scientists and engineers (34th 2016)
  - 57 Gov't procurement of advanced tech products (69th 2016)

Source: Global Competitiveness Report 2017-2018

… environment. The IMF recently warned that time is running out.

- Goods market efficiency: 54 out of 137 countries (54th 2016)
  - 28 Effectiveness of anti-monopoly policy (38th 2016)
  - 35 Buyer Sophistication (79th 2016)
  - 31 Total tax rate, % profits (110th 2016)
  - 59 Effect of taxation on incentives to invest (82nd 2016)
  - 44 Intensity of local competition (18th 2016)
  - 52 Extent of market dominance (39th 2016)

- Technological readiness: 54 out of 137 countries (25th 2016)
  - 11 Int'l Internet bandwidth, kb/s per user (34th 2016)
  - 38 Firm-level technology absorption (53rd 2016)
  - 45 Availability of latest technologies (40th 2016)
  - 71 Mobile-broadband subscriptions/100 pop. (26th 2016)
  - 60 FDI and technology transfer (27th 2016)
  - 76 Individuals using Internet, % (32nd 2016)
  - 98 Fixed-broadband internet subscriptions/100 pop. (24th 2016)

Source: Global Competitiveness Report 2017-2018

Exchange rates

Exchange rates: Emerging markets are at risk of volatility ...

- The rand's recent weakness (R14.00/USD, R16.18/EUR and R18.45/GBP) showcases its inherent characteristic of volatility as marked global risk-off saw a substantial sell-off of EM debt.
- However, the rand would likely have been much weaker currently, indeed closer to R17.00/USD, R19.00/EUR and R22.00/GBP, without the Ramaphosa effect (where the rand strengthened to a base of R11.51/USD, R14.18/EUR and R16.08/GBP, before its recent weakness).
- Foreigners purchased R32.3bn of South African portfolio assets, net of sales, in the period January to April 2018, but then sold close to R80bn on a net basis in May and June, on global market risk-off as the transition to neutral US interest rates was seen to be becoming more advanced. Global risk-on switched to global-risk off and EMs in general were afflicted.
- Indeed, the Institute of International Finance (IIF) shows EMs in general experienced this trend reversal in net foreign purchases/sales of portfolio assets. US$58.4bn of EM portfolio assets were purchased on a net basis in January to April 2018, and US$12.3bn net sold in May.
- India and SA are the two EM markets which have seen the biggest sell-off this year.

Exchange Rate forecasts: averages

	2018				2019				2020				2021			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
ZARUSD	11.96	12.65	13.20	12.70	12.50	12.30	12.35	12.25	12.20	12.10	11.90	11.70	11.60	11.70	11.85	11.90
ZARGBP	16.65	17.54	18.21	17.74	17.57	17.47	17.82	17.86	17.55	17.03	16.66	16.32	16.18	16.32	16.52	16.59
ZAREUR	14.70	15.32	15.84	15.43	15.38	15.38	15.68	15.80	15.62	15.25	14.99	14.68	14.50	14.63	14.81	14.88
JPYZAR	9.06	8.47	8.11	8.31	8.36	8.46	8.42	8.49	8.52	8.68	8.82	8.97	9.14	9.06	8.95	8.91
ZARCHF	12.61	12.94	13.20	12.70	12.60	12.55	12.75	12.80	12.91	12.55	12.29	11.99	12.08	12.19	12.34	12.40
ZARAUD	9.41	9.80	10.36	10.03	9.88	9.66	9.63	9.49	9.39	9.26	8.98	8.78	9.16	9.24	9.24	9.28

Source: Investec

… as the rand exchange rate remains at high risk as both an EM …

- The risk of EM outflows has been heightened under US monetary policy normalisation.
- Since the global financial crisis to April 2018, US$2.5trillion (IIF) flowed into EMs in a relatively low US interest rate environment. With the US seen as reaching, if not breaching, its neutral interest rate level in 2020, markets fret over a quickened US rate hike trajectory.
- A number of EM interest rate hikes have occurred this year, essentially to increase the attractiveness of interest rate differentials between emerging markets and developed countries.
- South Africa is unlikely to see any further interest rate cuts in the forecast period.
- While EM currencies could see some strength towards the end of this year as market players ‘return’ in September/October, and US dollar strength wanes, the risk is for heightened market, and so rand volatility in the near term.
- The heavy inflows into EMs since 2009 to April 2018 (US$2.5trillion), weight the risk to the downside for EM currencies and so the rand.

Exchange Rates: averages

	2018				2019				2020				2021			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
ZARUSD	11.96	12.50	13.20	12.70	12.50	12.30	12.35	12.25	12.20	12.10	11.90	11.70	11.60	11.70	11.85	11.90
ZARGBP	16.65	17.34	18.21	17.74	17.57	17.47	17.82	17.86	17.55	17.03	16.66	16.32	16.18	16.32	16.52	16.59
ZAREUR	14.70	15.14	15.84	15.43	15.38	15.38	15.68	15.80	15.62	15.25	14.99	14.68	14.50	14.63	14.81	14.88
JPYZAR	9.06	8.57	8.11	8.31	8.36	8.46	8.42	8.49	8.52	8.68	8.82	8.97	9.14	9.06	8.95	8.91
ZARCHF	12.61	12.79	13.20	12.70	12.60	12.55	12.75	12.80	12.91	12.55	12.29	11.99	12.08	12.19	12.34	12.40
ZARAUD	9.41	9.68	10.36	10.03	9.88	9.66	9.63	9.49	9.39	9.26	8.98	8.78	9.16	9.24	9.24	9.28

Source: Investec

… and commodity currency, heavily exposed to global events.

- The down and extreme down cases of Investec’s scenarios (see next page) show an exacerbation of international risks including trade tensions (trade war), geo-political conflict or even a global financial crisis/economic recession, and so an elevation in global market risk-off with consequent sharp depreciation for the rand. Additionally, the further elevation of the dot plot curve, or a hawkish tone could see further risk-off. Faster US growth elevates this risk.
- From a rand perspective, the risk is that the weighting of the probability for the expected case could drop back towards 40%, and so raise the down case probability towards 40%.
- We expect no credit rating downgrades for SA this year. However, economic growth has disappointed so far, and if this trend persists, could precipitate downgrades, as the agencies have all warned on insufficient growth following a weak environment for business confidence.
- Moody’s warns a downgrade for South Africa could still materialise if “policy ineffectiveness continues to undermine confidence, growth and social cohesion, with inevitable consequences for the government's balance sheet”, should “the government's commitment to, or capacity to engineer, revived growth and debt stabilization … falter ”and if “SOE sector risks crystalli(se) … in a manner which raised the government debt burden and put it on a higher trajectory”.

Exchange Rates: averages

	2017	2018	2019	2020	2021	2022	2023	2024
USD/ZAR	13.30	12.63	12.35	11.98	11.76	12.10	12.53	12.93
GBP/ZAR	17.13	17.53	17.68	16.89	16.40	16.87	17.54	18.10
EUR/ZAR	15.03	15.32	15.56	15.13	14.70	15.13	15.66	16.16
ZAR/JPY	8.39	8.48	8.43	8.75	9.01	8.82	8.54	8.28
GBP/USD	1.29	1.39	1.43	1.41	1.39	1.39	1.40	1.40
EUR/USD	1.13	1.21	1.26	1.26	1.25	1.25	1.25	1.25
USD/JPY	112	107	104	105	106	107	107	107

Source: Investec

Economic Scenarios – note updated probabilities

Extreme Up case 1%

		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Extreme Up case 1%	Rand/USD (average)	11.96	12.65	10.75	10.00	9.50	9.00	8.60	7.90
	Repo rate (end rate)	6.50	6.50	6.00	5.50	5.25	5.00	5.00	5.00

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 (individuals obtain title deeds to land they live on (EWC) without disruption to economy). Fiscal consolidation, credit rating upgrades to A grade.

Up case 10%

		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Up case 10%	Rand/USD (average)	11.96	12.65	11.15	10.70	10.50	10.50	10.30	10.25
	Repo rate (end rate)	6.50	6.50	6.25	6.00	5.50	5.50	5.25	5.25

Persistent growth of 3.0 – 5.0%, higher probability of extreme up case. Better governance, growth creating reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability, individuals obtain title deeds to land they live on (EWC) without disruption to economy. High business confidence, fixed investment growth in double digits, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base line case 45%

		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Base line case 45%	Rand/USD (average)	11.96	12.65	13.20	12.70	12.50	12.30	12.35	12.25
	Repo rate (end rate)	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00

Annual growth rate of 2.0% y/y reached by 2019, 3.0% y/y by 2024. Higher confidence and investment levels than past decade, limited impact of EWC/expropriation without compensation (to abandoned and unused land of government and agricultural sector – individuals are new owners and receive title deeds). Rand structurally stronger, returns to PPP by 2020. SA retains one investment grade (Moody's) rating on its local currency 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.

Down case 30%

		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Down case 30%	Rand/USD (average)	11.96	12.65	15.00	15.90	17.00	17.90	18.60	19.60
	Repo rate (end rate)	6.50	6.50	7.00	7.50	8.00	8.50	8.50	8.50

Partial expropriation of (certain groups') private commercial sector property (including productive land) without compensation, plus wide scale land grabs, title deeds not transferred to individuals. Confidence and investment depressed, marked rand weakness, significant strike action and load shedding. SA sub-investment grade, increased chance of further credit downgrades. Faster than expected global monetary policy normalisation, global sharp economic slowdown (commodity slump), escalation of US-China trade war, short global financial crisis (SA V shaped recession).

Extreme down case 14%

		Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Extreme down case 14%	Rand/USD (average)	11.96	12.65	15.50	17.00	19.00	21.00	22.80	24.00
	Repo rate (end rate)	6.50	6.50	8.50	10.50	14.00	16.50	18.00	21.00

Wide scale expropriation of private sector property (assets and land) rights without compensation with state as custodian. Credit ratings junk & sovereign debt default - state bankruptcy/failed state. Partial to no payment of public sector employees' wages and social grants, persistent government services outages and rolling mass strike action, civil unrest/war. Global economy falls into recession, severe global trade war, severe lengthy global financial crisis, SA economic depression.

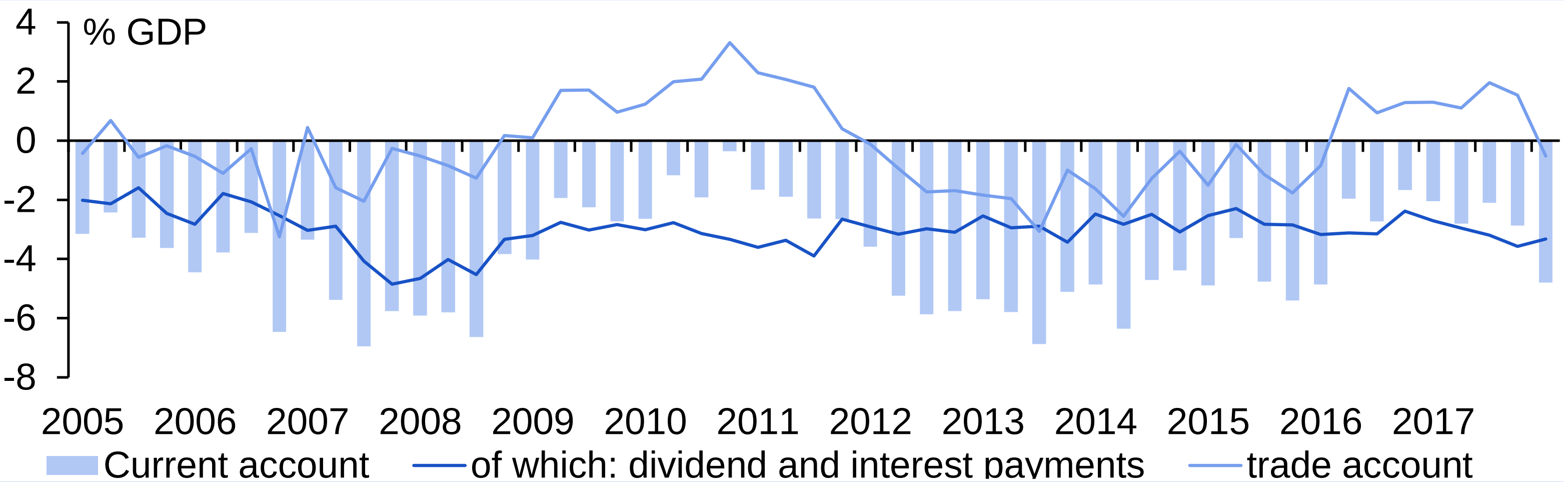
Note: Event risk begins Q3.18. Source: IRESS

Balance of payments

BOP: the current account deficit has widened notably in Q1.18, ...

- The current account rose to 4.8% of GDP in Q1.18, from an average of 2.5% of GDP in 2017, following a sharp fall in exports in Q1.18 mainly on the revaluation effects from marked rand strength.
- The trade account was in surplus in 2017 (1.5% of GDP), but fell to -0.5% of GDP in Q1.18.
- However, substantial rand weakness in Q2.18, and the likelihood that the rand will not strengthen back to Q1.18 levels this year, should see the current account deficit average around 3.5% of GDP for 2018, as export volumes also recover.

Breakdown of current account deficit



Source: SARB

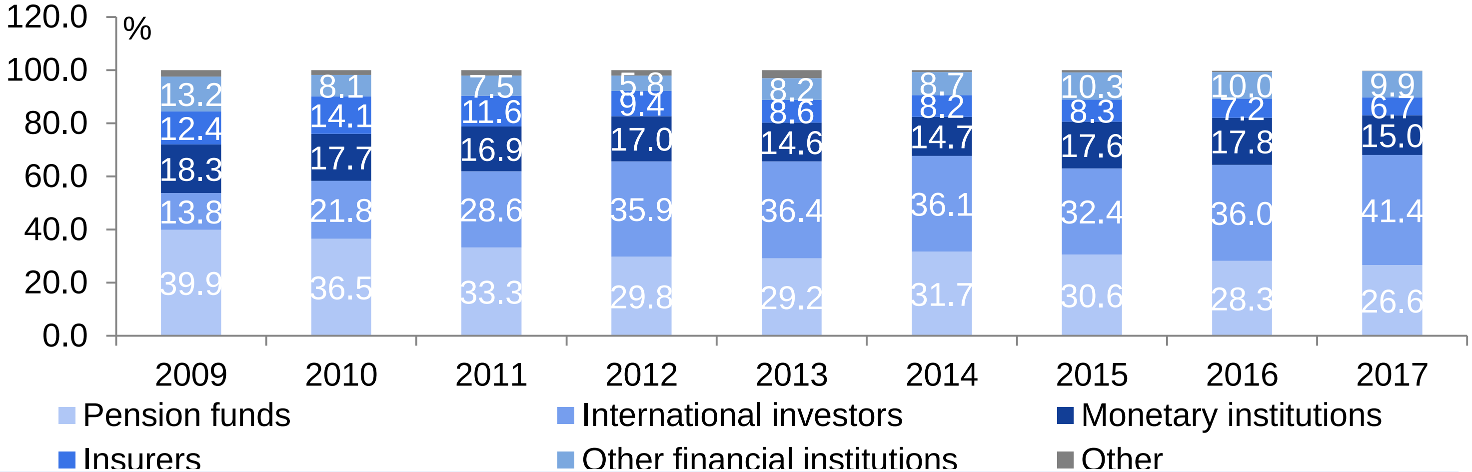
Expected case forecasts	2017	2018	2019	2020	2021	2022	2023	2024
GDP (% y/y, real)	1.3	1.4	1.9	2.2	2.4	2.6	2.8	2.9
Export (% y/y, real)	-0.1	3.3	3.8	6.3	5.7	5.1	5.2	5.1
Imports (% y/y, real)	1.9	3.2	3.3	6.5	5.7	5.1	5.2	5.1
Balance: Current Account (sa) - % GDP	-2.5	-3.4	-2.9	-2.9	-3.0	-3.0	-3.0	-3.1
Rand/USD	13.30	12.59	12.35	11.98	11.76	12.10	12.53	12.93

Source: Investec

… but could narrow in the remainder of 2018 (on lower dividend and coupon outflows) as significant foreign sales of SA portfolio assets ...

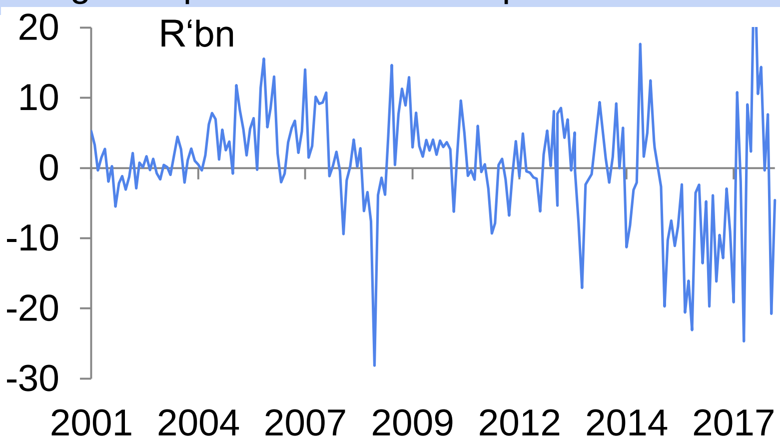
- South Africa has seen a surplus on the financial account since 2004 as foreigners became substantial holders of SA debt (see right hand graph below), with the latest figure at 41% of total.

Holders of domestic government bonds, 2011-2107



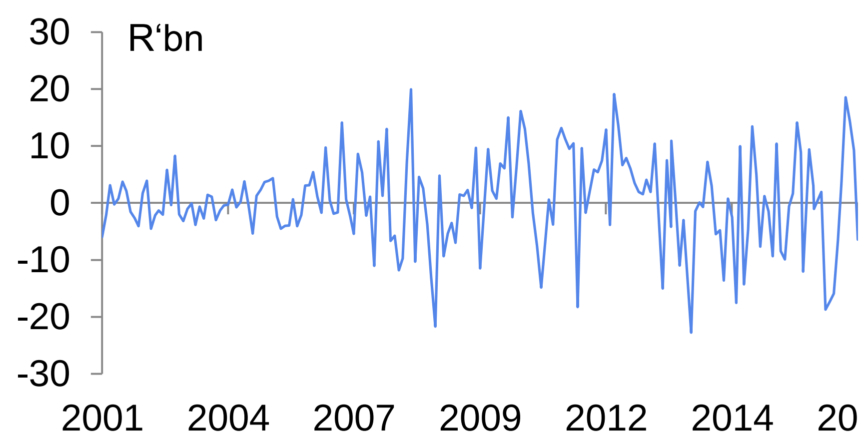
Source: Budget 2018

Foreign net purchases of SA Equities



Source: IRESS

Foreign net purchases of SA Gilts

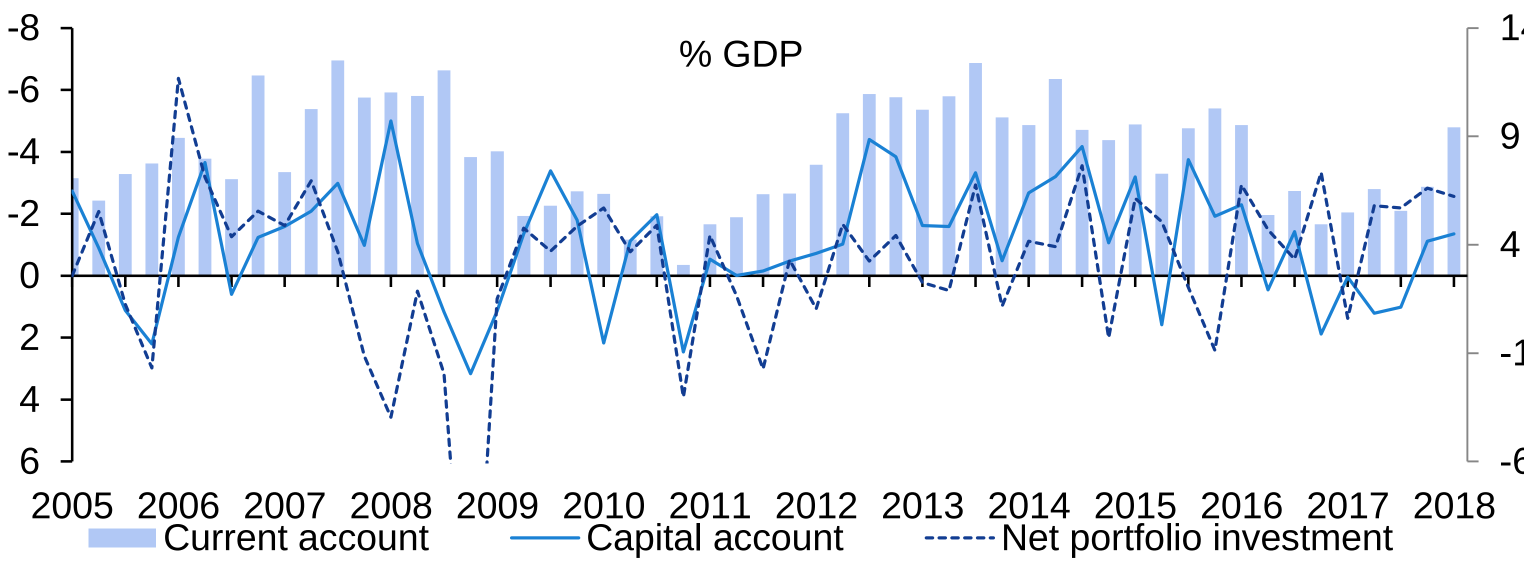


Source: IRESS

… occurred (if the trade account does not deteriorate). The trade balance ...

- In 2017 the capital account recorded R101.1bn and the current account -R114.3bn.
- The financial account recorded portfolio inflows of R220.4bn in 2017, but net outflows occurred this year to date.
- Risk-off spurred significant bond and equity sales in Q2.18, which is at risk of continuing in Q3.18.
- Indeed, close to –R80bn has flowed out in Q2.18, and these portfolio outflows could come out around -6.0% of GDP.
- This would negatively impact the financial account, and so the funding of the current account, adding to the risk of rand depreciation. The financial account risks a deficit in Q2.18.
- In the last financial crisis -R111bn in portfolio outflows occurred in Q4.08 (18.3% of GDP).

Capital account versus current account (both as % of GDP, current account inverted)

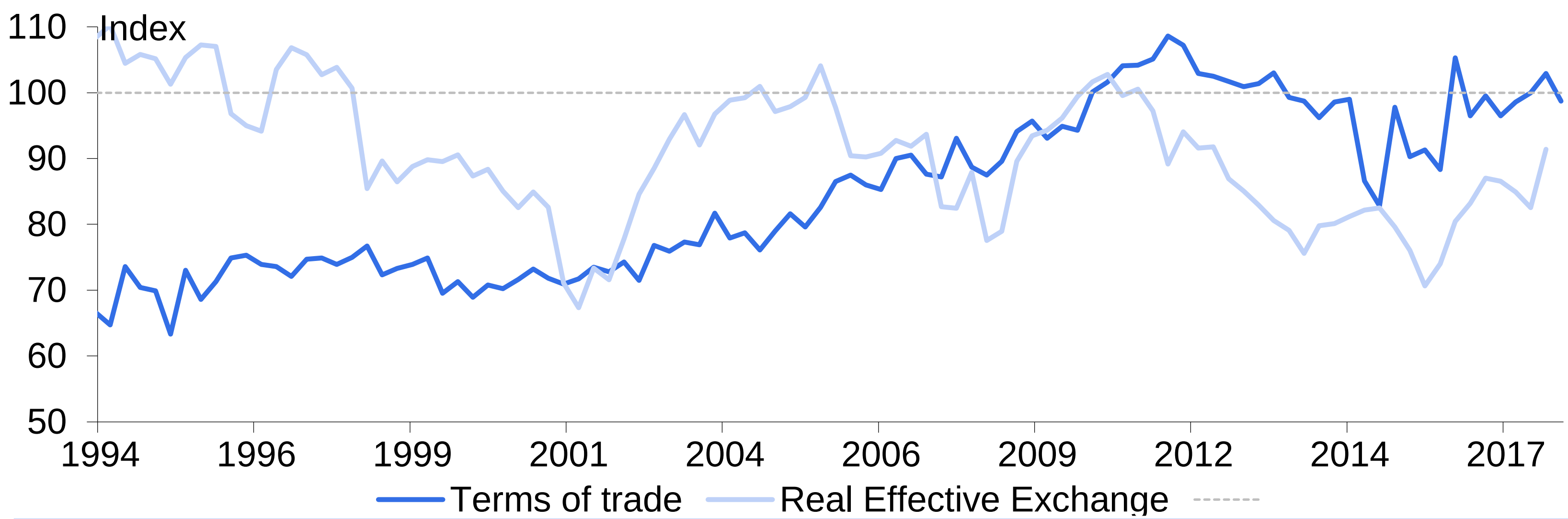


Source: SARB

… is at particular risk of deterioration if global trade tensions escalate into a trade ...

- Global markets remain concerned about the threatened US-led trade war with China, an aggressive surge in protectionism focused on increasing tariffs on US imports, and not just of Chinese goods (in line with President Trump pre-election campaign to attempt to bring manufacturing jobs back to the US via trade restrictions).
- However, protectionism can hurt the economy of the country imposing the tariffs just as much, if not more than the country having the tariffs imposed on it. This occurs not just by slowing economic growth and increasing inflation, but also by negatively impacting inputs in the manufacturing process of the country imposing the tariffs.
- Such a risk of slower growth in the world's two largest economies is adding to risk-off.
- US tariffs will also negatively affect South Africa. SEIFSA (the Steel and Engineering Industries Federation of Southern Africa) calculates that US tariffs against SA steel imported into the US will cost SA R3bn, and R0.5bn in tariffs levied against SA aluminum with as many as 7 500 jobs estimated at risk). A trade war is included in the down case for SA's scenarios.

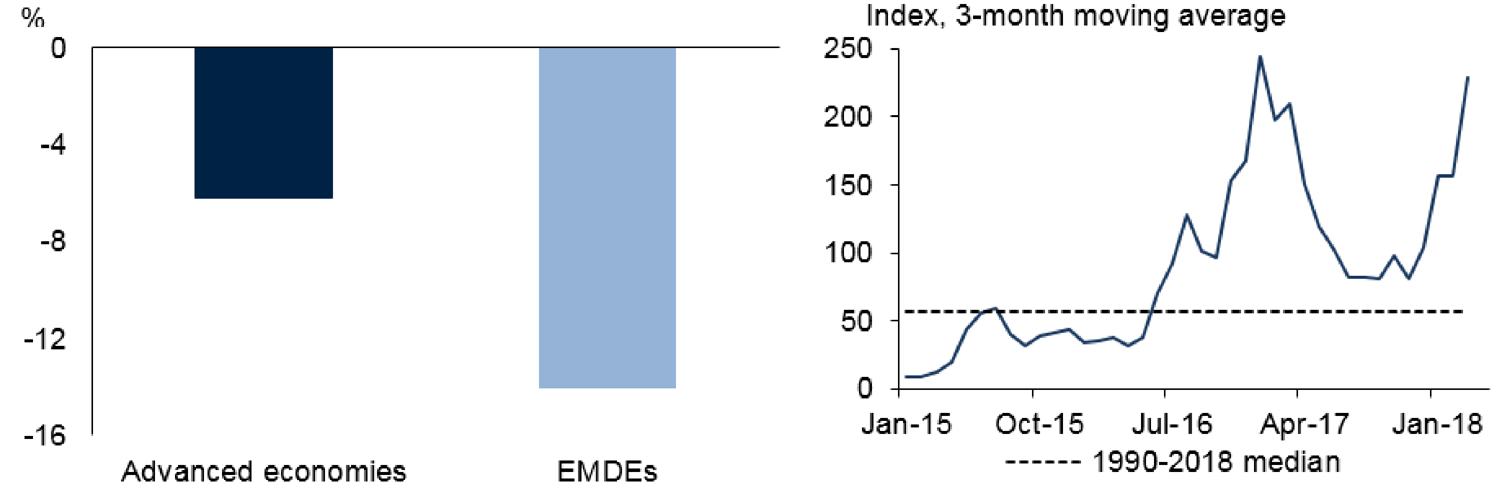
Terms of trade and SA's real effective exchange rate



Source: SARB

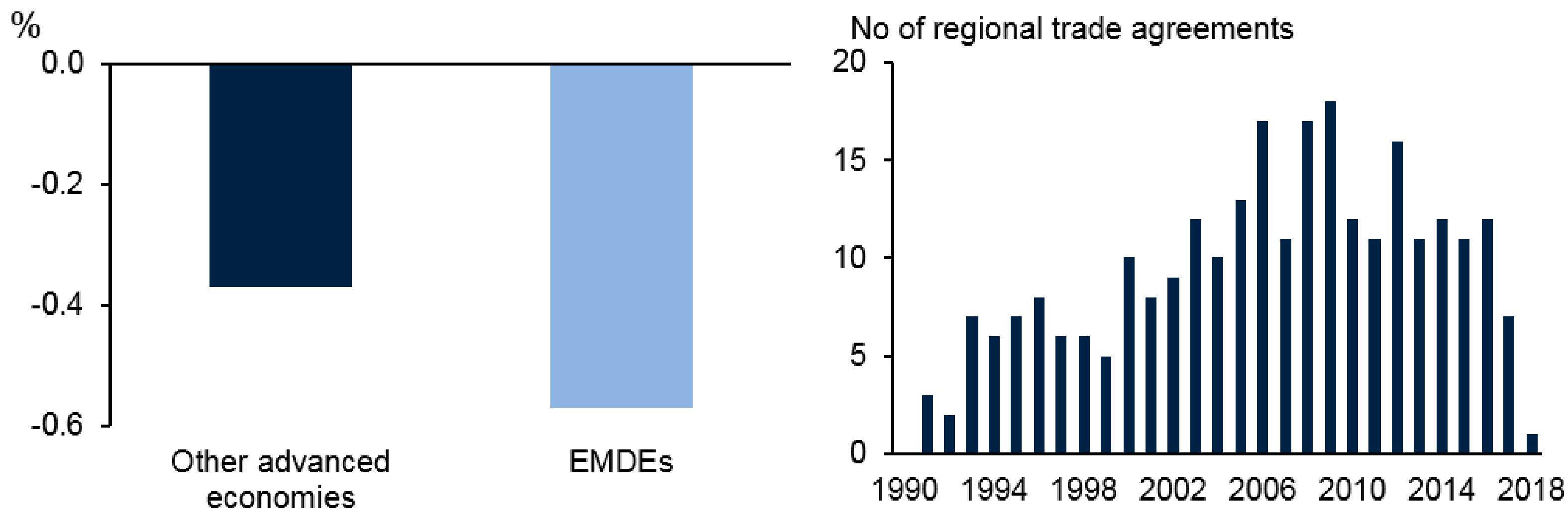
… war, - which the world Bank estimates would lower trade volumes, especially for emerging markets and developing economies.

Impact on trade from worldwide increase in tariffs to bound levels by 2020 and US trade policy uncertainty



Source: World Bank Global Economic Prospects June 2018

Investment impact of 10% rise in US economic policy uncertainty and new regional trade agreements



Source: World Bank Global Economic Prospects June 2018

Inflation rates

CPI inflation: troughed in the current cycle in Q1.18 on food price …

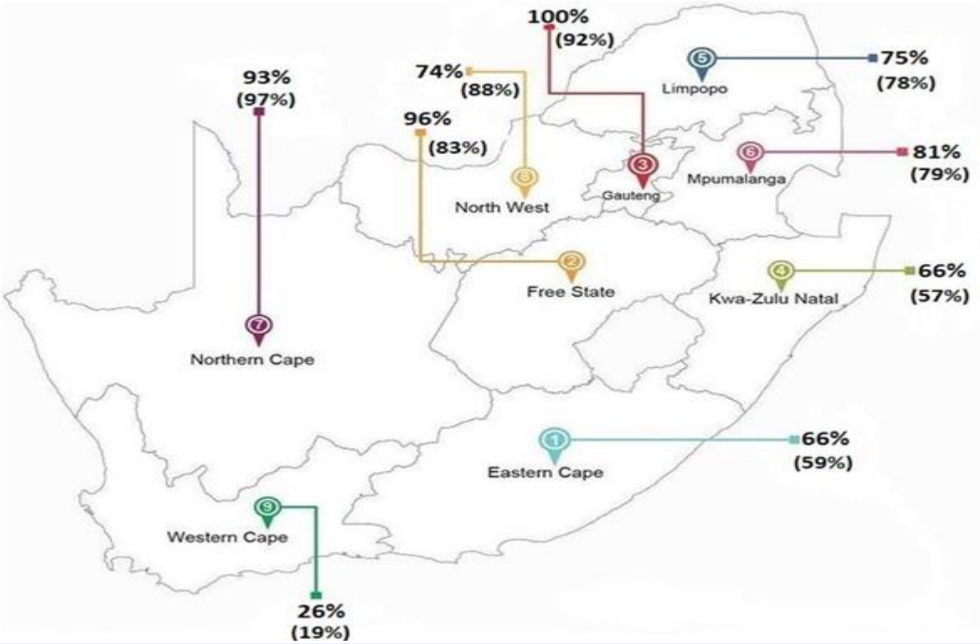
- SA saw CPI inflation bottom in March 2018 at 3.8% y/y (from 6.7% y/y in December 2016, 7.0% y/y in February 2016), then lift this year on higher petrol prices, rand weakness and broad scale substantial consumer tax increases as a historic VAT increase came through in April, rising from 14% to 15%.
- Food prices have the highest weighting in the CPI basket, at 15.48%, and the sharp price declines (disinflation), if not outright deflation have largely driven the drop in CPI inflation to March.
- However, the beneficial effects of drought alleviation in key areas of the country are working their way through the CPI inflation figures, and looking forward CPI inflation will likely rise towards 5.5% y/y this year, if not by next.
- Agbiz indicates many crops are in good shape this year, particularly the maize harvest, which could provide some cap on the escalation in CPI inflation in the last three quarters of 2018.
- The positive outlook for moderate food price inflation continues to underpin our CPI forecast for this year.

Inflation	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Consumer Inflation (Av: (%)	**5.3**	**4.8**	**5.4**	**5.0**	**5.4**	**5.5**	**5.4**	**5.6**
(year-end: %)	***4.7***	***5.4***	***5.1***	***5.0***	***5.6***	***5.2***	***5.6***	***5.2***
Producer Inflation (Av: %)	**4.9**	**4.6**	**5.1**	**5.2**	**5.1**	**5.2**	**5.3**	**5.2**
(year-end: %)	***5.2***	***3.9***	***5.5***	***5.2***	***4.9***	***5.5***	***5.0***	***5.3***
Salary & wage increases (%)	**6.5**	**6.3**	**7.0**	**6.9**	**6.9**	**7.1**	**7.2**	**7.0**

… disinflation (and outright deflation in some categories), but will …

- Additionally, there has been an improvement in dam levels compared to a year ago, and even for the Western Cape there is a level of optimism from weather and agricultural forecasters (South African Weather Service, International Research Institute for Climate and Society and Agbiz) on rain over the next three months.
- South Africa's 1% VAT increase on 1st April 2018 will add about 0.5% y/y to the CPI inflation rate for the remainder of 2018 and Q1.19, along with other consumer tax increases that were announced for ad valorem tax, fuel levies, alcohol and tobacco, and a sugar tax, bringing CPI inflation back above 5.0% y/y, along with the significant base effects due to disinflation in H2.17.
- While the favourable agricultural conditions experienced in SA this year may erode some of this rise slightly, CPI inflation is still expected to return to its structural (or long-run) rate of 5.5% y/y by Q4.18.

Holders of domestic government bonds, 2011-2107

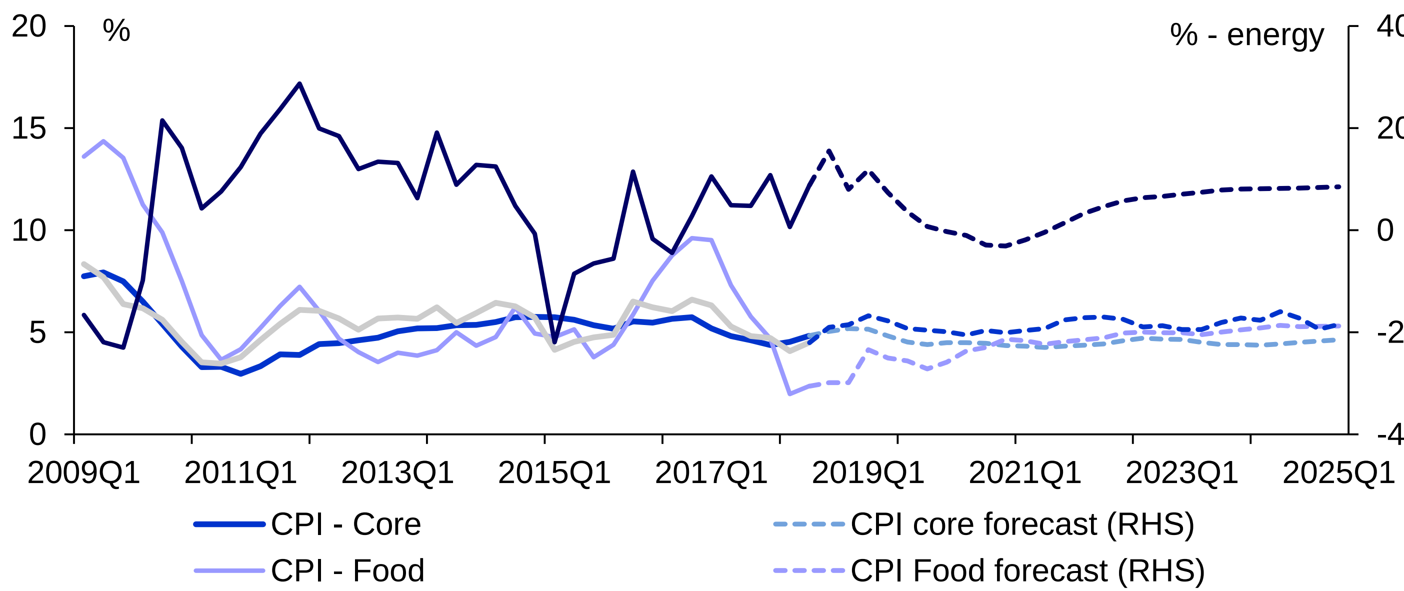


Source: Agbiz (& Department of Water and Sanitation)

… likely rise through the remainder of 2018 to 5.5% for the long-term, ...

- Significant electricity and water tariff (and a number of other state administered price) increases are likely to persist going forward, which will keep CPI inflation around 5.5% y/y on a structural basis.
- This will limit the chance for further interest rates cuts, along with elevating EM and US interest rates.
- Oil prices are expected to climb towards US$80/bbl (for Brent crude) over the medium-term, 2019-2024, as global demand firms moderately further, with expectations of periods of increased supply to limit the linear nature of the ascent.
- The SARB will be watching the CPI data closely to see if the domestic currency’s recent weakness gives rise to second round inflationary affects (not first round ones such as higher petrol, diesel etc. prices).
- However, there is no significant evidence yet of second round effects, with many categories of goods experiencing disinflation or deflation and retail inflation subdued.

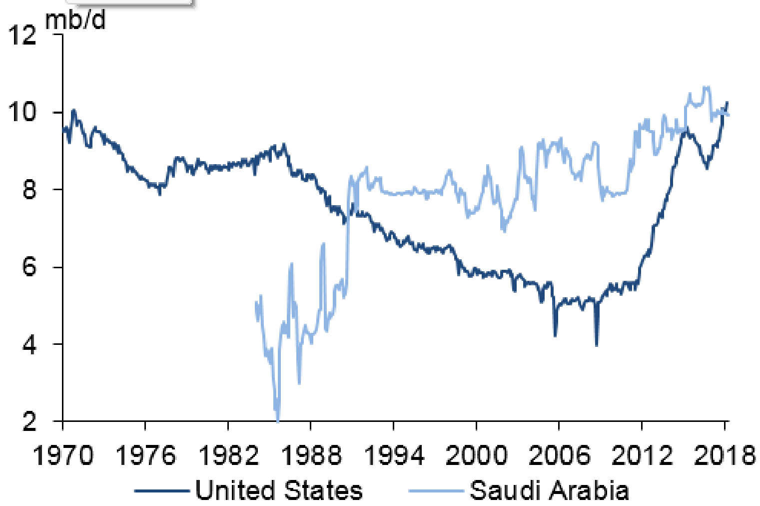
Price inflation, actuals and forecasts)

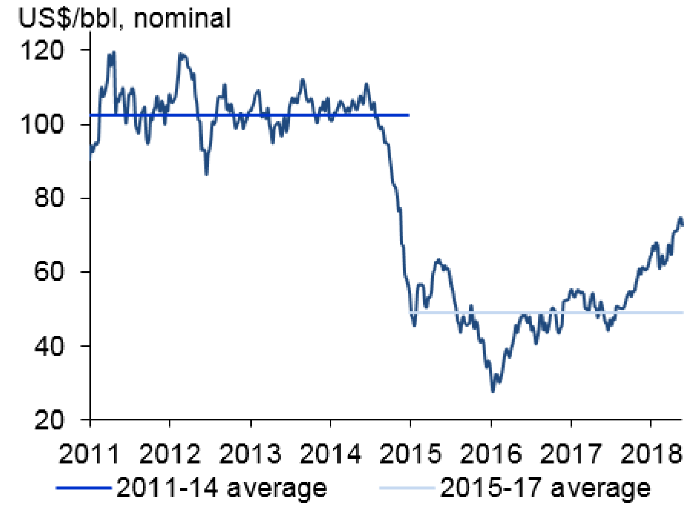


Source: Stats SA

… with higher global commodity prices and rand weakness a perennial risk to SA inflation.

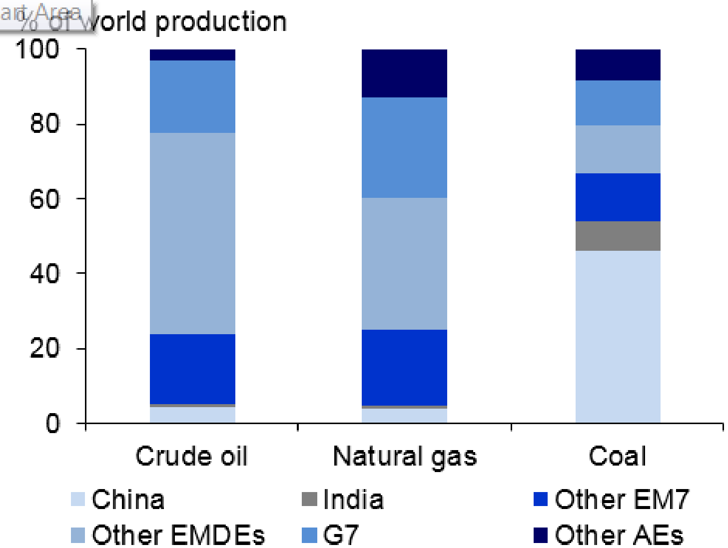
Crude oil production and crude oil prices

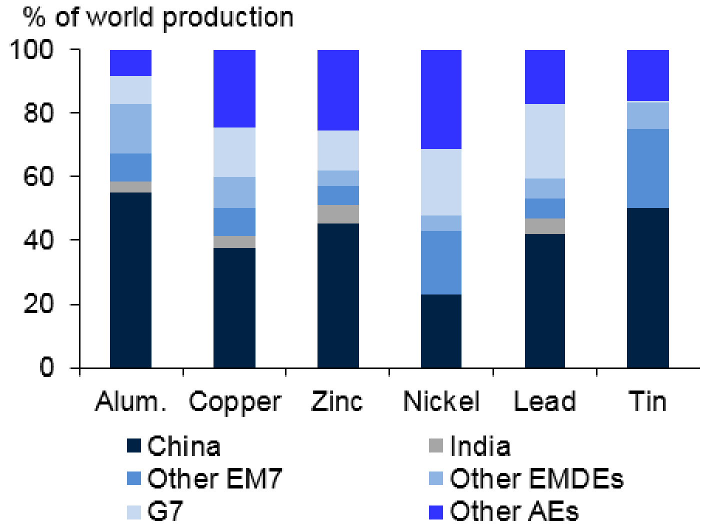




Source: World Bank Global Economic Prospects June 2018

Share of energy production, 2016 and share of metals production, 2016





Source: World Bank Global Economic Prospects June 2018

Interest rates

Interest rates: No further interest rate cuts are expected in the ...

- We continue to expect the next move in the repo rate will be a 25bp hike, in January 2019, although this hike may be moved forwards to November 2018, if not earlier.
- Additionally, we expect another 25bp hike in March 2019.
- CPI inflation is expected to peak around 6.0% y/y in March 2019, with the possibility that it could even rise above 6.0% y/y temporarily should the currency see further marked depreciation (not the expected case, see the scenario table).
- However, this March 2019 peak is expected to be the high point for CPI inflation as base effects and tax pressures from the 2018 budget wear out from Q2.19 (unless further consumer tax increases are instituted).
- H2.18 is likely to remain at risk of further rand volatility and potential marked global risk-off, which eliminates the possibility of any interest rate cuts for SA in the period.
- Indeed, the SARB (South African Reserve Bank) left the repo unchanged at its last meeting citing increased risks to the inflation outlook due to global events, as expected.
- The MPC recognised that the “(t)he global economic backdrop has become more challenging amid continuing trade policy tensions between the US and China as well as other geopolitical risks.”

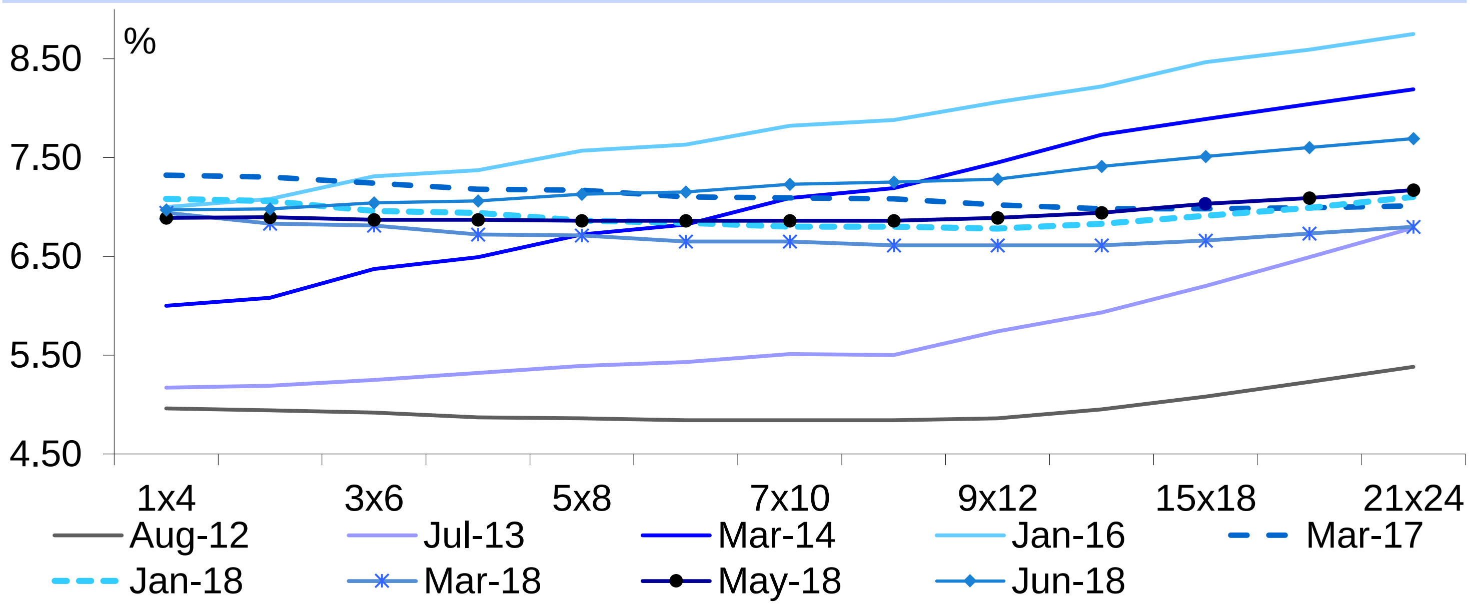
Monetary Sector	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Repo Rate (year-end: %)	**6.75**	**6.50**	**7.00**	**7.25**	**7.50**	**7.50**	**7.50**	**7.50**
Prime Overdraft Rate (year-end: %)	**10.25**	**10.00**	**10.50**	**10.75**	**11.00**	**11.00**	**11.00**	**11.00**
SA rand bond (year-end: %)	**9.57**	**8.79**	**9.35**	**9.53**	**9.92**	**10.13**	**9.87**	**9.82**

Source: Investec

… current interest rate cycle. Instead, a 25bp rate hike is likely either this …

- Furthermore, the SARB adds, "in the near term, the rand is expected to remain volatile, with movements dominated by the changing assessment of these global trends. Domestically, an expected moderate widening of the current account deficit, a result of deteriorating terms of trade, could also weigh on the rand."
- We continue to expect no change in SA's repo rate this year.
- Markets are factoring in a 25bp hike in SA's repo rate by January 2019 - a turnaround from the rate cut view earlier in the year.
- As global markets factored in higher US inflation expectations, and so higher US interest rate expectations, SA's leeway to cut interest rates has eroded.
- Besides a 25bp hike in the repo rate around year end, SA's Forward Rate Agreement (FRAs) curve currently shows another 25bp hike towards September 2019 (previously May 2019), and no third currently factored in (but previously a third 25bp hike was factored in by end 2019).

SA's forward rate agreement (FRA) curve

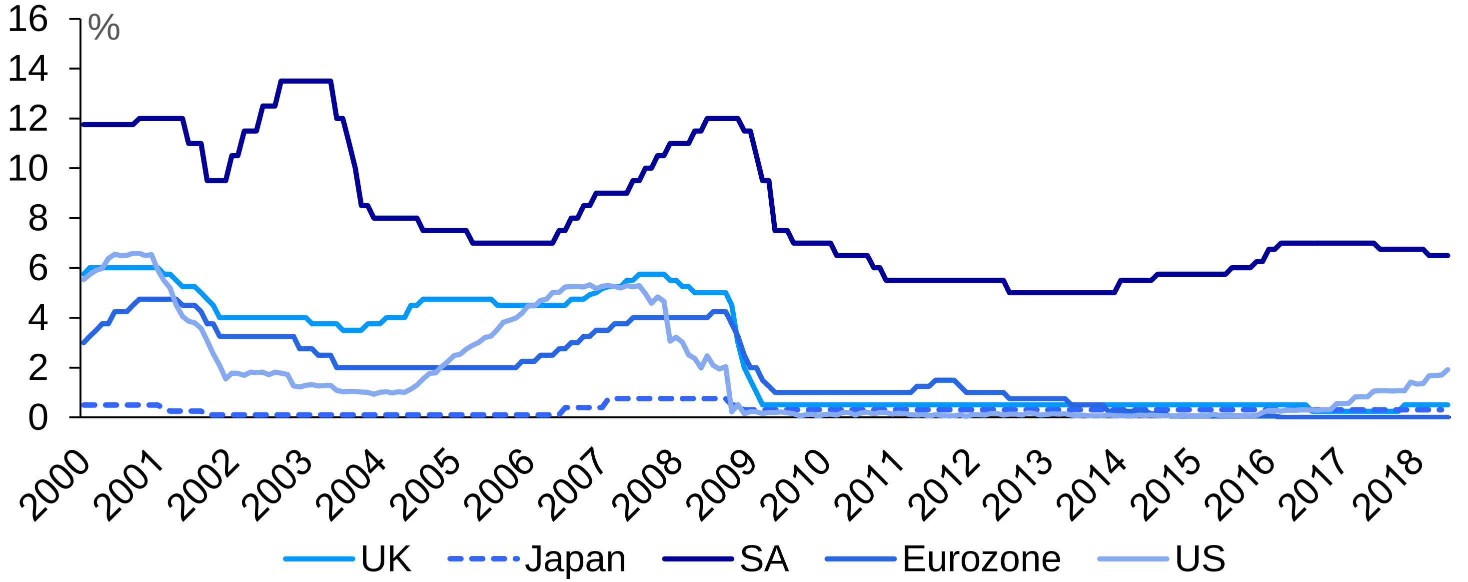


Source: Reuters

… year, or the start of next, with the SARB likely hiking by 75bp to 100bp over the long-term.

- The SARB's Monetary Policy Committee (MPC) adds that risks and uncertainties are now at high levels, our view that led to an increased tilt in our risk weights to the downside in the scenario table in May 2018.
- From a longer-term perspective, for CPI inflation to remain largely around the midpoint of the inflation target range (4.5% y/y) will require subdued (4.5% y/y or less) increases in state administered tariffs, rates and taxes, which is currently not being signaled.
- We estimate that the long-term structural inflation rate in SA is around 5.5% y/y, and that SA needs a 100bp lift in its Central Bank (repo) rate to get it to a neutral level.
- We continue to forecast a 25bp hike in the repo rate in January 2019, and another in March 2019, with a further 25bp lift in 2020 in order to return SA interest rates to neutral levels as CPI inflation will average 5.5% y/y in the long-term, which implies a neutral rate for the repo of around 7.50% (with a real interest rate of 2.00%).

Interest rate comparisons



Source: IRESS

Private sector consumption

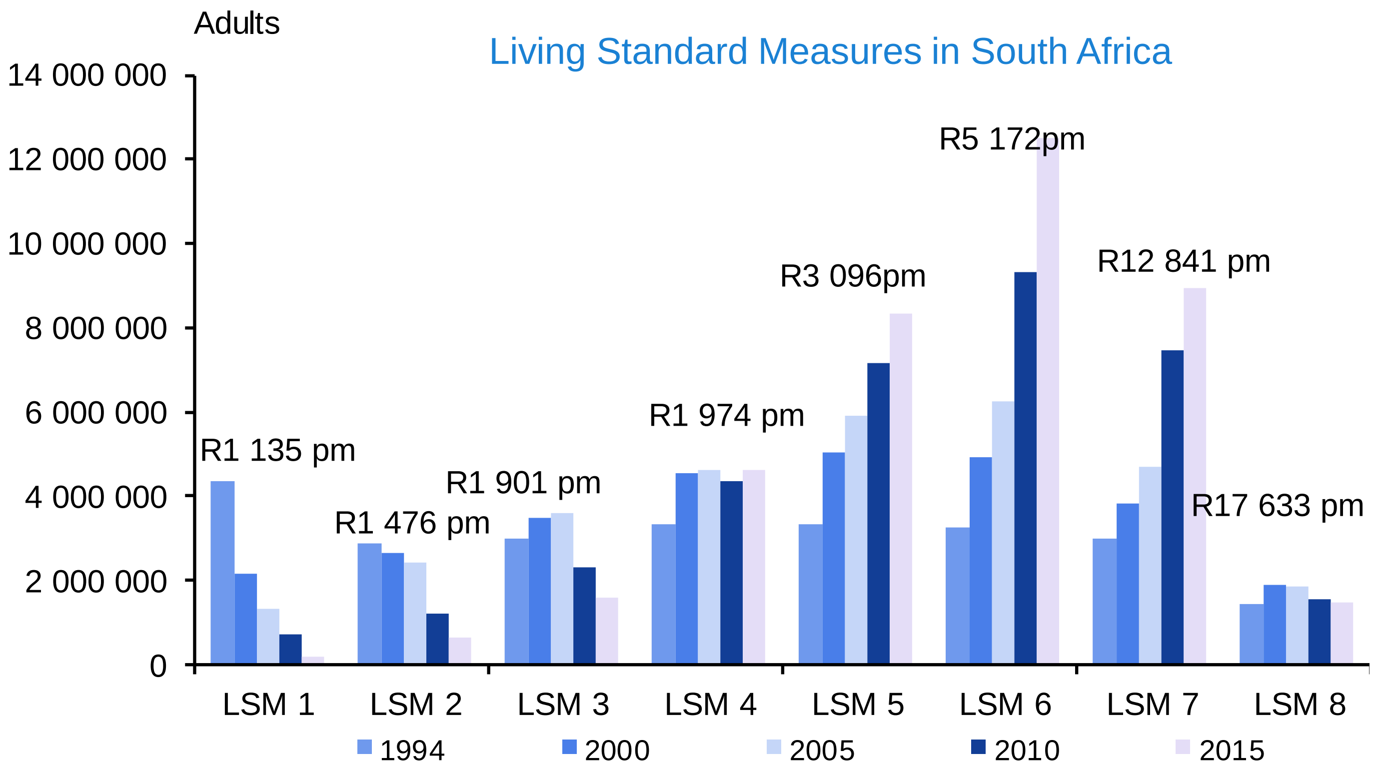
SA consumer: consumer confidence is a significant driver of …

- Since 2010 to end 2017, consumer confidence has been depressed on average, with the key factor depressing consumer sentiment being consumers' depressed outlook for the future.
- Q1.18 showed a dramatic rise in consumer confidence, but Q2.18 is likely to see a lower, but still positive reading.
- Consumers increasingly migrated out of the lower income brackets from 1994 to 2010, and we expect this trend will resume under the Ramaphosa Presidency as wealth and income levels improve, with a lag, as economic growth and the economic outlook does.
- With the economic outlook expected to brighten out to 2024, consumer spend is expected to lift, driving consumption and so growth, with higher levels of fixed investment.
- Indeed, faster growth in HCE (household consumption expenditure) could occur than forecast in the expected case below, if the Ramaphosa team manages to repair SA's key institutions quicker than currently expected. This would heavily boost investor sentiment, and so investment itself into SA, and could lift economic growth to 5.0% y/y by 2025 instead of the current expectations of 3.5% currently for 2025.

Consumption Expenditure	2017	2018	2019	2020	2021	2022	2023	2024
HCE, total (real, %)	2.2	2.0	2.0	2.5	2.7	2.9	3.0	3.0
HCE as % of GDP	61.0	61.4	61.4	61.6	61.8	62.0	62.1	62.1
Unemployment rate (%)	27.5	27.4	27.4	27.1	26.8	26.4	26.5	26.4
Population (million)	56.7	57.4	58.1	58.7	59.4	60.0	60.6	61.2
Employment growth rate (%)	2.5	2.4	1.0	1.3	1.4	1.5	1.6	1.6
Compensation of employees (%)	7.4	9.1	9.7	9.5	9.6	9.9	9.7	9.6
GCE as % of GDP	20.3	20.2	20.1	19.9	19.7	19.5	19.2	19.0

… spend. An improvement in the private sector expenditure (HCE) …

- Living standards rose substantially in SA from 1994, on social welfare transfers and service delivery.
- The number of individuals in poverty (less than US$2 a day) fell by 75% between 1996 and 2012.
- SA is expected to see this trend eventually resume under a Ramaphosa Presidency.



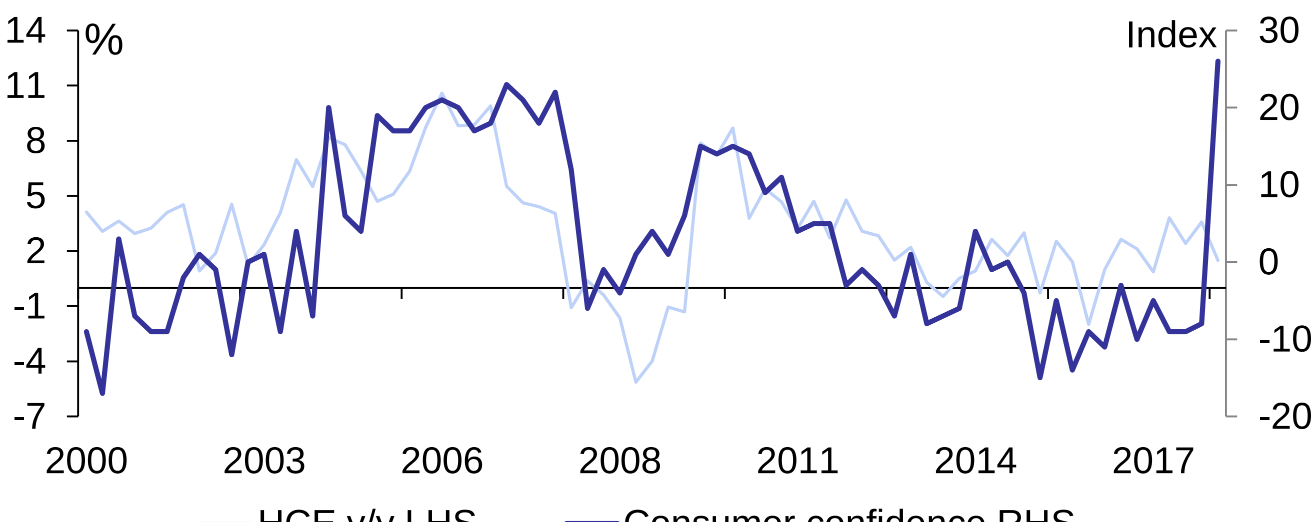
LSM 1 Radio, minimal access to services LSM 2 above plus stove, water on plot
LSM 3 above plus TV, DVD/video player, electricity LSM 4 above plus Hi-fi, flush toilet, fridge, electric hotplate, newspaper
LSM 5 above plus magazines, books, lottery tickets LSM 6 above plus cell phones, cinema
LSM 7 above plus DSTV, motor vehicles, internet, LSM 8, above plus full ownership of durables full access to services
LSM 9 above, higher income LSM 10 above, higher income

Source: Eighty 20, AMPS. Availability of historical data is limited

… outlook is key as HCE accounts for two thirds of GDP.

- The President proposes a 'New Deal' for SA in order to reach 5.0% y/y - a "New Deal for Jobs, Growth and Transformation that will turn the economy around and build a more equal society.
- "This New Deal will and must bring together government, business, labour and civil society in a meaningful and effective social compact to construct a prosperous, just society founded on opportunities for all."
- Mr Ramaphosa explains this as "an unwavering commitment to strengthening the structures of the state and re-asserting the independence of institutions supporting democracy,- basing everything we do on innovation and excellence, - massification of initiatives to promote inclusive growth,- a focus on the empowerment of youth and women, and- an uncompromising rejection of corruption, patronage, cronyism and wastage."
- Transformation is another core component of Ramaphosa's proposed economic policies, along with job creation, economic recovery and investment, reindustrialisation, inclusive growth, infrastructure, fiscal consolidation, education, good governance of SOE'S and eradication of corruption and state capture.

HCE (private sector spending) growth vs consumer confidence



Source: SARB, BER

Fixed investment

Fixed investment: it will take considerable time to repair the …

- The private sector remains the biggest capital expenditure investor in South Africa.
- As is usual in weak, uninspiring economic growth periods, corporates are displaying historically typical (average) savings behaviour and not expanding rapidly, due also to policy uncertainty, particularly around future property rights.
- The Ramaphosa Presidency is expected to deliver good governance, eradicate corruption, and follow economic policies that support growth and lean towards the free market approach, but progress is slow.
- A reduction in red tape and rise in business friendly legislation would see greater fixed investment taking place in SA, as would faster economic growth.
- However, it is key that for the lift in confidence measures that occurred in Q1.18 to be retrieved, and exceeded, the uncertainties remaining such as the methodology for expropriation without compensation are resolved, in order to maintain the rise in the leading indicator and so in the business cycle indicated for later this year.

Gross Fixed Capital Formation	2017	2018	2019	2020	2021	2022	2023	2024
GFCF, total (real, %)	0.4	0.8	1.5	3.5	3.3	3.9	4.6	4.6
GFCF as % of GDP	19.7	19.6	19.5	19.7	19.9	20.2	20.5	20.9
Private sector (real, %)	1.2	1.2	3.9	5.4	4.9	5.7	6.6	6.7
Government (real, %)	-1.0	0.1	-2.7	-0.1	0.2	0.1	0.3	-0.2
Non-residential GFCF (real, %)	1.1	1.3	3.6	5.4	5.3	6.0	6.9	7.1
Residential buildings (real, %)	1.5	0.5	6.0	5.3	2.8	4.1	4.6	4.6

…damage to SA's key institutions, and so realise higher GFCF growth. ...

- For the 2019 financial year, Eskom reportedly narrowed its funding gap to R58bn, raising R13bn.
- Recent government support to Eskom takes several forms:
  - New board appointed in January 2018 to improve governance.
  - Nersa granted Eskom a 5.2% y/y tariff increase for 2018/19, versus the requested 19.9% y/y. Eskom will apply to Nersa in August 2018 for subsequent annual tariff increase/s.
  - Nersa awarded Eskom R32.7bn of its Regulatory Clearing Account (RCA) amount, versus the requested R67bn.
  - Eskom government guaranteed debt stood at R221bn in 2017/18, with municipalities reportedly owing the entity R13.5bn.

Guarantee exposure to major state-owned companies and development finance institutions

R billion	2015/15 Guarantee	Exposure[1]	2016/17 Guarantee	Exposure[1]	2017/18 Guarantee	Exposure[1]
Public institutions	**469.9**	**255.8**	**475.7**	**290.4**	**466.0**	**300.4**
of which:						
Eskom	350.0	174.6	350.0	202.8	350.0	220.8
SANRAL	38.9	27.2	38.9	29.4	38.9	30.1
Trans-Caledon Tunnel Authority	25.8	21.2	25.6	20.9	25.7	18.7
South African Airways	14.4	14.4	19.1	17.8	19.1	11.8
Land and Agricultural Bank of SA	6.6	5.3	11.1	3.8	9.6	6.6
Development Bank of Southern Africa	13.9	4.4	12.5	4.1	12.3	4.2
South African Post Office	4.4	1.3	4.4	4.0	0.4	0.4
Transnet	3.5	3.8	3.5	3.8	3.5	3.8
Denel	1.9	1.9	1.9	1.9	2.4	2.3
South African Express	1.1	0.5	1.1	0.8	0.8	0.8
Industrial Development Corporation	2.0	0.2	0.4	0.2	0.5	0.1
South African Reserve Bank	3.0	-	3.0	-	-	-
Independent power producers	**200.2**	**114.0**	**200.2**	**125.8**	**200.2**	**122.2**
Public-private partnerships3	**10.3**	**10.3**	**10.0**	**10.0**	**9.6**	**9.6**

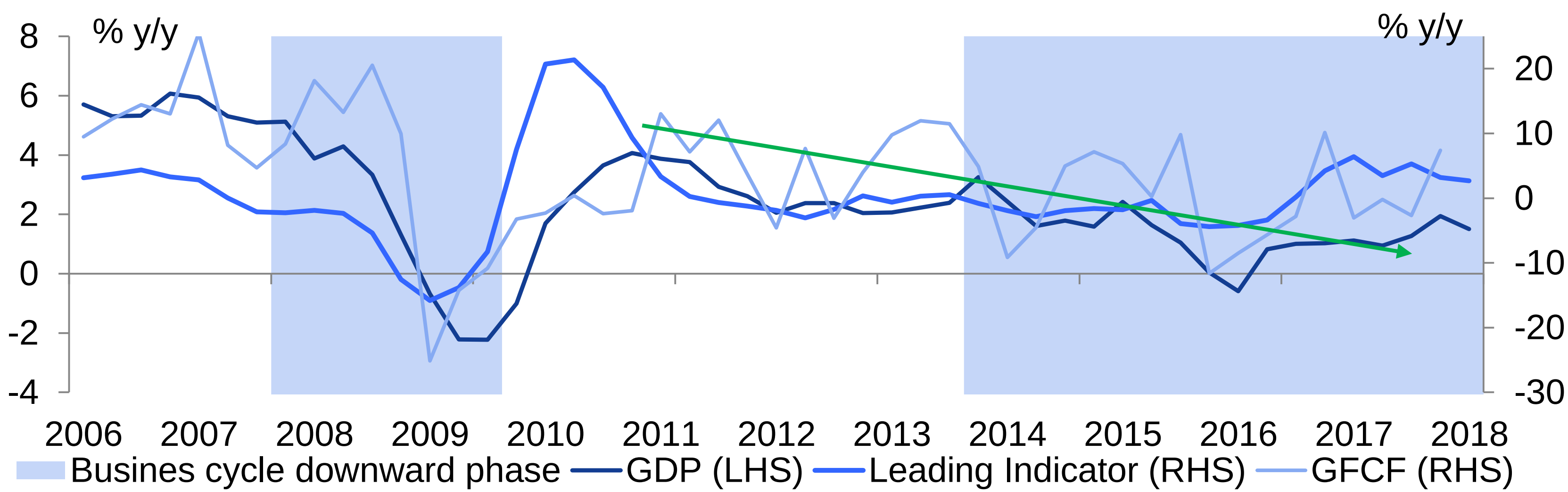
Source: National Treasury

1. Total amount of borrowing and accrued interest for the period made against the guarantee

Much will depend on boosting business confidence, and so on reducing policy ...

- Q1 2018 leading indicator came was well up on Q4.17, and on a year ago, indicating that from six months (Q4.18) the business cycle should strengthen (and so GDP growth).
- Q1.18's leading indicator reading rose by close to 6% on the quarter, annualised, a significant jump, which saw the lift tie in with the large leaps in confidence shown by the BER's consumer and business confidence readings on the substantial reduction in political uncertainty.
- However, Q2.17 showed a suppressed leading indicator reading, indicating a dip in the business cycle (and GDP) in Q1.18. Q1.18's industrial production and retail data confirm this risk.
- Depressed confidence levels in 2017 would have contributed to a weak GDP quarter in Q1.18 Investment lags business confidence by two quarters.
- Looking forward, SA is expected to see economic growth rise in the last three quarters of 2018.

Fixed investment, GDP, business cycle and the leading indicator

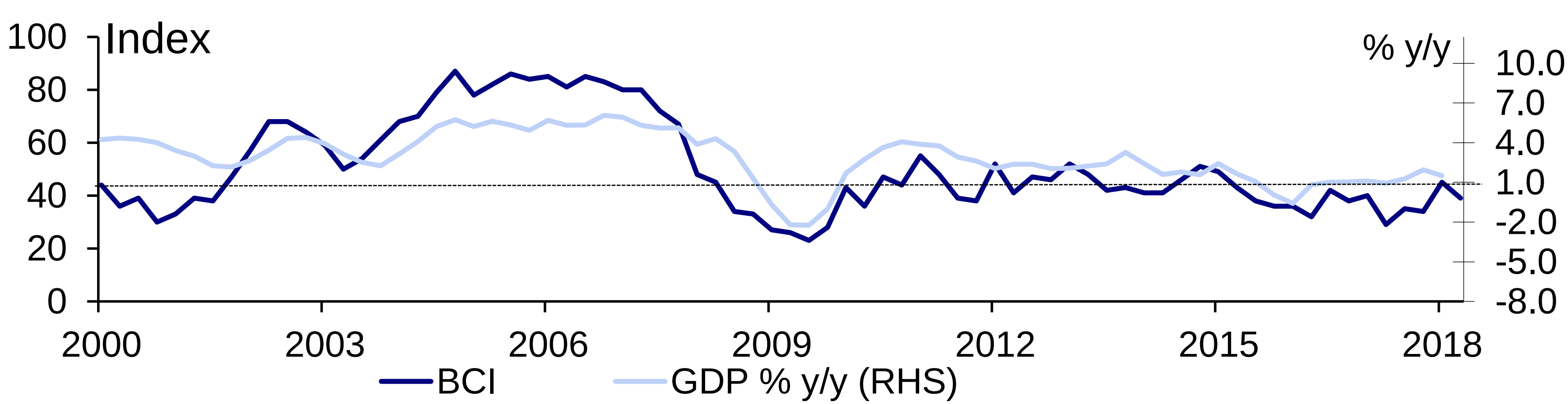


Source: SARB, Stats SA

... uncertainties, including EWC (expropriation without compensation) that does not damage business confidence.

- The expected case is one where land reform is handled responsibly, and the rand is structurally stronger on the political change, with a quicker return to PPP than previously expected.
- In particular, EWC (Expropriation without Compensation) is handled along the lines of the recent land summit (a "Codesa-like" summit with key members from SA's political parties, as well as farmers, including representatives from SA's large scale, commercial farming sector).
- This land summit communicated that there should be no fears about land grabs, specifying that they will not be allowed to destabilize the land reform process.
- Four types of land were identified to be targeted for expropriation without compensation, without any need for amendments to the constitution. These four are abandoned buildings/land, unutilised land, commercial property held unproductively and purely for speculative purposes or underutilised property owned by the state and land farmed by labour tenants with an absentee titleholder.
- The IMF secretly said "(c)learly articulating policy and regulatory decisions related to land reform in a fair, transparent and market-friendly manner would help remove uncertainty, which is currently weighing on investor sentiment". However, SA also urgently needs to restrain government expenditure in order to achieve fiscal consolidation, and so raise its credit ratings and business confidence.

Business Confidence and GDP



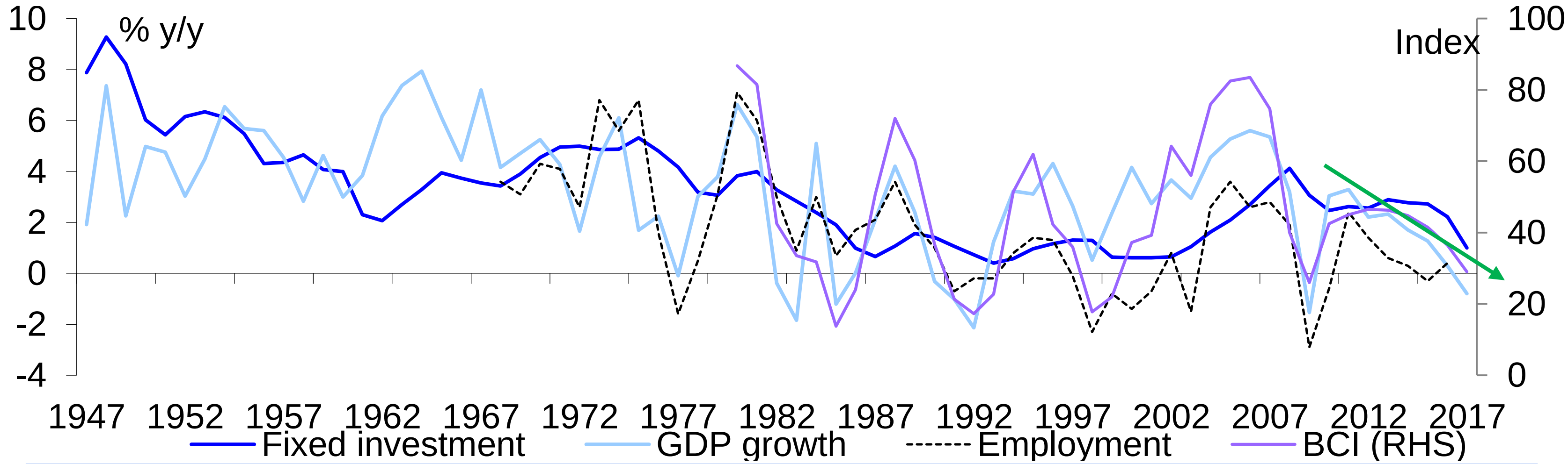
Source: BER, Stats SA

Repairing economic growth

Repairing economic growth: and returning to uniform …

- South Africa has made its way up the credit rating path before to A grade, even an A+, and it can make it back again. This previous upwards credit rating trajectory occurred in the 2000s, under Thabo Mbeki's Presidency, and was driven by strong economic growth, fiscal consolidation and good governance of both SOEs and general government.
- In the early 2000's Government started the upgrading of SA's infrastructure while following fiscal consolidation. Through improved fiscal management, money was available to spend on infrastructure, with good management typically yielding quality infrastructure delivered on time, within budget and which supported private corporate sector expansion.
- Fixed investment growth accelerated to double digits over this period, propelling economic growth to above 3.0% y/y above then onwards to above 5.0% y/y and unemployment to below 22%. Sentiment was positive due to the good governance of public finances and the country.
- Growth rose above the 2-3% range it was stuck in since 1994, to average of 3-4%, and then 4-5% plus as productive capacity rose, positive, robust consumption expenditure occurred on the back of this. Improved production allowed exports to rise to meet trade demand.
- Economic policy focused on the imperatives of expanding the ability of the economy to produce, ensuring sufficient infrastructure was in place to support faster growth.

SA's GDP and fixed investment growth, vs employment and BCI

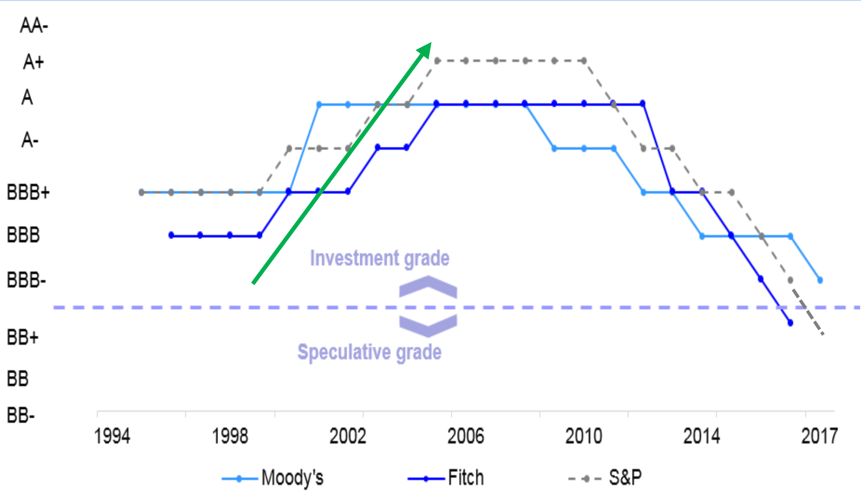


Source: SARB, BER

… investment grade credit ratings from the three key agencies …

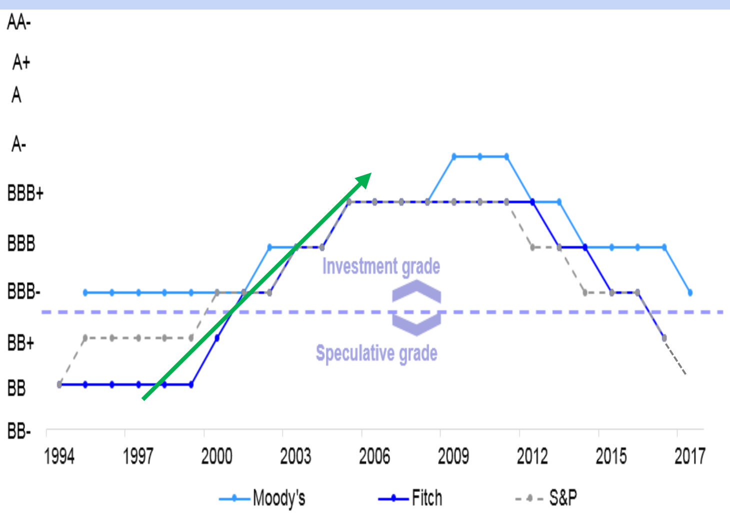
- The Mbeki years stretched from 1999 to 2008 and were known as the years of good governance, with the highest consistent growth rate in 35 years and fiscal consolidation yielded credit rating upgrades.
- Business confidence and the investor climate was boosted to the extent where the latter years of the Mbeki period of 2004 to 2008 saw an extreme up case (average growth 5.2% y/y), with metals prices more than tripling.
- SA fell into the global Citibank index (on A+ from Moody's), the rand returned to PPP, and significant government and parastatal infrastructure investment occurred, taxes were cut and income per capita rose substantially. The good governance allowed SA to take advantage of the global boom. Interest rates fell from 22% Jan 1999 to 11.5% Dec 2003.
- The expansion of government and SOE fixed investment, in partnership with the private sector, generated increased demand for goods and services. This, along with free market policies, entrenched protection of private sector property rights and strong institutions, created a virtuous cycle that boosted business confidence, and so corporate sector and economic activity in the 2000s.

SA local currency long-term sovereign debt credit ratings



Source: Rating Agencies

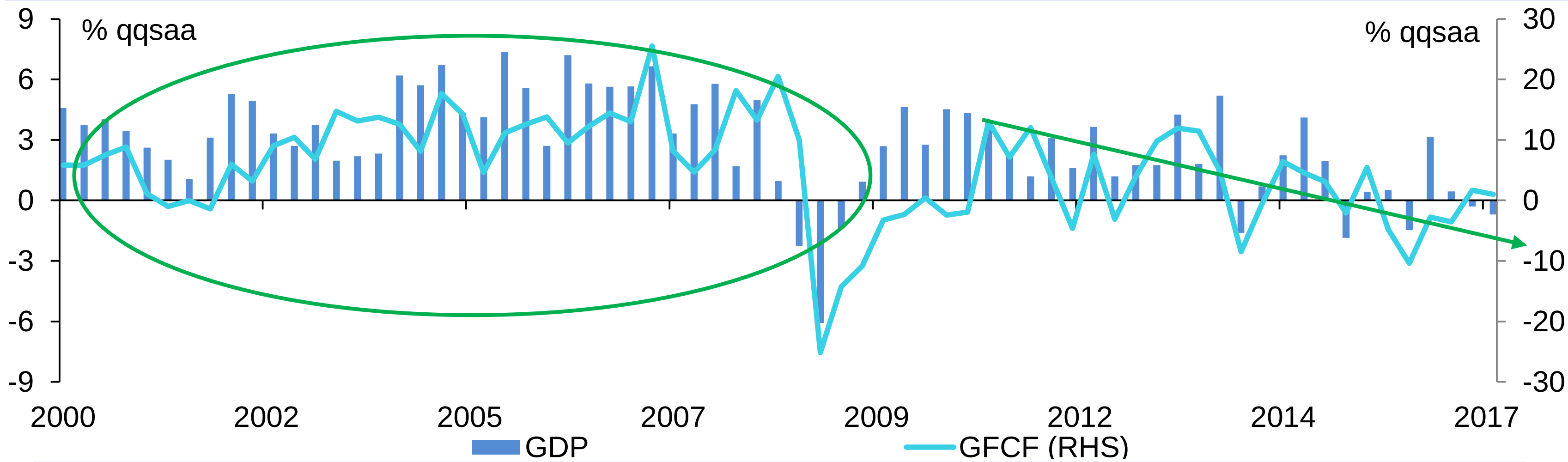
SA local foerign long-term sovereign debt credit ratings



Source: Rating Agencies

- The expansion of the productive capacity (private, parastatal and government fixed investment) of the economy allowed it to respond to increased global demand for SA's exports as global economic growth accelerated during the 2000s.
- All the infrastructure constraints were not overcome in this period however, limiting sustainable economic growth beyond 5.0%, due to the rapid acceleration in the economy.
- At least 25% of GDP needs to be constantly reinvested in the economy via fixed investment, particularly from government and utilities, not just the private sector.
- SA economic growth tends to rise (fall) when growth in total fixed capital stock rises (falls) as there is a very close correlation between SA's GDP and total fixed capital stock (productive capacity).
- Between 1946 and 1981 GDP growth averaged 4.5%, growth in fixed capital stock 4.7%.
- From 1982 to 1993 productive capacity increased by 1.5% on average, growth slipped to 0.8%.
- Demand, mining activity and government infrastructural investment fuelled growth in SA's productive capacity during most of the 1970s.
- However, in the 1980s and early 1990s foreign disinvestment in response to the domestic political situation resulted in many investors, both foreign and domestic, either disinvesting or

GDP growth vs GFCF

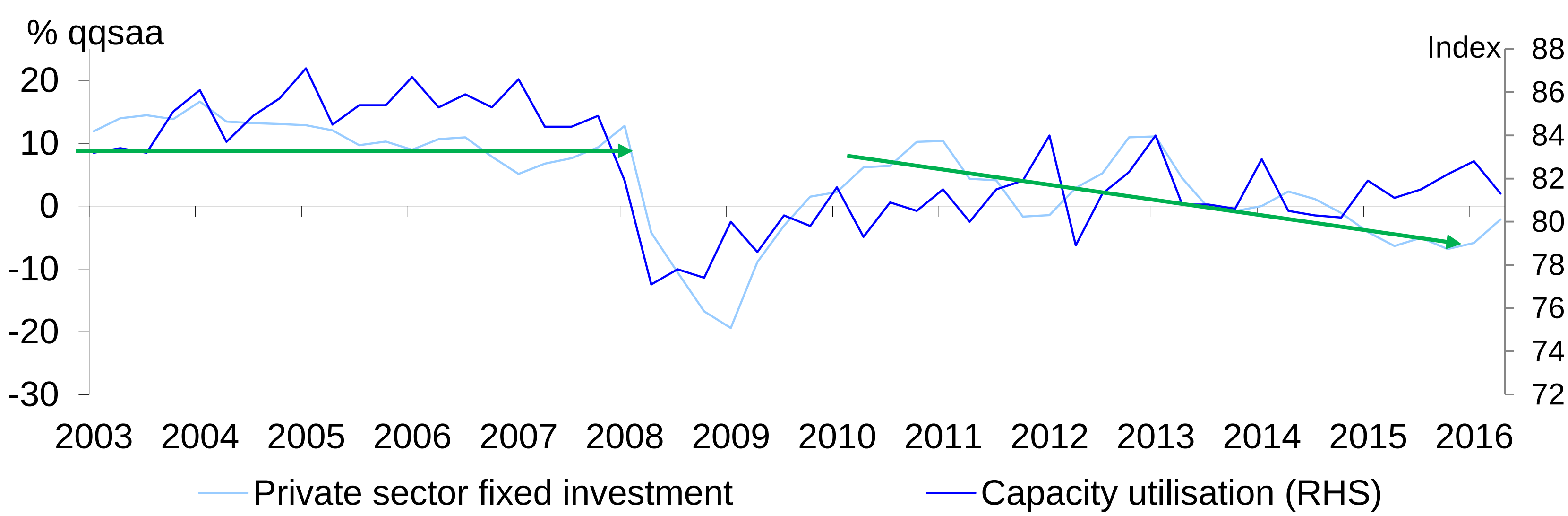


Source: SARB

… occur again – should the governance of SA improve substantially.

- developing a wait and see approach.
- The expansion of government and SOE fixed investment, in partnership with the private sector, generated increased demand for goods and services.
- This, along with free market policies, entrenched protection of private sector property rights and strong institutions, created a virtuous cycle that boosted business confidence, and so corporate sector and economic activity in the 2000s.
- Economic policy focused on the imperatives of expanding the ability of the economy to produce (output potential), ensuring sufficient infrastructure was in place to support faster growth.
- The expansion of the productive capacity (private, parastatal and government fixed investment) of the economy allowed it to respond to increased global demand for SA's exports as global economic growth accelerated during the 2000s, and commodity prices lifted.
- All the infrastructure constraints were not overcome in this period however, limiting sustainable economic growth beyond 5.0%, due to the rapid acceleration in the economy.

Capacity utilisation vs private sector GFCF



Source: Investec, SARB, Statistics SA

Conclusion for SA

Conclusion: Stronger growth is likely as governance improves.

- Higher business confidence (which instead fell in Q2.18) would kick-start faster economic growth, with both greater foreign direct, and domestic fixed, investment into SA.
- SA is expected to see economic growth rise in the last three quarters of 2018. However, it is key that the uncertainties surrounding the methodology for expropriation without compensation and the NHI are resolved, in order to lift business confidence and so improve the business cycle.
- We expect no credit rating downgrades this year, although if GDP growth continues to disappoint then this will become a risk. Interest rate cuts are unlikely.
- The rand is likely to remain volatile, and with further significant portfolio outflows from EM markets likely on elevated levels of global risk-off, SA could also be at risk of higher inflation and so interest rates. We expect SA's interest rates to reach neutral levels after the US does.
- Only through permanently reducing unemployment can we anticipate a sustained lowering of SA's socio-economic inequalities, and the ultimate eradication of poverty.

Summary, % real growth rates	2017	2018	2019	2020	2021	2022	2023	2024
GDP (real, %)	1.3	1.4	1.9	2.2	2.4	2.6	2.8	2.9
HCE (real, %)	2.2	2.0	2.0	2.5	2.7	2.9	3.0	3.0
GCE (real, %)	0.6	1.2	1.3	1.3	1.4	1.4	1.4	1.4
GFCF (real, %)	0.4	0.8	1.5	3.5	3.3	3.9	4.6	4.6
GDE (real, %)	1.8	2.0	1.8	2.4	2.6	2.9	3.0	3.1
Export (goods & non-factor services) - (real, %)	-0.1	3.3	3.8	6.3	5.7	5.1	5.2	5.1
Imports (goods & non-factor services) - (real, %)	1.9	3.2	3.3	6.5	5.7	5.1	5.2	5.1
Balance: Current Account - (% of GDP)	-2.5	-3.4	-2.9	-2.9	-3.0	-3.0	-3.0	-3.1
Imports as % of GDP	30.3	30.8	31.3	32.5	33.6	34.4	35.2	36.0
Exports as % of GDP	29.3	29.8	30.4	31.6	32.6	33.4	34.2	34.9

Disclaimer

The information and materials presented in this report (which includes presentations) are provided to you for information purposes only and are not to be considered as an offer or solicitation of an offer to sell, buy or subscribe to any financial instruments. This report may not be reproduced in whole or in part or otherwise, without the consent of Investec.

The information and opinions expressed in this report have been compiled from sources believed to be reliable, but neither Investec, nor any of its directors, officers, or employees accepts liability for any loss arising from the use hereof or makes any representation as to its accuracy and completeness.

Investec, and any company or individual connected to it including its directors and employees may to the extent permitted by law, have a position or interest in any investment or service recommended in this report. Investec may, to the extent permitted by law, act upon or use the information or opinions presented herein, or research or analysis on which they are based before the material is published.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgement at its original date of publication by Investec and are subject to change.

Investec is not agreeing to nor required to update research commentary and data. Therefore, information may not reflect events occurring after the date of publication. The value of any securities or financial instruments mentioned in this report can fall as well as rise. Foreign currency denominated securities and financial instruments are subject to fluctuations in exchange rates that may have a positive or adverse effect on the value, price or income of such securities or financial instruments. Certain transactions, including those involving futures and options, can give rise to substantial risk and are not suitable for all investors.

Investec may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them.

To our readers in Australia this does not constitute and is not intended to constitute financial product advice for the purposes of the Corporations Act.

To our readers in the United Kingdom: This report has been issued and approved by Investec Bank (UK) Limited, a firm regulated by the Financial Services Authority Limited and is not for distribution in the United Kingdom to private customers as defined by the rules of the Financial Services Authority Limited.

To our readers in the Republic of Ireland, this report is issued in the Republic of Ireland by Investec Bank (UK) Limited (Irish Branch), a firm regulated by the Financial Services Authority.

This report is disseminated in South Africa by Investec Bank Limited, a firm regulated by the South African Reserve Bank and in Switzerland by Investec Bank (Switzerland) AG.

This report is not intended for use or distribution in the United States or for use by any citizen or resident of the United States.