The Economy of South Africa Grows 2.2%

Dear Clients

After two consecutive negative quarter-on-quarter (q/q) contractions in the first (Q1) and second (Q2) quarter of 2018, the economy of South Africa is no longer in a technical recession following the third quarter (Q3) real gross domestic product (GDP) print coming in above market consensus at 2.2% q/q. The biggest positive contributor to the Q3 print was manufacturing, which expanded by 7.5% q/q, contributing 0.9% to GDP. This was on the back of depressed metal prices which led to an increase in basic iron ore and steel, metal products and machinery production.

Notwithstanding elevated fuel price inflation in Q3, induced by a weak South African rand and an elevated Brent crude oil price in United States dollar (USD) denominated terms; transport, coming from a low base, has expanded by 5.7% q/q contributing 0.5 percentage points to the GDP print. The price of Brent crude oil has since moderated to levels below 65 USD/barrel, and the rand, whilst remaining volatile, has also strengthened against the USD in the fourth quarter (Q4) of 2018. Conversely the depressed metal prices coupled with a volatile currency adversely impacted mining production, which was down 8.8% q/q making it the largest single negative contributor to the Q3 GDP print. Subsequent to the double digit contractions in the first half of the year, on the back of subsiding drought effects, agriculture has expanded by 6.5% q/q. Due to the lag in planting and harvesting, we expect agriculture to continue this positive trajectory into Q4.

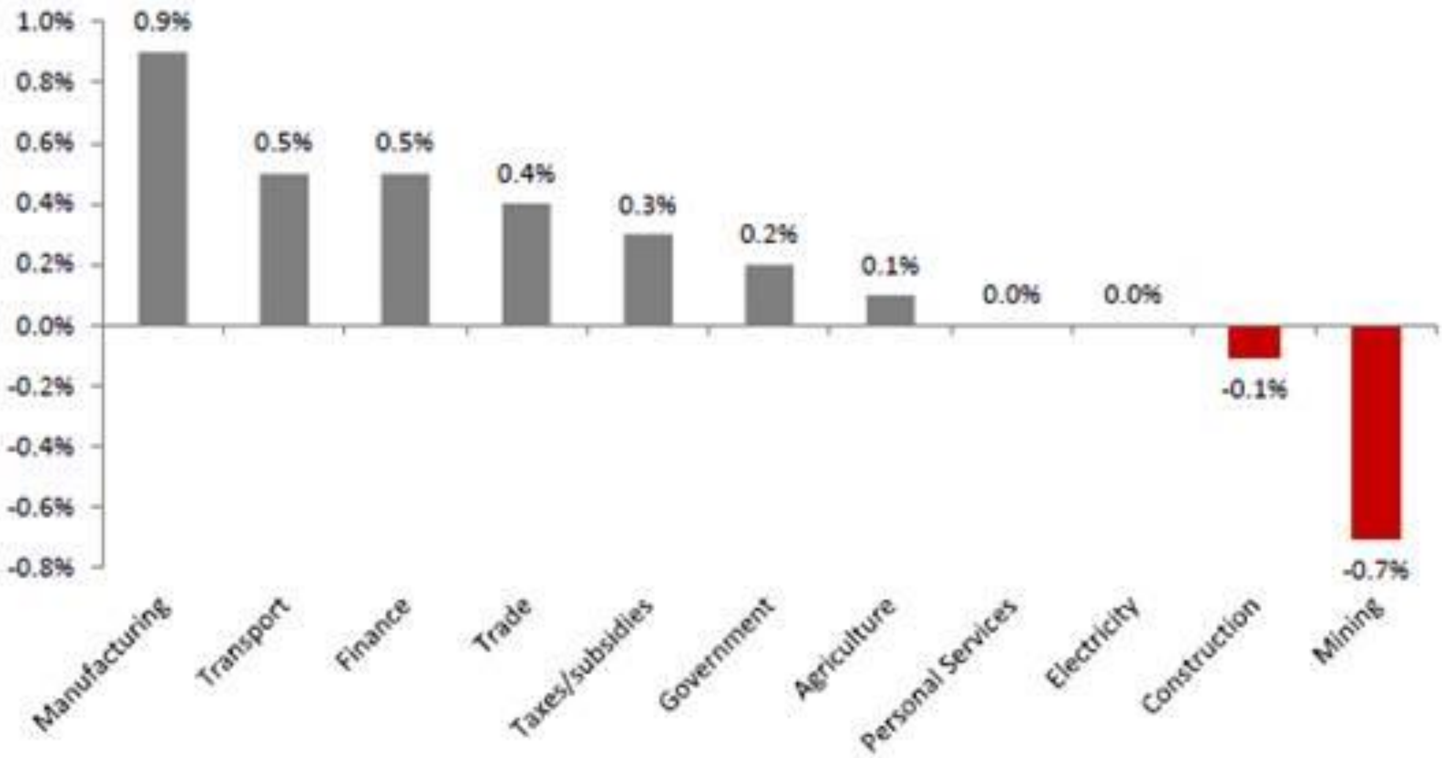
In-spite-of an elevated unemployment rate and a debt-to-disposable income in excess of 70%, household final consumption expenditure increased by 1.6% q/q, contributing 1 percentage point to the Q3 GDP print. This was on the back of a moderate inflation rate and a flat policy regime, providing relief to consumers, leading to positive private credit extensions in real terms and moderately elevated retail trade figures. Although inflation remains within the Monetary Policy Committee's (MPCs) upper-bound target of 6%, the MPC increased interest rates on the 22nd of November 2018, and the forward rate agreement markets are pricing in a rate hiking cycle over the next 2 years. This is going to put a squeeze on consumers over the next couple of quarters, but unlikely to have a severe impact on the 2018 Q4 GDP print.

Although the South African rand depreciated significantly over the period, net exports have decreased. South African exports have remained competitive in the global markets however they have been outweighed by domestic demand for imports. Twin deficits on the current account balance and government budget will persist unless domestic savings fund local investment.

Gross fixed capital formation remains in negative territory despite President Cyril Ramaphosa's initiatives to stimulate the local economy; implementation of growth enhancing reforms, reprioritisation of public sector spending to support growth and job creation, enhancing infrastructure investment and establishing an infrastructure fund, investing in municipal social infrastructure improvement and addressing urgent and pressing matters in health and education.

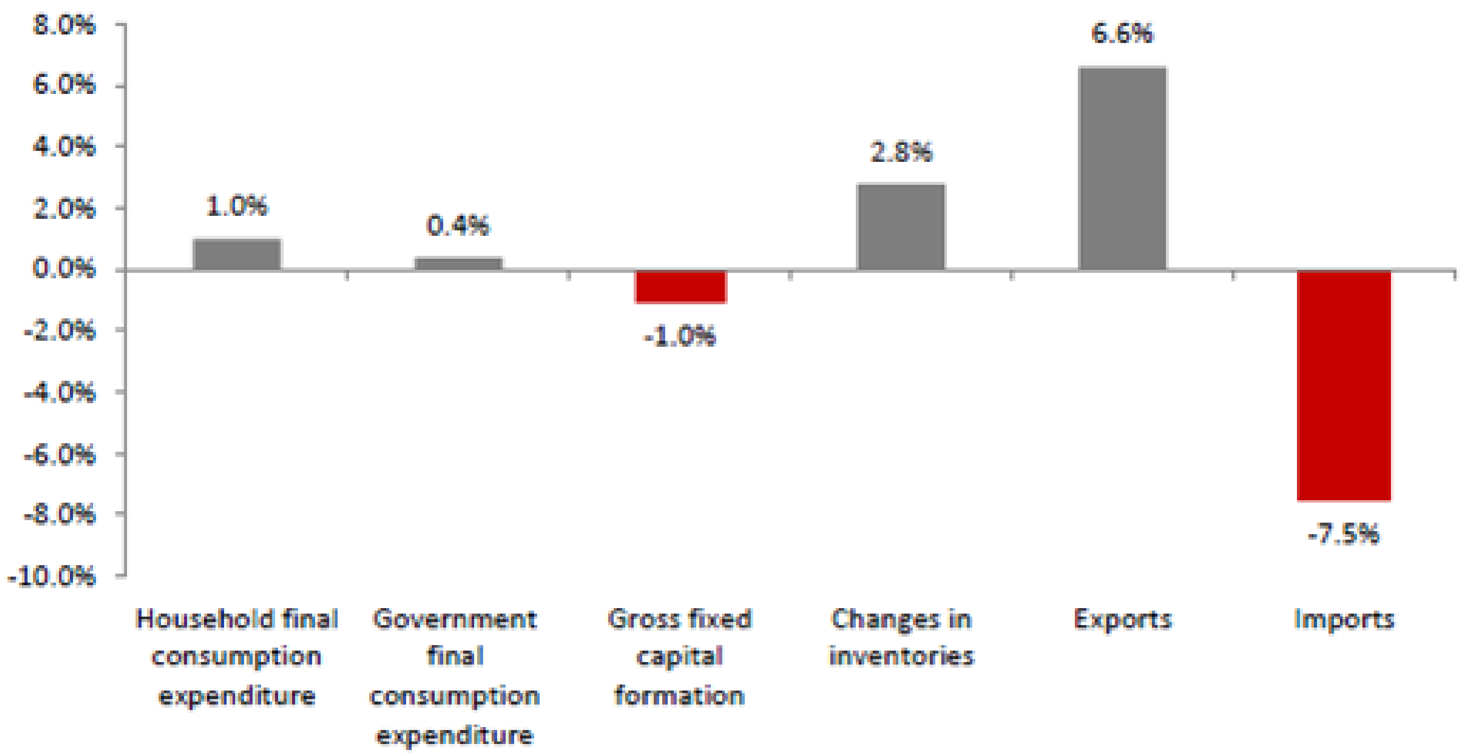
These initiatives are long-term in nature, and will take time to have a meaningful impact on the economy. We maintain our economic growth forecast at 0.6% and 1.4% in 2018 and in 2019 respectively.

Figure 1: 2018Q3 GDP q/q contribution by Industry



Source: Stats SA, 4 December 2018

Figure 2: 2018Q3 q/q contribution by Expenditure



Source: Stats SA, 4 December 2018

Market Reaction

The 10-Year benchmark yield dropped about 7 basis points just before the release of GDP, but retracted back to 8.9% by the close of day and currently trading at around 9% - indicating that much of the information in the economic release was already incorporated by the markets.

Credit ratings agency Moody's has sited low levels of economic growth as one of the main threats to South African government bonds maintaining their investment grade status. A credit downgrade by Moody's would imply that South African bonds would be removed from the World Government Bond Index, which would result in higher bond yields and a more volatile rand – as investors tracking the index would be forced to sell South African bonds.

The JSE All-Share rallied 83 basis points post the release of GDP, to close at around 52,234 points. Low corporate profitability levels, anaemic economic activity, currency volatility, tightening global financial conditions, increasing borrowing costs, regulatory uncertainties, and low business and consumer confidence continue to anchor market prices lower. In the absence of a strong earnings catalyst, the markets are likely to continue moving side-ways until both the 55,000 point mark and the 60,000 point mark, which were breached earlier in the year, are breached again.

Asset Allocation

From an asset allocation perspective, we hold true to our cornerstone philosophy, diversification, whose core objective is protecting our portfolios from massive drawdowns during periods of heightened market volatility whilst participating on the upside when markets run.

Kind regards

Global investments and solutions.

The Stockbroker and Portfolio Management Team

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