ABSA

Economic Research
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South Africa Quarterly Perspectives: Q3 17

Recession hits as confidence slumps

Peter Worthington
+27 21 927 6525
peter.worthington@absacapital.com
Absa, South Africa

Miyelani Maluleke
+27 11 895 5655
miyelani.maluleke@absacapital.com
Absa, South Africa

www.absa.co.za

- A shock negative GDP print for Q1 has delivered recession. Record harvests for summer crops will only partially offset widespread weakness elsewhere in the economy. Without a positive resolution to current political tensions and policy uncertainty, a lack of confidence will limit the likely recovery. The consumer is particularly weak. The ANC's bitterly contested electoral conference at end-year is key to South Africa's prospects.
- CPI inflation is falling due to helpful food price trends and a slowing momentum behind core CPI inflation. Electricity and petrol price assumptions are key to our inflation forecast. We think CPI inflation will hit a low in Q1 next year, before rising to the upper half of the target range in H2 18. Despite rising expectations of a rate cut, we think that the SARB will probably prefer to stay on hold until the ANC's electoral conference but the risks of a cut are certainly rising.
- A large part of the recent narrowing in the current account deficit was supported by the bounce in export commodity prices. However, commodity support for the trade balance is likely to weaken amid some recent softening in prices. Agriculture will provide only a limited offset as South Africa regains its net exporter position for maize this year. At the same time, weak domestic demand will keep the lid on import growth. We expect the current account deficit to average 2.7% of GDP this year before widening to about 3.4% of GDP in 2018.
- Fiscal stabilisation will be even more challenging, as disappointing growth is likely to weigh on tax revenue collections. While we think Treasury will stick to its expenditure ceilings, outright cuts in non-interest spending may be difficult. We expect a consolidated budget deficit of 3.5% of GDP for FY17/18 compared with the Treasury's target of 3.1% and we think the October MTBPS will hint at further tax hikes.
- We have been surprised by the rand's stability in Q2 17, but we still expect the ZAR to weaken in the second half of the year due to weak growth, a wider current account deficit, and depressed domestic sentiment. Buoyant global risk appetite and rising real policy rates pose the biggest risks to our persistently bearish view. Our updated forecasts are above the forward curve, but we are now only slightly more bearish than consensus.
- Following the recent credit rating downgrades, we believe that South Africa could secure ratings at current levels, but this will depend critically on political outcomes and their effect on policy and private sector confidence. On this front, the country faces a rather binary future, in our opinion.

PLEASE SEE ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES STARTING AFTER PAGE 7

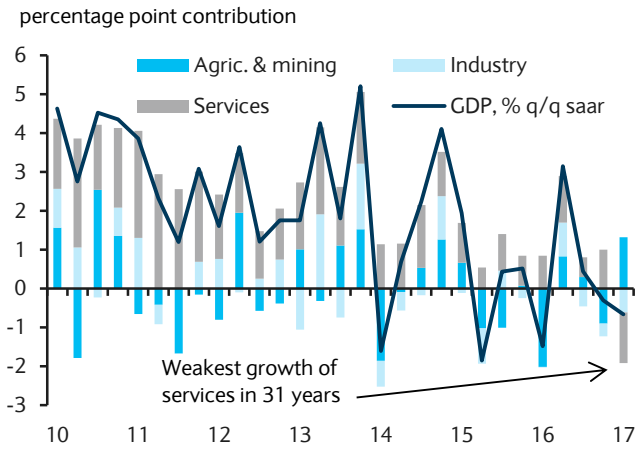
Growth prospects are dim

Unexpectedly, South African GDP contracted in Q1, thus pulling the economy into recession, with only the two primary sectors – agriculture and mining – registering any growth

Growth has faltered materially as political tensions have ratcheted up. Widespread weakness in the normally solid services sectors of the economy (down 2.0% q/q saar, the weakest print for this sector since 1986) and the ongoing slump in manufacturing sector (which helped to push overall industrial output 3.4% q/q saar lower) outweighed the robust rises in agricultural and mining activity (up 14.9% q/q saar) in Q1 to deliver the country into recession with a -0.7% q/q saar GDP print – much worse than expected (Figure 1). Record harvests for key summer crops like maize and soya beans will boost agricultural production further (Figure 2), but mining is unlikely to perform as well as it did in Q1 given some decline in commodity prices in the second quarter, combined with ongoing regulatory uncertainty as regards the Mining Charter and the Mineral and Petroleum Resources Development Act amendment legislation. Meanwhile, we think the manufacturing sector, outside of food processing, will continue to struggle given the negative impact of exceptionally weak business confidence. The Absa BER survey of the manufacturing sector in Q2 found a record net balance of 47% of respondents expected conditions to be even worse in the next twelve months compared to the already weak levels.

FIGURE 1

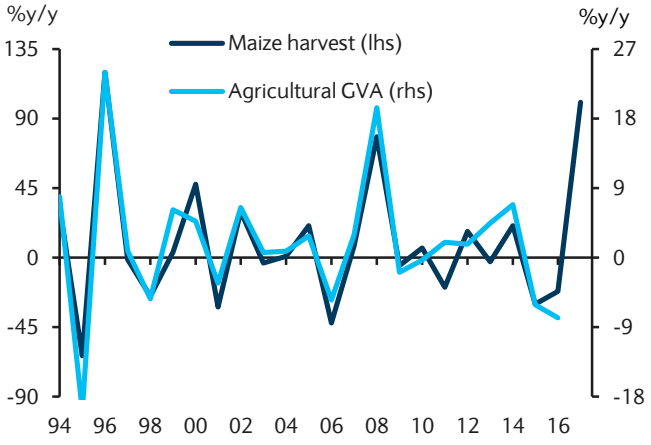
Only mining and agriculture grew in Q1



Source: StatsSA, Absa Research

FIGURE 2

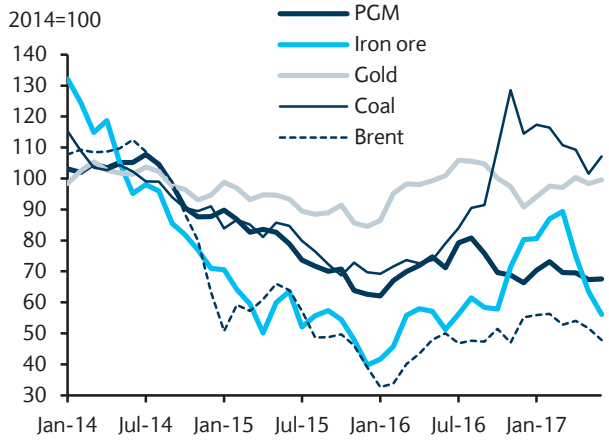
A record maize crop will lift agric. but it is only 2-3% of GDP



Source: DAFF, StatsSA, Absa Research

FIGURE 3

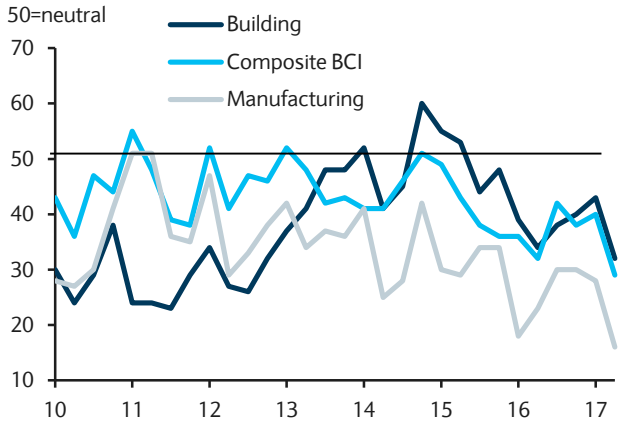
Key mineral output prices have softened in Q2



Source: Thomson Reuters, Absa Research

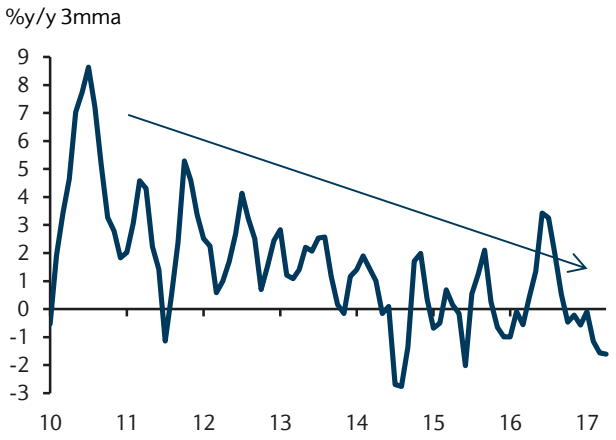
FIGURE 4

Business confidence has slumped in Q2



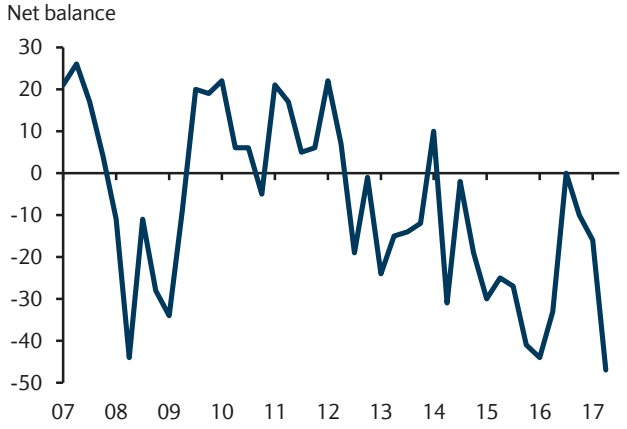
Source: BER, Absa Research

FIGURE 5
Manufacturing output has stagnated



Source: StatsSA, Absa Research

FIGURE 6
Manufacturers expect things to be worse in a year's time



Source: BER, Absa Research

A constrained consumer will not be able to provide much demand-side support for the economy

The overall weakness is manifesting strongly in the demand side of the economy as well. Overall household consumption shrank 2.3% q/q saar in Q1 17, the weakest print since the depths of the global financial crisis in 2009, pulled down especially by spending on goods – and not just cyclically-sensitive spending on durables either. Overall, we see little evidence that things will turn around for the consumer any time soon. Income growth is slowing, job gains are likely weak – though the inconsistency of South Africa's labour market data means that it is hard to know what is going on for sure – bank lending to households remains subdued (though credit conditions are easing slightly), and household wealth has stopped growing. See Box 1 and Figures 7-12 for more analysis of the consumer cycle. Perhaps most importantly, the 2017/18 Budget pushed through tax increases of 0.6% of GDP that will fall most heavily on the consumer starting from Q2 17. We forecast household consumption growth of just 0.6% in 2017, with a modest improvement, to 1.1%, in 2018.

Box 1: Consumer squeeze remains tight with little relief in sight

As noted above, the Q1 national accounts data show household consumption expenditure contracted by 2.3% q/q saar, with all categories of consumables spending falling sharply, with the exception of services, which grew a modest 1.0% q/q saar, driven by the recent trend of large real increases in health care spending. While the spending data are a broad indication of consumer financial strain, we believe that the weakness in goods sales in Q1 17 may have been exacerbated by the high base created in Q4 16 by the increasingly popular Black Friday sales promotions.

Notably, the strength in spending growth during Q4 was mainly concentrated in durables and semi-durables, which is where Black Friday specials are strongest, and it is also here where most of weakness manifests in Q1 17. Consumer spending on durables was up 0.2% q/q saar in Q4, after contraction for seven straight quarters, while semi-durables consumption grew by a strong 6.8% q/q saar in the same quarter. Both these categories contracted in Q1 17, with semis in particular falling by 10.2% q/q saar. Some normalisation from this pattern is likely from Q2. Indeed, the seasonally adjusted 3m/3m annualised growth in retail sales improved to -0.9% in April from -4.0% in March, although we note that these may also carry the distortions of the high number of holidays in April 2017.

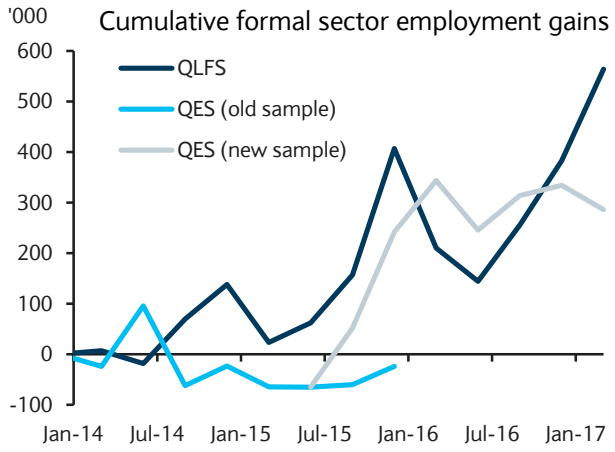
Unfortunately, we think the case for sustained improvement remains weak. We still see the labour market as broadly unsupportive. Although Stats SA's Quarterly Labour Force Survey (of households) showed total employment growth of 523k in H2 16 and a further 144k in Q1 17, other labour market indicators paint a less rosy picture. Stats SA's Quarterly Employment Statistics (based on a survey of enterprises), indicated only 88k formal sector jobs created in H2 16 and an outright contraction of 48k in Q1 17. Meanwhile, the BER's surveys of firms' hiring intentions across major sectors including retail, manufacturing and construction, were sharply negative during Q2 17. These constraints are also evident in income data. Nominal growth in compensation of employees of 6.0% y/y in Q1 17 was the slowest in decades while real disposable income growth contracted notably during the quarter.

On the credit side, conditions are mixed but lending growth appears likely to remain subdued. The SARB's Q1 data showed that after the recent cycle had added some pressure on debt service costs, these have eased over the course of 2016 and stabilised, while consumers also continued a soft pace of deleveraging. The TransUnion Consumer Credit Index (CCI), a measure of consumer credit health, improved to 52.4 in Q1 17 from a reading of 49.7 in the final quarter of 2016. However, the latest BER survey of the financial services sector shows that retail banks' lending standards to households tightened relative to the first quarter following the recent credit ratings downgrades. Against this, the latest private sector credit extension data show loss of momentum in household credit extension. The 3m/3m annualised print eased to 3.4% in May, the weakest this year and down from 4.6% in April.

Overall, while we think that Q1 17 was an outlier and there is some scope for reversal in Q2, we still see limited catalysts for sustained household spending growth in the near term. Falling consumer price inflation will provide only limited relief for consumers' real disposable incomes in the second half of 2017. Moreover, the high likelihood of fiscal slippage means that additional tax increases in the next fiscal year are very possible.

FIGURE 7

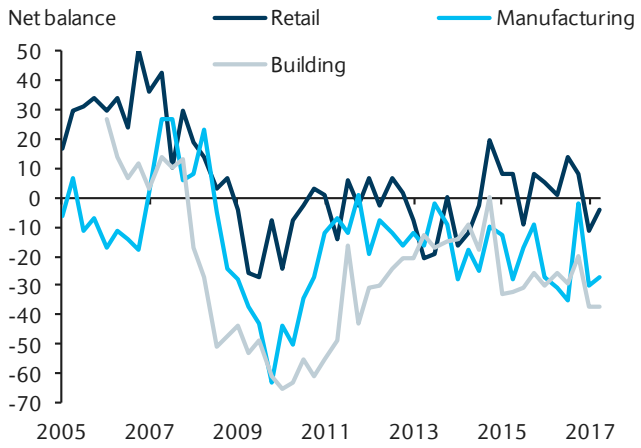
Official jobs data are contradictory



Source: StatsSA, NAAMSA, Absa Research

FIGURE 8

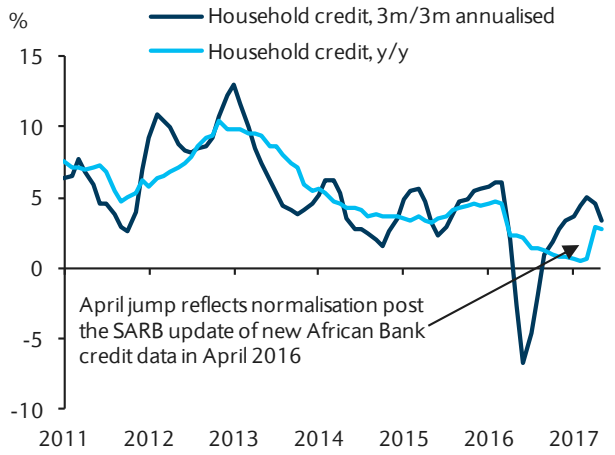
Firms' hiring intentions are negative across major sectors



Source: BER, Absa Research

FIGURE 9

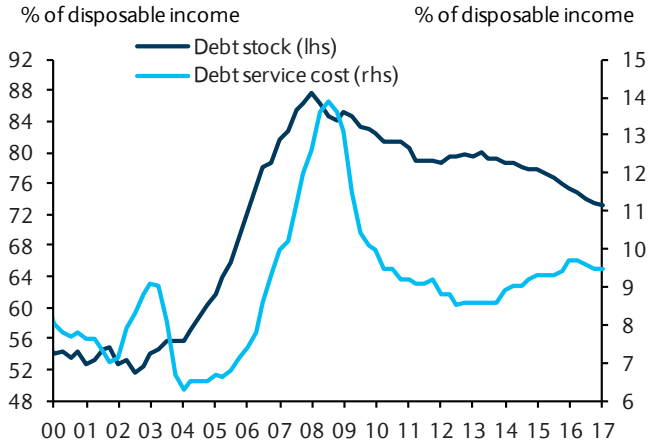
Bank lending to households remains muted



Source: SARB, Absa Research

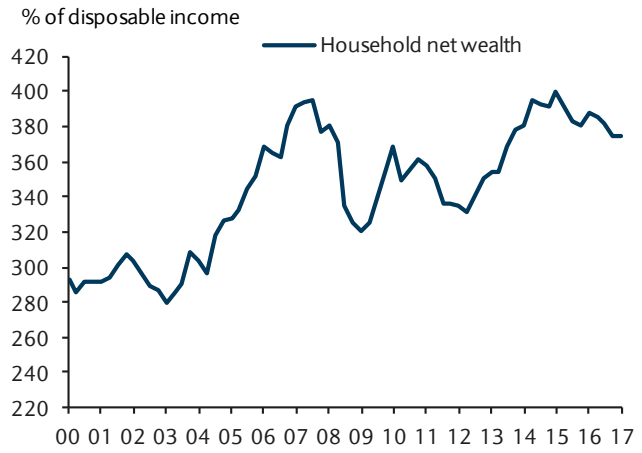
FIGURE 10

Households continue with a slow "soft" deleveraging



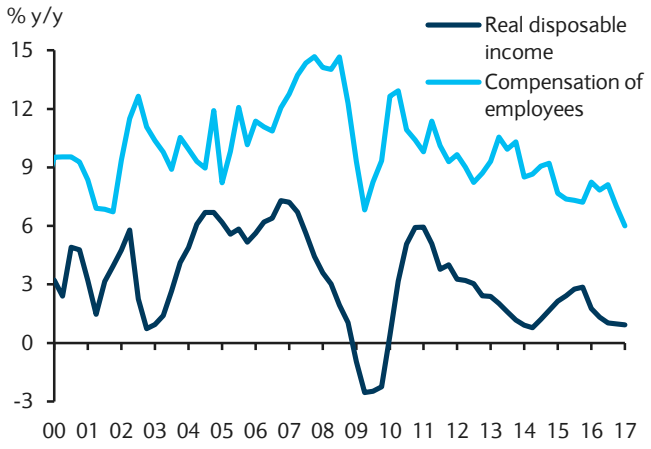
Source: SARB, Absa Research

FIGURE 11
Household net wealth has been sliding since 2014



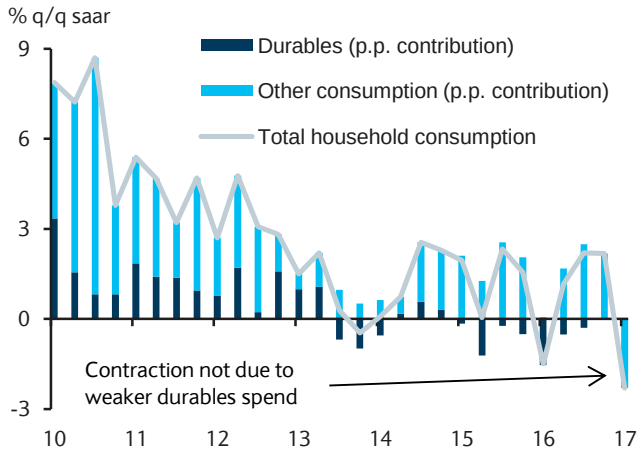
Source: SARB, Absa Research

FIGURE 12
Household disposable income growth has continued to slow



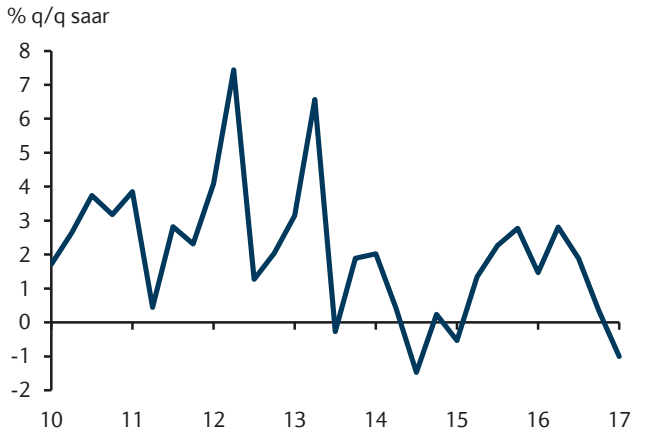
Source: SARB, Absa Research

FIGURE 13
Broad-based Q1 collapse of household goods consumption



Source: StatsSA, Absa Research

FIGURE 14
Government consumption also shrank in Q1



Source: StatsSA, Absa Research

Nor can government consumption provide much support if National Treasury is to reduce the fiscal deficit; after years of big increases in real spending, budget constraints are now biting hard

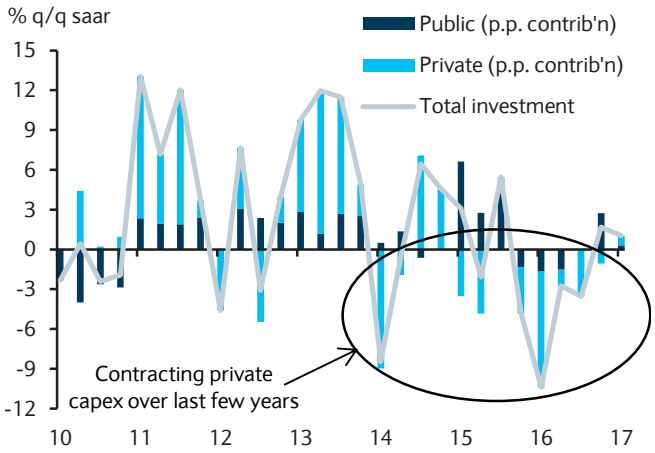
Gross domestic fixed investment registered a marginal pick up in Q1 17 to 1.0% q/q saar, with the private sector surprisingly contributing 0.7 percentage points of this – its first positive growth in a year and a half. But given the slump in overall business confidence in Q2, it seems unlikely that fixed investment spending will recover substantially until the issues that undermine private sector confidence – chiefly policy uncertainty and political tensions – are resolved. Some 87% of manufacturers, for example, cite the prevailing political climate as a constraint on their investment plans – the highest level over – with lack of demand also a key deterrent. We do not expect the Q1 recovery in private capex to be sustained and think gross domestic fixed investment is likely to shrink 1% in 2017.

Forecasting the economy beyond 2017 is very difficult since the outlook depends critically on the outcome of the ANC's electoral conference, which at this stage is too difficult to call, but could set the country on diametrically opposed paths

Overall, we find it difficult to be optimistic on GDP growth absent an unlikely big positive commodity price shock or sudden confidence-boosting political breakthrough. Growth is in many ways an accretive process and the weak prints in Q4 16 and Q1 17 do not provide any forward momentum for the economy. Even if the economy starts expanding again from Q2, the overall growth print for the year as a whole is unlikely to top 0.3%, even with several bumper agricultural harvests pretty much guaranteed. The outlook for 2018 and beyond is hard to call with any great degree of confidence, as it depends hugely on domestic policies and confidence levels which are almost entirely hostage to the outcome of the African National Congress's electoral conference at the end of the year. We forecast growth of just

FIGURE 15

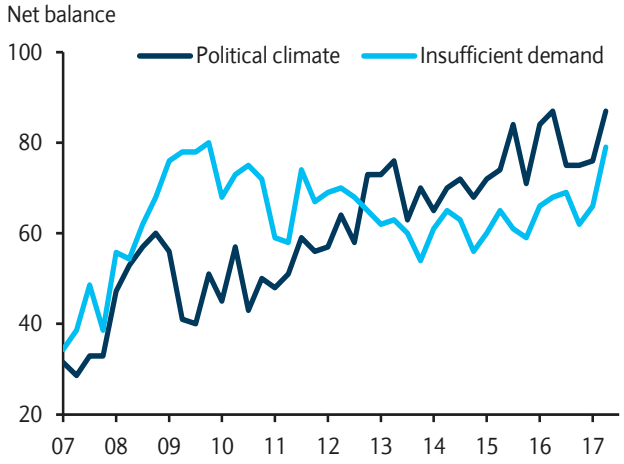
Private capex spend has evaporated over last few years



Source: StatsSA, Absa Research

FIGURE 16

Manufacturers cite political uncertainty and soft demand



Source: BER, Absa Research

0.3% this year, down from our previous forecast of around 1%. Beyond 2017 our forecast takes a middle of the road view, assuming neither a good outcome nor a bad one at the electoral conference. However, as we argue below, South Africa's political future and, hence, its economic future are rather more binary. A broadly poor outcome at the end of the year would take South Africa in the direction of persistent weak growth, low confidence, rating downgrades, and currency depreciation. A strong outcome, in which the technocrats emerge as the dominant voice within the ANC, would likely deliver an immediate boost to confidence and the exchange rate, and probably keep the ratings agencies on hold, even though it would almost certainly take some time for the technocratic constitutionalists to fix all of South Africa's ills and restore positive per capita GDP growth.

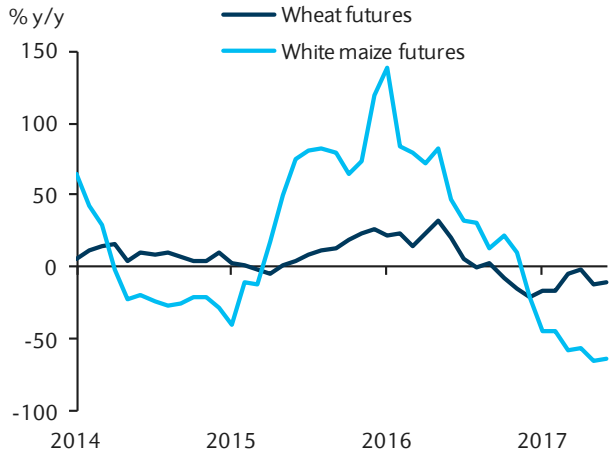
Inflation likely to track within target range in H2 17 and 2018

Robust harvest prospects are causing food price inflation to fall sharply

So far this year inflation has come in below what we expected, thanks in no small measure to prospects of a bountiful harvest leading to sharply lower grain and other food prices (which account for 17.2% of the CPI basket). Consumer food price inflation has fallen from a peak of 11.8%y/y in October 2016 to 6.9% in May, and we project that it will decline still further to below 3% in Q1 next year. However, thereafter, food price inflation will likely start to rise as favourable base effects drop out of the year-on-year calculation.

FIGURE 17

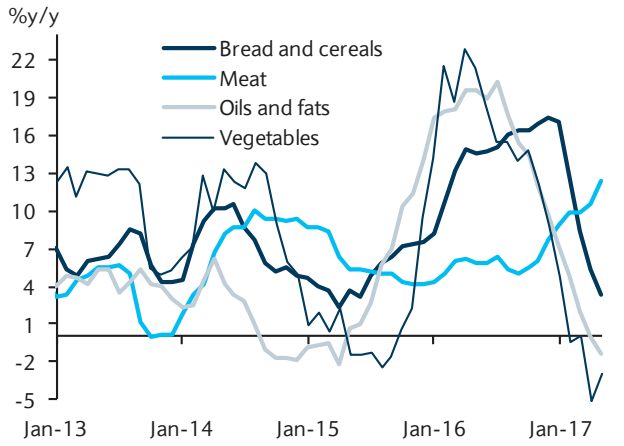
Great harvest expectations have driven key crop prices lower



Source: Thomson Reuters, Absa Research

FIGURE 18

Rising red meat prices likely to be offset by other food prices



Source: StatsSA, Absa Research

Inflation forecast dependent on assumptions about petrol and electricity prices

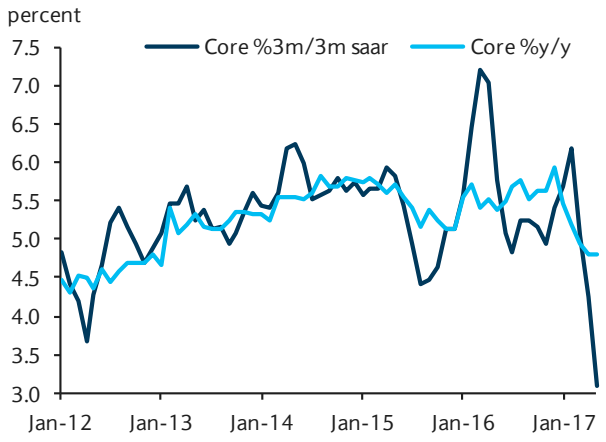
A strong rand and weak crude price have also helped contain headline CPI inflation this year, since they directly determine petrol and diesel prices which account for 4.6% of the CPI basket. Our outlook on petrol prices is driven by our assumption of a depreciating rand versus the USD, and the Bloomberg consensus forecast for a rise in oil prices out to 2018, notwithstanding the current unexpectedly weak crude spot prices. We have also assumed small electricity distribution margin increases each December and 25 c/l increases in fuel levies each April (see Figure 35 for a table of all key forecast assumptions). On the issue of fuel taxes, however, we note the 2017/18 Budget proposal to impose VAT on fuel sales with effect from April next year. It is not clear if it will be implemented, but if it is, it would pose a big upside risk to our current projection of fuel prices and, by implication, headline CPI. Another important assumption in our inflation forecast is electricity prices. We have assumed that municipalities impose on average a 3% tariff increase to consumers effective July, after the electricity regulator awarded Eskom a 2.2% tariff increase. Eskom has since revealed that it is applying for a tariff increase of nearly 20% for FY 2018/19, even before any tariff increases that they may be awarded under the Regulatory Clearing Account mechanism. It is unclear how much of Eskom's tariff request will ultimately be granted by the regulator. We have assumed a tariff increase of 12% for July 2018.

Observed deceleration in core CPI may not last unless wage settlements moderate substantially, and so far there is no sign of this happening

Beyond these assumptions, the trajectory for core CPI inflation is key. We have recently observed some welcome deceleration of core CPI inflation, with the momentum in core CPI (as measured by the 3m/3m annualized rate of inflation) having fallen sharply to just 3.1%, (Figure 19) although some of this owes to a technical (and ultimately transitory) effect due to the reweighting of the CPI index at the beginning of this year. We expect core CPI inflation, which hit 4.8% y/y in May, to ease a little further to 4.5% by the beginning of next year, and to drift slowly higher thereafter. Theoretically, the weakness of demand should bear down on pricing power and contain inflation but in practice cost-push influences working through annual wage settlements are a more important factor. In this regard, we would become more optimistic on the prospects for core CPI if current wage negotiations – particularly in the key metals and engineering sector between National Union of Metalworkers of South Africa (NUMSA) and the employers represented by the Steel and Engineering Industries Federation of South Africa (SEIFSA) – produce a notable moderation in wage settlements. So far, however, the two sides remain far apart in their respective wage demands. Taken altogether, we see headline CPI inflation touching a low around the middle of the target range in Q1 next year, before beginning to trend upwards, although remaining within the 3-6% target at least up until end 2018.

FIGURE 19

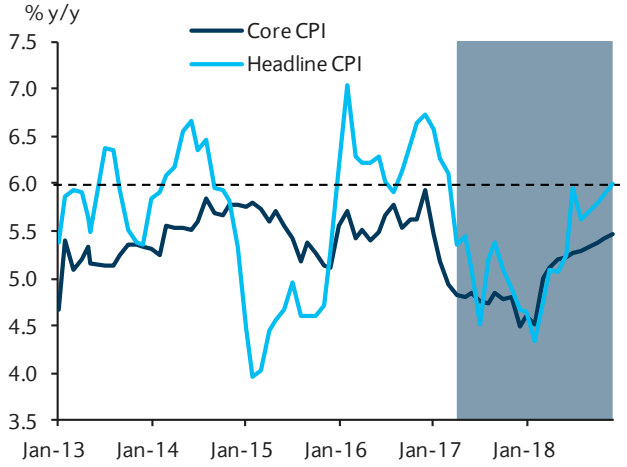
Momentum behind core CPI inflation has slackened sharply



Source: StatsSA, Absa Research

FIGURE 20

Headline CPI will stay with target rand but will rise in 2018



Source: StatsSA, Absa Research

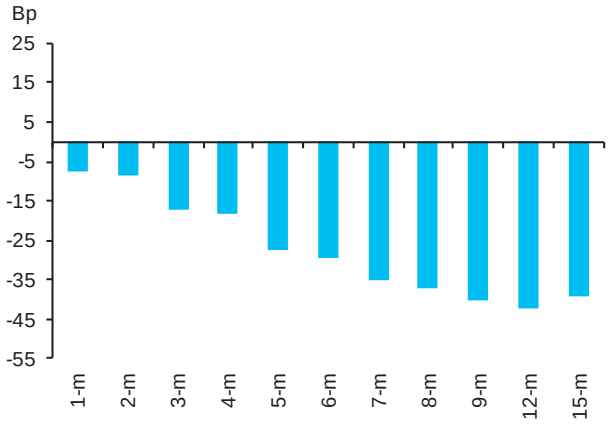
Monetary policy likely to remain on hold, but risks of a cut are rising

Despite growing expectations of a rate cut, we believe the SARB MPC will, on balance, prefer to keep rates on hold in the run-up to the end of the year's key electoral conference. However, given the weakness of the economy, we see rising risks of an earlier cut

Expectations of a rate cut are running strong. The market is currently pricing in roughly 40bp of rate cuts over the next twelve months. At the last two meetings of the SARB's Monetary Policy Committee, one of the six members voted for a 25bp cut. Since the last MPC meeting on 25 May, South Africa has had to face up to the fact that it is now formally in recession. However, up until quite recently the SARB was at pains in various speeches to point out that monetary policy can do little to address the causes of South Africa's weak growth and that it sets policy on the basis of forecasts of inflation 12-18 months in the future, as Governor Kganyago noted in a speech as recently as 10 June. Moreover, the recent interventions by the Public Protector and the Deputy Finance Minister to question the SARB's inflation targeting mandate have possibly boxed the SARB into a bit of a credibility corner, making it harder to ease without seeming to respond to political pressures. Our view is that the SARB is likely to keep rates on hold – despite the weak economy – in the run up to the ANC's electoral conference at the end of the year, but we cannot rule out a cut entirely. It will be key to see if the substance and tone of the SARB MPC's assessment change materially at the upcoming MPC meeting on 20 July. Beyond 2018, the direction of rates is dependent on the market and economic reaction to the ANC's electoral outcome. We believe that with current nominal repo rate of 7% delivers a real interest rate of around 1.5% which seems to us to be a fair estimate of the appropriate neutral real rate of interest, and thus, pending greater clarify on the direction South Africa is to take, we assume that the repo rate remains on hold for the foreseeable future.

FIGURE 21

FRA curve is pricing in nearly two 25bp rate cuts over a year



Note: Calculated by subtracting 3-month Jibar from the corresponding FRA rate.
Source: Thomson Reuters, Barclays Research

FIGURE 22

The consensus forecast for rates in early 2018 has fallen

	Q3 17	Q4 17	Q1 18	Q2 18
June Survey				
Absa Research	7.00	7.00	7.00	7.00
Median	7.00	7.00	6.75	6.75
Highest	7.00	7.00	7.00	7.25
Lowest	6.50	6.00	5.50	5.00
May Survey				
Absa Research	7.00	7.00	7.00	7.00
Median	7.00	7.00	7.00	7.00
Highest	7.25	7.50	7.50	7.50
Lowest	6.75	6.75	6.50	6.50

Source: Thomson Reuters, Barclays Research

Current account deficit likely to widen gradually

Widening of current account to 2.1% of GDP deficit in Q1 17 was due to a reversal of a Q4 16 surge in inward dividend receipts

The first quarter balance of payments data showed a slight widening in the current account deficit to 2.1% of GDP in Q1 17 from a six-year low of 1.7% of GDP in Q4 16. The outcome was slightly worse than we had expected. The deterioration owed to a widening of the deficit on invisible flows to 3.4% of GDP in Q1 from 3.0% of GDP in Q4 16. This, in turn, was a function of the fact that the surge in inward dividend receipts to 1.7% of GDP in Q4 reversed to a more normal level of 1.1% of GDP in Q1, with dividend receipts from South Africa's offshore direct investments falling especially sharply, possibly reflecting some decline in foreign corporate profitability in rand terms as a result of the Brexit-driven collapse in sterling. The merchandise trade surplus improved slightly in ZAR terms but it was unchanged as a percentage of GDP at 1.3%.

The most recent merchandise trade data from SARS suggest another merchandise trade surplus is likely in Q2, but a smaller one – implying that the current account deficit is likely to widen

Monthly customs and excise data suggest another merchandise trade surplus in Q2, with a surplus of ZAR9.5bn after a ZAR5.0bn surplus in April. However, it is important to note that the headline trade balance figures reported by SARS need to be seasonally adjusted in order to draw clearer implications for the current account since the SARB reports the current account data after seasonal adjustment. If we assume another surplus of ZAR12.5bn in June, we find that after seasonal adjustment the SARS data point to smaller surplus in Q2 of ZAR51.9bn compared to ZAR73.8bn in Q1. There is of course always some degree of uncertainty in this since the SARB usually makes adjustments (which can sometimes be large) to the SARS data for balance of payments purposes. Nonetheless, even under an assumption of a fairly sizeable surplus for June, the SARS data point to a smaller surplus in Q2.

Trade in mineral products has worked strongly in South Africa's favour this year

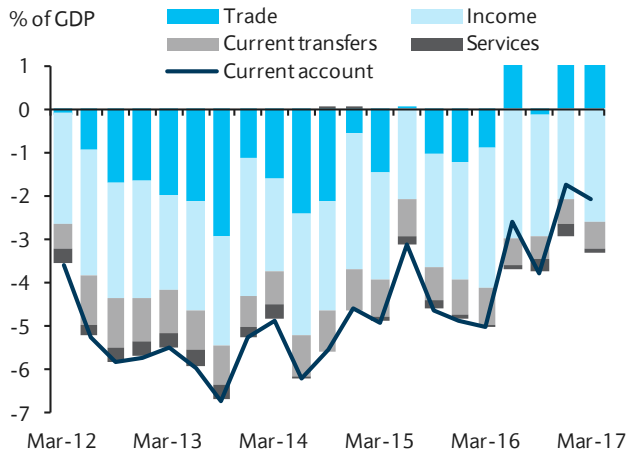
The detailed data from SARS also reveals interesting trends about the nature of the improvement in the merchandise accounts. From a goods category perspective, a large part of the trade surplus owes to trade in minerals products. By May, the year-to-date trade surplus in minerals was USD3.4bn, compared with a surplus of USD1.7bn in the year-earlier period. The improvement here is even more substantial compared with the USD0.6bn five-month surplus in 2015. We think this is largely a result of the rebound in prices of key export commodities, particularly in the final quarter of last year and in the early part of 2017. However, some of the shine in these commodities is coming off. The average spot price of platinum fell 4.1% in the second quarter compared to the Q1 average. Over the same period, averages prices of coal and iron ore are fell by 7.7% and 24.2%, respectively. This will be partly offset by lower oil prices, which fell 7% in the second quarter, on average. However, with the upward momentum on export commodity prices having diminished, the commodity support to the trade balance could wane.

Net trade in vehicles and components does not seem to be repeating last year's good performance

As regards trade in manufactured products, there has been little positive adjustment. In the year to May, the cumulative deficit stood at ZAR8.1bn, which is 9.2% larger than the deficit in this category at the same time last year. The recent strengthening of ZAR and the general malaise in the manufacturing sector mean the sector may be struggling to be competitive in foreign markets. Even in vehicles trade, where there had been significant improvement in the trade balance in 2016, the data so far this year suggest renewed challenges (see Figure 26). The one area that will be supportive to the trade balance this year is agriculture. South Africa is expected to harvest about 15.6mn tonnes of maize. With domestic consumption requirements of about 10mn tonnes and assuming about 2mn is retained as reserve, this still leaves about 3.6mn tonnes available for export. At prevailing prices, this would be equivalent to about ZAR6.5bn in export earnings, compared to last year's estimated import bill of ZAR9bn on the back of a shortage of 2.5mn tonnes.

FIGURE 23

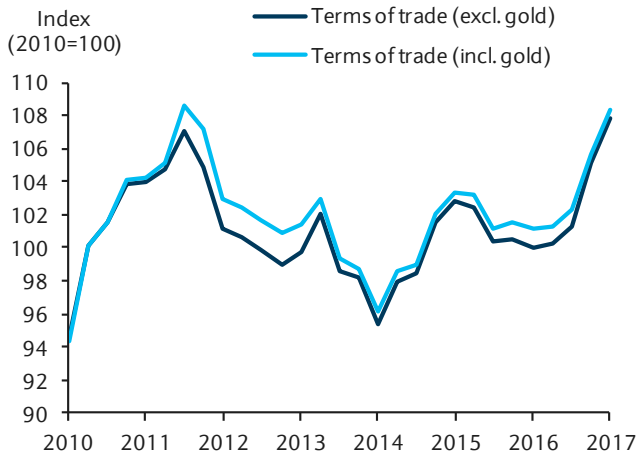
The merchandise trade balance has improved notably…



Source: SARB, Absa Research

FIGURE 24

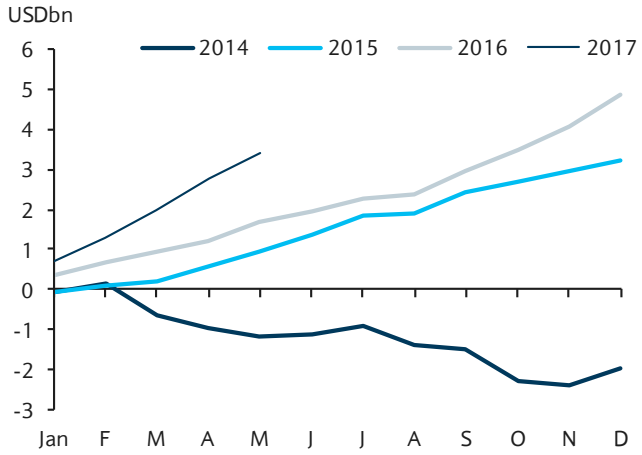
… supported by an improvement in terms of trade



Source: SARB, Absa Research

FIGURE 25

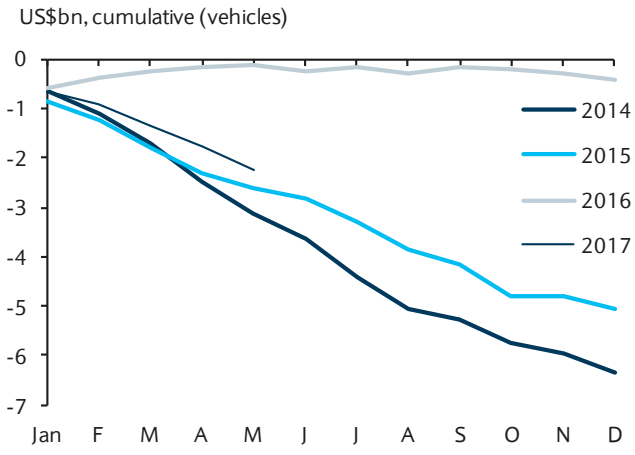
Cumulative trade balance on minerals has improved…



Source: SARS, Absa Research

FIGURE 26

… but most parts of manufacturing have not improved much



Source: SARS, Absa Research

We expect a current account deficit of about 2.6% of GDP in Q2

Where does all of this leave our forecasts for the current account? Given the lower export commodity prices and early evidence from the monthly SARS data, we think the current account deficit is likely to widen to about 2.6% of GDP in the second quarter. The general underperformance of the manufacturing sector amidst weak confidence could weigh on export volumes. However, we are also slightly more downbeat on the near-term recovery for domestic demand, which means that import growth could also remain fairly weak. Against this, we expect the current account deficit to average 2.7% of GDP this year, and to widen to about 3.4% of GDP in 2018 and 3.6% of GDP in 2019. These CA deficit forecasts are narrower compared to our projections at the time of the last Quarterly Perspectives.

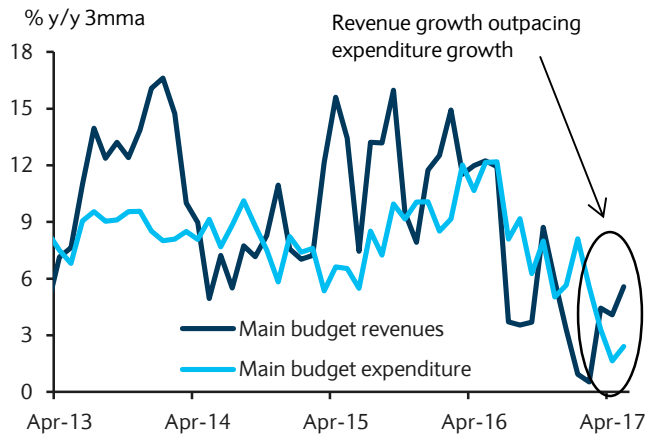
Fiscal stabilization will be hard to achieve against a weak growth backdrop

A last-minute surge of dividend tax receipts saved the revenue and deficit targets last year, but we think tax receipts will be sorely pressured this year by weaker-than-budgeted growth and inflation

Somewhat surprisingly, South Africa hit its revenue and deficit targets in the last fiscal year, but this was largely thanks to a last minute surge of dividend tax receipts in March as firms rushed in the wake of the 2017/18 Budget to declare dividends at 15% before the new tax rate of 20% kicked in. The main tax categories – personal income tax (PIT), corporate income tax (CIT) and VAT – all came in below target last year. As we argued at the time of the Budget, we think this pattern is likely to persist this year given that the 2017/18 Budget was programmed against overly optimistic real GDP and inflation assumptions. Subsequent inflation and GDP developments have strongly validated our sceptical view in this regard, although so far our concerns about tax receipts are not playing out in the main budget data. It is still only early days with just two months' worth of data, but main budget tax receipts are seemingly holding up well so far, with 8.5% y/y growth in total tax receipts and good performances from PIT and VAT offsetting declining y/y CIT receipts. While this growth rate of tax revenues is behind the budgeted growth rate of 10.6%, we note that expenditure growth in the first two months of the fiscal year has been just 0.3%y/y. Also, we have to acknowledge some potential upside to revenues from changes to the donations tax regime (which could serve to boost estate duties) and the Special Voluntary Disclosure Program which runs until end-August, which effectively imposes a 16% tax on the value of newly declared offshore assets. No receipts from these two sources were factored into 2017/18 Budget revenue line. Even so, given the growth slowdown we still expect some revenue slippage this year, though we broadly believe the government will stick to its nominal expenditure ceilings. Thus, we expect a main budget deficit of 3.8% of GDP this year, versus the budget target of 3.5%. The consolidated budget deficit should come three-tenths of a point narrower than the main budget deficit thanks to surpluses at provinces and various extra-budgetary institutions such as the social security funds.

FIGURE 27

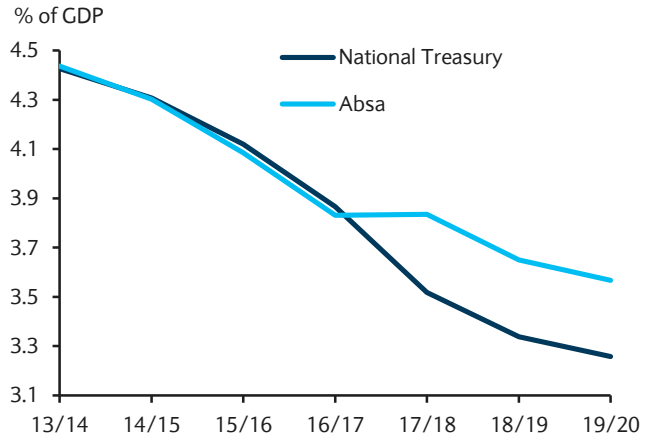
Budget numbers so far this year have been benign…



Source: National Treasury, Absa Research

FIGURE 28

… but we still expect some deficit slippage



Source: National Treasury, Absa Research

Renegotiation of public-sector wage deal to take effect in FY 2018/19 is a major risk to NT's expenditure targets

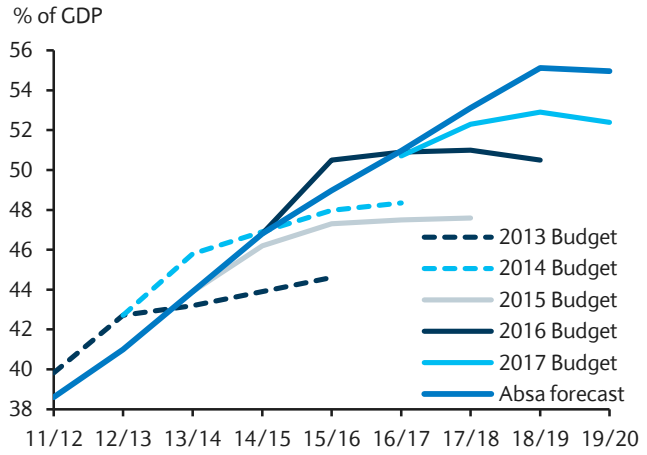
National Treasury will make no further pronouncements on its expectation for the current fiscal year until the Mid-Year Budget Policy Statement, sometime in the second half of October. Finance Minister Gigaba will then probably pencil into the three-year fiscal plans additional expenditure cuts and above-baseline tax increases without detailing their precise nature. We think it will be difficult for Gigaba to cut non-interest spending significantly, especially since a rising interest bill is already consuming an ever larger share of revenues, and the government is currently negotiating a public sector wage deal to replace the current three-year deal which expires in March. We see this as a major source of expenditure slippage risk. Currently, the 2017/18 consolidated budget allows for an uplift in current budget payments for compensation of employees from R550.4bn in FY 2017/18 to R588.7bn in FY 2018/19 – an increase of just 7.0%. We are mindful of the outcome of the last public sector wage discussions where the first year (of the three year deal) saw a basic salary increase of 7% but the uplift to various benefits boosted the total pay deal to nearly 10%, thereby seriously undermining the NT's consolidation path. Significantly, the public sector wage deal will be negotiated not by the National Treasury directly but by the Department of Public Service and Administration, which is controlled by a key Zuma loyalist. Without an ability to directly control the size of the pay awards or an instrument to downsize the public sector payroll more proactively than attrition allows, we see public sector pay as a key expenditure-side risk to National Treasury's fiscal consolidation objectives, especially with a general election looming only a year afterwards in Q2 2019. Further suspicions about the government's approach to public spending have been raised by Finance Minister Gigaba's statement that price should only be a small part of the considerations on public procurement. The market is watching nervously for the appointment of a permanent Chief Procurement Officer at National Treasury as an indicator of its real intent on spending discipline. Overall, we believe that taxes will likely go up again next year.

Public debt-to-GDP unlikely to peak without stronger efforts to curb spending or a more holistic approach to the government's balance sheet

Without still stronger efforts to narrow the deficit through further tax hikes or spending cuts, the public debt to GDP ratio is very unlikely to peak in 2018/19 as projected in the Budget. Instead, we see it flattening but still not peaking. We think it will hit about 55% of GDP by 2019/20, and this does not include any crystallization of the contingent liabilities arising principally from the issuance of Treasury guarantees on highly troubled state-owned enterprises' borrowings.

FIGURE 29

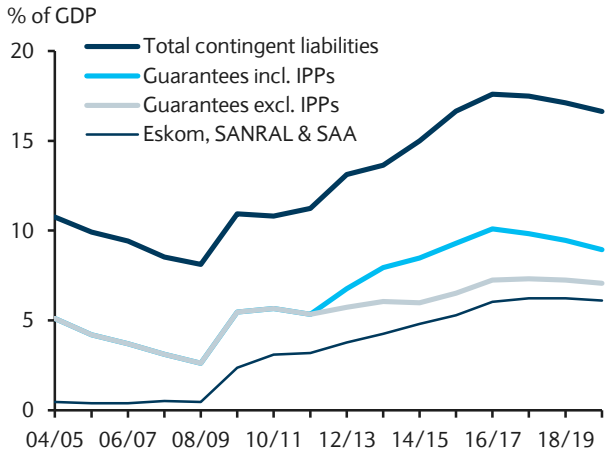
Debt unlikely to peak, in contrast to Budget forecast



Source: National Treasury, Absa Research

FIGURE 30

Contingent liabilities have risen sharply



Source: National Treasury, Absa Research

Weak economy and fractious politics likely to weigh on rand

ZAR has recently benefited from global factors

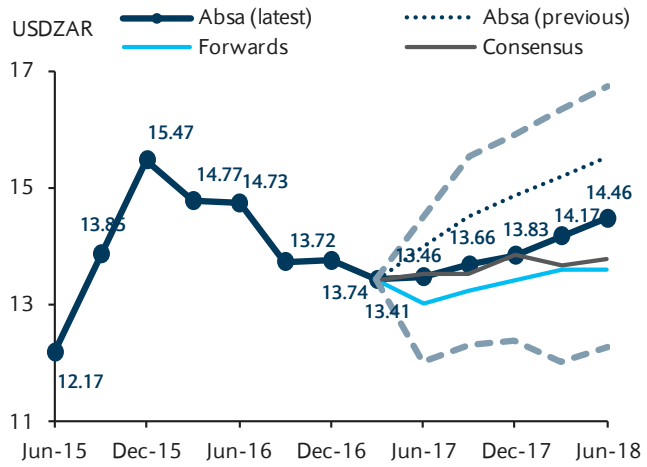
Considering SA's recent credit rating downgrades, uninspiring fundamental backdrop and ongoing socio-political tensions, we were surprised by the ZAR's resilience during Q2 17. We believe that global factors, namely favourable commodity price developments and a risk-on international trading environment best explain why the ZAR bulls have brushed aside idiosyncratic concerns and consequently ensured that the ZAR has recently strengthened to two-year highs in relation to the USD and in trade-weighted terms.

We remain ZAR bears, but have moderated our expected rate of deprecation

However, albeit to a lesser extent than previously, we still expect the ZAR to weaken in the latter half of the year on the back of SA's deteriorating GDP growth outlook, suppressed domestic sentiment and some renewed widening of the current account deficit. Buoyant global risk appetite and rising real policy rates pose the biggest risks to our persistently bearish view, not to mention that we have also become less constructive about the USD in general. Our updated forecasts are above the forward curve, but we are now only slightly more bearish than consensus.

FIGURE 31

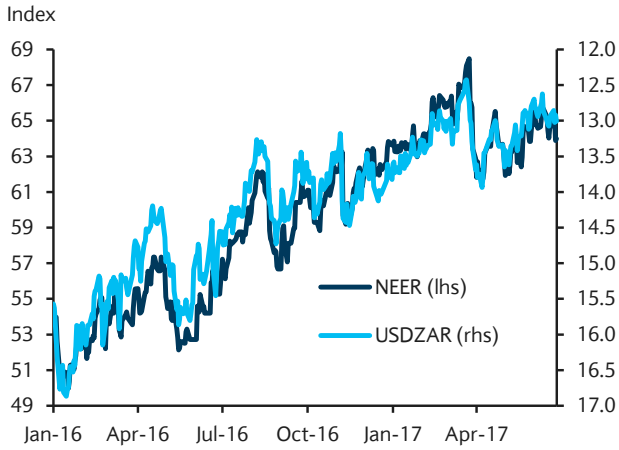
We have trimmed our forecast of rand depreciation



Source: Bloomberg, Absa Research

FIGURE 32

Exchange rate has strengthened, but now has stabilized



Note: Rise/fall in Nominal effective exchange rate implies ZAR app/depreciation.
Source: Thomson Reuters, Absa Research

Credit ratings depend on political outcomes that are impossible to call

Creditworthiness will be further pressured this year by weak growth, fiscal slippage and continued, widespread mismanagement at state-owned enterprises

South Africa experienced a swift round of downgrades from all three credit rating agencies following President Zuma's highly controversial cabinet reshuffle in early April. Most rating agencies viewed the sacking of independent and highly regarded ministers (including former finance Minister Gordhan and his deputy Mcebisi Jonas) and the retention and even advancement of key loyalists as an attempt by the patronage network to "capture" the remaining pockets of independence in the state. Two of the credit rating agencies (S&P and Moody's) have South Africa on Negative Outlook. The credit rating agencies have broadly indicated that they would potentially downgrade again if growth proves weaker than expected, fiscal consolidation is derailed, and/or political tensions get in the way of vital structural reforms and/or compromise key institutions. All of these negative considerations seem to be playing out to some degree. As regards structural reform, for example, little has been achieved. The recently gazetted Mining Charter seems likely to harm the mining industry rather than reduce uncertainty and the chaos at state owned enterprises continues unabated. For example, South African Airways reported to parliament's standing committee on finance in June that it recorded a loss of ZAR1.9bn in 2016/17, and a further loss of ZAR734mn in the first month of FY 2017/18. Finance Minister Gigaba said last week that he is putting an emergency ZAR2.2bn cash injection into South African Airways after one lender refused to roll over a loan.

Ultimately, credit ratings agencies are likely to wait on the outcome the ANC's electoral conference at the end of the year because it generates a binary future

However, there are no scheduled rating reviews now until the end of the year, and we would expect rating agencies will want to wait for the outcome of the ANC's electoral conference before deciding on a course of action as regards their credit ratings. Notably, for example, S&P's guidelines for sub-investment grade credits are that an outlook should be resolved (either acted upon or removed) within a year, more or less, of its assignment. This would give it until the June 2018 review before it would feel pressured to act. Moody's too is likely to wait. Fitch has a stable outlook on its BB+ ratings, and would want to move through a Negative Outlook before downgrading again, barring some big shock (like a total victory of the patronage network at end year, which would potentially spell another disastrous decade of ineffective governance, rent-seeking and increasingly populist rhetoric and policies).

FIGURE 33

South Africa's sovereign credit ratings

	S&P	Moody's	Fitch
Foreign currency	BB+	Baa3	BB+
Local currency	BBB-	Baa3	BB+
Outlook	Negative	Negative	Stable
Date assigned	03-Apr-17	09-Jun-17	07-Apr-17
Next scheduled review	24-Nov-17	11-Aug-17 and 24-Nov-17	Flexible – but probably last week November or first week December

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

Politics just too difficult to confidently call right now

South Africa is currently at a critical political crossroads, and the country is on tenterhooks as it waits to see whether the current bitter factional battle for control of the ANC, and hence of the government and the country, resolves in a positive direction or a negative one. We do not think a compromise between the two sides is likely, given the diametrically opposed interests and philosophies of the two factions. At the moment, the factional network around President Zuma appears to control key party structures, such as various provincial leaderships, and the youth, women's and veterans' leagues. However, the steady stream of allegations of corruption and state capture via the so-called GuptaLeaks are doing damage to the president and his allies, both within the ANC and outside of it. A number of things have not gone President Zuma's way recently. But the fight is an existential one, and thus South Africa should buckle down for a rocky second half of the year, as both sides struggle to gain the upper hand. South Africa's future hangs in the balance.

FIGURE 34

Main macroeconomic variables in South Africa

	2016		2017				2018				2015	2016	2017F	2018F	2019F	2020F
	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F						
Output (% q/q saar)																
Real GDP	0.4	-0.3	-0.7	0.6	0.5	0.8	1.2	1.4	1.6	2.0	1.3	0.3	0.3	1.2	1.8	2.0
Real GDP (%y/y)	0.6	0.4	0.6	0.0	0.0	0.3	0.8	1.0	1.3	1.6	1.3	0.3	0.3	1.2	1.8	2.0
Household consumption	2.2	2.2	-2.3	1.0	1.1	1.6	1.0	1.0	1.0	1.0	1.7	0.8	0.6	1.1	1.7	1.9
Durable goods	-3.2	0.2	-0.2	-5.1	0.0	1.6	3.0	3.0	3.0	3.0	-1.9	-7.3	-1.6	1.8	3.0	3.7
Semi-durable goods	-0.9	6.8	-10.2	6.1	1.0	2.0	1.0	1.0	1.0	1.0	4.0	3.3	-0.1	1.5	1.6	2.0
Non-durable goods	1.1	0.3	-4.6	4.0	2.0	2.4	0.4	0.4	0.4	0.4	2.2	0.9	0.2	1.2	1.5	1.7
Services	5.0	3.2	1.0	-1.2	0.6	0.8	1.1	1.1	1.1	1.1	1.5	2.1	1.5	0.8	1.7	1.8
Public consumption	1.9	0.3	-1.0	2.8	1.9	0.1	1.0	1.0	1.0	1.0	0.5	2.0	1.0	1.1	1.0	1.0
Investment	-3.5	1.7	1.0	-4.3	-0.8	0.5	1.4	1.6	1.7	2.0	2.3	-3.9	-1.0	0.7	2.3	2.8
Exports	-21.2	12.5	-3.2	5.6	0.5	1.1	1.3	2.0	2.1	3.4	3.9	-0.1	0.5	1.8	2.1	2.2
Imports	-1.0	6.1	3.2	4.6	1.9	1.9	1.5	1.5	0.7	1.1	5.4	-3.7	2.4	1.7	1.9	2.3
External and government accounts (% of GDP)																
Current account	-3.8	-1.7	-2.1	-2.6	-2.9	-3.1	-3.3	-3.4	-3.4	-3.4	-4.4	-3.3	-2.7	-3.4	-3.6	-3.6
Consolidated fiscal balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-3.4	-3.3	-3.5	-3.1	-2.9	-2.6
Consolidated primary balance*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-0.1	0.2	0.1	0.7	0.9	12
Government debt*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	49.0	51.0	53.1	55.1	55.0	54.6
Prices (% y/y)																
CPI inflation	6.0	6.6	6.3	5.3	5.0	4.9	4.6	5.1	5.8	5.9	4.6	6.3	5.4	5.4	5.7	5.8
Core CPI inflation	5.7	5.7	5.2	4.8	4.8	4.7	4.7	5.2	5.3	5.3	5.5	5.6	4..9	5.2	5.2	5.6
PPI inflation	7.1	6.9	5.6	4.6	4.4	4.2	4.3	5.1	5.9	5.4	3.6	7.1	4.7	5.2	6.2	6.5
Interest rates (% eop)																
Repurchase rate	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	6.25	7.00	7.00	7.00	7.00	7.00
Prime rate	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	9.75	10.50	10.50	10.50	10.50	10.50

* Fiscal year commencing April. Source: SARB, National Treasury, Stats SA, Absa Research

FIGURE 35

Our key forecast assumptions compared to the SARB's May MPC forecast assumptions

Variable	Absa assumption	SARB assumption (May MPC)	Risks to our assumption and impact on forecast
Global growth	G7 growth of 1.9% pa 2017-2020	Growth of SA's main trading partners 2017-19: 3.2%; 3.4%; and 3.3%	The global economy, particularly in Europe appears to be picking up steam, but demand in neighbouring Africa, which is important for South Africa's export performance but which is not explicitly incorporated into our model, remains weak
Food prices	Good harvests will push domestic food price inflation below 3% by Q1 18 before a base-effect reversal	World food prices rise in 2017-19: 7.0%, 2.7% and 3.4%, respectively	Food prices are particularly hard to forecast, but the risks of a second El Nino event in the upcoming South African summer appear to be dissipating
Crude oil prices (Brent)	Using Bloomberg consensus forecasts as a base we forecast Brent at $54/bbl in 2017, $60/bbl in 2018, and $62/bbl in 2019	Spot Brent averages $54/bbl, $56/bbl, and $60bbl in 2017-2019, respectively	Current spot prices suggest downside risks to oil price assumptions but Increased Middle East tensions could push up oil prices more than we expect
Petrol prices	Petrol price forecasts are derived from our ZAR and crude price assumptions. We also assume 10c/l rise in distribution margins each December and 25 c/l increase fuel excise duties each April. This generates annual petrol price hikes of 9.8%, 11.2%, and 10.7% in 2017-19, respectively	Average Increases of 8.6%, 7.7% and 6.3% in 2017-19, respectively	The 2018/19 Budget mooted the idea of applying VAT to fuel sales (applied to the retail selling price post excise duties). If implemented in April 2018 without any offsetting drop in the fuel levy, it would push up petrol prices by 14% m/m, as opposed to the currently 2.4% assumption in our model based on 25c/l fuel levy hike
Electricity prices	We assume an average municipal tariff increase of 3% in July this year following on from Eskom's 2.2% award, and 12% next year	Average electricity tariff hikes of 5.7%, 6% and 8% in 2017-19, respectively. The text of the SARB's last MPC statement noted an assumed tariff hike of 4% effective 1 July this year. The assumed 6% average tariff hike for calendar 2018 therefore implies an 8% tariff increase effective July 2018. However, this assumption was made before news of Eskom's tariff application emerged	Eskom has applied to NERSA for a tariff increase of nearly 20% effective July 2018, plus any additional tariff adjustments that may be allowed by the Regulatory Clearing Account mechanism. We think high tariff increases may not be politically feasible and have opted for an assumption of a low double-digit increase, but clarity on the tariff hike will not be forthcoming for some time. The new MYPD for the financial year commencing April 2018 has not been finalized
Exchange rate	Our forecast is consistent with a depreciating NEER	SARB usually assumes a constant real effective exchange from the date of the MPC, which translates into 10.9% in 2017, -0.6% in 2018, and 0% in 2019	The outcomes of the end year electoral conference and consequent rating actions could have a significant impact on the rand
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 5%	20%	The size of FX pass-through to inflation is one of the great debates in South Africa, especially since it is likely to change over time and can only be teased out of the data with complicated econometrics
Commodity prices	We use Bloomberg consensus forecasts for 2017-19 as a base: Gold in $/oz at 1235, 1264, and 1294; Platinum in $/oz at 979, 1059, 1150; Coal at $/mt 78, 72, 68; Iron ore in $/mt at 64, 52, 50	SARB does not reveal any specific commodity price assumptions. Instead it assumes international commodity prices up by 15.5% in 2017, -5.0% in 2018, 2.5% in 2019	Very recent price trends suggest iron ore prices might come in lower than we assume
Growth in gov't consumption	We forecast real government consumption (G) growth of 1% per annum for 2017-19	SARB's forecast is the same as ours	A public sector wage deal currently under negotiation for April 2018 could derail this without stronger efforts at headcount shrinkage
Potential growth	We estimate potential growth at 0.6% in 2017, 0.7% in 2018, 1.2% in 2019 and 1.7% in 2020	1.4%, 1.5% and 1.6% in 2017 to 20 19 respectively	Estimates of unobservable potential growth are usually statistically derived from recent growth trends and could be lowered post South Africa's technical recession

Source: SARB, Absa Research

Analyst Certification
We, Miyelani Maluleke and Peter Worthington, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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