

Audio Commentary Transcript: What Lies Ahead for South Africa?

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Brian: Hi I'm Brian Giuliano part of the Global Fixed Income team.

Anujeet: Hi I'm Anujeet Sareen, portfolio manager on the Global Fixed Income team.

Brian: Today we're going to talk about a market that has really disappointed economically speaking for almost a decade now. Corruption, mismanagement—just a general lack of direction. Back in 2009, when Jacob Zuma became president of South Africa, he brought with him hope, promise that tomorrow will be better for South Africans. Yet 10 years down the road and he's delivered in essence a lost decade. The country's anemic growth, a doubling of the national debt, has been one challenge after the next. Credit rating agencies have downgraded South African debt multiple times now. Institutional stability has come into question and even more broadly questions around whether the South African democracy itself can be sustained. How strong is it? Maybe that's a good place to start. What is the state of the South African democracy? In other words do we have another Zimbabwe on our hands or are things actually better than the market perceives?

Anujeet: I think the verdict from what we've seen over just the past few weeks is that the South African democracy is actually in pretty good shape. There's no doubt that there are governance issues at lots of levels of government in South Africa. There is corruption. There are ways in which governance could be substantially improved. Nevertheless, we just went through a period where Jacob Zuma, the president of South Africa, lost support in the ANC election.

A few months ago, there was tremendous pressure for him to step down and make way for Cyril Ramaphosa to take over not only as the president of the ANC, but also as president of the country. Zuma eventually stepped down; this is significant for a couple of reasons. One you know a lot of the critique of Zuma had to do with his corruption. The scale of corruption that he supported throughout the government and he is vulnerable to being charged and pursued in the courts for some of the infractions that he incurred while he was in office. So he had plenty of reason to make it as difficult as possible to prevent himself from stepping down. The fact that he stepped down anyway says that there is a process in place, and that even someone who has that kind of particular set of challenges where he could go to jail if he's indicted and convicted. The fact that the process—even for someone like him with his level of support—forced Zuma to step down, is a very encouraging sign for democracy in South Africa.

Brian: Anujeet, you mentioned Cyril Ramaphosa. Zuma resigns, and Cyril Ramaphosa becomes the current president of South Africa. Tell me a little bit more about Ramaphosa, who he is and what gives you confidence that he's the right man for the job?

Anujeet: It's good to just maybe take a step back. Ramaphosa was there at the beginning. He was Mandela's right hand man, and in fact, was discussed as a possible successor to Mandela back then. However, at the time he was pretty young—in his late 30s—and the ANC thought let's go with somebody a little older, more seasoned, and encourage him to just pursue his interest in the private sector, and he did. And he did very successfully. So his reputation today is someone that's a very savvy businessman—so savvy in fact, and so successful, that he doesn't need the graft that Zuma pursued as aggressively as he did. He's considered to be someone with a high moral standard but also very capable. He carries that into this role and some of the things he's done just off the chute, validate that view. He has replaced the cabinet board, that is to say Eskom, the agency of the government; he has replaced the cabinet with people that are very capable and well-regarded in their various expertises. He's brought a degree of excellence to governance that we haven't seen long time.

Brian: I think his background is so interesting and you figure 25-30 years ago, this guy was the head of a number of unions, he's one of the architects of the post-apartheid constitution. And Mandela—you mentioned Ramaphosa thinks he's going to be his successor and that doesn't work out. And then he goes on to become one

of the most prominent businessmen in South Africa, and still stays actively involved in politics throughout that time. If there's a chance for somebody to turn this thing around, to have that kind of intersection of involvement in public sector the private sector, he's the guy that can get it done. And we talk about this all the time on our fixed income team: leadership matters. Having a direction, and being able to set up an actual roadmap for South Africa is so important.

Anujeet: Yeah, and I would add that you often need a change of leadership to change direction. You know, in terms of a country, we saw that in Brazil a couple of years ago, and we've seen that in a number of emerging markets. The challenge to the change of leadership is that you don't always have institutional support. You get this outsider coming in and that's great. It's a fresh face, a fresh perspective, a fresh voice. But you don't necessarily get institutional buy in from the rest of government. In this case, we have the best of both worlds. You have somebody who's very credible. But he's come up through the ANC. He has the support of the ANC. And so I think that allows him to be more effective than somebody from the opposition party. There is no doubt there are constraints that he's going to have to consider and deal with, but I think we're starting from a much stronger point now than we were just a few months.

Brian: With all of the longer-term structural issues that South Africa has, there are also a lot of low-hanging fruit that Ramaphosa could go after to try to revive the economy. Give us an idea of longer term and shorter term, what could he do to really get things going?

Anujeet: I think there are a couple of things he could do. The first is just as there is this slow, inexorable degradation of the story in South Africa that you mentioned earlier, it seems to have been arrested. At least at the level of governance and leadership. That matters. We do pay attention to what rating agencies are thinking and saying about countries, and this is certainly something they consider a positive. He wants to do a number of things, certainly one of the first things he has done is to address the fiscal deficit. That has been an issue.

South Africa needs to find a way to either cut expenditures wages on the public sector side or increase revenue—and he's trying to do both. And this is prudent orthodox fiscal management, the likes of which the IMF would be very supportive of, so I think he's going down a path that I think is constructive for how they need to address their fiscal deficit. At the same time I think he'd like to address the longer-term issues as well. I think he certainly recognizes that education in particular, there's a lot more investment that the country can make in their human capital, let alone their fixed capital, that would improve the growth prospects of the country longer term. But, you know, he's got to start somewhere and he's starting right where he should. He's starting with governance by getting the right people in place. Let's look at the fiscal deficit, and we can address that at least to some extent on a shorter-term basis. And the third thing he's done, and I mentioned this earlier, is Eskom. He went in and immediately replaced the board. That was a very quick and important signal. This government entity has been such a drag on the government sector, actually might turn around now.

Brian: Confidence is up, capital is coming back to the economy. The rand-dollar exchange rate is below 12 for the first time since 2015. Clearly there are other people besides us who share some of the optimism around South Africa. My last question is: valuation wise, is there too much optimism right now being priced into markets or is there still room to go? Do we need to start seeing some of those reform measures from former Ramaphosa? Where do things go from here?

Anujeet: Well, I would say to you that opportunity in South Africa was there before this change in leadership. It's important to note that the South African economy has been pretty weak for the last couple of years, right? It went through a recession a couple of years back. Unemployment—which is always high in South Africa compared to other countries—went from the low 20s up to 27 percent. Not just the level of employment compared to other countries, it's that increase in unemployment by six or seven percentage points. That's pretty substantial and we felt that would have significant implications for weaker wage growth, and therefore weaker inflation in South Africa.

Bond yields, particularly the 30-year bond in South Africa, just a few months ago was close to or actually somewhat north of 10 percent. Ten percent yields when inflation was falling at the time—it was closer to 5 percent—headline inflation is now four and a half percent, and core inflation is at 6.4 percent and still falling.

Given all that slack in the labor market, we think inflation could fall another percentage point or two. And when you have bond yields that are 10 percent, or now at 9 percent, that's a substantial risk premium in the market. Real yields in the order of 5, 6, 7 percent on your inflation view, that's pretty substantial. The value proposition has been there and we thought that value proposition was attractive regardless of who is in power. With Ramaphosa in power, it's even more compelling because what he's doing with fiscal policy is he's going to reinforce the broader cyclical backdrop, inflation is likely to continue falling, and at 9 percent 30-year bond yields, that's still a very attractive value proposition.

Brian: Anujeet, we talked about a lot of positives, a lot of things that could go right if Ramaphosa does start to execute upon some of his plan. Tell me about some of the risks involved.

Anujeet: Sure. I think the first risk that's worth noting is that Ramaphosa has the support of the ANC; however the ANC isn't a uniform body either. So there are still large cohorts of the ANC that are Zuma supporters and you can see this in the fact that Ramaphosa has had to place some of those Zuma supporters in certain cabinet posts in his government. That says that he does have to compromise, he does have to consider Zuma's supporters still, and that will constrain some of what he can get done. I don't think that constrains him on a shorter-term cyclical window, but as you said, he will reduce the fiscal deficit and that has positive impacts on financial assets.

But the longer-term structural changes that I think he would like to effect, that's a risk. The risk is there is a part of the ANC that just limits how much he can actually get done on policy. I think that's one risk. I think the second risk, which is related to that, is that the longer-term growth story in South Africa is challenged. Gross domestic product per capita in South Africa is around six thousand U.S. dollars. South Africa is in that classic spot of emerging markets that don't quite emerge, right? They can certainly become a much wealthier country if they do the right things. But there's a lot they have to do—education, infrastructure—to get there.

South Africa no longer enjoys the tailwind that it enjoyed in much in the 2000s. You had this massive commodity boom, and China was ascendant. That story, or that driver of growth isn't nearly as powerful today. While commodities have done better over the last couple of years as the global economy is improving—that's positive for South Africa. It's not quite the real bullish demand story that we had in prior cycles and there are going to need to be other drivers of growth. That's a structural issue that Ramaphosa will have to address. So it's still a risk: can he actually get something done?

Brian: It's clear South Africa has a tough road ahead. The good news is there's finally an ability and a desire of the people and the politicians to move forward so that the next 10 years looks vastly different than the last 10. Thanks so much for listening today. And please don't hesitate to contact us if you have any questions.