Economic review and outlook

Q3 2017

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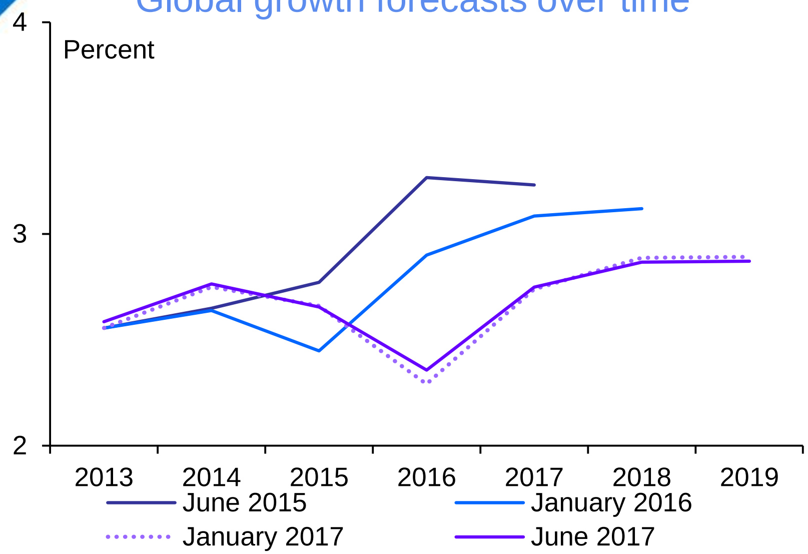
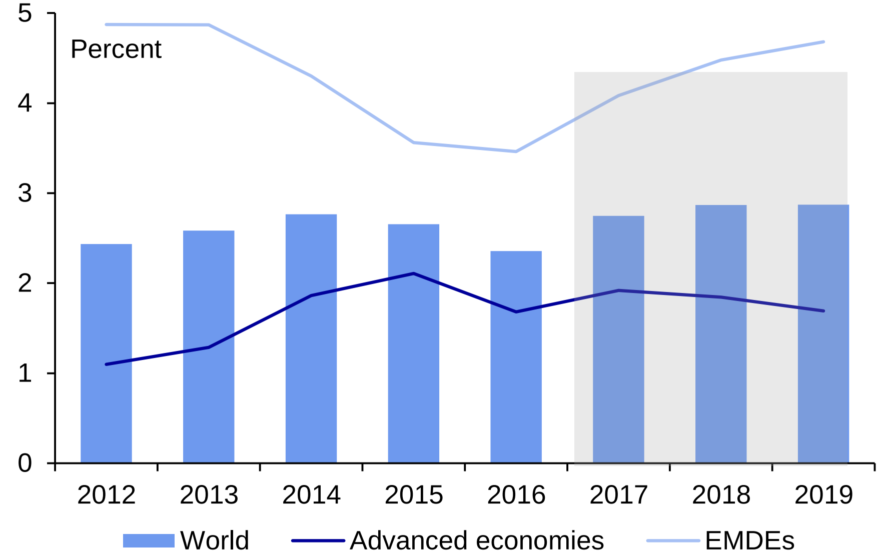
http://www.investec.co.za/research-and-insights/economy/economic-research-v1.html

Introduction

Global growth forecasts over time



Global Growth



Source: World Bank Group. 2017. *Global Economic Prospects, June 2017: A Fragile Recovery*. Washington, DC: World Bank. Washington, DC: World Bank. doi: 10.1596/978-1-4648-1024-4. License: Creative Commons Attribution CC BY 3.0 IGO

Introduction: South Africa’s faltering economic performance is …

2017 shows that the mild pick up in global growth begun in 2016 is continuing and becoming broad based, as global trade continues to lift, along with industrial production. Imports and investment are strengthening as confidence improves, and global lending conditions remain favorable, which are all sustaining the upswing. Global growth is expected to lift to 2.7% this year, from 2.3% last year, and reach 3% by 2018.

While commodity exporters continue to see a differentiated performance, particularly amongst EM (emerging market) and low income countries, this has come down to the main commodity exported. SA is chiefly a metals exporter, and so is falling into the lowest growth category predicted, tracking below some other sub-Saharan countries. Most recently SA has fallen into recession due to a depressed investor climate.

Besides feeble economic outcomes, South Africa continues to experience high government debt ratios and attendant credit rating downgrades, with confidence readings depressed on political and economic policy volatility. Looking forward, SA growth is expected to remain below both world and the sub-Saharan region’s forecasts.

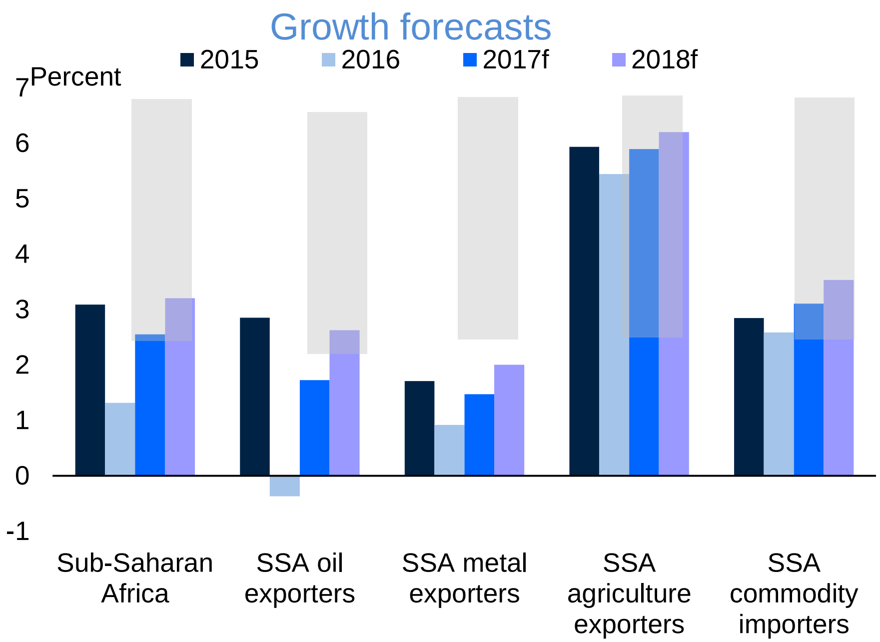
US economic activity is still expected to underpin global growth, with other key advanced economies seeing improvements, and growth rebounding in low income economies and EMs (emerging markets). Commodity prices are expected to firm only slightly, but global industrial activity recover, with confidence levels consequently lifting.

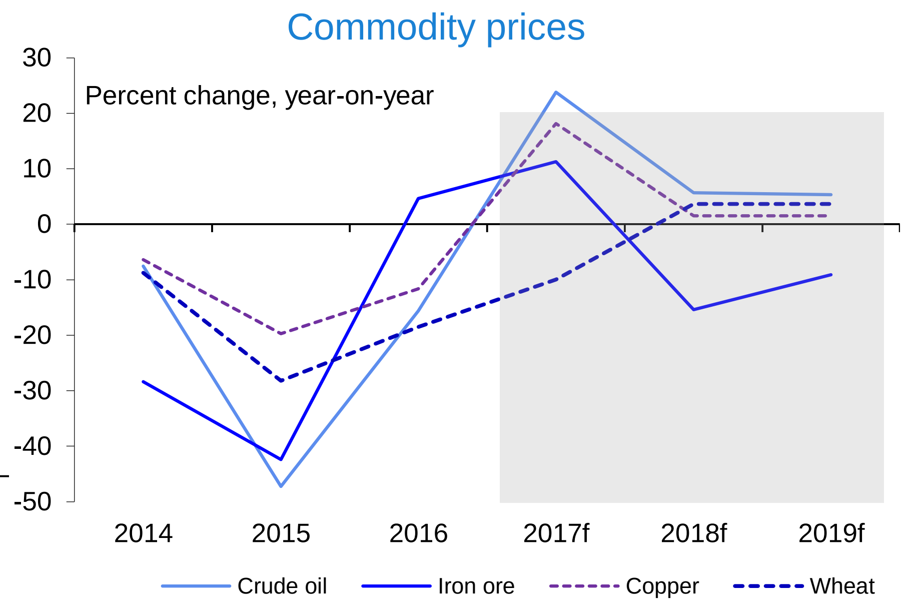
As actual growth continues to fall well below potential growth in South Africa, narrowing output gaps and moderating inflation have raised the prospects of a more accommodative monetary policy stance for SA. However, for a cut to materialise CPI inflation needs to be expected to fall towards 4.5% in 2018, an outcome not yet widely anticipated.

Unless otherwise stated all views in this document are of the baseline case.

… at odds with the synchronized global upswing, as domestic issues, …

- The modest upswing in global growth is expected to strengthen, as the systemic improvement gains traction on further advances in both trade activity and investment levels globally.
- However, commodity prices are not expected to see a substantial rise, especially those of metals.
- The Q1.17 expectation of a mild acceleration in global economic growth on improvements in key advanced economies and emerging markets, along with some low-income economies, became increasingly evident over Q2.17.
- SA's economic performance is constrained by, among other factors, rising government debt/ % GDP (which limits fixed investment) and frequent, conflicting political and economic policy proposals. These create uncertainty and so suppress business confidence levels, which in turn has a direct, negative impact on economic growth. In turn, this lowers credit ratings.
- Business confidence readings are severely depressed, with 71% of respondents dissatisfied with the operating environment. Since 2009 on average 59% of respondents have been dissatisfied with the operating environment, which shows the environment is worsening.





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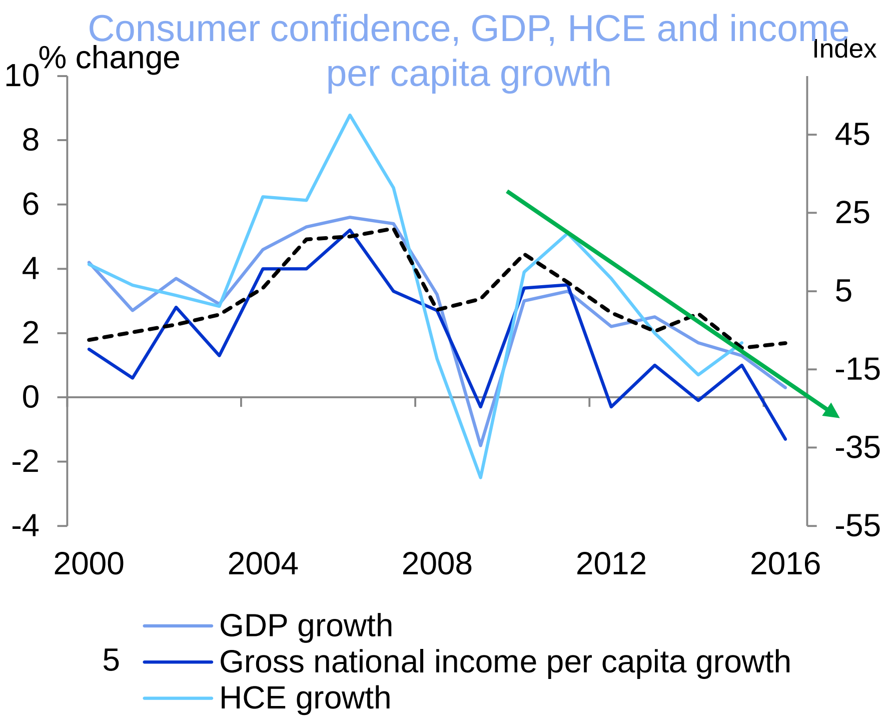
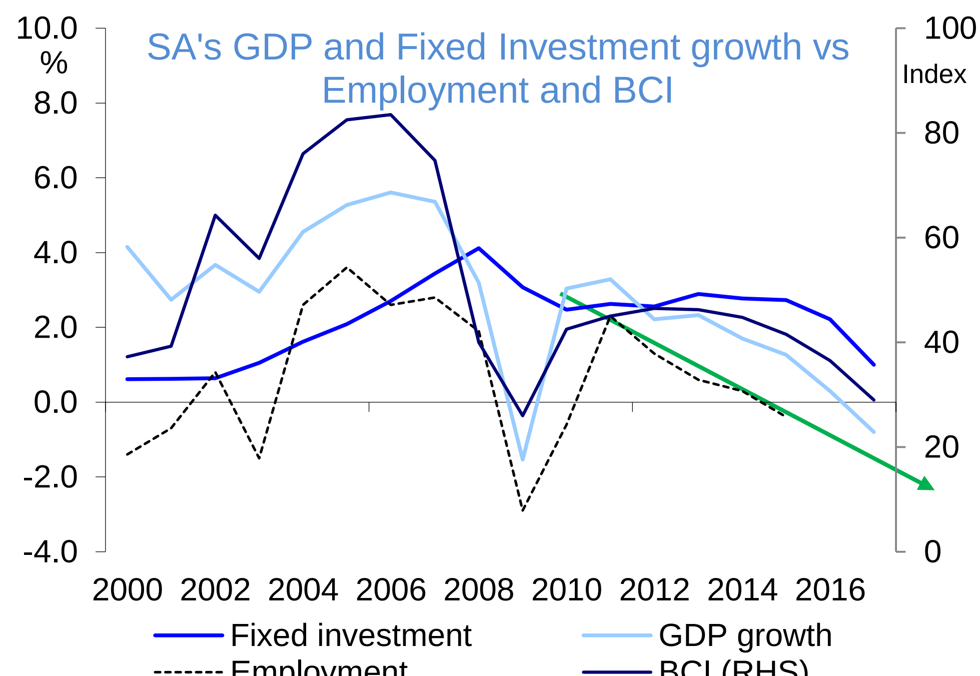
… evidenced by collapsing confidence and credit rating downgrades, …

- Increased global protectionism, with the threat of potential trade wars, remains a risk to the long-term global growth outlook.
- The IMF shows that inequality can be substantially reduced in poor countries with fast growth, increased trade internationally and technological changes.
- In particular, the IMF recommends "trade policies consistent with maximum productivity, supplementing those with other policies that better distribute the gains from foreign trade internally, improve the skills and adaptability of their workforces, and smooth the process of adjustment for those adversely affected by the need for economic reallocation."
- "Policymakers … must do the hard work of investing in their economies, especially in people, to create greater resilience to a host of potential and ongoing structural changes—including the changing modalities of globalization. Useful reforms can focus on active labor market policies, greater tax progressivity where helpful, more effective investment in education, and changes to housing and credit markets that facilitate worker mobility."





Source: SA Reserve Bank, BER, Stats SA

… see recession. The risk is that South Africa's recession extends into …

- 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, or below, is insufficient to prevent further credit rating downgrades, particularly if government debt to GDP ratios do not fall significantly, and there is insufficient SOE reform.
- The credit rating agencies also point to concerns on GDP per capita and the possibility of future government policies undermining economic or fiscal strength, the latter of which is creating uncertainty that is further weakening business confidence.
- 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.

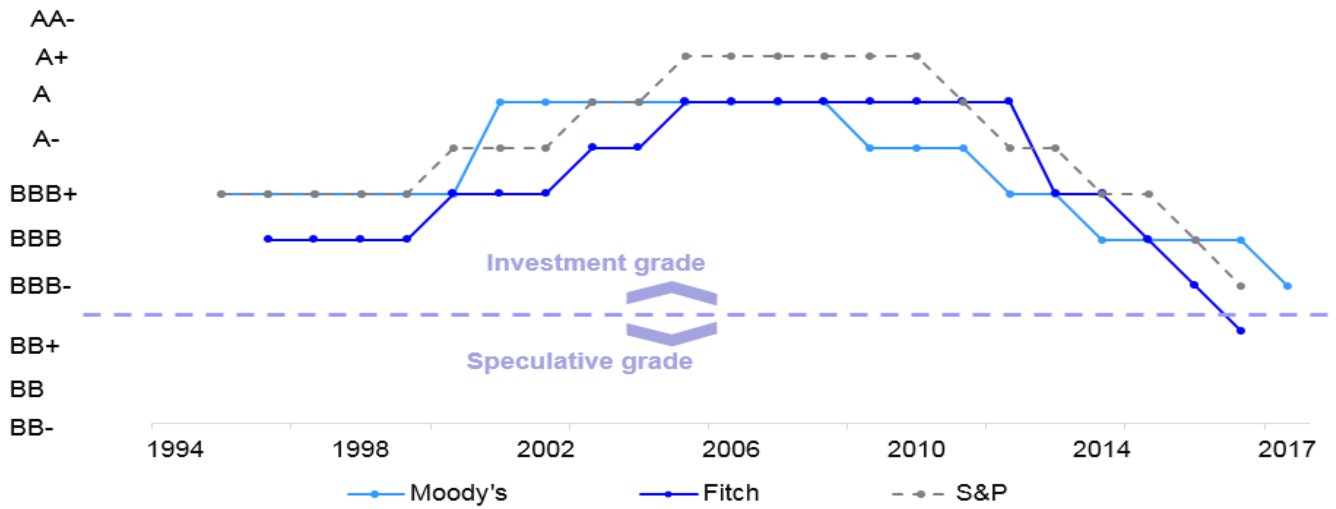
Macro-economic outlook	2017	2018	2019	2020	2021	2022
GDP (% y/y, real)	0.6	1.1	1.6	1.8	1.9	2.0
HCE (% y/y, real)	1.0	1.3	1.8	2.1	2.1	2.1
GCE (% y/y, real)	0.9	0.0	0.4	1.1	1.1	1.1
GFCF (% y/y, real)	-1.5	-0.5	1.1	3.0	2.3	3.4
GFCF as a % GDP	19.6	19.2	19.2	19.4	19.4	19.7
Export (% y/y, real)	3.9	4.3	4.9	6.1	5.2	5.0
Imports (% y/y, real)	2.0	2.9	4.4	6.2	5.3	5.6
Balance: Current Account (sa) - % GDP	-2.5	-2.7	-2.8	-3.1	-3.3	-3.4
Consumer Inflation (% y/y)	5.4	5.2	5.4	5.5	5.6	5.6
Prime Overdraft Rate (year-end: %)	10.50	10.50	10.50	10.50	10.50	10.50
Rand/USD	13.18	13.16	12.13	11.54	11.66	12.13

Source: SARB, IRESS, Investec

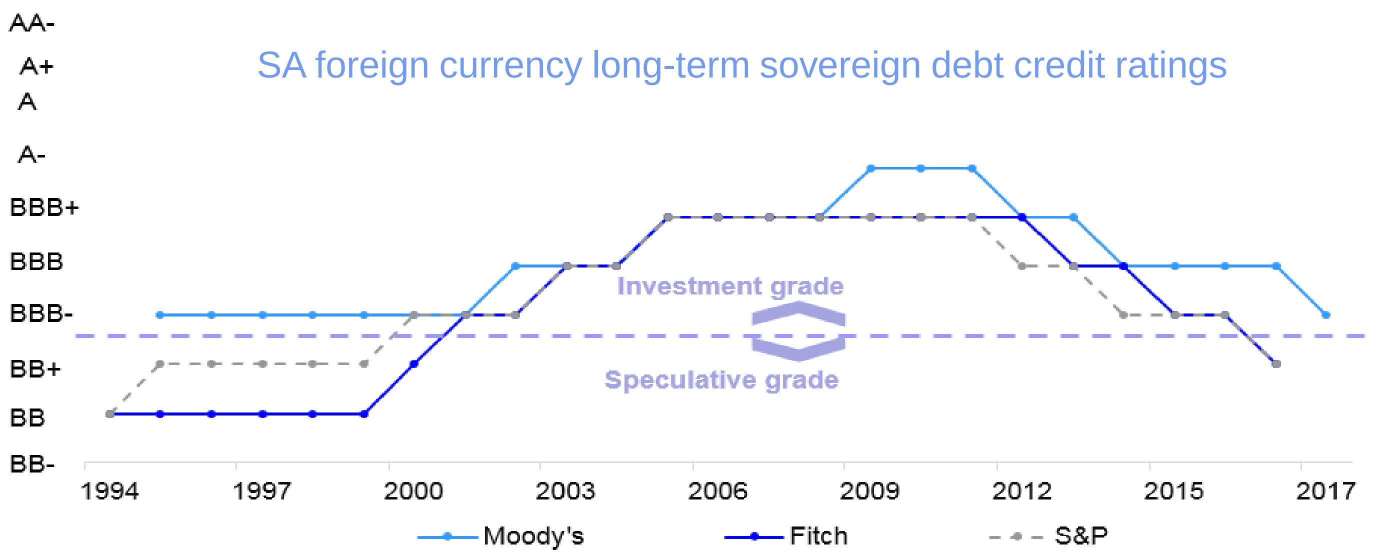
… Q2.17, as the crisis of confidence South Africa is facing about its ....

- From the three key rating agencies SA has two local currency (LC) long-term sovereign debt (LSD) investment grade (IG) ratings, from Moody’s and S&P.
- SA has only one foreign currency (FC) LSD investment grade rating, from Moody’s.

SA local currency long-term sovereign debt credit ratings



SA foreign currency long-term sovereign debt credit ratings



Source: Rating Agencies

… outlook is reflected by suppressed readings in the macroeconomic…

- While the risk of secular stagnation has faded globally, it is increasingly manifesting in South Africa. Secular stagnation occurs where low confidence levels translate into low fixed investment growth and employment, dampening incomes and personal expenditure and inflation, leading to stagnant growth outcomes.
- SA's credit rating downgrades this year were brought about by its substantial, declining economic growth trend as government debt to GDP ratio escalated (with substantial contingent liabilities on SA's balance sheet from the guarantees extended to its state owned entities) since 2009.

Foreign Currency – Long term

	S&P	Moody's	Fitch
Brazil	BB	Ba2	BB
Russia	BB+	Ba1	BBB-
India	BBB-	Baa3	BBB-
China	AA-	A1	A+
South Africa	**BB+**	**Baa3**	**BB+**
Nigeria	B	B1	B+
Kenya	B+	B1	B+
Namibia	NR	Baa3	BBB-
Ghana	B-	B3	B
Botswana	A-	A2	NR
Mozambique	NR	Caa3	NR
Zambia	B	B3	B
Ethiopia	B	B1	B
Rwanda	B	B2	B+
Uganda	B	B2	B+
Angola	B	B1	B
Dem. Rep of Congo	B-	B3	NR

Source: Rating Agencies

… data, both in our GDP growth forecasts, and those of other institutions.

- South Africa's economic growth projections remain below those of the sub-Saharan African region, global and advanced economies, as well as below that of EMs, as has become the norm.

Overview of the Work Bank Growth Projections

Real GDP [1]	Estimates		Projections		Percentage point differences from January 2017 projections			
	2016	2017	2018	2019	2016	2017	2018	2019
World Output	**2.4**	**2.7**	**2.9**	**2.9**	**0.1**	**0.0**	**0.0**	**0.0**
Advanced Economies	1.7	1.9	1.8	1.7	0.1	0.1	0.0	0.0
United States	1.6	2.1	2.2	1.9	0.0	-0.1	0.1	0.0
Euro Area	1.8	1.7	1.5	1.5	0.2	0.2	0.1	0.1
Japan	1.0	1.5	1.0	0.6	0.0	0.6	0.2	0.2
Emerging and developing economies (EMDE's)	**3.5**	**4.1**	**4.5**	**4.7**	**0.1**	**-0.1**	**-0.1**	**0.0**
East Asia and Pacific	**6.3**	**6.2**	**6.1**	**6.1**	**0.0**	**0.0**	**0.0**	**0.0**
China	6.7	6.5	6.3	6.3	0.0	0.0	0.0	0.0
Indonesia	50	5.2	5.3	5.4	-0.1	-0.1	-0.2	-0.1
Thailand	3.2	3.2	3.3	3.4	0.1	0.0	0.0	0.0
Europe and Central Asia	**1.5**	**2.5**	**2.7**	**2.8**	**0.3**	**0.1**	**-0.1**	**-0.1**
Russia	-0.2	1.3	1.4	1.4	0.4	-0.2	-0.3	-0.4
Turkey	2.9	3.5	3.9	4.1	0.4	0.5	0.4	0.4
Poland	2.8	3.3	3.2	3.2	0.3	0.2	-0.1	-0.2
Latin America and the Caribbean	**-1.4**	**0.8**	**2.1**	**2.5**	**0.0**	**-0.4**	**-0.2**	**-0.1**
Brazil	-3.6	0.3	1.8	2.1	-0.2	-0.1	0.0	-0.1
Mexico	2.3	1.8	2.2	2.5	0.3	0.0	-0.3	-0.3
Middle East and North Africa	**3.2**	**2.1**	**2.9**	**3.1**	**0.5**	**-1.0**	**-0.4**	**-0.3**
Saudi Arabia	1.4	0.6	2.0	2.1	0.4	-1.0	-0.5	-0.5
South Asia	**6.7**	**6.8**	**7.1**	**7.3**	**-0.1**	**-0.3**	**-0.1**	**-0.1**
India [3]	6.8	7.2	7.5	7.7	-0.2	-0.4	-0.3	-0.1
Sub-Saharan Africa	**1.3**	**2.6**	**3.2**	**3.5**	**-0.2**	**-0.3**	**-0.4**	**-0.2**
South Africa	0.3	0.6	1.1	2.0	-0.1	-0.5	-0.7	0.2
Nigeria	-1.6	1.2	2.4	2.5	0.1	0.2	-0.1	0.0
Angola	0.0	1.2	0.9	1.5	-0.4	0.0	0.0	0.6

1. Aggregate growth rates calculated using constant 2010 US Dollars GDP weights
2. GDP growth values are on a fiscal year basis. Aggregates that include these countries are calculated using data compiled on a calendar year basis.
3. The column labelled 2016 refers to FY2016/17

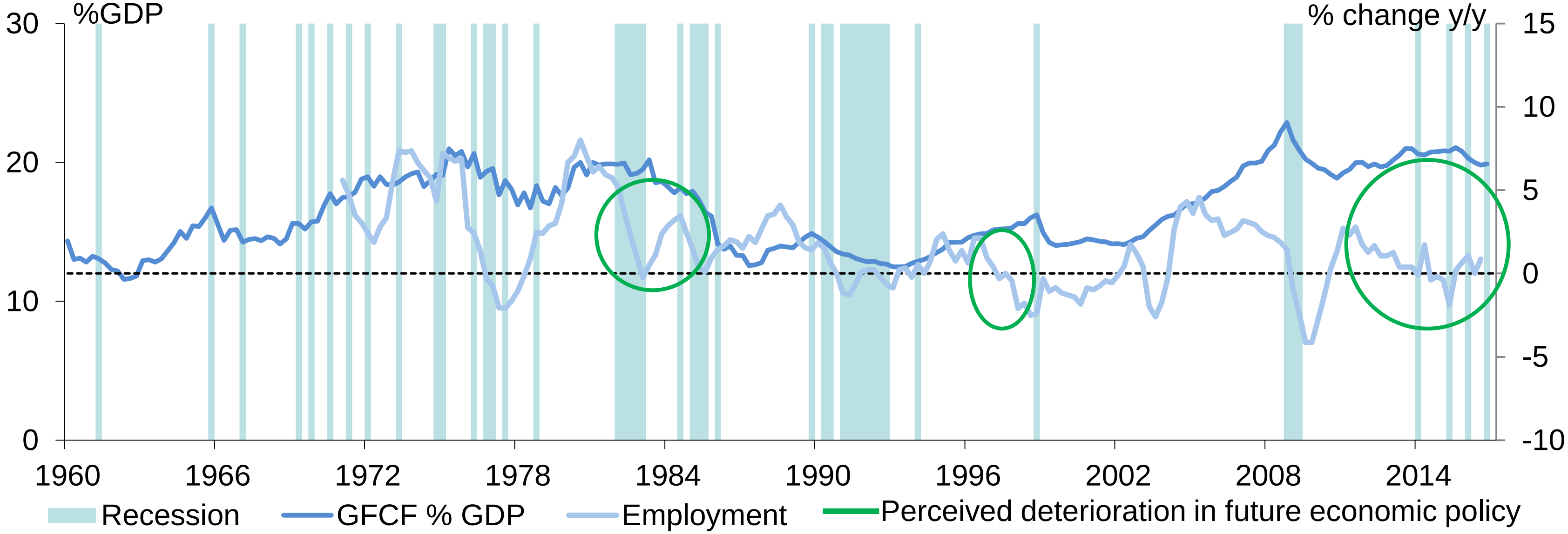
Source: World Bank Group. 2017. *Global Economic Prospects, June 2017: A Fragile Recovery*. Washington, DC: World Bank. Washington, DC: World Bank. doi: 10.1596/978-1-4648-1024-4.

Fixed investment

The key to sustainably, and substantially, lifting employment,

along with a stable political & economic policy outlook

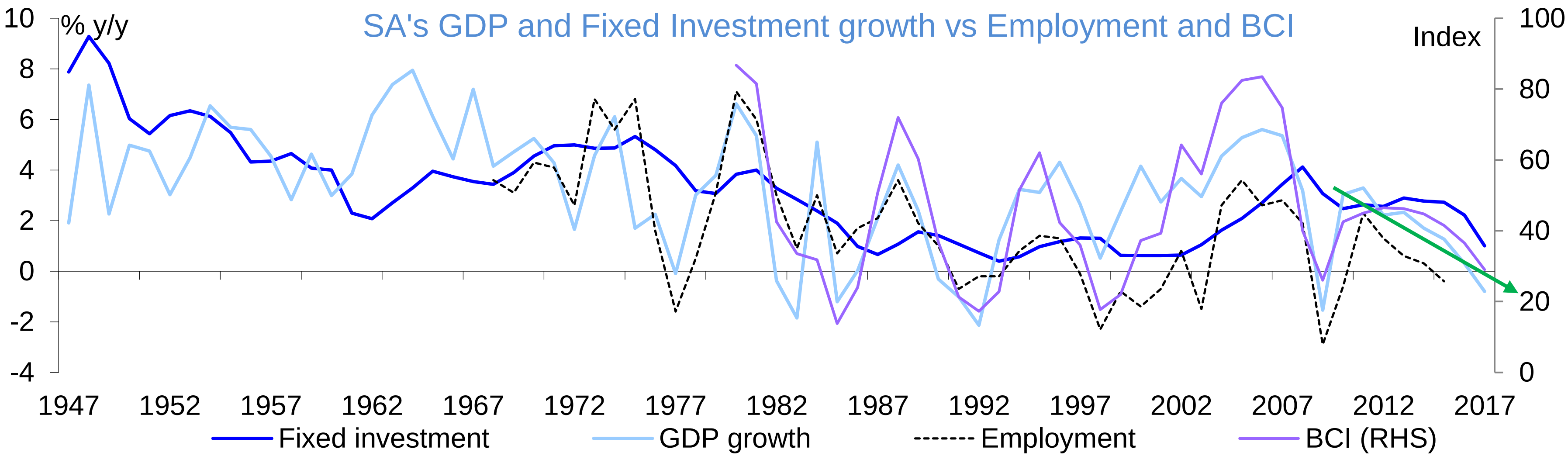
Investment and employment



Source: SARB, Investec

Fixed investment: contracted in 2016, with the growth ...

- In the early 2000's Government both stated its intention to intensify fixed investment and then undertook the upgrading of SA's infrastructure, in an environment of ongoing fiscal consolidation.
- Fixed investment growth accelerated to double digits, propelling economic growth above 5.0% y/y and unemployment down to below 22%.
- Specifically, growth rose above the 2-3% range it was been 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.
- Credit rating upgrades ensued, with an A grade rating from Moody's.

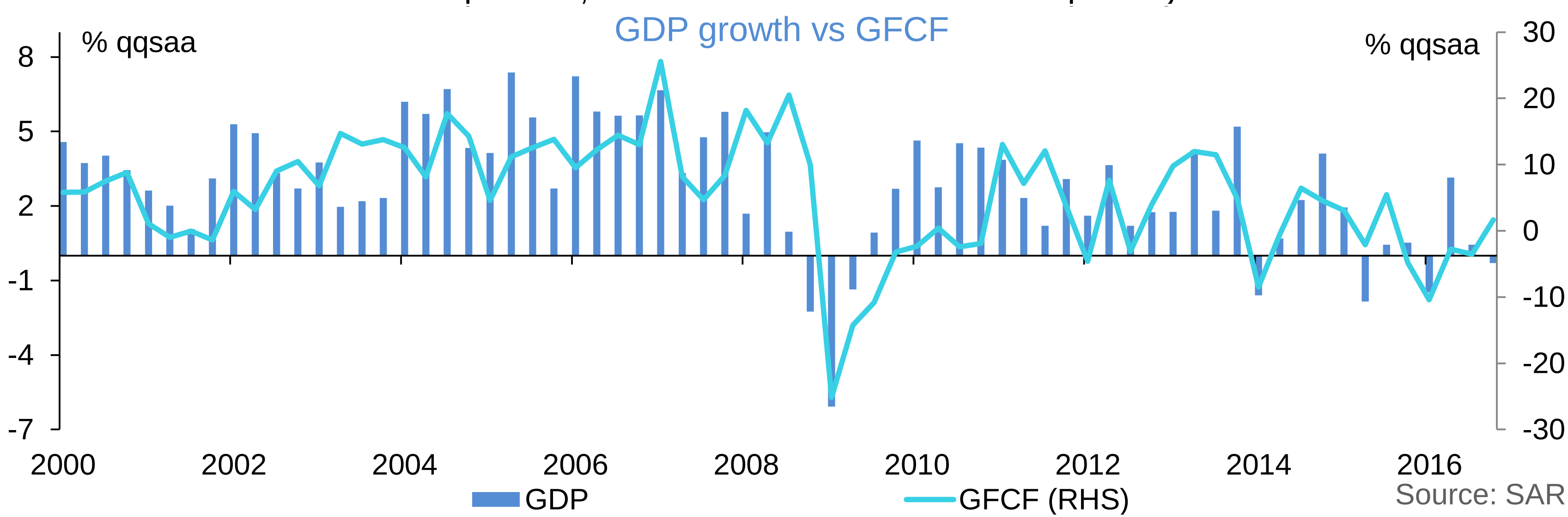


	2017	2018	2019	2020	2021	2022
GFCF (%), real growth y/y	-1.5	-0.5	1.1	3.0	2.3	3.4
GFCF as a % GDP	19.6	19.2	19.2	19.4	19.4	19.7

Source: Investec, SARB, BER

… potential of the economy consequently shrinking. This reinforced …

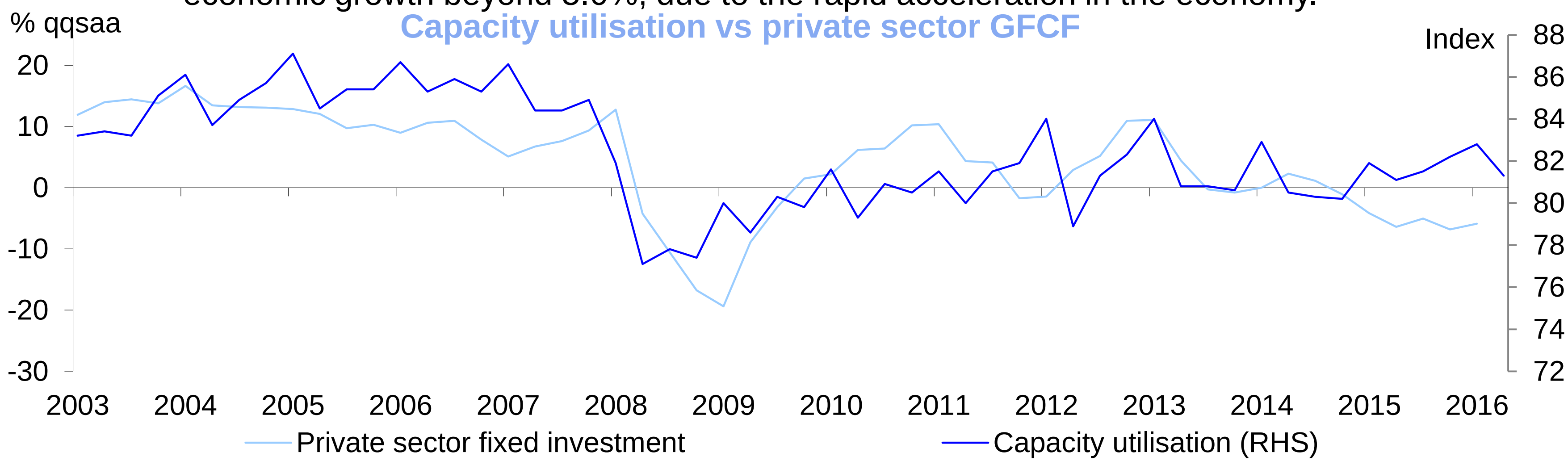
- Through improved fiscal management, money was available to spend on infrastructure, as well managed fixed investment yielded quality infrastructure delivered on time, within budget and which supported private corporate sector expansion.
- Successful delivery by government of its part in productive capacity (including well managed, well financed and efficient SOEs that are not a drag, but instead make a profit, contributing to public finances) is prerequisite to drive domestic growth.
- For economic growth of 5% plus to be sustained (for the purpose of reducing unemployment to single digits over the long-term), fixed investment growth needs to run in double digits.
- 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.
- Only though permanently reducing unemployment can we anticipate a sustained lowering of SA's socio-economic inequalities, and the ultimate eradication of poverty.



Source: SARB

… the weak economic growth trend that has been in evidence in the ...

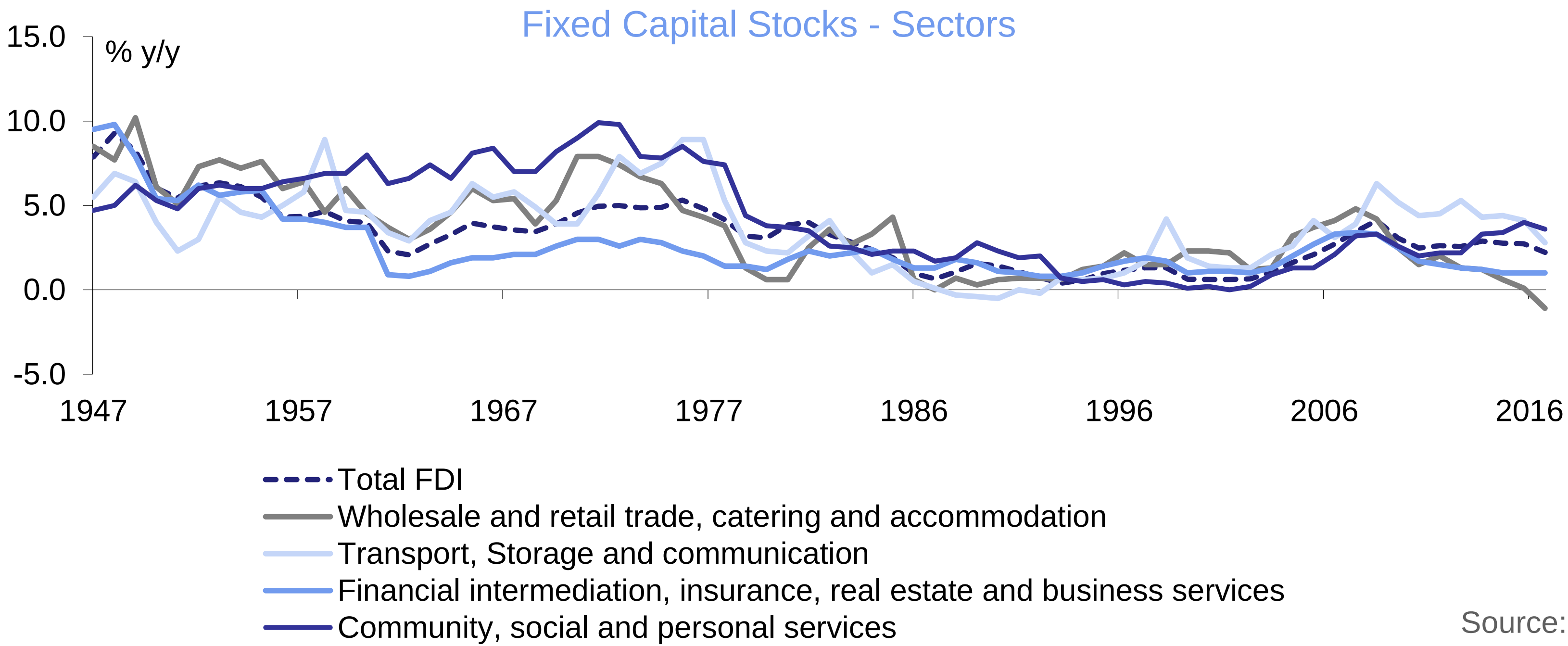
- The expansion of government and SOE fixed investment, in partnership with the private sector, generated increased demand for goods and services.
- This, along with free market policies, entrenched protection of private sector property rights and strong institutions, created a virtuous cycle that boosted 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.



Source: Investec, SARB, Statistics SA

… economy since 2009, underscoring the low job creating capability …

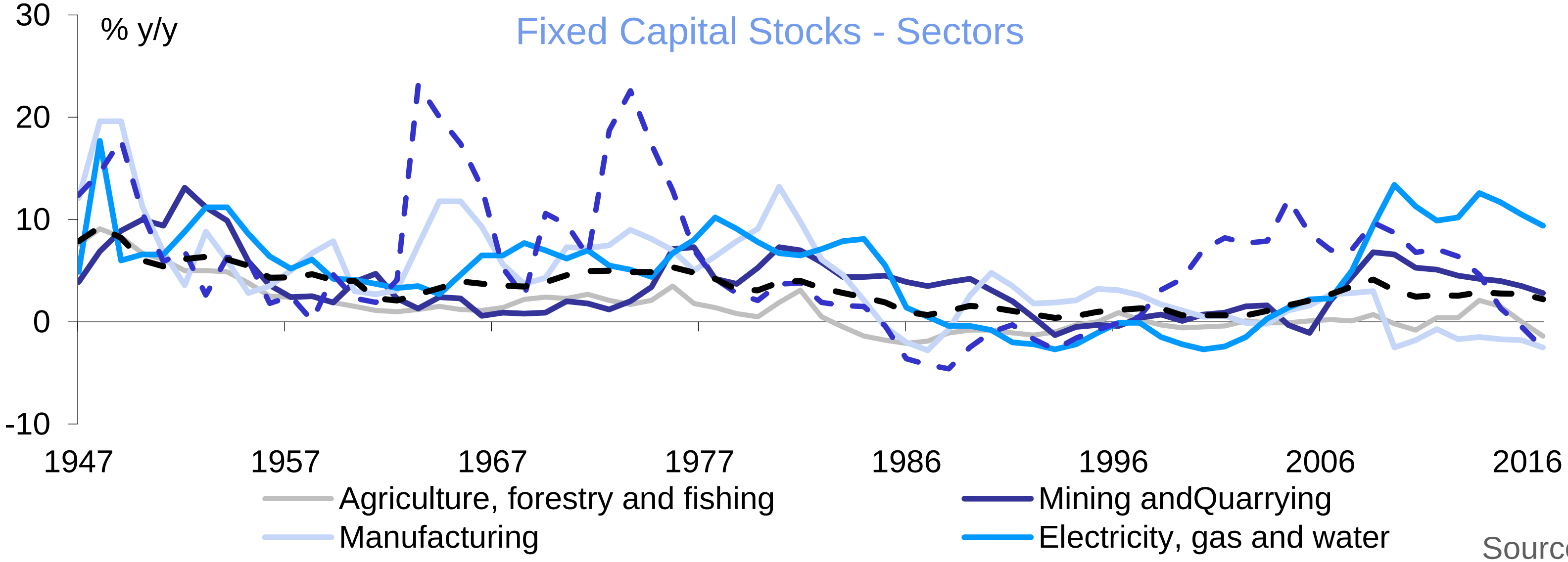
- SA economic growth tends to rise (fall) when growth in total fixed capital stock rises (falls).
- There is a very close correlation between South Africa's GDP and total fixed capital stock (or productive capacity).
- Between 1946 and 1981 GDP growth averaged 4.5%, growth in fixed capital stock 4.7%.
- 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 developing a wait and see approach or disinvesting.



Source: SARB

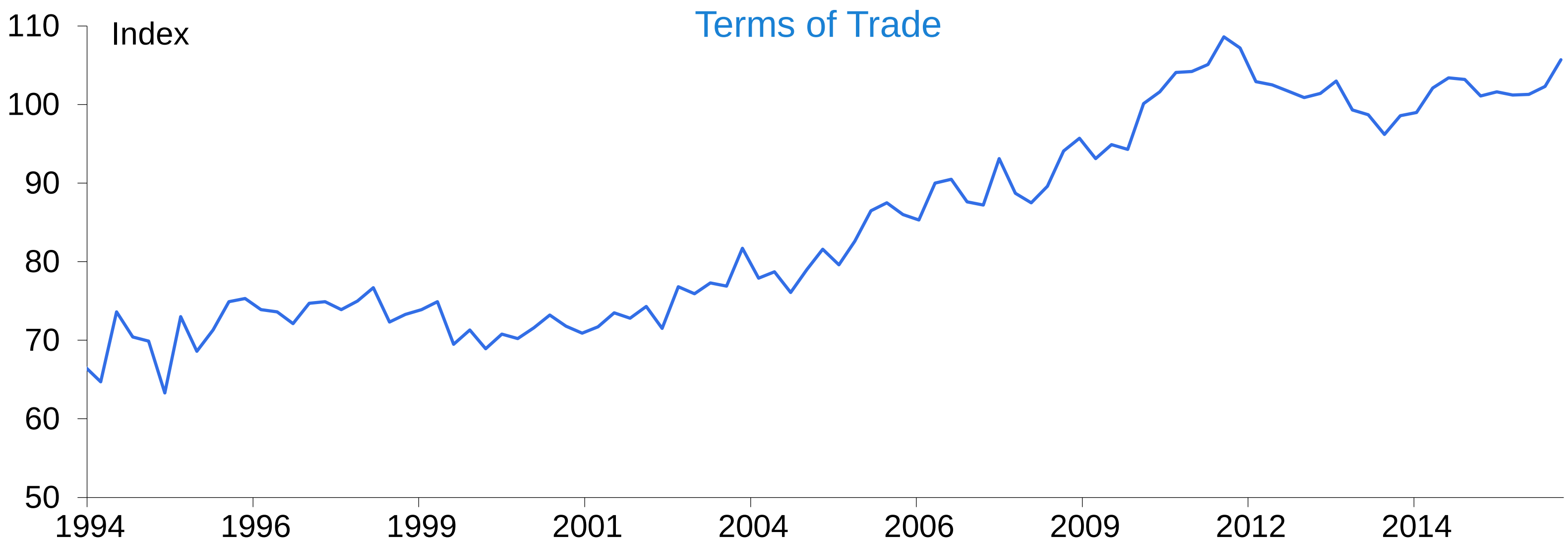
… of the SA economy, in a low business confidence environment.

- Robust economic growth stimulates growth in private sector fixed investment naturally.
- SA's current weak economic growth environment and threats to private sector ownership of their property/fixed investment (including policy proposals), weakens the incentive for the private sector to increase their fixed investment.
- SA needs to reform governance in SOEs and increase public private sector partnerships, particularly improving the relationship between government and business, as business has substantial expertise having incubated a large number of multinational companies.
- State intervention and control of the economy needs to reduce in SA, with free market policies increasingly followed, as these increase economic freedom, and so boslter GDP growth and substantially boost employment, confidence and investment.
- SA also needs to be more efficient and effective in public utilities fixed investment, with a strong focus on cost saving, and matching future capacity to likely growth outcomes.



Source: SARB

Balance of payments (BOP)

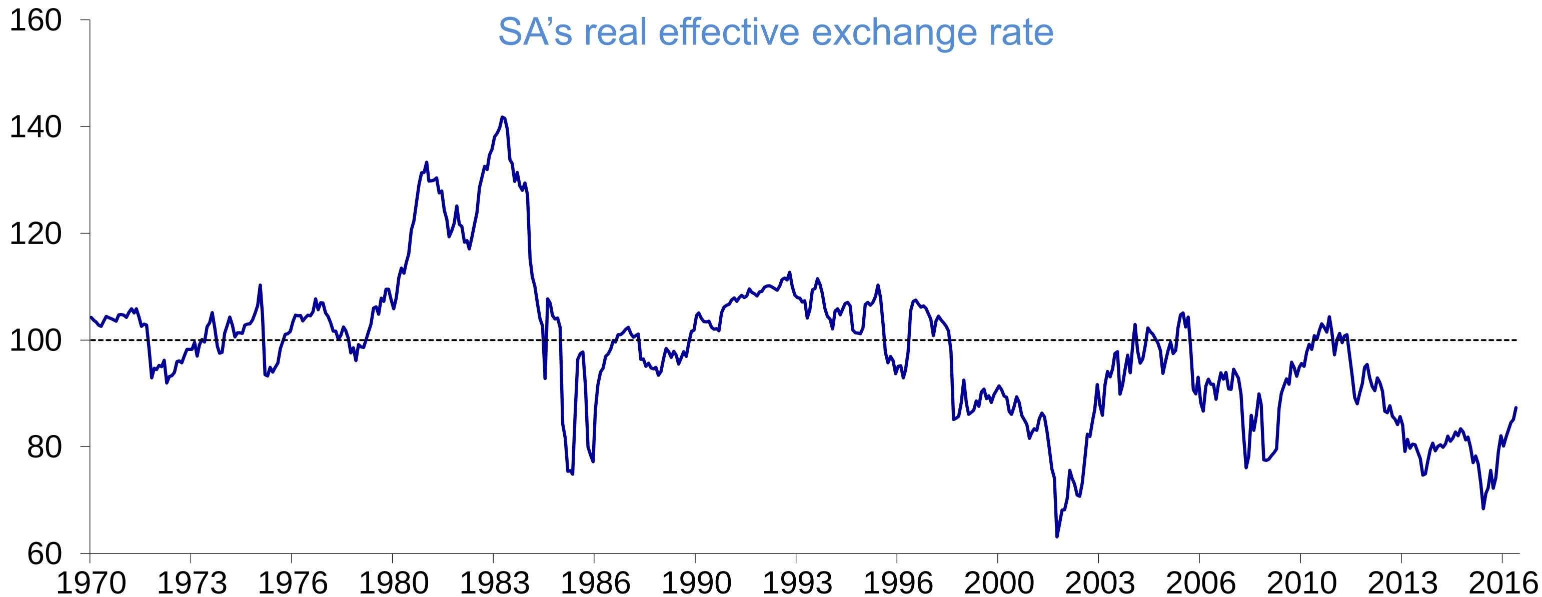


	2017	2018	2019	2020	2021	2022
Balance: Current Account (sa) - % GDP	-2.5	-2.7	-2.8	-3.1	-3.3	-3.4
Rand/USD	13.18	13.16	12.13	11.54	11.66	12.13

Source: SARB, Investec

BOP: the real trade weighted rand is much weaker than in 2009, ...

- Besides global risk-on, the rand has also been supported in H1.17 by the improvement in both SA's trade balance and terms of trade, as weak domestic demand (which helps to subdue inflation in the absence of supply side pressures) has contributed to moderating imports.
- The mild improvement in both global demand (which is expected to lead SA economic growth slightly stronger out to 2022) has been a factor in the improvement in SA's exports, as well as having played some part in the currency's strength since last year.
- The current account has fallen to around 2.0%, and is likely to be close to 3.0% of GDP this year.

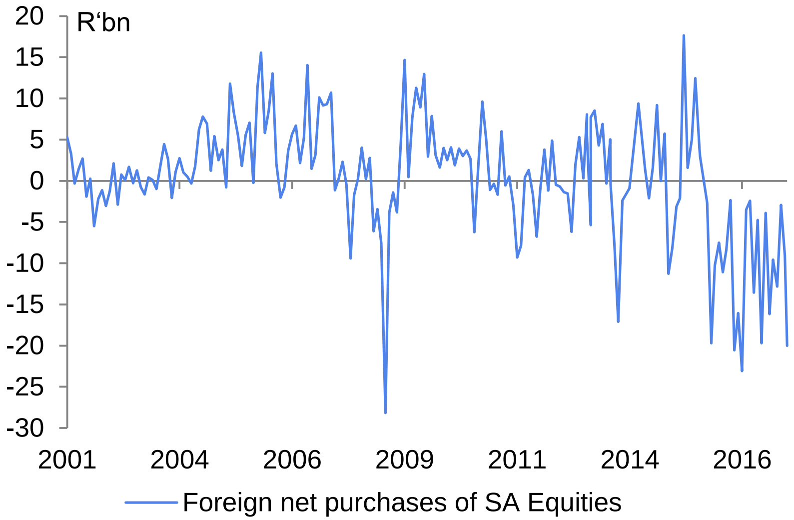


Source: SARB

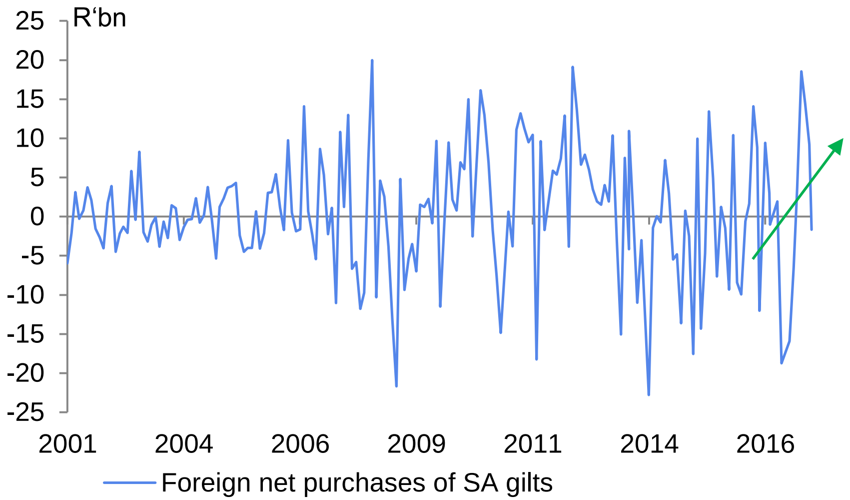
… while substantial portfolio inflows have been recorded on the ...

- South Africa has seen a surplus on the financial account since 2004 as foreigners became substantial holders of South African government debt, with the latest published figure at 36% of total.
- In 2016 the financial account recorded R163.1bn and the current account -R141.6bn.
- Portfolio inflows on the capital account recorded R255bn in 2016.
- An exit from the Citibank WGBI index is estimated to potentially cause around a R135bn outflow, which would negatively impact the financial account, and so the funding of the capital account, causing rand depreciation.

Foreign net purchases of SA Equities



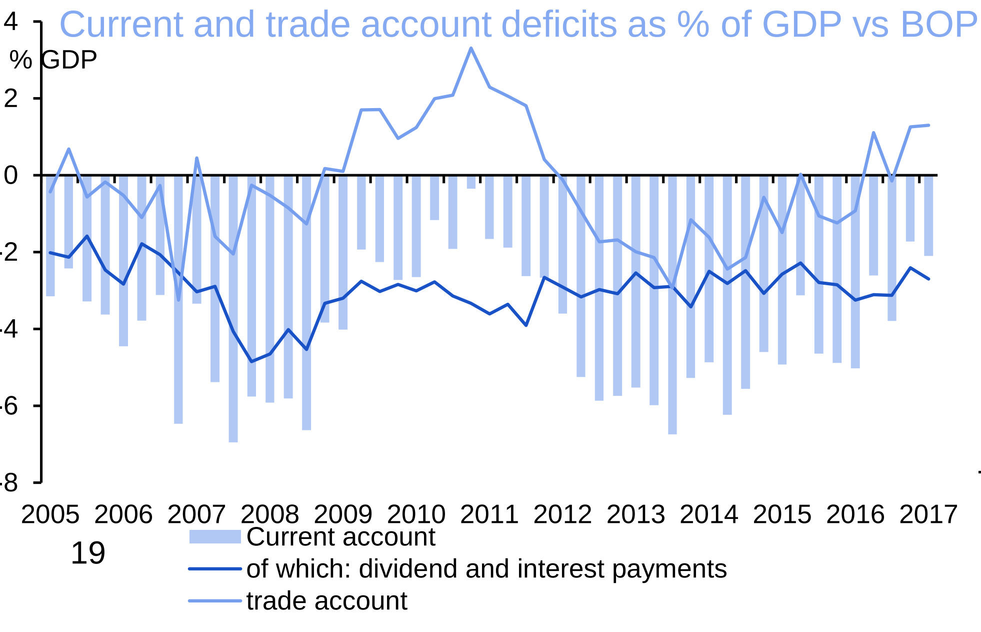
Foreign net purchases of SA gilts

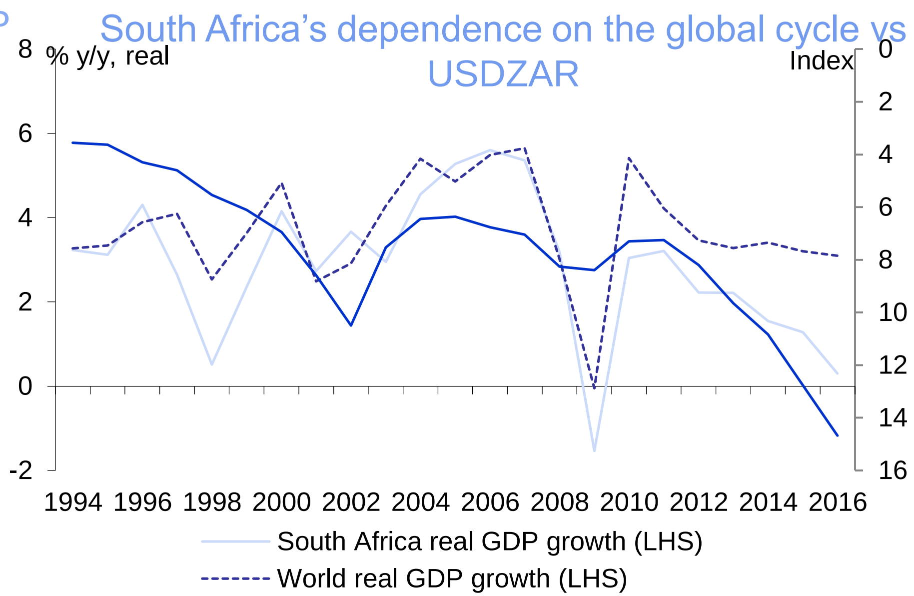


Source: IRESS

… financial account, and the current account deficit has narrowed.

- The trade account moved into surplus last year, aiding to diminish the current account deficit, to -3.3% of GDP in 2016 from -4.4% in 2015 and closer to 6.0% in 2013.
- The improvement in the trade account came about on a moderation in imports on weak domestic demand, with some lift in export earnings as the trade surplus with Africa widened.
- Trade deficits with Europe and Asia narrowed, with the mild lift in global economic activity helping both the trade deficit and financial market sentiment.
- Risk-on has spurred significant bond purchases, which have boosted the financial account and so the rand.
- Looking forward, the current account deficit is expected to widen slightly as economic growth lifts somewhat, but remain below 4.0% of GDP.





Source: SARB, IMF, IRESS

Exchange rate

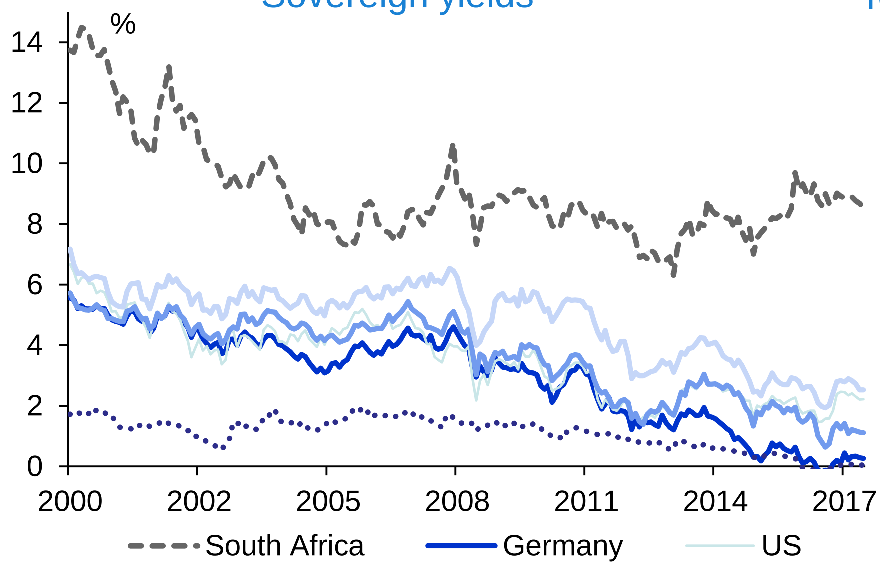
Exchange Rates: averages	2017	2018	2019	2020	2021	2022	2023
USD/ZAR (Av)	13.18	13.16	12.13	11.54	11.66	12.13	12.73
GBP/ZAR (Av)	16.76	17.19	16.64	16.09	16.44	17.22	18.20
EUR/ZAR (Av)	14.61	15.23	14.32	13.79	14.26	15.04	15.91
ZAR/JPY (Av)	8.41	8.05	8.66	9.21	9.18	8.83	8.41
GBP/USD	1.27	1.31	1.37	1.40	1.41	1.42	1.43
EUR/USD	1.11	1.16	1.18	1.20	1.22	1.24	1.25
USD/JPY	111	106	105	106	107	107	107

Source: Investec, IRESS

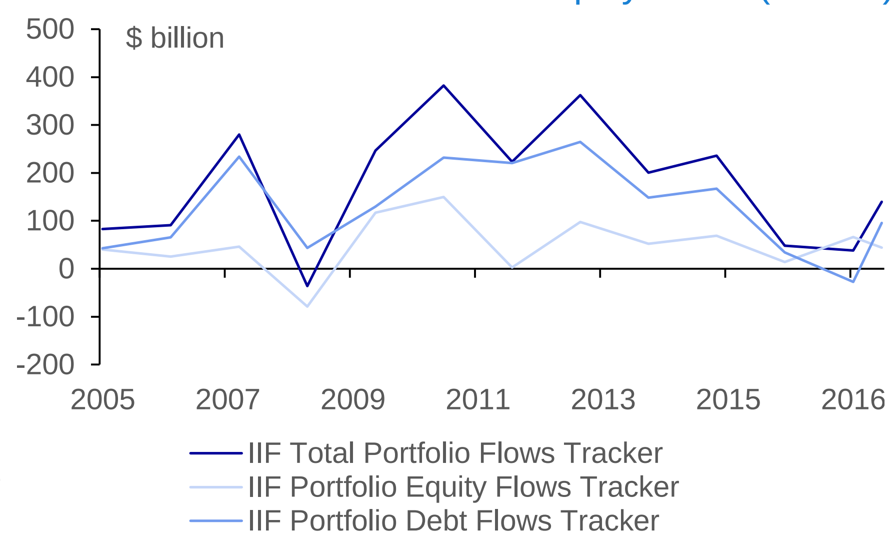
Exchange rates: strong global appetite for local currency EM …

- This year the rand has been bolstered by global risk-on sentiment (particularly for EM local currency debt), opening at R13.74/USD, R14.45/EUR and R16.93/GBP and strengthening to R12.29/USD, R13.29/EUR and R15.31/GBP by March.
- Specifically, foreign investors have favoured local currency emerging market (EM) debt given the comparative lower yields on developed economies debt, particularly in the Euro area.
- However, end March's change in Finance Minister, and early April's drop in its sovereign credit ratings, weakened the rand to R13.96/USD, R14.87/EUR and R17.34/GBP. The domestic currency subsequently bounced back over Q2.17 on continued global risk-on, aided by SA's remaining two investment grade ratings on its local currency long-term sovereign debt.
- Risk-on faded slightly at the start of Q3.17, with the rand weakening somewhat as developed

Sovereign yields



Total Portfolio Flows vs Debt and Equity Flows (annual)

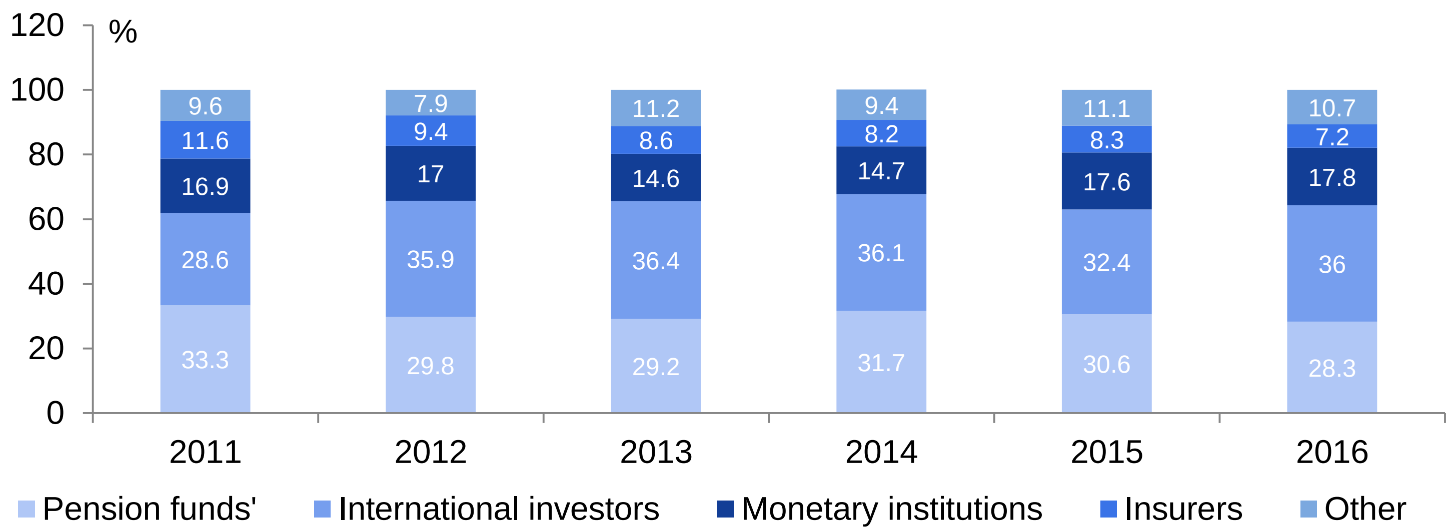


Source: IRESS, IIF Portfolio Flows Tracker

… sovereign debt has seen strong foreign inflows into this asset ...

- economies Central Banks suggested a shift towards a tightening bias, causing global bond yields to lift.
- A faster normalisation of global interest rates than currently expected would erode the global risk-on sentiment, likely to the point of risk-off, which could see rand weakness.
- Domestically, the rand's Purchasing Power Parity (PPP) is at R10.50/USD.
- The rand's future attainment of its fair value (or PPP, which is expected to depreciate by about 3-4% per year) will depend on SA retaining at least one investment grade local currency (rand denominated) long-term sovereign credit ratings.
- However, the outlook from S&P and Moody's are both negative, signalling the likelihood of further downgrades (Fitch stable but has SA already on sub-investment grade).
- SA's rand denominated sovereign debt issuance is around 90% and hard currency 10%.

Holders of domestic government bonds, 2009-2016

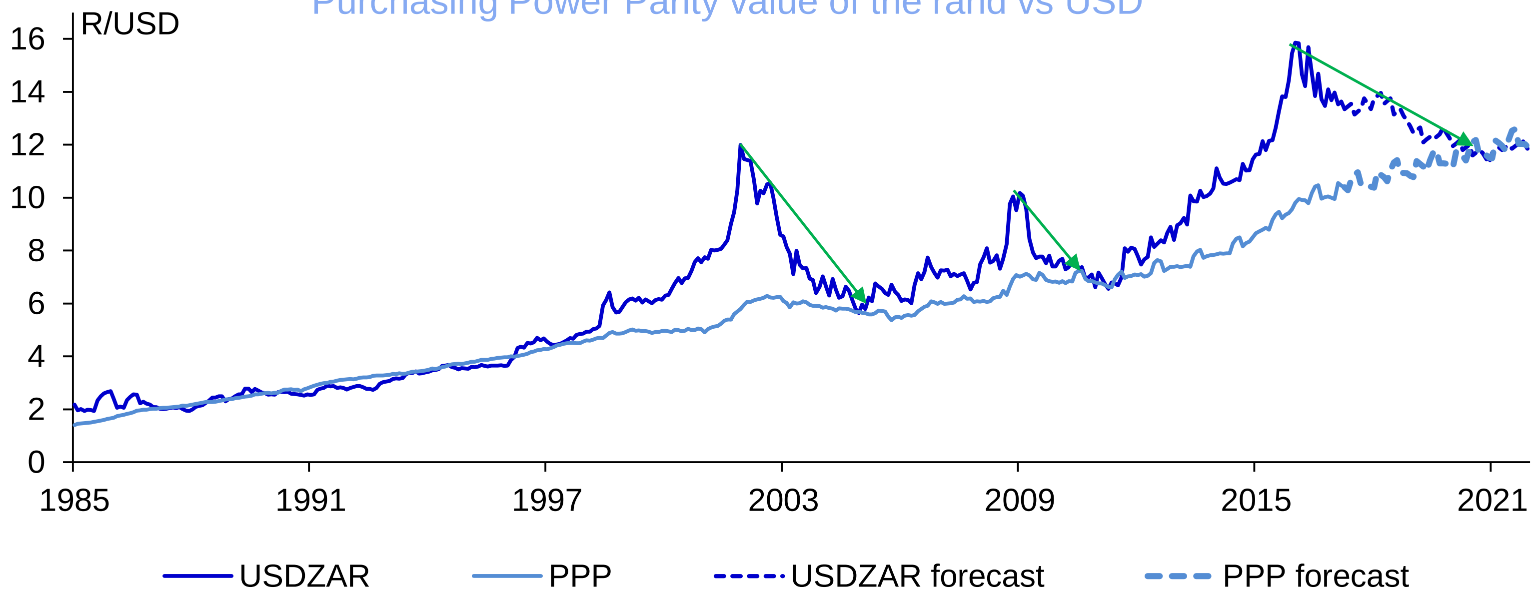


Source: Budget 2017

... class, with the rand strengthening post South Africa's credit rating …

- South Africa's net debt has risen from 22% of GDP in 2008/09 to 46.0% of GDP in 2016/17, and is scheduled to rise to 48% of GDP in 2019/20.
- If government fails to reverse the trend (to closer to 40% of GDP) then the rating agencies perceived credit worthiness of South Africa's debt (SA's sovereign credit ratings) will likely fall further.
- A more gradual trajectory than previously is likely in the return to PPP, given the recent downward trend in credit ratings.
- The rand could reach PPP in 2020, where PPP valuation will then be closer to R11.50/USD in the absence of a loss in its remaining investment grade credit ratings.

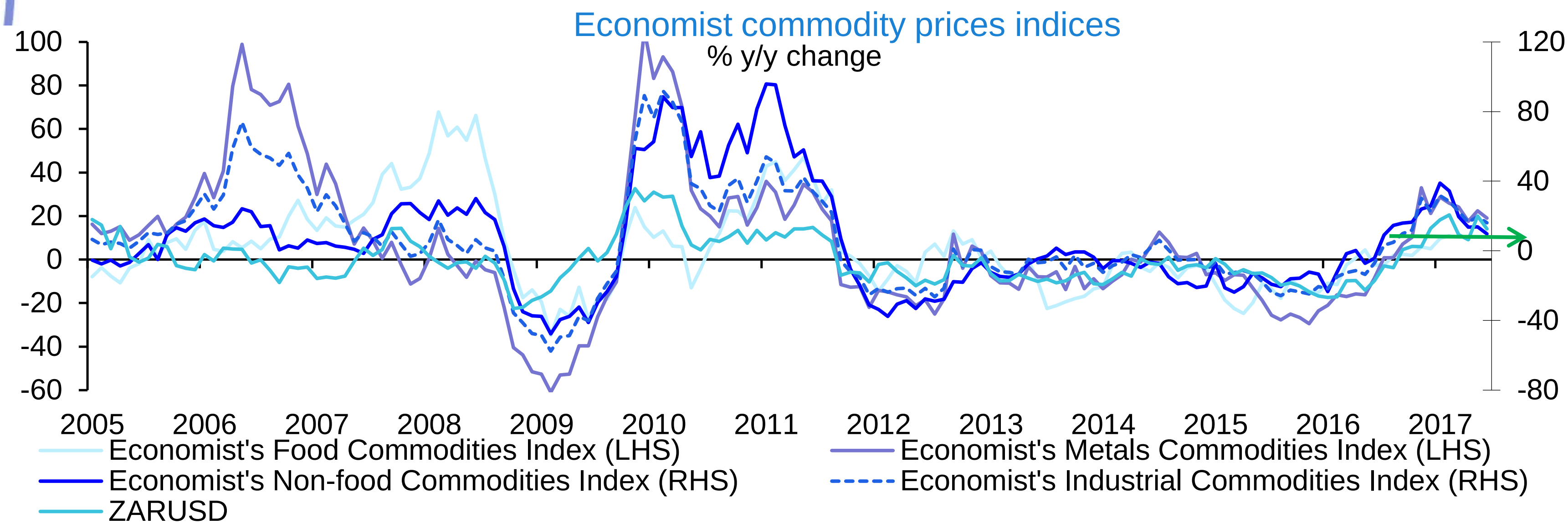
Purchasing Power Parity value of the rand vs USD

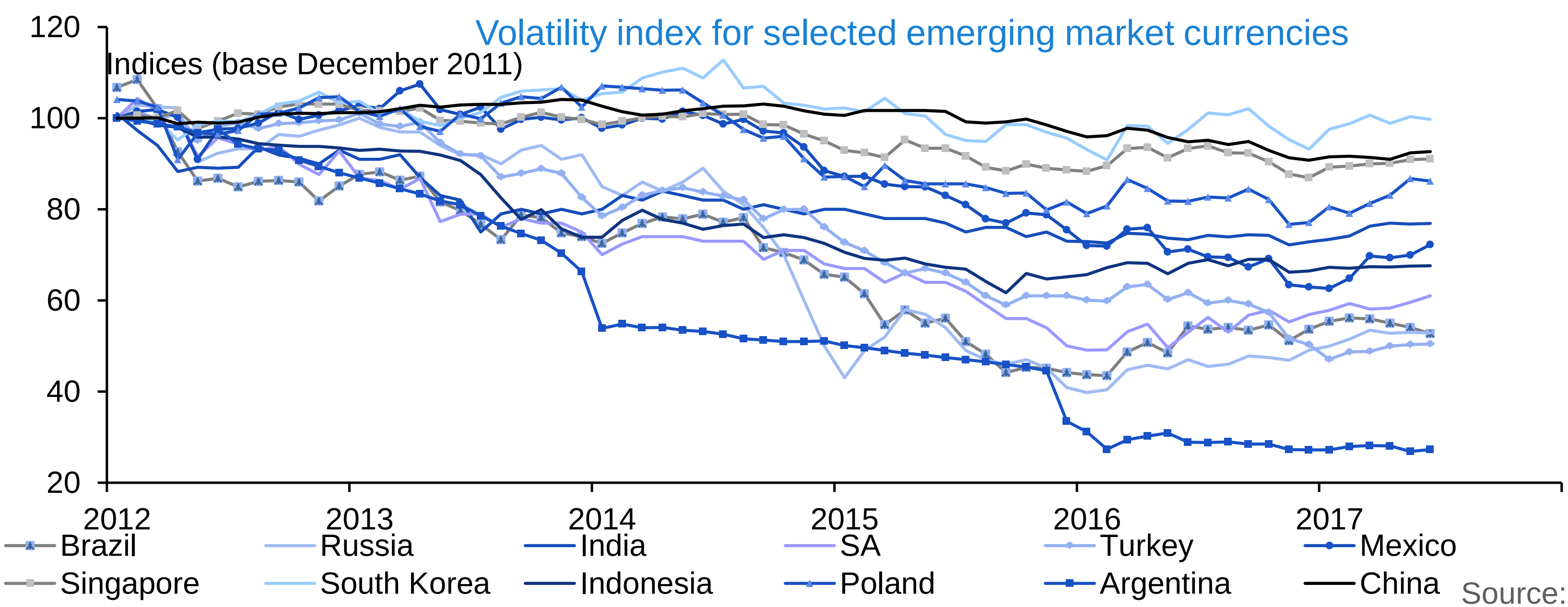


Source: Investec, IRESS

… downgrades as a result (SA still has two LCIG). Commodity prices ...

- In this forecast modest global growth environment, with only a gentle upward trend in commodity prices, the rand cannot be expected to gain substantial strength from this source.





Source: IRESS

… are only somewhat off their lows. SA faces material risk of further credit rating downgrades.

- Should SA lose all its local currency (LC) long-term sovereign investment grade (LSD) credit ratings then the structural adjustment is likely to be greater.
- SA bonds would fall out of Citibank's WGBI as it requires at least one LC LSD IG rating.
- 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.
- On average it takes several years for a country to regain its investment grade rating once lost.
- The rand would then be unlikely to regain PPP by 2020, as is currently forecast in the expected case.

Base line (expected) case currency forecasts:

	Q1.17	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18
USD/ZAR (Av)	13.22	13.19	13.00	13.30	13.60	13.40	13.00	12.65
GBP/ZAR (Av)	16.35	16.85	16.65	17.18	17.65	17.49	17.01	16.60
EUR/ZAR (Av)	14.08	14.52	14.68	15.16	15.57	15.48	15.08	14.80
ZAR/JPY (Av)	8.54	8.39	8.53	8.20	7.87	7.91	8.12	8.30
GBP/USD (Av)	1.24	1.26	1.28	1.29	1.30	1.31	1.31	1.31
EUR/USD (Av)	1.07	1.09	1.13	1.14	1.15	1.16	1.16	1.17
USD/JPY (Av)	114	112	111	109	107	106	106	105

Source: IRESS, Investec

Economic Scenarios: the risk is currently tilted to the downside

		Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Extreme up	Rand/USD (average)	13.00	11.70	10.60	9.50	8.60	7.90	7.60	7.40
Case 1%	Repo rate (end rate)	7.00	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. .

Up case		Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
10%	Rand/USD (average)	13.00	12.60	12.20	11.80	11.50	11.20	10.50	10.55
	Repo rate (end rate)	7.00	6.75	6.50	6.25	6.25	6.00	5.50	5.50

Persistent economic growth of 3-5%, 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	Rand/USD (average)	13.00	13.30	13.60	13.40	13.00	12.65	12.30	11.95
case 35%	Repo rate (end rate)	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00

Trend growth rate of 2.0% y/y, reached by 2023. Recent downgrades subdue confidence and so growth somewhat. 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.

		Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Down case	Rand/USD (average)	13.00	16.00	18.00	19.00	19.50	18.50	17.80	16.90
35%	Repo rate (end rate)	7.00	7.50	8.25	9.00	10.00	10.50	10.50	10.50

All three agencies rate SA's foreign and local currency long-term debt sub-investment grade, increased chance of further credit downgrades. Rand weakness (SA debt exits Citibank WGBI), confidence and investment measures depressed. Government's capacity for expenditure reduced, including social welfare grants. Commodity slump, global sharp slowdown/recession (SA V shaped recession).

		Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Extreme	Rand/USD (average)	13.00	17.00	19.00	21.00	22.80	24.00	25.50	26.00
down case	Repo rate (end rate)	7.00	8.00	10.00	13.00	15.50	17.00	19.00	22.00

19%

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.

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

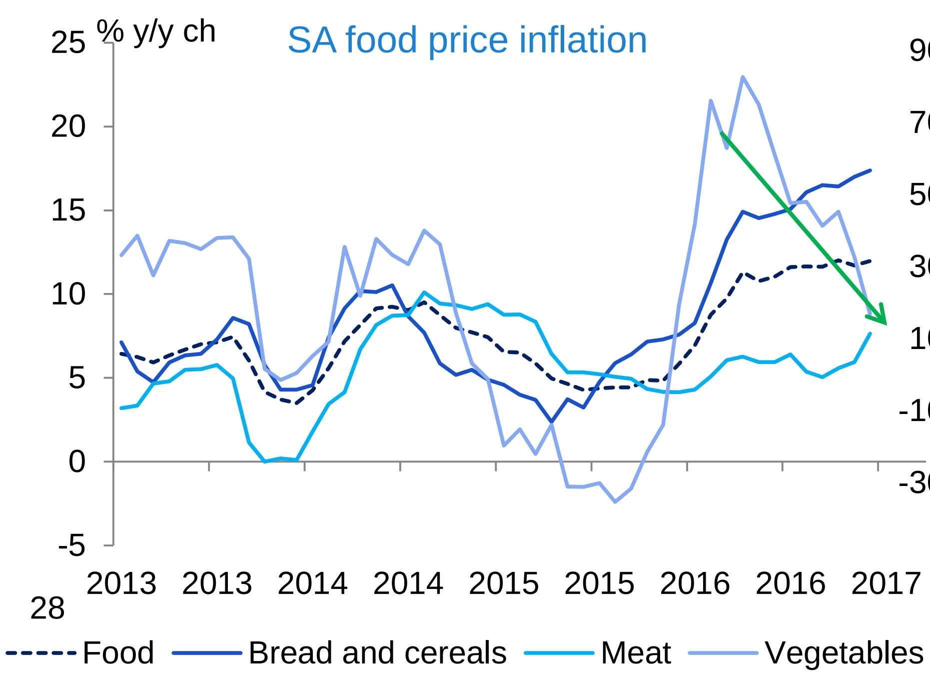
Inflation

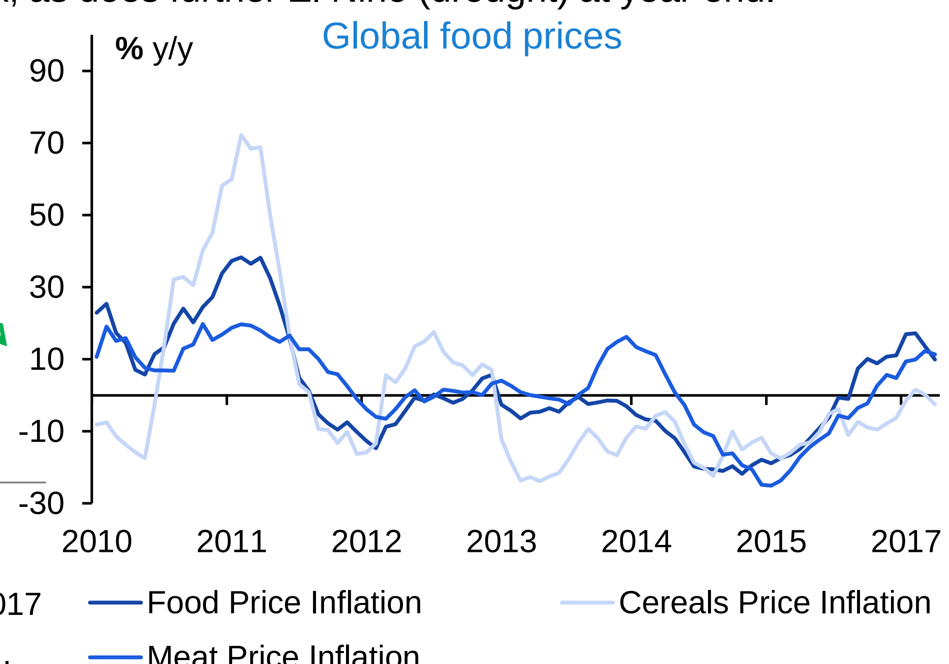
Inflation	2017	2018	2019	2020	2021	2022
Consumer Inflation (Av: %)	5.4	5.2	5.4	5.5	5.6	5.6
(year-end: %)	4.8	5.8	5.4	5.4	5.5	5.5
Producer Inflation (Av: %)	4.7	5.0	5.5	5.3	5.4	5.5
(year-end: %)	3.9	6.1	5.2	5.4	5.2	5.8
Salary & wage increases (%)	7.2	7.2	7.1	7.2	7.3	7.3

Source: Investec, SARB, Stats SA

Inflation: peaked in Q1.16, and 2017 is seeing a downward trend ...

- CPI inflation is waning and is expected to fall below 5.0% by the end of this year on meaningful alleviation of the drought in many areas.
- A bumper maize and soybean crop is expected in the regions which have had relief. Our inflation forecasts fall for this year as food price disinflation (falling inflation) occurs.
- However, some areas do not have drought relief, and will likely take more than a year to recover, due not least to farm debt. Even if drought relief comes to these regions, meat price inflation will not recover quickly.
- With the risk being for further credit rating downgrades, rand weakness consequently remains an upside risk to the CPI inflation outlook, as does further El Nino (drought) at year end.

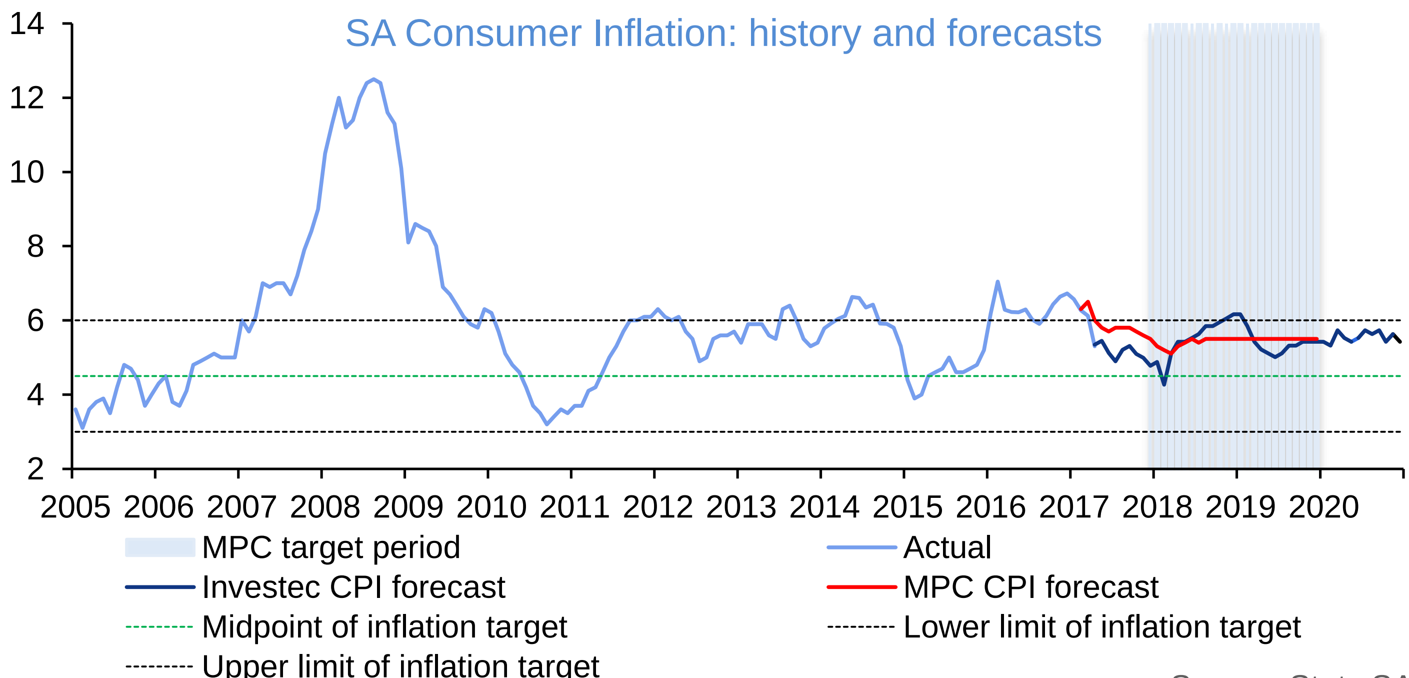




Source: Stats SA, UN

… but will likely average 5.5% both next year, and over medium-term.

- Demand pressures are expected to remain weak in the economy as economic growth is likely to remain below trend until 2022.
- While the electricity tariff has been set for a 2.2% y/y increase this year, previous high increases and the utility's need for funding will likely see upward pressure from this source potentially as early as next year.
- In particular, state administered prices (electricity, water, property rates and taxes etc) are likely to see robust price hikes continue, which will keep CPI inflation at the upper end of the 3.6% inflation target range in the long-term.
- Our long-term inflation forecast subsequently is 5.5% y/y.



Source: Stats SA, Investec, SARB

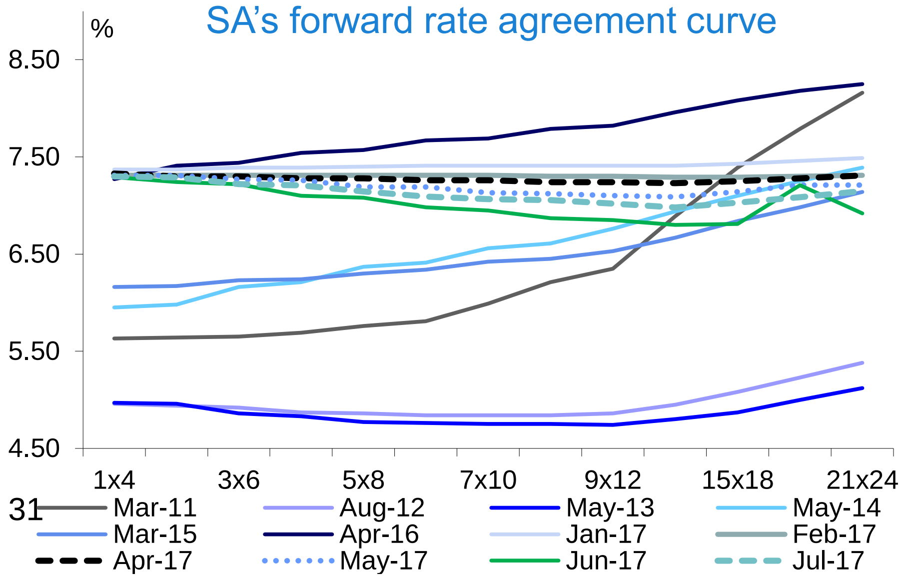
Interest rate

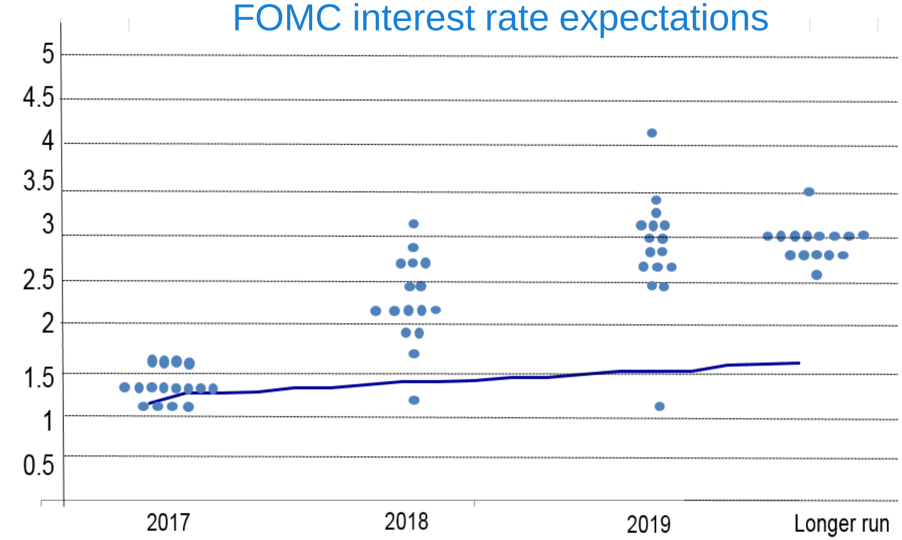
Monetary Sector						
	2017	2018	2019	2020	2021	2022
Repo Rate (year-end: %)	7.00	7.00	7.00	7.00	7.00	7.00
Prime Overdraft Rate (%)	10.50	10.50	10.50	10.50	10.50	10.50
SA rand bond (%)	8.61	8.45	8.37	8.45	8.53	8.62
US Fed funds rate	1.25-1.50	2.00-2.25	2.75-3.00	2.75-3.00	2.75-3.00	2.75-3.00
UK Bank rate	0.25	0.25	0.50	1.00	1.50	1.50

Source: Investec, SARB, IRESS

Interest rates: flat repo rate likely this year in SA. Global risk-on …

- The recent credit rating downgrades, on their own, are not expected to drive an interest rate hike in SA, with the impact on the rand and bonds proving limited in this global risk-on period.
- Foreigners have made substantial purchases of SA government bonds, less sales, this year on global risk-on sentiment.
- The R186 has dropped lower than immediately before the downgrades, inflation is moderating.
- No further repo rate hikes are expected this year as a result.
- The FRA curve is flat to down this year, signaling the potential for a 25bp cut towards year end. Our forecast is currently flat, although we expect July's MPC meeting to see a more dovish tone.
- The SARB's CPI inflation forecast would need to fall below 4.5% y/y over the six to twenty-four month period (but specifically over twelve to twenty four months) for it to consider a cut.
- The US is expected to hike by two to three 25bp increments in 2017.

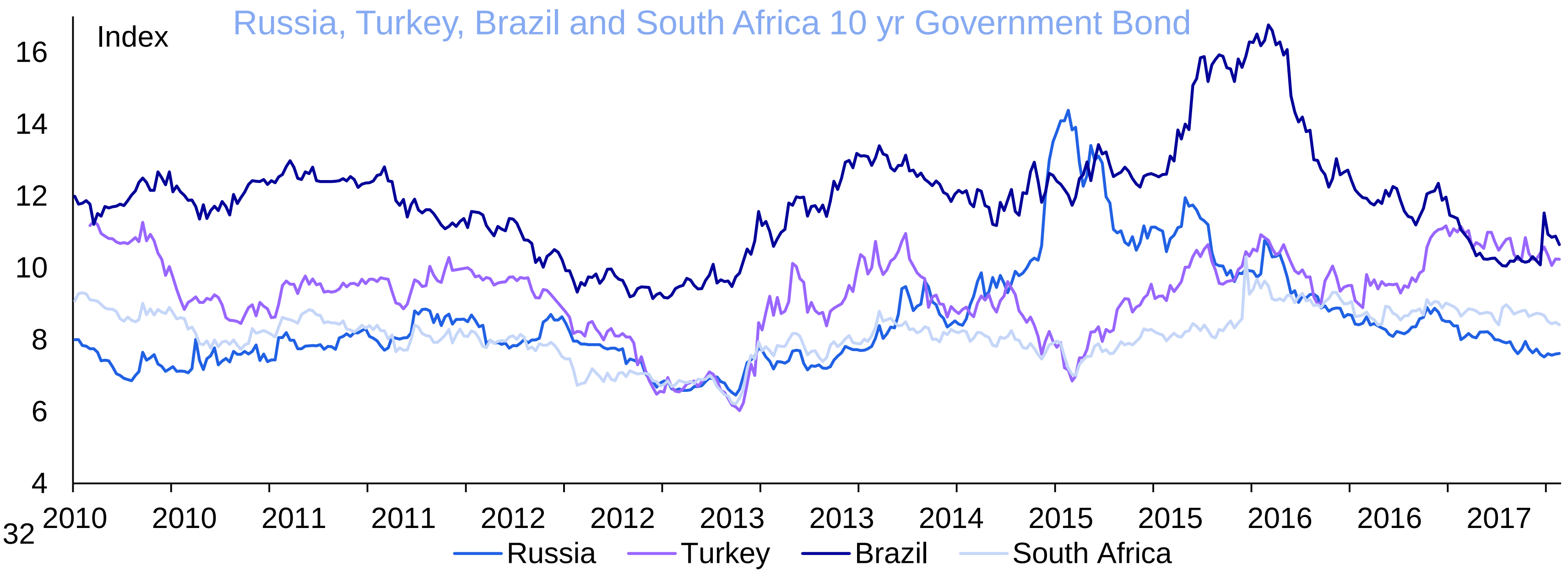




Source graphs: Fed Reserve Bank, Thomson Reuters, Investec

… has lowered yields on the appetite for EM local currency debt, ...

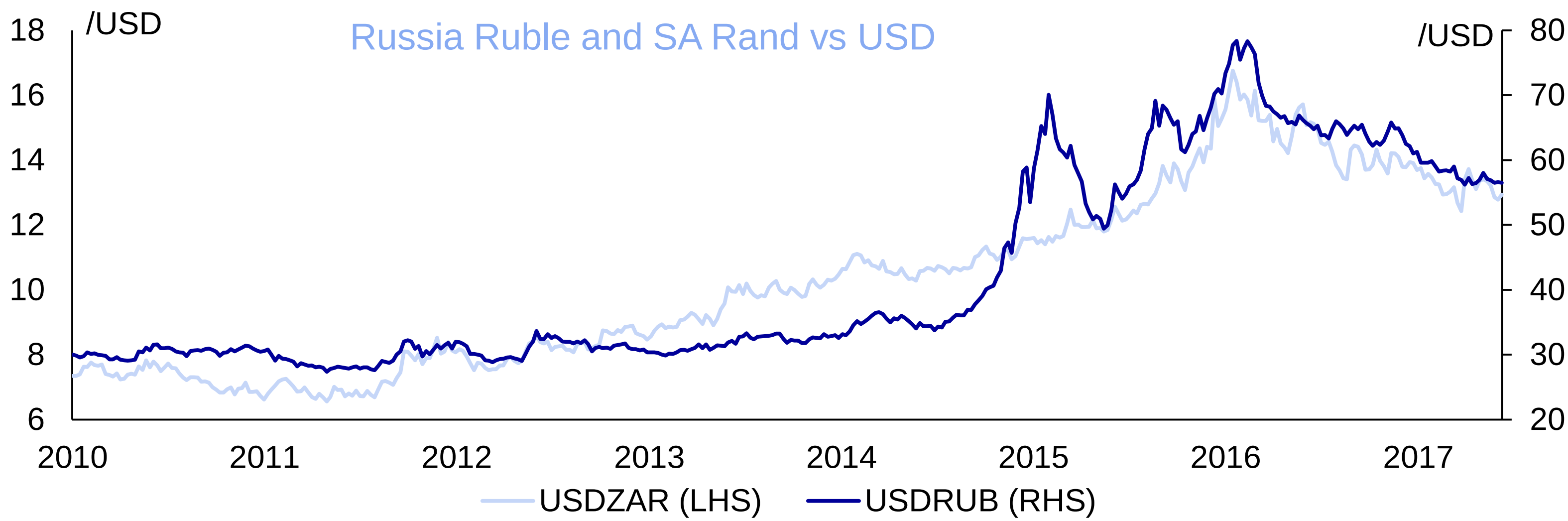
- Credit rating downgrades in emerging markets (EM) have seen some yield strength.
- This occurred in Brazil and Russia in 2015, and SA in 2017, with Turkey also seeing some strength after its late 2016, and early 2017, downgrades, albeit interrupted by political events.
- While SA had the same experience, markets had also already largely factored in the expectation of the recent downgrades that occurred.
- The global, strong risk-on phase has been aided by yields in developed economies (DM) being particularly low, offering a good differential. These inflows have strengthened the rand.
- In particular, SA still has two LC IG ratings and investors are reaping the yield differentials on IG debt while they can (making hay while the sun shines).

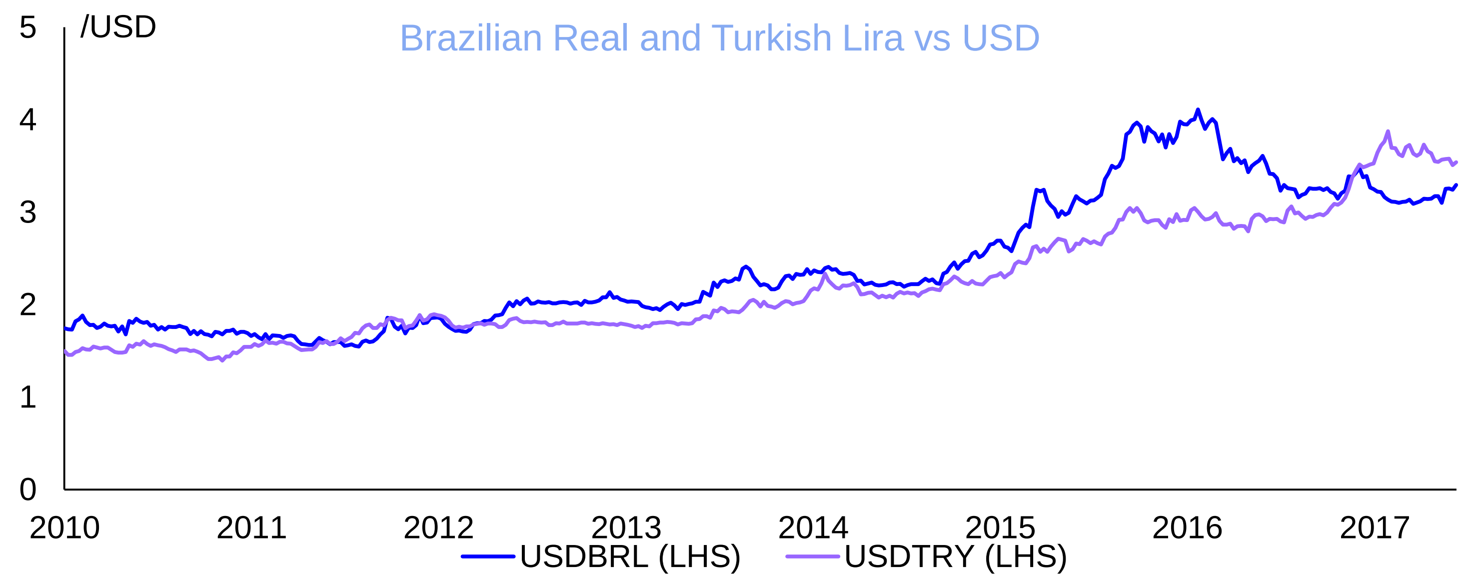


Source: IRESS,

… and a number of EM currencies have strengthened as a result, but ...

- EM currencies have generally benefitted from the global risk on environment.

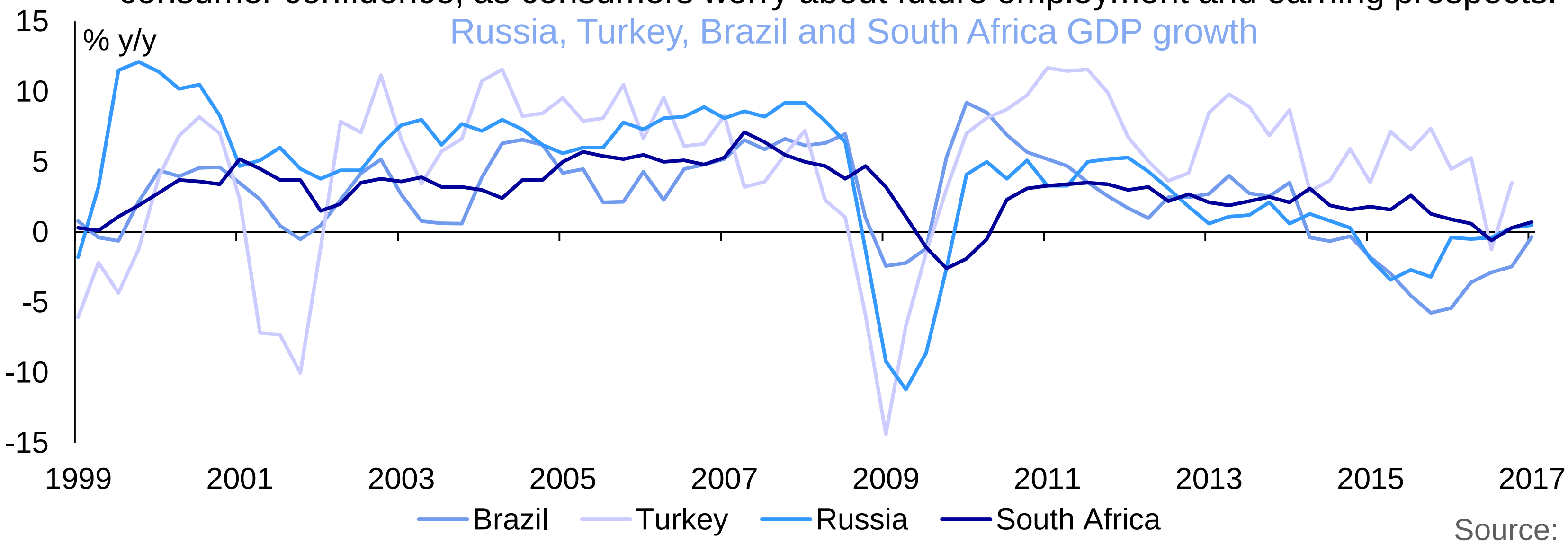




Source: IRESS

… GDP growth is likely to be negatively impacted by the downgrades.

- The 2017 credit rating downgrades are expected to have negatively affected confidence, with some large corporate fixed investment, and consumer expenditure, decisions put on hold.
- As the Q1.17 GDP data showed for SA, low confidence levels are already negatively affecting spending and investment, which means that the two key growth drivers of the domestic economy are subdued, with unemployment rising. GDP contacted in Q1.17 by 0.7% qqsaa.
- In particular, concerns over political and economic policy uncertainty for the future is negatively impacting sentiment, and negatively impacting decision to take on more debt.
- Furthermore, when uncertainty about the future is severe enough, confidence over the future macroeconomic performance of the economy falls.
- This, further reduces business confidence (and so fixed investment), and also further reduces consumer confidence, as consumers worry about future employment and earning prospects.



Source: IRESS,

SA consumer

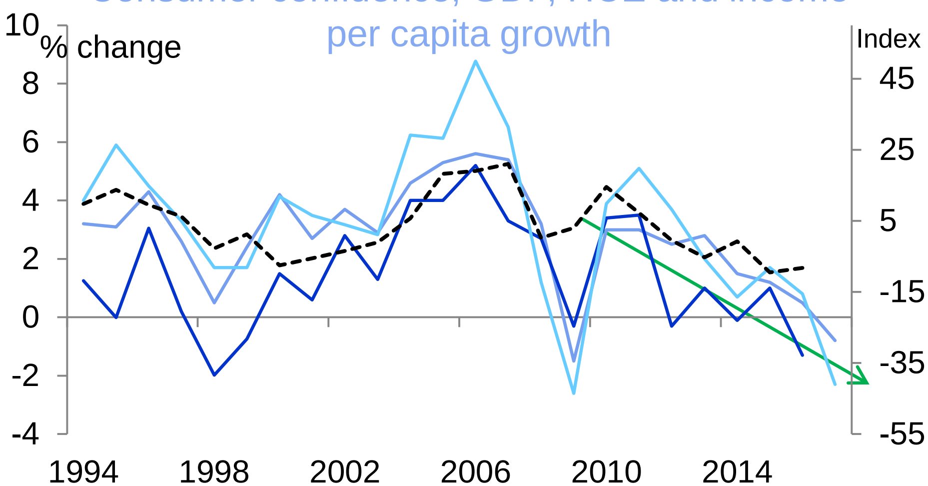
Consumption Expenditure						
	2017	2018	2019	2020	2021	2022
HCE, total (real, %)	1.0	1.3	1.8	2.1	2.1	2.1
HCE as % of GDP	60.7	60.8	60.9	61.1	61.2	61.3
Unemployment rate (%)	27.8	28.7	29.1	28.7	28.8	29.0
Population (million)	55.4	55.9	56.3	56.7	57.0	57.4
Employment growth rate (%)	0.5	-0.9	0.3	1.4	0.6	0.6
Compensation of employees (%)	5.6	8.9	9.6	9.6	9.6	9.7
GCE as % of GDP	20.6	20.4	20.1	20.0	19.8	19.6

Source: Investec, SARB

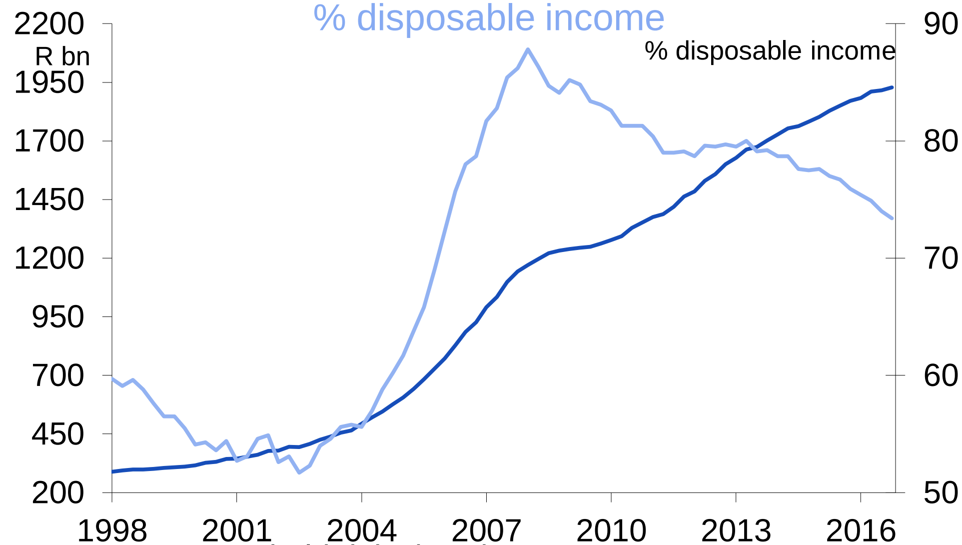
SA consumer: household consumption expenditure growth is …

- Consumer confidence has weakened since 2008, 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. Consumer confidence has in particular been affected by a negative outlook on the economy, with debt levels rising and credit growth limited.
- Business confidence has essentially remained at depressed levels since 2009, with an average of 59% of business dissatisfied with business conditions.
- Heightened uncertainty, reflected in poor confidence levels leads to lack of investor appetite, as does anaemic domestic demand.
- The tax base in SA remains small, with further tax increases on the horizon.

Consumer confidence, GDP, HCE and income per capita growth



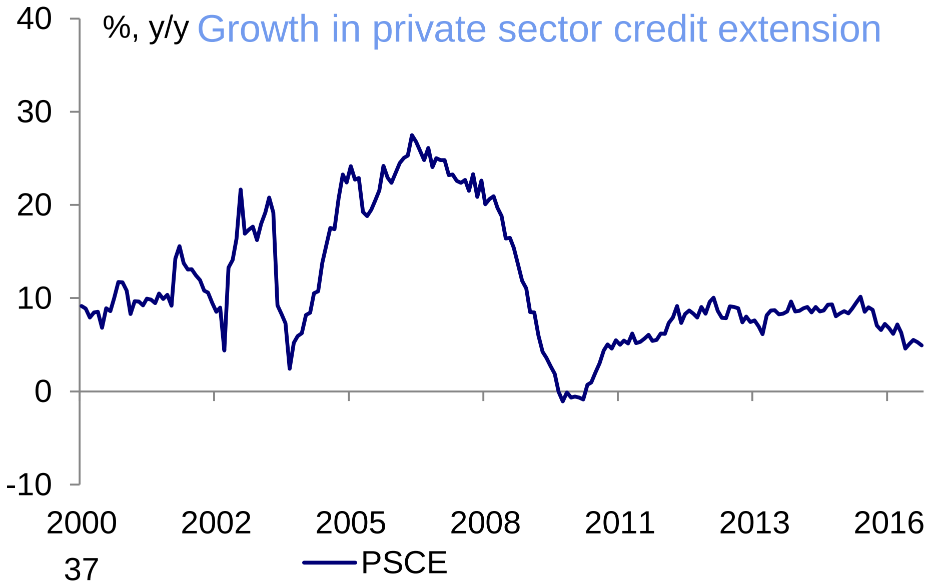
Household debt (R'bn, nominal) and household debt % disposable income

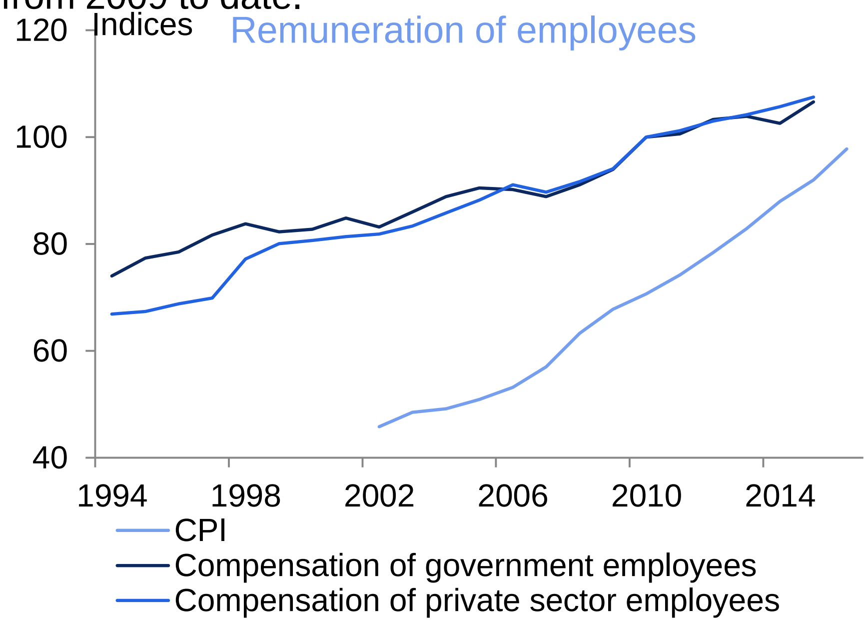


Source: SARB, BER

... weak, on falling consumer confidence, high unemployment, falling …

- The South African Reserve bank says it “sees no evidence of significant demand pressures impacting on inflation. The growth outlook remains disappointing, and the MPC is concerned that increased political uncertainty could impact negatively on private sector investment and household consumption expenditure, and further undermine employment growth. The risks to the growth outlook are therefore assessed to be on the downside.”
- The SARB forecasts GDP growth this year of 1.0% and 2018 of 1.5% with 1.7% in 2019.
- Private sector credit extension is suppressed on tight lending conditions, while unemployment has been rising towards 30%.
- Government finances are constrained, which will not allow for another run up in public sector job creation and remuneration as occurred from 2009 to date.





Source: SARB

… real gross national incomes and weak credit extension, limiting …

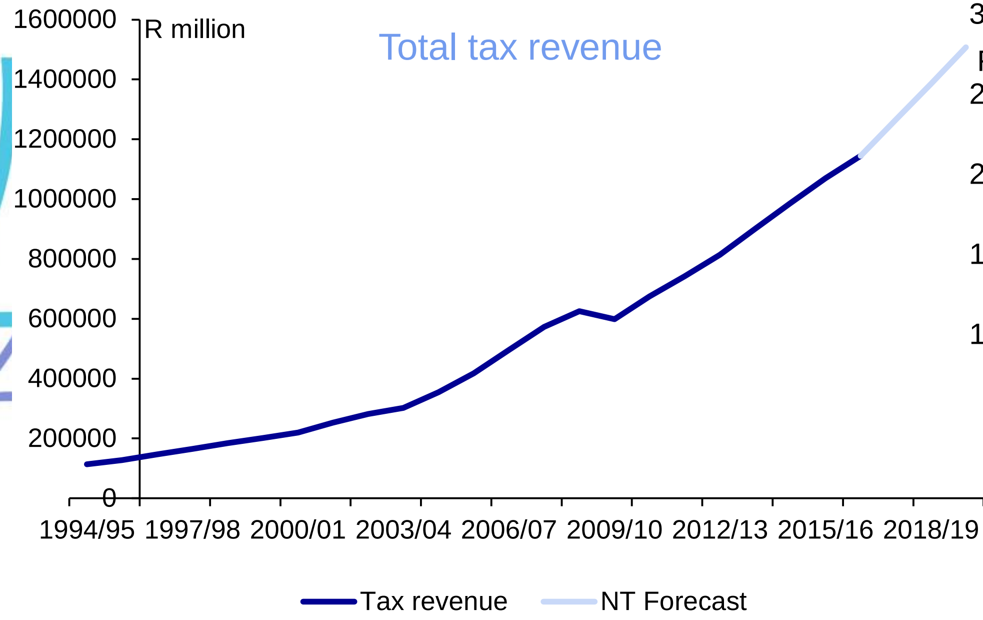
- The Davis tax committee has recently proposed either: 1. A land tax 2. A national tax on the value of property (over and above municipal rates) 3. An annual wealth tax
- Currently, SA has three forms of wealth tax, namely estate duty, transfer duty and donations tax (together about 1% of tax revenue). Capital Gains Tax (CGT) is considered by some to be a form of wealth tax but the DTC (Davis Tax Commission) has taken the view that CGT is a form of income tax. The DTC has previously considered CGT in its estate duty reports so it will not be considered further during this inquiry, but thereby risking double taxation.

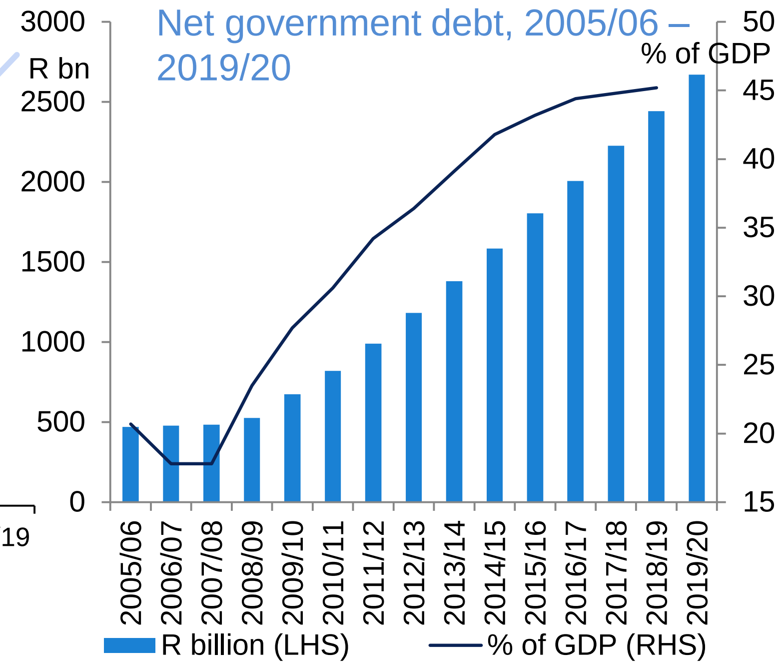
Estimates of individual taxpayers and taxable income, 2017/18

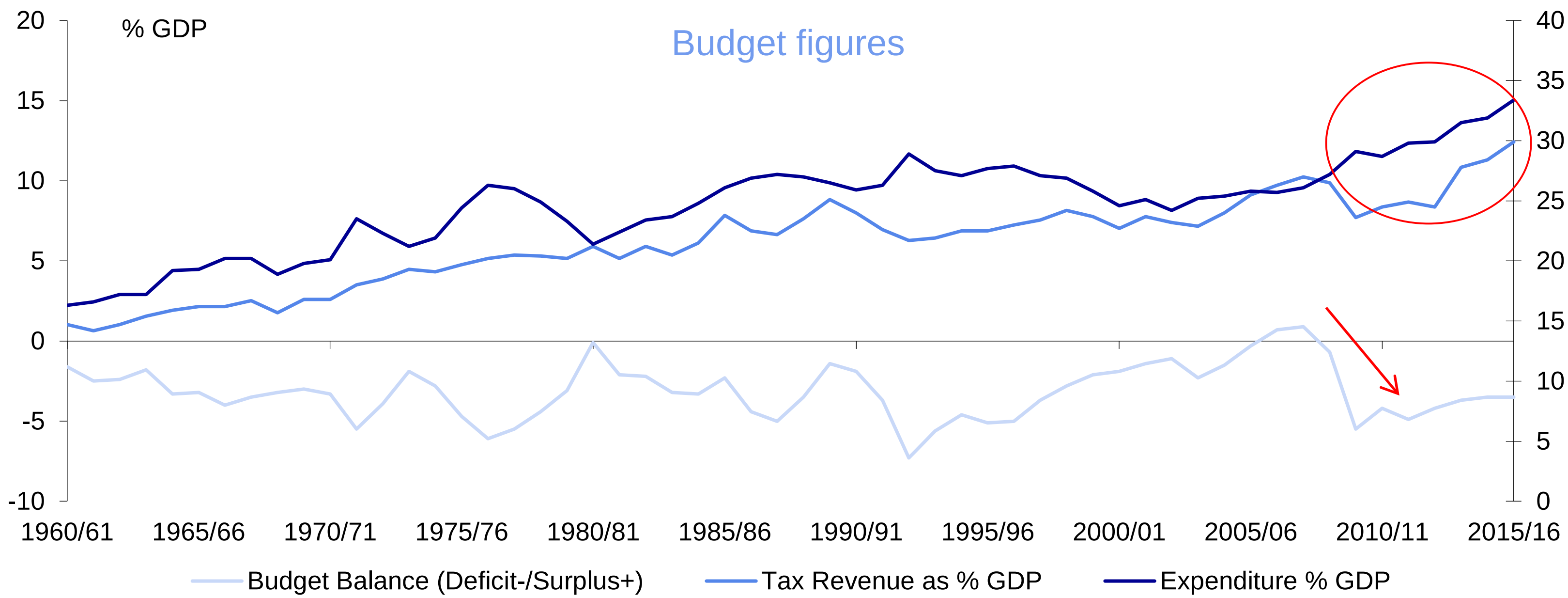
	Taxpayers		Taxable Income		Income tax payable relief		Personal income tax relief		Income tax from new top rate		Income tax payable after proposals	
Taxable bracket	**Number**	**%**	**R bn**	**%**	**R bn**	**%**	**R bn**	**%**	**R bn**	**%**	**Rbn**	**%**
0 to R70 000	6 582 884	-	159.8	0.0	-	0.0	0.0	0.0	-	0.0	-	0.0
R70 001 to R150 000	2 602 563	35.1	274.4	11.9	12.5	2.6	-0.3	13.5	0.0	0.0	12.1	2.5
R150 001 to R250 000	1 813 517	24.5	355.6	15.4	35.6	7.4	-0.4	16.6	0.0	0.0	35.2	7.3
R250 001 to R350 000	1 077 915	14.5	315.1	13.7	46.9	9.8	-0.4	15.9	0.0	0.0	46.5	9.6
R350 001 to R500 000	906 151	12.2	365.1	15.8	70.6	14.7	-0.5	19.5	0.0	0.0	70.1	14.5
R500 001 to R750 000	527 288	7.1	310.4	13.5	77.3	16.1	-0.4	16.1	0.0	0.0	76.9	16.0
R750 001 to R1 000000	227 561	3.1	189.6	8.2	56.0	11.7	-0.2	8.7	0.0	0.0	55.8	11.6
R1 000 001-R1 500 000	152 604	2.1	178.4	7.7	58.9	12.3	-0.1	5.8	0.0	0.0	58.7	12.2
R1500 001+	103 353	1.4	319.0	13.8	122.6	25.5	-0.1	3.9	4.4	100	126.9	26.3
Total	7 411 042	100.0	2 308	100.0	480.2	100.0	-2.5	100.0	4.4	100.0	482.1	100.0
Grand total	13 993 926		2 467		480.2		-2.5		4.4		482.1	

Source: Budget 2017

… growth. Taxation has climbed in SA, and the gradient of steeper …

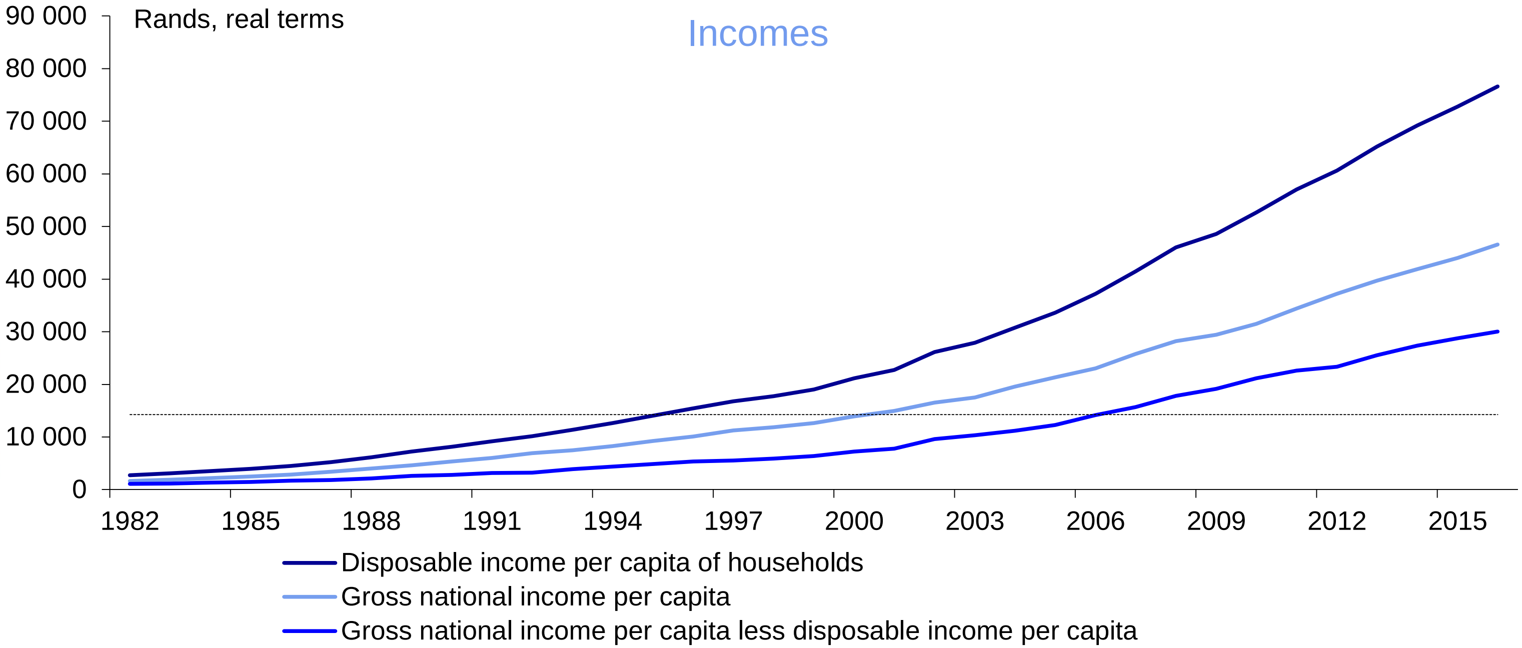






Source: National Treasury, SARB

…taxation is likely to continue, with substantial spend on social services.



Source: SARB

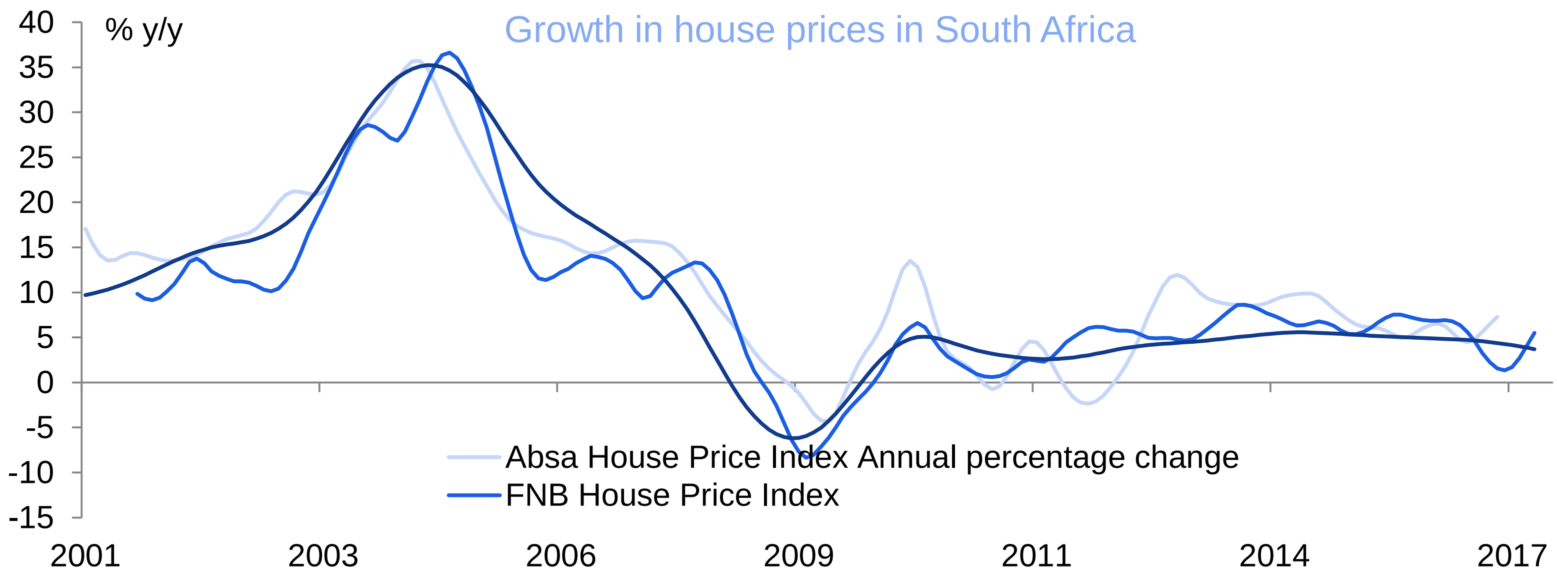
Social grants beneficiary numbers by type, 2016/17 – 2019/20

	2016/17	2017/18	2018/19	2019/20	
Type of grant	Revised estimate	Medium-term estimates			Average annual MTEF growth
Child support	12 051	12 313	12 566	12 821	2.1%
Old age[1]	3 279	3 391	3 505	3 624	3.4%
Disability	1 070	1 061	1 052	1 044	-0.8%
Foster care	425	420	416	413	-1.0%
Care dependency	145	150	156	162	3.8%
Total	16 970	17 335	17 695	18 064	2.1%

National Treasury, Budget 2017

The housing market is moderate to weak overall in SA.

- Building plans passed fell in Q1.17, suggesting weak building activity in Q2.17 and Q3.17 as the housing market is constrained by costs and affordability following on from rising interest rates and unemployment over the past few years.
- Credit conditions have also tightened and consumer debt is at high levels, despite some pull back in the ratio to disposable income.
- Growth in building plans for cheaper housing (flats etc.) continues to perform best in the strained affordability environment for housing in the macro environment.
- This has been a trend for the past few years.
- The latest building confidence statistics as recorded by the BER remain suppressed.



Source: IRESS

Outlook

Outlook

We continue to expect a modest global growth environment, with only a gentle upward trend in commodity prices out to 2022. However, commodity metal exporters cannot expect a notable boost to economic growth this year or next, or their currencies from this source.

Government debt/% GDP will need to be reined in to avoid further credit rating downgrades, and GDP growth needs to quicken materially. SA's recent downgrades were driven by the escalation in debt to GDP since 2009 in a declining growth environment (with substantial contingent liabilities on its balance sheet for its SOEs).

With country reviews from Fitch and S&P twice a year, and the possibility of ratings changes between scheduled reviews, further downgrades cannot be excluded. We ascribe a 35% weighting to the down case of further credit rating downgrades, 35% to the expected case.

Business confidence has essentially remained at depressed levels since 2009, with private sector fixed investment contracting over the period. Industrial production is expected to be weak, but marginally positive over the period (2017 to 2021). Faster fixed investment is key to faster economic growth.

Initial model estimates for the Q3.17 forecasts suggest GDP growth could drop toward 0.6% y/y for 2017 from our previous estimate of 0.8% y/y for this year, with 1.1% (from 1.3% y/y previously) for 2018, 1.6% y/y in 2019, 1.8% in 2020, 1.9% 2021 and 2.0% y/y by 2022.

This growth trajectory is below both that expected for world growth and also for Sub-Saharan Africa. Economic weakness tends to follow credit rating downgrades, and SA's GDP growth, and hence employment

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