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Featured G

South Africa, Where Politics Don’t Matter Except When They Do

In emerging markets investing, political backdrops can change quickly. Particularly at a time when political approval ratings for many global leaders are at multi-decade lows, it can be tempting to use politics to explain away asset price performance. Sometimes politics do matter, but often the business cycle matters more.

Consider the following two examples. In Poland, the governing party has been sharply criticized for shifting away from the European Union and faces possible sanctions stemming from recent judicial reforms. Yet, a secular increase in tax collections and its trade exposure to an improving Europe led the Polish zloty to be one of the best performing currencies in 2017. Meanwhile, in Argentina, President Macri has assembled the most talented, pro-market cabinet in at least two decades, but inflation has remained stubbornly sticky. As a result, bonds have given back gains and the Argentine peso likely has more weakness ahead.

South Africa seems to be at a crossroads. The political environment is inarguably shifting in a more constructive direction. The ruling African National Congress (ANC) has made a positive choice in electing reform-minded Cyril Ramaphosa, but it is unclear whether new leadership alone can solve the country’s problems quickly. Equally if not more important is where the business cycle stands amid all this political turmoil. At a time of an ongoing synchronized global growth recovery, South Africa has decoupled from the world and has unfortunately found itself on the wrong side of the equation (see Chart 1). How much does the change in politics matter when it comes to economic performance?

Chart 1: Real GDP Growth—World versus South Africa

Annual Percent Change, As of 9/30/2017

Source: Macrobond

One way to approach this question is to look at survey data that gauges local business sentiment. The South African Bureau of Economic Research (BER) publishes a manufacturing survey that asks a number of questions about the economy. Generally speaking, the more orders companies are receiving, the more confident one would expect them to be about general business conditions with a greater likelihood to be increasing investment. When we look at a 30-year history for South Africa, this pattern has held up to about 2012, but an odd gap has opened since then. On balance, a few more companies are reporting declining rather than rising orders. While this data is not great news, it is far from recessionary levels. However, overall business confidence and, by extension, investment are at recession-like levels (see Chart 2). In fact, the gap between the two series is the widest since the South African recession in the mid-1990s. There is a potential that the gap in business perception could be related to politics.

Chart 2: South Africa BER Manufacturing Survey—General Business Conditions

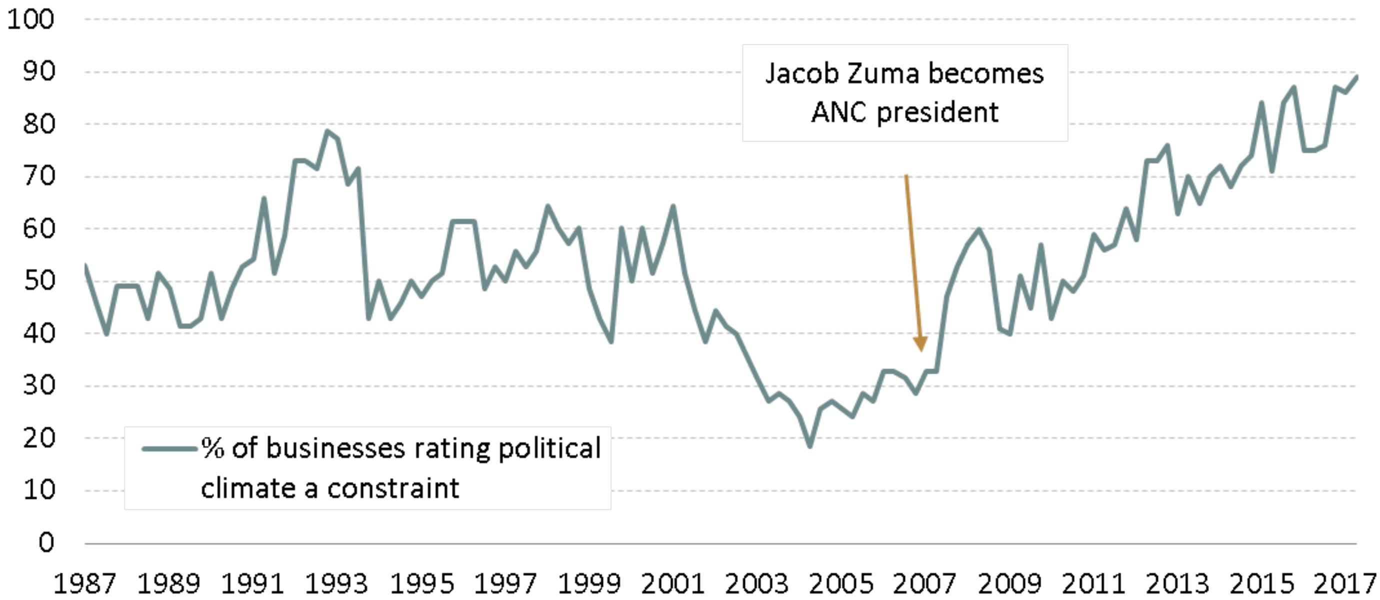
Net Balance, Percent, As of 12/31/2017

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

The same BER survey also asks companies to cite constraints to increased business. The percentage of respondents citing the political climate as a constraint has been on a steady upward trend since 2007 when Jacob Zuma won the ANC presidency (see Chart 3). This trend coincides with anecdotal evidence from company earnings calls, research analysts, and local traders.

Chart 3: South Africa BER Manufacturing Survey—Political Climate a Constraint

Percent, As of 12/31/2017

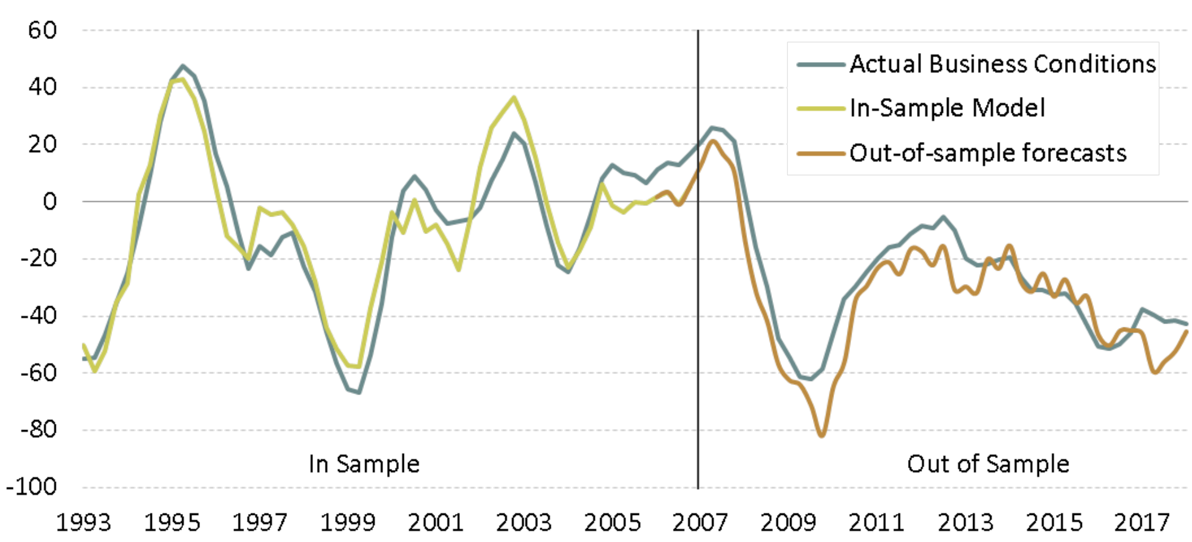


Source: Bureau of Economic Research, South Africa / Haver Analytics

A simple regression analysis can tie the two concepts of political risks and the business cycle back together by modeling business conditions as a function of order volumes and political risk constraints from 1993 to 2007. Projecting the correlations between these variables forward from 2007 to the present, the model does a good job of explaining the underperformance of business confidence (see Chart 4). To the extent that politics stop being a binding constraint, we would expect to see a recovery in business confidence and investment. This improvement in turn would boost overall growth and tax collections, thereby alleviating fiscal issues. In other words, political change can boost the business cycle.

Chart 4: Business Conditions as a Function of Order Volumes and Political Risk Constraints

Net



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

The question at this juncture is how much optimism is reflected in the currency and asset prices? After all, Cyril Ramaphosa is the leader of the ANC, but Jacob Zuma remains the president of the country. The next presidential election is not until 2019. There are early indications that the business cycle is turning up, but it is too soon to tell. Meanwhile, labor relations with business, particularly in the mining sector, remain fraught. Several state-owned enterprises face insolvency and pose a risk for the sovereign balance sheet. The fiscal deficit remains wide and requires further tax hikes. The February budget should provide a good indication of Ramaphosa's level of influence. The future of politics in South Africa will matter a lot. However, just remember that the business cycle and valuations will matter as well.

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