

Comment

Drivers of macro and markets in 2016

The Fed

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& ratings

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Introduction

The past 12 months has been challenging for the domestic economy as both domestic and external factors weighed in on confidence levels and GDP growth. Our October 2015 baseline forecast was for growth to remain tepid in 2016 with a number of downside risks. As we close in on 2016, this comment reflects on some of these risks in more detail. We specifically stayed clear of topics, including the health of the consumer, that were elaborated on in our 2015Q4 *Economic Prospects* publication. In our view, there are likely to be at least five main drivers of the SA economy and financial markets in 2016. These are:

The Fed (ECB & others) and SA balance of payments dynamics

The US Federal Reserve (Fed) is widely expected to (finally) start its interest rate normalisation process later in December. This is at a time when the European Central Bank (ECB) has just announced a further (albeit less than some had expected) loosening of monetary policy. Divergence in monetary policy between the Fed (and perhaps the Bank of England later in 2016) on the one hand and the ECB / Bank of Japan (BoJ) on the other is set to intensify in 2016. While the Fed is likely to be ultra-moderate in the pace of rate rises through 2016, the policy divergence should see the US dollar gain further ground against the Euro. The ECB / BoJ stimulus should ensure that global liquidity remains elevated. However, the taper tantrum of 2013 is a timely reminder that, on the margin, US policy actions have by far the greatest influence on international financial market sentiment.

Against this backdrop, the financing of SA's current account shortfall will remain a challenge. This is especially the case since there are pull (higher US interest rates) and push (weak domestic growth with little scope for a policy response) factors that seem to be denting foreign investor sentiment towards SA. Increasingly, these concerns seem to be top of mind at the SA Reserve Bank (SARB) and (in our view) largely explain why the repo rate was increased by 25bps in November. Fed tightening and domestic vulnerabilities expose the rand to further losses (against the US dollar) in 2016 and place downside risk to our forecast that the currency will average R14.20/\$ in the first half of 2016. Furthermore, it also suggests that the SARB may be forced into more aggressive interest rate hikes than our baseline forecast of "only" another 50bps worth of increases in 2016.

Drought impacts

While global interest rate developments are arguably the biggest threat to the rand exchange rate, the worsening drought poses one of the major domestic GDP growth risks for 2016. Unlike late 2014/ early 2015 when drought mainly impacted the maize-growing areas, the drought conditions are now more widespread. Indeed, KwaZulu-Natal, Mpumalanga, North West, Limpopo and the Free State have all been declared drought disaster areas. A number of companies have already reported significantly reduced crops, or expectations for lower yields. Kaap Agri recently said that it expects the Swartland (Western Cape) wheat crop to be 40% below normal levels¹. Tongaat Hulett expects SA sugar output of 310,000 to 325,000 tonnes in 2015/16, which would also be down 40% from the 541,000 tonnes in 2014/15. Wheat was responsible for 2.6% of the total value of agricultural output in 2014 with sugar cane contributing 3.8%. Sappi has also warned about the likelihood of lower pulp production.

One of the key drivers of overall agricultural production in 2016 is set to be the size of the maize crop. In 2014, maize contributed about 13% to total agricultural output. In late October 2015, the Crop Estimates Committee released the results of its 'intentions to plant' survey amongst maize farmers. It showed that, in mid-October, farmers planned to plant 2.55 million hectares of maize, down almost 4% from the area planted in 2014/15. However, more recent indications from Grain SA are that, with only a couple weeks left to plant, there are large parts of the country where farmers have not nearly planted the earlier expected hectares. If the rain stays away through end December, the 2015/16 maize crop could be down sharply from the 9.9 million tonnes produced in 2014/15.

The impact on GDP growth will not only flow from weaker agricultural output, but also from increased imports as the domestic shortages will have to be sourced from abroad. Besides the impact on agriculture, reports have already surfaced that water shortages are hampering mining activities in certain parts of the country. Although the agricultural sector only makes up around 2% of GDP, weaker agricultural demand has spillover effects to other sectors. Reduced farming income is set to keep tractor and other agricultural equipment sales under pressure. Indeed, selected respondents to the BER's monthly PMI survey have indicated that the drought is weighing on the demand for manufactured goods.

We will be in a better position to make a call on the GDP impact early next year once there is greater clarity on maize plantings. However, at this stage, there is little doubt that the drought places a specific downside risk to our GDP growth forecast of 1.4% for 2016.

Fiscal slippage, municipal elections and credit ratings

It could be argued that the concerns surrounding fiscal policy, the lead-up to and outcome of the 2016 municipal elections and the potential that SA loses its investment grade credit rating warrant individual mention. In our view, these developments are closely related, hence we grouped them together. Starting with **fiscal policy**, the February 24 budget speech may be pivotal (albeit not necessarily conclusive) in deciding our short-term credit rating fate. The growing sense amongst local commentators and international investors that we speak to, is that the Treasury's authority within government is being undermined by individual interests and wasteful expenditure. The ongoing debacle at SAA is a prime

¹ This will mainly impact 2015 GDP growth as opposed to 2016 as the decline refers to the winter 2015 crop.

example². The implication is growing pressure on the Treasury to spend more during a time when the weak economy is curtailing government's revenue growth. The ultimate result is that the Treasury is being forced into postponing the planned (and much needed) fiscal consolidation process.

To their credit, the Treasury has held the line on the expenditure ceiling put in place in the last number of years. This means that there have been no additional spending allocations. The fiscal slippage has been driven by weaker revenue outcomes / projections as the growth outlook deteriorated. However, while overall expenditure remained in check, the quality of spending has deteriorated as funds are allocated from capex expenditure to fund rising current costs amid higher than expected public sector wage increases. At a projected 1.7% for 2016, the Treasury's GDP growth forecast is somewhat on the optimistic side. This raises the risk of another revenue undershoot and with it the prospect of further fiscal slippage. Given his track record, we are giving Minister Nene the benefit of the doubt on the expenditure side. However, it is unclear whether he will be able to hold the expenditure line. It is in this sense that the fiscal situation places a risk on SA's investment grade credit rating.

The broader **socio-economic environment** is another factor that the rating agencies will consider. In an environment of potentially rising water shortages, lack of employment growth and rising food prices, the lead-up to the **municipal elections** may see an intensification of service-delivery (and related) protest action. The protest environment has already been ratcheted up with the #FeesMustFall (and other) movements gaining traction. With the elections nearing, opportunistic politicians, including the EFF's Julius Malema, are likely to try and gain traction by fuelling the discontent on the ground.

The second area of potential concern surrounding the elections is how the ANC will react in the event that the ruling party loses further ground in key metros. While we are not in a position to delve into specifics, a significant loss of ANC voter support is likely to intensify the ANC presidential succession battle. This may have a number of implications, but from the economy's point of view, this scenario is likely to sustain the current policy gridlock. If it is further accompanied by increased populist talk³ from the government, it will argue against a recovery in business confidence from current low levels.

If one throws all of this into the ratings pot, 2016 may well be the year that S&P and Moody's decide to pull the plug and downgrade SA to junk status. Especially the bond market and rand exchange rate will suffer in this scenario. This is not our baseline forecast, these comments only serve to highlight the risks.

European politics and global terrorism

The still weak Eurozone growth environment and migration / refugee crisis in Europe has led to a rise in popularity of right-leaning, populist political groupings in many European countries. In fact, the governing parties in countries such as Hungary and Poland are already strongly resisting the influx of immigrants. The recent terrorist attacks in Paris will only serve to further entrench these sentiments. In a recent article, the *Financial Times* quoted a senior European diplomat as saying that the dynamic in Europe has changed from the "fiscally sensible north versus the profligate south" to the "...altruistic west against the

² In a positive move, Minister Nene reinforced his independence by turning down a proposal from the SAA board to restructure a transaction with Airbus. See the details [here](#).

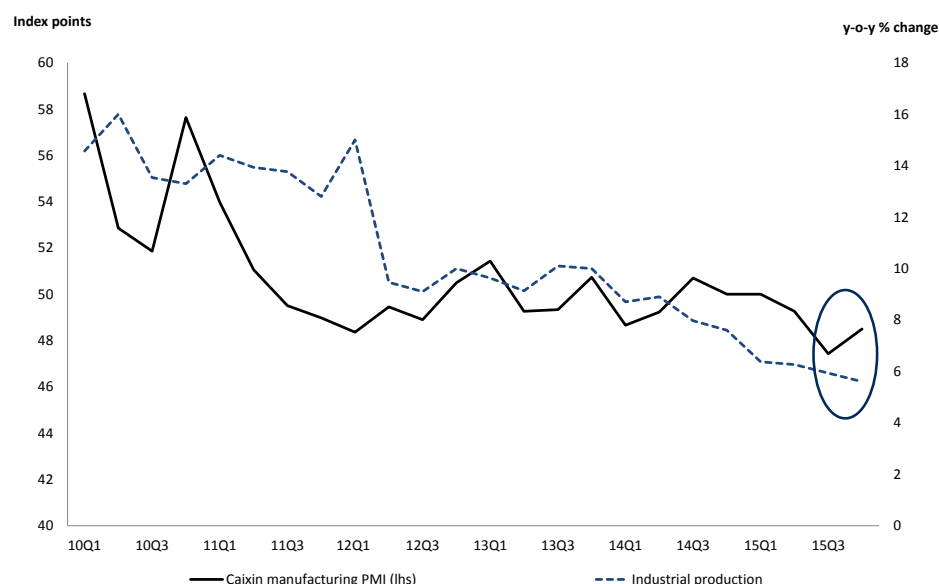
³ This will be more likely if the EFF increases its share of the vote.

xenophobic east.” A further hardening of attitudes (including in the UK where a referendum on continued Eurozone membership has been set for 2017) has the potential to again throw open the debate about the future of the Euro project. Increased Eurozone political tension, with the possibility of startling election results (including German local polls) have the potential to heighten global risk perceptions in 2016.

China and commodity prices

The slowdown in Chinese industrial production and associated decline in SA’s major export commodity prices was an important theme during 2015. We think this will remain the case in 2016, albeit that the Fed and Eurozone developments are likely to dominate the global economic landscape. This is assuming that the slowdown in Chinese industrial production stabilises. There are some tentative signs that this may already be happening (figure 1).

Figure 1: Trend in Chinese industrial output key for commodity prices



Source: Reuters

After reaching a low of 47.2 index points in September, the Caixin Chinese manufacturing PMI recovered in October and rose further to 48.6 during November. A stabilisation in Chinese output growth is an important assumption underlying our view that key commodity prices will not experience further declines in 2016. However, any mismanagement on the part of the Chinese authorities regarding the Chinese rebalancing process could result in a further decline in raw material prices. This will be negative for SA’s current account balance and exacerbate the risk (highlighted earlier) of reduced foreign capital inflows to SA.

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