



ECONOMY

LIVE

South African Economy

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SA economy in 2017: shallow cycles vs. optimism that politics will improve in 2018

While we expect that GDP has bottomed and inflation is peaking, the cycle is heavily dependent on politics and commodity prices.

We expect that it may be a relatively quiet year for SA economics in comparison with the uncertainty and volatility which will be provided by domestic politics, commodity prices, US monetary and trade policy, and global geo-politics. We think that these dynamics are likely to be the biggest drivers of SA asset prices as opposed to fundamental domestic macro factors such as growth and inflation, which we think are largely known and priced.

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We agree broadly with consensus expectations, that SA inflation will peak in Q1:17, and, while growth will remain structurally low and below potential, cyclically it has troughed and will gain momentum in 2017 – aided by the end of the domestic drought and higher commodity prices. SARB's and Treasury's forecasts for SA GDP growth (1.1% and 1.3% respectively) and inflation (6.2% and 5.8% respectively) are relatively realistic, which reduces policy risks.

We expect GDP growth of 1.4% y/y in 2017, up from 0.4% last year. Post re-weighting by Stats SA and a higher oil price assumption, we have revised our CPI forecast to 6.0% y/y (previously 5.9%), down from 6.3% y/y in 2016, and expect that rates will remain unchanged in 2017 after rising 75 bps in 2016 and 200 bps in total since January 2014. Our outlook assumes that the USDZAR will remain resilient despite political volatility, supported by better fundamentals, and average 13.25 in Q4:17 (Figure 21).

We anticipate that the current account deficit (CAD) will narrow in 2017 to 1.7% of GDP from an estimated 3.8% of GDP in 2016, although this is heavily dependent on commodity prices remaining near current levels, as most of the narrowing comes from the trade balance which we forecast will remain in surplus in 2017. The net income deficit will remain in deficit but is likely to narrow from 3.8% of GDP to 3.3% of GDP as offshore equity markets outperform versus 2016.

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With respect to growth, SA's biggest risk apart from political volatility will be the outlook for commodity prices and global growth. Following the significant improvement in commodity prices in H2:16, we revised our GDP growth forecast for 2017 from 1.0% to 1.4%. Because the outlook for commodity prices is uncertain, with the fundamental underpin not well understood, we assess risks to growth to be to the downside.

With respect to inflation, risks lie to the upside due to the oil price as well as food inflation, specifically red meat and poultry price inflation, which may rise by more than we anticipate.

With respect to the repo rate outlook, we expect a volatile year, and that at different times pressure will mount for both a hike and a cut

With respect to the repo rate outlook, we expect a volatile year, and that at different times pressure will mount for both a hike and a cut, as markets on the one hand anticipate rate hikes in the US and face domestic political volatility, leading the call for a higher risk premium, and on the other hand inflation falling back below 6.0%.

Qualitative assumptions

We assume that investors, particularly offshore investors, will be tempted to look through the noise of 2017

Our forecasts, specifically for the currency and interest rates, depend on political noise remaining in line with that of 2016, and assume that the National Treasury is not 'captured' by those looking to push through projects such as the nuclear build programme, which could be fiscally ruinous. We assume that investors, particularly offshore investors, will be tempted to look through the noise of 2017 in anticipation that *firstly* much of this is known and merely a continuation of what had started in late 2015 – and is therefore priced to some extent, and *secondly* that 2018 will be cyclically stronger from a domestic demand perspective. If this is the case, we expect portfolio inflows to be broadly supportive of asset prices and the ZAR.

GDP outlook

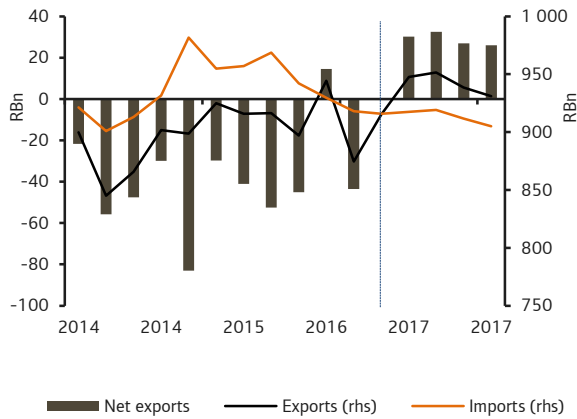
If commodity prices remain near current levels, GDP could recover to 1.4% in 2017

We expect that GDP growth will be driven by cyclical factors in 2017, and accelerate from its trough in 2016 which we estimate will average 0.4%. The current cycle is shallow and the drivers are mild; inflation is set to slow from 6.3% to 6.0% and our outlook for the repo rate is that it is likely to remain unchanged this year, versus 75 bps worth of increases in 2016, and we foresee pressure for both a cut and a hike to build at different times over the year. GDP growth over the next three years is expected to remain structurally below potential and importantly below population growth of 1.6%.

A recovery in GDP growth in 2017 is predicated primarily on a recovery in net exports, and will be most sensitive to global growth and commodity prices. If we exclude the most recent rally in commodity prices (i.e. Oct 2016 – Dec 2016), our estimate for GDP growth in 2017 would average 1.0%, rising to 1.4% in 2018 (Figure 14). This growth outlook assumes that a weighted index of SA's export commodity prices falls marginally, by 4.1% y/y on average in 2017 (Figure 13). However, if we assume the recent rally is sustained, such that SA's export commodity price index is on average 6.7% higher than it was in 2016, we could see GDP growth recover to 1.4% y/y in 2017 (see *Table 2* for more detail on our commodity price assumptions).

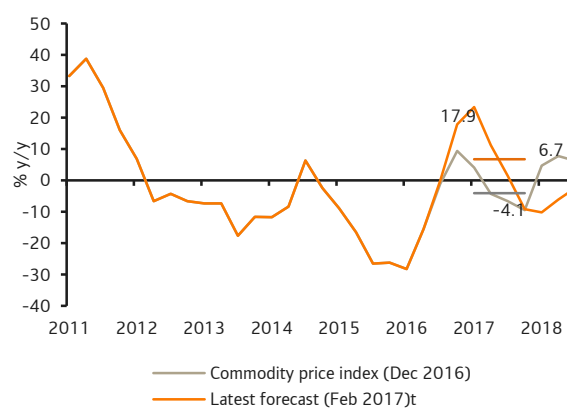
- **Higher export growth due to a recovery in commodity prices.** A weighted index of the price of SA's commodity exports rose 18% y/y in Q4:16, and we expect it will rise by a further 23% y/y in Q1:17 (in USD) (Figure 13), taking net exports from -R43bn in Q3:16 to -R0.5bn in Q4:16 and R30bn in Q1:17 (Figure 12). In a scenario in which commodity prices remain near current levels, net exports remain in surplus and average R29bn in 2017 after being in deficit in 2016 (we estimate net exports averaged -R19bn in 2016).
- **Our recovery in exports is also dependent on global growth** averaging 3% (Figure 15).
- **Net exports will also be driven by a continued contraction in import growth,** by 1.4% y/y on average for the year as consumption slows and investment remains in contraction (Figure 12);
- **The end of the drought** in SA should see the country return to being a net exporter of maize in Q2:17 after being a net importer in 2016.

Figure 12: Net exports to drive GDP recovery



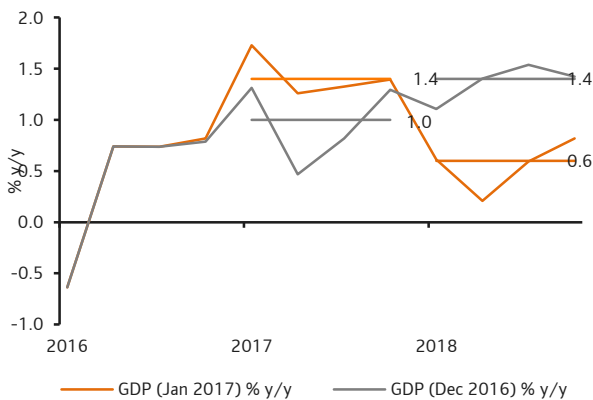
Source: SARB, Standard Bank Research

Figure 13: A weighted index of SA's commodity exports



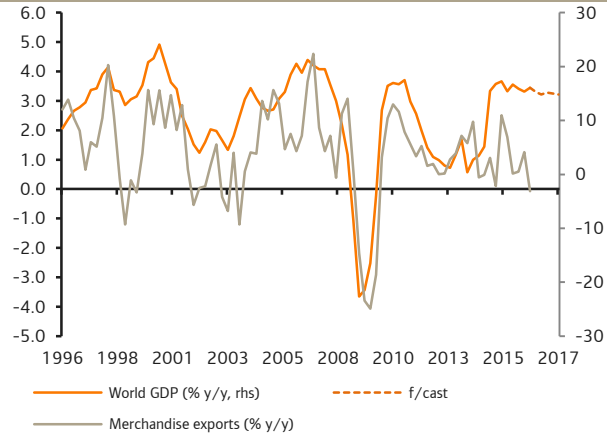
Source: Bloomberg, Standard Bank Research

Figure 14: GDP Growth scenarios based on commodity price assumptions



Source: SARB, Standard Bank Research

Figure 15: Exports dependent on world growth



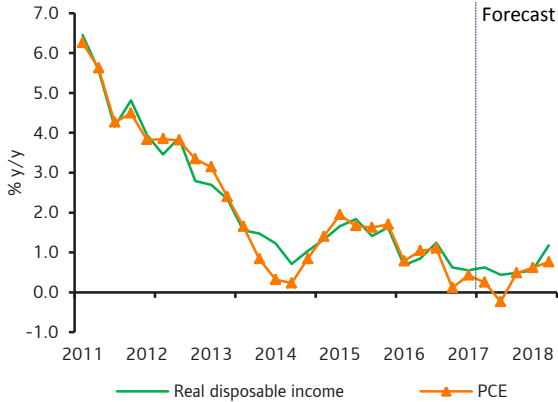
Source: SARB, Standard Bank Research, Bloomberg

Domestic demand: GDE to trough in Q3:17

- Real private consumption expenditure (PCE) growth averaged 0.8% in 2016 (according to our estimate), and we expect that it will slow to 0.2% in 2017** in response to last year's interest rate hikes, combined with tighter fiscal policy and continued job losses. Lower inflation should buffer these forces to some extent. We anticipate subdued growth in real disposable income (Figure 16) and for lenders to remain risk-averse for at least the first half of the year. Our forecast for employment growth is -0.8% in 2017 (Figure 18). This is equivalent to 108,000 cumulative net job losses.
- Cyclical PCE is expected to remain in contractionary terrain until 2018**, while non-cyclical PCE is estimated to remain slow but in positive territory (Figure 17). PCE growth is expected to remain below potential throughout our forecast period (to end 2018). Potential PCE growth is estimated to average 1.9% in 2017. Theoretically, this consumption gap should allow monetary policy to remain accommodative.
- Real fixed investment is projected to have contracted 4.2% y/y in 2016** as business sentiment struggled to recover to pre-2008 levels (Figure 19). In 2017,

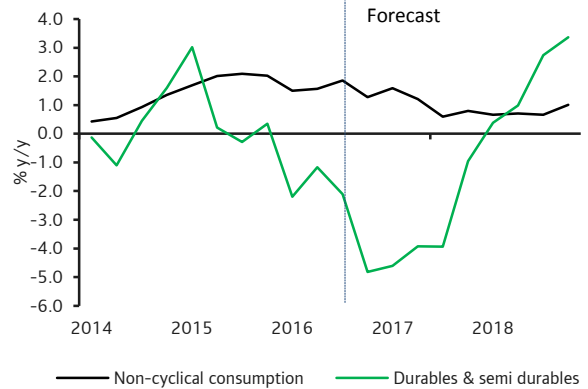
fixed investment is estimated to average -1.9%, rising to 2.5% in 2018 as confidence levels begin to pick up in response to a more stable electricity supply and reduced political uncertainty. Fixed investment has averaged 20.2% as a percentage of GDP since 2010 but is projected to remain below this average in the forecast horizon.

Figure 16: Subdued real disposable income to remain a drag on PCE growth



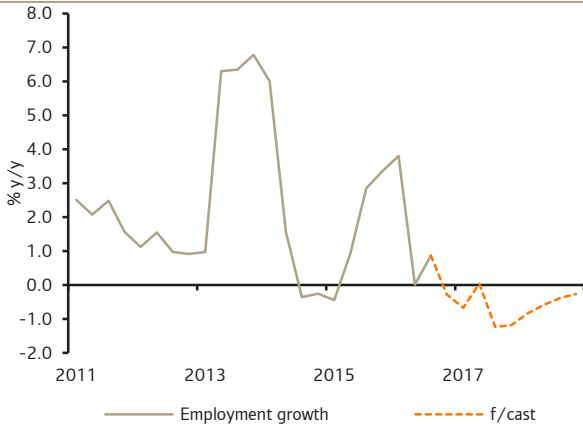
Source: SARB, Standard Bank Research

Figure 17: Cyclical consumption to remain in contractionary terrain through 2017



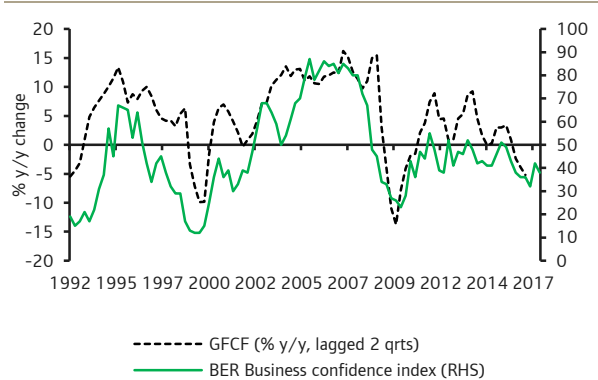
Source: SARB, Standard Bank Research

Figure 18: Employment growth to average -0.8% in 2017



Source: SARB, Standard Bank Research

Figure 19: Business confidence to remain a drag on fixed investment



Source: SARB, Standard Bank Research

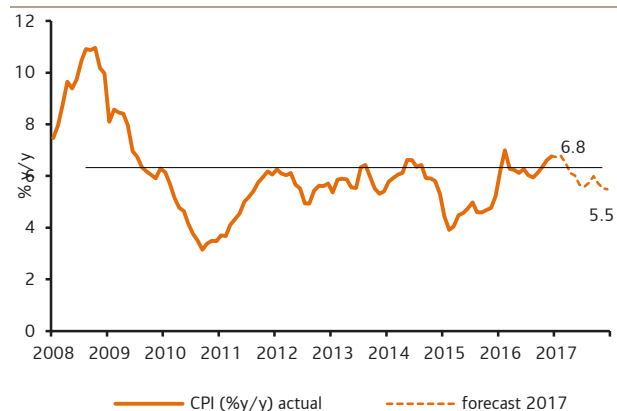
Inflation to average 6.0%

Inflation is expected to average 6.0% y/y and fall back within the target band in June. Risks lie to the upside due to the oil price, food inflation, and the exchange rate pass-through.

After the reweighting by Stats SA as well as assuming a marginally higher oil price in Q1:17, we have revised our CPI forecast for 2017 up slightly, from 5.9% to 6.0% versus SARB's forecast of 6.2%. This would still imply some moderation from an average of 6.3% y/y in 2016, although as with growth the inflation cycle is relatively shallow. Our 2017 forecast assumes oil averages USD53/bbl over the year, versus an

average of USD45/bbl in 2016, and the USDZAR strengthens over the year to average 13.25 in Q4:17 from 14.70 in 2016 (Figure 21).

Figure 20: CPI actual to Dec 2016 and forecast to end 2017



Source: Stats SA, Standard Bank Research

Figure 21: Quarterly average CPI and USDZAR forecasts, and oil assumptions

	CPI	Food	Oil	USDZAR
Q1:16	6.5	8.5	35	15.80
Q2:16	6.2	11.0	47	15.00
Q3:16	6.0	11.6	47	14.08
Q4:16	6.6	11.9	51	13.91
Q1:17	6.7	10.0	55	13.52
Q2:17	5.9	7.3	52	13.73
Q3:17	5.8	5.7	51	13.58
Q4:17	5.6	4.4	52	13.25
2015	4.6	5.1	54	12.77
2016	6.3	10.8	45	14.70
2017	6.0	6.8	53	13.52

Source: Stats SA, Bloomberg, Standard Bank Research

The inflation trajectory

We expect inflation peaked in December at 6.8% y/y (Figure 20). It may remain at 6.8% y/y in January and February, falling to 6.5% in March. Under our current oil and USDZAR assumptions, CPI should fall below the 6.0% target band in June for the first time since August 2016, to 5.7% y/y. There is likely to be volatility in headline CPI due to petrol price base effects (Figures 22 and 23) with CPI possibly printing above 6.0% again in September. We expect CPI to end the year at 5.5%/y.

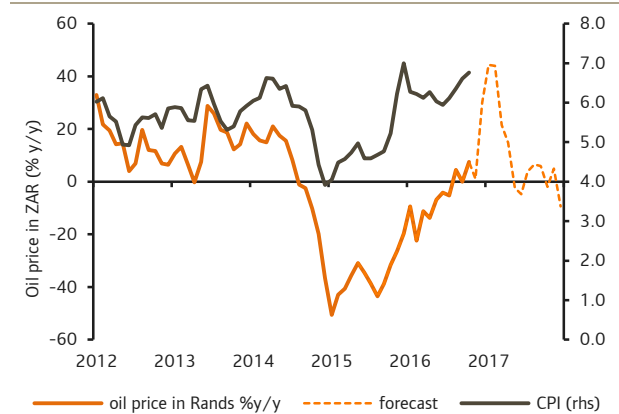
Two supply side factors should ensure that inflation moderates over the next few months:

- **Firstly, oil price base effects are positive in 1H2017:** oil rose from USD35/bbl on average in Q1:16 to USD47/bbl in Q2:16 and USD51/bbl in Q4:16. Using our assumption that oil will average USD54/bbl in 1H:2017, inflation in the price of oil peaks at 74% y/y in January and falls sharply to average 12% in Q2:17 (Figure 24).
- **Secondly, the maize price peaked in January 2016 and has been in decline since February 2016 while the wheat price has been in decline since May 2016.** Agricultural PPI inflation peaked at 25% y/y in February 2016 (due to wheat and maize prices) and has already fallen to 8.1% y/y.

In addition:

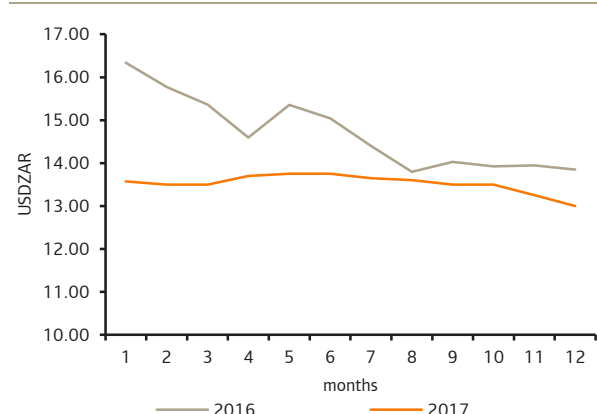
- **The Safex wheat price has started to fall** towards export parity on expectations of a healthy domestic harvest in 2017, and global wheat futures on average for 2017 are trading below the average wheat price in 2016. The Safex wheat price started to deflate year-on-year in September 2016, and we expect it will remain in deflation until August 2017.
- **We expect the Safex maize price will continue to fall**, from import parity to export parity, post SA’s domestic harvest in April. Currently import parity trades at just over R1,000/ton above export parity.
- **The stronger USDZAR should also assist inflation to moderate versus 2016**, although base effects will become less positive over the year (Figure 23); the USDZAR averaged 15.82 in Q1:16 and 15.00 in Q2:16 and we expect that it will average 13.63 in H1:17.

Figure 22: We expect the oil price base effect to become increasingly positive from February



Source: Bloomberg, Standard Bank Research

Figure 23: Stronger USDZAR will assist inflation, although base effects become less positive in 2H2017



Source: Bloomberg, Standard Bank Research

Poultry inflation is not expected to respond to lower maize prices as the capping of brine levels and import tariffs keeps chicken prices elevated versus 2016

Inflation risks

There are several sources of uncertainty with respect to the inflation outlook in 2017:

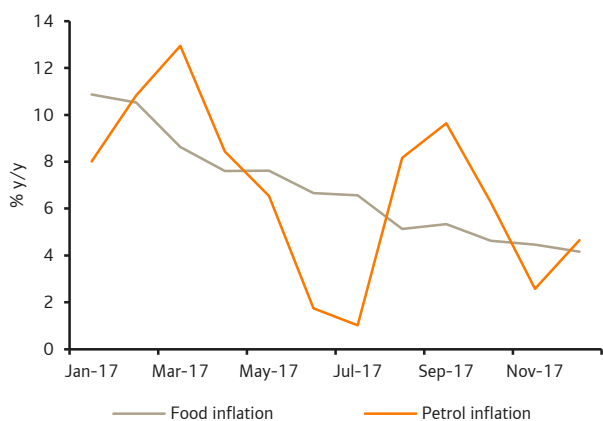
- *Firstly*, the exchange rate pass-through (ERPT), which has been falling by our estimates since 2010, may be starting to rise, or at least appeared higher according to the December 2016 data release, which will have implications for core inflation throughout the year.
- *Secondly*, food inflation has been sticky in recent months, with the fall in maize and wheat not being passed onto consumers as yet, despite weak demand (Figure 25). We suspect that pass through from wheat to cereals and bread will pick up at the end of February, once we have more certainty with respect to the 2017 domestic maize and wheat harvests. February rains will be critical to securing the bumper harvest expected and food prices may only respond to the fall in agricultural commodity prices once this year’s harvest is confirmed.
- *Thirdly*, we do not expect poultry prices to feel the full effect of lower maize prices, which will keep meat inflation elevated, due to:
 - Recent legislation, implemented in November, which has capped brining of frozen IQF chicken at 15% down from an estimated average of 40%. IQF chicken accounts for around 42% of the total chicken market. This will raise the price of IQF chicken per kilogram in 2017 versus 2016, despite lower feed costs.
 - DTI (Dept. of trade and industry) placed a 13.9% import tariff on chicken from the EU, which was implemented in December. The DTI may raise the import tariff again at some point this year. Industry is requesting import tariffs of 37%.
- *Fourthly*, the oil price remains a risk to our forecast and we have run some scenarios to look at the effects of a higher versus lower oil price. If oil rises to USD60/bbl by May and stays there, our model estimates that CPI would average 6.2%, ending the year at 5.8% y/y.

Table 1: 2017 CPI scenarios assuming different oil price trajectories

	Average in 2017			
Brent (USD/bbl)	52	53	55	59
CPI (%y/y)	5.9	6.0	6.0	6.2

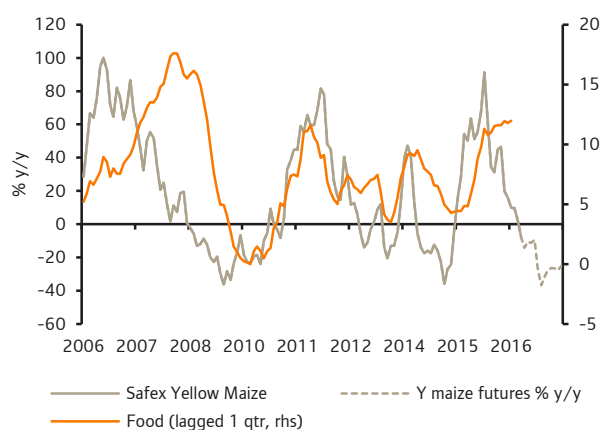
Source: Standard Bank Research

Figure 24: Food and petrol price inflation forecast



Source: Stats SA, Standard Bank Research

Figure 25: Food inflation has been sticky



Source: Stats SA

Repo rate outlook

If inflation declines as we expect to 5.5% by the end of the year, and the nominal repo rate remains unchanged at 7.0%, the real repo rate should rise from 0.2% currently to 1.4%. This could in theory give the SARB room to cut rates, especially if 1.) Growth remains below potential 2.) The currency is well behaved, supported by stronger global growth and higher commodity prices and 3.) The inflation differential between the US and SA falls as expected (Figure 26). This scenario assumes that emerging markets do not face a sudden stop scenario due to global risk events.

2017 is littered with event risks

However, we expect the repo rate will remain unchanged in 2017 and that the SARB is more likely to cut when some of the uncertainties, both global and domestic are behind us – yet again, 2017 is littered with event risks.

The SARB may also want to cut only once inflation is more firmly within the target band. Because inflation is anchored so close to the upper end of the target band, the SARB has very little room for manoeuvre; if the oil price moves towards USD60/bbl or the currency weakens, CPI could average above 6.0% to the end of Q3:17 – as they have conservatively anticipated in their latest outlook.

We also think the SARB is mindful of global inflation, and the effect rising global inflation may have on the exchange rate pass-through (ERPT).

The SARB has expressed their apprehension and warned that while they feel SA is close to the end of a rate hiking cycle, the sensitivity of the ZAR to the US is of concern

The challenge for the SARB (and central banks globally) will be how to deal with increased levels of uncertainty with respect to US policy and Brexit, and consequently developed market asset prices, and the spill-over effects for EM flows and EM asset prices, especially currencies. The SARB has expressed their apprehension and warned that while they feel SA is close to the end of a rate hiking cycle, the sensitivity of the ZAR to the US is of concern. We also anticipate that the sensitivity of the ZAR with respect to commodity prices and uncertainty surrounding their outlook will be of concern.

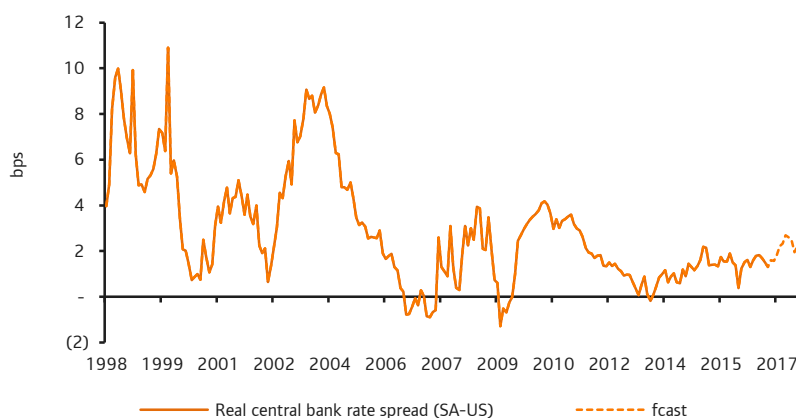
Pressure to hike

- **If the Fed starts to hike**, pressure may also mount for the SARB to hike. The SARB’s response to this question is consistent – that it does not track the Fed and that it has already raised rates 200 bps, while the Fed has only raised by 50 bps.

Market pressure should theoretically be placed on the SARB to maintain the *real* interest rate spread. We show in Figure 26 that even if the Fed hikes by 75 bps in 2017 and the SARB leaves rates unchanged at 7.0%, the spread of SA's real rate over the US Fed funds real rate (using spot CPI forecasts) would rise from 1.3% currently to 2.2% by the end of the year. This is because the SA real repo rate is expected rise from 0.2% to 1.5%, and the US Fed funds real rate is expected to rise from -1.1% to -0.7% (this assumes US CPI rises to 2.0% by year end from 1.6% currently).

- **Higher than expected oil price:** We believe the SARB will look through first round effects from a higher oil price and wait for it to manifest in second-round effects.
- **Domestic political noise resulting in a weaker currency:** The currency is vulnerable to extreme political noise involving further attempts to capture the Treasury.

Figure 26: SA's real repo rate spread over the real Fed funds rate

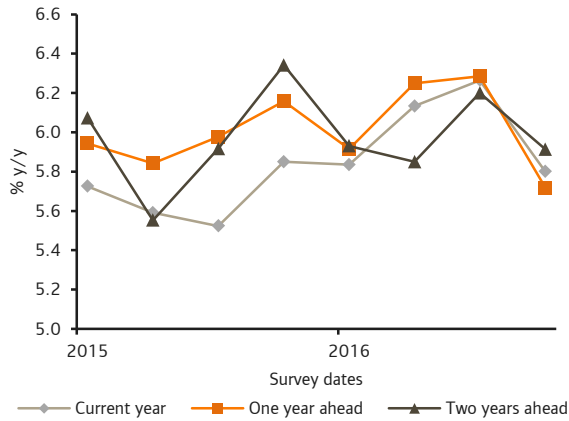


Source: Bloomberg, Standard Bank Research

Pressure to cut

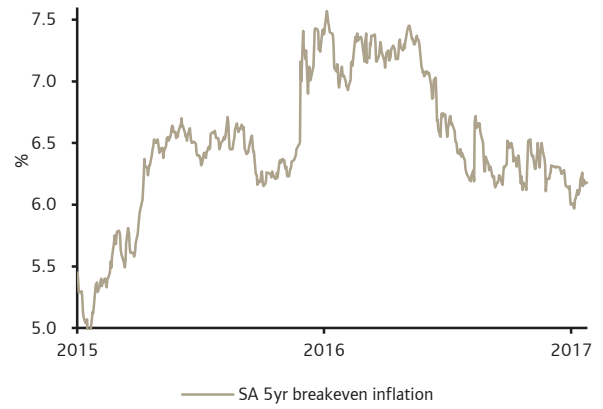
- **Weak growth:** If the cyclical upswing in growth plays out as we expect in 2017, pressure to cut in support of growth will diminish.
- **Lower structural inflation:** The SARB has emphasised lower structural inflation risks specifically risks emanating from wage inflation. Real wages have declined and the latest BER survey shows a fall in the inflation expectations of labour unions (Figure 27). Although labour unions may raise their inflation expectations by the time the next survey is completed for Q1:17, they are fragmented and far less powerful than they were during the commodity price boom. The market's inflation expectations have also moderated, according to the 5Y break-even inflation (Figure 28).
- **Cyclically lower inflation:** Despite upward revisions to the near term inflation forecast due to higher oil prices as well as sticky food inflation, SA is still near if not at a peak in inflation and recent rains, base effects and weak domestic demand should allow CPI to slow towards 5.5% by year-end.
- **Resilient ZAR:** In addition, the currency has become a lot more resilient to political noise, and much of the ongoing battle for power is within market expectations.

Figure 27: Labour union's inflation expectations (BER)



Source: BER

Figure 28: 5Y Break-even inflation falling



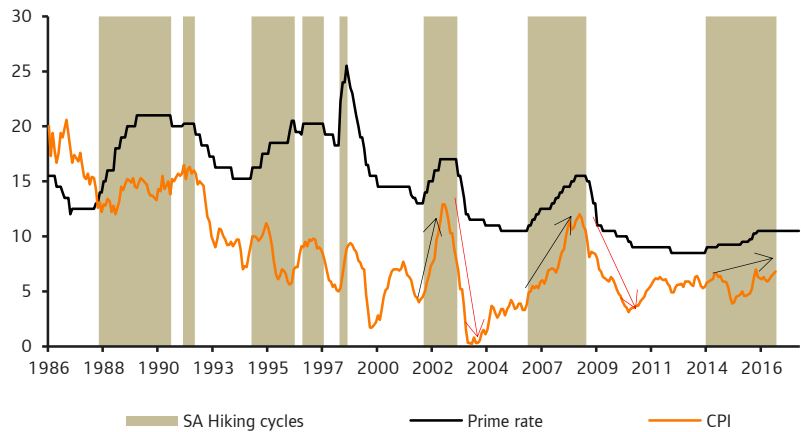
Source: Bloomberg

Pressure for the SARB to move in both directions is a symptom of shallow cycles

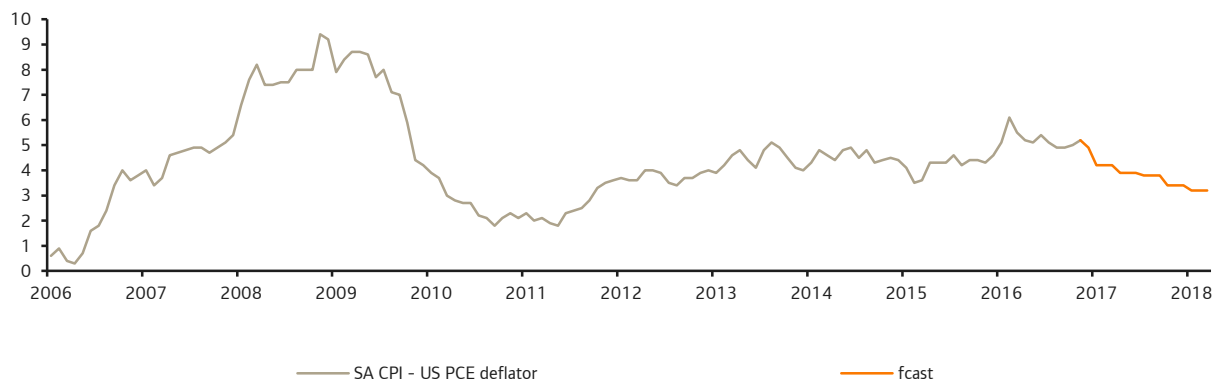
Shallow inflation and interest rate cycles translate into shallow growth and earnings cycles, and we expect this will characterise the recovery in SA over the next 18 months

We highlight how long and shallow the 2014-2016 inflation and rate hiking cycles have been, relative to history, in Figure 29. We expect this will continue in 2017 and that it should remain the case for as long as global inflation remains historically low and below targets. In this respect, we note that US inflation at 1.6% y/y is still below the Fed's target of 2.0%. Shallow inflation and interest rate cycles translate into shallow growth and earnings cycles, and we expect this will characterise the recovery in SA over the next 18 months.

Figure 29: The current inflation and rate hiking cycle are very shallow



Source: Stats SA, SARB, Standard Bank Research

Figure 30: We anticipate that the inflation differential between SA and the US should fall in 2017, would should place less pressure on SA rates

Source: SARB, Standard Bank Research

Table 2: Commodity price assumptions for 2017 and 2018

	Platinum	Palladium	Aluminium	Steel	Copper	Iron ore	Coal	Gold
Q4:16	949	684	1709	620	5291	71	83	1213
Q1:17	980	700	1700	600	5868	76	75	1225
Q2:17	1000	750	1700	600	5500	65	70	1250
Q3:17	1000	725	1700	575	5500	60	70	1250
Q4:17	1000	700	1700	550	5500	60	70	1275
Q1:18	1000	700	1700	550	5750	55	65	1300
Q2:18	1000	700	1700	550	5750	55	65	1300
Q3:18	1000	700	1700	550	5750	55	65	1300
Q4:18	1000	700	1700	550	5750	55	65	1300

Source: Standard Bank Research, Bloomberg

Table 3: Macroeconomics forecasts

Growth data (% y/y, seasonally adjusted & annualised)	Q1:16	Q2:16	Q3:16	Q4:16	Q1:17	Q2:17	Q3:17	Q4:17	2016	2017
Expenditure on GDP	-0.6	0.7	0.7	0.8	1.7	1.3	1.3	1.4	0.4	1.4
Household consumption expenditure	0.8	1	1.1	0.1	0.4	0.3	-0.2	0.5	0.8	0.2
Durable consumption	-8.2	-7.1	-7.1	-6	-4.9	-3	-3.4	-2.3	-7.1	-3.4
Semi-durable consumption	4.4	5.1	3.1	-3.6	-4.3	-4.8	-4.4	0.3	2.3	-3.3
Non-durable consumption	1.2	0.9	1.2	0.7	1	1.1	0.6	0.5	1	0.8
Services consumption	1.8	2.1	2.4	1.8	2.1	1.3	0.6	1	2	1.2
Government consumption	1.5	1.5	1.8	1.6	0.5	-0.3	-0.5	-0.5	1.6	-0.2
Gross fixed capital formation	-2.4	-3.9	-5.2	-5.4	-3	-1.7	-1.7	-1.2	-4.2	-1.9
Gross domestic expenditure	-1.8	-0.7	0.8	-0.5	-0.3	0.7	-1	0.1	-0.5	-0.1
Exports	-0.2	2.1	-4.5	-0.1	5.7	0.8	7.3	1.7	-0.7	3.9
Imports	-4	-2.6	-4.1	-5.5	-2.6	-1.1	-0.7	-1.2	-4	-1.4
Current Account Balance % of GDP	-5.3	-2.9	-4.1	-2.3	-0.5	-1.1	-2.3	-2.8	-3.6	-1.7
Prices										
Inflation (average)	6.5	6.2	6	6.6	6.6	6	5.9	5.7	6.3	6.0
Interest rates (%)										
Prime lending rate (end period)	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5	10.5
Commodity prices										
Gold (\$/oz)	1193	1259	1335	1218	1225	1250	1250	1275	1251	1250
Platinum (\$/oz)	917	1012	1097	949	980	1000	1000	1000	994	995
Palladium (\$/oz)	527	568	679	684	700	750	725	700	614.5	719
Copper (\$/mt)	4669	4728	4793	5291	5868	5500	5500	5500	4870	5592
Brent (\$/bbl)	34	47	47	51	55	55	55	55	45	55

Source: SARB, Standard Bank Research

Rand may surprise in 2017 – broadly sideways to marginally stronger

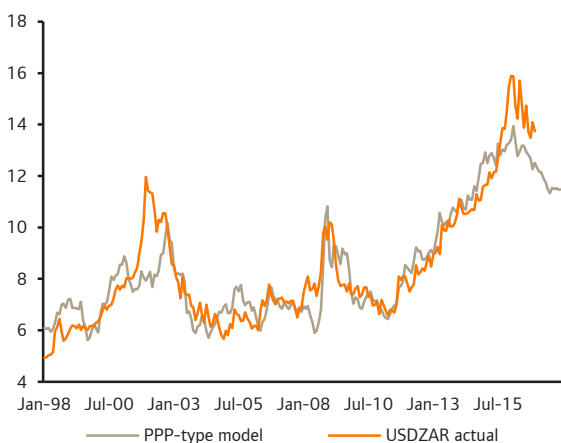
We still expect the rand to approach 13.00 against the dollar

Our view is still that rand weakness will fade, based on the underlying fundamentals. We define rand weakness on approach of 14.00 – 14.50. As base case we still expect the rand to move closer to 13.00 against the dollar. At this stage we pencil this level in closer to year-end, but the currency may well move there earlier.

The rand remains well behaved, in line with our expectations

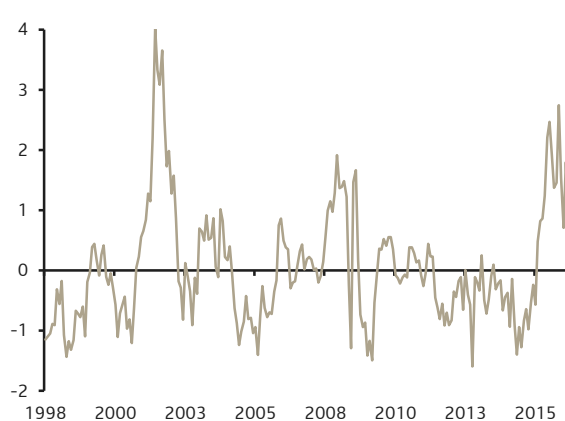
We continue to believe the rand is undervalued based on underlying economic fundamentals including inflation, growth, and interest rate differentials. We note that since H2:15, based on fundamentals, the rand has been trading between R0.70 and R2.70 higher than it should (Figures 31 and 32). The PPP-type model suggests that the currency should have traded closer to 12.50 during December 2016 than the 13.70 we saw. We believe that most of this risk premium can be attributed to country-specific risks.

Figure 31: ZAR PPP-type model vs. actual



Source: Bloomberg, Standard Bank Research

Figure 32: Spread btw ZAR PPP-type model and actual



Source: Bloomberg, Standard Bank Research

The long-term trend support for the USDZAR, dating back to 2011, comes in at around 13.40/13.50 (Figure 33). If this support should give for an extended period, the USDZAR may well push lower, towards 12.50. This would be a momentum trade, similar to the one seen in the GBP early October (Figure 34). On the balance of probabilities, given lingering risks, our base case is that resistance at 13.40/13.50 will hold in early 2017.

Figure 33: USDZAR long-term support



Source: Bloomberg, Standard Bank Research

Figure 34: GBPUSD breaking below support in Oct'16

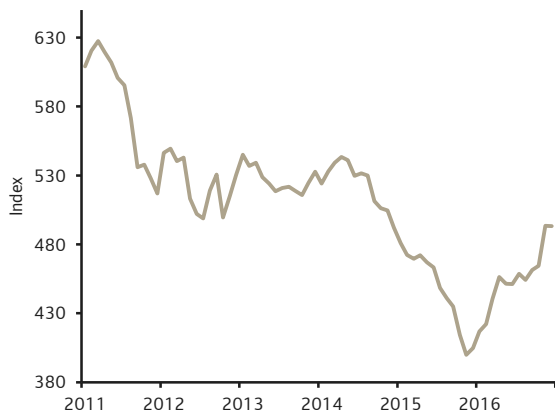


Source: Bloomberg, Standard Bank Research

At the same time, on the back of expectations of higher growth in the US, commodity prices have turned higher

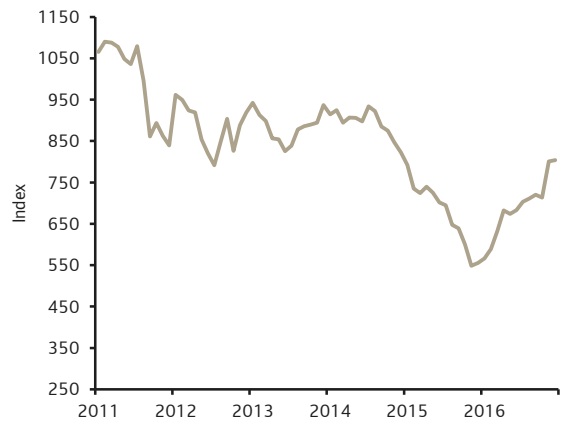
The rand remains a commodity currency and growth optimism has also seen commodity prices move higher. This should support the rand in an environment where US rates are expected to increase.

Figure 35: CRB raw industrials



Source: Bloomberg, Standard Bank Research

Figure 36: CRB metals



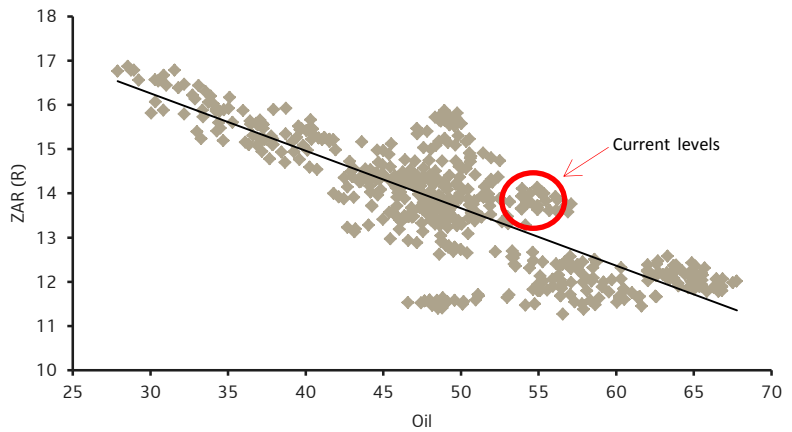
Source: Bloomberg, Standard Bank Research

This is especially the case for metals and bulk commodities – South Africa’s major exports – as indicated by the CRB metals and raw commodities indices (Figures 35 and 36).

Although oil, which is South Africa’s single largest import, is also higher, there is generally a linear negative relationship between higher oil prices and the USDZAR over the medium term

Although oil, which is South Africa’s single largest import, is also higher, there is generally a linear negative relationship between higher oil prices and the USDZAR over the medium term (Figure 37). The current linear relationship has been in place since 2015 and suggests that with Brent crude placed around \$55/bbl, the USDZAR should be closer to 13.00 than 14.00.

Figure 37: ZAR vs. oil (2015 – present)



Source: Bloomberg, Standard Bank Research

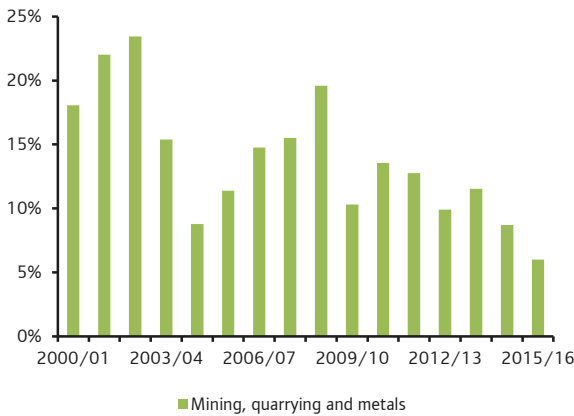
We won't argue that a higher oil in the long run is negative for the rand from a trade balance perspective but, as long as it goes alongside a rise in other commodity prices (as we have seen), the impact is mitigated.

An additional benefit is the possibility that higher commodity prices may see corporate income tax surprise on the upside, compared to expectations six months ago

Tax payments by the mining and quarrying sector (including metals) has diminished in share of total corporate tax payments

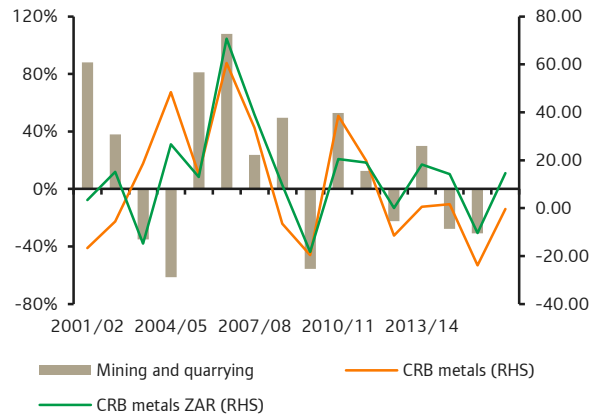
Tax payments by the mining and quarrying sector (including metals) has diminished in share of total corporate tax payments, from as high as 18.2% in 2002/03 to an average of 9% over the past three fiscal years, and more recently to 6% in 2015/16 (Figure 38).

Figure 38: Provisional tax payments (share of total CIT)



Source: National Treasury

Figure 39: CIT sectoral growth



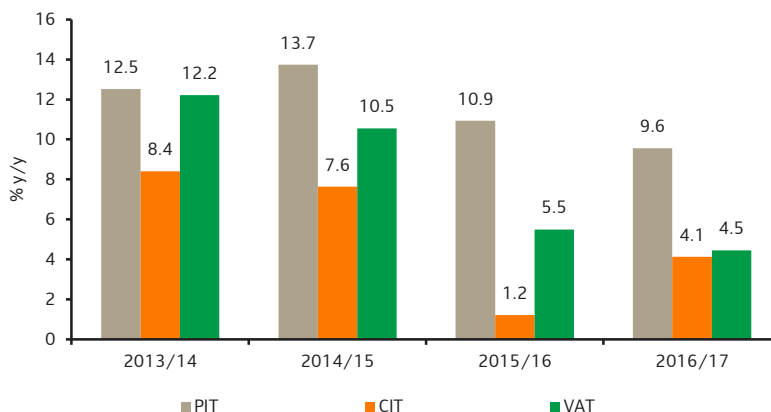
Source: National Treasury

The relationship between tax payments in the mining and quarrying sector and commodity prices can easily be seen in Figure 39. The CRB metals index closely tracks the growth in mining and quarrying tax payments. This is encouraging as it is likely to see tax payments increase accordingly on the back of corporate income tax collection in the mining and quarrying sector.

Corporate income tax (CIT) revenue collection has, for the fiscal year up to November, shown growth of 4.1% y/y. This is already faster than growth seen in 2015/16 (over the same period) and may accelerate even further on higher commodity prices.

The 2016 MTBPS puts CIT revenue growth estimates for the current fiscal year at 5.2% y/y. This we believe is likely to be reached now (and maybe even slightly overshoot) on higher commodity prices and the fact that seasonally, CIT revenue collection picks up in any case in the final quarter of the fiscal year.

Figure 40: Revenue collection – YTD (% y/y)



Source: National Treasury

Inflation set to peak as rand finds support, providing for further tightening in real terms – which is in turn rand-positive

Support for the rand, despite a higher oil price, would put the peak in South African inflation behind us. We continue to see inflation moving lower from here, falling back into the target band in Q2:17, after peaking in Q1:17, and remaining within the target band for the rest of 2017. We expect inflation to average 6.0% y/y in 2017.

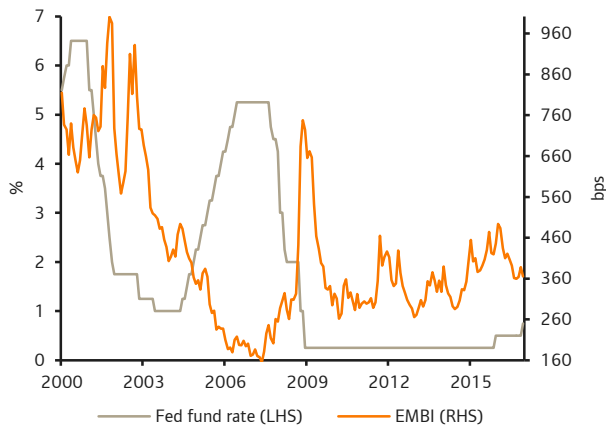
Fed policy impact on South Africa will depend on the growth outlook which goes alongside Fed hikes

Alongside higher inflation expectations, especially in the US, and the possibility of a US rate hike, we note that South Africa’s bond spread over that of the US doesn’t necessarily need to rise. In fact, in the past higher US policy rates, that coincided with higher growth generally, went hand-in-hand with a compression of South Africa’s country spreads.

The EMBI spread compressed during the previous Fed hiking cycle, while a longer time series of South African 10-year spread to the US also indicates that there is no consistent reaction to US policy tightening. Once again, what is important in our view is that the Fed hiking cycle will have to go alongside higher global growth for spreads to remain steady or decline rather than rise. The worst outcome would be a stagflation environment in the US where growth slows, but accelerating inflation forces the Fed to hike.

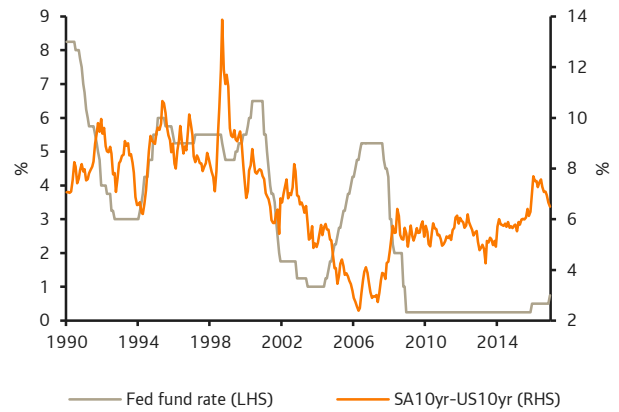
Alongside higher inflation expectations, especially in the US, and the possibility of a US rate hike, we note that South Africa’s bond spread over that of the US doesn’t necessarily need to rise

Figure 41: EMBI spread vs. Fed since 2000



Source: Standard Bank Research, Bloomberg

Figure 42: SA 10-year spread vs. Fed since 1990

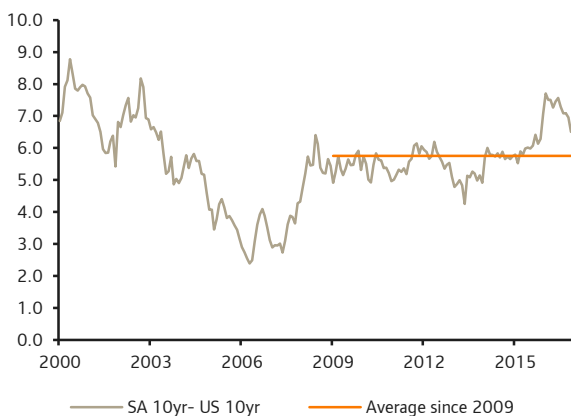


Source: Standard Bank Research, Bloomberg

How we interpret local bond yields in terms of US bond yields

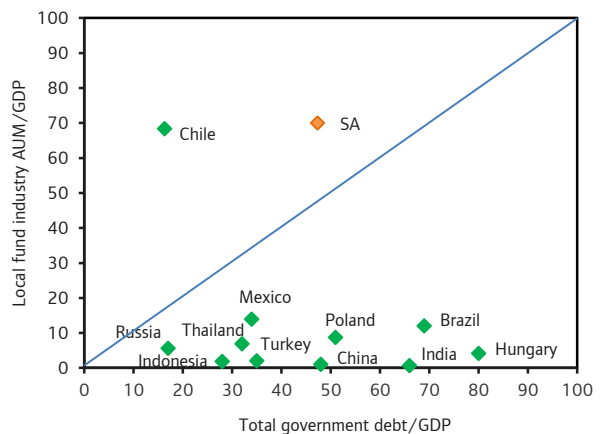
In our report “Closing the Nene-gap” dated 7 December 2016 we argued that South Africa’s country spread over the US could revert to the mean of 575 bps since 2009 irrespective of rating actions as spread compression is not only a function of credit risk, but also inflation risk (which, arguably, dominates in local bond yields). Since December, the spread has compressed marginally from around 645 bps to the current 630 bps. We continue to believe some compression of around 50 bps is possible. While foreign interest in EM bonds may decline, we continue to believe that South Africa is better placed to withstand foreign selling mainly because local assets under management is far greater than most of South Africa’s peers, arguably making the South African bond market more resilient than most as long as locals are willing to buy SAGBs. This of course will to a large degree depend on inflation and, by implication, the rand.

Figure 43: SA 10-year bond spread relative to US 10-year



Source: Bloomberg, Standard Bank Research

Figure 44: Assets under management (AUM) vs. debt



Source: Standard Bank Research, IMF, NT, OECD

The Nene-gap

The spread between the US 10-year bond yield and that of South Africa has widened substantially since 2013, with pressure on South Africa’s bond yields initially triggered by the Taper Tantrums in 2013 and then again in Q2:15 on a rising probability that the US Fed might hike rates. The move higher in domestic yields was compounded by idiosyncratic risk – specifically the removal of then Finance Minister Nene in December 2015 (Figure 43). Although, during the course of 2016, the spread has narrowed again, it is still at 650 bps – almost 100 bps wider than the average since 2001 of 550

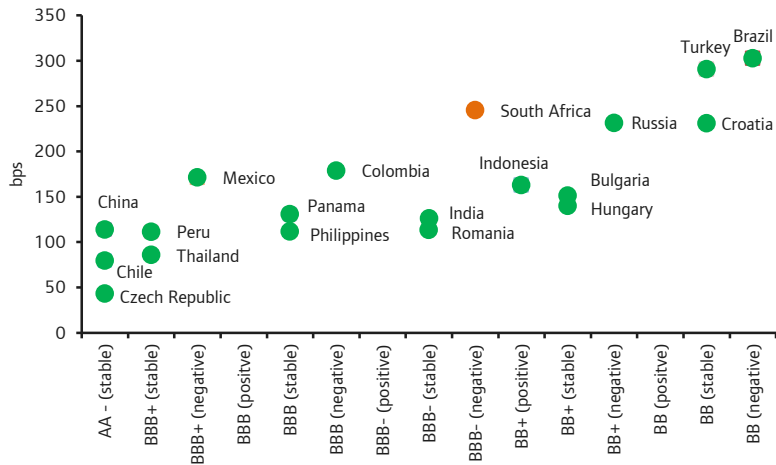
bps when inflation targeting was implemented and around 75 bps wider than the average spread since 2009 of 575 bps.

The important question is whether South Africa can remove the Nene-premium despite the fact that South Africa’s creditworthiness, both on the local and foreign currency front, deteriorated in recent months, according to the major rating agencies. We believe so.

Peers managed to revert to averages despite a rise in risk

We take a look at how South African peers have performed relative to the US. Specifically, we look at Brazil, Turkey, Russia, Indonesia, Mexico and Colombia. All of these countries currently have a 5-year USD CDS that’s trading high relative to the respective foreign currency rating by S&P (Figure 45). Some countries, such as Brazil, Russia and Turkey, have experienced ratings downgrades to non-investment grade in recent years by one or more rating agency, while the likes of Indonesia and Mexico have seen an improvement in their foreign currency rating.

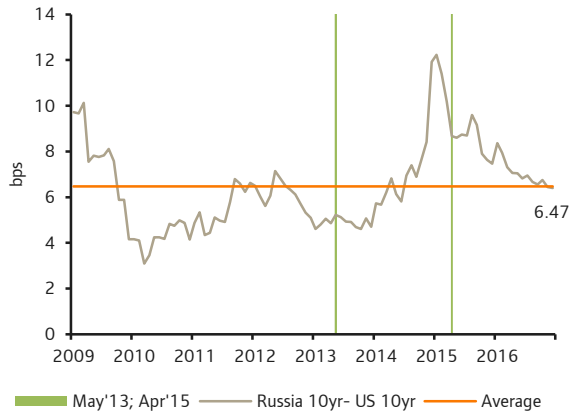
Figure 45: 5-year USD CDS vs. country risk



Source: Bloomberg, Standard Bank Research

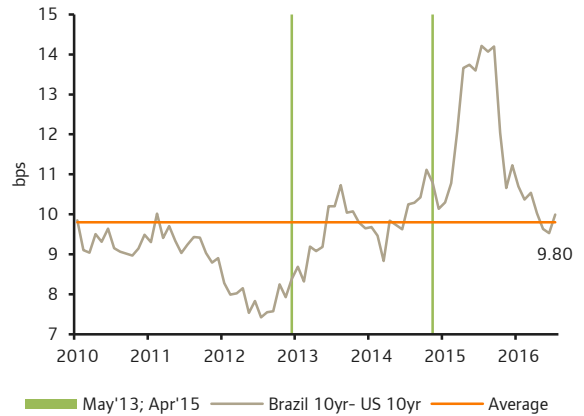
Similar to South Africa, all six countries under discussion moved from a position where their 10-year domestic bond spreads (relative to the US) traded well below the average spread since 2009, before the Taper Tantrums of 2013, to a position where spreads were trading well above the average by the start of 2016.

Figure 46: Spread between Russia10yr and US 10yr



Source: Reuters, Standard Bank Research

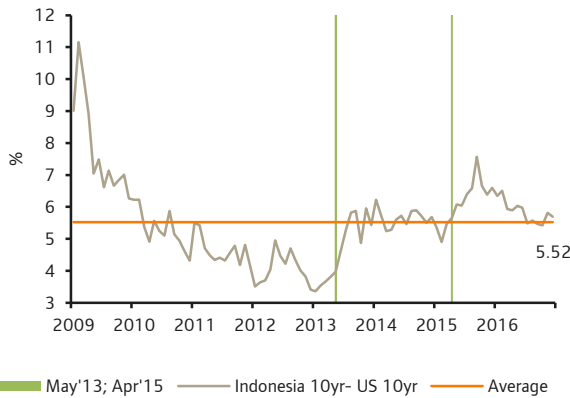
Figure 47: Spread between Brazil10yr and US 10yr



Source: Reuters, Standard Bank Research

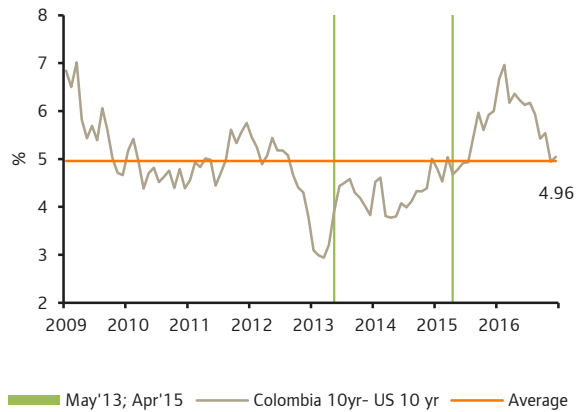
The country spreads for Russia, Brazil, Indonesia and Colombia peaked in either 2015 or 2016, and has subsequently returned to their average levels, irrespective of whether a country has seen an improvement in its foreign currency rating such as Colombia and Indonesia, or whether it has seen deterioration such as Russia and Brazil (Figures 46 to 49).

Figure 48: Spread between Indonesia10yr and US 10yr



Source: Reuters, Standard Bank Research

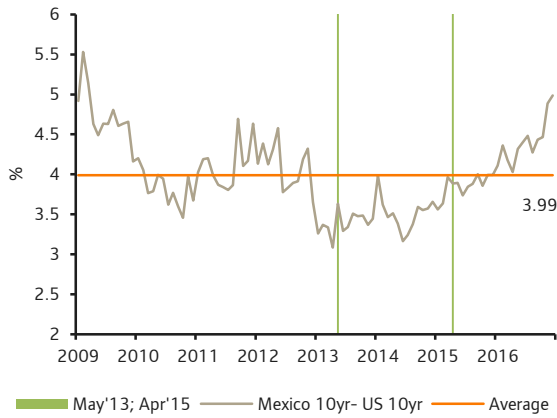
Figure 49: Spread between Colombia10yr and US 10yr



Source: Reuters, Standard Bank Research

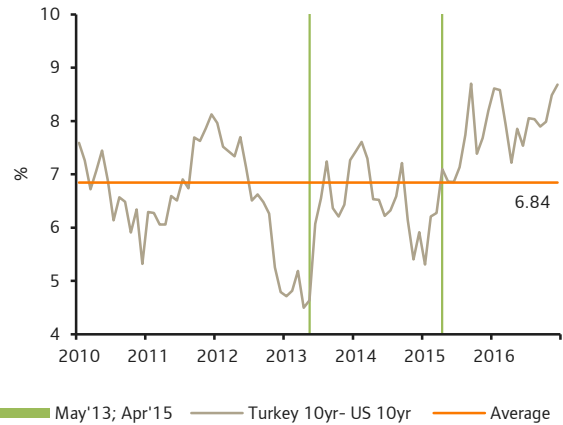
As always, there are exceptions; in this case, Mexico (upgraded by rating agencies) and Turkey (downgraded by rating agencies). Both countries, irrespective of their rating actions, have seen the spread relative to the US blow out in recent months. But we believe that this was due to very specific circumstances, such as the US presidential election in the case of Mexico, and the political purge in Turkey in recent months (Figures 50 and 51).

Figure 50: Spread between Mexico 10yr and US 10yr



Source: Reuters, Standard Bank Research

Figure 51: Spread between Turkey 10yr and US 10yr



Source: Reuters, Standard Bank Research

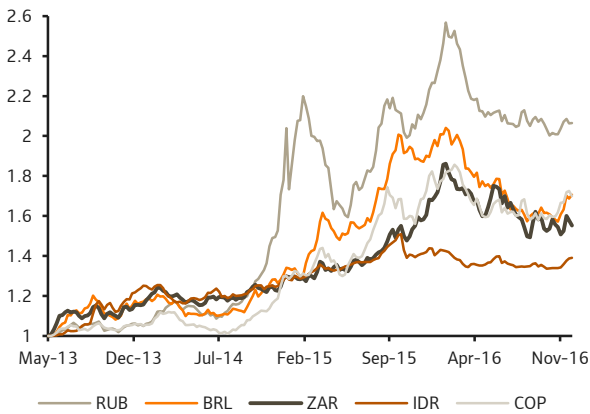
Closing the Nene-gap

Clearly, a country’s bond spread can compress to average levels, no matter which way credit ratings went. Spread compression is therefore not only a function of credit risk, but also inflation risk (which, arguably, dominates in local bond yields).

Looking at the recent developments in Mexico and Turkey (and, earlier, Brazil and Russia), the political landscape matters, and it is a key driver of idiosyncratic risk, currency weakness and, ultimately, inflation.

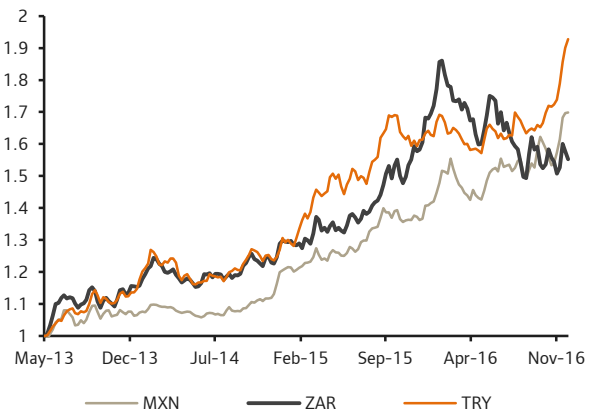
For South Africa, we believe that although the political landscape will remain in flux, 2017 will be less uncertain than 2016; i.e. the momentum is positive. This, in our view, would be one factor (amongst others) driving a more stable rand in 2017, compared to what we’ve witnessed since 2015.

Figure 52: Ccy movements for mean-reverting spreads



Source: Bloomberg, Standard Bank Research

Figure 53: Currency performance of Mexico and Turkey



Source: Bloomberg, Standard Bank Research

South African bond yields, if US yields rise

Firstly, if politics in South Africa become less uncertain and inflation indeed peaks in November, then we see little reason why South Africa’s country spread cannot compress closer to the average since 2009 of 575 bps. Brazil, Russia, Colombia and Indonesia have done this – South Africa could do the same.

Secondly, the absolute value of South Africa's 10-year bond yield would of course depend on where the US 10-year bond yield is. With a US 10-year bond yield at say 2.50% and South Africa manage to close the Nene-gap, it would put South Africa's bond yield (eventually) at 8.35%. Likewise, a US 10-year bond yield at 3% will put South Africa's 10-year yield (eventually) at 8.85%.

Thirdly, irrespective of where the US 10-year bond yield is, and is going, we believe that given a lack of compression in South Africa's country spread relative to many of its peers, combined with a more stable rand, South African bonds may outperform peers.

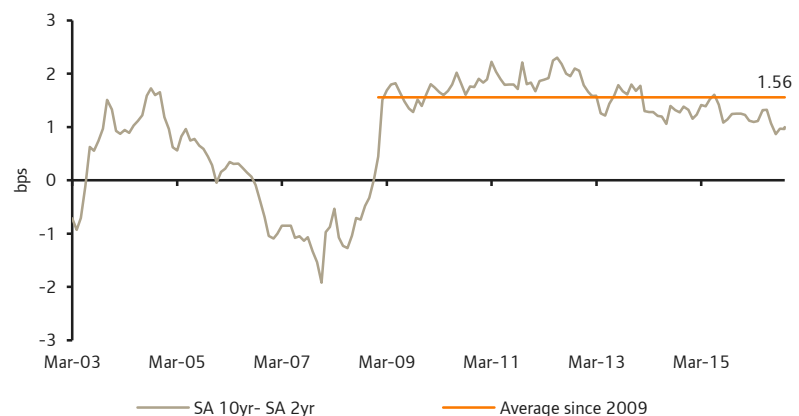
This implies an even flatter curve first via a bull curve flattening

The SA 10y/2y slope is already quite flat, with the spread below 100 bps (Figure 54). But it may flatten even further.

Assuming that the SARB keeps rates on hold in 2017 (our base case), combined with the fact that the front-end of the curve (R203) is only 25 bps above 3m JIBAR and the 10-year bond yield (R186) could potentially compress 75 bps, the curve is likely to flatten.

Eventually, once there is more certainty on whether the next move by the SARB is indeed a cut (also our base case), and the market actually starts pricing a cut, it will provide further upside for bonds, although we would expect some bull-curve steepening when this happens.

Figure 54: SA 10yr-2yr spread



Source: Bloomberg, Standard Bank Research

Our strategy

We still favour bonds in 2017, with potential upside for the R186 towards 8.10% – 8.30%. There is of course the possibility that the US 10-year bond yield could move to 3% (rather than stabilise between 2.30% and 2.50% in the medium term), which ultimately may put the R186 at 8.85% (assuming eventual mean-reversion of the country spread). We therefore would refrain from increasing exposure from levels close to 8.85%. While there may be value already, from a risk-return perspective anything above 9% is worth at least a look.

Table 4: Currency forecasts (period end)

	Q1 17	Q2 17	2017	2018	2019
USDZAR	13.75	13.75	13.00	14.00	14.50
EURZAR	13.75	13.48	13.26	16.10	16.74
GBPZAR	15.81	15.95	16.12	18.20	18.93
ZARJPY	8.73	9.45	9.23	7.86	5.86
AUDZAR	9.90	8.94	9.10	11.76	13.05
CADZAR	10.04	9.48	9.29	10.77	13.06
CNYZAR	1.94	1.88	1.78	14.00	14.50
CHFZAR	14.71	15.13	13.78	16.10	16.74
NZDZAR	9.35	8.94	8.71	18.20	18.93

Source: Standard Bank Research

Table 5: SAGB forecasts (period end)

Bond	Years-to-maturity	Yields as of 31-Jan'17	Previous Q4:17 forecast	Q2:17	Q4:17
R203	1	7.66	7.10	7.30	7.10
R208	5	8.15	7.80	7.90	7.80
R186	10	8.84	8.10	8.20	8.10
R209	20	9.47	8.80	8.90	8.80
R2048	32	9.60	8.90	9.00	8.90

Source: Standard Bank Research

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