South Africa 2019 Budget

Deficits wider but broadly convincing

The 2019 Budget is founded on a marginally weaker economic outlook. Real GDP is now projected at 1.5% in 2019/20, as opposed to the 1.9% forecast in the Medium Term Budget Policy Statement (MTBPS). The National Treasury's inflation projection for 2019/20 is too low, in our view.

As we expected, the government limited the overall tax grab to a modest ZAR15bn, but contrary to our expectations again aimed to collect most of this through stealth personal income taxes, in other words by not adjusting tax brackets to offset the effects of inflation.

The 2019 Budget projects a ZAR15.4bn revenue underperformance in 2018/19 in part because of an even larger VAT refund book. Thus, tax buoyancy is now projected at 0.98 for this fiscal year versus 1.21 in the MTBPS, but rising to 1.31 next year, in part due to tax policy changes.

The commitment to the previously announced expenditure ceilings has been relaxed due to provisional allocations for Eskom of ZAR69.0bn over the next three years, with ZAR23bn in 2019/20 versus our forecast of ZAR15.0bn. With baseline expenditure cuts of only ZAR9.0bn in 2019/20, the expenditure ceiling for 2019/20 is lifted by ZAR14.0bn.

The 2019 Budget contained a welcome progress on containment of the public sector wage bill. The government will introduce penalty-free early retirement, which could trim the wage bill (relative to the baseline) by ZAR20.3bn over the MTEF period. High attrition is also delivering a headcount reduction.

Budget deficits are now projected wider. The main budget balance is broadly unchanged for the current fiscal year from the MTBPS at 4.4% of GDP (previously 4.3%). However, for 2019/20, it is now projected at 4.7% of GDP, 30bp worse than previously projected in the MTBPS. For 2020/21 it is projected at 4.5% versus 4.3% in the MTBPS.

The Budget adopted a credible approach on Eskom, in our view. The decision to stagger the financial support rather than accede to Eskom's request for a ZAR100bn debt transfer should incentivise a reform at Eskom. However, Moody's has issued some negative commentary on the Budget, suggesting a materially greater than even chance they assign a Negative Outlook to the rating or worse, on 29 March.

Despite a wider budget deficit, projected SAGB issuance targets have been increased only slightly from ZAR200.5bn in the 2018 Budget last year to ZAR212.5bn in the MTBPS, and up only very marginally further to ZAR216.0bn in the latest 2019 Budget documentation. National Treasury is finally utilising some of its substantial cash balances, ZAR65bn in the upcoming fiscal year for example.

We believe today's budget remains supportive of our R2035 (16y)/R186(7y) curve flattener trade recommendation because the Treasury has decided to fund its larger borrowing requirement by making more use of its cash reserves and by increasing the pace of T-bill and foreign bond issuance. Further switch auctions activity and the Treasury's updated portfolio risk benchmarks are also conducive to a flatter nominal yield curve.

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PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE **12**

Treasury's inflation projections are likely too high for 2019/20

Today, Finance Minister Mboweni unveiled the 2019 Budget, surely the most challenging in South Africa's democratic history. Broadly, the 2019 Budget sets out a programme of modest tax increases and large baseline expenditure cuts, with some public sector compensation containment measures. However, the baseline expenditure cuts are more than fully offset by higher provisional allocations for Eskom. Consequently, budget deficit targets have widened. The Budget's approach to Eskom is to stagger the financial support to gain some conditionality and control over Eskom's hitherto sluggish efforts to reform itself. Overall, despite the wider deficits, we find the 2019 Budget to be reasonably convincing on measures to support Eskom and contain public sector compensation costs.

Treasury has revised down its growth projections

In the 2019 Budget, the National Treasury (NT) revised down its real GDP growth forecasts. Like us, the NT believes that real GDP will likely grow 0.7% y/y in 2018/19, but for 2019/20 and 2020/21, it now forecasts 1.5% and 1.9%, respectively, down from 1.9% and 2.1% forecast in the MTBPS. We are somewhat more optimistic than the NT, with standing forecasts of 1.9% and 2.2% in our Quarterly Perspectives published on 11 January. The NT's downward revisions to its growth expectations compared with October are guided by the view that a recovery in household income will likely be more fragile and that exports will likely moderate given the slowing global economy. Our forecast argued that real GDP would be bolstered by improved business confidence, which ought translate to higher investment spending, should the African National Congress (ANC) win a sizeable enough majority of votes in the general elections on 8 May to bolster President Ramaphosa's political capital. We thus forecast a gradual improvement in fixed investment spending growth from a 0.9% increase in 2019 to 2.8% in 2020 and 3.3% in 2021. The NT's forecast is more bullish than ours in 2019 at 1.5% but a little less optimistic than ours at 2.1% in 2020 and 3% in 2021. We acknowledge a fair degree of downside risk to our GDP growth projections given the recent strike action and load shedding. In particular, unstable electricity supply is a serious deterrent to new business investment. We will look to update our GDP growth forecasts once the SARB publishes the Quarterly Bulletin data set on 20 March.

Figure 1: Treasury's inflation forecasts seem too high in 2019/20

	2019/20		2020/21		2021/22	
	NT	Absa	NT	Absa	NT	Absa
Real GDP, %y/y	1.5	1.9	1.9	2.2	2.1	2.1
Nominal GDP, % y/y	7.0	5.7	7.4	6.4	7.5	7.4
GDP inflation, % y/y	5.5	3.7	5.5	4.2	5.5	5.2
CPI inflation, % y/y	5.2	4.8	5.5	5.2	5.4	5.2

Source: National Treasury, Absa Research

Treasury's inflation projections for FY 2019/20 could be too high

We also differ with the NT on our inflation forecasts and think the NT's inflation forecasts are too high in the early years of the planning horizon. The NT now forecasts nominal GDP growth to print at 7.0% y/y in 2019/20, 7.4% in 2020/21 and 7.5% in 2021/22, which implies GDP inflation of 5.5% in each year of the planning horizon. Correspondingly, we also think that the CPI inflation forecast provided by the NT is too high. The reason is that, despite food and electricity prices posing an upside risk to our headline CPI forecast, we believe that core inflation will remain contained around the mid-point of the 3%-6% target band, as demand remains weak, limiting pricing power, and as wage settlements slow. With lower inflation, the NT's tax projections could come under pressure.

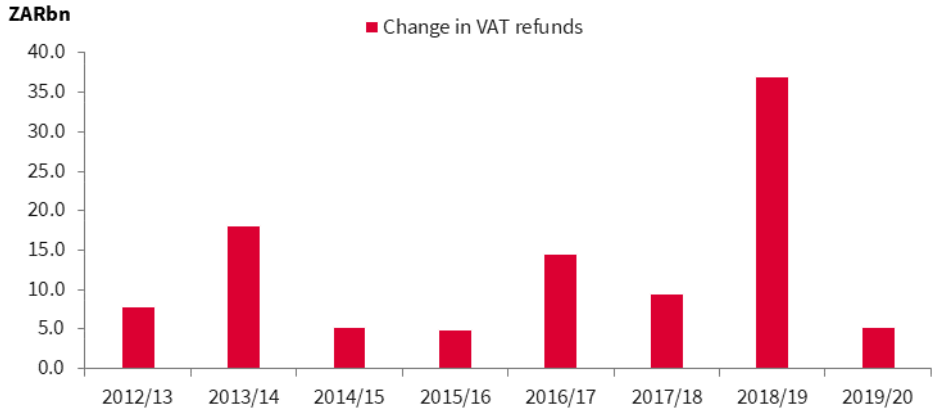
Revenue side of fiscus remains challenged

Ongoing revenue underperformance, partly due to higher VAT refunds

Following the last update on expected tax revenue collections in the 2018 MTBPS, revenue growth has continued to underperform. In the 2018 MTBPS, the NT announced that it expected tax revenues to come in ZAR27.4bn lower than it projected at the time of the 2018 Budget. However, a combination of subdued economic activity, administrative inefficiency and higher-than-expected VAT refunds have weighed on collections further. The NT now projects that gross tax revenue for 2018/19 to be ZAR1302bn – which is nearly ZAR43bn lower than its initial estimate in the 2018 Budget and about ZAR15bn lower than the revised estimate in the 2018 MTBPS. This is a lot weaker than we had expected. However, a little more than half of the additional slippage relative to MTBPS targets was due to a faster-than-expected acceleration in VAT refunds, which are now expected to

be ZAR8bn higher than in October (Figure 2). This is expected to offset slightly better-than-expected domestic VAT and import VAT, resulting in overall VAT under-collection of ZAR2.2bn.

Figure 2: VAT refunds have spiked in the current fiscal year



Source: National Treasury, Absa Research

Tax collections have really disappointed in personal and corporate income taxes

However, personal income tax collections are also underperforming due to job losses and slowing nominal wage growth. The NT now sees PIT coming in ZAR6.7bn lower than its MTBPS forecast. Falling profitability, particularly in the mining and financial services sectors, is also weighing on corporate income tax receipts, which are now expected to be ZAR6.9bn lower than the MTBPS projection. Another notable miss was on the general fuel levy, which is now expected to generate ZAR2.1bn less than envisaged in October. The NT attributed this to higher diesel refunds to electricity generation plants, farmers and mining companies. The overall underperformance in gross tax revenue collections leaves the tax buoyancy rate for 2018/19 at just 0.98. This is the second consecutive year that tax buoyancy has come in below 1 and the latest figure comes despite the additional revenues worth ZAR36bn introduced in last year's Budget. Moreover, the figure is substantially lower than the NT's initial estimate of 1.51 in the 2018 Budget, which it subsequently lowered to 1.21 in the 2018 MTBPS.

Tax elasticity could bounce once a new SARS head is appointed and the government implements the recommendations of the Nugent Inquiry

The NT noted that tax administration weakness was a contributing factor to continued weakness in revenue collections and indicated that it would prioritise measures identified in the Nugent Commission of Inquiry to improve efficiency at the South African Revenue Service (SARS). These measures include appointing a new Commissioner, re-establishing the large business centre by April 2019, an Illicit Economy Unit launched last August, and strengthening the management of its information technology infrastructure. It remains to be seen how quickly these measures will pay off but the NT has stuck to relatively conservative estimates for tax buoyancy, expecting the ratio to lift to just 1.31 in 2019/20 (largely due to tax measures tabled for this year) before easing to 1.17 and 1.08 in 2020/21 and 2021/22, respectively. Improved tax elasticity could be higher than the Treasury has penciled in once the new head of SARS is appointed 'within weeks', according to Minister Mboweni in his budget speech.

Figure 3: Big projected shortfalls of tax revenues even relative to MTBPS targets

				FY 2018/19		
ZARbn	FY 2017/18	Budget '18	MTBPS' 18	Current estimate	Shortfall vs Budget	Shortfall vs MTBPS
Gross tax revenue*	1216.5	1345.0	1317.6	1302.2	-42.8	-15.4
Personal income tax	460.8	505.8	504.2	497.5	-8.3	-6.7
Corporate income tax	217.5	231.2	225.3	218.4	-12.8	-6.9
Dividend withholding tax	27.7	30.8	29.3	30.3	-0.5	1.0
Value-added tax	298.0	348.1	328.1	325.9	-22.2	-2.2
Domestic VAT	336.2	378.6	377.4	379.8	1.2	2.4
Import VAT	152.8	169.5	170.7	174.0	4.5	3.3
VAT refunds	-191.1	-200.0	-220.0	-228.0	-28.0	-8.0
General fuel levy	70.9	77.5	77.4	75.3	-2.2	-2.1
Customs duties	49.2	52.6	54.0	55.6	3.0	1.6

**includes other taxes not included in this table; Source: National Treasury, Absa Research*

Treasury aims to raise an extra ZAR15bn in FY2019/20, mostly from freezing PIT brackets

For the 2019/20 fiscal year, the NT has proposed measures to raise an additional ZAR15bn in tax revenues, with strong reliance on personal income taxes, contrary to our expectations. The NT did not make any changes to personal income tax rates for the second year in a row. However, the NT has announced that personal income tax brackets will be left completely unadjusted for inflation in 2019/20. There will only be a marginal increase in personal income tax rebates, providing almost negligible relief for inflation. Meanwhile, medical tax credits will not be adjusted this fiscal year. The combination of these measures is expected to bring in an additional ZAR13.8bn from personal income tax in fiscal year 2019/20.

Figure 4: Tax take focuses again on stealth personal income taxes

Tax measures	ZARbn	
Direct taxes		13.8
Personal income tax	13.8	
Revenue from not fully adjusting for inflation	12.8	
Revenue if no adjustment is made	14.0	
Partial bracket creep for personal income tax	-1.2	
No adjustment to medical tax credit	1.0	
Indirect taxes		1.2
General fuel levy adjustment	-0.5	
Introduction of carbon tax on fuel	1.8	
Additional VAT zero-rated items	-1.1	
Increase in excise duty on tobacco	0.4	
Increase in excise duty on alcohol	0.6	
Total additional tax to be raised in 2019/20		15.0

Source: National Treasury, Absa Research

Carbon tax to raise ZAR1.8bn, but otherwise indirect tax increases are small, and the government expanded the list of goods that are zero-rated or VAT at a cost of ZAR1.1bn

The NT also introduced some adjustments to indirect taxes, which are expected to raise an additional ZAR1.2bn in fiscal year 2019/20. The major single change here is the introduction of a carbon tax on fuel due to be effective from 5 June 2019. The fuel carbon tax is to be introduced at 9cents/litre for petrol and 10cents/litre for diesel, with expected revenues of ZAR1.8bn. However, the increase in the general fuel levy is only 15cents/litre, a bit less than inflation (yielding a negative revenue effect of ZAR0.5bn), while the Road Accident Fund will only rise by 5cents/litre. In net terms, total fuel levies will rise by just 29cents/litre (in the case of petrol), a lot lower than the size of the increase last year, likely in part due to the sharp fuel price hikes last year as well as the subsequent social backlash. Meanwhile, 'sin taxes' will again be hiked at rates higher than inflation. The additional changes on tobacco and alcohol duties will result in an additional ZAR1bn in 2019/20. But, despite these new measures and further measures to raise ZAR10bn in 2020/21, the weak performance in 2018/19 has set a lower base for future years, and thus overall tax revenue projections are weaker than in the MTBPS.

Eskom bailout needs causes breach of expenditure ceiling commitment

Expenditure ceiling lifted by ZAR14bn in FY2019/20

While the revenue side of the Budget reflects continued underperformance in collections, the expenditure side was substantially weakened by rising demand for SOC funding support. In the 2018 MTBPS, the NT announced a reallocation of ZAR33.4bn over the medium-term expenditure framework period to support President Ramaphosa's 'stimulus plan' and provide liquidity support for the South African Post Office and South Africa Airways. However, this was well contained within the existing expenditure ceilings. In fact, the NT announced a downward adjustment of the 2018/19 ceiling by ZAR4.8bn. However, despite some strong downward adjustments to the previous spending baseline for the next three fiscal years, additional support for Eskom has resulted in upward adjustments to the previously announced expenditure ceilings. The expenditure ceiling is now expected to be ZAR14bn higher in fiscal year 2019/20 relative to the 2018 Budget target. The ceiling has been lifted by ZAR1.3bn for 2020/21 relative to the 2018 Budget estimate, while the 2021/22 ceiling is now ZAR0.7bn higher than the MTBPS target.

Figure 5: Expenditure ceilings are set to be breached because of financial support to Eskom

ZARbn	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
2017 Budget Review	1075.0	1144.2	1229.8	1323.6	1435.4		
2017 MTBPS		1142.0	1233.7	1316.6	1420.4	1524.2	
2018 Budget Review			1232.7	1315.0	1416.6	1523.8	1630.0
2018 MTBPS			1225.5	1314.9	1416.6	1523.8	1630.0
2019 Budget Review				1310.2	1430.6	1525.1	1630.8
Changes since 2018 Budget	-	-	-	-4.8	14.0	1.3	0.7

Source: National Treasury, Absa Research

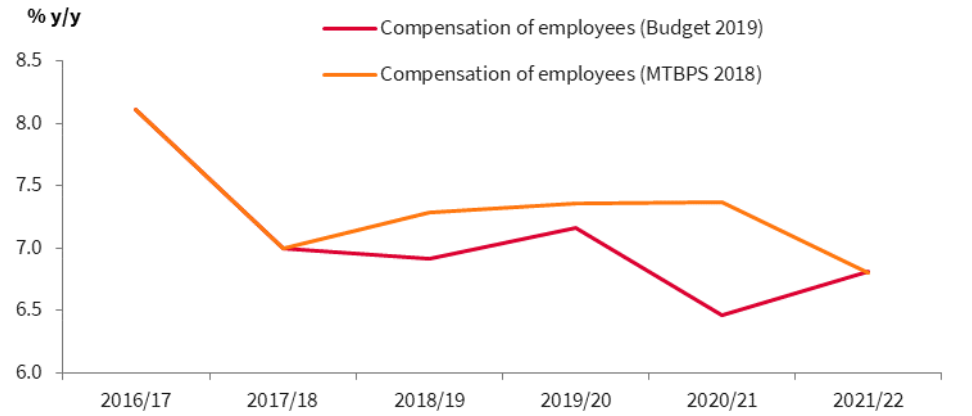
National Treasury to allocate ZAR23bn per annum to Eskom

The biggest adjustment to spending projections by far is the financial support to the finally and operationally ailing Eskom. The government has penciled in ZAR23bn per annum for each of the next three years in liquidity support to Eskom in order to help with the reconfiguration of the entity. The Minister of Finance stated that the ZAR69bn worth of support to Eskom over the MTEF was not automatic and would be conditional but details of the conditions were sketchy. The government also announced that it would allocate ZAR5bn over the MTEF period to capitalise its proposed infrastructure fund, while an extra ZAR1.3bn extra would be allocated for the 2021 Census. As a result, the 2019 Budget contains ZAR75.3bn worth of new spending priorities over the MTEF period.

Major cuts to baseline expenditure, with half due to lower compensation budgets

However, these were offset by some sizeable downward adjustments to the previous expenditure baseline, totaling ZAR50.3bn over the next three years. More than half of this is expected to come from lower-than-expected spending on compensation budgets. In the Budget tabled last year, the NT reported that the public sector wage deal would result is about ZAR30bn more spending on the public sector than it previously anticipated. The 2019 Budget makes the encouraging claim that 'recent data show that employee numbers are declining at a rate sufficient to absorb wage agreement pressures', with monthly payrolls in 2018 about 16,000 lower than their levels in the corresponding month of 2017. This headcount reduction is sufficient, apparently, to accommodate the pressure from the public sector wage deal, such that overall estimated expenditure on compensation in 2018/19 is ZAR585.2bn, ZAR1.9bn lower than what was originally budgeted.

Figure 6: Growth of compensation bill now projected to be lower



Source: National Treasury, Absa Research

Government to introduce early retirement

To facilitate cost containment efforts, the Budget states that the government will introduce early retirement, with departments required to realise 50% permanent savings on the costs of early retirement. The Budget notes that in December 2018, there were nearly 127k employees between the age of 55 and 59, and if 30k opted for early retirement packages, this would save ZAR20.3bn (relative to baseline projections) in compensation costs over the three-year planning horizon. Thus, the public sector wage bill is now expected to be lower by ZAR5.3bn in 2019/20, with further reductions of ZAR11.0bn and ZAR10.7bn in 2020/21 and 2021/22, respectively. Upfront costs of ZAR16bn are to be met by the contingency reserve and the Government Employees Pension Fund, with contributions from the latter to be repaid by the state. Additionally, it notes that the government will phase out over four years the annual performance bonuses, which have become

pretty much automatic, amounting to ZAR2.0bn per year. Other cuts were made in specific programmes that have accumulated surpluses or are assessed to be underperforming. However, these cuts were not sufficient to fully offset the quantum of the proposed bailout to Eskom over the next three years, resulting in the relaxation of previously announced expenditure ceilings.

Figure 7: Financial support for Eskom has offset all other spending cuts

ZARbn	2019/20	2020/21	2021/22	MTEF
2018 non-interest expenditure ceiling	1434.9	1543.6	1651.6	4630.1
Skills development levy adjustment in MTBPS	0.5	0.6	0.7	1.8
2018 non-interest expenditure ceiling in the 2018 MTBPS	1435.4	1544.2	1652.3	4631.9
New spending allocations in 2019 Budget	24.0	23.0	28.3	75.3
of which				
Allocations to Eskom	23.0	23.0	23.0	69.0
Infrastructure fund capitalisation	1.0	-	4.0	5.0
Census (2021) allocations	-	-	1.3	1.3
Baseline adjustments	-9.0	-19.7	-21.6	-50.3
Changes to contingency reserve	6.0	-2.0	-6.0	-2.0
NRF payments adjustment	0.1	0.0	0.0	0.1
2019 Budget non-interest expenditure	1456.5	1545.5	1653.1	4655.1
less				
skills development levy	-18.8	-20.4	-22.3	-61.5
other adjustments	-7.1	-	-	-7.2
2019 Budget expenditure ceilings	1430.6	1525.1	1630.8	4586.4
Change from 2018 Budget	14.0	1.3	0.7	16.0

Source: National Treasury, Absa Research

Room made for further bailouts for other SOCs, but no lasting clarity on the plan for SAA

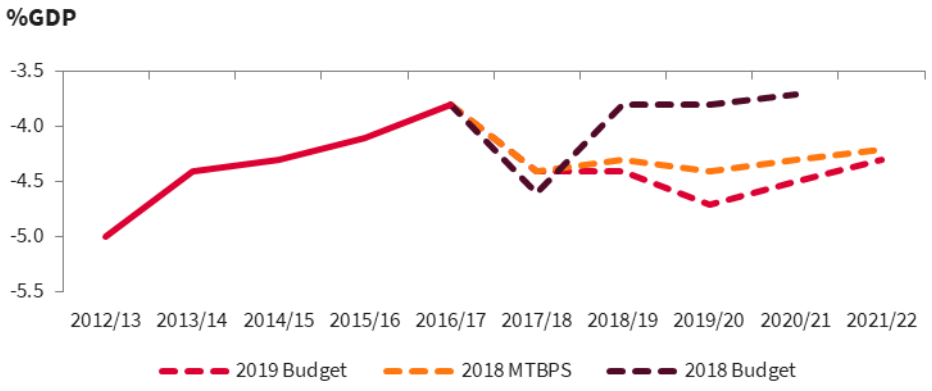
Interestingly, while there were no other major bailouts announced in the 2019 Budget, it is clear that the NT sees the risk of further requests for SOC financial support as very high, given ongoing challenges at the South African Airways, the South African Broadcast Corporate and Denel. Against this, the NT raised the contingency reserve by ZAR6bn to allow the government to accommodate such possible requests for support. However, the NT added that any further support would have to be raised from the sale of non-core assets and would not be met by raising expenditure ceilings further. Regrettably, the Treasury was not specific about what non-core assets might be sold to fund what could be ongoing clamours for bailout funding. In particular, some more clarity on South African Airways (SAA) would have been desirable, given its parlous financial state. The 2019 Budget document states that SAA is working to renegotiate some ZAR12.7bn guaranteed debt that falls due on 31 March. To us, this seems a large amount due very imminently that the Treasury may have to step up to the plate on.

Main and consolidated budgets wider deficit targets

Main budget deficit now projected 0.3% of GDP wider for FY 2019/20

The main budget balance is broadly unchanged for the current fiscal year from the MTBPS at 4.4% of GDP (previously 4.3%), but for 2019/20 it is now projected at 4.7% of GDP, 30bps worse than previously projected in the MTBPS, and equivalent to a primary deficit of 1.0% of GDP (and only projected to narrow to 0.3% of GDP by 2021/22). The parts of the government that lie outside the main budget (social security funds and the like) generate a surplus of 0.2% of GDP. So the consolidated deficits are a little narrower than the main budget. Importantly, the deficits are still too wide to stabilise debt-to-GDP over the long run. However, interestingly, the debt trajectory is revised only slightly higher, it is now projected to peak at 60.2% in 2023/24 as opposed to 59.6% in the same year. This is because the government has accessed a non-debt source of budget financing, specifically its decision to run down its sizeable cash balances.

Figure 8: Main budget deficits have been widened out



Source: National Treasury, Absa Research

Eskom dominated the 2019 Budget

The 2019 Budget provides key details on the Eskom issue

Eskom was clearly the main focus of investors and credit rating agencies ahead of the 2019 Budget, given its large intertwined structural, operational and financial challenges. The State of the National Address on 7 February and President Ramaphosa's subsequent speech in the parliament after the worrying outbreak of load shedding did not provide a great deal of detail on the way forward for Eskom, save to confirm that the utility would be unbundled into three separate (but state-owned) entities. The 2019 Budget provided more detail, especially as regards the quantum and modality of the financial support for Eskom. On Eskom's turnaround plan and the conditionality links to the financial support, the Budget perhaps provided less detail than investors and credit rating agencies would ideally desire, but we judge it nonetheless to have been a fairly convincing attempt to plot the next step forward on a long and complex process. On balance, we think markets should be happy with what the Treasury has set out for Eskom in the 2019 Budget.

The 2019 Budget promises big reforms for Eskom, soon

In particular, the Budget reiterates the commitment to splitting utility into three operating entities, with the government to consider Eskom board proposals 'within the next three months'. The first step is a transmission entity, with an independent board to be appointed by mid-2019, which will invite the participation of strategic equity partners. The Budget sets out a compelling case for the unbundling, which will 'reduce information asymmetries, mitigate and distribute risks accordingly, and strengthen incentives for efficiency'.

ZAR23bn per annum allocated to Eskom over the three-year planning framework

As regards the quantum and modality of the Treasury's financial support for Eskom, the Budget lays out provisional allocations of ZAR23bn per year over the MTEF starting in 2019/20. This is somewhat higher than the ZAR15bn in 2019/20 we had expected. The amount, however, reflects the Treasury's total expected support to Eskom of ZAR150bn over 10 years, amortised (with interest costs) over 10 years. This should be enough to allay fears about Eskom's cash flows and liquidity position in 2019/20, provided Eskom's coal-fueled power plants do not experience further, leading to deterioration in generating capacity, therefore leading to more frequent and intense bouts of load shedding, with adverse consequences for Eskom's maintenance expenditure, recourse to expensive open cycle gas turbine generation and foregone electricity sales.

Financial support is structured not to impact balance sheets

In the SONA and afterwards, President Ramaphosa promised 'balance sheet support', which might have encouraged some to believe that Eskom's suggestion that the government transferred ZAR100bn of its ZAR419bn debt to its own balance sheet would feature in the 2019 Budget. It is therefore possible that some stakeholders might be disappointed by the approach taken by the government to stagger the assistance. Additionally, the Minister of Finance said emphatically in his speech that the support did not represent the state taking on Eskom's debt but instead was simply 'financial support' for Eskom during its reconfiguration. While in some sense this is simply a matter of accounting and semantics, it may nonetheless be important. The current approach would leave Eskom's (guaranteed) debt unchanged, therefore delivering no reduction in the government's contingent liabilities. But, all other things being equal, the government's ZAR23bn annual payments to Eskom will clearly raise the government's borrowing requirement and debt. Of course,

all other things are not equal, in that the government is imposing swinging expenditure cuts elsewhere.

Details of the conditionality accompanying the financial support to chivvy Eskom to reform and cut costs in particular remain murky

As regards the conditionality underpinning the Treasury's financial support for Eskom, the 2019 Budget does not really set out the key performance indicators. Instead, it simply indicates that they will be detailed in a shareholder compact to be agreed between the Minister of Public Enterprises and the Eskom Board. Additionally, in his speech, Minister Mboweni also said that the support was 'conditional' on the appointment of a Chief Reorganisation Officer, with the explicit mandate on delivering on the recommendations of the Eskom Sustainability Task Team with announcements on this front due 'in the coming weeks'. Nonetheless, the budget claims Eskom is committed to cost compression amounting to ZAR20bn annually by 2022, excluding savings from reducing Eskom's ZAR33bn salary bill. The details of the government and Eskom's approach on Eskom's bloated salary bill are still unclear, pending 'consultations with labour', but the 2019 Budget document makes reference to 'rationalising mid-level management' and elsewhere speaks of the desirability of pay freezes.

We think it is now materially more likely than not that Moody's implements some kind of adverse rating decision, such as a Negative Outlook, on 29 March

Overall, we view the 2019 Budget to be a broadly creditable fiscal effort to deal with the imperative of rescuing Eskom against the backdrop of difficult economic circumstances. We are particularly heartened by the willingness to substantially cut spending, especially on compensation budgets, and applaud the introduction of the early retirement tool. Markets initially reacted negatively, however, to the wide deficits, and Moody's has also issued a rather gloomy assessment, saying it represents a 'further erosion of fiscal strength'. It also argues that the bailout modality generates an upward revision in fiscal deficits and debt levels, whilst leaving contingent liabilities unchanged. Previously, after the SONA, Moody's said that any sequencing of bailout funds before accompanying reform measures would be viewed as negative for the sovereign credit. Given Moody's comments, we think the likelihood of some negative decision on 29 March is now materially greater than even. Thus Moody's is likely to assign a Negative Outlook to the Baa3 rating, or worse, such as putting the rating under review for a downgrade.

Fixed Income Strategy

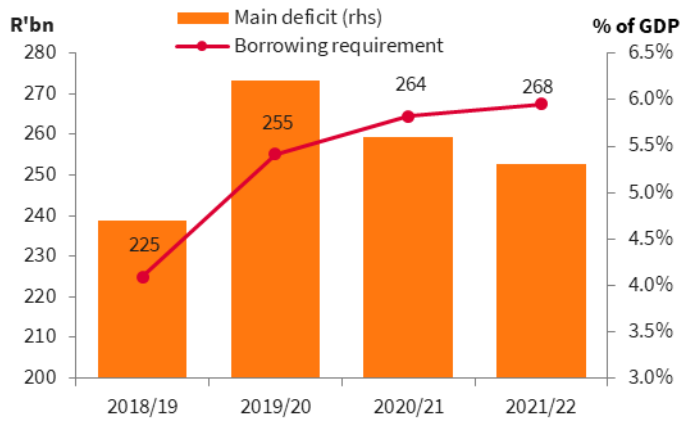
Treasury's issuance projections support our curve flattener

We believe February's budget remains supportive of our R2035 (16y)/R186(7y) curve flattener trade recommendation because the Treasury has decided to fund its larger borrowing requirement by making use of its cash reserves and by increasing the pace of T-bill and foreign bond issuance instead of upping the pace of domestic bond issuance. The prospect of further switch auctions activity and the Treasury's updated portfolio risk benchmarks are also conducive to a flatter nominal yield curve. That said, our view could be hindered if Moody's ultimately decides to downgrade SA's Baa3 credit outlook/rating over the coming months.

Treasury has not felt the need to increase the pace of domestic bond issuance.

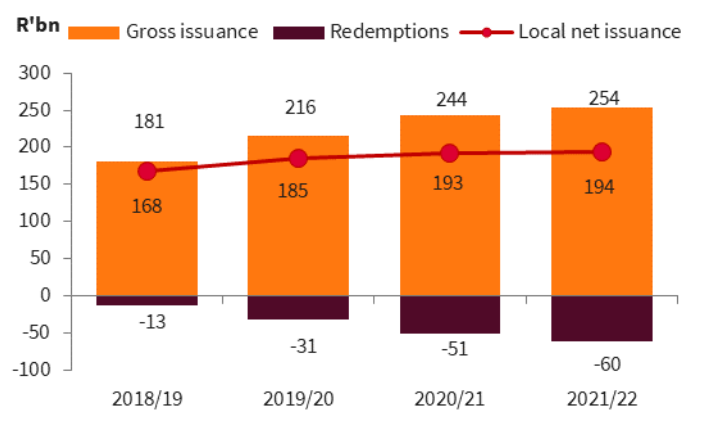
Although the government upwardly revised its borrowing requirement estimates (Figure 1) for the current and the next three fiscal years, there was no mention of the need for the Treasury to further increase the current pace of domestic bond issuance (Figure 2), which helps explain why the SA yield curve has actually bull flattened in the wake of the February Budget speech. As we have previously suggested, because the Treasury already increased the pace of domestic bond issuance back in November 2017 by ZAR500mn/week and given that there has been a welcomed improvement in non-competitive auction allocations in more recent months (Figure 4), there seems no urgent need for the Treasury to issue more than ZAR2850mn worth of nominal bonds or R650mn worth of linkers per week (see *Insight: Favouring Flatteners, 28 January*).

Figure 1: Treasury's borrowing requirement projections



Source: National Treasury, Absa Research

Figure 2: Breakdown of domestic bond issuance



Source: National Treasury, Absa Research

Treasury is looking to diversify its funding mix.

The fact that the Treasury is looking for alternative sources of funding will also help to allay supply fears in the domestic bond market. More specifically, the Treasury indicated that it will look to issue a maiden Sukuk bond during 2019/20. That said, the magnitude of these rand-denominated domestic bonds is likely to be small initially, when compared to regular size of local bond issuance.

Figure 3: Breakdown of borrowing requirement

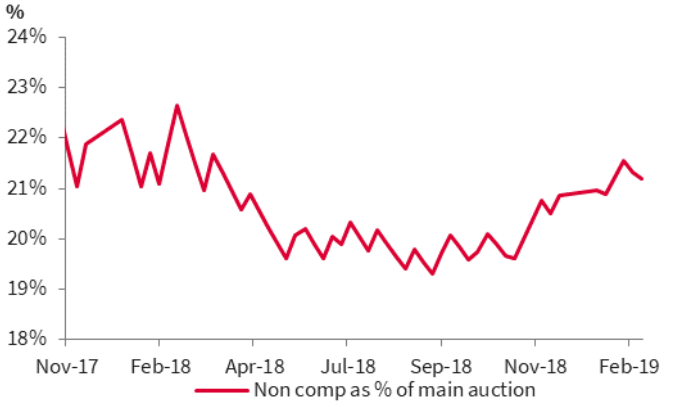
	2018/19			2019/20			2020/21				2021/22
R'bn	**Feb-18 Budget**	**Oct-18 MTBPS**	**Feb-19 Budget**	**Feb-19 Budget**	**Oct-18 MTBPS**	**Feb-19 Budget**	**Feb-18 Budget**	**Oct-18 MTBPS**	**Feb-19 Budget**	**Oct-18 MTBPS**	**Feb-19 Budget**
Borrowing requirement	**191.1**	**215.2**	**225.0**	**204.8**	**237.6**	**255.2**	**214.8**	**253.7**	**264.4**	**262.7**	**267.6**
deficit % of GDP	4.5%	4.3%	4.7%	5.6%	4.4%	6.2%	4.9%	4.3%	5.6%	4.2%	5.3%
Short term net issuance	**14.2**	**24.0**	**14.0**	**22.7**	**23.0**	**25.0**	**30.0**	**34.0**	**35.0**	**36.0**	**36.0**
Treasury bills	4.2	14.0	14.0	22.7	23.0	15.0	30.0	34.0	35.0	36.0	36.0
CPD	10.0	10.0	-	–		10.0	–		-	–	–
Long-term net issuance	**159.9**	**162.5**	**168.0**	**149.2**	**181.9**	**185.4**	**152.7**	**185.9**	**192.9**	**192.0**	**194.0**
Gross issuance	191.0	175.5	181.0	200.5	212.5	216.0	208.9	237.0	244.0	252.0	254.0
Redemptions	-31.1	-13.0	-13.0	-51.3	-30.6	-30.6	-56.2	-51.1	-51.1	-60.0	-60.0
Foreign net issuance	**35.9**	**51.7**	**52.2**	**-6.2**	**-20.2**	**-21.0**	**29.4**	**30.1**	**30.9**	**39.1**	**39.3**
Gross issuance	38.0	53.8	54.2	39.2	27.5	28.5	40.7	41.9	43.1	43.3	43.6
Redemptions	-2.1	-2.1	-2,.1	-45.4	-47.7	-49.5	-11.3	-11.8	-12.1	-4.2	-4.3
Change in cash balances	**-19.0**	**-23.0**	**-9.2**	**39.1**	**52.9**	**65.8**	**2.7**	**3.7**	**5.6**	**-4.4**	**-1.7**

Source: National Treasury, Absa Research

Ongoing switch auctions and will also help contain issuance.

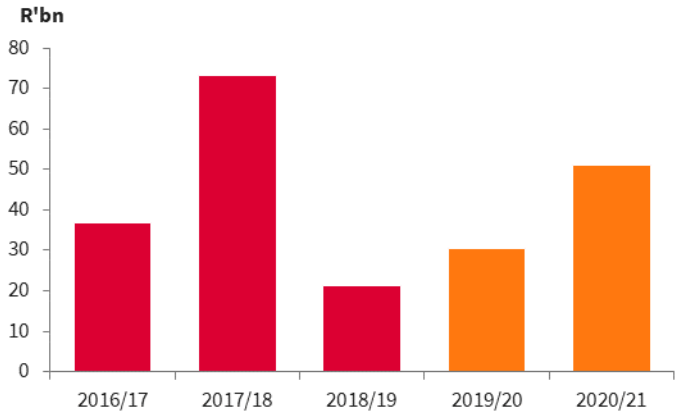
Even though gross SAGB issuance is expected to increase by ZAR35bn to ZAR216bn during 2019/20, we still do not expect the pace of issuance to increase next year, partly because the Treasury confirmed in the budget that it will conduct further switches to help reduce the roll-over risk associated with the sizeable redemptions that fall due in 2020/21 (ZAR51bn) and 2021/22 (ZAR60bn). We continue to estimate that the Treasury will conduct ZAR20-35bn worth of switches during 2019/20, which would be slightly higher than this year's ZAR21bn switch auction activity (Figure 5). The risk to our view, as outlined by the Treasury, would include further substantial fiscal slippage, significant ZAR depreciation, spiraling inflationary pressures and/or considerable disinvestment by foreign SAGB holders, which could come on the back of any heightened fears of a sub-investment ratings downgrade by Moody's, which in turn would eject SAGBs out of the WGBI.

Figure 4: Non-competitive weekly bond allocations



Source: National Treasury, Absa Research

Figure 5: Previous switches actions and future redemptions

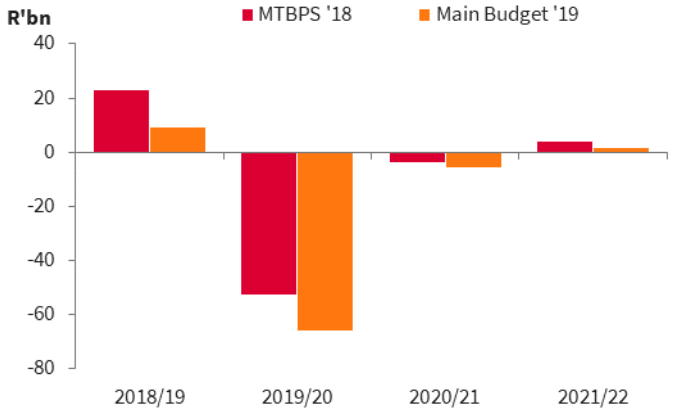


Note: Red (yellow) bars represent previous switch auctions (future redemptions)
Source: National Treasury, Absa Research

Greater cash drawdowns and foreign issuance is now expected.

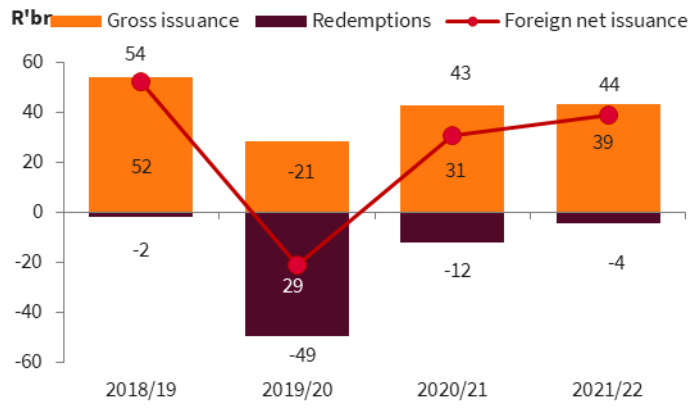
The fact that the Treasury has shown an uncharacteristic willingness to tap into its substantial cash balances over the coming years also helps explain why the pace of SAGB issuance need not rise despite a burgeoning borrowing requirement. During the 2019/20 fiscal year in particular, the Treasury intends reducing its cash holdings by a considerable ZAR65bn (Figure 6). The pace of foreign bond issuance has been upwardly revised across the forecast horizon and the Treasury has also signaled that it intends issuing a second USD2bn bond during the current fiscal year - which ends in March (Figure 7). This implies the authorities are eager to place this USD-denominated paper prior to the Moody's rating review (29 March). The proceeds of this bond issue, together with other pre-funded foreign currency cash balances, will help meet the sizeable foreign currency redemptions of ZAR49bn that fall due during 2019/20.

Figure 6: Change in cash balances



Source: National Treasury, Absa Research

Figure 7: Breakdown of foreign bond issuance



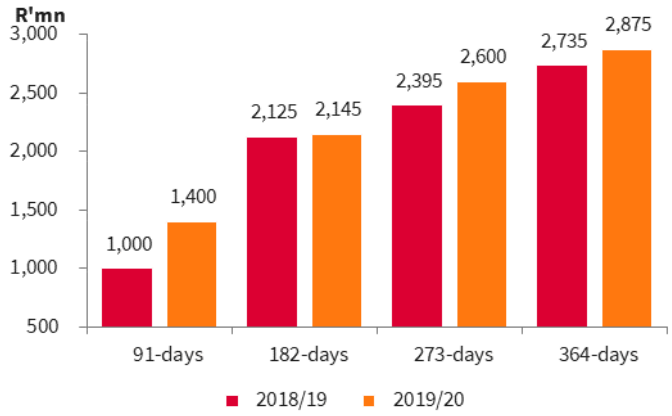
Source: National Treasury, Absa Research

T-bill issuance will continue to mount.

The fact that the Treasury intends increasing the pace of weekly T-bill issuance by ZAR0.7bn/week during the next fiscal year should also help anchor SAGB yields from an issuance perspective. The greatest pick-up in weekly T-bill issuance will take place at the front end of the curve (Figure 8), which could once again cause the T-bill curve to bear flatten and possibly push up interbank

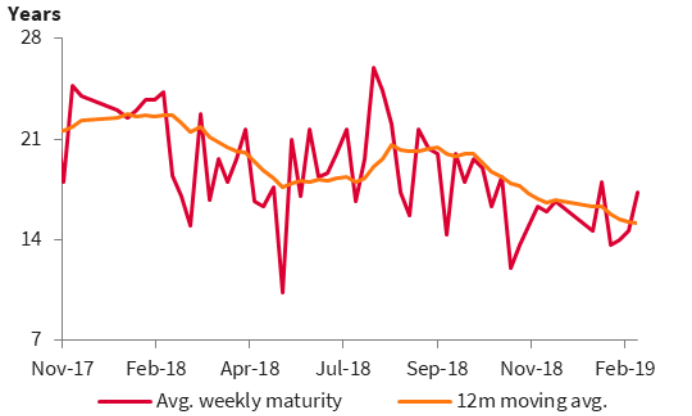
funding rates even if the SARB refrains from actually hiking policy rates. That said, given the unwinding of the SARB Committed Liquidity Facility over the next three calendar years and banks' ongoing HQLA and LCR requirements, there should be some structural demand for T-bill scrip (*see Roadmap Local may need to step up to the plate, 10 September). This* should help restrict the extent to which T-bill clearing yields will rise in response to greater issuance in our view.

Figure 8: Expected change in weekly T-bill issuance



Source: National Treasury, Absa Research

Figure 9: Maturity of weekly issuance



Source: National Treasury, Absa Research

Treasury continues to effectively manage the sustainability of its debt structure, as per the government's updated strategic portfolio risk benchmarks.

It seems as if the Treasury's first two benchmarks are likely to remain well below the prescribed ceiling during the current and forthcoming fiscal years, which implies that the Treasury has scope to issue even more T-bills and or shorter-dated bonds. Meanwhile, when one includes all fixed rate bonds (Benchmark 5), the Treasury is expected to get very close to the upper ceiling of the target during 2019/20, which suggests that the average maturity of weekly issuance could continue to trend lower (Figure 9) and by implication be proportionately more supportive of back-end bonds (Figure 10). Meanwhile, the Treasury also has limited scope to up the pace of linker issuance over the coming years (Benchmark 3), which is supportive of our view that real yields will compress over the coming month. Moreover, any ILB issuance that does take place is likely to be concentrated at the back end of the curve, given that the maturity of the Treasury's ILB portfolio is close to the lower end of the prescribed range (Benchmark 6). Hence, based on these benchmark considerations, the ILB curve could bull steepen, which could somewhat hinder our prevailing I2029/R212 curve flattener trade recommendation.

Figure 10: Strategic portfolio risk benchmarks

Benchmark	Target	2016/17	2017/18	2018/19	2019/20
1) Share of short-term debt maturing in 12 months (Treasury bills)	15%	13.1%	12.7%	12.5%	11.7%
2) Share of long-term debt maturing in 5 years	25%	15.0%	14.5%	12.5%	11.2%
3) Inflation-linked bonds as a percentage of total domestic debt	20-25%	22.3%	23.4%	24.0%	24.2%
4) Foreign debt as a percentage of total government debt	15%	11.3%	11.1%	10.1%	9.3%
5) Weighted term-to-maturity of fixed-rate bonds + T-bills	10-14 years	12.7	13.2	13.4	13.7
6) Weighted term-to-maturity of inflation-linked bonds	14-17 years	15.5	14.7	14.3	14.5
7) Term-to-maturity of total government debt in years	n/a	14.7	14.8	13.2	13.5
8) Term to maturity of foreign debt in years	n/a	10.1	9.2	9.9	10

Source: National Treasury, Absa Research

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