

South Africa – is there a light at the end of the tunnel?

It is no secret that South African news has been dominated by negative stories of late, in fact in 2016 it would have been quite difficult to find a positive story about South Africa. This is understandable as the year was characterised by lacklustre economic growth, an unpredictable political system, with parliament at times looking more like a wrestling match than a democratic parliament, and of course the dark cloud of sovereign ratings downgrade that hung over us all.

However, amidst all this negative news, there seems to be a faint light at the end of the tunnel, as the sentiment towards the South African economy has started to improve, with encouraging signs that economic momentum will build and an upside to growth may well be achieved. This positivity is fuelled by the view that many of the negative events in 2016 have faded, with electricity supply stabilising and load shedding coming to an end; the end of the drought, as well the strengthening of the Rand; the large amounts of cash sitting on SA companies balance sheets; and the potential for an improved political landscape. Looking across the investment industry, the consensus view is now pro-SA. We explore this in some more detail below.

The end of the drought

Towards the end of last year, we saw the end to a two-year drought, the worst drought in South Africa since 1992. The drought severely impacted crop production volumes and the effects of this were far reaching, with the primary impact felt on inflation levels. An end to the drought will bring with it some much needed alleviation of pressure on the SA economy. One of the negatives from these reduced production levels meant that SA went from a net exporter of food to a net importer. It is estimated that these imports cost the SA government more than R22 billion, which had a negative effect on the trade balance. Another negative of the drought was that because of the scarcity of food and the added cost of the imports we saw rising food prices, that helped to increase the overall inflation levels in SA.

Rand strength

2016 saw the Rand strengthen against all major currencies, and although there are negatives to a strong Rand in terms of increasing the costs of our exports, a strong Rand will assist in keeping inflation under control, which is essential for economic stability. This move was in line with broader emerging markets which benefitted from a recovery in the commodities sector.

Potential for an improved political landscape

The risk premium associated with South Africa hit relative highs early in 2016, post the Nenegate debacle. This is a measure of the country specific risk, of which politics has been a major contribution. This level has now almost halved from the highs, reflecting significantly higher levels of confidence in SA in general, with a lower perception of risk.

Cash on company balance sheets

As business confidence in SA has been decreasing since its peak in 2011, corporates have been investing less and less in SA which has resulted in a substantial buildup of cash on their balance sheets. This is generally seen as a negative for the economy as investment levels are low, impacting growth, however the fact that there is this amount of capital waiting to be invested is a positive, and should the SA economy continue on its recovery path this is the primary driver of future growth given the current high levels of government debt placing constraints on the ability to implement fiscal stimulus.

Lower expected inflation

Inflation ended 2016 at 6.8%, the highest for the year. However, we have already started to see inflation decreasing with the January 2017 inflation sitting at 6.6% and is expected to return within the South African Reserve Bank's (SARB) target range of 3-6% in the second half of the 2017. Because of this it is most likely that the SARB is at the peak of its interest rate cycle, and although we might only see a rate cut when inflation reaches levels well below 6%, the SARB will most likely want to remain flexible to react to any shocks that could negatively affect inflation – such as a sharp depreciation of the Rand - interest rates should remain flat most of the year.

So, what does this mean for South African investment markets?

The change in sentiment for the SA economy has led to a more positive outlook for SA equities as well as SA bonds.

SA Equity outlook

For the last three years, we have seen the local equity market mostly move sideways in real terms, and in 2016 generate a total return of 2.2%. However, over the past three years' earnings prospects of certain sectors have improved, which means from a valuation perspective more opportunities to buy cheap shares have presented themselves. The bottoming out and recovery of commodity prices has also assisted the strong recovery in earnings expectations for the resources sector.

Bonds outlook

The positive outlook for inflation and potential interest rate cuts in 2017 will be supportive for SA bonds, and although the increase in developed market yields has caused an erosion of the real bond yield differential between SA and the developed market, the size of the differential remains large enough for SA bonds to remain internationally attractive. Allied to the lower country risk premium, bonds appear reasonably priced. Figure 1 illustrates this differential.

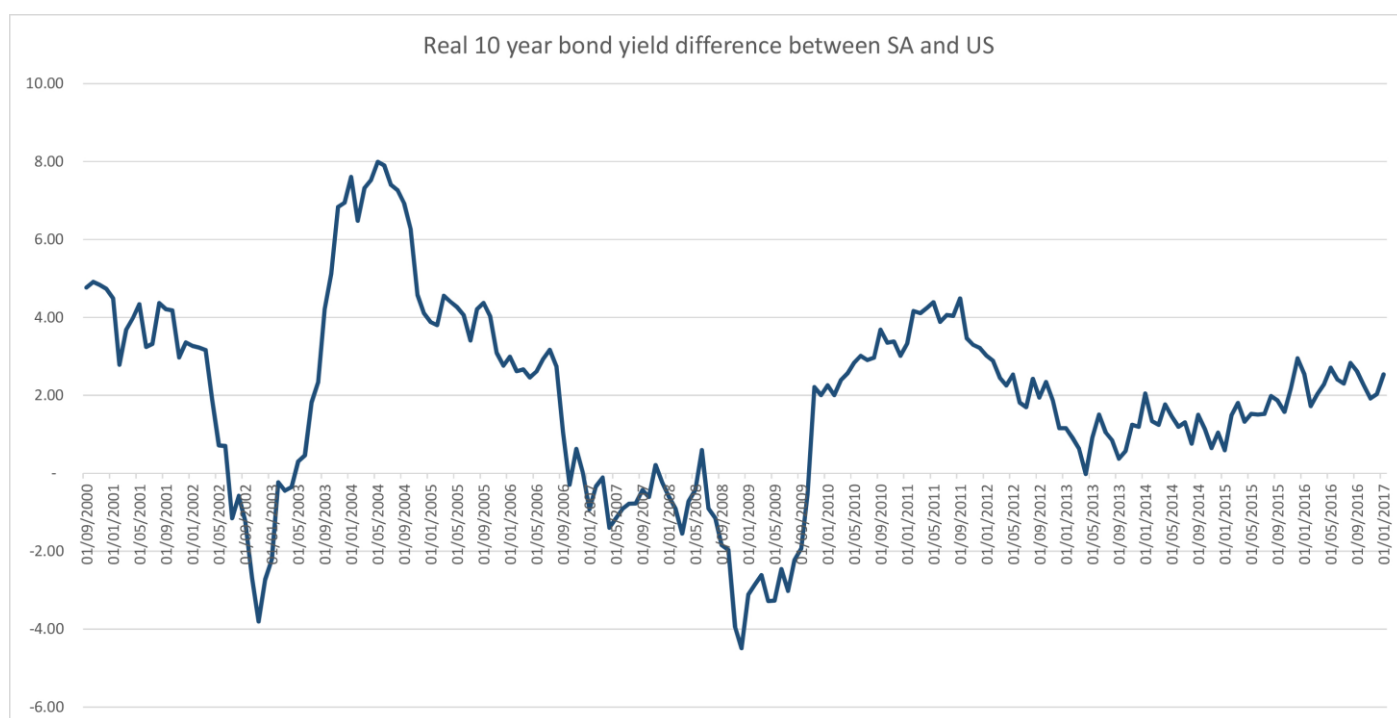


Figure 1: SA real bond yield differential with average of Germany and US

Source: Credit Suisse

But risk remains....

Although we welcome this positive sentiment towards the SA economy there are still local risks that cannot be overlooked when making an investment decision about SA. Firstly, although the local bond market seems to have already priced in the risk of the sovereign debt rating, we are still not certain what the actual effect would be if the downgrade does happen. Secondly, political risk is also something that will remain and with the latest cabinet movements and the addition of Brian Molefe, we are reminded how much quickly changes in parliament can happen. Thirdly, capital flows out of SA have also escalated in recent months, a sign that the switch back towards yielding assets in developed economies is a substantial event for emerging economies. Lastly, the strengthening of the Rand in 2016 assisted to keep inflation at a manageable level, however if we see the rand losing ground in 2017 this could add more pressure to the SA consumer who is already under stress.

Overall, we remain cautious in terms of how risk is managed across client portfolios. Despite positive sentiment being supportive of local assets, substantial risks remain which are not currently being reflected in fund positions – with a few exceptions. At all times we look to diversify across differing fund management approaches, and what is evident at this point is that there is now a much smaller set of SA bears to choose from to diversify portfolio risk.

28 February 2017

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol ¹	10yr Vol ¹
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	2.0%	1.1%	6.3%	5.7%	11.6%	10.2%	10.5%	15.1%
FTSE/JSE SA Listed Property	ZAR	5.5%	1.3%	11.0%	16.2%	16.3%	14.6%	14.3%	15.4%
SA All Bond Index (ALBI)	ZAR	3.7%	2.1%	13.5%	7.9%	7.3%	8.0%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.8%	1.2%	7.5%	6.7%	6.2%	7.3%	0.2%	0.6%
Balanced Benchmark ²	ZAR	1.6%	0.9%	5.3%	7.8%	12.4%	10.6%	6.2%	6.2%
SA Inflation (1 month lag)	ZAR	1.3%	0.6%	6.6%	5.7%	5.7%	3.9%	1.4%	6.5%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	7.8%	5.3%	21.3%	5.2%	9.4%	4.3%	11.0%	16.5%
Emerging Markets Equity (MSCI EM)	USD	8.9%	8.7%	29.5%	1.4%	-0.4%	2.9%	15.4%	23.5%
Global Bonds (Barclays Global Bond Index)	USD	1.1%	1.6%	0.6%	-0.5%	0.2%	3.3%	4.6%	5.9%
Global Cash	USD	0.2%	0.1%	0.6%	0.3%	0.3%	1.0%	0.1%	0.5%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	2.0%	1.1%	6.3%	5.7%	11.6%	10.2%	10.5%	15.1%
Global Equity (MSCI World)	ZAR	0.5%	0.7%	0.5%	12.3%	22.4%	10.6%	13.4%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	1.6%	4.0%	7.3%	8.2%	11.5%	9.1%	12.0%	15.7%
SA All Bond Index (ALBI)	ZAR	3.7%	2.1%	13.5%	7.9%	7.3%	8.0%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	-5.7%	-2.8%	-16.6%	6.3%	12.1%	9.6%	12.5%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	5.3%	7.6%	0.9%	-2.0%	-6.9%	6.3%	17.2%	19.4%
Gold (Rands)	ZAR	-1.8%	2.9%	-16.4%	4.7%	4.2%	12.8%	18.7%	21.8%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	-6.5%	-4.5%	-17.4%	6.9%	11.9%	6.1%	14.2%	16.5%
Rand / GBP Pound	ZAR	-7.1%	-4.0%	-26.3%	-3.3%	6.4%	1.3%	14.2%	15.2%
Rand / Euro	ZAR	-6.5%	-4.0%	-19.4%	-2.1%	6.8%	3.8%	12.9%	13.8%

Spot Rates

		28-Feb-17	7-Mar-17	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Currencies	Rand/US\$	Rand	12.97	13.68	15.50	8.07	7.05	4.68
	Rand/GBP	Rand	15.81	16.88	23.11	12.52	13.80	8.01
	Rand/EUR	Rand	13.72	14.42	16.83	10.48	9.30	NA
	Rand/Aus \$	Rand	0.10	0.10	0.09	0.12	0.18	0.27
Rates	Libor 6m \$	US\$	1.42	1.32	0.85	0.81	5.37	5.60
	Prime	Rand	7.00	7.00	6.25	5.50	9.00	NA
	Repo Rate	Rand	10.50	10.50	9.75	9.00	12.50	20.25
	All Bond Index Yield	Rand	9.15	9.39	10.11	8.12	NA	NA
Commodities	Gold (\$/oz)	US\$	1,218.90	1,157.49	1,062.38	1,574.57	634.50	369.65
	Palladium	US\$	770.00	670.00	555.00	630.00	324.00	116.50
	Platinum	US\$	966.00	898.00	868.00	1,354.00	1,117.00	369.50
	Oil (Brent Crude) \$	US\$	56.07	56.71	35.70	108.28	59.44	23.99
Inflation	SA Inflation	Rand	NA	6.72	5.28	6.15	5.80	9.40

data provided by Profile Data Analytics, Reuters and Datastream