DEC
26
2018

Featured G

South Africa Has a Long Road to Travel

J. Patrick Bradley |

South Africa is one of those countries with tremendous economic potential. Unfortunately that potential has gone largely unrealized. The country has been a victim of cronyism and corruption that has characterized past governments. A new reform-minded government may be set to start down the road of maximizing economic potential. Cyril Ramaphosa was elected the new president by the South African Parliament earlier this year, following the resignation of Jacob Zuma. A surge in consumer and business confidence has since receded as South Africans and the markets realized the enormity of the task ahead of Ramaphosa. The road to be traveled is long.

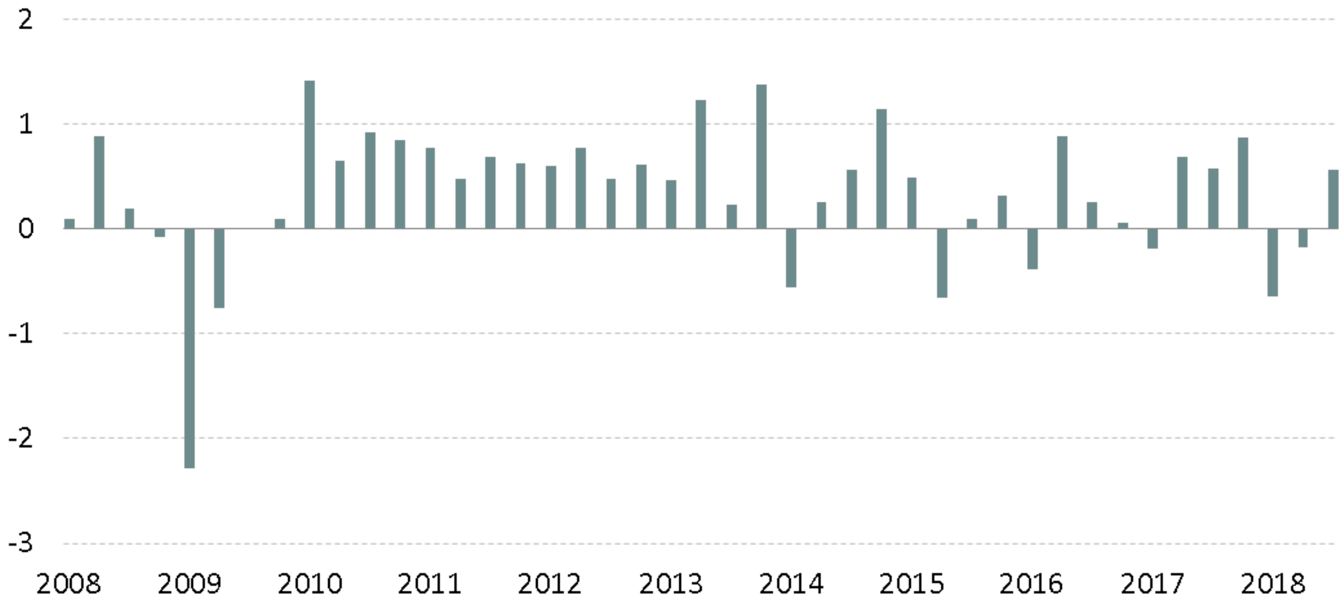
Cyclical and Structural Paths

Exiting from Recession

The South African economy entered a technical recession at the end of the second quarter 2018, as the economy posted back-to-back quarterly declines in output. It emerged from that recession in the third quarter, as Chart 1 shows. Yet that growth promises to be anemic over the next year, weighed down by poverty, low educational achievement, an excessively high unemployment rate, and a fiscal drag created by bloated public employment and the strain of state owned enterprises (SOEs). The South African Reserve Bank (SARB) estimates potential growth over the next two years to move to 1.4%—a rate too low to help South Africa address innumerable structural economic issues. A global economic recovery will help South African commodities. The economy did manage a 2.2% quarterly growth rebound in the third quarter, led by manufacturing and services.

Chart 1: South Africa: Real GDP Quarterly Growth

%, GDP by Expenditure Approach, As of 9/30/2018



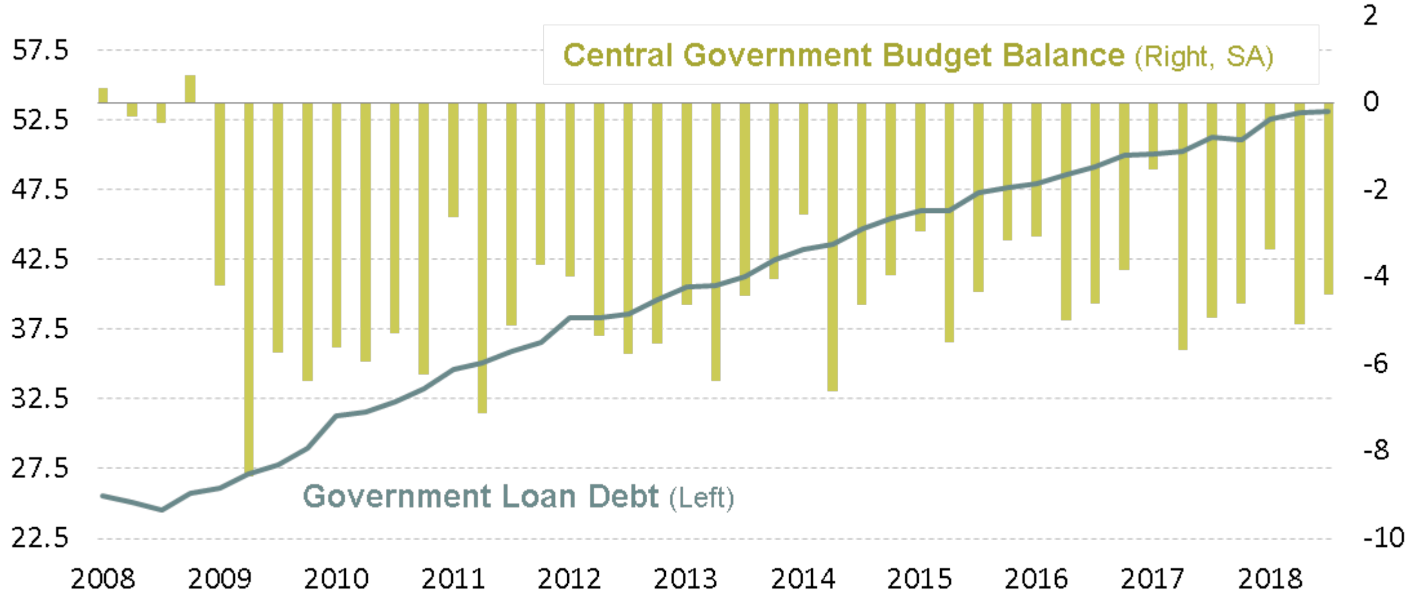
Source: South African Reserve Bank / Haver Analytics

Precarious Finances

The country's finances led two rating agencies to lower the country's sovereign debt to junk status. Only Moody's rates the bonds investment grade (barely) but Moody's outlook is negative, raising the specter of a downgrade. Over the next several years, without some dramatic fiscal belt tightening, the budget deficit will not show any material improvement. The new government has made a first attempt to reduce the deficit by raising the value added tax (VAT). Nevertheless, the budget deficit stays at 4% of gross domestic product (GDP) and the debt peaks at over 50%, unless herculean efforts are undertaken. These unfavorable budget dynamics limit what the government can do to stimulate the economy and institute polices to restructure the economy. South African finances also face a possible risk from contingent liabilities emanating from government guarantees of the SOE debt. The largest of those is the beleaguered energy company, Eskom, whose government guarantees total right around 5% of GDP. Reforming the SOEs is critical to improving potential growth.

Chart 2: South Africa Budget Deficit and Debt

As % of GDP, As of 9/30/2018



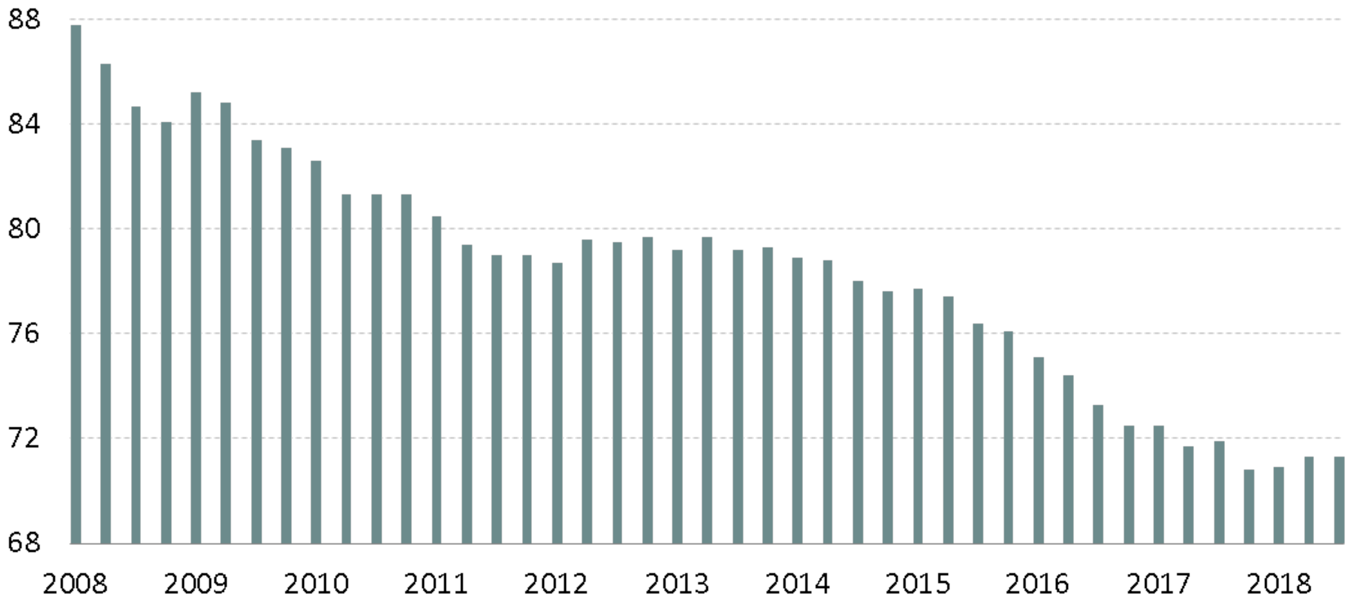
Source: South African Reserve Bank / Haver Analytics

Domestic Demand Relatively Weak

The consumer sector will be unable to significantly contribute to economic growth. Confidence and spending plans remain weak, as fewer consumers think it is now a good time to make major purchases. Even as earnings have picked up, consumers have engaged in a long period of deleveraging, as Chart 3 below indicates. Consumer debt as a percent of GDP hit a high of near 88% in early 2008 and has fallen to below 72%, which is still high.

Chart 3: South Africa: Household Debt as % of Disposable Income

%, As of 9/30/2018



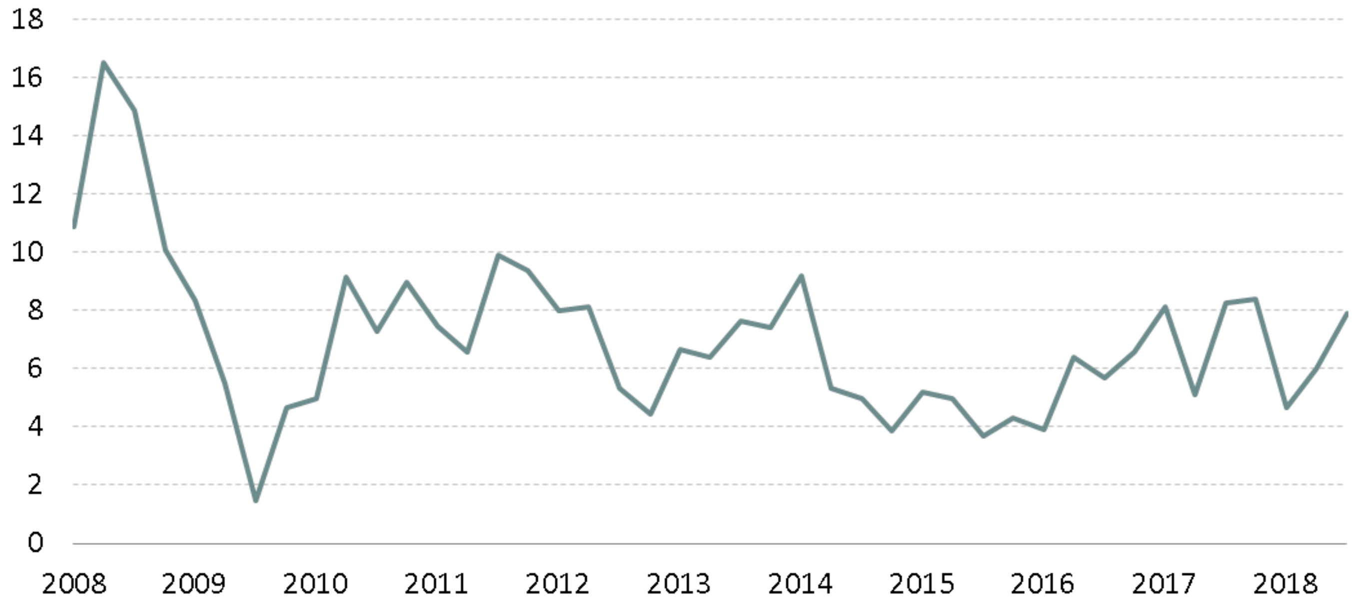
Source: South African Reserve Bank / Haver Analytics

The South African economy currently exhibits an unemployment rate of 27%. This rate is currently among the highest in the world and falls disproportionately on the young, less educated South Africans. Better educated South Africans demonstrate a greater tendency to be employed. Those unemployed lack the necessary education and skills to be employed. A part of the requirement for government is to address education and the skills that are needed to be employed. In its February budget the government proposed free tertiary education for the poor, but the problem lies in the quality of primary and secondary education.

Likewise, investment spending is expected to be sluggish. Businesses lack confidence in the economy and that would be a drag on investment spending. “Ramaphoria” has clearly ebbed. Industrial production has been weak, but should cyclically rebound. Supporting a pickup in capital spending is the high rate of manufacturing capacity utilization and, as Chart 4 shows, an over 6% gain in corporate profits. Despite the onset of a cyclical rebound in the economy, long-term structural issues remain, which the Ramaphosa government needs to address. The May 2019 elections (Chart 5) hang like a dark cloud over the economy and the uncertainty over agricultural land redistribution without compensation adds to investor angst regarding the direction of the economy.

Chart 4: South Africa: Gross Operating Surplus

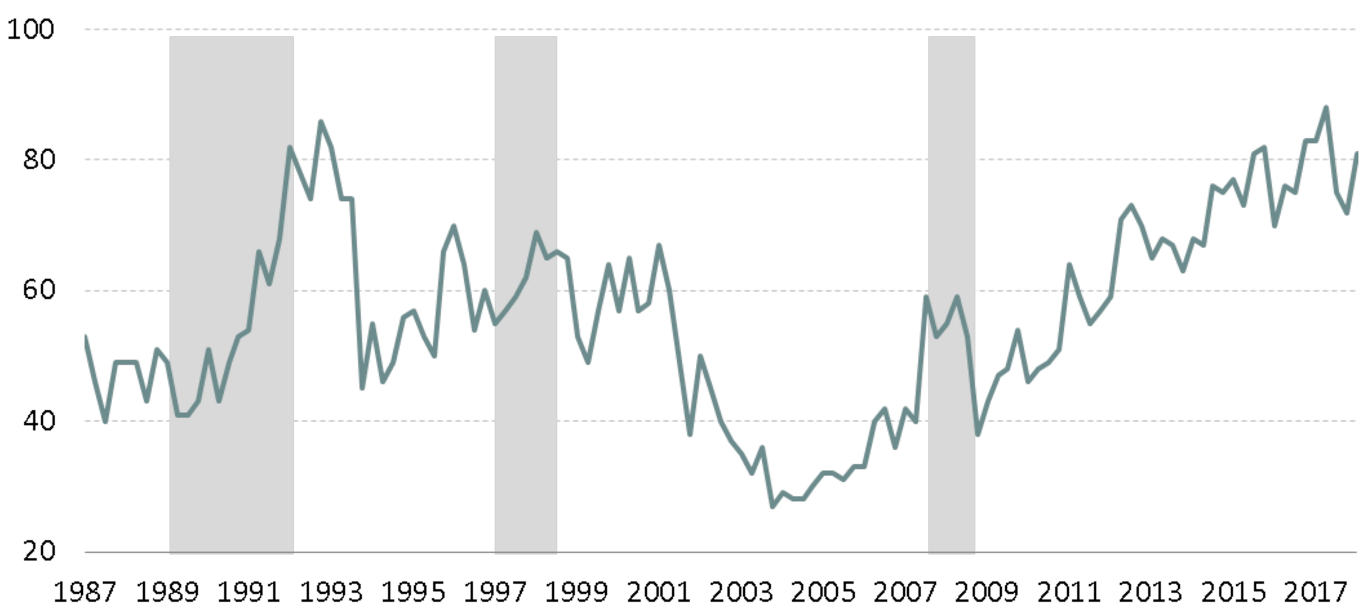
%YoY Growth, As of 9/30/2018



Source: South African Reserve Bank / Haver Analytics

Chart 5: South Africa: BER Manufacturing Survey: Political Climate a Constraint

%, As of 12/18/2018



Shaded gray areas indicate recession.

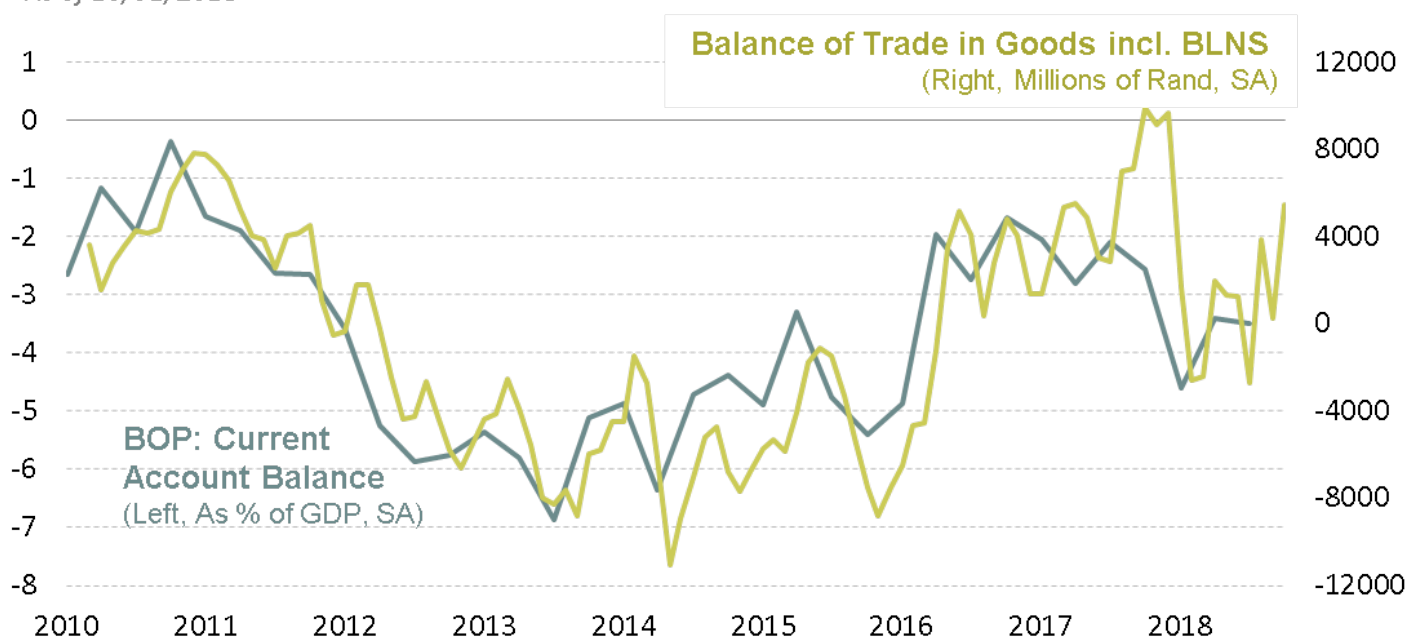
Source: Bureau of Economic Research, South Africa / Haver Analytics

The improvement in the trade sector has begun, both through a pickup in exports and slower growth in imports, a byproduct of domestic sector sluggishness. Some trade improvement ought to help the current account deficit, which now stands at around 4% of GDP. That is the message of Chart 6. South Africa remains a commodity-exposed country so demand for commodities will influence exports. That depends on the demand from China, India, Japan, and U.S.—the largest markets for South African commodities. Non-oil export demand should also be helped by demand from Germany and the U.S.

Foreign confidence, primarily investor confidence, in the South African economy is key to financing the current account deficit, since financing has largely come from portfolio flows. Non-resident investors own almost 40% of South African debt, with risk somewhat mitigated by the large proportion of those bonds denominated in the local currency. On a more positive note, foreign direct investment flows have turned positive, promising a more stable source of financing, and, perhaps, an early sign of foreign confidence in doing business in South Africa.

Chart 6: South Africa: Current Account and Balance of Trade

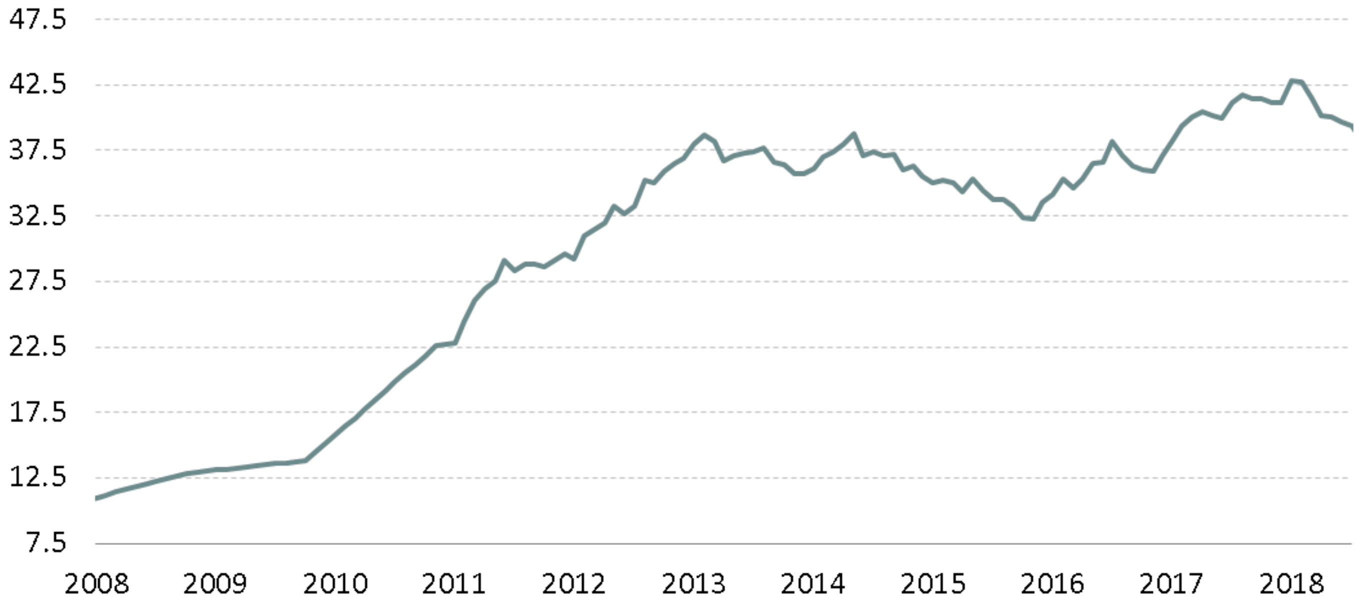
As of 10/31/2018



Source: SARB/H, SARS/H / Haver Analytics

Chart 7: South Africa: Nonresident Holdings of Domestic Bonds

EOP, %, As of 9/30/2018



Source: South African Reserve Bank / Haver Analytics

Institutional Strength

The South African Reserve Bank (SARB) is one institution that should help both domestic and foreign confidence in the South African economy. The central bank stands out as a credible institution that has focused on inflation targeting, despite the cyclical weakness and structural issues. Its hawkish tone and willingness to raise its policy rate have contributed to the reduction of inflation to within the bank's target and, as importantly, the reduction of inflation expectations, which as shown in Chart 8, are anchored at lower expected rates. The central bank needs to maintain its vigilance, as temporary factors could push the inflation rate higher. Electricity tariffs could rise. The rand could depreciate. A drought could affect agricultural production and food prices. Oil prices could accelerate once more. The central bank, though, has said it will focus policy on keeping inflation at the target's midpoint and acting if it breeches that midpoint. That well-earned credibility should give some support to the currency and provide high real-yield comfort to investors.

Chart 8: South Africa: Inflation Expectations

CPI: All Items (%, SA, Dec. 2016 = 100), As of 11/30/2018

Source: Statistics South Africa /Haver Analytics

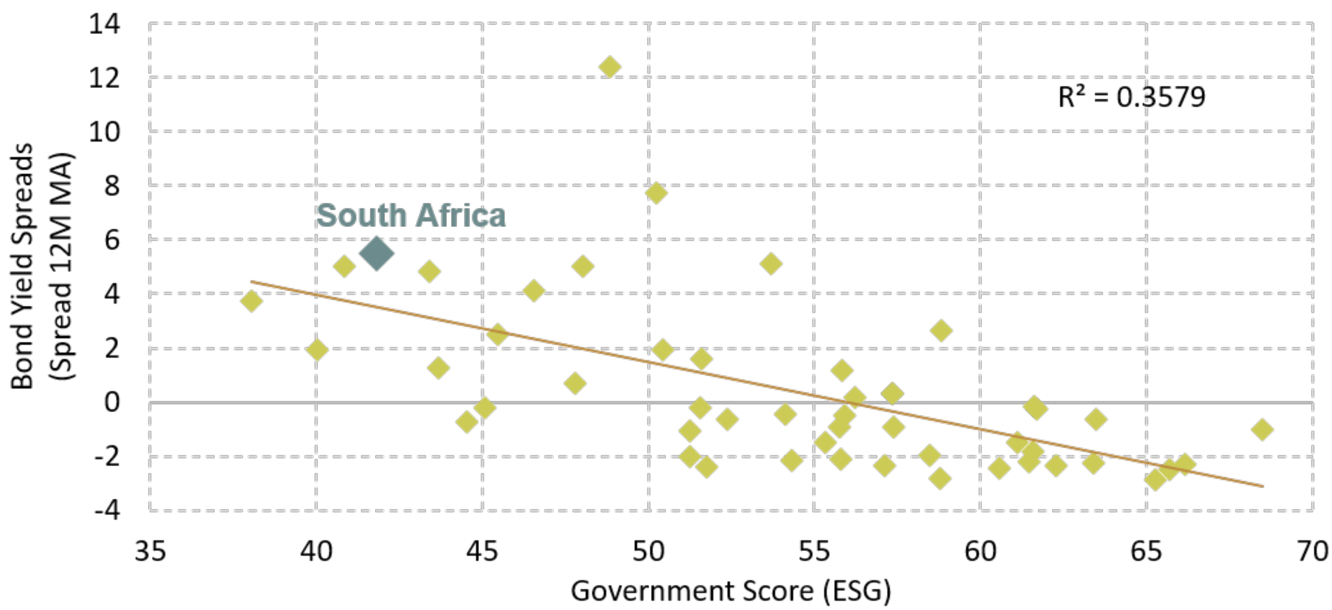
Moving to the Structural Path

Without a major overhaul of its economy, South Africa will struggle to grow more than 2%. The government has recently proposed some reforms and stimulus, which could lift potential growth above the current 1.5%. The problem is these measures—even if fully enacted—would not produce sufficient growth to reduce the unemployment rate meaningfully. Estimates suggest a 7% growth rate would be necessary and the economy exhibits slack. Getting consumers, businesses, and foreigners more excited about the economy requires a structural reform program that includes the government addressing its finances, SOEs, and South Africa's high unemployment rate.

Part of the deterioration in confidence has been the result of the failure to bring forward a comprehensive plan for reforming the economy. The International Monetary Fund (IMF), in its Article IV analysis of South Africa, argues that strong growth will be the product of stronger governance, labor market reforms, digitalization, and reforms of the product market. In fact, the IMF cites a forthcoming working paper that estimates a 10 point increase in governance indicators could add 2% to the country's growth rate. That would mean improving regulatory quality, government effectiveness, and the rule of law, making it easier to do business in South Africa. For example, reducing corruption according to the IMF, could be additive to economic growth. Ramaphosa and the South African government have already started down this path with the replacement of Jacob Zuma and initiating a number of corruption investigations. Chart 9 also shows that a low governance score can raise financing costs for a government like South Africa. Conversely, improve a governance score and a country can reduce its financing costs.

Chart 9: Governance Score and Interest Rate Spreads

As of 12/31/2016



Source: Bloomberg (© 2018, Bloomberg Finance LP)

SOE Reform

The government has already begun reforming its SOEs, but the market has not been impressed. As the IMF notes, SOE boards have been changed and professional management installed. Fraud charges have been levied. Dumping state money into the SOEs is not the answer. Companies like Eskom have to come to the government with a credible turnaround plan. Public and private partnerships should be explored. Payrolls and costs need substantial reduction. Improvements to SOE governance offer the opportunity to improve their operations.

Conclusions

South Africa has emerged from its recession. That is the cyclical story. The ensuing growth promises to be lackluster and insufficient to reduce a globally high unemployment rate. Cyril Ramphosa needs to create a comprehensive structural economic blueprint to overhaul the South African economy, unleashing the animal spirits of investment. Unless such a plan is brought forward, the economy is doomed to remain in the doldrums. That plan likely waits until the May 2019 election, which the African National Congress and Ramaphosa should win. However, don't ignore what has already been done. Perhaps Ramaphosa should be guided by the Chinese proverb that says, "a journey of a thousand miles begins with a single step."

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.

Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.