South Africa Q2 19 Quarterly Perspectives

Economy stutters under the weight of Eskom

Polling data suggest that the African National Congress (ANC) will retain its majority at a national level in the 8 May elections, but may lose control of Gauteng. We think continued factionalism within the ANC will prevent President Ramaphosa from sharply accelerating reform efforts post the elections, but his promised reconfiguration of government and cabinet appointments will be key.

Eskom will continue to dominate the headlines, with interlinked structural, operational and financial challenges. Eskom remains a huge source of macroeconomic risk. The unbundling of the utility and reform sequence needed to unlock Treasury bailout funding are still unclear. Even with the Treasury funding, Eskom is probably not financially viable without further support.

We trim our growth forecasts, and now project 1.3% growth in 2019, with more downside than upside risk, especially given ongoing risks of power rationing. Weak business sentiment is holding back private investment and the consumer has little room to spend, given tax hikes, a weak jobs market and rising petrol prices.

Inflation remains under control. Headline CPI inflation will rise due to electricity price hikes, base effects on fuel and rising food price inflation, but we now forecast core CPI inflation to track below 5% over the forecast horizon.

We have opted to stick with our existing ZAR projections, forecasting USD/ZAR 14.80 by end year. The current account deficit is likely to remain modest, despite higher oil prices and subdued global demand. More dovish ECB and Fed language is supportive of bond inflows, but the ZAR remains vulnerable to further equity outflows.

We have removed our call for a rate hike in September. The favourable Moody's decision, easier global monetary context and subdued domestic inflation have eliminated much of the need for a rate hike. Consequently, we no longer forecast a rate hike in September. We are leaving in our call for a hike in March 2020, however. We think the bar to cuts is quite high.

Fiscal policy remains a key weakness. The 2019 Budget did not present a convincing consolidation plan for stabilising public debt. Some upside risk to revenues from a recovery in tax elasticity may be offset by weaker-than-budgeted nominal GDP growth. The Treasury's ability to contain spending by implementing an early retirement programme will be key. Additionally, Eskom claims it has a ZAR250bn hole even after the recent tariff award and the Treasury bailout funding.

Moody's stay of execution does not represent a permanent reprieve in our view. South Africa's Baa3 Stable Outlook credit rating is now likely secure until the next Moody's rating date of 1 November. However, we think the risks of a downgrade at some point in the future are material unless South Africa can lift its GDP growth rate, stabilise Eskom and narrow the budget deficit considerably.

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Politics: Critical elections approach

Recent polls suggest the ANC will maintain its majority at a national level in the 8 May elections…

National and provincial elections are due on 8 May, against a backdrop of heightened voter uncertainty and eroding party loyalty. Nonetheless, two recent opinion polls both suggest that, at a national level at least, the governing ANC will retain its majority. A telephone-based poll by the Institute of Race Relations in February put the ANC at 54.7% (55% on a moderate turnout), about on par with the 53.9% it received in the 2016 elections. Of course, local government elections are quite different from national elections and 2016 was quite different from 2019, in that back then, the ANC was lumbered with a deeply unpopular president, but the party's popularity had not been buffeted by endless state capture revelations. Meanwhile, the IRR poll puts the Democratic Alliance (DA) at 21.8% (24%) and the Economic Freedom Fighters (EFF) at 12.2% (11%). A considerably larger face-to-face poll by IPSOS (2,835 participants versus 1,611 for the IRR) suggests that the ANC enjoys the support of 61% of the electorate, and will secure the same share of the vote under a medium turnout scenario, while the DA pegs in at 16% support (18% under a medium turnout) and the EFF at 9% (10%), with smaller parties splitting the rest (Figure 1).

Figure 1: Two recent polls suggest the ANC will win a majority at a national level

	2014	2016	2019 projections			
	National elections	Municipal elections	IRR	2019*	IPSOS	IPSOS*
ANC	62.1	53.9	54.7	55	61	61
DA	22.2	26.9	21.8	24	16	18
EFF	6.3	8.2	12.2	11	9	10
IFP	2.4	4.3	2.7	3	1	2
FF+	0.9	0.8	1.7	2	1	2
ACDP	0.5	0.4	0.7	1	--	1
GOOD	NA	NA	0.6	NA	--	1
COPE	0.6	0.4	0.4	0	--	1
UDM	1.0	0.6	0.8	2	--	1
Other	4.0	4.5	1.9	2	--	3
DK, WS & WV**	NA	NA	2.5	NA	11	NA
Sample size			1611		2835	
Estimated sample error			3.3%		1.8%	
Fieldwork dates			12-16 Feb		1 Feb - 4 Mar	

**Adjusted for plausible turnout. ** Don't know, won't say, won't vote.*
Source: Independent Electoral Commission, IPSOS, IRR, Absa Research

…but could lose its majority in the heartland of Gauteng, opening the way to potential coalition with the EFF

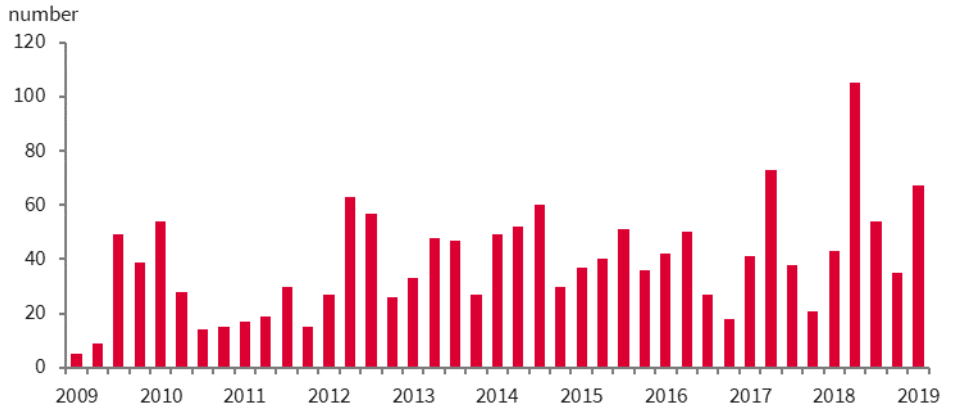
Even if the broad outcome seems fairly predictable at a national level, a couple of the provinces would seem to be important battlegrounds. In particular, there is some uncertainty about whether the ANC will retain majority control of Gauteng, the country's economic heartland and most populous province. The IRR poll, which published some detail of its findings at a provincial level (with supplementary sampling), suggested that the ANC only had the support of 41.6% of voters, and would take only 47% of the vote on a medium turnout scenario. Meanwhile, the DA looks set to win 36% of the vote, and the EFF 11%. This would seem to leave the EFF in a kingmaker position, although possibly, the ANC might just be able to cobble together a thin majority with the support of several of the minor parties. Regardless of the exact composition, a coalition provincial government would be unprecedented and would potentially be politically unstable. While the EFF supported the DA-led governments in some metros, it has said that it will only enter coalitions with parties that support its radical policies on the nationalisation of land, banks and mines post the elections. Elsewhere, despite some downward pressure on the DA's support, the IRR poll suggests it will be just able to hang onto its hitherto impregnable majority in the Western Cape, polling at 50.1% support, which translates into a 54% share of the vote under a medium turnout.

Load shedding and the release of the ANC's parliamentary candidate list could have further weighed on ANC popularity since the poll fieldwork was conducted

Of course, international experience has shown that polls can get it wrong. All polls have a margin of error at a 95% confidence rate. For this reason, given that the IPSOS poll has a larger sample and therefore a smaller sample error, and because it is a face-to-face poll rather than a telephone-

based poll, which might be presumed to tend to exclude older, poorer, rural voters who are the bedrock of ANC support, we are inclined to favour the IPSOS poll results. However, we have to point out that both of these extant polls are based on fieldwork done in February i.e., before the latest bout of intense load shedding and the release of the ANC's parliamentary candidate list (which features a number of individuals associated with state capture). Both these events might have further depressed support for the ANC, despite President Ramaphosa's popularity. Service delivery protests remain at elevated levels, indicating a high level of voter dissatisfaction with the status quo (Figure 2). Furthermore, revelations that President Ramaphosa's son was associated more closely than previously believed with a company mired in corruption could hurt the president's drive to roll back corruption and clean up the reputation of the state. Despite the appointment of a new head of the National Prosecuting Authority who took office at the beginning of February, there are still no state capture cases filed before the courts, although President Ramaphosa's proclamation of a new unit within the National Prosecuting Authority with both investigative and prosecutorial powers is a big step forward.

Figure 2: Service delivery protests in Q1 19 were the third highest ever



Source: Municipal IQ, Absa Research

More of the same on the policy front post elections

Of course, what matters for the country is not the election itself, per se, but how it impacts policy settings and implementation in the subsequent five-year term for the government. We are inclined to agree with the consensus view that a high share of the vote for the ANC on 8 May would support President Ramaphosa's position within the party, and would enable him – to some degree – to push back further against state capture. However, we think there is another divide within the factionalised ANC, and this is between what might loosely be termed 'left and moderates', with the former still backing the vision of the government at the vanguard of a developmental state and the latter understanding that private capital and markets need to play a primary role in driving growth. Within the ANC at large, we suspect that the 'left' is a larger faction than the 'moderates', with the Congress of South African Trade Unions and the South African Communist Party being two of Ramaphosa's strongest constituencies in the battle against state capture. Thus, we think that following elections, there will be continuing contestation within the party on key policy battlefields like educational reform, labour market liberalisation, privatisation of state-owned enterprises, the role of the SARB, and so on. Even if President Ramaphosa 'brings home the bacon' for the ANC in the elections, we question whether his personal popularity with the electorate and his access to state power will be enough to override the ideological divide within the party and deliver faster and deeper reforms. The next big political test after the elections will be President Ramaphosa's appointment of a cabinet, and whether he quickly implements a promised reconfiguration of government with a slimmed-down cabinet. In particular, President Ramaphosa's choices for the Minister of Finance and Public Enterprises will be key, as will his appointment of the minister to drive the land reform programme and labour.

Eskom will continue to dominate the headlines

There is not enough spare capacity in the system to guarantee against a possible resumption of load shedding, especially if there are multiple unplanned outages at South Africa's coal fired plants

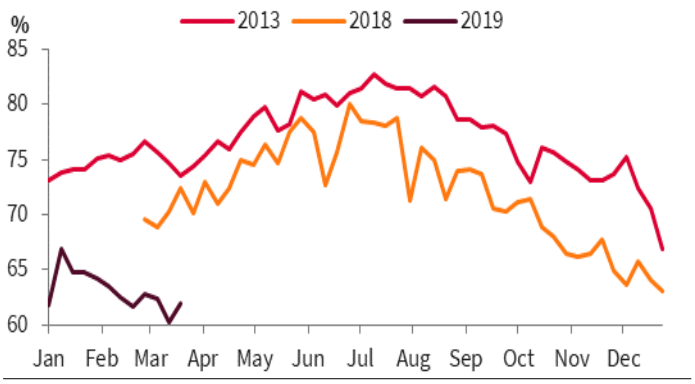
With pressing and complicated interlinked structural, operational and financial challenges, Eskom remains a huge source of fiscal and macroeconomic risk. An unfortunate coincidence of events, including multiple generating plant breakdowns and a cyclone that took down the high-voltage transmission line from Mozambique, tipped South Africa into unprecedented Stage 4 load shedding in March, with rotational power cuts of 25% over the course of 6 days. Since 23 March, however, power rationing has been avoided. However, this could prove a temporary respite. South Africa's 15 coal fired power stations are supposed to provide the bulk of South Africa's energy supply (Figure 3). However, many of them are nearing the end of their natural life and have not received sufficient maintenance in recent years, while the Medupi and Kusile new builds are much delayed and burdened with various design and construction flaws. Breakdowns are common. Thus, the Energy Availability Factor (EAF), which is the actual generating capacity at any given moment as a percentage of theoretically installed capacity (accounting for both planned outages for scheduled maintenance and unplanned outages or breakdowns) has slumped to the low 60s versus an Eskom target of 80% (Figure 4). Recently, Eskom argued that it ought to be able to keep the lights on (or at worst just resort to Stage 1 load shedding) even during the energy-hungry winter months (Figure 6). This is partly because new units from Medupi and Kusile are due to come on line soon (Figure 7). Additionally, Eskom is pushing for new more agile procurement arrangements for diesel for the open cycle gas turbines and spare parts for maintenance.

Figure 3: Coal power stations are operating below theoretical capacity

Type	Number	Nominal capacity (MW)
Coal-fired	15 stations	38 023
Gas/liquid fuel turbine	4 stations	2 409
Hydroelectric	6 stations	661
Pumped storage	3 stations	2 724
Nuclear	1 station	1 860
Wind energy	1 station	100
Renewable IPP	64 stations	3 811

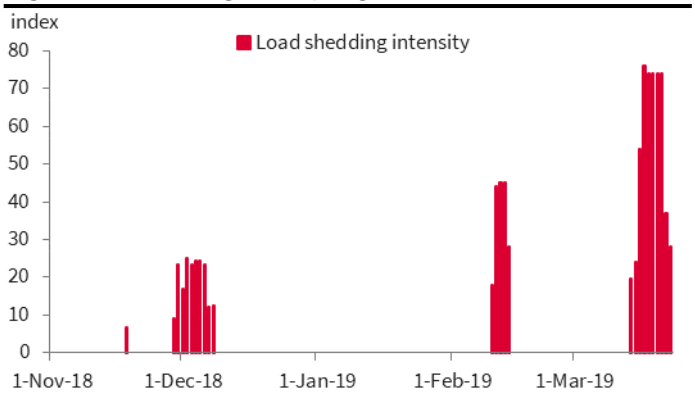
Source: Eskom, Absa Research

Figure 4: Energy Availability Factor has slumped in recent years



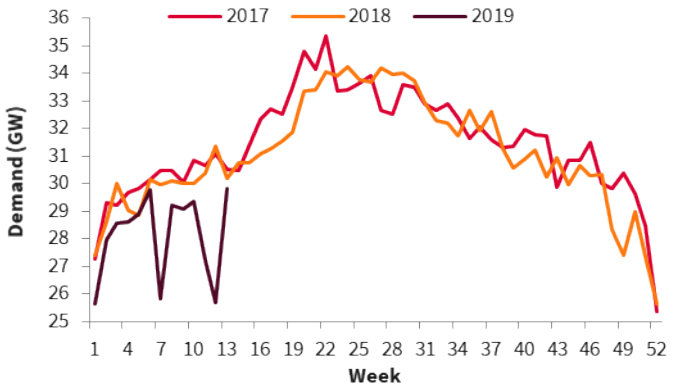
Source: Eskom, Absa Research

Figure 5: Load shedding intensity surged in March



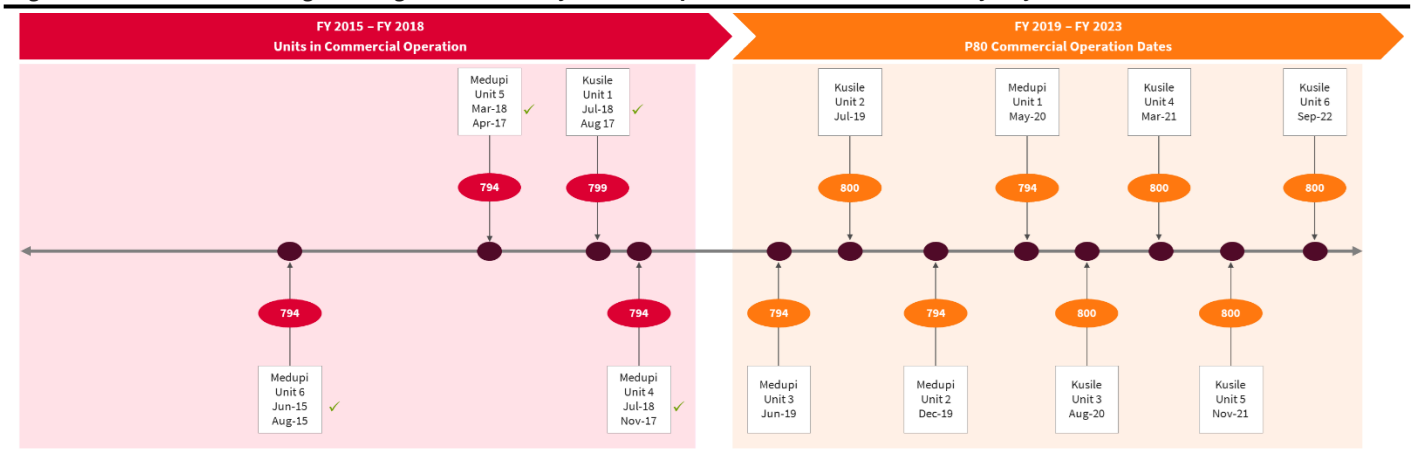
Source: Eskom, Absa Research

Figure 6: Energy demand picks up in winter



Source: Eskom, Absa Research

Figure 7: Two of the new build generating units with nearly 1600MW of power are due to come on line by July



Source: Eskom, Absa Research

The government aims to fix Eskom by unbundling it, but the path forward here is not clear

The operational challenges feed through into Eskom's financial challenges in three ways. First, breakdowns of Eskom's coal-fired generating plant cost money to fix, and second force greater recourse to the more expensive open cycle gas turbines to generate electricity, both with adverse impacts on Eskom's costs. Third, periods of load shedding represent foregone electricity sales, with an adverse impact on Eskom's revenues. The government aims to unbundle the vertically integrated utility into generation, transmission and distribution units, but the path forward here is complex and opaque, and it will not immediately address Eskom's acute challenges. The idea would be that unbundling would make it easier for private power producers to sell the electricity on the grid, but the regulatory landscape for this needs to be overhauled. Additionally, organised labour appears opposed to such a move. Moreover, it is not clear how Eskom's staggering debt (ZAR419bn as of last September) should be allocated between the unbundled entities and the state. Some progress towards unbundling is likely needed for Eskom to access the ZAR23bn per year in bailout funds given by the National Treasury, but the exact conditionality is still being negotiated. Even after the National Treasury bailout funding, Eskom says that the lower-than-requested tariff award from the national energy regulator leaves the utility with a ZAR250bn 'hole' in its finances. A fix for this is neither easy nor obvious. Public Enterprises Minister Pravin Gordhan has said that the government is looking at additional mechanisms to support Eskom, but it is not clear what it has in mind.

Q4 18 GDP growth surprised on the upside but near-term growth might be soft

GDP growth slowed in Q4 after rebounding from a recession in Q3

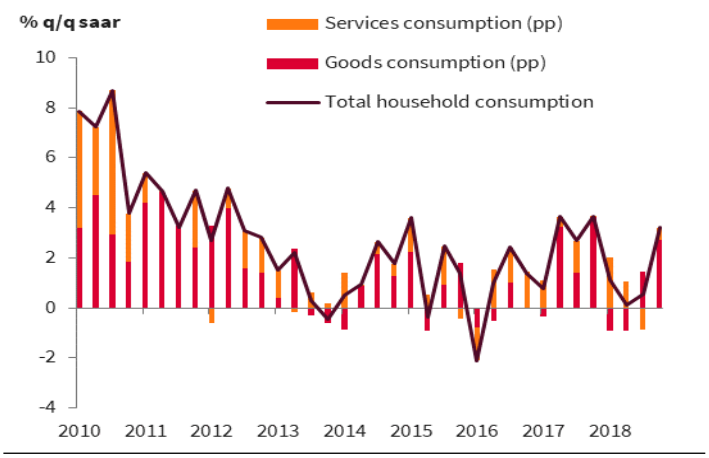
After recession in the first half of 2018, GDP growth rebounded to 2.6% q/q saar in Q3 but slowed to 1.4% in Q4. The Q4 18 quarterly growth is equivalent to just 0.2% on a y/y basis. Overall, South Africa delivered full-year GDP growth of 0.8% in 2018 compared with 1.4% in 2017. Production-side GDP data showed mixed performance across different sectors of the economy in Q4 18 (Figure 8). Gross value added in mining shrank -3.8% q/q saar, but manufacturing expanded 4.5% q/q saar. Agriculture, which has been highly volatile in recent quarters, increased by 7.9% q/q saar in Q4. The latest Crop Estimates Committee 2019 summer crop forecasts point to sharp declines in key summer crops this year, suggesting further volatility for this sector in the quarters to come. Meanwhile, weakness in the construction sector persisted, with gross value added in this sector having fallen in seven of the last eight quarters. In the services sector, gross value added in 'transport and communications' had another quarter of solid growth in Q4 of 7.7% q/q saar, while 'finance and business services' also came in stronger.

Figure 8: The economy grew in Q3 and Q4 following 1H 18 recession

% q/q saar	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q418
Agriculture, forestry and fishing	41.7	39.0	-33.7	-42.3	13.7	7.9
Mining and quarrying	6.2	-4.4	-9.1	8.1	-8.9	-3.8
Primary sector	13.8	5.2	-16.4	-7.3	-4.0	-1.1
Manufacturing	3.7	4.3	-8.4	1.4	7.5	4.5
Electricity and water	-6.1	3.3	1.0	0.7	0.8	0.2
Construction	-1.2	-1.4	-2.3	1.5	-1.7	-0.7
Secondary sector	1.5	3.1	-6.2	1.3	4.9	3.0
Trade & accommodation	-0.1	4.8	-3.0	-1.2	3.4	-0.7
Transport and communication	0.8	2.8	1.4	-3.8	6.8	7.7
Finance, real estate and business services	1.9	2.5	1.0	1.7	2.1	2.7
Personal services	1.2	1.0	1.2	0.8	0.6	1.7
General government services	1.1	1.4	2.1	0.2	1.9	-0.6
Tertiary sector	1.1	2.7	0.4	-0.1	2.9	1.7
GDP at market prices	2.3	3.1	-2.7	-0.5	2.6	1.4

Source: Stats SA, Absa Research

Figure 9: Strong showing from the consumer in Q4 18



Source: Stats SA, Absa Research

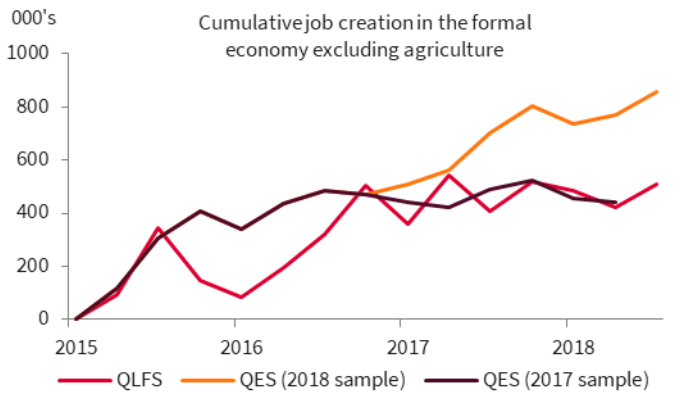
Household consumption expenditure increased due to durables consumption

Expenditure-side GDP data showed stronger household consumption towards the end of last year, with expenditure growth of 3.2% q/q saar in Q4 18, up from 0.6% in Q3 (Figure 9). All four broad categories of household spending increased in Q4, but the biggest swing came from durables consumption, which surged 7.7% q/q saar, while services consumption rose 1.1% q/q saar. Semi-durables also showed strong growth in Q4 of 8.7% q/q saar. We believe the strength in durables and semi-durables consumption partly reflects the effects of Black Friday, which may not still be fully accounted for in Stats SA's seasonal adjustment framework.

New QES sample frame suggests more employment creation in 2018 than previously indicated

Part of the reason for the good consumption print in Q4 18 could have been the relatively good employment figures. Both the Quarterly Employment Statistics (QES) and the Quarterly Labour Force Survey (QLFS) registered a surprising increase in jobs in Q4 18. The QES shows that total non-agricultural jobs increased by 87k (or 0.9% q/q) during Q4 18. Notably, Stats SA's annual sampling adjustment of the QES revealed that formal non-farm job growth in the last two years was stronger than previously estimated (Figure 10). The sampling frame adjustment had the effect of lifting total formal non-agricultural employment by 331k from the previously stated level for Q3 18. Meanwhile, the QLFS reported a Q4 18 rise in employment of 149k, due especially to increased employment in financial services and to a lesser extent household employment and mining. All other formal and informal sectors, however, registered employment declines. Even so, the increase in employment is a little surprising, given the prevailing narrative of overwhelming pressure on jobs and weak business confidence, and we are reluctant to get too optimistic about a single quarter showing improvement, because the data series are in fact quite volatile from one quarter to another. Meanwhile, on the earnings side of the QES, growth in average monthly earnings slowed to 4.9% y/y in the final quarter of last year from 6.0% y/y in Q3 18 and an average of 9.0%y/y in 2017. Similarly, the SARB Quarterly Bulletin showed compensation of employees increased by 4.1% y/y in Q4 18 from a record low of 4.0% growth in Q3 (Figure 11). The available Q1 19 surveys of hiring intentions suggest that job growth could be under pressure in the near term across major sectors of the economy.

Figure 10: Employment picked up in Q4 18



Source: Stats SA, Absa Research

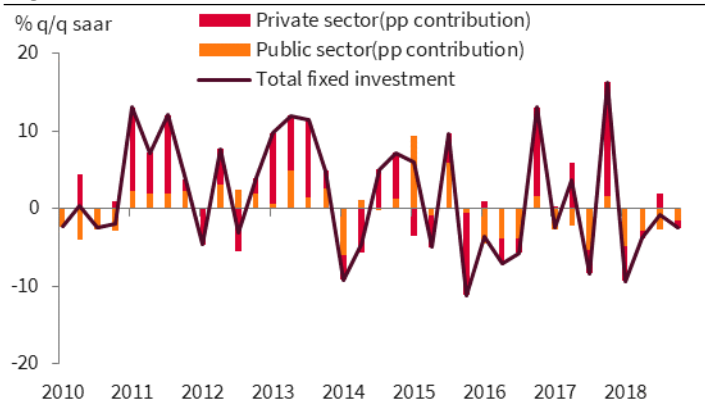
Figure 11: Compensation of employees continues to moderate

Source: Stats SA, Absa Research

Fixed investment spending remains weak, but net exports added to GDP growth in Q4 18

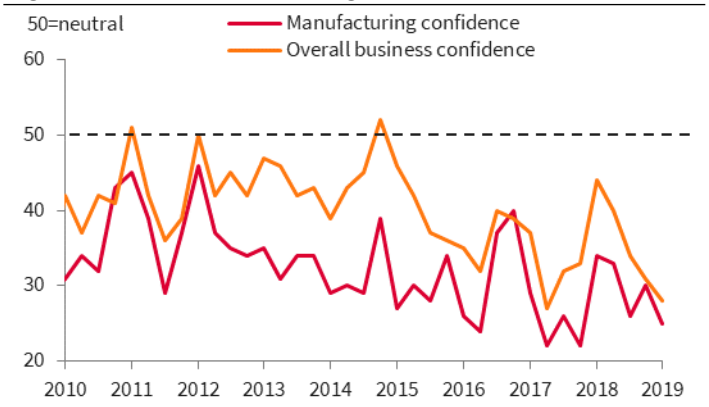
Disappointingly, gross fixed capital formation (GFCF) fell 2.5% q/q saar in Q4 18, the fourth consecutive quarterly decline (Figure 12). Private sector investment fell 1.4% q/q saar following growth of 2.9% in Q3. Meanwhile, general government and public corporations also recorded sharp investment contractions of 4.1% and 5.6% q/q saar, respectively, in Q4 18. Private sector fixed investment spending has now contracted in real terms on a q/q basis in four of the last six quarters. Meanwhile, net exports increased again in Q4 18, with export growth of 11.1% q/q saar versus an import contraction of 16.0% q/q saar in Q4 18. Rounding off the national accounts demand-side drivers of GDP, we can see that a strong inventory drawdown subtracted from GDP growth in Q4.

Figure 12: Investment declined in all four quarters of 2018



Source: Stats SA, Absa Research

Figure 13: Business confidence plunges further in Q1 19

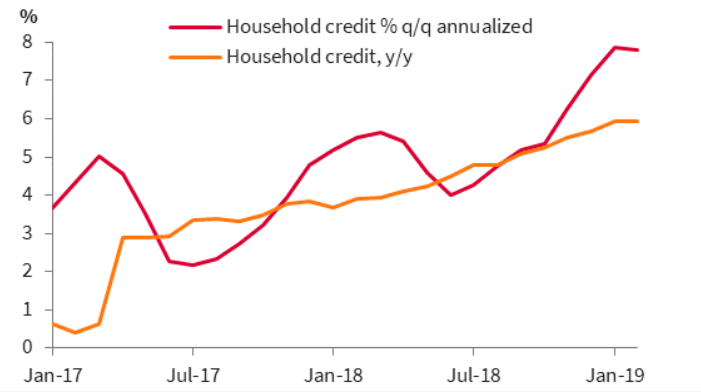


Source: Bureau for Economic Research, Absa Research

The consumer to come under pressure due to multiple headwinds

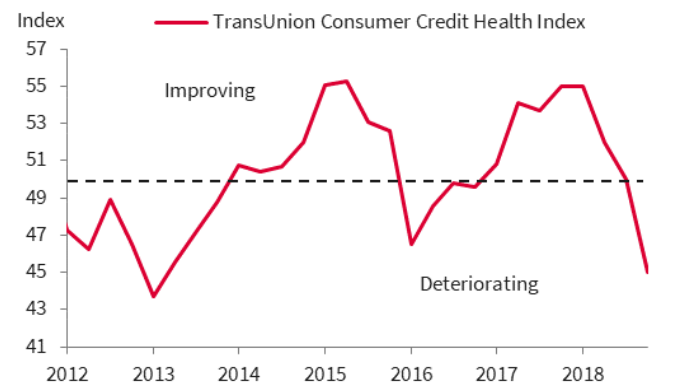
Looking ahead, we think that consumption spending is likely to remain constrained, notwithstanding the consumer's fairly strong showing in Q4 18. Newspaper narratives suggest that the consumer confidence index, which tracked sideways at +7 in Q4 18, will ebb in the face of various headwinds, including moderating income growth, weak credit extension, a higher tax burden announced in the February Budget and a tepid labour market. Higher administered prices, with big electricity tariff adjustments from Q3 onwards and rising fuel prices (from Q2 19 onwards after a temporary Q1 19 respite) will also likely constrain consumption spending. In particular, we estimate the consumer saved about ZAR1bn in lower fuel costs in Q1 19, which might have flowed into spending, but this help for consumer wallets reversed quickly in April, under the impact of higher USD/ZAR and crude prices, as well as increased fuel taxes and levies. All of these negative developments are likely to weigh on consumer sentiment and spending and outweigh the positive impact of a mild increase in banking lending to households, which currently sits just shy of 6% (Figure 14). However, even this modest growth may not be sustained in the face of declining consumer credit health. For example, the TransUnion consumer credit health index deteriorated sharply in Q4 18 (Figure 15). This marks its third successive decline, its lowest reading since Q1 13. An increase in credit defaults, rising household debt service costs and weak household cash flow weighed on the index. Overall, we forecast real household consumption expenditure growth of 1.3% this year compared with 1.8% last year.

Figure 14: Bank lending to households is slowly rising



Source: SAR, Absa Research

Figure 15: Credit health index deteriorated further in Q1 19



Source: TransUnion, Absa Research

The BER BCI came in weaker in Q1 19

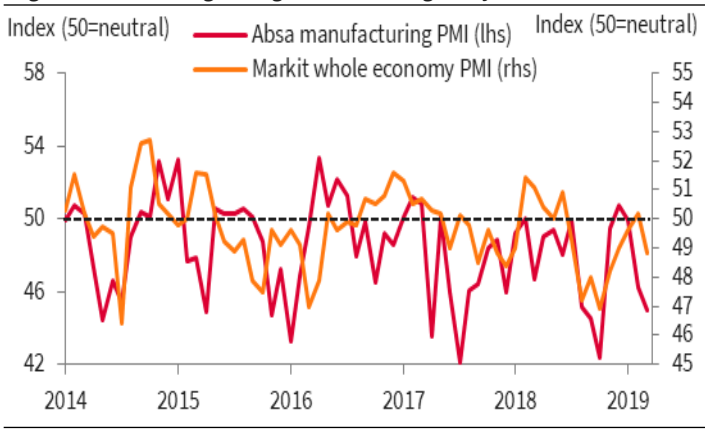
Weak business sentiment will dampen investment spending

Fixed investment spending is also likely to remain subdued in the face of weak public sector balance sheets, and for the private sector, exceptionally weak business confidence. Despite President Ramaphosa's various political successes and growth initiatives such as the Investment Summit, businesses remain deeply pessimistic. The Bureau for Economic Research's Business Confidence Index (BCI) fell further to just 28 in Q1 19 from 31 in the previous quarter, showing that 72% of South African businesses are dissatisfied with the current operating environment (Figure 13). Meanwhile, the Agbiz/IDC Agribusiness Confidence Index improved by 4 points in Q1 19 to 46 index points, but only after falling to its slowest level in a decade in Q4 18, and still below the neutral 50-point mark, implying that agribusinesses are still downbeat about business conditions in South Africa. The Bureau for Economic Research's civil confidence index fell further into contractionary territory in Q1 19, registering its lowest print on record of 10 index points in Q1 19, down from 18 in Q4 18. Businesses cite the political climate and weakness in demand as two big constraints on their businesses, and increasingly, the renewed spectre of widespread load shedding will also weigh on the prospects for investment spending. (Notably, the BCI likely did not fully factor in the most intense load shedding because the survey work was conducted between 13 February and 4 March, and Stage 4 load shedding only commenced on 16 March and ran for six days.) Overall, we forecast that GDFI will contract 0.6% this year, after a 1.4% decline in 2018.

We forecast GDP growth for 2019 to be 1.3%, down from 1.7% in the last Quarterly Perspectives

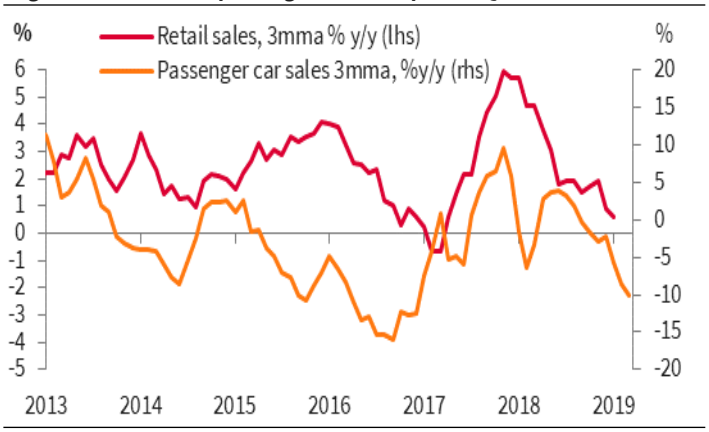
So far, on balance, high frequency indicators point to a relatively weak start to Q1 19. Seasonally adjusted manufacturing output fell markedly by 2.0% m/m during the month. Meanwhile, seasonally adjusted mining output increased slightly by 0.2% m/m in January, but only following consecutive contractions of 1.6% and 5.7% m/m in December and November, respectively. The Absa manufacturing PMI prints in Q1 19 were also weak. Since coming in just marginally above 50 at the end of 2018, the Absa manufacturing PMI declined for the third straight month to just 45.0 in March (Figure 10). Another worrying outcome from the survey is that the index measuring expected business conditions in six months' time fell by 6.3 points to 59.6 index points. At the same time, the SARB's January leading business cycle indicator fell by 1.8% m/m to its lowest in nearly 20 months. Predicting the stability of Eskom's generating grid is hard. We believe the real possibility of further unplanned outages leading to more load shedding will be a persistent deterrent to business confidence and a persistent downside risk to GDP in 2019. We have lowered out GDP growth projections to 1.3% (from 1.7%) for 2019 and to 1.7% (from 2.1%) for 2020. We now forecast South Africa's annual GDP growth to remain below 2% through to 2022.

Figure 16: Purchasing managers indices are gloomy



Source: Bureau for Economic Research, Markit, Absa Research

Figure 17: Consumer spending in cars collapsed in Q1 19



Source: Stats SA, NAAMSA, Absa Research

Inflation set to remain within target despite some upside cost-push impetus

Headline CPI inflation has eased sharply in recent months due to lower food price inflation and fuel prices

Domestic inflation dynamics have remained broadly benign in recent quarters due to a combination of factors, including unusually weak second-order effects from shocks, muted demand pull pressures, a further slowdown in food price inflation, and in the early part of 2019 lower fuel price inflation. After ending 2018 at 4.5% y/y, headline CPI inflation eased further below the mid-point of the SARB's target range to print at just 4.0% y/y in January before edging marginally higher to 4.1% y/y in February. The muted nature of inflation pressures has also been clear in core CPI inflation, which has continued to surprise to the downside, remaining unchanged

at 4.4% y/y in the four months to February. Looking ahead, there are several factors, mostly of a cost-push nature, that will add some upside impetus to headline inflation, but there are also factors that may continue to maintain a dampening effect.

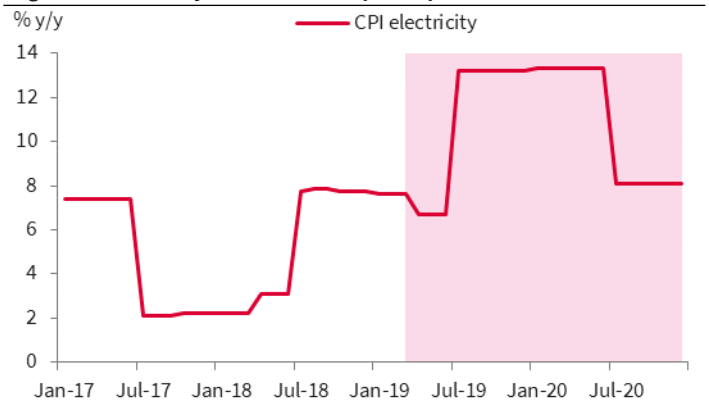
Rising Brent crude oil prices will add some upside pressure to inflation in the short term

One of the factors that will add some upward pressure in the near term is fuel prices. While fuel only has a weight of 4.58% in the CPI basket, the high degree of volatility in fuel price inflation generates noticeable effects on the path for headline CPI inflation. For instance, a big part of the decline in headline CPI inflation from 5.2% y/y in November to the recent low-point of 4.0% in January was due to a decline in fuel price inflation from 23.1% y/y to -1.2% y/y, resulting in the direct contribution of fuel prices to headline CPI inflation falling from 1.1pp in November to -0.1pp. However, the recent increase in Brent crude oil prices on supply concerns and some weakening in the exchange rate has delivered big fuel price increases in March and April. Petrol price rose by 5.3% m/m in March and by a further 9.2% m/m in April, with the latter increase including a 15c/litre increase in the General Fuel Levy and a 5c/litre increase in the Road Accident Fund Levy. The cumulative effect of these two increases alone will add 0.6pp to headline CPI inflation. The carbon tax will add an additional 9c/litre for petrol and 10c/l for diesel in June. However, more importantly, the path for fuel prices will remain heavily dependent on Brent crude oil prices and the exchange rate. The latest consensus figures, which guide our forecast, suggest that Brent crude oil prices could remain close to USD70/bbl for an extended period following the surge from just above USD50/bbl at the start of the year. We have therefore assumed that Brent crude prices will average USD68/bbl in H2 2019 and about USD69/bbl in 2020.

Figure 18: The rand price of Brent crude oil has risen sharply

Source: Thomson Reuters, Absa Research

Figure 19: Electricity tariffs will add upward pressure to inflation



Source: Stats SA, Absa Research

Electricity tariffs are set to register double-digit inflation over the next two years

Electricity tariffs will also add some upward pressure to inflation. On 7 March, the National Energy Regulator of South Africa (NERSA) announced its tariff determination for Eskom's Multi-Year Price Determination (MYPD4), stating that the standard tariff would rise by 9.4% for the utility in FY19/20, followed by further increases of 8.1% and 5.2% for FY20/21 and FY21/22, respectively. However, when including the regulatory clearing account (RCA) adjustment, the tariff increase for Eskom's upcoming financial year comes to 13.9%. NERSA has subsequently announced that the related retail tariff and structural adjustment (ERTSA) increase that municipalities will face for bulk purchases from Eskom comes to 15.6%. However, bulk purchases of electricity are on average only about 75% of the tariff structure of municipalities. Assuming that the remaining 25% (including maintenance costs, capital charges and others costs) inflates at about 6%, the implied tariff increase that will kick in from July for most consumers is 13.2%, which would take average inflation for electricity to 10.2% for 2019. In line with the NERSA determination, annual electricity inflation for 2020 would remain elevated at 10.7%.

Rising crop prices likely to offset lower meat prices and push food price inflation higher over the coming months

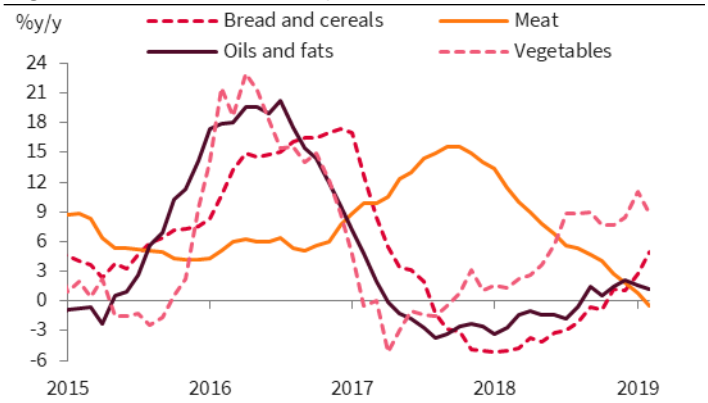
The outlook for food price inflation is also critical, given the significance of food prices in the CPI basket. In recent months, food and non-alcoholic beverages inflation has surprised to the downside, easing to just 2.9% y/y in February, its lowest level in more than eight years. An important driver of this decline is meat prices (the single largest group in the food basket), where inflation has collapsed to outright deflation of -0.5% y/y in February from an average of 2.9% in Q4 18 and 11.6% in Q1 18. We believe that some supply pressure due to dry weather conditions last year in some parts of the country, weak demand, and more recently, a nation-wide meat export

ban due to detection of foot and mouth disease (FMD) in Limpopo are the main factors behind the big slowdown in meat price inflation. However, some rainfall improvement and a lifting of the export ban to some countries imply that meat supply could tighten (with good rainfalls encouraging farmers to rebuild rather than slaughter their livestock herds).

Maize futures have risen by nearly 50% from the same time last year and will add some upward pressure on food price inflation

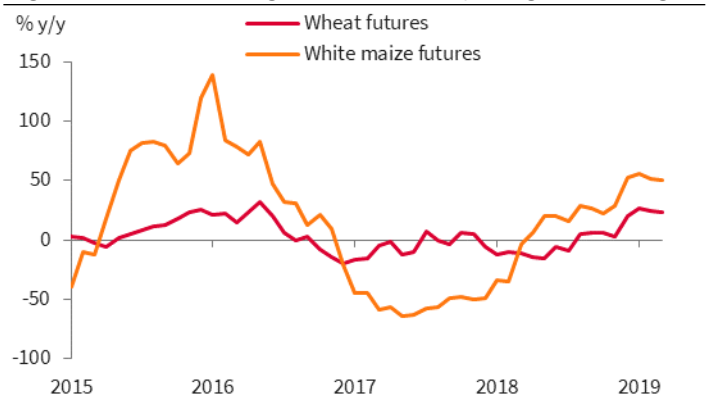
With regard to summer crops, better rainfalls have probably come a little late for the crop and prices have already picked up sharply due to lower expected volumes. In early April, white maize futures were nearly 50% higher than the same time last year, while exchange rate depreciation has pushed wheat futures up by about 20% over the same period. The effects of these higher crop prices are already evident in parts of the food basket. Bread and cereals inflation reached 4.9% y/y in February after ending 2018 at 1.1% and averaging -2.5% for 2018 as a whole. Vegetable price inflation has also picked up in recent months. This is also clear in the PPI data, where grail mill products increased at 11.5% y/y in February compared with a print of 4.3% y/y in December. Admittedly, forecasting turning points for food price inflation can be tricky. Nonetheless, we expect the upward pressure on crop-related products to dominate and push overall food price inflation higher over the coming quarters. We forecast food price inflation to rise to about 4.9% y/y by Q4 19 and to average 5.5% in 2020.

Figure 20: Low meat prices the key driver of muted food price inflation…



Source: Stats SA, Absa Research

Figure 21: …but effect of higher crop prices likely to begin dominating



Source: Thomson Reuters, Absa Research

Despite upside cost-push pressures, demand-pull inflation pressures remain muted

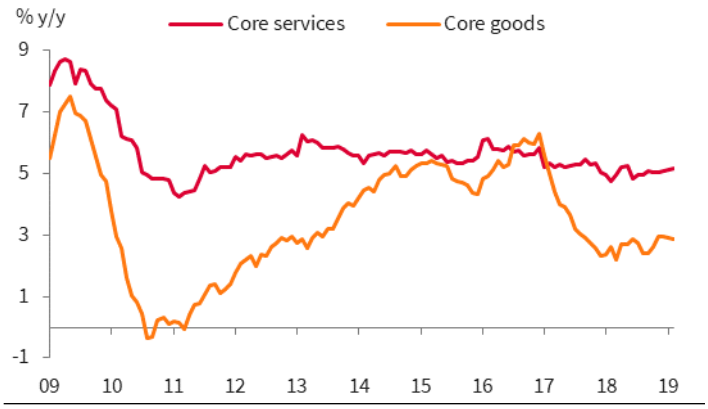
Away from cost-push factors, which are likely to add some upward pressure on inflation, underlying demand-pull pressures are key for the inflation outlook, particularly as these often determine the strength of second-order effects of exogenous shocks on headline inflation. Positively, recent readings of core CPI inflation have continued to surprise to the downside more often than not, suggesting limited demand-pull pressures. The muted nature of underlying inflation pressures is also clear in the SARB's forecasts of core inflation, with the bank having consistently lowered its projection of core CPI inflation for 2019 to just 4.7% in the March MPC meeting compared with a forecast of 5.5% in July last year. Much of the macro discourse around South Africa's version of 'missingflation' has focused on the nature of exchange rate pass-through to tradable goods. Indeed, price inflation of various goods where such pass-through would be expected to be most evident, such as vehicles and household appliances, has shown very little upward pressure. By our calculations, core goods inflation was 2.9% y/y for three consecutive months to February compared with an average of 2.6% for 2018 and 3.6% in 2019.

We expect core CPI inflation to average 4.5% in 2019 and to rise gradually to 4.9% in 2020

Core services inflation showed a relatively sticky path around 5% by our calculations. However, this is largely due to the fact that many of the prices in core services are administratively determined, with no real competitive pressure. We also note that there are parts of services that are showing some signs of easing price inflation. For instance, hotels and restaurants inflation has averaged about 4.0% over the past year compared with 4.6% in 2017 and just above 6% in the year before. This is also evident in other smaller services components such as financial services and insurance where price inflation has edged lower in recent months, possibly reflecting intensifying competition for financially constrained consumers who may be shopping around cheaper alternatives. Rentals inflation has also eased in recent quarters, and the March CPI data, which will include a quarterly survey of rental prices, will be a key read of the latest developments. Slower growth in wage settlements and unit labour costs have likely contributed to weaker core inflation

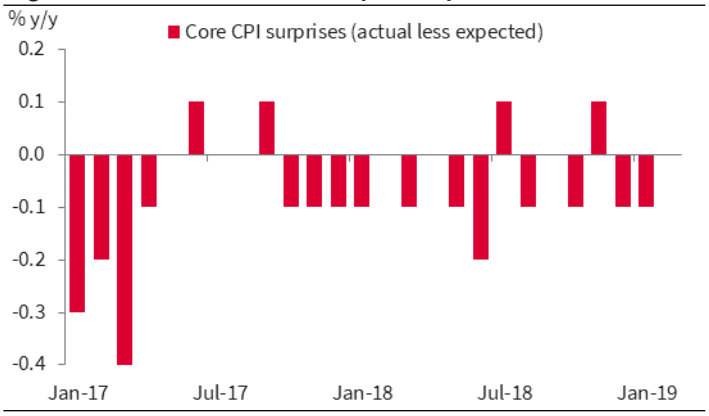
dynamics. The latest data from the SARB shows that unit labour cost growth was just 4.1% y/y in Q3 18. If this remains unchanged when the Q4 data are released, it would be the slowest rate since 2003. It is hard to know if some of this represents a structural adjustment in wage and pricing dynamics in response to sustained weakness in demand and persistent slack in the economy. Nonetheless, we expect these factors to keep core CPI inflation relatively contained over the near term, averaging 4.5% in 2019 before picking up to about 4.8% in 2020, as growth improves marginally and the negative output gap narrows.

Figure 22: Core CPI inflation remains relatively benign



Source: Stats SA, Absa Research

Figure 23: Still more downside than upside surprises

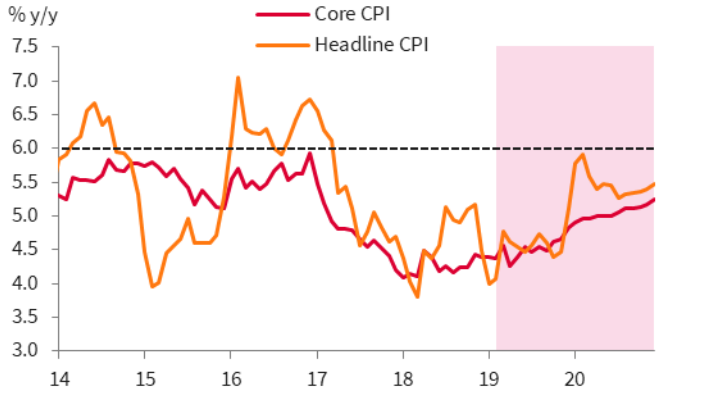


Source: Stats SA, Bloomberg, Absa Research

Figure 24: Unit labour cost growth is easing

Source: SARB, Absa Research

Figure 25: Headline CPI inflation set to remain within target



Source: Stats SA, Absa Research

We forecast headline CPI inflation to average 4.5% in 2019 and 5.3% in 2020 with a peak of 5.6% in Q1 2020

So, where does the balance of these upside cost-push push factors and subdued internal pressures leave our headline CPI inflation forecast? The sharp fuel price increases in March and April are likely to push headline CPI inflation to a near-term peak of about 4.8% y/y in April. However, we expect headline CPI inflation to ease slightly from May, hovering around 4.6% y/y through to year-end as muted demand-pull pressures keep the second-round effects of exogenous shocks low. We expect a sharp increase into 2020, partly due to unfavourable base effects with a peak of 5.6% y/y in Q1 2020, but project some easing further into the year towards year-end.

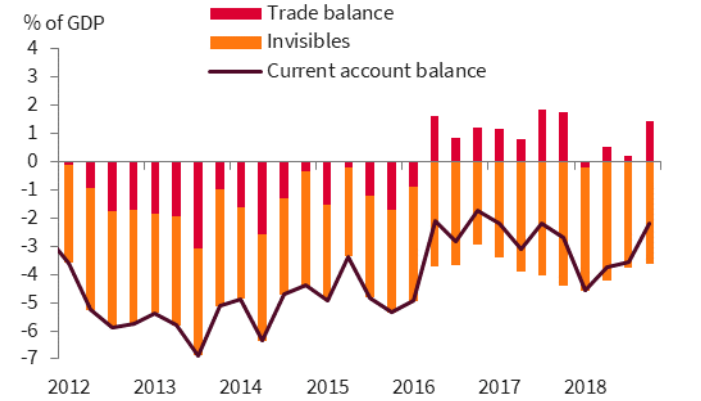
Current account deficit contained by weak domestic demand

The current account deficit narrowed notably to just 2.2% of GDP in Q4 18

The state of South Africa's external accounts often features as one of the key source of macroeconomic vulnerability, particularly given the volatility of capital flows. Expectations of a relatively more dovish stance from major central banks from developed markets should ease concerns about the outlook for global liquidity conditions. However, concerns about the slowing global economic growth could potentially affect global risk sentiment. Positively, South Africa's current account balance has shown some adjustment. In Q4 18, the current account deficit narrowed more than the market expected to just 2.2% of GDP from 3.6% of GDP in Q3 18. The improvement in the current account deficit was largely due to a large increase in the trade surplus to 1.4% of GDP (or ZAR71.8bn, sa) from 0.2% of GDP (or ZAR10.2bn). The seasonally adjusted value

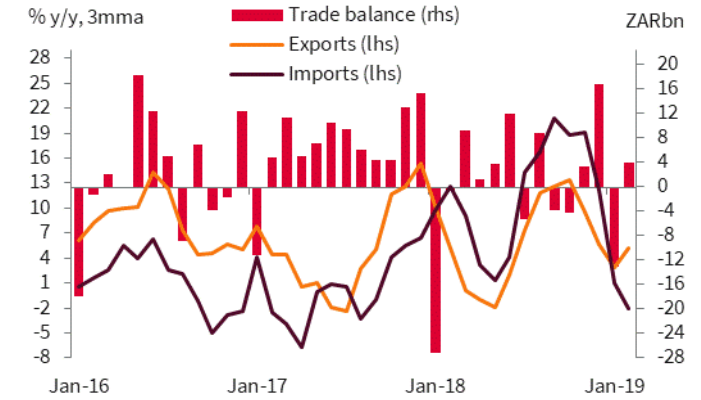
of merchandise exports increased by 3.6% q/q in Q4 18, supported by mining and manufacturing. Meanwhile, the value of merchandise imports decreased slightly by 1.1% q/q, partly due to the effect of lower Brent crude oil prices during this period and lower imports of other mineral products and manufactured goods. The deficit in the invisibles accounts (i.e., net service receipts, net income payments and transfers), which is a lot more structural, narrowed only slightly to 3.6% of GDP (Q3 18: 3.8% of GDP).

Figure 26: Deficit on the current account has narrowed



Source: SARB, Absa Research

Figure 27: Import growth has softened into Q1 2019



Source: SARS, Absa Research

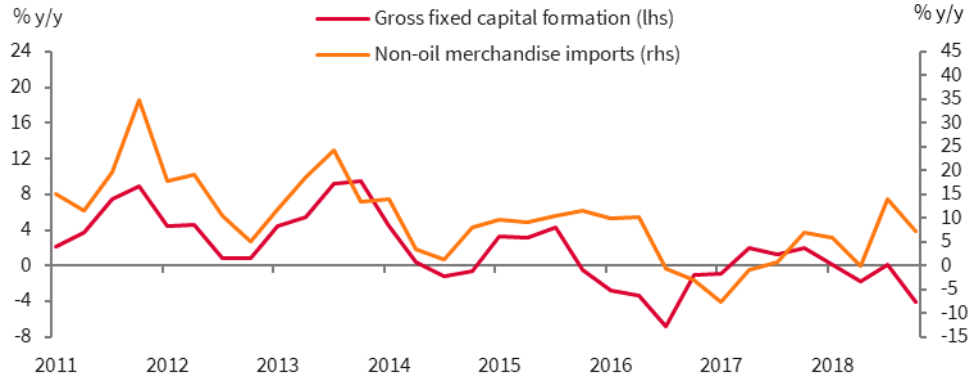
Early 2019 merchandise trade data point to another merchandise trade surplus for Q1 19

Into 2019, the monthly merchandise trade data have remained volatile but broadly point to another surplus in Q1. In February, the South African Revenue Services (SARS) data showed a merchandise trade surplus of ZAR4.0bn after a large deficit of ZAR13.1bn in January. However, the monthly trade in its raw form cannot be easily mapped into the trade data reported in the balance of payments. Assuming that the March print comes broadly in line with seasonal trends at around ZAR4bn, the seasonally adjusted and annualised merchandise trade balance as per the SARS data would come in around ZAR35.9bn by our calculations. However, Eskom's imports of diesel for its peaking power stations and possible adverse effects of the strike at Sibanye are downside risks to the March merchandise trade data. We, therefore, expect the current account deficit to widen out to 2.7% of GDP in Q1 2019.

We expect the current account deficit to average around 3.2% of GDP in 2019 and 3.7% in 2020

Commodity price trends, global growth and strong domestic demand will remain key drivers of current account dynamics. South Africa's terms of trade declined in Q4 and Q3 18 by 2.9% and 2.3, respectively. More recently, Brent crude oil prices have continued to rise, reaching USD70/bbl in early April. On the export side, coal prices have also come under a lot of pressure, falling by about 30% since the start of the year to early April. However, these adverse effects will be partially offset by some improvement in iron ore and platinum prices. Iron ore prices have surged by more than 30% in the first quarter of 2019 due to supply concerns from some of the world's top producers. Meanwhile, platinum prices have increased by about 13% during the first quarter of the year. Signs of a slowdown in global economic growth, particularly among some of South Africa's trading partners could also dampen export growth. However, domestic demand weakness will likely keep the lid on merchandise import growth. We, therefore, see the current account deficit averaging 3.2% of GDP this year before widening gradually to about 3.7% next year as domestic demand improves slightly.

Figure 28: Weak domestic demand is likely to keep growth in merchandise imports contained

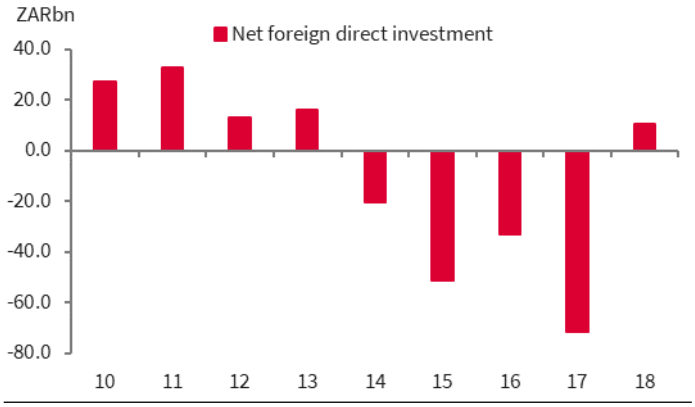


Source: SARS, Stats SA, Absa Research

Recent data have showed modest FDI inflows but portfolio flows remain volatile

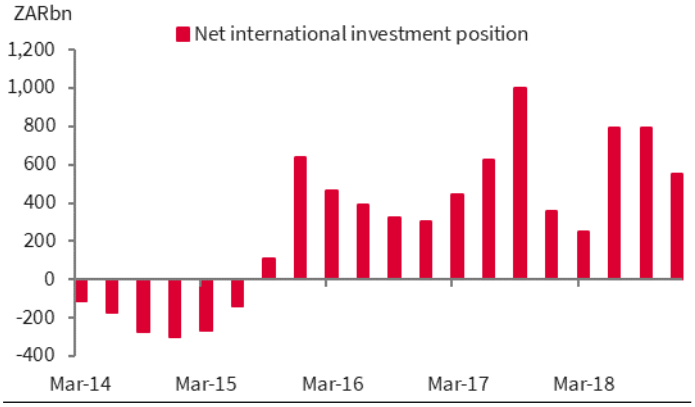
South Africa's reliance on portfolio flows to finance its twin deficits means that developments in the capital account warrant close attention. The one encouraging development in this regard is that net foreign direct investment picked up slightly in H2 18. After six consecutive outflows, net foreign direct investment recorded inflows of ZAR28.3bn and ZAR15.1bn in Q3 and Q4 18, respectively. However, it is still too early to call this the start of a trend. Meanwhile, portfolio flows have remained volatile but remained negative on a monthly basis since September last year. Of course, any evaluation of South Africa's external position needs to take stock positions into account. In this regard, South Africa continues to enjoy a relatively strong buffer from its net international investment position, although this was somewhat lower at the end of Q4. The country's net international investment position declined from ZAR795bn at the end of September 2018 to ZAR552bn at the end of December 2018 due to an increase in the value of foreign liabilities and a fall in the value of foreign assets.

Figure 29: Some promising modest inflows during H2 2018



Source: SARB, Absa Research

Figure 30: South Africa's IIP remains relatively robust



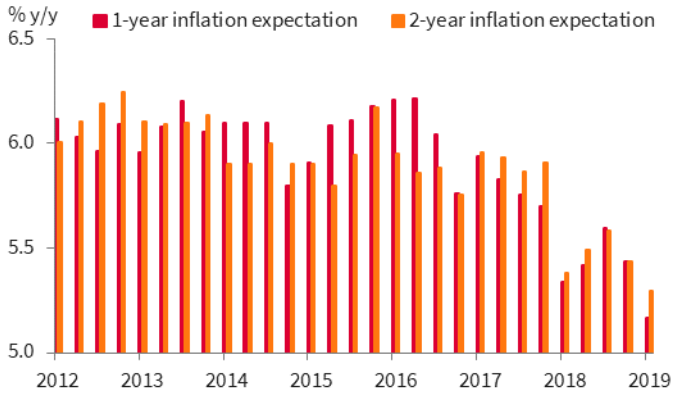
Source: SARB, Absa Research

Monetary policy: Conditions are softening

We are rescinding our call of a 25bp hike in September…

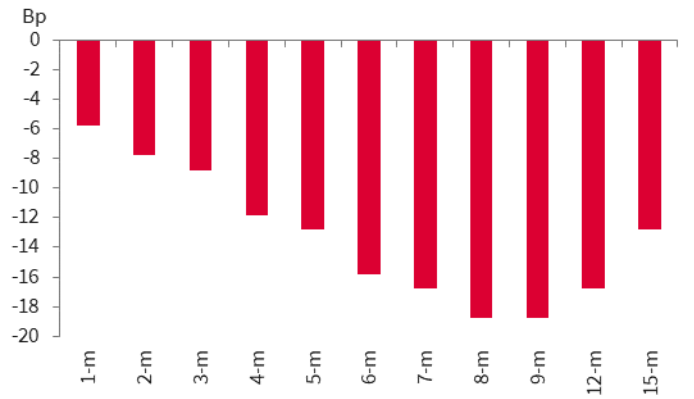
The global monetary policy context has become considerably more dovish since last year, and aside from administered prices, domestic inflationary pressures are subdued. Furthermore, as we discuss below, Moody's recently left South Africa's rating unchanged. For now, this has removed the risk of a sudden weakening in the ZAR and a surge in bond yields that would likely result from the wave of foreign selling of South African rand-denominated bonds if South Africa were to lose its last investment grade credit rating. As for the risk from elections, the exact outcome is of course unknown, but the ANC seems unlikely to lose its majority at a national level, mitigating upside inflation risks from the exchange rate. (We think a scenario of a national-level coalition government would be quite rand-negative.) Even allowing for some second-round effects from higher electricity and fuel prices, there seems little risk that headline CPI inflation will breech the MPC target of 3-6%. Moreover, the MPC should draw a lot of comfort from decelerating wage settlements, and also from the fact that inflation expectations have moderated again (Figure 31). Consequently, we are removing our forecast of a rate hike in September 2019.

Figure 31: Inflation expectations eased afresh in Q1 19



Source: BER, Absa Research

Figure 32: FRA curve pricing in 75% rate cut probability by end-year

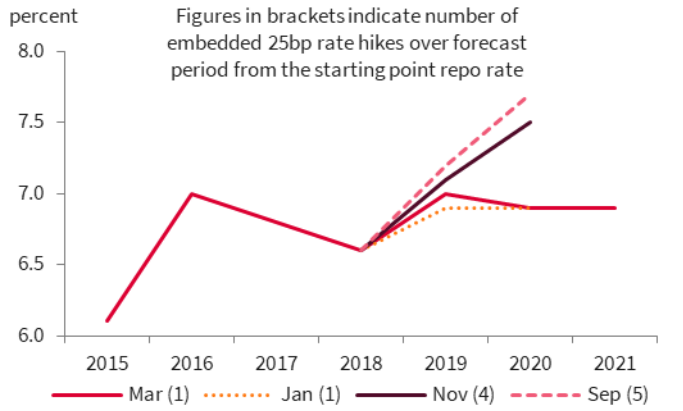


Source: Thomson Reuters, Absa Research

…but are leaving intact our forecast of a 25bbp rate hike in March 2020. We think the bar to a cut is quite high

However, we are leaving in place, for now, our call of a 25bp hike in March 2020. This is in contrast to the current sentiment in South Africa's markets. The FRA curve, for example, is currently pricing in a 75% probability of a 25bp rate cut by year-end, although this is then significantly reversed in the subsequent six-month period (Figure 32). Of course, we cannot completely rule out a cut, especially if the economy continues to soften much further in the remainder of 2020. The SARB MPC will continue to consider the appropriate monetary policy settings at its bimonthly meetings on a case-by-case basis with a high degree of data dependency. However, in practice, we think the bar to cuts is actually quite high. We note, for example, that the Quarterly Projection Model continues to price in a hike before the end of 2019, although it then appears to factor in some easing afterwards (Figure 33). Moreover, headline CPI inflation will be rising in 2019, which could serve to halt the recent improvement in inflation expectations, even if core CPI remains subdued, since inflation expectations tend to be more 'backward adaptive' than forward looking. We think the SARB, which has repeatedly emphasised its view that the current weakness of growth has little to do with monetary policy settings, is likely to prove quite cautious. However, forecasting the decisions of the MPC is difficult, given the apparent diversity of views on the committee on key inputs to the policy decision, such as what level of real interest rates are 'neutral', and hence on the degree to which whether monetary policy can be described as accommodative or not. Predicting the MPC's stance has also been made more challenging by recent and prospective changes to the membership. The term of Deputy Governor Mminele (thought to be a hawk) expires in June, and Deputy Governor Groepe resigned earlier this year. Unless President Ramaphosa appoints a new Deputy Governor soon, South Africa could soon have an MPC with just four members.

Figure 33: QPM continues to pencil in a rate hike in 2019



Source: SARB, Absa Research

Figure 34: MPC is hard to predict with split votes and personnel shifts o

Mar	3-4	25bp cut
May	7-0	hold
Jul	7-0	hold
Sep	4-3	hold
Nov	3-3	25bp hike
Jan	6-0	hold
Mar	5-0	hold

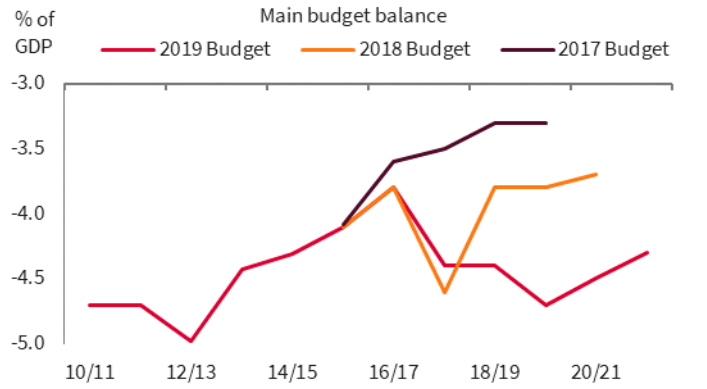
Source: SARB, Absa Research

Fiscal policy: No room to maneuver

The main budget deficit for 2018/19 will likely be higher than estimated in the 2019 Budget

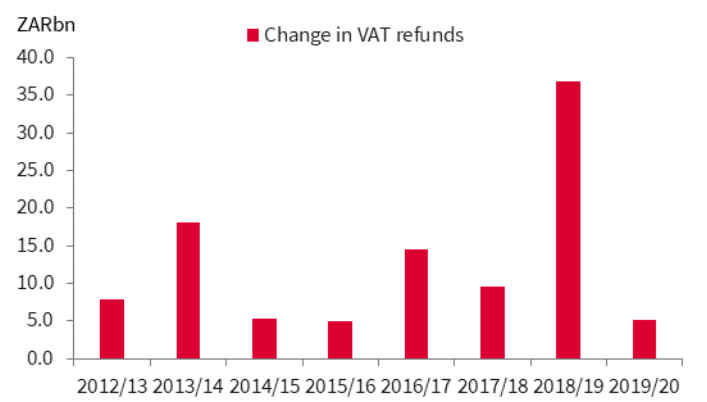
The 2019 Budget and the recent release of preliminary tax data for FY18/19 highlight South Africa has a big fiscal problem. The 2019 Budget estimated the main budget deficit for 2018/19 at 4.4% of GDP, up from the 3.8% of GDP that was originally budgeted (Figure 35). Part of the reason for this was accelerated VAT refunds to catch up with a backlog accumulated under previous SARS leadership (Figure 36). However, tax collections elsewhere, especially in corporate income tax, were weaker than originally budgeted. With South Africa's social security funds, provinces and other public bodies likely to post a net surplus of about 0.2% of GDP, South Africa's consolidated deficit for 2018/19 was estimated by the National Treasury at 4.2% of GDP. We use the National Treasury terminology of 'estimate' for the data pertaining to the extant fiscal year, but in fact these numbers are more of a forecast as they were made in January when only 10 months of data for the respective fiscal year were known. With this in mind, the statement on 1 April from South African Revenue Service that tax collections in FY18/19 had fallen short of even the 2019 Budget estimate by ZAR14.6bn suggests the main budget deficit could be even higher than the Treasury's 4.4% of GDP estimate. Furthermore, the National Treasury's forecast of the denominator in the deficit ratio may also be too high. The National Treasury forecasts nominal GDP growth of 7.2% and real GDP growth of 0.7% in FY19/20. However, we think weaker-than-expected GDP inflation and a likely poor number for real GDP in Q1 (the hard data for which will only be published in early June) could deliver weaker outcomes. Thus, if actual spending in 2018/19 comes in exactly as estimated in the 2019 Budget, the main budget deficit could hit as high as 4.9% of GDP. However, South Africa often delivers a slight underspend at the end of fiscal years.

Figure 35: Treasury has sharply widened out budget deficit targets



Source: National Treasury, Absa Research

Figure 36: VAT refunds increased sharply during FY18/19



Source: National Treasury, Absa Research

We think that tax elasticity could surprise on the upside due to institutional rehabilitation at SARS

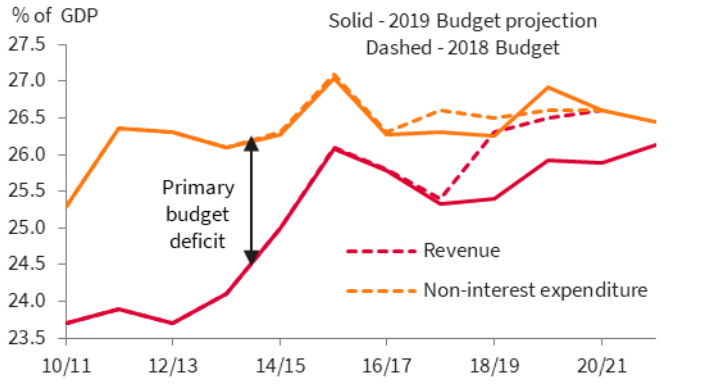
Perhaps, more significant than the outcome for 2018/19 is the fact that the 2019 Budget sharply raised the deficit forecasts for each of the subsequent three fiscal years of the Medium Term Expenditure Framework (MTEF), in part due to the decision to allocate ZAR23bn per annum (about 0.5% of GDP) to Eskom. Baseline expenditure elsewhere was cut aggressively to make room for

the Eskom bailout by ZAR50.3bn over the MTEF, with more than half of this (ZAR27.0bn) coming from cuts to compensation budgets, especially thanks to the new early retirement programme. The National Treasury reported at the 2019 Budget that already constrained compensation budgets were leading to some headcount reduction. Even so, the hitherto sacrosanct expenditure ceiling was lifted by ZAR16bn over the three-year expenditure framework and by ZAR14.0bn in FY19/20 alone. Revenue projections in the 2019 Budget were left pretty much unchanged from the MTBPS, but compared with the 2018 Budget, they were teased back to reflect more moderated GDP growth and subdued tax buoyancy. Looking forward, we see some potential upside risk to revenues from stronger-than-budgeted tax buoyancy, as the newly appointed SARS head further rehabilitates the organisation. However, we see countervailing downside risk to revenues from weak inflation, and hence nominal GDP growth. We note, however, that weak inflation may hurt nominal revenue collections but there will be some offset on the expenditure side of the budget where pay is set according to a CPI plus *x* formula. We, therefore, think the main budget deficit target of 4.7% of GDP for FY19/20 is still achievable. However, we think the main budget deficit could be 0.2% of GDP wider for each of the two subsequent fiscal years due to weak economic growth.

Projected consolidation of the deficit is currently too modest to stabilise debt to GDP

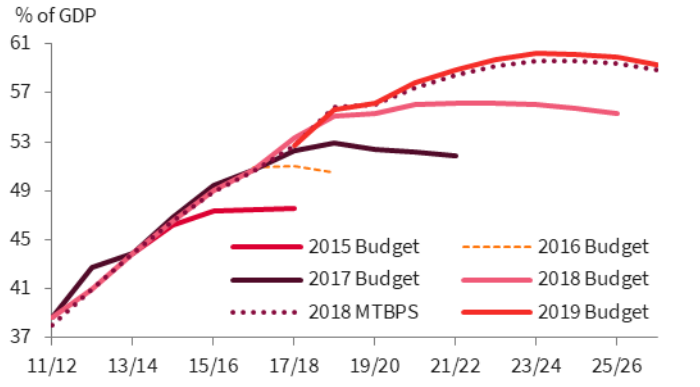
Overall, however, the targets in the 2019 Budget perpetuate (albeit in a declining fashion) South Africa's primary fiscal deficits, estimated at 0.8% of GDP in 2018/19 (Figure 37). This matters because South Africa needs to run a primary surplus to offset the fact that the real interest rate on the government debt is well in excess of the real growth rate of the economy. Thus, debt to GDP looks set to rise further until the deficit can be brought under control or the country's GDP growth rate materially lifted. The 2019 Budget document projected that debt-to-GDP would peak at 60.2% of GDP in 2023/24 compared with an estimated 56.2% at the end of the current fiscal year, but it is not clear what deficit and growth assumptions underpin this beyond the three years of the MTEF. We find it curious that the 2019 debt trajectory would only be lifted very slightly from the MTBPS, even though the fiscal deficit targets have been widened and the real GDP growth forecasts cut. Given the underlying debt dynamics, we think the risk of another upward iteration of the debt profile at some point is material

Figure 37: Primary deficits no longer projected to close over MTEF



Source: National Treasury, Absa Research

Figure 38: Debt trajectories continue to be revised upwards



Source: National Treasury, Absa Research

Eskom will continue to weigh on the fiscus for many years

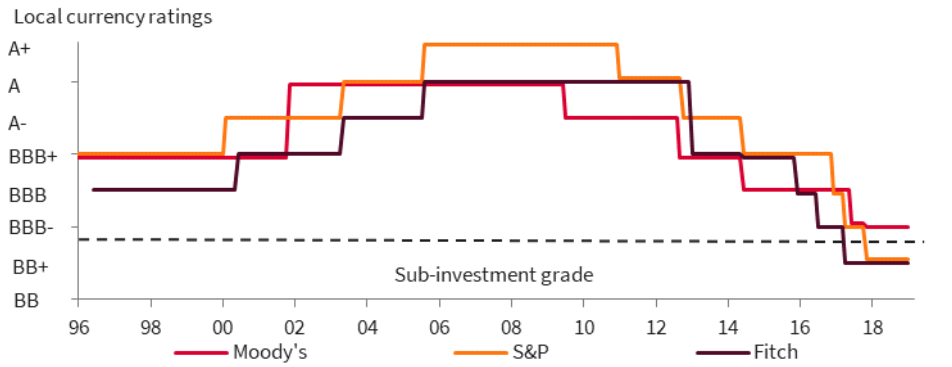
The 2018/19 Budget was in some ways born of desperation in the face of Eskom's staggering problems, which will likely continue to weigh heavily on the fiscus for many years. The National Treasury said that it was pencilling in allocations of ZAR23bn per year, contingent on Eskom implementing necessary structural reforms. However, it also disclosed subsequently that it envisaged having to provide these amounts annually for the next 10 years. We fully expect these amounts to be revised, not only because the tariff award was not known at the time the 2019 Budget was formulated, but also because estimates of Eskom's financial need will evolve as its restructuring and rehabilitation efforts progress. The National Treasury appears intent on ensuring that Eskom does not receive an upfront lump sum bailout, but instead aims to assist Eskom as needed with disbursements contingent on reforms. Discussions between Eskom and the National Treasury on the timing of disbursements and associated conditionality are still ongoing.

Credit ratings: Still on tenterhooks with Moody's

Moody's left South Africa's FX and local currency credit rating unchanged at a Baa3 Stable Outlook

On 2 April, Moody's issued a Credit Opinion, which left South Africa's local and foreign currency credit ratings unchanged at a Baa3 Stable Outlook. This is a better outcome than what we and a number of other market participants had been expecting. A Bloomberg poll of 16 economists published in late March found them evenly divided on what Moody's would do, with half (including ourselves) expecting Moody's to assign a Negative Outlook. Moody's has now left the credit rating at Baa3 (the lowest investment grade rating) since June 2017, though the other two rating agencies, Fitch and S&P, pushed their local currency ratings below investment grade in April 2017 and October 2017, respectively (Figure 39). (Although the market tends to focus on the hard currency credit rating, we focus on the local currency rating here because Moody's has typically been less generous on the local currency rating than the other two agencies, and it is the local currency rating that matters for foreigners' substantial holdings of rand-denominated government bonds, especially passive index matching.)

Figure 39: Moody's local currency ratings have not always been more generous than other agencies'



Source: Moody's, S&P, Fitch, Absa Research

Moody's has taken a dim view of fiscal developments in South Africa

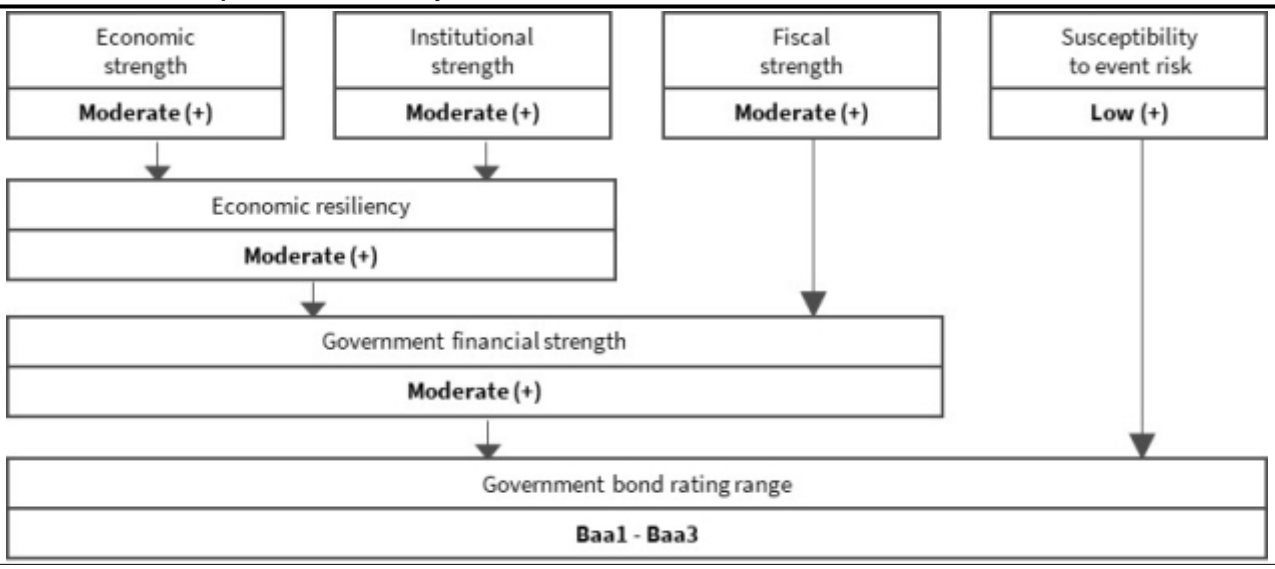
South Africa thus now looks set to retain its investment grade status with Moody's, probably at least until the next review date on 1 November (Figure 40). However, we do not think South Africa is out of downgrade danger over the longer term. Before issuing its latest Credit Opinion, Moody's published some fairly negative comments about South Africa's fiscal deterioration, although it has seemingly been more relaxed about the impact of the Eskom bailout on the rating, saying it would only be credit negative if the fiscal transfers to Eskom preceded the suite of necessary structural reforms at the utility. Overall, however, in its latest Credit Opinion, Moody's continued to assess its Fiscal Strength (one of the four key planks in its creditworthiness model) as Moderate +, unchanged from October (Figure 41).

Figure 40: Fitch and S&P opine in a couple of months, but we do not expect any change

	S&P	Moody's	Fitch
Foreign currency	BB	Baa3	BB+
Local currency	BB+	Baa3	BB+
Outlook	Stable	Stable	Stable
Date assigned	November 2017	June 2017	April 2017
2019 scheduled review dates	24 May 2019 and 22 November 2019	1 November 2019	Flexible, but probably last week of May/first week of June and last week of Nov/first week Dec.
Absa forecast	On hold for now	Could change outlook to Negative in November	On hold for now.

Source: S&P, Moody's, Fitch, Absa Research

Figure 41: South Africa's credit profile is determined by four



Source: Moody's Investor Services, Absa Research.

Some things have improved since the last Credit Opinion, while other things have deteriorated; assessing the balance is a fine judgment call

Of course, the fiscus and Eskom are only two drivers (albeit to our minds the important ones) of the South African credit picture, but they are clearly in a much more fragile state than previously understood. Growth is also under pressure from load shedding and persistently weak business confidence. However, some aspects of South Africa's macroeconomic and political story relevant to Moody's rating have improved recently. For example, there is new leadership at key institutions such as South Africa Revenue Service and the National Prosecuting Authority. Inflation has fallen dramatically. Risks from global monetary tightening have abated.

Failure to consolidate the fiscal deficit or stabilise Eskom could lead to a downgrade

We think it is worth paying close attention to Moody's' exact words in the April 2019 Credit Opinion when it discussed the factors that could lead to a downgrade:

"South Africa's ratings would likely be downgraded if we expect that government debt and contingent liabilities risk from SOEs will continue rising to levels no longer consistent with a Baa3, or that medium-term growth will persist at very low levels as recorded in 2018."

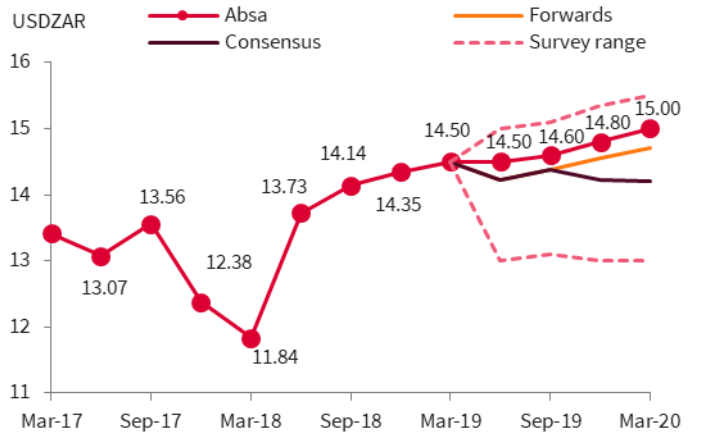
We think the jury is still out on these two important questions. Given this, Moody's likely wants to wait a little and see how the government progresses with its Eskom restructuring efforts, fiscal consolidation, and how the 8 May elections pan out and affect policy settings, before coming up with any firm views on South Africa's credit rating. That said, we are worried that it will possibly prove difficult to lift South Africa's GDP growth, and we believe it is difficult to tackle South Africa's fiscal and social challenges in the absence of growth, with adverse implications over the long run for South Africa's creditworthiness. Thus, we are inclined to think that South Africa's creditworthiness is currently on a slowly deteriorating trend and that Moody's could therefore assign a Negative Outlook at the next scheduled review date of 1 November.

Rand likely to weaken anew

Sticking with our existing ZAR projections

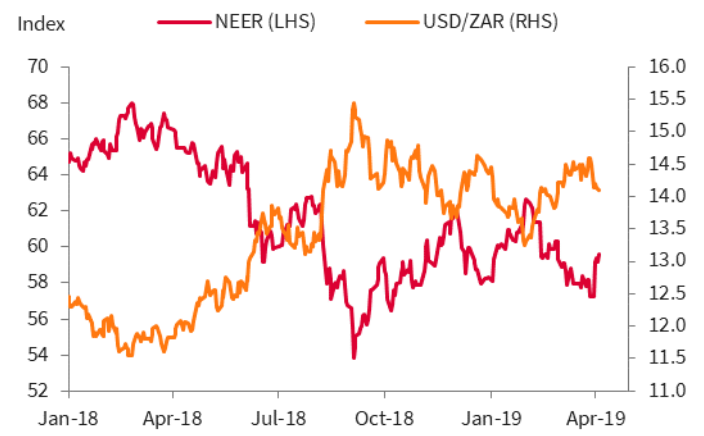
Recently, Moody's' somewhat unexpected stay of execution caused the ZAR to recover back to levels that are now consistent with its FX peers (current peer fair value: 14.12/USD). Although the more dovish message from both the Fed and the ECB has rekindled foreign demand for high-yielding SAGBs, we believe these bond inflows will be largely offset over the coming months by further equity outflows stemming from the reduced weighting of JSE shares in the MSCI between May and November, as well as South Africa's persistently weak GDP backdrop. Net trade inflows are also unlikely to be supportive, given higher oil prices and weakening global demand. The ZAR typically strengthens prior to a general election, but such bouts of appreciation are seldom sustained once the election outcome is actually decided. Consequently, we have opted to stick with our existing ZAR projections, with an expectation that the ZAR will weaken back up to 14.50/USD by mid-year and 14.80/USD by year-end.

Figure 42: Comparative FX projections



Source: Bloomberg, Absa Research

Figure 43: Rand weakened in Q1 19, but bounced a bit post Moody's



Source: Thomson Reuters, Absa Research

Figure 44: Assumptions are key to the macroeconomic forecast

Variable	Absa assumptions (April)	SARB assumptions (March MPC meeting)	General comments and risks to our assumptions
Key Global Economic Assumptions			
Global growth	G7 GDP growth of 1.9% and 1.7% for 2019 and 2020, respectively. China GDP growth of 6.2% and 6.0% for 2019 and 2020, respectively.	Growth of SA's major trading partners is projected to be at 2.9% in 2019 and 3.1% in 2020.	Absa's and SARB's global assumptions for model inputs are not strictly comparable. Nonetheless, while the risk of escalation in protectionist trade policies to global growth appears to have diminished somewhat, there are growing signs of a slowdown in economic activity among SA's major trading partners.
Brent crude	Using Bloomberg consensus forecasts as a base, we assume Brent to average USD66/bbl in 2019 and USD69/bbl in 2020.	Brent averages USD64/bbl in 2019 and USD65/bbl in 2020.	The Brent crude oil price has risen sharply in Q1 19 on supply concerns. However, consensus estimates suggest prices are likely to settle around USD70/bbl for some time.
Non-oil commodity prices	We use Bloomberg consensus forecasts for 2019-20 as a base: Gold in USD/oz at 1281 and 1349; Platinum in USD/oz at 879 and 1104; Coal USD/mt at 81 and 84; Iron ore in USD/mt at 78 and 70.	The SARB does not reveal any specific commodity price assumptions. Instead, it assumes international commodity prices to fall by 0.5% in 2019 and rise by 1.0% in 2020.	Absa's and SARB's commodity price assumptions are not strictly comparable. The Bloomberg consensus, which guides our baseline, is for moderately higher gold and platinum prices. Iron ore prices, which have shot up in early 2019 due to Brazil supply concerns, are expected to ease slightly as supply pressures reduce.
Key Domestic Economy assumptions			
Food prices	We forecast food price inflation to average 4.2% in 2019 and 5.5% in 2020 with a peak of 5.6% in Q2 2020.	The SARB typically does not reveal its forecast profile for food price inflation, but noted that it projects a peak of 5.9% y/y in Q2 20.	Higher crop prices are already exerting upward pressure in crop-related parts of the CPI basket but these have been offset by falling meat prices. However, meat prices could stabilise due to improving grazing conditions and resumption of meat exports to some markets after foot-and-mouth disease concerns.
Fuel taxes and levies	We assume a 10c/l rise in distribution margins each December and a 30c/l increase fuel levies each April.	Taxes and levies on fuel are expected to rise by 5.5% and 6.2% in 2019 and 2020, respectively.	The carbon tax on fuel prices of 9cents/litre (10c/l for diesel) is due to kick in from June. The recent political backlash against fuel prices likely means that depending on the path of Brent crude prices and exchange rates, the government could be reluctant to push aggressive fuel levy hikes.
Electricity prices	We have assumed average electricity tariff increases of 10.2% for 2019 and 10.7% for 2020.	The SARB expects average electricity increases of 10.2% in 2019 and 10.9% in 2020.	The NERSA announcement on Eskom's MYPD4 application has removed some uncertainty about electricity tariffs, of course keeping in mind that RCA applications in future are always possible. The small difference in our 2020 assumption to the SARB's is likely due to differences in municipal margins factored.
Growth in government consumption	We forecast real government consumption (G) growth of 0.7% in 2019 and 0.5% 2020.	The SARB no longer published its assumption for G.	The need to stabilise the growth of government indebtedness and the slow pace of economic growth will limit the growth of government consumption.
Potential growth	1.5% in 2019 and 1.7% in 2020.	1.3% in 2019 and 1.3% in 2020.	Assumptions about potential GDP growth are tricky as they cannot be directly observed, but instead estimated by using statistical techniques on recent GDP trends. Both the SARB and we expect the negative output gap to persist over the forecast horizon.
Neutral real interest rate	Absa's model makes no explicit assumption about the neutral real interest rate but we estimate it to be around 1.5%.	The neutral real interest rate is estimated to be 2.2% in 2019 and 2.3% in 2020.	Globally, there is much debate about what the neutral level of real rates is because it cannot be directly observed. However, structural economic shifts in the wake of the global financial crisis have probably lowered the neutral real rates everywhere.
Exchange rate	In Absa's macro model, our exchange rate serves as an exogenous input. Our baseline forecast assumes a NEER depreciation of 7.7% and 7.3% in 2019 and 2020. This equates to a REER depreciation of 3.8% in 2019 and 3.8% 2020.	The SARB's QPM model endogenously determines the exchange rate path, forecasting a NEER depreciation of 4.3% in 2019 and 2.2% in 2020. For 2019, the REER is expected to depreciate by 1.5%. However, it is forecast to appreciate by 1.0% in 2020.	The exchange rate assumption is one of the most important variables in any forecast, regardless of whether it is set as an exogenous assumption or endogenously determined, as with the SARB's new QPM. Exchange rate outcomes that are materially different from the path embedded into the forecast will have a range of knock-on effects on nearly all the other macroeconomic variables. The volatility of the rand and the uncertainty about its path over the forecast horizon generate uncertainty around the model's output.
FX pass-through to CPI	Our current long-term coefficient is between 10% and 20%, and the short-term pass-through is very small at about 5%.	20% - SARB also notes that the short-term pass-through coefficient is closer to 10%.	The size of FX pass-through to inflation is hard to pin down since it is likely to change over time and be both asymmetric and not linear. It can only be teased out of the data with extremely sophisticated econometric techniques.
Interest rates	We expect the SARB to hike the repo rate by 25bp in Q1 2020.	As with the exchange rate, the SARB's QPM endogenously determines an interest rate path, which implies one 25bp hike by the end of 2019.	The FRA market is pricing in a 69% chance of a 25bp rate cut by year-end at the time of writing. However, we think the bar for interest rate cuts is higher than the market seems to believe.

Source: SARB, Absa Research

Figure 45: Growth forecasts have been trimmed since the last forecast round

	2018		2019				2020								
	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2018	2019F	2020F	2021F	2022F
Output (% q/q saar)															
Real GDP	2.6	1.4	0.5	1.6	1.6	1.9	1.4	1.6	1.8	2.2	0.8	1.3	1.7	1.8	1.8
Real GDP (%y/y)	0.7	0.2	1.0	1.5	1.3	1.4	1.6	1.6	1.7	1.8	0.8	1.3	1.7	1.8	1.8
Private consumption	0.5	3.2	0.0	1.3	1.6	2.0	1.6	1.7	1.8	1.9	1.8	1.3	1.7	1.6	1.6
Public consumption	0.4	0.6	0.7	0.9	0.5	0.5	0.5	0.5	0.5	0.5	1.9	0.7	0.5	0.5	0.5
Investment	-0.7	-2.5	-0.9	0.6	1.4	1.5	1.6	1.7	1.8	2.0	-1.4	-0.6	1.6	1.9	1.9
Exports	26.0	11.1	-9.9	-6.1	0.2	1.5	1.6	2.0	2.0	2.2	2.6	1.4	1.0	2.2	2.2
Imports	22.3	-16.0	5.0	2.8	2.8	2.7	2.2	2.5	2.5	2.5	3.3	1.6	2.5	2.4	2.5
Prices (% y/y)															
CPI inflation	5.0	4.9	4.3	4.6	4.7	4.6	5.6	5.3	5.1	5.2	4.6	4.5	5.3	5.1	5.1
Core CPI inflation	4.2	4.4	4.4	4.4	4.5	4.6	4.7	4.8	4.8	4.9	4.3	4.5	4.8	4.9	5.0
PPI inflation	6.2	6.3	4.8	5.1	4.1	3.6	6.1	5.6	5.6	5.6	5.5	4.4	5.7	5.6	5.6
External and government accounts (% of GDP)															
Current account	-3.6	-2.2	-2.7	-2.9	-3.5	-3.6	-3.6	-3.6	-3.7	-3.7	-3.6	-3.2	-3.7	-3.7	-3.8
Main budget fiscal balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-4.4	-4.7	-4.7	-4.5	-4.1
Main primary balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-0.8	-1.0	-0.8	-0.4	0.0
Government debt*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	55.6	56.2	57.9	59.1	59.7
Interest rates and exchange rate (eop)															
Repurchase rate, %	6.50	6.75	6.75	6.75	6.75	6.75	7.00	7.00	7.00	7.00	6.75	6.75	7.00	7.00	7.00
Prime rate, %	10.00	10.25	10.25	10.25	10.25	10.25	10.50	10.50	10.50	10.50	10.25	10.50	10.50	10.50	10.50
ZAR per USD	14.14	14.30	14.30	14.50	14.60	14.80	15.00	15.20	15.45	15.60	14.35	14.80	15.60	16.40	17.30

**Note: Fiscal year starting 1 April, Source: StatsSA, SARB, National Treasury, Thomson Reuters, Absa Research*

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