ABSA

Economic Research
20 June 2018

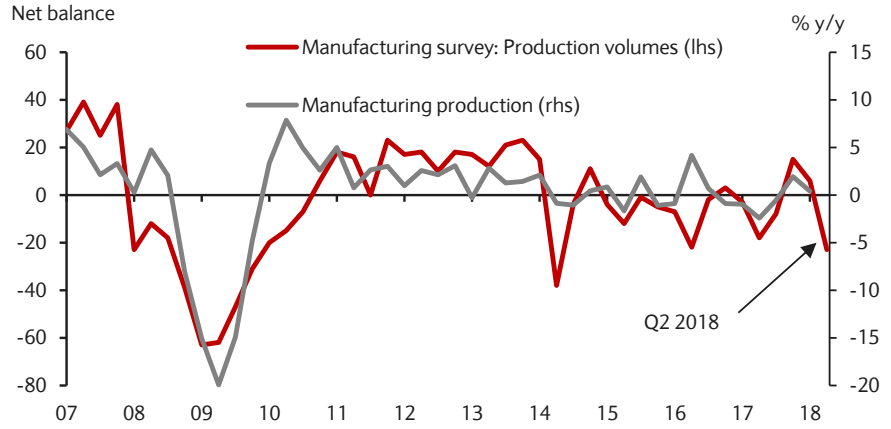
South Africa manufacturing sector survey

Sentiment falls as demand slumps

- **The weakness of the hard manufacturing data in Q1 18 owed much to a decline in output of the petrochemical sector, due to a refinery shutdown. However, the April manufacturing output print was also weak, and PMI data for Q2 18 have been mixed to weak so far.**
- **After a Ramaphoria surge in Q1 18, confidence levels among South Africa's manufacturers slumped Q2 18, from 37 to 27 in Q2 18, showing that 73% of survey respondents view business conditions as "unsatisfactory". Over the long run confidence levels roughly correlate with actual production levels (Figure 1).**
- **The survey reveals a sharp slump in domestic demand as the main reason for the decline in confidence levels, with 12 of the 16 manufacturing subsectors reporting declining sales volumes. Export demand held up a little better. The survey also revealed stronger price pressures with both input costs and selling prices increasing.**
- **Survey respondents remain more optimistic about business conditions in 12 months' time, albeit less so than in Q1 18. Interestingly, manufacturers still report a net improvement in their fixed investment spending in Q2 18, despite their generally pessimistic sentiment, but their expectations regarding capex spend in 12 months' time have deteriorated sharply.**

FIGURE 1

In the long run manufacturing production volumes correlate with confidence levels



Source: Statistics South Africa, Bureau for Economic Research, Absa Research

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Manufacturing output contracted sharply *in Q1 18, and recorded another weak print in April*

After a very weak Q1, manufacturing production remained subdued in the first month of Q2, with a seasonally adjusted 0.6% m/m drop in April. This delivered a 1.1% y/y increase, better than our forecast of 0.9% but worse than consensus expectations of 1.7%. This subdued print follows a weak start to the year, with positive m/m sa growth recorded only in March. For Q1 18 as a whole, manufacturing production fell 6.4% q/q saar (Figure 2). This subtracted 0.8 percentage points from overall GDP growth of -2.2% q/q saar. We note, however, that much of the manufacturing sector's weakness in Q1 18 came from large contractions of output by the petrochemical sector, due to a shutdown in a major refinery in February (Figure 3). Output in the petroleum, chemicals and rubber sector fell by 29.6% q/q saar in Q1 but increased 4.0% m/m sa in April.

The latest survey of the manufacturing sector shows a big slump in confidence levels in Q2 18, with 73% of respondents expressing dissatisfaction with current operating conditions

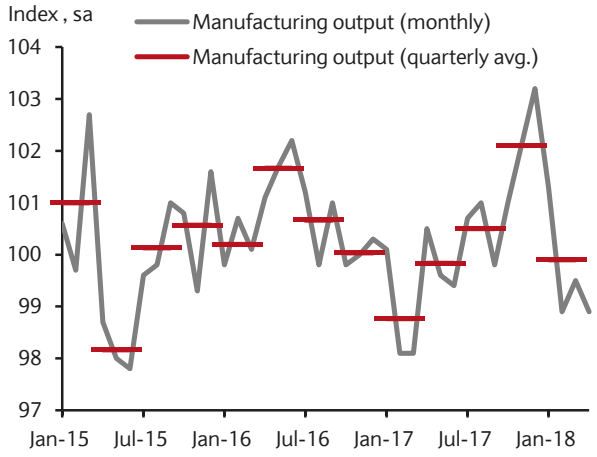
After recording a "Ramaphoria-induced" surge in Q1 18 from 24 to 37, manufacturing confidence dipped anew in Q2 18, by 10 index points to 27 (Figure 4). This indicates that more than 7 out of 10 respondents deemed current business conditions unsatisfactory. The main driver seems to be a notable slump in domestic demand. Domestic sales volumes came in a lot weaker than expected in Q2 18, with significant deterioration from -4 to -32, even though in the Q1 18 survey manufacturers had expected improvement in Q2, with a forecast of +3 (Figure 5). Of the 16 subsectors covered by the Bureau for Economic Research in its survey, 12 reported declining domestic sales volumes. The picture for export sales volumes was also weak, printing at -13 compared with 10 in Q1 18. Consequently, production volumes declined quite sharply, from a net balance of 6 in Q1 18 to -23 in Q2 18 (Figure 1). Production declines were most notable in the paper, printing and machinery sectors. Notably, while manufacturers remain optimistic about the future, with a net balance (expressed as a diffusion index) of 14 expecting business operating conditions to be better in 12 months' time, this is a marked deterioration from the Q1 print of 39 (Figure 6).

Input and output price pressures both appear to have risen in Q2 18

We also note that price pressures went up significantly in Q2 18. The survey metric for input costs went from 47 to 70 (Figure 8). However, encouragingly, the diffusion index of those manufacturers reporting increased average domestic selling prices per unit rose from 34 to a net balance of 42, while the export sale price metric soared to 32 from -14, probably reflecting the weaker rand in Q2 18. Interestingly, while most of the indices in the manufacturing survey deteriorated in Q2, fixed investment proved to be something of an outlier, with a sharp improvement from 10 in Q1 18 to a net balance of 26. And surprisingly, despite overall subdued confidence in the sector, manufacturers still expect investment to remain at elevated levels in Q3.

FIGURE 2

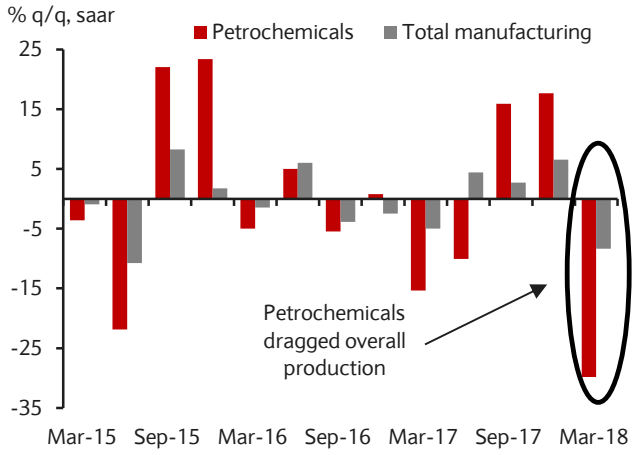
Manufacturing production declined sharply in Q1…



Source: Statistics South Africa, Absa Research

FIGURE 3

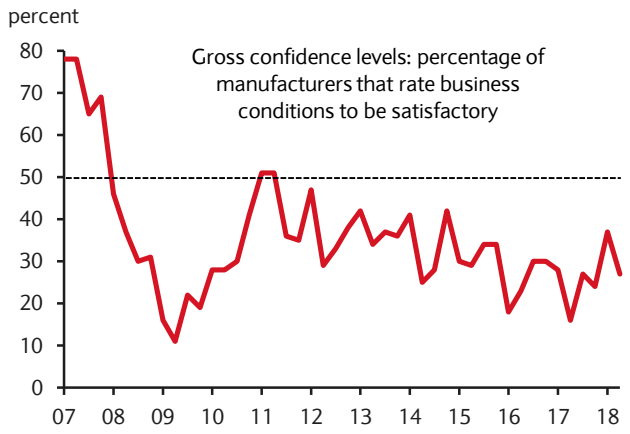
…due in large measure to a petroleum refinery shutdown



Source: Statistics South Africa, Absa Research

FIGURE 4

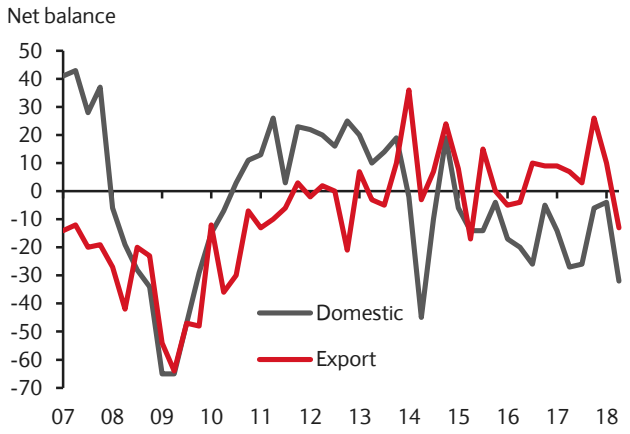
Confidence remains weak, reversing most of the Q1 gain



Source: Bureau for Economic Research, Absa Research

FIGURE 5

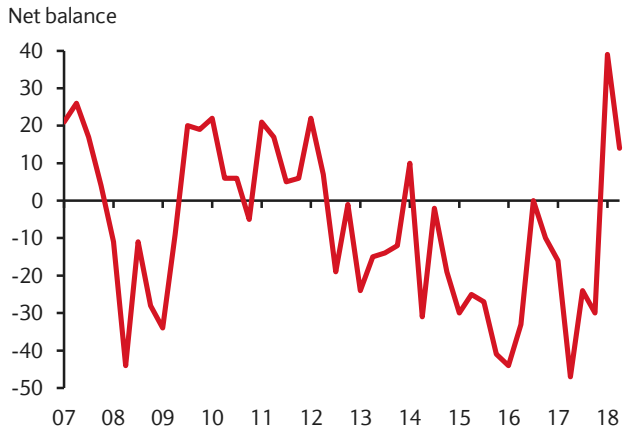
Diffusion indices for sales volumes have dropped sharply



Source: Bureau for Economic Research, Absa Research

FIGURE 6

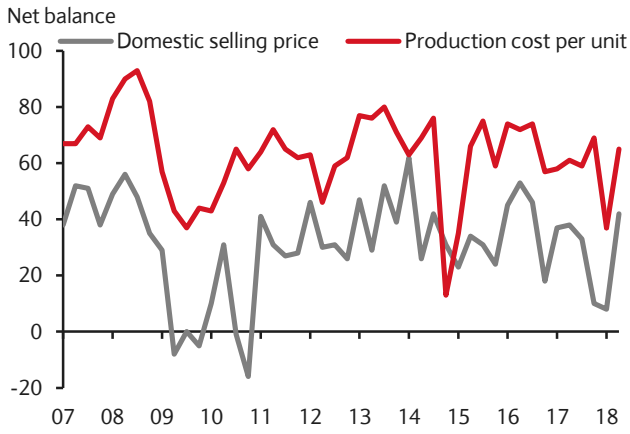
Manufacturers remain confident about the future



Source: Bureau for Economic Research, Absa Research

FIGURE 7

Price pressures look to be on the increase



Source: Bureau for Economic Research, Absa Research

A deficiency of demand now tops the list of manufacturers' cited constraints

Looking at the sector's ranking of constraints, insufficient demand remains a key risk in the sector, cited by 75% of survey respondents, compared with 68% in Q1 18 (Figure 9). This is above both the averages that prevailed in the previous cycle and over the long term. While the rating for general political climate improved slightly from 72% to 70%, it remains elevated. Encouragingly, manufacturers reported the shortage of skilled labour and raw materials as having improved in Q2.

FIGURE 8

Insufficient demand now looks to be the strongest constraint

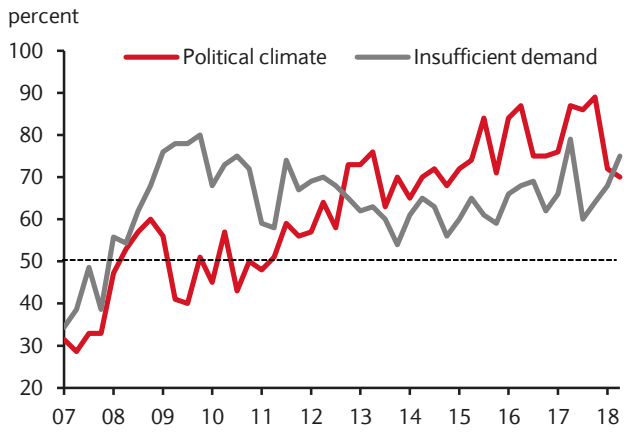


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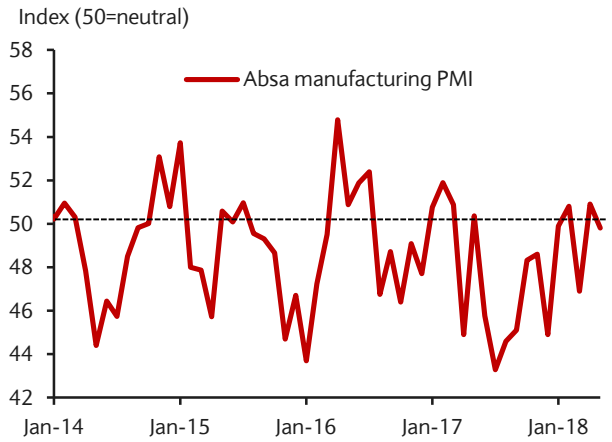
FIGURE 9

PMI also paints a muted picture



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PMI suggests continuing lacklustre outlook for the sector

Overall, the outlook for the manufacturing sector looks rather bleak, with the ebbing of Ramaphoria undermining business confidence, even though over the longer term the weaker rand should prove good for South Africa's manufacturers, as it boosts both exports and import substitution. The weak Absa PMI in May does not paint a positive picture for the sector, either. The Absa PMI fell back to below 50, registering 49.8 index points, down from 50.9 in April, although the average PMI of the first two months of Q2 is still just above 50 and thus higher than Q1's average of 49 (Figure 9). However, we note that the PMI print for June might be negatively affected by recent load-shedding. We have argued that most of the weakness of manufacturing output in Q1 is likely to have been transitory, as it was caused by the refinery shutdown. While this is likely to deliver favourable base effects, we do not think a strong Q2 recovery is likely given the PMI and confidence survey data.

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