

South Africa. Beautiful Country, Shame about the Politics

Richard Lawrence |

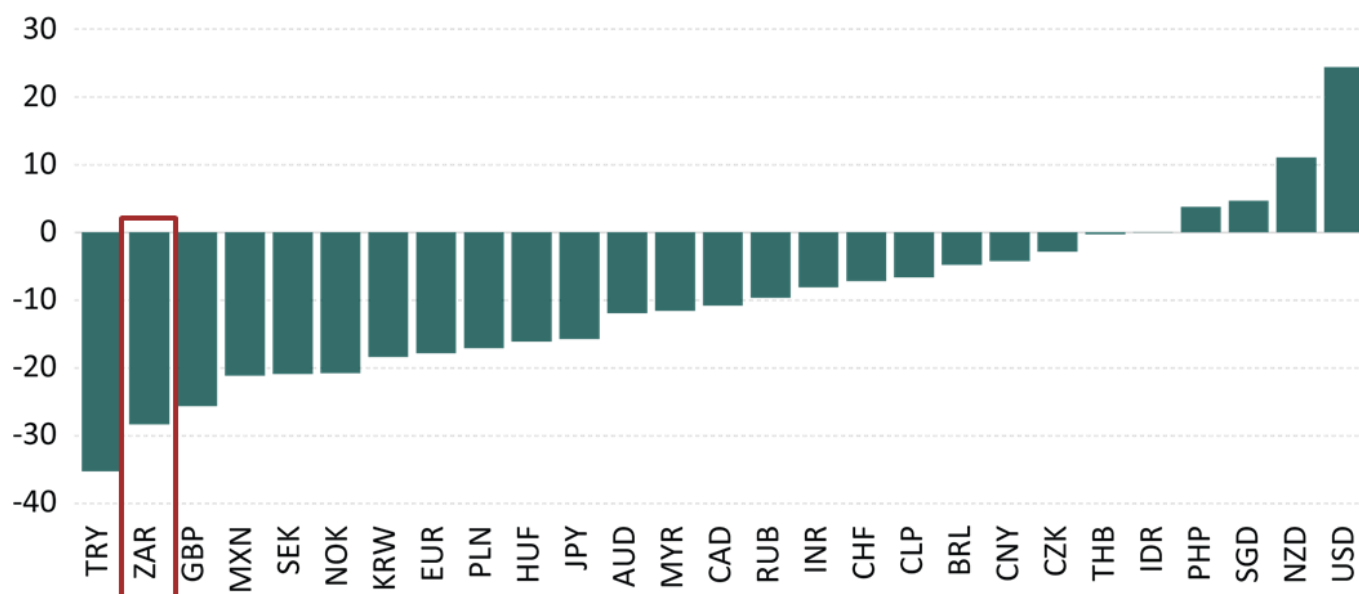
Our investment process marries the art and science of price and information risk analysis. We are invariably attracted to undervalued assets where the price risk is typically lower, thanks to the margin of safety implied by the valuation. Our goal is to make assessments as to whether an asset is deservedly cheap or whether it may be mispriced by the market, often due to some level of uncertainty surrounding the story. Meaning, the information risk may be elevated.

Currently, one segment where this is playing out in spades is in emerging markets (EMs), where valuations continue to be attractive but information risks remain elevated. Part of the information risk is the uncertainty surrounding the potential path of trade policy in the U.S., although signs remain encouraging that the highly trade hawkish, protectionist candidate Trump has evolved into a more reasoned and pragmatic dealmaker, stepping back from his most fervent campaign promises and indicating a willingness to compromise. This welcome shift in posture is likely to keep the U.S. dollar weaker, and we believe EMs should thrive in an environment where the dollar stays weaker and commodity prices remain healthier than the past three years.

Another key element of information risk that one assumes when investing in EMs, is the high level of political uncertainty. While most EMs continue to move in a positive direction with respect to their politics, we get frequent reminders that autocrats, pseudo-dictators, and corruption are part of the recipe that make EMs challenging to analyze, and partly explain why EM bond yields are significantly higher than in developed countries with longer-established political institutions.

We received our latest EM wake-up call recently from South Africa. The valuation story in South Africa is compelling, and the rand (ZAR) is currently one of the cheapest currencies in our universe.

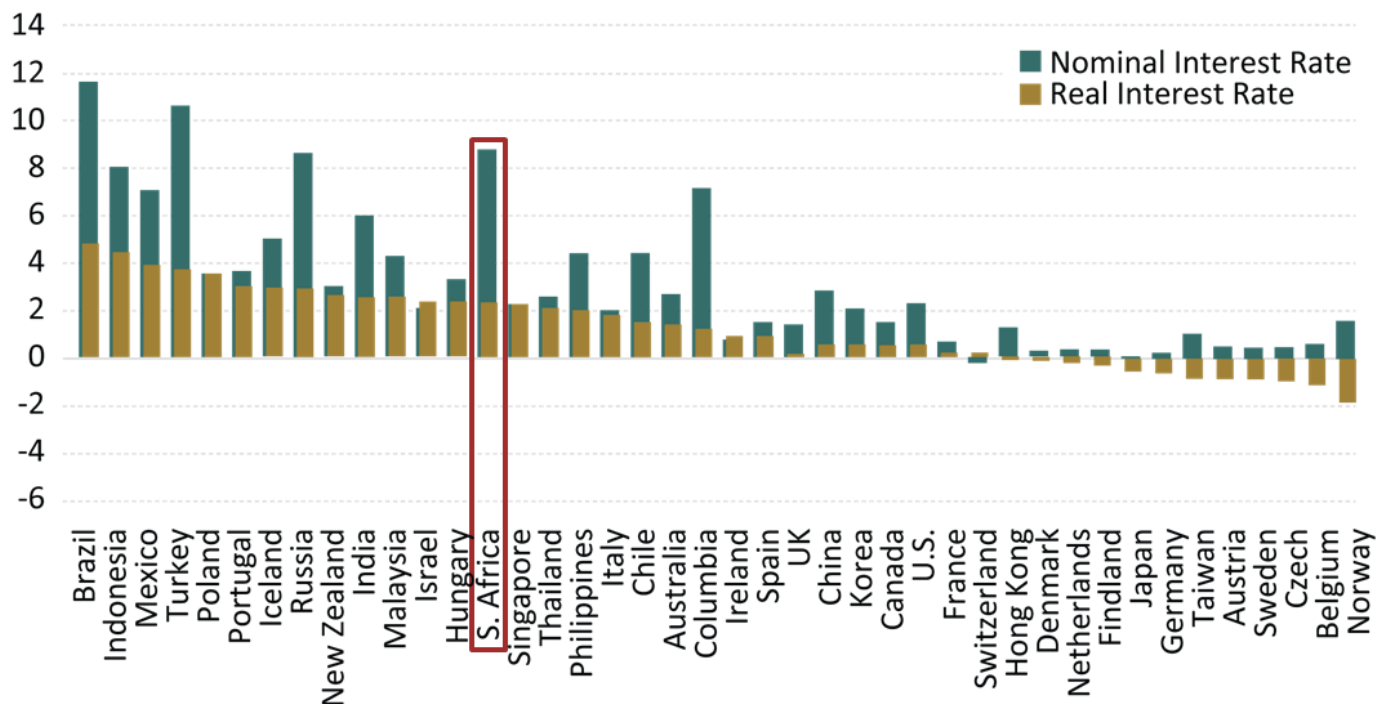
Chart 1: Percentage Deviation from BGIM PPP %, As of 2/28/17



Source: Brandywine Global

Furthermore, South African bond yields remain amongst the most attractive on both a nominal and real basis—you get paid to wait by owning South African bonds.

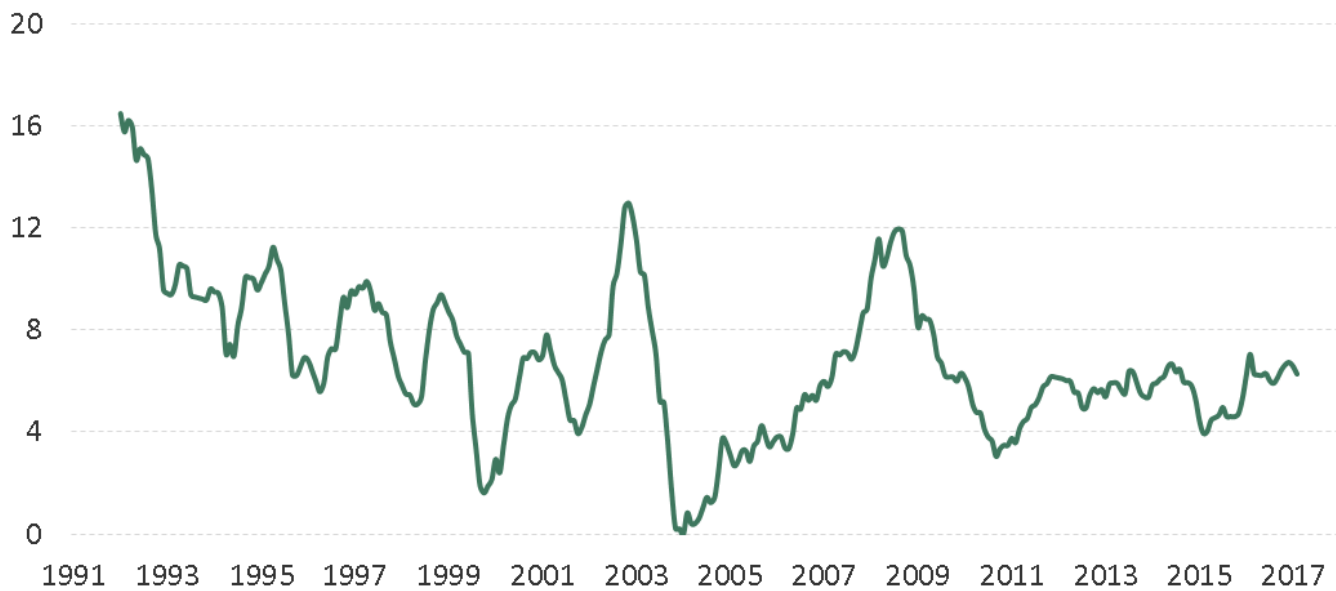
Chart 2: Real and Nominal Bond Yields Based on 12-Month % Change of Headline CPI, As of 2/28/17



Source: Brandywine Global

The basis of the underlying macro story in South Africa is one of a commodity-producing EM where growth should modestly improve on the back of better commodity demand and stabilizing inflation.

Chart 3: Consumer Price Inflation (CPI) *Annual Percentage Change, As of 2/28/2017*

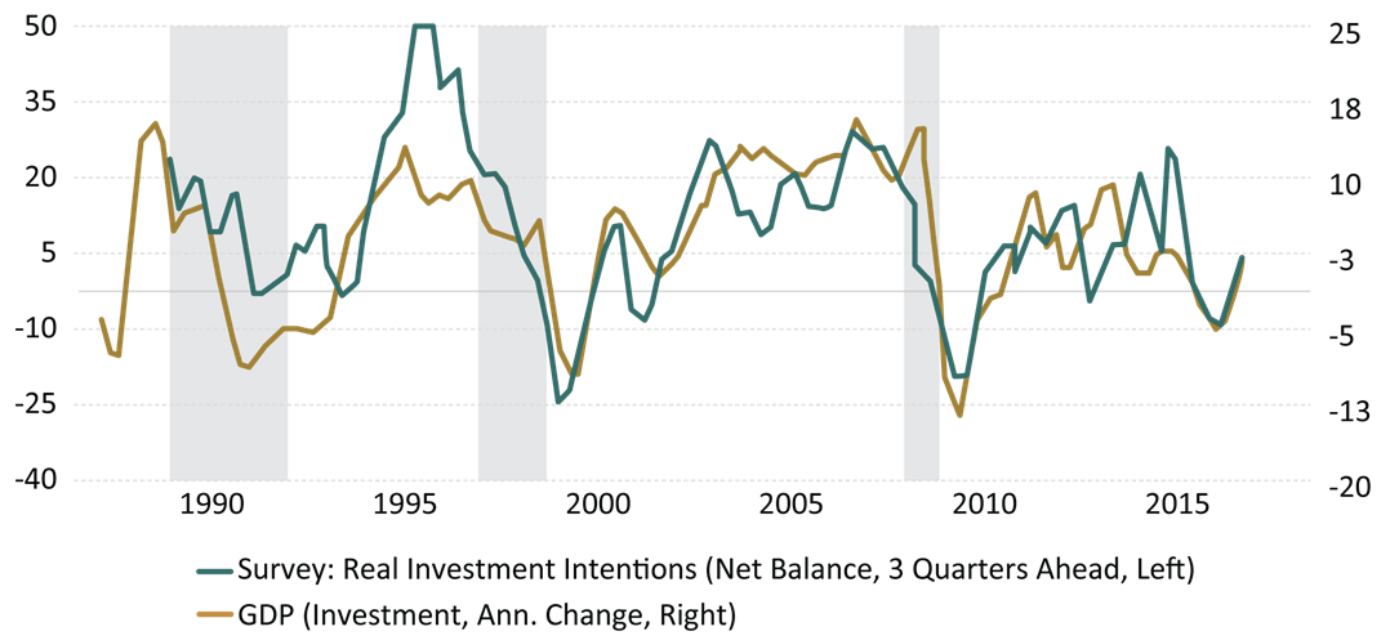


*Price index, not seasonally adjusted.
Source: Statistics South Africa*

Inflation pressures have subsided as ZAR valuations stabilized, and CPI is forecast to continue moving lower, potentially allowing the South African Reserve Bank (SARB) to consider easing monetary policy in late 2017 or early 2018. Furthermore, government spending has remained fairly stable at approximately 26% of gross domestic product (GDP) while revenues have continued to improve since bottoming in 2011. The National Treasury projects a modest primary budget surplus in 2018.

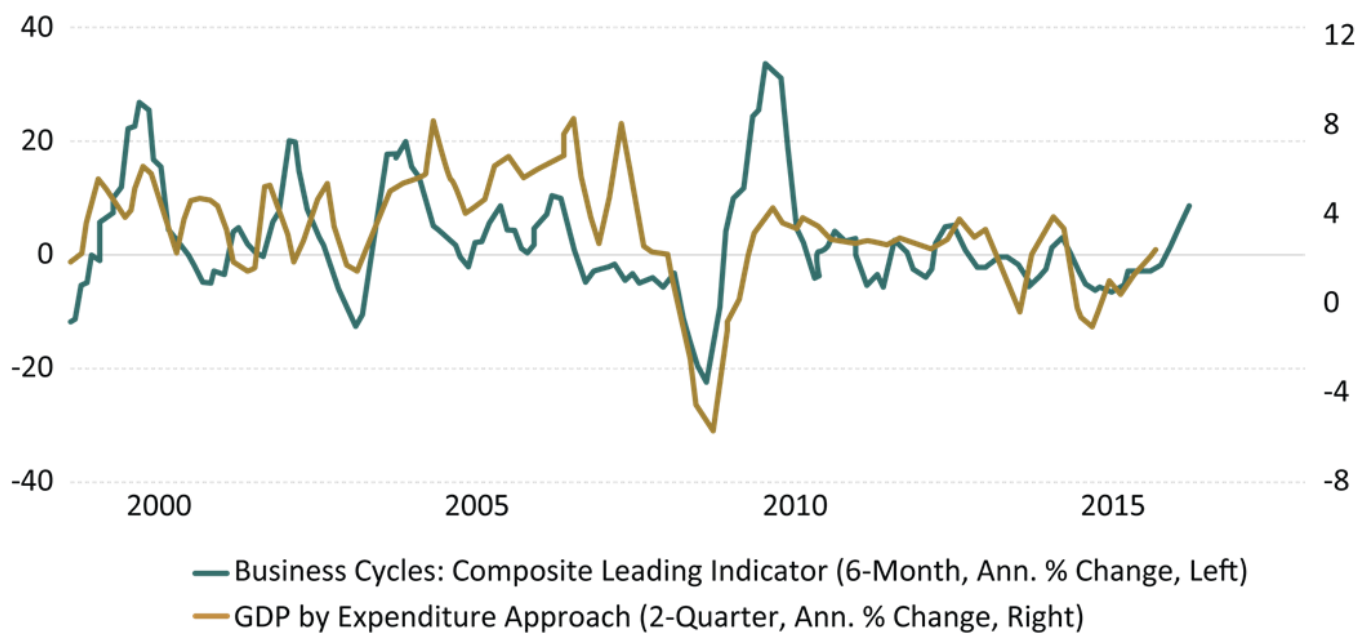
Furthermore, investment intentions have rebounded from a weak 2016. Leading indicators suggest an economy headed for an upturn.

Chart 4: Real Investment Intentions



*Periods of recession.
Source: BER, SARB via Haver Analytics*

Chart 5: Composite Leading Indicator



Source: South African Reserve Bank via Haver Analytics

However, the events unfolding from the end of March and into April have been a nasty reminder of the ever-present political risks of investing in a market like South Africa. Things started to unravel on March 27 when President Zuma pulled his finance minister at the time, Pravin Gordhan, from an investor roadshow, a move that sent the ZAR 2% lower. Gordhan is an internationally respected banker who held the role of finance minister in the aftermath of the global financial crisis, from 2009 to 2014. Gordhan was re-appointed in late 2015 after an imbroglio where Zuma initially replaced then-Finance Minister Nhlanhla Nene with a little-known politician with limited finance experience. Markets trading South African assets went into a complete tailspin, forcing Zuma to backtrack and appoint Gordhan instead. Such is life in EM investing!

Upon the roadshow recall, investors began to speculate on whether Gordhan was being removed as finance minister, at the same time as rumors circulated regarding a larger cabinet reshuffle. All of this conjecture came to fruition on March 30 when Zuma replaced Gordhan with Malusi Gigaba, the former Minister of Home Affairs and made 20 changes to his cabinet—10 at the minister level. Zuma has always been a leader we viewed with some skepticism, but this recent move appears to have troubling undertones as Zuma attempts to further consolidate his power while appearing to play by the rules of the democracy. Until recently, South Africa had been on a path of fiscal improvement, but the worry is that Zuma may go down the path of fiscal largesse to stoke support with voters. As a result of his shenanigans, the major ratings agencies reacted.

Standard & Poor cut its rating to BBB- on local currency long-term debt, with a negative outlook, and also cut its rating to junk level BB+ on hard-currency long-term debt. Fitch kept its outlook stable, but cut the local-currency long-term debt rating to BB+, citing domestic politics as a significant distraction from the much-needed focus on economics. Moody's has undertaken its own review, which may take a few weeks. In the event that South African local-currency debt gets downgraded to junk level, the country will be removed from global developed market indices, which will likely cause severe selling pressure, push yields up, and raise debt service costs. Since the country can ill afford this, we believe it is possible that fiscal policy doesn't shift significantly despite the political quagmire that exists.

Given the complexity of the political landscape, I can't adequately cover all the aspects regarding the legitimacy of the current administration in one blog post; however, I can address the question of why we are still invested in South Africa. For now, we argue that these are the reasons to stay:

- ▣ Spreads on South African bonds widened following the ratings agencies' response to Zuma's cabinet reshuffle. We think the technical selloff will be short lived and that the ratings downgrades have been priced into South African yields, and then some.
- ▣ South Africa, for now, still has other highly independent and credible government institutions—the SARB is well respected and has run free of political interference, the Treasury has, to-date, been responsible for the improving fiscal pathway, and the court system appears to operate without undue influence from political interference.
- ▣ We have seen this movie before. South African politics have always been complicated to say the least—a statement that also holds true for many other EMs. Every once in a while we experience what later turns out to be a storm in a teacup. As the chart below illustrates, the currency can get rocked by the headlines only to then calm down and continue its path of improvement led by the underlying economic fundamentals.

Chart 6: The Rand's Reaction to Political Noise *As of 4/13/17*



Source: JP Morgan

Emerging market politics are complex, and sometimes downright ugly. However, the EMs of today are generally more politically mature than they were in the 1990s. This chart above outlines the information risk I touched upon earlier, and that despite some ugly headlines, investors can look at a market like South Africa and embrace the bigger picture. With that said, South Africa seems a far riskier place to be invested than a month ago, a development clearly reflected in the prices of South African assets. Therefore, we are watching developments there like a hawk and will be ready to reevaluate our position in the event of fiscal deterioration.

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