The Economy In 2019

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Introduction

Global growth is slowing, recession concerns are rising and, all the while, policymakers in major developed nations have less ammunition to fight off a downturn given that policy rates are still very low and balance sheets bloated. It is little wonder that asset prices, such as stocks and corporate credit, have had a difficult time. And, it seems unlikely that 2019 will be easier for either asset prices or the global economy.

In **China**, policy stimulus significant enough to reverse the economic slowdown there seems most unlikely. Further support will undoubtedly be forthcoming, and the authorities have taken a pro-growth policy tilt in recent months, confirmed by key agencies after the Central Economic Work Conference. Rightly, Beijing anticipates that 2019 will be a difficult year, and is, constructively, positioned accordingly. However, we believe that policy aims to merely cushion the slowdown, not reverse it.

In 2019, Chinese leaders will do more to support the economy: strengthening counter-cyclical adjustments, implementing an active fiscal policy, supported by a stable monetary policy. Nevertheless, we foresee no large-scale stimulus. The focus remains on improving the business environment and aiding consumption. Thus, China's growth will continue to slow in 2019.

As for **Africa**, last year we posited that the narrative for the next two to three years would likely revert to emphasising the structural reforms that many African economies need to undertake. After all, the FX supply problems that some of these economies experienced in the prior two to three years were behind us. We still hold this view.

Key elections are due in a number of African countries in our coverage, but mostly carrying little security or policy risks. This might be because the chances of a change in government are low, or lack of divergence in policy preferences among the leading parties.

From a **South African political perspective**, 2019 looks like a game of two halves. In the first half, which will run until the national and provincial elections, which are expected to be held on 8 May, the ANC government will take a cautious and defensive stance, its leader wary of taking risks for fear of weakening his future positioning. During this period a range of issues carried over from 2018 will continue to dominate the political discussion.

As for the **SA economy**, H1:19 will likely be in wait-and-see mode, with pre-election policy and political uncertainty still weighing on growth. The only support is expected to come from low oil prices (even if they should rise modestly), base effects, and stronger support from household credit growth. In H2:19, premised on sufficient ANC electoral support to allow for deeper economic reforms, clear signals about the ANC's policy agenda, and pragmatic expropriation without compensation constitutional change, private sector employment and fixed investment could begin to show signs of life. But, the risks are biased downwards, as we are as concerned about downside risks to the decelerating global economy as well as the domestic risks of electricity load-shedding and negative credit rating action by Moody's.

The **rand and SA bonds** will likely remain on the back foot in H1, awaiting clarity on the global economic trajectory as well as the national election outcome and credible policy reform interventions. Both these assets are, in our view, undervalued, and we see scope for gaining, premised on credible policy reform.

G10 outlook for 2019

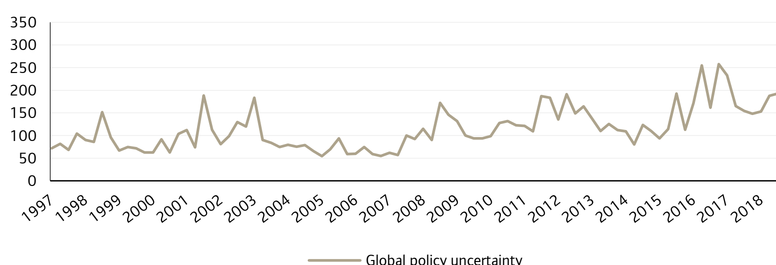
A wall of worry

Global growth is slowing, recession concerns are rising, and policymakers in major developed nations are less able to fight off a downturn given that policy rates are still very low and balance sheets bloated. Asset prices, such as stocks and corporate credit, have therefore had a difficult time. 2019 will not be much easier for either asset prices or the global economy.

Rising uncertainty

2018 proved that aggressive trade policy – from the US – can not only damage business confidence abroad but blow back to hit the US as well. **Protectionism is not a zero-sum-game, as the US seems to be finding out.** The countries and regions most heavily hit by protectionist fears have been those with large trade surpluses that stand directly in the US line of fire. Here, we mean the likes of China, the euro zone, and Japan. But elsewhere as well, policy uncertainty has risen significantly due not only to US protectionism but also other aspects of US behaviour, such as the policy-by-tweet preference of the president.

Figure 1: Policy uncertainty soars



Source: Baker, Bloom, Davis

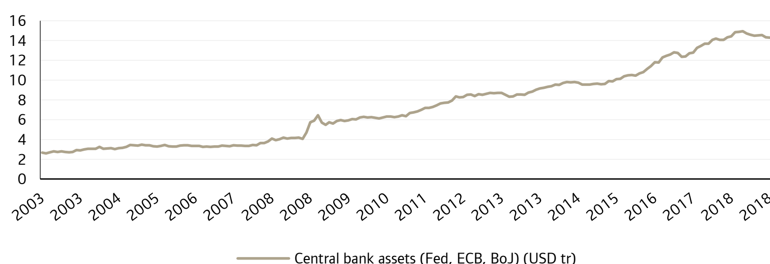
The cost of protectionism has been a waning of global growth. Last year's global GDP is likely to have been slightly below the 3.7% seen in 2017, and 2019 should be weaker still, with growth likely to be in the 3.0%-3.5% range. An added problem is that China's talismanic role in propping up global growth is also waning as it fights its own demons of excessive debt. Talk of recessions among advanced economies has increased due to many factors. One is the sheer longevity of the expansion. The US for example has enjoyed one of its longest ever expansions. But, as former Fed Chair Yellen said, expansions don't die of old age; to which another former Fed Chair Bernanke quipped that they tend to be killed off instead. For many, the murderer is the Fed which is perhaps why it has been put under so much pressure to cease rate hikes by President Trump.

However, we believe that the murderer is more likely to be found in the financial markets which may, or may not, slump because of overly zealous Fed tightening. Asset prices have fallen sharply already, with a 10%-plus decline in global stocks last year. We doubt that the fall will end here, and that could endanger business and consumer confidence still further. Policymakers should try to come to the rescue with the Fed, for instance, pausing, if not ending, rate hikes. The US administration could try to dial down the protectionist rhetoric, possibly even agreeing new trade deals with China, the EU and Japan to prevent further tariffs. But, in our view, much of the damage to global growth has been done and, while some trade and Fed optimism might aid asset prices for a while, **it probably won't cause 2019 global growth to outperform 2018 or mitigate recession risks materially**.

The tricky process of policy normalisation

The Fed might be criticised by the president for lifting policy rates but at least it now has rates at the bottom end of the Fed's 'neutral' range of 2.5%-3.5%, and presumably has some room to ease policy should the current downturn become far more material. But for other advanced-economy policymakers, rates are still far below neutral and, for some, like the ECB and BoJ, the rate hike process has not yet started, let alone moved on to the balance sheet reduction that we are seeing in the US. This clearly raises concerns that their policy response might be lacking should economic growth slide significantly. The Fed's balance sheet normalisation, which is currently worth some USD50bn per month in terms of asset reduction, has turned the tide when it comes to balance sheet reduction among the major central banks.

Figure 2: Balance sheets starting to fall



Source: Federal Reserve, ECB, BoJ

The Fed could continue to wind down the balance sheet at its present pace and allow this to tighten monetary conditions as a substitute for further rate hikes. **A pause in the rate-hike cycle certainly seems to be in place.** It could prove temporary, but our view that global (and US) growth will wane and financial conditions will tighten, suggests longevity. We doubt that the Fed will hike rates again this year.

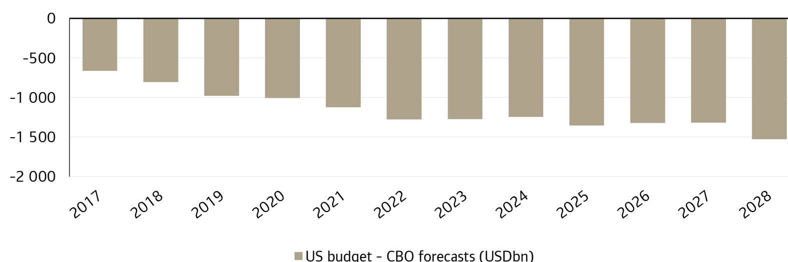
For most other advanced-country central banks the path back towards a more 'normal' monetary policy setting is proving a tortuous one, and we don't see this changing in 2019. The ECB has ended net asset purchases this year but its hints that the first rate hike could occur before the end of 2019 seem far-fetched. Instead, it seems likely that the Bank will deploy more tools to keep monetary conditions loose, such as extra long-term repos for banks. The Bank of Japan had helped to engineer slightly higher government bond yields last year by widening the target range for 10-year JGBs. But as we see dollar/yen falling to below 100 this year, the BoJ will have its work cut out to 'tighten' any more as the stronger yen should push the Bank of Japan even further away from its 2% inflation target. Other central banks that have started to lift rates, such as the Bank of Canada, Riksbank and Norges Bank, should all find that their best laid plans for **further rate hikes are stymied by soft growth and elevated global risk aversion**.

Headwinds for treasuries

The outlook for sovereign bonds in 2019 will have, as usual, the US treasury market at its heart. On the surface at least, it might look as if yields can fall given a likely Fed pause, softer growth and ongoing anxiety about risker assets, such as stocks. All these things could lower yields and redeem treasuries safe-asset appeal. But while all these factors could have a role to play, we suspect that treasuries won't rally significantly, and yields will end the year higher than where they started; probably around 3.0% for 10-year notes, for instance. This is partly because of our reading of the economy and the Fed's likely actions and partly due to some other factors that we feel are a bit disconcerting when it comes to the attraction of treasuries. Indeed, the Fed's pause could persist through this year but that probably won't stop the president from complaining that high rates are "killing" the economy. This political meddling in Fed policy counts as one of the 'other' factors we mentioned earlier. Others include

inconsistencies in the administration's fiscal and trade policies. At the heart of the administration's policies to date are tax cuts and spending increases that have inflated the budget deficit, aggressive trade policy designed to lower the trade deficit, and a quest for strong economic growth unencumbered by Fed policy. But, these three aims are inconsistent. The huge increase in the budget deficit from around two-thirds of a trillion dollars in 2017 to a projected one trillion in 2020 implies that the federal government will have to attract more savings from the domestic private sector and/or the foreign sector to fund the bigger deficit.

Figure 3: Deficit expansion expected



Source: Congressional Budget Office

If the funding comes from domestic consumers and businesses, there will be less consumer and/or investment spending, and hence weaker growth. If the foreign sector is the supplier of extra savings, this will imply larger capital inflows; the flipside of which is a bigger current account deficit in the US. Already it seems as if this extra treasury supply from the rising budget deficit, which is compounded by the Fed's balance sheet normalisation of USD50bn per month, is weighing on the market. The bid-to-cover ratios at treasury auctions have slipped to levels not seen since before the financial crisis. Treasury yields are also very low in currency-hedged terms, which diminishes their attraction to overseas investors. For instance, 10-year yen hedged yields are below zero, and also below the yield available on 10-year JGBs to domestic Japanese investors. Finally, we've also seen reserve diversification away from the dollar by foreign central banks and not just those, such as Russia and Turkey that seem to have ditched treasuries in a fit of pique over their treatment by the US administration. When we put all these things together, **we think that yields may be hard pressed to fall significantly from current levels, and we look for 10-year yields to trade out much of the year in a 2.5%-3.0% range,** with the top end of this range most likely in play come the end of 2019.

A moderately weaker dollar

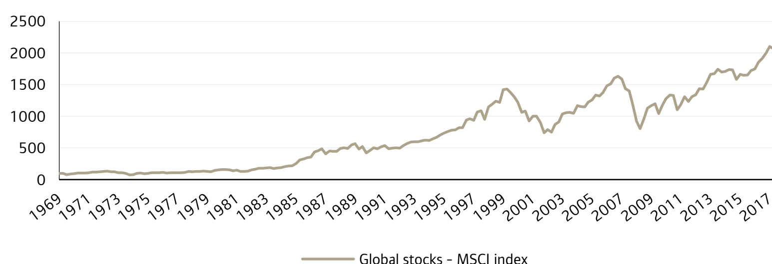
Our misgivings about US policy in areas such as trade and the budget lead us to a bias for dollar weakness. Still, if the combination of US policy and frail nerves in financial markets lead to a sharp decline in risk assets, such as equities, the dollar is likely to gain as its safe-asset qualities come to the fore. Don't forget, the global financial crisis was largely created in the US (with some help from the UK), and yet the dollar soared as risk assets plunged. Hence, **we think there could be a fine dividing line between dollar strength and weakness in 2019**: modest economic and financial market weakness, or indeed a recovery in both, should lead to general dollar weakness. But if economic and financial market vulnerability proves severe, the dollar is expected to rise, just as it did in 2018. Of the two, we lean towards the former scenario, and hence a modest fall in the dollar, probably of the order of 5-10% on a developed currency trade-weighted basket. The currencies with the most to gain from dollar weakness arguably fall into two camps. The first are even 'safer' currencies, like the yen and the Swiss franc, that should rally if the global economy and financial markets stay fragile. If things improve, then emerging market currencies that have been pushed down to very undervalued levels probably stand the best chance of strengthening against the greenback. The euro falls somewhere between the two. A rise to around 1.25 this year is anticipated as the dollar

softens but the euro is set to lose out to other currencies such as the yen, for reasons we've already mentioned, and the pound as the UK recovers from the Brexit fog that has shrouded the economy and the currency since the 2016 EU referendum. Indeed, with **the pound** sitting at very undervalued levels against the dollar and the euro, following its post-referendum slide, it **is one currency that could prove surprisingly strong in 2019**, should the thorny Brexit issue be solved in a way that's not too detrimental to the UK economy. Of course, sterling will slump should Brexit turn out to be hugely destructive for the economy, via a failure to secure both an exit deal and a transition period. The Bank of England's worst-case-scenario modelling suggests that sterling could fall as much as 25% under such a "disorderly" Brexit outcome but we think that the odds of such an outcome are very low – probably below 10%.

Risk aversion to remain elevated

On the surface, at least the rise in risk aversion that we saw in 2018 was down to issues such as US trade aggression, slowing growth and Fed policy tightening. These factors appeared to contribute to the 10%-plus fall in global stocks that we saw last year and weakness in many other 'risk' assets such as corporate debt. **In 2019** it is certainly possible, perhaps probable, that some of these **headwinds will ease**. The US seems minded to try to make trade progress with China, if only to shore up the slumping stock market, and the Fed is expected to pause its rate hikes for possibly the whole year. At face value these things could allow a recovery in risk assets in developed countries. However, this ignores the fundamental problem that the central bank monetary largesse that has been in place since the financial crisis has started to turn (Figure 2). It is turning slowly and gradually, but that's not important. What is important is that this monetary largesse has largely been 'spent' on acquiring financial assets rather than investing in productive resources. **One consequence of this is that developed-country asset prices have become over-extended to the upside, notwithstanding the slide we saw last year.** Another is that global productivity growth remains very weak partly because wages have remained low and investment poor. We feel that this is creating a conflict that's most likely to be resolved by more weakness in risk assets. This process started last year, and we doubt that the correction to date will prove sufficient.

Figure 4: Insufficient correction so far



Source: Bloomberg

There are other areas of financial markets that also bear watching if risk aversion continues to rise. For while global regulators appear to have done a good job of shoring up the banking system since the financial crisis, there are areas outside of banking that are concerning policymakers more and more. One such area is leveraged finance; lending to highly indebted companies and then packaging these loans into assets that are sold on to investors. It has echoes of the subprime crisis which engulfed the US housing market and the global financial system in 2007 and 2008. Few are predicting a repeat but, as is usually the case, crises tend to come as a shock, not as a predictable event.

Steven Barrow

China – another year of living dangerously

Policy stimulus significant enough to reverse China's economic slowdown seems most unlikely. Further support will undoubtedly be forthcoming, and the authorities have taken a pro-growth policy tilt in recent months, confirmed by key agencies post the Central Economic Work Conference. Rightly, Beijing anticipates that **2019 will be a difficult year**, and is, constructively, positioned accordingly. However, we believe that **policy aims to merely cushion the slowdown, not reverse it**.

Over the past two years the government has staved off panic, worked diligently to bolster private sector and consumer confidence, whilst remaining steadfast in de-risking the financial sector. Getting this balance right in 2019 will be critical.

Beijing's true north remains disincentivizing the allocation of resources towards non-productive investment to reduce this proportion as swiftly as possible without causing unemployment to rise, non-performing loans to balloon and destabilize the financial architecture, or batter confidence. However, currently, it is impossible to replace the non-productive investment with productive investment, thereby maintaining past rates of growth in fixed asset investment, which accounts for half of the economy. To wit, **investment growth slowed for the tenth consecutive year**, slipping from 7.2% in 2017 to the lowest rate on record of 5.9% in 2018.

It is hard to be optimistic in 2019. Last year, fixed asset investment in the tertiary sector, which accounts for 60% of total investment and includes large sub-components like real estate, infrastructure, water utilities and so on, expanded by just 5.4% y/y – the slowest pace in over two decades. Even with the increase in local bond financing anticipated, for example, which should support infrastructure investment, given the high base it would take time a tremendous fiscal impulse for a sustainable rebound in infrastructure spending. Consider this: railway investment accounts for just 2-3% of China's total domestic fixed asset investment and would need to increase by 100% in 2019 from 2018 levels, for total fixed asset investment to expand 1-2pps faster. Meanwhile, fixed asset investment in the secondary sector, which makes up almost another 40% of total investment, and is dominated by manufacturing, expanded by just 6%.

Private-led manufacturing investment held up well last year and we do expect supportive industrial policies to continue to channel funding for investment in technology. However, it is the firms in these external-orientated areas that are the most vulnerable to the trade war.

For stimulus large enough to move the dial, the government would need to reverse course on the housing market and slacken scrutiny over credit flows and the shadow banking sector. But, that would be foolhardy and short-sighted. Thus, **fixed asset investment is likely to remain soft in 2019**. Rather than tremendous additional fiscal outlays, policymakers will continue to lean on reductions and exemptions in taxes to ameliorate challenges facing the private sector and support consumption.

The government has, correctly, focused on ensuring that consumption growth holds up, but that too has proven difficult. Last year, nominal retail sales growth expanded by just 8.1%, the slowest rate since 2002 – and, in real terms, expanded at half the speed of the rate just 18 months prior. Alarmingly, consumption growth has become increasingly reliant on household debt – albeit from a low base – adding a **new risk to the outlook**. Consumer loans have more than doubled in the past three years, rising by 20% in just 2018, reaching near USD40trn in 2018. As a result, the household debt-to-GDP ratio has jumped by 10pps since the start of 2017. Of course, levered consumption works

counter to plans to halt the rapid growth in debt growth, with interest payments absorbing a greater share of income.

The headwinds facing consumption in 2019 are particularly important. Unlike previous episodes of softness in the economy, like 2008 and 2015, consumption seems more vulnerable. Much like in the past sluggishness is driven by capacity cuts, property restrictions and/or infrastructure investment slowing. However, unlike the past consumption may not remain relatively stable, suggesting that consumers ability to smooth consumption has been eroded. We know that if consumer spending falls it usually means there has been quite an unexpected shock to confidence: something that Beijing will work hard to avoid.

Another pressure valve has been the **increase in external debt**. For now, China's foreign debt doesn't look large relative to GDP, and over one-third of China's external debt is denominated in CNY, leaving around USD1.25 trillion in foreign-currency borrowing. The largest share of that dollar-denominated debt is held by Chinese banks, the PBoC and MoF. However, there are sectors, such as property developers that could run into headline-grabbing problems in 2019. Therefore, China's potential for injecting volatility into the global financial system should not be ignored.

Added to the depressed growth in fixed asset investment and household consumption, external demand will be negatively affected by the trade war because the front-loading which occurred in H2:18 will become a headwind to export growth. That means that the economy is unlikely to find a bottom in the near term, even with a supportive policy mix. Instead, **GDP growth is forecast to slow from 6.6% y/y in 2018 to 6.1% y/y in 2019**. That would be the most sizable decline in GDP growth – in both absolute and relative terms – in over five years, undermining China's L-shaped recovery.

The PBoC is clearly concerned about the economy, committing to intensifying counter-cyclical adjustments. However, a widespread acceleration in credit is unlikely due to the continued crackdown on non-bank financial institutions, the difficulties facing smaller banks, and the depressed economy. The RRR was cut four times last year, and both credit and money supply growth subdued. Last year, TSF increased by CNY19tr – down 15% y/y. For most of the year, commercial banks opted to hold extra reserves rather than lend money to the real economy. The is likely to persist in 2019 even though we anticipate another 200 bps cuts in the RRR in 2019, in tandem with additional injections through the targeted medium-term lending facility and other medium-term lending facilities, pledged supplementary lending, and open market operations. However, **monetary policy has lost traction**, with the subdued economic climate limiting the demand for loans that aren't simply being used to roll over existing debt.

One thing we are sure of is that the PBOC is not in a position to follow any Fed hikes, so **we therefore expect the interest rate differential to narrow even further in 2019.** Against the USD, then, the CNY is likely to be pressured – the extent to which will depend on the trade war and rate trajectory in the US. Generally, as growth continues to come under pressure, **the government is likely to accept a weaker CNY**. The biggest risk is that China may misjudge the delicate balance it faces in the financial market and real estate sector, derailing the gradual nature of the slowdown, and sparking panic such as in late 2015.

In 2019, Chinese leaders will do more to support the economy: strengthening counter-cyclical adjustments, implementing an active fiscal policy, supported by a stable monetary policy. Nevertheless, **we foresee no large-scale stimulus**. The focus remains on improving the business environment and aiding consumption. Beijing's measures will only slow the momentum loss, not reverse it, and will take longer to have an impact. Thus, **growth will continue to slow in 2019**.

Jeremy Stevens

Sub-Saharan Africa

Differentiated growth outlook

Global backdrop still supports a moderate improvement in growth

The next two to three years will emphasise the **structural reforms** that many African economies need to undertake. After all, the FX supply problems in some of these economies are now behind us.

Admittedly, Angola still has the remnants of the FX challenges that hamstrung economic growth, ensuring that the economy would endure three years of recession. But, even here there is light at the end of the tunnel. Recall that the central bank devalued the kwanza, taking USD/AOA to 166 in mid-2016 from about 103 at the end of 2014. Having kept the pair around 166, the Banco Nacional de Angola then devalued the kwanza more forcefully during 2018.

But, before then, oil prices had recovered, with Brent crude rising back above USD60/bbl in late-2017. The current account balance, which registered a deficit of nearly 9.0% of GDP in 2015, gradually improved and turned to a surplus that we estimate was just over 7.0% of GDP in 2018. This is despite the decline in oil production from nearly 1.8m bpd in 2015 to less than 1.5m bpd in 2018. The fiscal balance also improved, turning to surplus last year. All these developments suggest that the backlog of FX demand is likely to be fully satisfied quite soon.

To top it all, the Angolan government has obtained financial assistance from the IMF via a SDR2.67bn (roughly USD3.7bn) Extended Fund Facility program. Fiscal consolidation, diversifying tax revenue by mobilising non-tax revenues and structural reforms to diversify the economy are key elements of the program.

In Nigeria, another economy that is enjoying a recovery after suffering from FX supply shortages, structural reforms are likely to be on the agenda. There will be elections in February and March for national and state elective offices respectively. Challenging President Buhari is Atiku Abubakar of the Peoples Democratic Party, who served as the Vice President between 1999 and 2007. He has made forceful arguments for floating the NGN, reforming the national oil company (perhaps even partly privatising it), and allowing domestic fuel prices to be cost-reflective.

Even if he were not to win, President Buhari is likely to press ahead with the reform agenda that he proposed when he got elected the first time around.

These reform efforts, and many others across the continent, are likely to be bolstered by a **global backdrop that still supports a continuation of the moderate acceleration in economic growth across the continent**.

The experience of 2018, where an emerging market sell-off occurred against a backdrop of strong global economic growth and elevated commodity prices, is comparable to 1998. Just as in 2018, global economic growth was strong in 1998. The US economy was enjoying a productivity-fuelled surge in economic growth.

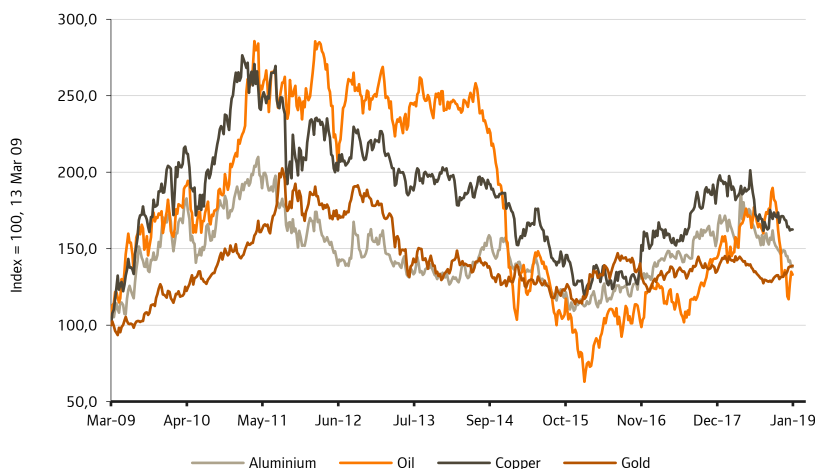
But unlike 1998, commodity prices were still elevated in 2018. Sure, some of these dropped meaningfully in H2:18. Copper prices fell from over USD7,000/MT in mid-Jun to just below USD6,000/MT in mid-Aug, where they remained for the remainder of the

year. Brent crude oil price fell from just over USD85.0/bbl in early-Oct to nearly USD50.0/bbl in late-Dec.

Commodity prices: murky near-term outlook

The decline in commodity prices in the latter part of 2018 has put many of them in no-man's land. They are neither low enough to suggest that they are oversold nor high enough to suggest further upside.

Figure 1: Commodity prices have dropped



Source: Bloomberg

The decline in oil prices was very curious. It came just days after OPEC members and some other major non-OPEC countries decided to cut production further. The recovery since the beginning of the year has put the Brent crude oil price at a level that is consistent with the budget assumptions for Nigeria and Angola.

Although consensus forecasts for copper were pulled lower in Q3:18, following the decline in copper prices, expectations are still that they will rise above USD6,500/MT by the end of this year. It seems like the prognosis to the effect that the supply-demand balance for copper points to supply tightness in coming years has led to expectations of elevated copper prices in coming years.

As is the case with oil prices, there is nothing to suggest that copper prices might not initially decline from current levels before rising later in the year. There are already indications that perhaps the Chinese economy is slowing more quickly than consensus expectations, with the PMI indicating that the manufacturing sector may have contracted towards the end of 2018. Of course, there are plenty of other risk events that may dampen confidence somewhat, not least of which is the trade negotiation between the US and Chinese governments.

Political risks: heavy electoral calendar

The market is likely to keep an eye on a number of key elections in the countries in our coverage. However, for the most part these elections carry little security or policy risks. This might be because the chances of a change in government are low or there isn't that much divergence in policy preferences among the leading parties in those countries.

Mauritius epitomises this. That country's politicians are adept at realigning alliances. Admittedly, political leadership tends to revolve around a small core of what might be regarded as political dynasties. Who becomes Prime Minister at any given point in time depends on the alliances of the day. But a political alliance led by either a Ramgoolam or a Jugnauth has always won.

From 1967 to 2014 the country had 11 elections, but only 5 prime ministers. Sir Seewoosagur Ramgoolam was the first prime minister, replaced by Sir Anerood Jugnauth in 1983, who in turn was replaced by Dr Navin Ramgoolam (Seewoosagur's son) in 1995. Although Sir Anerood Jugnauth became prime minister after the 2000 elections, he resigned 3-y later to allow Paul Berenger to take over. In 2005 Dr Navin Ramgoolam returned as prime minister. In 2014 Sir Anerood Jugnauth became prime minister again, but resigned in 2017 to allow his son, Pravind Jugnauth, to become prime minister.

It is also hard to regard the upcoming general elections in Namibia as risk events. Sure, the ruling South West African People's Organisation (still referring to the country's old name), is presiding over an economy that is in recession. The deterioration in fiscal metrics, characterised by a rising debt/GDP ratio that contributed to the downgrade in credit ratings, also leaves the government with little room for manoeuvre.

The elections are likely to be peaceful. Despite contentious land reform proposals, we doubt that business and investor sentiment towards the country will deteriorate in the period leading up to the elections.

At face value, the Nigerian elections could usher meaningful change in macroeconomic policy management, if Abubakar were to win and follow through on his promises with respect to the currency. But it is hard to believe that policymakers would actually float the NGN. The exchange rate would probably end up being extremely volatile relative to the past. After all, oil exports account for close to 90% of total goods exports. The volatility of oil prices would probably be a primary driver of USD/NGN volatility. Furthermore, portfolio flows would very likely exaggerate any oil price induced volatility in USD/NGN.

The DRC had its first ever peaceful transfer of power via the ballot box since independence. However, this is probably easy to overlook, and instead focus on the uneasy calm that has descended upon the DRC following the announcement by that country's electoral commission that Felix Tshisekedi won the presidential elections held in late-December. The presidential election was essentially a 3-horse race between Emmanuel Shadary of the ruling People's Party for Reconstruction and Democracy (PPRD), Felix Tshisekedi of the Union for Democracy and Social Progress (UPDS) and Martin Fayulu of Lamuka, a coalition of 7 parties.

There was something of a controversy on the eve of the elections. Opposition parties decided to club together and present a single presidential candidate. At the summit to nominate the candidate, Martin Fayulu emerged as that nominated candidate. But immediately after the summit, Felix Tshisekedi had a change of heart and opted to go it alone.

In the end, Tshisekedi pipped Fayulu to the post. Fayulu challenged the validity of the results, alleging that they were a fabrication following a deal between outgoing President Kabila and Tshisekedi for the latter to be declared as the winner. The Constitutional Court ruled against Fayulu. It remains to be seen whether his call for demonstrations will lead instability.

Ian Khama stepped down as Botswana's President in April 2018, appointing Mokgweetsi Masisi in his place. But the two fell out almost instantly, apparently over Khama's retirement entitlements and pension. 4 opposition parties could form a coalition in an effort to unseat the ruling Botswana Democratic Party in the October elections.

Anxiety could mount in the lead-up to the Mozambican general elections in October. If the local government election in September 2018 are any guide, the outcome could be close. The opposition RENAMO party's fighters are supposed to be integrated into the

army as part of a peace agreement between the party and the government. But the party complained last year that in some regions its agents were not being allowed to freely operate, raising the risk that the party might boycott the elections.

A peaceful election, and progress in implementing the peace agreement will be crucial for the country. Key investments in the fledgling gas sector may well be dependent on this. These investments have the potential to transform the country's economy in the next 10 to 15 years.

Debates between presidential candidates will headline the Malawian presidential elections due in May. President Mutharika dismissed his former deputy, Saulos Chilima in early November 18. Chilima may well challenge him. There are allegations of corruption against the president, with news reports indicating that he may have received a bribe. Former president Joyce Banda, implicated in a 2013 corruption scandal, may also be a candidate.

Although Ghana's general elections are not until next year, they are likely to affect market sentiment this year too. It is not so much the elections that might matter, but perceptions that political calculations might enter fiscal policy conduct. Already there has been a delay in the completion of the 7th review of the IMF's Extended Credit Facility.

Although IMF staff visited the country in September 2018, there has been no indication that the review was completed. We believe that the 7th and 8th reviews might be combined in April, when the program is due to expire. We also believe that it is fiscal performance that is preventing a successful completion of the 7th review. Revenues were consistently below budget in 2018, prompting the government to revise the budget and cut spending, mostly capital expenditure.

This experience might cause many market players to doubt that the government will stick with the fiscal consolidation effort going into next year. To be sure, the government has been trying to assure the market that it will stick with the aim of keeping the fiscal deficit between 3% and 5% of GDP, meant to be enshrined in a fiscal responsibility law, even if there are delays in enacting such a law.

Elections in Côte d'Ivoire will also only be next year. But following the fracture between the Democratic Party of Côte d'Ivoire (PDCI) and the Rally for Republicans, the market will probably watch developments there very closely. Additionally, the International Criminal Court dropped charges against Laurent Gbagbo, potentially allowing him to make a return to active politics We still think that a process that will lead to a realignment of coalitions could be underway there. It is well worth noting that nearly 30% of MPs are independents. But reports of fatalities last year as a result of post-election violence in parts of the country might be a source of lingering concern for the market.

FX outlook: stability likely to return

Most **African currencies are likely to rebemain stable this year**. The terror attack in Nairobi in mid-January hardly caused a flutter in the FX market, even though it could have caused some trepidation. Even as we admit that there is a risk that the attack may undermine tourism, which has enjoyed a long period of revival, we are not convinced that it could cause the shilling to depreciate that much.

It is worth recalling that a similar attack in 2013, exacerbated by other security incidents along the coast immediately afterwards, precipitated an average 12.0% y/y drop in visitor arrivals in the four years to 2015. In response to this attack, many governments of countries from which most tourists originate issued travel advisories urging their citizens not to travel to Kenya.

Yet, despite this drop in tourist arrivals, the USD/KES exchange rate rose by just 3.1% in the 12-m following the 2013 attack. But in the 12-m to September 2015 it rose by a further 18%. Foreign investors' holdings were close to 10% of total domestic debt in September 2013. Arguably, the pressure on the shilling in 2015 was mainly due to these outflows. Foreign investors' holdings are currently less than 5% of total debt, potentially reducing the upward pressure on the exchange rate.

As already argued above, there are reasons to believe that the naira peg will remain in place even if the opposition were to win the elections. This is all the more so if oil prices were to remain in a USD60/bbl to USD65/bbl range.

The Angolan kwanza was the worst performing currency in 2018, with the central bank devaluing it by about 45%. But it essentially stopped devaluing it since about mid-October 2018. It is highly unlikely that it will be devalued significantly this year.

The IMF does not require the kwanza to be devalued further as part of the economic program that it has financed. In fact, the IMF's assessment is that the devaluation of the kwanza in 2018 took it from being about 26% overvalued to being less than 4% undervalued. Furthermore, the IMF seems happy with the narrowing of the gap between the official and parallel exchange rates. Even then we expect the exchange rate to rise by just over 11% this year.

The Malawian and the Zambian kwacha are 2 currencies that continue to defy our expectations. We are still concerned about the Zambian kwacha. Foreign exchange reserves fell to USD1.6bn in October from USD2.4bn in June 2017 and USD2.1bn in December 2017. Clearly, if copper prices were to decline to below USD4,500/MT then some copper mines might be forced to cut production.

If portfolio investors holding local currency bonds do not liquidate those, then the Zambian kwacha will likely not depreciate as much as we expect. Additionally, the government has budgeted for a reduction in domestically-financed capital expenditure, something that should lower the government's FX requirements. But it will need to obtain all the external financing that it budgeted for. Otherwise it would face challenges meeting its external debt service obligations.

Similarly, something will perhaps need to trigger the depreciation of the Malawian shilling. The sharp depreciation of the MWK ended in early 2016, having depreciated at a 23.5% annualised pace in the prior five years. Financial support from the IMF has helped not only in bolstering FX reserves, but also encouraging aid inflows.

There is an election later this year. Former President Banda, who was implicated in the bribery scandal in 2013, intends to run. The current president, who is running for re-election, is suspected of taking bribes. Perhaps, only if the risk of fiscal slippage materialises or there are threats to aid inflows would the MWK depreciate sharply.

Even though there is likely to be disruption to oil production this year due to repairs to the offshore platform on the Jubilee field, portfolio flows probably matter more for the Ghanaian cedi. The amount of coupon payments that will likely accrue to foreign investors is quite large. With the Bank of Ghana likely to be biased towards easing the policy stance, there might be some portfolio outflows that might weaken the cedi. As pointed out above, the market is apprehensive about fiscal policy conduct, something that will likely skew portfolio flows towards outflows.

Phumelele Mbiyo

SA politics in 2019 will be a game of two halves

From a political perspective, 2019 looks like it will be a game of two halves. In the first half, which will run until the national and provincial elections, which are expected to be held in May, the ANC government will take a cautious and defensive stance, its leader wary of taking risks for fear of weakening his future positioning. During this period a range of issues carried over from 2018 will continue to dominate the political discussion. These include the following.

- **The ongoing processes to enable the state to more readily expropriate land without compensation**. Here two processes will be key: (1) the parliamentary process initiated last year which is aimed at amending Section 25 of the Constitution to more "explicitly" enable EWC; and (2) the public consultations and potential re-drafting of the Expropriation Bill, which was gazetted by government in December last year.
- **The need for bold interventions to stabilise Eskom and avert further sovereign rating downgrades.** In this regard, focus will rest to a great extent on the balancing act Finance Minister Tito Mboweni is able to deliver in the Budget Speech on 20 February 2019, as well as on any indication of executive support for Eskom's long-term stabilisation plan by President Ramaphosa in his State of the Nation Address (SONA) on 7 February 2019.
- **The ongoing appointment of more competent officials to staff institutions driving economic and governance stability across the state**. Last year an impressive array of personnel changes were made at the senior level across cabinet, SOEs, and some of the more vital institutions staffing government's Anti-Corruption Task Team (here particularly notable new appointments included Godfrey Lebeya as head of the Hawks, and Shamila Batohi as head of the NPA). Some loose ends will still need to be tied up this year, the foremost of which will be the appointment of a new and permanent commissioner at the SARS.
- **The unfolding interrogation into the extent of state capture during the former president's time in office**. The Judicial Commission of Inquiry into State Capture is set to run throughout the year and perhaps into 2020 as well. Already the hearings thus far this year have been explosive, drawing the political gaze towards the extent of governance slippage suffered over the past decade in particular, and outlining the challenge faced by the president in ensuring that some accountability for the wrongdoing that appears to have flourished under his predecessor's watch is guaranteed.

Meanwhile, **the collective energy of the political establishment will be primarily directed towards campaigning for the national and provincial elections**, which are likely to be held in May (and most likely 8 May, though the date still needs to be officially announced by President Ramaphosa). Of course, knowing that government is eyeing a stronger showing in the second half of the year, the opposition will seek to exploit government's weaknesses in the pre-May period, poking holes in claims of internal institutional renewal, and capitalising on an economic environment which questions the prospects for recovery. The presiding question during the first half of the year will be whether the president's strategy will deepen the deficit of the past years too profoundly, allowing for little chance of a rebound in government's wider fortunes in the second half of the year.

As things stand, **a fairly comfortable win for the ANC in the coming elections appears relatively assured**, as is an electoral gain of some quantum for the EFF. At best the DA, which has battled to contain and effectively manage its own internal divisions and contradictions, and has not been able to present a compelling strategic opposition to President Ramaphosa's 'New Dawn' messaging, will reach the same

national support level (22.2%) that it secured in 2014. Together the ANC, the DA and the EFF will likely garner between 85% and 90% of the total national vote, leaving little real space for electoral gains for some of the new political entrants that are seeking to secure valued seats in parliament this year. With that said, two existing parties that will almost certainly gain additional space in the National Assembly will be the IFP, which will benefit from the ANC's retreat in more traditional rural regions in KZN; and the FF+, which may benefit from a boost in support amongst its minority voter community on the basis of the stance it has assumed in opposition to land EWC.

By and large, **this outcome would allow President Ramaphosa to emerge from the polls with a comfortable enough grasp on power to be able to begin to more boldly assert a cohesive national policy agenda**. However, while the election outcome may not fundamentally rearrange the *status quo* at the national level, certain provincial races will likely present far greater opportunity for disruption. Most importantly, the provincial election in Gauteng will be strongly contested, and there is a real chance that no party will be able to secure an outright majority, thus necessitating the kinds of coalitions which could offer meaningful support or resistance (depending on the shape of the coalition that is struck) to long-term and stable reform. Meanwhile, the DA will face definite pressure in holding on to its provincial majority in the Western Cape in light, amongst other factors, of the fallout from its handling of former Cape Town mayor Patricia de Lille's dismissal.

Should this basic trajectory play out, President Ramaphosa will enter the second half of the year buoyed. Freed to an extent from some of the internal hostilities and wider policy sensitivities that likely prevailed in the first half of the year, the president might reveal his longer-term ambitions, the early signal for which will come in the size and composition of the team he selects for his first full cabinet. Beyond this, the president will need to provide deeper and more cohesive long-term leadership on matters of economic policy; endorse the kind of action that will create more lasting stability across key SOEs but that will necessarily antagonise some of the ANC's tripartite alliance partners; and (re)build the bridges between key economic stakeholders that had been systemically decimated by his predecessor. Meanwhile, the politically challenging task of holding those accountable for past non-performance and malfeasance will abide. Here, the president will hope that those staffing positions of seniority in the Anti-Corruption Task Team, which his predecessor undermined, will hold their own, allowing him to keep the distance from the cases that they take on that is constitutionally expected of his office. A strong showing in the second half of the year would enable a somewhat more benign economic path to emerge and will certainly embolden the president as he begins what could, provided he and his party remain at the helm, be a decade in power that has the capacity to shape a multi-generational reorientation of SA's prospects.

If 2018 taught us anything, it is that there will be no easy remedy to the myriad political economy maladies that the country faces. If in mid-2017, during the period of peak concern and uncertainty that prevailed then, a scenario was pitched to an investor, in which President Ramaphosa would assume the helm of the ANC and state; all Gupta-linked ministers would be removed from the cabinet; Pravin Gordhan would be minister of public enterprises and Tito Mboweni minister of finance; all key SOE boards would be overhauled; the state's ill-advised nuclear programme would be shelved; the leadership of the SARS, the NPA and the Hawks would be fundamentally improved; and Mr Zuma would finally face up in court to the corruption charges he has for over a decade managed to avoid, such an investor would have grasped eagerly at an outcome that seemed – at that time – to be impossibly positive. Yet, despite the fact that these and other changes indeed characterised the political calendar in 2018, the year still ended with deep unease amongst the investor community. Perhaps most disconcerting was the realisation that these personnel changes have been insufficient to turn the tide. That too much damage had been done for the turnaround to be satisfied by the harvesting of the abundant low-hanging fruit available to President Ramaphosa early in

the year. And that the lasting confidence boost required to reorient the country's economic path relies on far deeper and more challenging structural reforms, for some of which there is no guarantee that the president will be able to accumulate the requisite political capital. While 2019 will begin with many of these questions remaining unanswered, **the May elections will, or at least should, provide an opportunity for new clarity to emerge**.

Simon Freemantle

South Africa: a year of two halves

We expect two distinct parts to the SA economy this year. In H1:19, the economy will likely remain in wait-and-see mode, with pre-election policy and political uncertainty still weighing on growth. The only support is expected to come from low oil prices (even if they should rise modestly), base effects[1] and stronger support from household credit growth. In H2:19, premised on sufficient ANC electoral support to allow for deeper economic reforms, clear signals about the ANC's policy agenda, and pragmatic expropriation without compensation-related constitutional change, private sector employment and fixed investment could begin to show signs of life after protracted stagnation. Unfortunately, the risks are still biased downwards, as we remain concerned about downside risks to the decelerating global economy as well as the risks of electricity load-shedding and negative credit rating action by Moody's.

Likewise, the rand and local bonds will likely remain on the back foot early in the year, awaiting clarity on the global economic trajectory as well as the national election outcome and credible policy reform interventions. Both these assets are in our view undervalued, and we see scope for them to gain once there are credible policy reform (premised on a reasonably benign global economic outlook). But for now, the elevated risks keep us cautious.

Growth hinges on politics and policy

Consumer spending should again be the key growth driver in 2019. Consumer balance sheets seem in good enough shape (except for the low-income groups) – but discrepancies among data series create uncertainty about the strength of income growth; this is a significant forecast risk. Our inventory and capital stock analyses suggest that the case for imminent rebounds is not as strong as commonly assumed, until political perceptions and demand improve. A rebound in gross fixed capital formation (GFCF) will ultimately be a key medium-term growth driver – but we don't expect this to be imminent. **We forecast growth of 1.3% in 2019.**

The forecast global growth deceleration is unhelpful, though the global backdrop is expected to remain benign without material downward pressure on SA's key export commodities' prices, though this is a key forecast risk. A slight improvement in SA growth amid a global deceleration is not unprecedented, though we are concerned about the weakness in the composite leading business cycle indicator[2]; and our econometric business cycle model, based on it, points to weak H1 growth.

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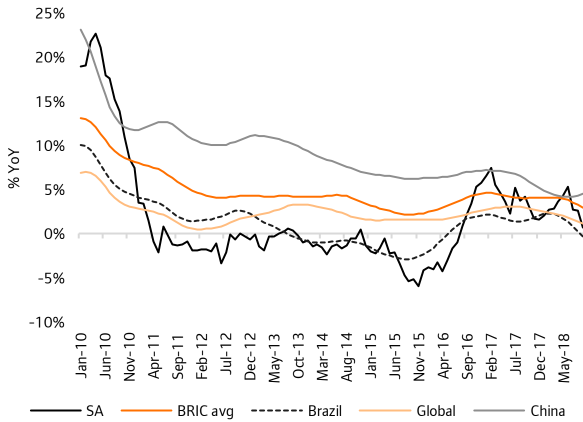
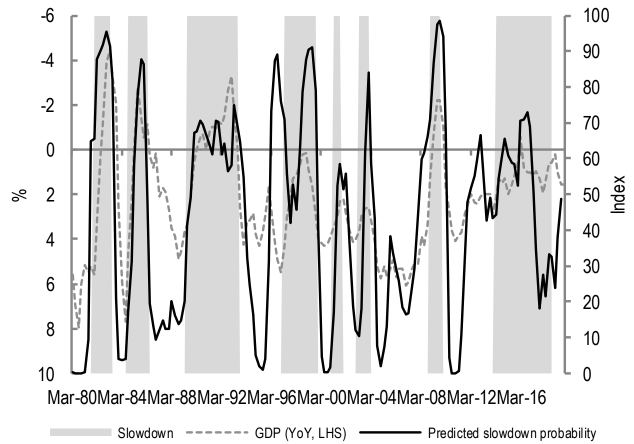
[1] *Including a reversal of the impact of the Western Cape drought, though deteriorating rainfall forecasts weigh on the national agricultural prospects[1].*
[2] *In relative and absolute terms.*

Figure 5: Global leading indicators – not supporting SA growth outperformance



Source: SARB

Figure 6: Econometric business cycle model giving worrying signals

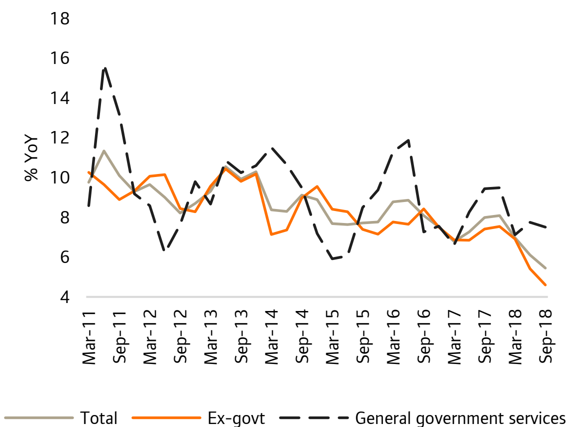


Source: SARB, Standard Bank Research

Consumers: supported by benign inflation and credit growth

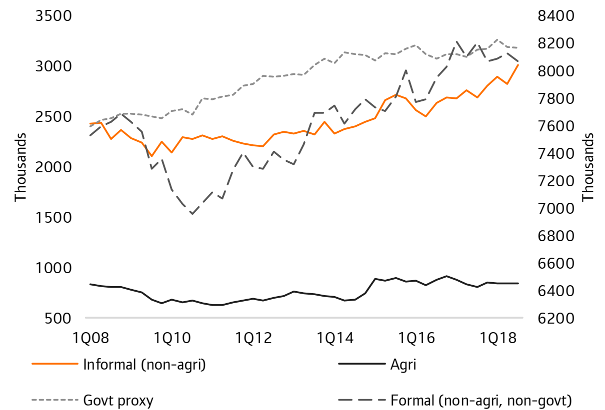
The main driver of consumer spending growth in 2019 is likely to be real wages again, although accelerating credit growth also provides growing support. Unfortunately, the wide discrepancies among the various official measures of income growth that concerned us during 2018 (see our report The state of the consumer of 3 December 2018) seem to have been resolved with a convergence towards the lower measures. This is a significant risk to consumer spending growth and, in turn, economic growth, in 2019.

Figure 7: Compensation of employees slowed



Source: Stats SA

Figure 8: Employment stagnating, with downside risk

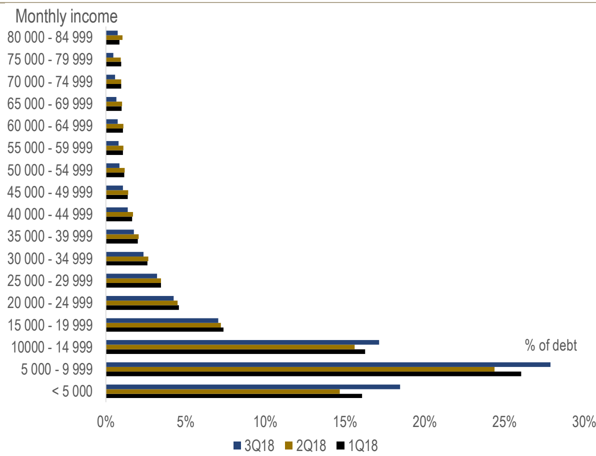


Source: Stats SA, Standard Bank Research

Total private sector employment has essentially been trending sideways although this seems to mask a shift from formal to informal employment. As with most of our recent structural analyses (see our 2019 SA macro outlook report for detail), the manufacturing, mining and construction sectors have been the weakest. Government employment seems to be gradually grinding lower. We assume that total employment will trend sideways in 2019, though the risks are modestly biased downwards. The relatively low ratio of employment to GDP is encouraging insofar as it should limit the downside risks (to employment) to a large extent.

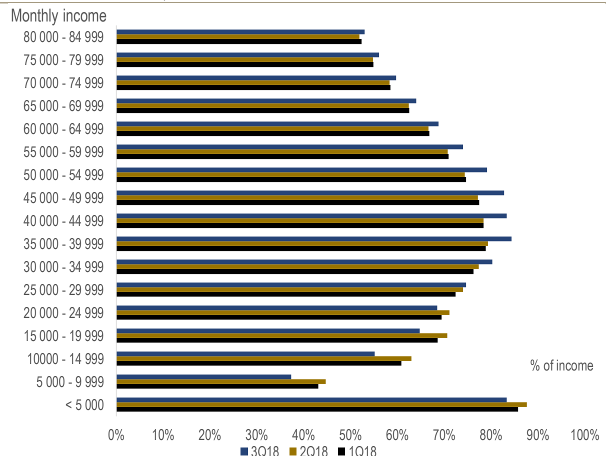
There should be some support for consumer spending growth from the ongoing (albeit moderate) acceleration in credit growth. **All types of households' bank credit have been accelerating, with asset-backed credit responsible for more than 76% of the credit growth in the last six months**[3]. This should counteract the impact of slowing wage growth. If the recent growth in households' bank credit persists, the additional spending power that this provides to households (in rand terms) exceed that provided by the growth in the total private sector wage bill. The data from one of the credit bureaus (which is not as robust as official data, and need to be used with circumspection) suggests that this stronger credit uptake has generally been by the middle- to higher income groups. Their arrears have been reasonably low and declining, suggesting that this is not distressed borrowing[4].

Figure 9: Arrears across income groups – lower end under pressure



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Figure 10: Debt-income ratios across income groups – lower end can't yet afford more debt

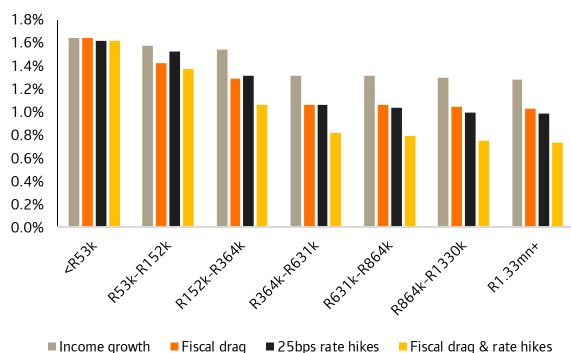


Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Assuming 6.5% (nominal) income growth, we estimate that **real income growth should remain positive across the income spectrum, even once the impact of modest fiscal drag[5] and the usual "sin" tax increases[6] are taken into account,** alongside the November 2018 interest rate hike. With just some fiscal drag and no monetary tightening, real income growth after tax and interest costs are around 0.7% for the higher-income groups and around 1.6% for the lower-income groups. The risk is that income growth may be below the 6.5% assumed in these estimates, given the recent deceleration, weakness and discrepancies among different datasets.

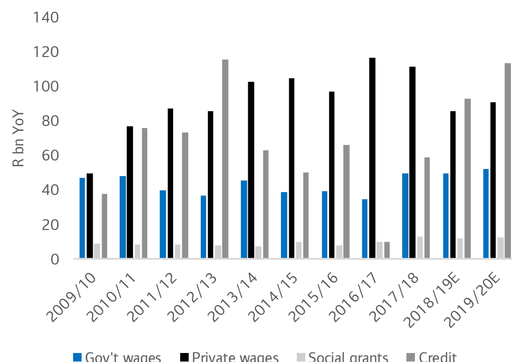
[3] *Though the year-on-year growth rates are strongest in their unsecured credit.*
[4] *This is supported by the aforementioned bias of the bank credit towards asset-backed credit.*
[5] *Tax brackets not adjusted for inflation.*
[6] *These are here incorporated into our inflation forecasts.*

Figure 11: Real spending power growth impact of inflation, with/out fiscal drag and monetary tightening



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Figure 12: Gov't vs private wage bill, social grants and credit growth



Source: SARB, Treasury, XDS, Eighty20, Standard Bank Research

Fixed investment: not resurging yet

We expect very weak public-sector infrastructure spending growth in the short- to medium term, given the generally precarious SOE financial positions and limited fiscal space. Total public-sector infrastructure spending forecasts will likely be cut again in Budget 2019 given savings and delays announced by the SOEs. It is more difficult to judge the likely momentum in government infrastructure spending.

Ultimately, capital expansion is one of the areas in which there is the most upside potential in a benign political/policy setting, and we are optimistic about a possible increase in private sector participation in infrastructure construction (and potentially maintenance and operations). This was strongly echoed in the October 2018 Medium-Term Bu MTBPS. It is, however, still unclear exactly how the proposed Infrastructure Fund will work, and we suspect that this may take some time to finalise so that it is unlikely to start making a difference in 2019 yet.

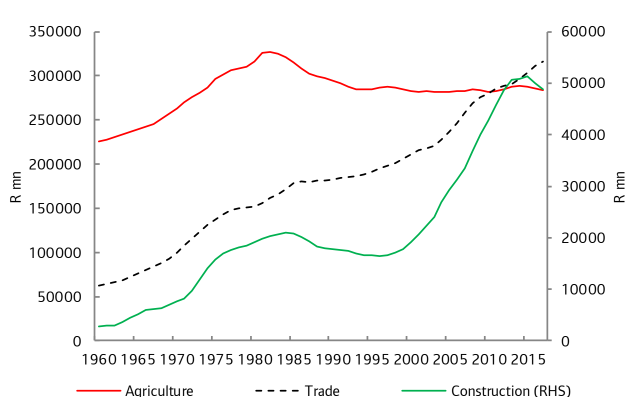
There should be some lift to private sector gross fixed capital formation (GFCF) from the new round of contracts signed as part of the renewable energy independent power producer (REIPP) programme at the beginning of 2018. However, in general, **private sector gross fixed capital formation (GFCF) is likely to remain subdued in the near term given policy and political uncertainty** despite some improvement in company profitability and incremental progress with policy reform. This is echoed in surveys of manufacturing firms which indicate that they are not yet increasing fixed investment despite rather high capacity utilisation.

While there was a lack of growth in aggregate private sector gross fixed capital formation over the past two to three years, **capital stock levels continued rising in most sectors bar manufacturing and construction**. In other words, on aggregate, firms' fixed investment continued to exceed depreciation. There is thus no general backlog in "replacement" investment. However, over the past decade, the ratio of capital stock to output has declined somewhat in the manufacturing, construction and financial services sectors.

It is noteworthy that the contraction in the manufacturing sector's capital stock started around a decade ago – well ahead of firms perceiving the political climate (and policy uncertainty) to be particularly problematic. The stagnation in the agricultural sector's capital stock began even earlier. The weakness in the construction sector, in contrast, is more recent, and partly reflective of fiscal constraints. The weakness in real private sector fixed investment in 2016-2017, when the political climate perceptions deteriorated sharply following the quick succession of Finance Ministers in December 2015 and

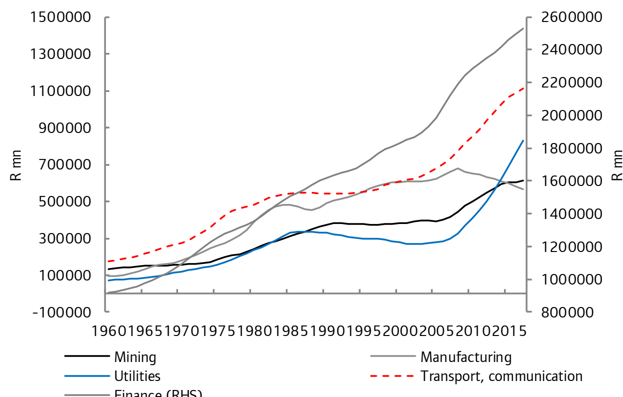
heightened uncertainty about unaffordable nuclear procurement and sovereign credit rating downgrades, was broad-based across sectors. However, in most sectors (bar some of the services sectors) the weakness started earlier.

Figure 13: Sectoral capital stock (1) – construction falls, agriculture stagnates, trade rises



Source: Stats SA, SARB, Quantec

Figure 14: Sectoral capital stock (2) – generally rising, except for manufacturing decline



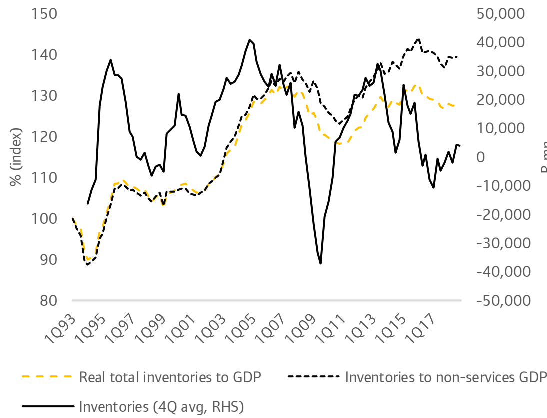
Source: Stats SA, SARB, Quantec

Inventories: case for restocking not obvious yet

Despite a decline in inventories during the latest economic downturn, a more certain improvement in the economic prognosis might be required to trigger a material rebound in stocks. **Surveyed firms do not at this stage regard inventory levels as particularly low relative to demand**, supporting our view that an economic growth boost from restocking is not imminent. While the low ratio of commercial and industrial inventories to GDP published by the SARB is commonly interpreted as a signal that restocking is imminent, real inventories to GDP (total or non-services GDP, as services sectors generally carry lower inventories) are not as convincingly low enough to compel a restocking boost to economic growth yet. Our estimates suggest that **aggregate inventory volumes are below their recent peak (relative to GDP), but well above previous troughs that were followed by restocking cycles**.

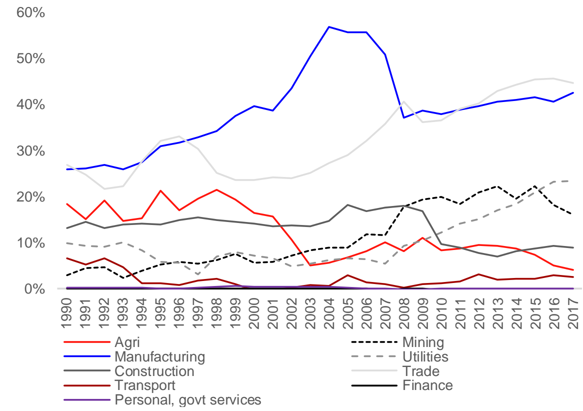
However, trends differ across sectors. In 2017 (the latest data available), real inventories (relative to the sector's output) were near peak levels in the wholesale and retail trade, leisure and catering sector, as well as the transport and communication sector, and at a new peak in the utilities sector. In the construction sector, real inventories (relative to the sector's output) were at the highest since their global financial crisis (GFC) plunge. Real inventories (relative to output) seemed somewhat low in the agricultural sector. Manufacturing stocks have been rising (as percentage of the sector's output) and are at the highest since the GFC, though still well below the pre-GFC spike in the mid-2000s.

Figure 15: Inventories lower, but not necessarily low enough to compel material restocking yet



Source: SARB, Stats SA, Standard Bank Research

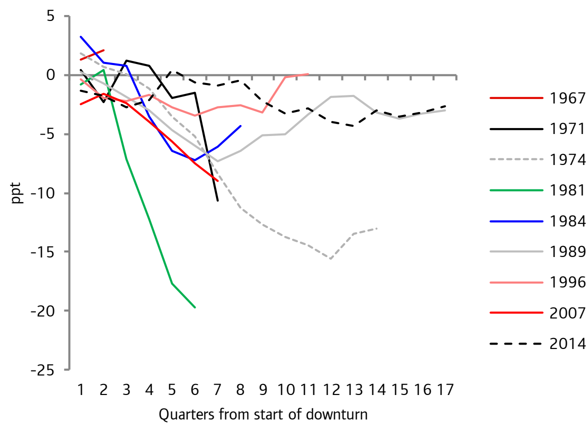
Figure 16: Real inventories low vs GDP in mining and agriculture, high in trade, rising in manufacturing



Source: Stats SA, SARB, Standard Bank Research

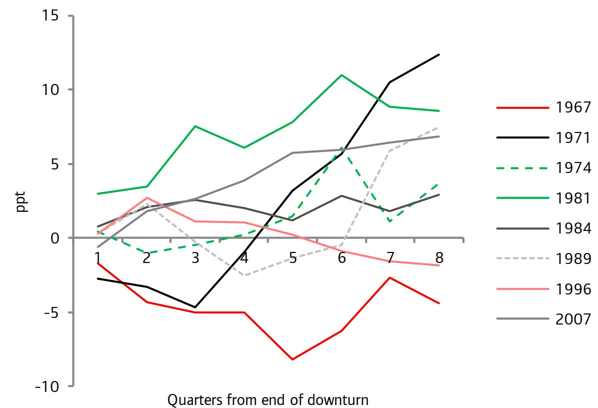
The key sectors, in terms of the magnitude of their inventories, are the trade, catering and accommodation sector as well as manufacturing (we estimate that they constitute around 50-60% of total inventories, depending on the measure used), followed by the mining and agricultural sectors. **Real inventories are not particularly low in either of the two key sectors in terms of the magnitude of inventories** (trade and manufacturing). The latest inventory destocking cycle has been rather shallow; we thus expect the restocking cycle to make a reasonably modest contribution to GDP growth once the economy recovers. We assume modest inventory restocking in 2019, that is unlikely to have a material impact on GDP growth.

Figure 17: Cumulative contribution of change in inventories to GDP growth from start of each downturn[7]



Source: Stats SA, Standard Bank Research

Figure 18: Change in inventories' cumulative contribution to GDP growth from end of downturn



Source: Stats SA, Standard Bank Research

Government consumption: modest contribution to GDP growth

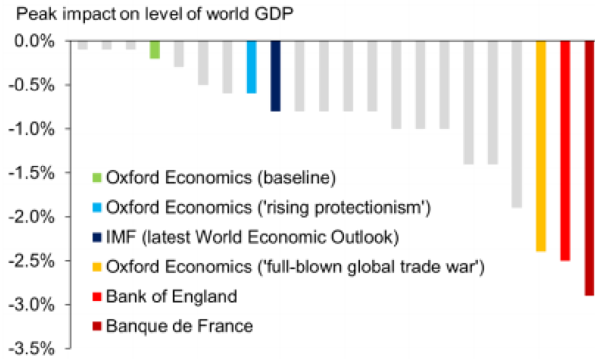
Our assumptions for the growth in real government consumption expenditure are slightly higher than those in the MTBPS. This is partly owing to our lower inflation projections.

[7] *The date in the legend refers to the beginning of the downturn.*

Net exports: could modestly support economic growth

We expect a small positive (real) economic growth contribution from net exports in 2019, from a negative contribution in 2018. A flare-up in global trade tension is a pertinent risk to this reasonably benign assessment, with SA's trade and current account balances some of the most vulnerable among EM.

Figure 19: Trade war growth impact – wide range of estimates reflect uncertainty about the end-game



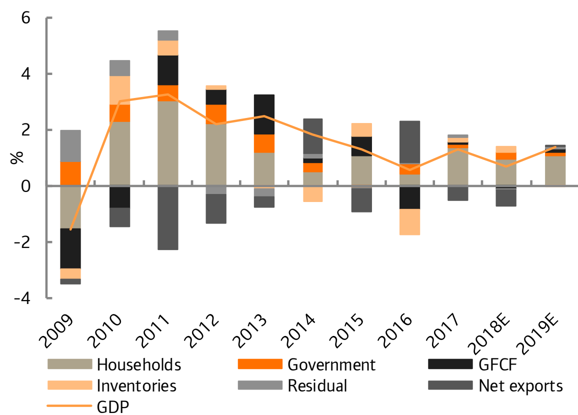
Source: Oxford Global Economic Model, Standard Bank Research

Figure 20: US-China very aggressive tariff war estimated impact – SA CAD more vulnerable than peers, SA GDP not

% avg	2019	2020
World GDP	-0.18	-0.39
SA GDP	-0.06	-0.24
China GDP	-0.55	-1.10
Russia GDP	-0.28	-0.72
India GDP	-0.05	-0.00
Indonesia GDP	-0.12	-0.26
SA CAD	-0.25	-0.32
Brazil CAD	-0.15	-0.17
Australia CAD	-0.03	-0.10
Chile CAD	-0.60	-0.70
Russia CAD	-0.60	-0.90
India CAD	0.08	0.09
Indonesia CAD	-0.03	-0.06

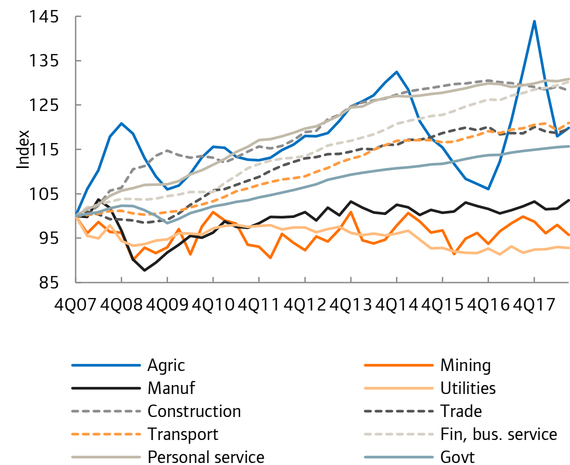
Source: Oxford Global Economic Model, Standard Bank Research

Figure 21: Growth composition – near-term growth still dependent on consumers



Source: Stats SA, Standard Bank Research

Figure 22: Sectoral GDP trends – mining, manufacturing, utilities sectors the post-crisis laggards



Source: SARB, Standard Bank Research

CAD fundamentally fragile

We expect the CAD to compress from an estimated 3.6% of GDP in 2018 to around 3.3% in 2019, but it may then expand to around 3.8% in 2020 if the economy recovers as expected

We expect the current account deficit (CAD) to remain at levels (particularly when SACU payments are excluded) that are typically not hard to fund. There should be some CAD support from a reasonably competitive (real trade-weighted) rand, a reversal of the Western Cape drought impact, and strong (albeit sub-peak) terms of trade. However, along with the fiscal deficit, the total funding requirements still make it one of the more vulnerable among EM to changes in actual or expected global liquidity conditions. The still-sizeable CAD despite the terms of trade only 4% below an all-time high[8] and still

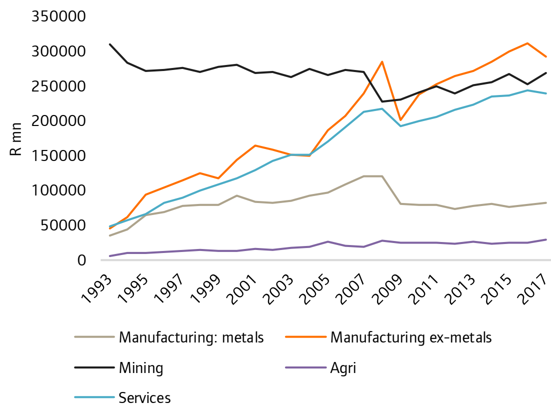
[8] *In 3Q18, the latest data available.*

14% above the 20-year average (amid sluggish domestic demand) reflects structural economic constraints. Our analysis highlights two key constraints.

It is very worrying that the CAD is at current levels despite the terms of trade only 4% below the all-time high

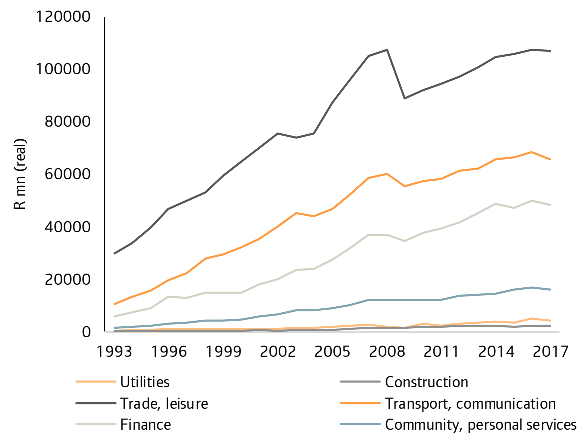
First, there is a clear constraint from stagnating mining export volumes, using either the strict technical classification or expanding it to include processed metals (from the manufacturing sector). If (the latter broad definition of) mining (related) export volumes had since the global financial crisis grown in line with non-mining exports, total exports would have been around 0.5% of GDP higher in 2017 (*ceteris paribus*). The importance of the mining sector for the trade balance is fading, with (a very broad classification of) mining and metals now only around 38% of total real exports (in 2010-rands) from 53% in 2004 and 60% in 1999. [9]

Figure 23: Real exports – mining and metals a key weakness



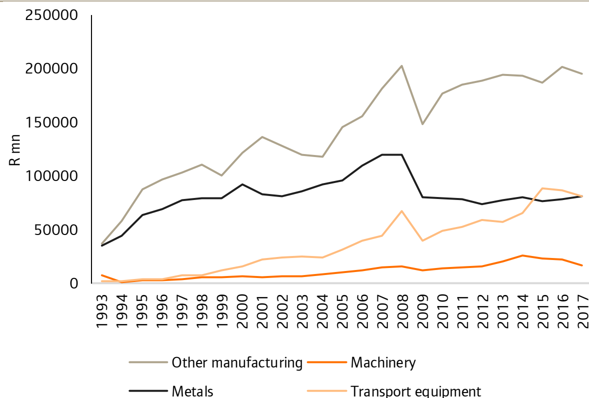
Source: Quantec

Figure 24: Real sectoral exports (excluding mining, agri and manufacturing)



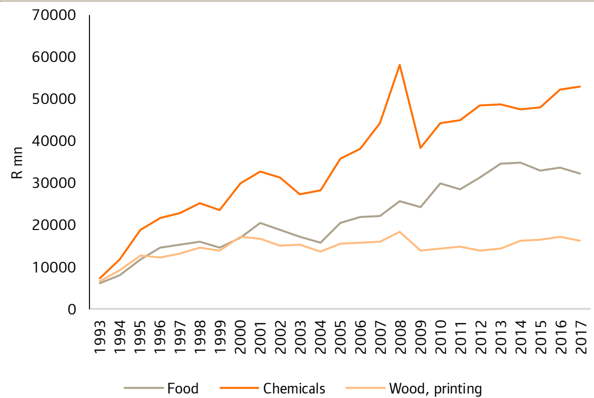
Source: Quantec, Standard Bank Research

Figure 25: Real manufacturing exports – metals and machinery particularly weak



Source: Quantec, Standard Bank Research

Figure 26: Select manufacturing industries' real exports – chemicals[10] strong, food strong till the drought



Source: Quantec, Standard Bank Research

Second, import intensity of domestic demand reached record-high levels Our analysis suggests that it is mainly in the manufacturing sector that imports have been

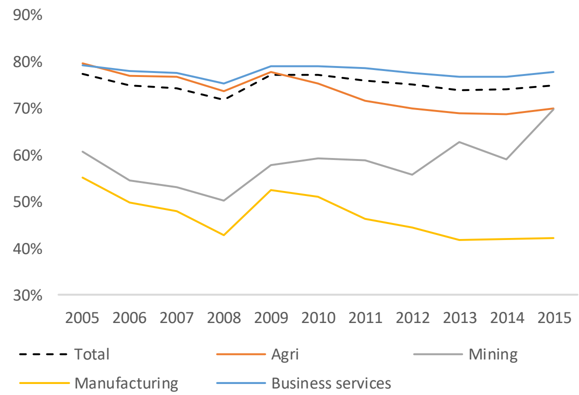
[9] *In the manufacturing sector, export volumes outside of (the aforementioned) metals are around 2.6% above their pre-GFC peak and now bigger than the (narrowly defined) mining export volumes (though still smaller than the joint mining and manufactured-metals exports). Within the manufacturing sector though, industries' performances varied markedly. Metals exports have been generally flat, while chemicals, transport equipment, and (until recently) food and beverages exports have been rather strong.*
[10] *Petroleum products, chemicals, rubber and plastic.*

rising relative to the size of the sector's output; this has been quite broad-based across many manufacturing industries[11].

Figure 27: Record-high imports vs demand a concern

Source: SARB, Standard Bank Research

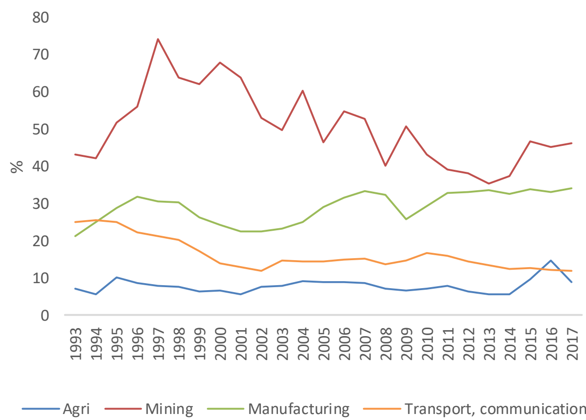
Figure 28: Local value added in final domestic demand (select sectors)



Source: SARB, Standard Bank Research

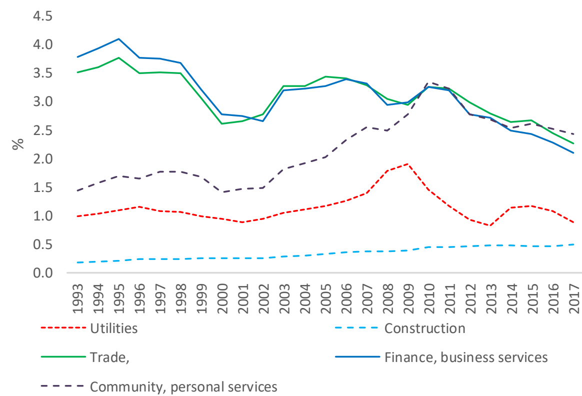
Import-leakage charts portray a similar general picture. **The manufacturing sector is again the main culprit in driving up the aggregate import leakage**. Similarly, the deeper analysis by the OECD into the local value added in final domestic demand and/or exports also point to an aggregate deterioration that is driven mainly by the manufacturing sector (this weakness is broad-based).

Figure 29: Domestic demand satisfied by imports – general manufacturing uptrend, drought-spike in agriculture



Source: Quantec, Standard Bank Research

Figure 30: Domestic demand satisfied by imports – services sectors generally declining



Source: Quantec, Standard Bank Research

Bar some weakness during the GFC, **the services portion of the CAD has generally been balanced**. Tourism receipts have generally been on an uptrend; a counteracting rise in tourism payments has been partly offset by a decline in other service imports[12]. **Services imports and exports are on average more rand sensitive than goods**, and

[11] Part of the rise in imports relates to the expansion in exports, though our analysis suggests that this is not a critical driver.
[12] Services sectors' export volumes have grown 2.8% on average per year over the post-GFC period, and they were by 2017 (the latest data available) nearly 10% higher since the GFC (this compares with 2.2% for goods). Generally, services are also bucking the goods sectors' rise in import intensity.

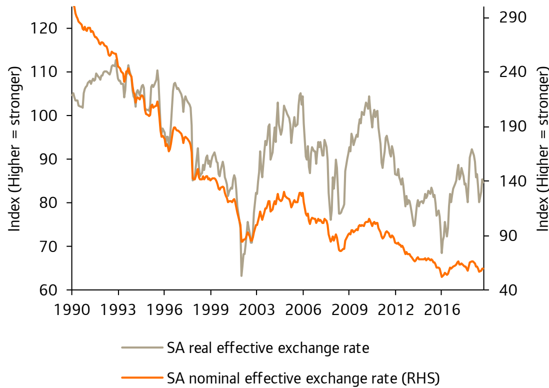
to the extent that the real rand remains competitively valued, it should provide a boost to this portion of the CAD.

Rand: undervalued yet vulnerable

Like the economy, **the rand will likely be weaker early this year**, with a possible rebound later in the year. The rand is still relatively weak according to our valuation models, but pre-election uncertainty and renewed load-shedding risks from Eskom (alongside global headwinds and risks) are expected to keep it weak and vulnerable in 1H19. A pragmatic budget that doesn't trigger negative sovereign credit rating action might be an initial catalyst for some appreciation, though more political certainty and concrete policy reform actions will be required for a significant rerating. There is a risk that, like early in 2018, rand strength will overshoot once optimism about policy and political reform is revived. Purchasing-power parity (PPP) estimates are unsustainably strong, in our view, but are so widely followed that they may become self-fulfilling if policy reform is convincing.

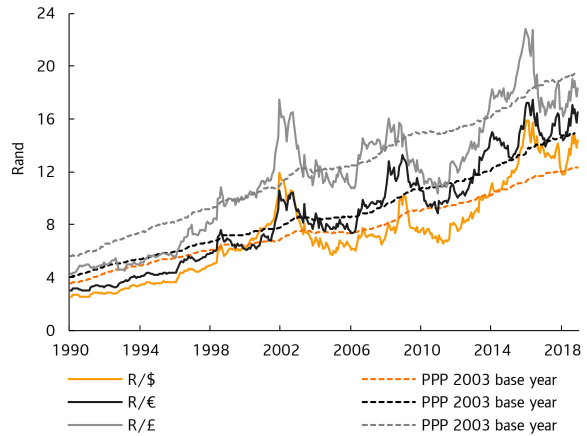
We expect the rand to strengthen to R13.40/$ by end-2019, remaining there in 2020, before declining to R13.50 by end-2021.

Figure 31: Trade-weighted rand – marginally weak vs historical benchmarks



Source: Bloomberg

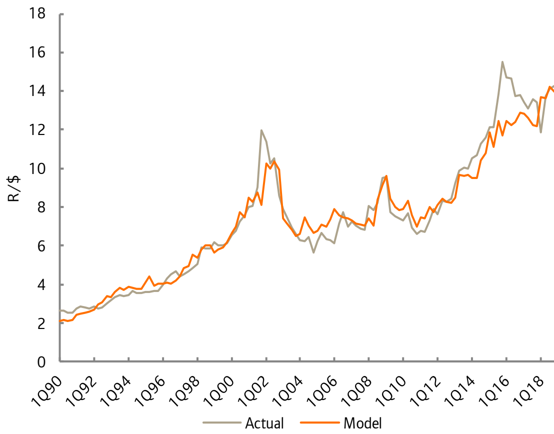
Figure 32: PPP estimates – suggest the rand is generally materially undervalued



Source: Bloomberg, Standard Bank Research

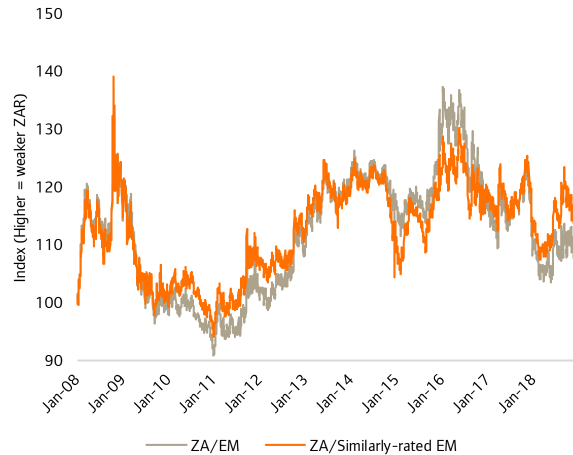
Our reasonably constructive rand forecasts are premised on a relatively benign global economic outlook despite tightening global liquidity conditions and a marginal growth slowdown. The risks to the global economic assumptions are decidedly biased to the negative side. A key negative risk is the expected global growth deceleration to which a possible resurgence in trade friction and an uncertain Brexit pose further downside risks. This, in turn, underscores downside risks to commodities – the biggest risk to our forecasts for 2019. We also acknowledge the risk that we might be underestimating the impact of rising US rates on the rand. Positive global risks include the possibility that oil prices may remain low, and probable dollar weakness.

Figure 33: Econometric rand model suggests marginal undervaluation (against weak AUD)



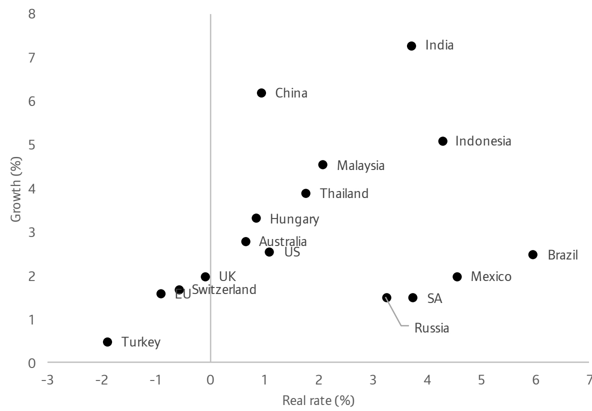
Source: Bloomberg

Figure 34: Rand vs EM currencies – risk premium back at 3Q17 levels



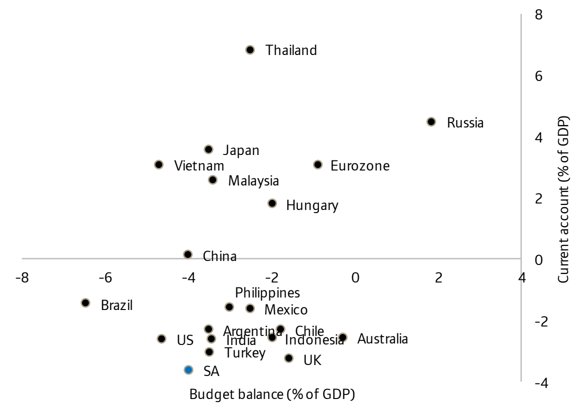
Source: Bloomberg, Standard Bank Research

Figure 35: SA growth and interest rates in context



Source: Bloomberg, Standard Bank Research

Figure 36: SA twin deficits (2019) in context



Source: Bloomberg, Standard Bank Research

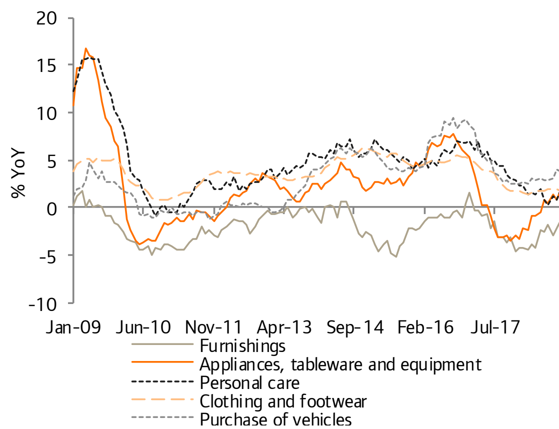
Inflation and interest rates: benign

Our 5.1% average inflation forecast for 2019 is below the consensus

Specific factors – including the fading disinflation of early-2018 rand strength, rising food inflation (from low levels, and owing to a weaker rand and global price pressure) and still-elevated administered tariff increases (including a double-digit forecast electricity tariff increase) – will put upward pressure on consumer inflation in 2019. However, subdued exchange rate pass-through, low oil prices, weak wage growth and generally subdued global inflation should help to keep inflation contained in 2019. Our 5.1% average 2019 forecast is below the consensus; our in-target inflation forecasts support our view that the SARB will not hike interest rates again in 2019 (though we tentatively pencil in another hike in 2020), particularly given our concerns around downside risks to near-term economic growth.

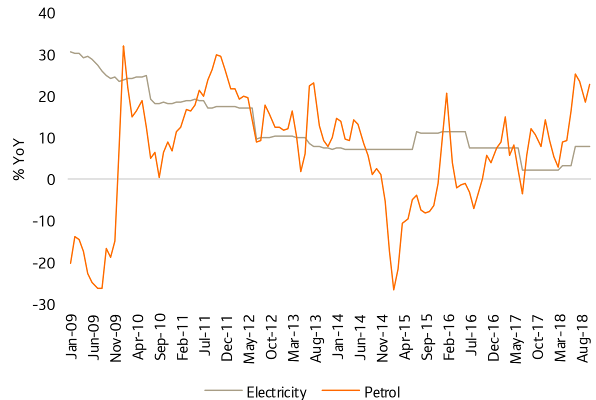
While the domestic economic outlook and risks clearly do not require imminent monetary tightening, the risks are in our view still biased towards slightly earlier tightening than we currently forecast, given the negative rand risks and the SARB's desire to anchor inflation expectations lower. Investors would have to be nimble this year, as rate expectations will likely be particularly data-dependent.

Figure 37: Rand-sensitive categories – benefit of early-2018 appreciation is fading



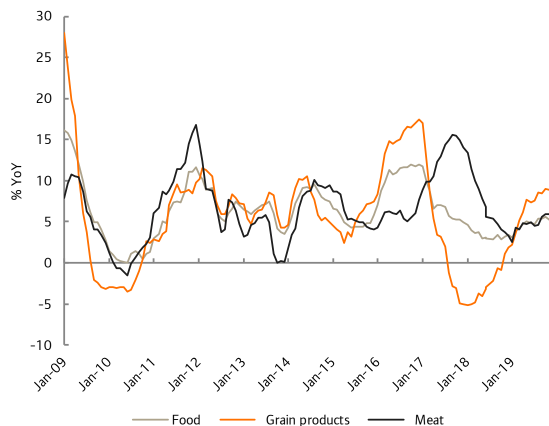
Source: Stats SA

Figure 38: Energy costs a significant inflation forecast risk for 2019



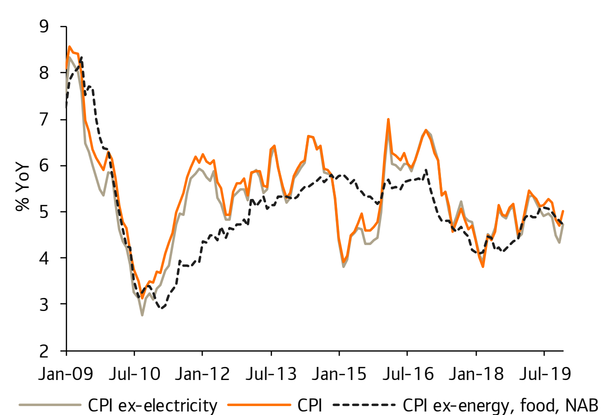
Source: Stats SA

Figure 39: Food inflation – cycle should be reasonably modest, but risks have increased



Source: Stats SA, Standard Bank Research

Figure 40: CPI forecasts – comfortably inside the target range



Source: Bloomberg, Standard Bank Research

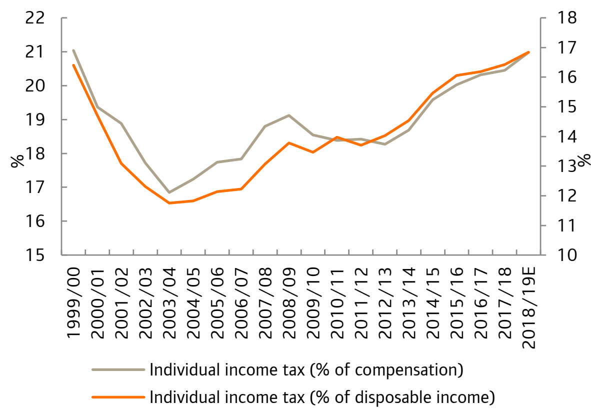
Fiscal policy and ratings: legacy risks

The fiscal deficit trajectory should not change much in the 2019 budget; Eskom's need for fiscal support is a major risk

We expect the 2019 fiscal trajectory to broadly match that of the October 2018 Medium-Term Budget Policy Statement (MTBPS). Revenues for FY18/19 are on track, and subsequent forecasts seem achievable, though there are obvious further economic growth and in turn tax revenue risks. We do not expect tax hikes, apart from modest fiscal drag and inflation-related increased in consumption taxes; government and the ANC are very cognisant of the sharp rise in households' tax burden over the past 15 years, to the highest in two decades. Treasury is optimistic that an improvement in SARS's efficacy may ultimately significantly boost tax revenues.

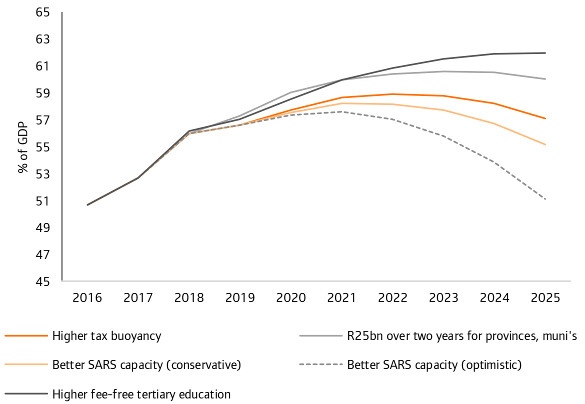
We expect the expenditure ceiling and deficit-neutral SOE support pillars of fiscal consolidation to be preserved. Eskom's funding requirements – a key risk – are not imminent, and at this stage we assume the budget will only pencil in a modest fiscal injection for FY19/20 – perhaps enough to service the R100bn of debt that Eskom has asked government to assume. This can be deficit-neutral (if funded, for example, via the mooted sale or leasing of unused properties identified in 2018 by the Department of Public Works, a spectrum auction, the recovery of identified overdue tax receipts and/or modest fiscal drag). Additional government spending (including spending related to president Ramaphosa's stimulus and recovery plan announced in 2H18 and the above-budget wage increase granted in 2018) gets accommodated within the expenditure ceiling and the risk is that other spending will be crowded out rather than the expenditure ceiling breached. According to our detailed analysis, negative credit rating action (by Moody's in particular) is only likely if there is a deterioration in key relevant metrics (see our reports Eskom and the economy: Some thoughts and Fiscal sustainability and Moody's for more detail). This remains a risk, but not our base case at this stage.

Figure 41: Households' tax burden – highest in decades



Source: Treasury, SARB, Standard Bank Research

Figure 42: Debt scenarios – material two-sided risks



Source: Treasury, IMF, Standard Bank Research

Figure 39: Macroeconomics forecasts

Growth data (% y/y, seasonally adjusted & annualised)	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	Q4:19	2018F	2019F
Expenditure on GDP	1,3	1,5	1,4	1,1	1,5	1,8	2,0	2,1	1,3	1,9
Household consumption expenditure (HCE)	1,0	1,7	1,8	1,8	1,9	2,0	2,0	2,0	1,6	2,0
Gross fixed capital formation (GFCF)	-0,8	-0,5	1,7	2,1	3,0	3,8	4,0	4,0	0,6	3,7
Exports	8,8	5,8	0,7	0,7	1,9	2,2	2,5	2,7	4,0	2,3
Imports	7,1	6,4	0,7	1,5	1,9	2,2	2,4	2,5	3,9	2,2
Current Account Balance (CAD) % of GDP	-3,8	-3,0	-3,5	-2,7	-4,4	-3,7	-4,2	-3,3	-3,3	-3,9
Prices										
Inflation (average)	4,9	5,1	5,3	4,9	5,3	5,0	5,0	5,2	5.1	5.1
Interest rates (%)										
Prime lending rate (end period)	10,25	10,25	10,25	10,25	10,50	10,50	10,50	10,50	10.25	10.50

Source: SARB, Standard Bank Research

Elna Moolman

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