Budget Speech: Enough to avoid a ratings downgrade?

In the few weeks since the Nenegate debacle, South African investors have held their breath to see how their futures will be impacted by the roller coaster ride that is the investment market. Looking to Mr Gordhan in an almost saint-like fashion, we found ourselves waiting in anticipation for him to save us from this precipice into the unknown we find ourselves at – a rating downgrade of our sovereign debt to junk status by the rating agencies.

The implications of such a move are well understood. A junk rating would immediately up the perceived riskiness of our government debt. Riskier debt demands higher interest rates, so the state's finances come under pressure. Further to that, many investors are mandated to only invest in stocks and bonds of investment grade nations. The result would be an outflow of offshore money, putting pressure on asset prices and the Rand. Ultimately, we would feel the effects flow through into higher general interest rates, higher inflation (due to the weak Rand), softer asset prices and a weakened state purse. Hence the scramble by government to save face and muster an image of a financially prudent, investment friendly state in kinship with the business community. With Mr Gordhan acting as the figurehead of this campaign, his 2016 budget speech was seen as the perfect opportunity to add substance to the façade.

To win back the confidence of the rating agencies, Mr Gordhan had to impress in three categories fundamental to the ratings outcome: The state's policies to boost our economic growth rate, improvements to state finances, and ideas toward plugging the holes in the balance sheets of state owned enterprises (SOEs) such as SAA and Eskom. Our expectations therefore called for comprehensive, perhaps even radical solutions to address the nation's financial problems.

To improve the country's economic growth forecasts, we would have liked to see the government take a stern stance on policy uncertainty. Ambiguous land reform policies, wobbly Visa regulations (which have now been repealed), labour 'overregulation' and dispute 'irresolution', electricity supply constraints and increased state meddling in business affairs have eroded confidence in the business community, with South African corporates hoarding billions in cash. The knock on effect of unspent cash piles is an ageing capital stock, which erodes industrial and agricultural competitiveness, only serving to exasperate the country's economic woes. Mr Gordhan was rather mute on addressing the government's commitment to improving policy uncertainty. Instead, he decided rather to admit to the issues, and focus on the improved dialogue that has opened up between the state and the business sector. Not a bad thing.

Slow economic growth of course eats into the state's future tax revenues, placing a burden on the government balance sheet. To reduce the budget deficit to more manageable proportions, we hoped to see the government tighten its belt, especially with regard to the state's ballooning wage bill. Many taxpayers were even willing to bite the bullet now, in the form of higher income taxes, in order to stave off the more serious consequences of a ratings downgrade. On cost containment, the state will sacrifice some managerial and administrative vacancies. All tenders will flow through an E-tender portal that should reduce corruption and waste. There will also be an outright reduction of R25 billion in the government expenditure ceiling, spread across departments and provinces. Pricey government initiatives, however, like the NHI and the nuclear power procurement program, would continue. On the revenue side, increases in capital gains tax, transfer duties, sin taxes and the fuel levy would attempt to plug the hole without having to raise income taxes – a rather politically conscious move. All in all, the proposals are nothing new really, and have been used many times before. These measures would see the budget deficit reduce to 2.4% in 2018/19 from the current 3.9%, and government debt stabilise at 46.2% of GDP over that same timeframe. The problem is that the figures are very much on the margin and leave little room for error. The economic growth assumptions used by the treasury in the projection, for example, were far more optimistic compared to what analysts and the rating agencies predict. The question is also of course if state employees will settle for an 'at inflation' wage increase.

The final problem we would have liked Mr Gordhan to address is the strained balance sheets of the SOEs, and their insatiable appetite for bailout money. With R467 billion in contingent liabilities on the government's books, we had hoped to see talks of privatisation. Clearly a political swearword, there was no mention of the 'p-word'. Instead, the only changes announced were the scrapping of overlapping and redundant enterprises, and the possible merger of behemoth SAA and tiny SA Express – hardly austerity moves. With boards of several SOEs populated by the politically connected, it is increasingly difficult to imagine radical change happening soon, evidenced by the brewing spat between the treasury, SARS and SAA for example.

Interestingly, at the same time Mr Gordhan was giving his budget speech, another event altogether was punishing the Rand – Brazil was downgraded to junk status by Moody's, the last of the three ratings agencies to do so. On the surface, one could find many similarities between our situation and that of Brazil. A commodity dependent economy, sizeable budget deficit, stagnant growth, an emerging market, rampant corruption (although apparently on a level that puts SA to shame), glaring income inequality and more. No doubt the announcement made many investors in SA nervous, hence the Rand being punished. Yet the figures point to our fellow Brics member facing a materially more difficult position. Brazil sits with government debt levels at almost double that of SA, a budget deficit upwards of 10% of GDP amidst a shrinking economy. South Africa is clearly much more capable of reversing itself out of this fiscal crisis, if the political will exists to do so.

By the numbers

	Brazil	South Africa
Economic Growth*	-1.70%	0.70%
Budget deficit**	-10.30%	-3.90%
Debt to GDP	66.23%	39%

**annualised Q3 2015*
***2015/2016*
Source: Trading Economics

The budget speech was very much in line with what has been expected of it historically in South Africa, but for a business friendly tilt to appease the ratings agencies. Mr Gordhan had to operate within a certain political comfort range to keep most parties happy, resulting in a rather lacklustre speech, but one in the right direction nonetheless. Brazil held an investment grade rating from all three agencies as recently as September 2015, with a far more disastrous fiscus compared to what we have. Our next rating review date, by S&P, is scheduled for June 2016. We still have time for Mr Gordhan's speech to deliver. Current sentiment is that a ratings downgrade is already inevitable. Our fate, however, would seem to depend on whether the state can make good on the promises (albeit little) they have voiced over the last two months. If so, we should keep our investment grade status, at least for now.

29 February 2016

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	0.6%	-4.1%	0.2%	-2.4%	-4.4%	10.9%	12.3%	13.2%	15.2%
FTSE/JSE SA Listed Property	ZAR	3.6%	-5.6%	-3.3%	0.6%	-2.0%	12.2%	18.4%	16.1%	16.8%
SA All Bond Index (ALBI)	ZAR	-0.7%	-3.1%	-2.9%	3.8%	-3.7%	3.2%	7.3%	7.2%	7.5%
SA Cash Index (SteFI)	ZAR	0.6%	1.6%	3.3%	1.1%	6.6%	5.9%	5.8%	7.3%	0.6%
Balanced Benchmark [2]	ZAR	0.4%	-1.6%	3.1%	-0.8%	2.6%	12.4%	13.6%	12.9%	7.0%
SA Inflation (1 month lag)	ZAR	0.8%	1.1%	1.4%	0.8%	6.2%	5.5%	5.6%	6.1%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	-1.0%	-8.7%	-6.0%	-7.0%	-12.7%	3.3%	2.7%	1.7%	16.5%
Emerging Markets Equity (MSCI EM)	USD	-0.2%	-8.7%	-8.9%	-6.6%	-23.4%	-8.9%	-5.4%	1.8%	23.5%
Global Bonds (Barclays Global Bond Index)	USD	2.2%	3.7%	2.7%	3.1%	0.8%	-0.1%	1.4%	4.0%	5.7%
Global Cash	USD	0.0%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	1.5%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	0.6%	-4.1%	0.2%	-2.4%	-4.4%	10.9%	12.3%	13.2%	15.2%
Global Equity (MSCI World)	ZAR	-1.7%	0.0%	11.9%	-5.2%	18.2%	24.7%	21.1%	11.7%	13.5%
Emerging Markets Equity (MSCI EM)	ZAR	-0.9%	-0.1%	8.5%	-4.9%	3.7%	10.0%	11.5%	11.9%	15.6%
COMMODITIES										
Gold (US Dollars)	USD	10.6%	15.1%	8.4%	15.4%	0.7%	-8.5%	-2.9%	8.1%	19.3%
Gold (Rands)	ZAR	12.0%	28.6%	31.6%	20.0%	39.2%	11.2%	14.9%	19.0%	21.8%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	-0.7%	9.5%	19.0%	1.9%	35.5%	20.7%	17.9%	9.9%	16.2%
Rand / GBP Pound	ZAR	-2.5%	1.3%	7.8%	-3.7%	22.2%	17.3%	14.3%	7.4%	14.4%
Rand / Euro	ZAR	-0.3%	12.6%	15.4%	1.9%	31.2%	13.5%	12.3%	8.8%	13.9%

Spot Rates

29-Feb-16		3-Mar-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US$	Rand	15.59	15.46	11.45	6.62	6.32	3.65
Rand/GBP	Rand	22.09	22.55	17.95	10.31	10.89	5.66
Rand/EUR	Rand	17.07	16.80	13.99	8.84	7.48	4.33
Rand/Aus $	Rand	11.48	11.25	9.45	6.76	4.64	2.72
Libor 6m $	US$	0.89	0.85	0.36	0.46	4.70	N/a
Prime	Rand	10.25	9.75	9.25	9.00	10.50	18.50
Repo Rate	Rand	6.75	6.25	5.75	5.50	7.00	N/a
All Bond Index Yield	Rand	9.16	9.38	8.24	8.58	9.40	13.31
Gold ($/oz)	US$	1,263.29	1,060.82	1,183.15	1,421.40	517.10	387.20
Palladium	US$	524.00	547.00	798.00	797.00	258.00	130.75
Platinum	US$	949.00	891.00	1,209.00	1,770.00	970.50	399.50
Oil (Brent Crude) $	US$	36.95	37.28	57.33	94.75	57.63	18.32
SA Inflation	Rand	6.20	5.20	5.30	3.50	3.60	6.90

data provided by Profile Data Analytics and INET BFA