The Economy in 2021

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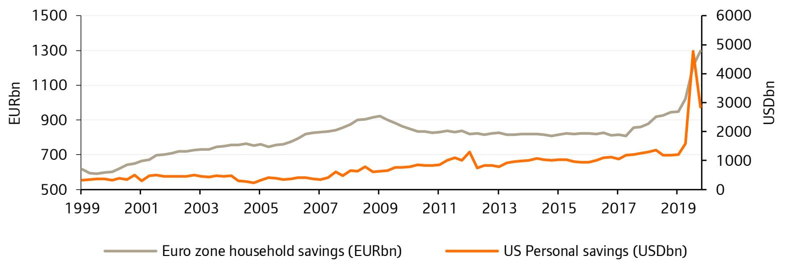
The long road back

2021 should be a year of recovery. However, much of this will be crammed into the second half of the year as vaccine rollouts should allow countries to ease lockdown restrictions. Policymakers, on both the fiscal and monetary side, will nurture this recovery, not jeopardise it with less accommodative policy. Economic recovery and policy accommodation should ensure an encouraging backdrop for asset prices, such as stocks, as should our call for a lower dollar. However, dangers are lurking, not least a rise in inflation that could run ahead of expectations as demand rebounds but supply stumbles.

Release

After a decline of close to 4% in global GDP last year, 2021 should see growth rebound by between 4% and 5%. But the year will be very uneven, with many developed nations, particularly in Europe, experiencing double-dip recessions. Economic activity should however recover from the spring and then surge ahead in the second half of the year, provided that vaccine rollouts remain on schedule and with their efficacy not compromised by emerging new strains of the coronavirus. The source of such economic rebound should be pent-up consumer demand as the closure of many service-related establishments during lockdown has led to a sharp rise in consumer savings (Figure 1).

Figure 1: Savings surge



Source: Refinitiv datastream

For some, savings will have been burnt through as the income lost from the coronavirus crisis forces consumers to fall back on their own resources and/or those provided by governments. But, for most, savings have risen as spending opportunities have been reduced. As these opportunities for spending return, so economic growth is likely to surge. But, quite clearly, this represents a temporary development. It seems very unlikely over the long haul that economies will be stronger than where they were before the pandemic struck. Pent-up spending may still be released this year, and probably next year by those that are behind in the vaccine rollout process but, over time, consumers are likely to be more cautious and would want more precautionary savings than they had maintained before coronavirus struck.

There may be similar caution amongst the corporate sector, not least because debt levels have risen sharply, providing a stronger headwind to economic activity.

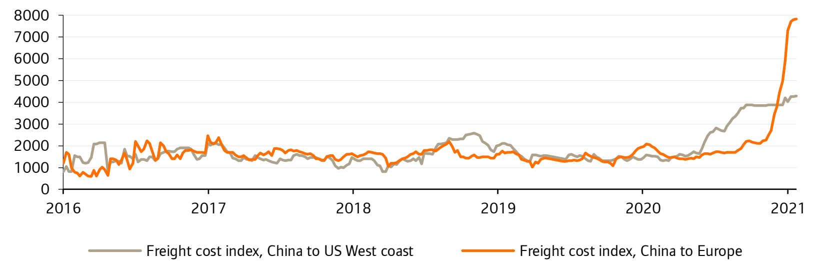
Governments too have seen debt levels rise sharply on account of the USD14tr or so that has been spent trying to combat the economic effects of the pandemic. Even if governments delay attempts to claw back some of this outlay, consumers and businesses will be cautious that tighter fiscal policy lies around the corner. There are also numerous other long-term costs of coronavirus to consider, such as medical pressures caused by so-called ‘long Covid’ and the educational damage implied by many months of missed schooling. All of these sorts of issues suggest that the sharp bounce-back in economic growth likely this year, and perhaps next year as well, will be a misrepresentation of the longer-term outlook. The aftermath of the 2008/09 global financial crisis (GFC) might have been a long period of economic expansion but it was a very weak one. We've every reason to believe that the post-coronavirus economic outlook will be similarly muted.

The return of inflation

There is one sense in which the post-coronavirus outlook could differ from the GFC which makes the longer-term economic outlook even more feeble. It relates to inflation. Most adverse shocks that have hit the world have been negative shocks to demand in the economy. These lower output and also lower inflation. And it is this persistence of low inflation that allows central banks to keep monetary policy very accommodative and so nurture the recovery.

The coronavirus pandemic is both an adverse demand and an adverse supply shock. It is an adverse demand shock because people have not been able to spend as they would have wished. But it is also an adverse supply shock because many of these same individuals have not been able to work as they would have wished. They might have lost jobs, been placed on furlough, lost working hours and more. The result is that the economy's supply capacity is reduced. That might not matter too much when demand has been stifled as well. But what happens if, and when, demand comes surging back as lockdowns ease? If supply cannot respond sufficiently there's a danger that economies temporarily overheat and higher inflation ensues. Such pressures could be exacerbated by any international tensions that impact trade flows. For instance, China's relationship with many countries, and perhaps especially the US, could remain fraught due to coronavirus. Globalisation already seems to be in retreat and coronavirus could have speeded up this process. In addition, there are already technical challenges that coronavirus has created, such as container shortages that have helped cause a surge in many freight costs (Figure 2).

Figure 2: Freight costs soar



Source: Freightos

Sweet spot

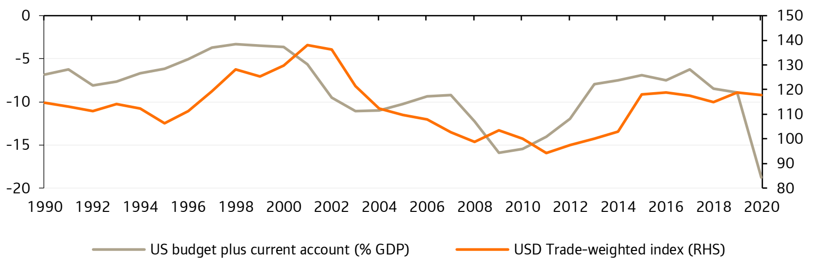
The jury might be out on whether inflation is likely to make a significant return but, even if it does, we should remember that policymakers in the major central banks want higher inflation. Hence, there is no sense at all that central banks will be in any sort of rush to tighten monetary policy if inflation proves more pronounced than widely anticipated. In fact, one central bank, the Federal Reserve has tweaked the operation of its monetary policy to allow inflation to rise to higher levels than previously before considering tighter policy. This tolerance of higher inflation is likely to be adopted elsewhere, not least at the ECB which has its own monetary policy review to complete this year.

Hence, from the perspective of the front-end of the bond markets, investors might be in something of a sweet spot for a time because returning inflation won't spark higher rates. Most of those central banks that do proffer a view on future policy indicate that rate hikes are a good few years away, and we have no reason to doubt them. We certainly see no scope for major central banks to hike rates this year or even reduce the extra accommodation they are providing through means such as quantitative easing or direct lending. The longer end of government bond markets could be more challenged later in the year as economic growth revives strongly, inflation moves higher, and central banks continue to show indifference. We believe that these factors could push yields somewhat higher than widely anticipated later in 2021. For instance, we look for 10-year US treasury yields to be around 1.75% by the end of 2021, which seems to be almost half a percent above the current consensus.

Weaker dollar

We expect bond yields in the US to increase relative to those in most other nations, and especially in the euro zone where lowflation or even deflationary pressure seems more entrenched. However, we do not expect the dollar to rise against the euro, or any other developed currencies for that matter despite higher US yields. This is because the US has developed a yawning funding gap as a result of coronavirus. The twin deficit, comprising the budget and current account, is close to 20% of GDP (Figure 3).

Figure 3: Pointing to a weaker dollar



Source: OECD, Refinitiv datastream

The threefold surge in the US budget deficit in 2020 requires financing by both the domestic private sector and the foreign sector. The Federal Reserve can clearly lend a hand with the USD80bn of treasuries that it is buying every month, but that won't last forever. Domestic private savings are currently elevated because of coronavirus as we showed earlier, but this too won't last. In our view, more external financing will be required and that's the equivalent of a much larger current account deficit. Higher US yields are going to be needed to pull in these capital inflows especially as the dollar already seems overvalued after a long rise since 2011, and other US assets, particularly stocks, also look somewhat expensive compared to other countries.

In short, we doubt that the US will achieve sufficient inflows without some cheapening of the dollar. Indeed, it appears that the dollar has already started this decline given the 10%-plus decline that we have seen on a narrow trade-weighted basis since last spring. Over the coming year or so, we look for another decline of 10% or more. A weaker dollar should provide a positive backdrop for non-US assets like stocks and corporate debt. For even if the US stock market were to record limited improvement in 2021, other stock markets may still catch up with US valuations as dollar weakness provides some sort of cushion.

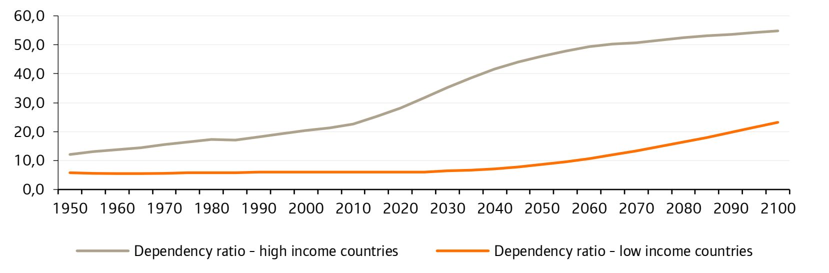
Taper tantrum two?

The biggest danger to financial asset prices this year would seem to be the possibility of the Fed starting to scale back its bond purchases. Memories are still fresh from the infamous 'taper tantrum' in 2013 when former Fed Chair Bernanke started to talk about the prospect of reduced Fed bond purchases. Just the mention of this possibility in May 2013 caused yields to surge, with ripple effects across other assets. In the end, the Fed did not actually start to taper until the end of 2013 but, by then, much of the damage had been done.

Fast-forward to today, and clearly the Fed will face a similar communication challenge at some point. The key question is whether financial markets will be able to absorb such a decision without a similarly deleterious effect on treasuries and possibly other asset prices outside the US. While we don't think that the Fed will taper this year, the bank could still start to engage in the discussions that will likely see this outcome in 2022. The reaction in the market could be determined in part by the balance between growth and inflation. Should the US economy be rebounding strongly, in line with global improvement, and with modest inflation, it seems reasonable to assume that the prospective change in bond purchases won't upset financial assets. Alternatively, if inflation is rising materially the reaction in the market could be altogether different. We mentioned earlier that the recovery from the GFC was modest, even if it was long-lived. Much of the reason why financial market assets like stocks managed to rise through much of this period was due to low policy rates from the Fed and others. Investors felt comforted that, if the economy slowed, the Fed, or any other central bank would be in a position to ease policy and so keep the risk rally going. Even setbacks, like the taper tantrum, proved temporary.

Looking ahead, investors will be hopeful that central banks can still become more accommodative if growth is sluggish and inflation low. But the possible difference now, is that sluggish growth might not be accompanied by low inflation, for the reasons we mentioned earlier. Should central banks lose their ability to provide more accommodation because of higher inflation, the outlook for investment in risk assets such as equities or corporate credit would deteriorate significantly. But is this likely? After all, policymakers have spent many years, even decades, coping with inflation that is stubbornly too low. Are we to believe that this could all flip around quickly and turn into an inflation problem? We don't think so. But we do believe that the longer-term, multi-year, even multi-decade, trend is for higher inflation as the global demographics that have bought about significant deflation in many advanced countries go into reverse. Sharp increases in the elderly relative to working age adults (the dependency ratio) will strain global supply in developed nations and the ability of emerging nations to fill this gap will become more limited as China's demographics turn as well (Figure 4).

Figure 4: Rising inflation threat



Source: United Nations

Add to this the de-globalisation we mentioned earlier, and it seems that the days of very low inflation, even deflation, may pass into history. But none of this is going to happen quickly and, as we have also mentioned, there is a sweet spot for investors because increases in inflation now won't provoke quick central bank rate hikes. Hence, inflation is something to bear in mind for the long haul, not necessarily the coming year or so.

If there's a sweet spot in terms of inflation risks, there's also a sweet spot for investors. For this year should see rebounding growth and continued policy accommodation. Both these bode well for the appreciation of risk assets. Further out, as some of the legacy effects from coronavirus show through, such as higher inflation, onerous debt headwinds, declining trend growth, and more, the investment outlook will likely turn more hostile. But this is a story for 2022 or later, not this year.

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EM outlook for 2021

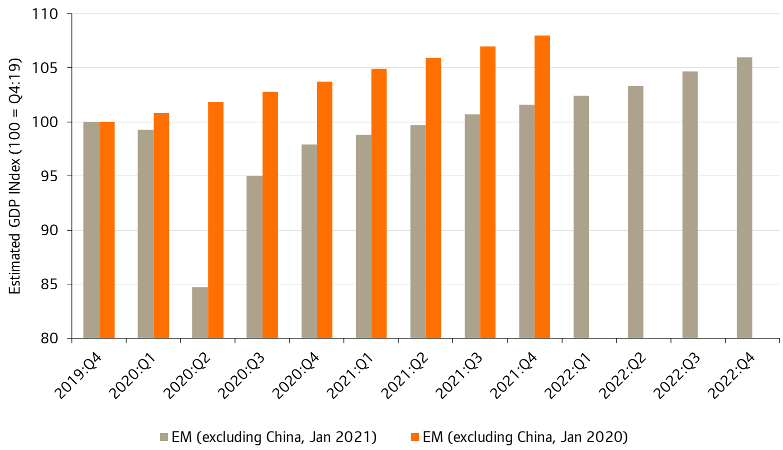
An uneven recovery

Led by rapid rebounds in weighty economies, such as India and China, emerging markets will likely experience a sharp recovery in 2021 by expanding by the fastest pace in a decade, exceeding 6% in 2021 – an obviously welcome reversal from the -2.5% decline in 2020. Growth should gain significant momentum in H2:21 as emerging markets shrug off the effects of the pandemic and external demand rebounds.

However, this is a vast group of countries, and the strength of their recovery is projected to vary significantly, depending on access to vaccines, the degree of fiscal and/or monetary policy support, and the exposure to the envisioned improvement in domestic demand in advanced economies as the year unfolds. In general terms, growth will be slower for oil producers, tepid too for those focused on other raw materials, and faster for the more diversified economies, led by Asia, and followed by Latin America and Africa.

Critically, however, Covid-19 is a major disruptive event for all. Total output for emerging markets will only get to where it was expected to be in Q1:21, by 2023. And, the pandemic hit has revealed a host of economic and financial vulnerabilities. Eventually, once the base effects have come out in the wash, the structural characteristics of each country when entering the crisis, and exposed by Covid-19, will come to the fore, testing the agility of policymakers, the strength of institutions, as well as investor conviction.

Figure 1: Covid-19 hit to output



Source: IMF, WEO Jan 2021

Positive halo for risk sentiment in 2021

Our current base case assumes that the economic recovery remains steadfast and activity accelerates for most emerging markets as the year progresses. The improved cyclical vista combines with several additional forces to provide a positive halo for risk sentiment in 2021. These include:

- First, as we know, the global economy has faced a shock – a health crisis – and even though we expect a prolonged and bumpy recovery, the positive news about transmission rates and the development and rolling out of vaccines ameliorates some of this shock.
- Second, even though we expect tensions between China and the US to remain part of the global narrative, and we accept that President Biden likely wouldn't want to alter the now established bipartisan consensus that sees China as a strategic competitor, we do expect a more soothing and predictable policy environment in 2021.

- Third, momentum and base effects suggest that high-frequency and closely watched, monthly macro-economic data out of China should continue to support risk sentiment in H1:21.

- Fourth, the low global rate environment is likely to remain through 2023 – as is a weaker USD.

Given that the policy environment will remain supportive and the virus is likely to be brought under control in most countries – albeit more slowly in some – the external conditions are broadly favourable for risk sentiment and maintaining moderate capital inflows to emerging markets this year.

Vaccine rollouts a key investment theme in 2021

Despite the commendable early efforts of many governments to lock down their economies – including many countries in Africa – the pandemic has not dissipated. Several countries are undergoing second or third waves – many of which are proving more severe. Recurring pockets of outbreaks are inevitable, and the uncertainty will straight-jacket economic growth. Critical then, is vaccine rollouts, which will prove to be an important investment theme this year.

Naturally, missteps along the way, in what is likely to be a patchy rollout of vaccines, will add kindle to any embers of discontent relating to pre-existing socio-economic issues. Put plainly, the pandemic recovery will be painful, magnifying the scope for civil unrest and volatility – especially wherever institutional capacity is weak.

So far, investors have shrugged these obvious concerns aside, displaying less pickiness, stampeding back into emerging market assets. Emerging-market stocks have surpassed a 13-year peak, trading a few points shy of a record high; the MSCI's EM index has rallied 85% since bottoming in March 2020. Since the lockdowns in March last year, individual investors have rushed into equities in many emerging markets. More recently, expectations for a robust economic revival from the pandemic have fuelled an acceleration in gains.

Yet a longer-term global recovery would depend in part on vaccine distribution and, on these, emerging markets are expected to lag developed markets which have secured more vaccines than needed. On this score, it is worth noting that some countries that have gotten ahead with inoculation, such as New Zealand, are reaping only limited rewards. Second, and more concerning, little space has been priced in for any potential setbacks such as further viral waves and/or vaccination delays.

GDP recovery belies pain

Nevertheless, what the narrative and data ignores is that the economic damage that's been suffered from the pandemic – the subsequent rise in unemployment, fall in consumption and deferment of investment decisions, the increase in leverage and financial fragility – across emerging markets will prolong the Covid-19 hangover. Just consider, over the past year, per-capita income declined by near 5% across emerging markets – the first contraction since 1991 and the biggest contraction on record. For many across emerging markets, living standards have been taken back by a decade – particularly the poor and informally employed.

Worse still for emerging markets is that the pandemic shock and its synchronized and harmful impact on the global economy couldn't have come at a worse time for emerging markets. Successive years of external shocks, including Brexit, the EU Debt Crisis, the Trade War and others, had seen their vitality gradually sapped each year since the 2008/9 Global Financial Crisis. Indeed, the three-year trend in GDP growth for emerging markets had slowed from 7.4% in 2008 to just 4.5% in 2019 – the lowest rate since 2003.

Debt sustainability may become a focus after recovery

Last year, emerging market economies struggled to navigate the need to help manage their economic lockdowns at the same time as a virtually unprecedented outflow in capital. FDI and remittance flows declined in 2020 leaving little room to manoeuvre for finance ministers – many of which also faced falling export earnings. Policy support from the US and other key central banks has since Q3:20 enabled flows to emerging markets.

That said, the damage had been done: corporate debt in emerging markets jumped by 14.4% of GDP in Q2:20 – the fastest on record. And, despite ongoing concerns about mounting debt levels, government debt increased by an average of 9 percentage points of GDP in 2020 – to the highest level on record. Furthermore, facilitated in large part by the low global rate environment and maturing of the yield curve, emerging market debt had already piled up at an unprecedented pace, increasing from 170% of GDP in 2015 to near 200% in 2019. And much of that in market-sensitive and foreign-denominated bonds. Eurobond issuance increased by USD40bn in 2020 to USD380 billion in 2020 – and almost all of that was denominated in USD.

The justifiable fear now is that rising interest payment obligations will see some countries forced to sacrifice their developmental targets, such as those in health and education. Indeed, a host of emerging market governments face increasing interest burdens, notably in India, South Africa, and Turkey. And for those small businesses that have managed to survive protracted periods of lockdown – traditionally the engines for growth and job creation – have seen debt-to-revenue ratios ratchet to unsustainable levels. Thus, governments and SOEs are set to play a key role in generating employment and restoring confidence, and this will come at the cost of lower productivity and higher debt levels.

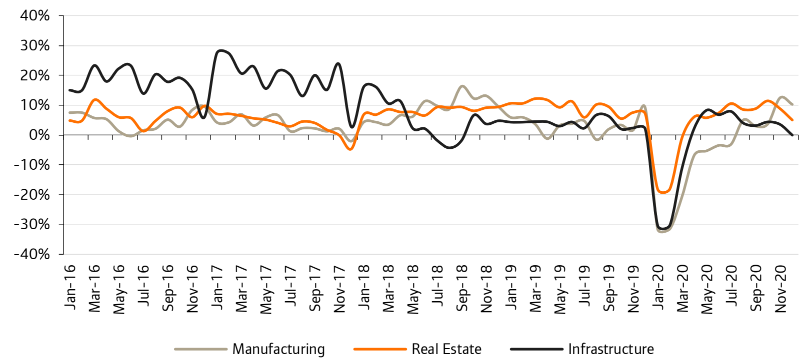
China's path ahead presents a novel risk for commodity markets

Indeed, in both advanced and emerging markets much of the reported economic gains will largely be on the back of unwinding base effects. As a result, data, and news flow this year, will be tricky for financial markets to navigate. The early part of the year will likely manifest in decade-high growth prints of almost all monthly macroeconomic data points in China. However, those record-breaking Q1:21 data outcomes will demand careful scrutiny – especially because China's "new normal" of GDP growth under 5% may return rather swiftly.

China's economic resilience has been impressive, and recovery has been reasonably robust — but the prognosis is far from bullet-proof. The outlook relies on policymakers' ability to navigate the path balance between incompatible near- and medium-term policy priorities. In turn, much hinges on consumption's uninterrupted return to at least 2019 levels, and maintaining the run rate of manufacturing investment growth, which has been lively since July.

At the very least, infrastructure spending looks set to slow as policymakers shift their focus from supporting growth toward reining in government debt and terminating one-off policy support. In fact, it already has slowed since October 2020. Meanwhile, tough new rules on developer borrowing introduced last August, already starting to weigh on new property starts late last year. Since then, caps on bank loans for mortgages and rising mortgage rates confirm headwinds for the sector. In fact, for the first time in many decades both infrastructure and real estate investment may contract this year, but only after record-breaking positive data prints into May.

Figure 2: Slowdown of investment and real-estate investment in recent months



Source: CEIC & NBS

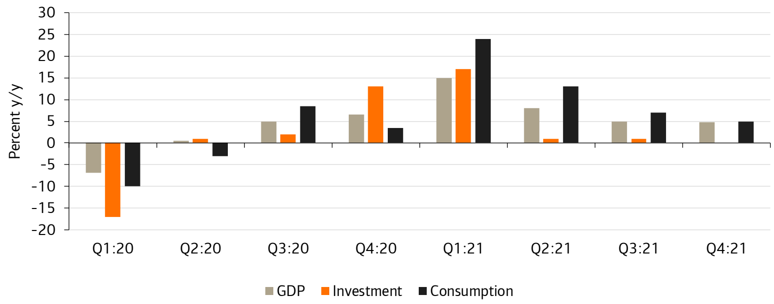
This year, policymakers plan to pivot away from stop-gap measures tooled to place a floor under economic activity and will feel able to do so now that a wider arc of economic data points is firmer. Pivoting back to deleveraging and de-risking is necessary. This implies that just as swiftly as the recovery took hold, it will fade — and the "new normal" of slower growth will return because headwinds are building, not least of which is placing the de-risking campaign front and centre once again, which cascades into more neutral fiscal and monetary policy but also translates into headwinds for government incentivized infrastructure spending and tighter scrutiny over the real estate sector. Additional complexity stems from the coming due of an extraordinary amount of loans to SMEs extended last year, and the general erosion to the resilience of the financial system, which will also inevitably divert resources.

Importantly, manufacturing investment growth has accelerated since turning positive in July. The strength of external demand has pushed capacity utilization rates in various industries towards their limits. Furthermore, government policy can incentivize investments in the sector targeting the meeting of domestic demand or moving up the value chain, both of which are consistent with China's longer-term objectives, including specifically dual circulation. This matters a great deal as manufacturing remains the biggest sub-component of investment, and positive momentum there could offset anticipated sluggishness elsewhere.

Most important to the 2021 trajectory will be household spending. Consumption has thus far lagged the recovery in income growth. It is therefore promising that, even though retail sales ended the year -3.9% y/y in 2020, the monthly data remains robust: +4.056trn in December, up 4.6% y/y, from +3.6% y/y in November. The labour market, less negatively affected, is seeing consumer confidence clawing back from Q1 – the PBOC's diffusion index of current and future income are both approximately halfway back to pre-Covid levels and above 50 points. If the status quo holds, households should soon start spending more freely. Indeed, savings rates increased in 2020, implying that households are on average in a stronger financial position than pre-Covid — but also more cautious. Already, at the higher-end, Chinese tourists have increasingly been supporting local options, and at the lower-end, even though policymakers are starting to withdraw investment-focused stimulus, they will maintain or expand measures to support consumption.

Tied together, it seems reasonable to assume that most macroeconomic data through much of Q1:21 will be reporting record highs. Indeed, the Chinese economy seems set to rally, first from 6.5% y/y in Q4:20, then to a staggering 15.0% in Q1:21 — before slowing to 7% y/y in Q2:21, and to below 5% in H2:21. This implies 8.3% growth in 2021 but also that this period of rising GDP growth is likely to be short-lived. The key question is whether 2020 was the peak in China's demand for some raw materials and/or whether China can keep expanding demand.

Figure 3: Getting to 8% in 2021 leaning on consumption and manufacturing



Source: Standard Bank Research

Too soon for India to fill the gap

India is expected to be the fastest-growing large economy in 2021, expanding by around 10%. It is also expected to accelerate in H2:21 – just as China starts to see a step-change towards lower economic growth.

By Q3:21, India's GDP is expected to be rising by 25% y/y. By then, wide distribution of vaccines is anticipated, and this economy should benefit from profound base effects combined with tailwinds from supportive financial conditions, improved domestic demand, and more robust global economic activity. Even though this could be a sign of what's to come – India's economy expanding faster than China's on a consistent basis – the impact of the pandemic on the informal sector here is likely to be underestimated, and job growth remains a significant challenge beyond the initial cyclical rebound foreseen in 2021.

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Sub-Saharan Africa
Guarded optimism as vaccines roll out

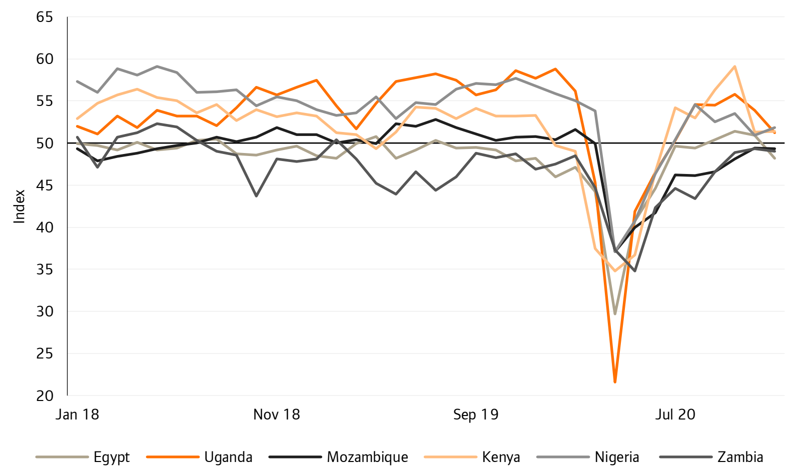
Africa GDP growth: vaccine and base effects to underpin recovery

One could argue that the macroeconomic outlook for 2021 can only be better than 2020. Not just the African continent but the global economy at large has had to contend with an unprecedented economic and health crisis. However, following the successful human trials of the Covid-19 vaccine in Q4:20, there now is reason for optimism. Also, rates in advanced economies will likely to remain near zero for the next few years at least, possibly providing African economies with cheap liquidity in the form of budgetary funding. One should also factor in far more cordial global trade relations following the change of guard in the US. However, there will always be idiosyncratic factors in play when assessing Africa's economic performance. Given some of the uncertainties persisting from last year, 2021 could be a year of growth rehabilitation, at best, not one of economies performing even close to, or above, potential.

But first it may be important to look back at 2020 for a sense of whether economic growth can recover over the coming year, using recent economic history as our compass. Indeed, some of the quarterly GDP growth outcomes last year were shocking. The unprecedented nature of the current crisis has made it most complicated to forecast economic variables.

Our long-held view still is that Q2:20 was most likely the worst of the pandemic for economic activity. GDP growth contracted in every economy in our coverage in Q2:20. However, as economies globally began to relax public health restrictions, domestic demand and external trade, albeit off a low base, recovered into Q3:20, evident in leading economic indicators such as the Purchasing Managers Index (PMI) surveys which rose towards or above 50.0 for most countries in that quarter.

Figure 1: Purchasing Managers Index

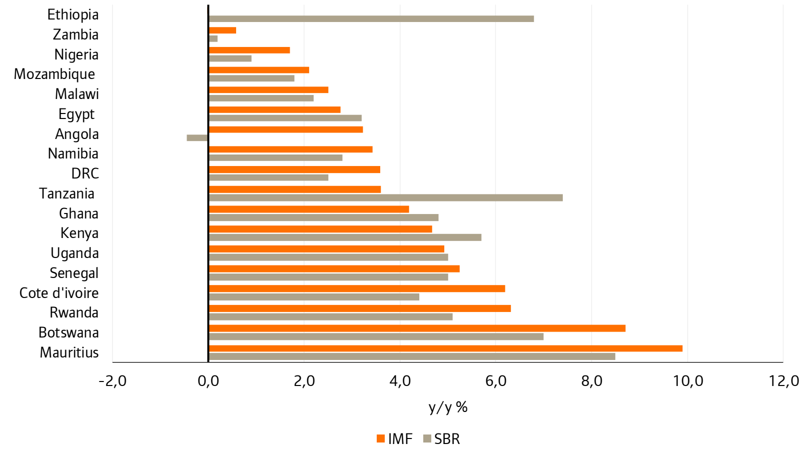


Source: IHS Markit, Bloomberg

Interestingly, from data published at the time of writing, only Egypt, Côte D'Ivoire and Senegal had posted, mildly positive, growth in Q3:20. Furthermore, bar Namibia, all other economies in our coverage contracted again in Q3:20 but by less than in Q2:20. A handful of African economies could however buck the trend and record positive growth for 2020, an elite growth group of sorts, considering that globally most economies contracted in 2020. Kenya, Tanzania, Ethiopia, Senegal and Côte d'Ivoire are likely to post growth for 2020 but even so, in USD terms, even some of those economies contracted in 2020. We expect GDP growth to broadly recover in 2021 (see Figure 2). However, firms that use GDP growth as a benchmark to forecast sales or consumption in an economy ought to be careful how they interpret the 2021 numbers.

Bear in mind that on an annual basis in 2021, GDP growth figures are most likely going to be bolstered by unwinding base effects from mainly Q2:20. Inevitably, this will underpin the calendar year 2021 growth forecast, notwithstanding the likelihood that underlying consumption, and perhaps even investment, may not be as robust as the GDP growth number would imply for the period. Notably, we still see the Angolan economy in recession in 2021, a condition now dating back to 2016.

Figure 2: Standard Bank Research growth forecasts vs the IMF



Source: IMF, Standard Bank Research

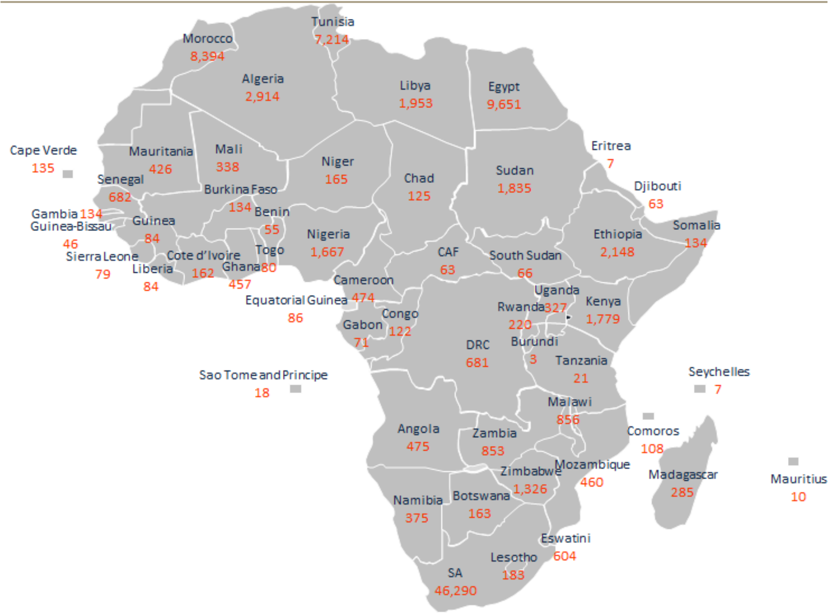
Fundamentally, besides unwinding base effects, the growth outlook for 2021 depends predominantly on the success of the vaccine. For Q4:20, as indicated by the PMI trends, clearly private sector economic activity had slowed down, likely driven largely by viral resurgence from around Sep 20 which prompted recurring public health restrictions.

However, most governments are unlikely to reimpose public health restrictions again in 2021 should vaccines halt the rise in new infections. That should underpin both domestic and external demand and also informs our base case scenario for 2021. Still, given the uncertainties related to rolling out vaccines, it was tough to decide on whether this was the base or bear case.

Our bear scenario, despite vaccine rollouts, sees new infection cases rising further in 2021 and incurring further containment measures which then further disrupts economic activity. Despite 2021 offering some early element of relief pertaining to vaccines, uncertainties persist. Firstly, aside from the risk that the vaccines may not work, especially with new viral variants emerging around the world, logistical and timing complications around inoculation too could foster further uncertainty.

For the African continent, a comprehensive vaccination rollout seems highly unlikely in 2021. Still, the African Union (AU) has secured 270m doses of vaccine for the continent. However, with some 1.3bn people in Africa, and two jabs required according to medical experts, Africa would require near 2.6bn vaccination doses. Also, it remains unclear how vaccines will be administered across African countries. Thus, new infections could still spike until most citizens have been inoculated. Apart from straining health systems, governments may well be forced to bring back containment measures, even if less stringent than those between Q2 and Q3:20. If so, the growth rehabilitation expected in 2021 would be disrupted, if not unbalanced.

Figure 3: Covid-19 fatalities



Source: Worldometer

Education: schools re-opening will support growth but could also fuel contagion before vaccine rollouts

Traditional economic crises or output shocks over the past three decades on the African continent have emanated mostly from droughts, oil price shocks, or insecurity and political issues. However, another unique aspect of the pandemic crisis was the acute decline in growth in the education sub-sector.

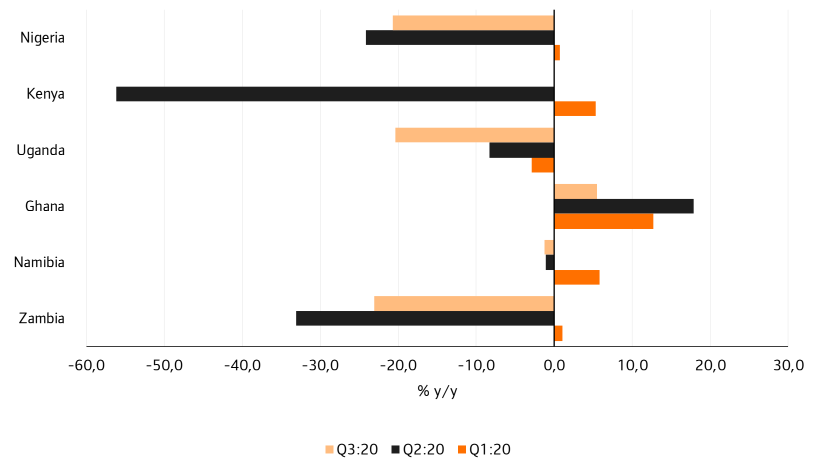
In most economies since Apr last year, the authorities opted for the closure of schools and universities to curb contagion. They further switched to remote and virtual learning, which made computation of education output cumbersome for national accounts statisticians.

Across most countries in our coverage, public sector schools account for the lion's share of education output, at 85-90%. However, admittedly, remote learning through virtual means was probably the more practical for most private education institutions. For instance, most public education students lack access to laptops or broadband services. In fact, many students on the continent lack reliable or constant power supply. Hence, remote learning was probably impossible.

So, how would one measure education output when computing GDP growth figures in a Covid-19 setting? Based on hours studied, there would obviously have to be a broad contraction in growth since the closure of schools and some universities back in Mar/Apr 20. However, from an expenditure side, salaries for public education teachers or professors were still being paid.

Not all countries report education GDP as a separate sector. But for those that do, education output has contracted for most since Q2:20, per Figure 4. Surprisingly, in Ghana, even though schools were only partially opened, growth in the education sub-sector grew by 17.9% y/y in Q2:20, from 12.7% y/y in Q1:20, then easing to 5.5% y/y in Q3:20. Admittedly, this has to be a different methodology approach being used by the respective bureau of statistics, compared to other economies on the continent.

Figure 4: Education sector annual growth



Source: Various statistical agencies

Most schools on the continent have re-opened since Jan 21, with certain Covid-19 protocols expected to be adhered to. Now while this may very well be a primary factor in GDP growth recovering from Q2:21, as base effects unwind from the education sub-sector, we ought to also highlight the risk that the re-opening of schools, perhaps combined with the second wave from Q4:20, may also increase the risk of contagion, especially if vaccine rollout is slow. If so, growth could remain subdued, along with the services and industrial sectors as restrictions return.

Bear in mind that if schools remain open all through the year, and contagion is curbed, the education sub-sector may well spearhead growth in 2021, particularly as the value chain that relies on this sector, such as printing presses, books and uniform stores, among many others, will also be supported.

AfCFTA: short-term pain but with long-term gains

Faced with the worst economic crisis in over a hundred years, thinking out of the box and doing things differently becomes the norm for any economy to survive. Similarly, in 2020, especially during the intense economic pressure in Q2:20 when global supply chains were disrupted, African economies had to turn inward and test their latent manufacturing sectors.

Indeed, there were some success stories in the local industrial sector that grabbed attention such as in Kenya where manufacturers converted their existing factories into producing personal protective equipment (PPE), while Rwanda utilised their locally assembled drones and robots to track Covid-19 patients. Similarly, in Ghana they have locally produced a low-cost Covid-19 antibody test, while in Senegal engineering students developed a multifunctional medical robot to ease the burden on healthcare workers. As they say, never waste a good crisis.

However, this shift in local production will probably not be enough to counterbalance the decline in output witnessed in the broader services sector. But now, understandably the focus around industrialization has shifted to the African Continental Free Trade Area (AfCFTA) that was originally planned for Jul 20 but will now be operational from Jan 21. Malawi became the 35th country to deposit their instrument of ratification. More ratifications are expected ahead of the 34th African Union (AU) summit in Addis Ababa in early Feb 21.

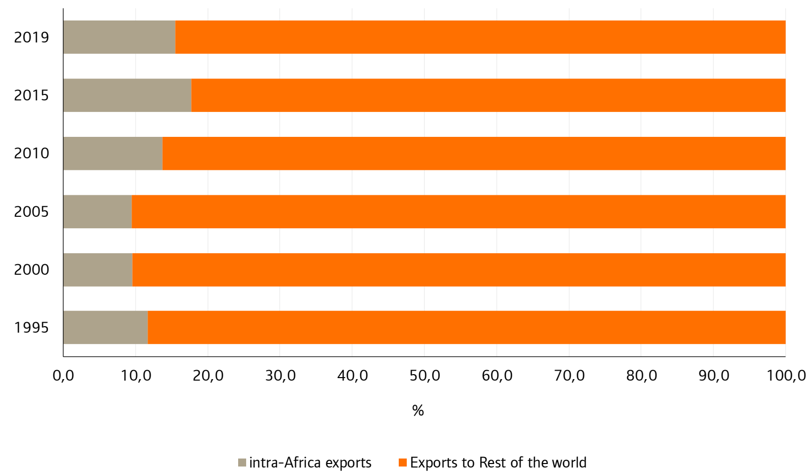
Bringing together all 55 members of the African Union (AU) the AfCFTA is expected to be the largest free trade area in the world since the formation of the World Trade

Organization (WTO), with a combined population of 1.3bn people and combined GDP of over USD2.5trn.

In theory, should this trade area work seamlessly, there are long-term macroeconomic benefits for most African economies even though the short-term adjustment costs may be prohibitive. However, the practicality of making this arrangement a success is a lot more concerning, especially when assessing previous efforts to form a free trade area on the continent.

Intra- Africa trade has been on the rise over the past two decades, per Figure 5. Africa's nascent manufacturing sector has mostly been unable to punch above its weight and has thus traded more within the continent rather than globally. Africa's exports globally have mostly been commodity-related rather than industrial goods.

Figure 5: Share of exports



Source: UNCTAD

However, one of the chief obstacles to be overcome for the AfCFTA to become a lasting success, is for non-tariff barriers to be eliminated amongst economies. Furthermore, for increased intra-Africa trade under the AfCFTA to manifest, infrastructure connectivity would also have to be bolstered. However, due to growing fiscal pressures that have perhaps also been compounded by the Covid-19 pandemic, abolishing non-tariff barriers and sourcing additional funding to boost infrastructure capabilities may initially complicate the AfCFTA.

While phase 1 of the trade agreement is largely centred around liberalization of goods and services, phase 2 could eventually bring about more substantial challenges pertaining to intellectual property rights, investments and competition policy.

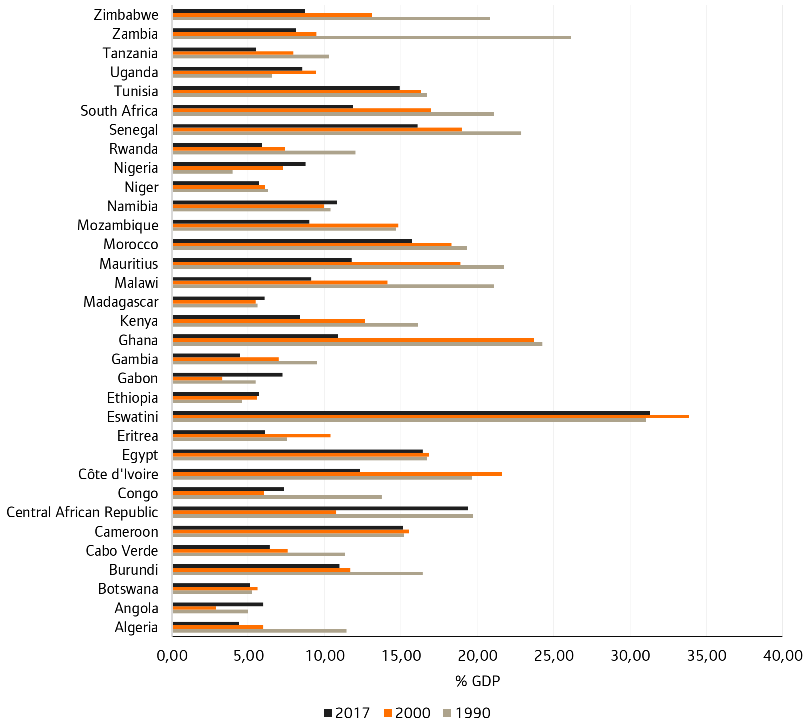
Empirical evidence from countries joining other regional trade areas such as the East African Community (EAC), Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) on the continent are mixed, with respect to whether fiscal revenues or export earnings increase over the medium- to long term. Of course, one must account for other idiosyncratic factors that could have negatively affected public finances since the economies' admission into the trade area. We find that if pertinent issues such as non-tariff barriers are not addressed initially, the expected gains from being part of the free trade area are fairly limited as well as short-lived.

If common market protocols are adhered to, intra-African trade increases over time, which would boost economic growth as firms will have access to larger markets.

Additionally, consumers are likely to benefit from a decline in average product prices given the probability that both supply and variety will increase. These benefits tend to be more pronounced in the longer term through free trade areas.

However, there are always short-term adjustment costs that perhaps prevent a lot of countries from enjoying the longer-term benefits. For instance, according to data from previous trade agreements, it is quite clear, and not surprising, that economies that are more industrialized tend to benefit more under these arrangements. Also, given that production of goods may transition to economies with cheaper labour costs, initially employment and wages will probably decline. Of course, countries will also forego custom tax revenues in the early stages of the AfCFTA, potentially resulting in fiscal pressures. Essentially, the success of the AfCFTA will depend primarily on whether economies can overcome teething problems, as the longer-term benefits of regional integration should be sound.

Figure 6: Manufacturing % of GDP



Source: UNCTAD

DSSI could be extended into Dec 21

The World Bank Debt Service Suspension Initiative (DDSI), which is also endorsed by the G20, was extended to Jun 21, from Dec 20. Of the 29 African countries participating so far, around USD4.6bn in debt service owed to their official bilateral creditors has been deferred. In addition, the G20 has also asked private and Non-Paris Club creditors to participate.

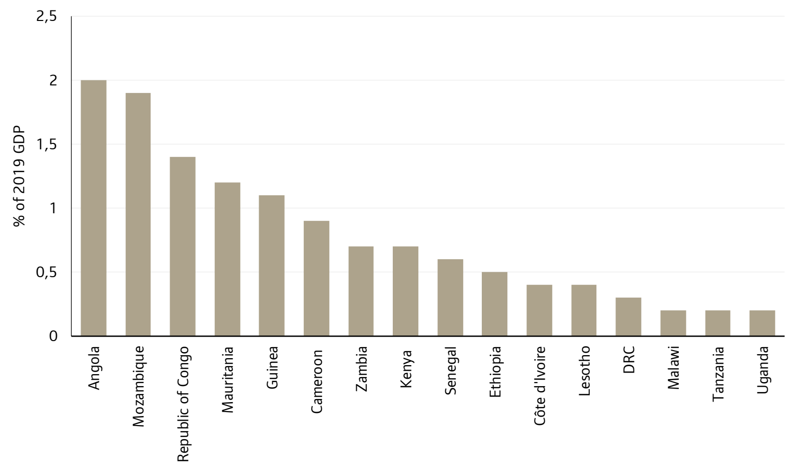
It had been quite cumbersome for the G20 to convince Non-Paris Club members such as China to participate. According to the Institute of International Finance, nearly a third of the USD305bn owed in debt service in 2021 by African economies was owed to official Chinese creditors.

However, according to media reports citing the Finance Ministry in China, the government in China had already provided debt relief of around USD2.1bn to poor countries under the G20 arrangement.

The G20 has also tried to cajole private external creditors to participate in the DSSI, but without any luck. In fact, a large part of the lending done by the Chinese government was via what they consider private or multilateral agencies, hence their reluctance to ask these institutions to join the DSSI despite lobbying from the G20.

Per Figure 7 below, from the countries in our coverage, Angola, Ethiopia, Mozambique and Kenya stand to benefit materially under the DSSI. Interestingly, the Kenyan government only just applied in Jan 21 for the DSSI, after previously publicly downplaying the possibility. The authorities in Kenya had initially expressed their reservations in participating in the DSSI, owing largely to concerns around the risk of being downgraded by international credit rating agencies as well the complications that could arise due to existing cross default clauses from commercial creditors.

Figure 7: Potential savings from the DSSI



Source: The World Bank

However, the Kenyan government received clarification from rating agencies that they wouldn't be downgraded from undertaking DSSI, so long as they don't extend the debt relief to private commercial creditors. Furthermore, we also understand that, as long as a government is not looking to write off external debt, they don't need a consent solicitation with external commercial creditors. Recall that Angola had received a debt write-off from China. For this, they had to seek consent from commercial creditors. According to media reports, Ethiopia and the DRC have also benefited from debt write-offs.

Perhaps other governments may now follow suit and take up the DSSI, following the clarification from credit rating agencies. According to data compiled by the World Bank, Ghana could save USD377.9m, or around 0.6% of GDP, while Nigeria could defer USD123.5m.

Our base case expects the current DSSI to be extended at least to Dec 21 initially. However, we wouldn't rule out a scenario where an enhanced Highly Indebted Poor Countries (HIPC) broad debt relief is considered again over the medium term. More importantly, you can't even rule out further pressure on private external creditors to provide debt relief should the economic and health issues from 2020 persist for some years, likely to the dismay of credit rating agencies.

FX and fixed income strategy

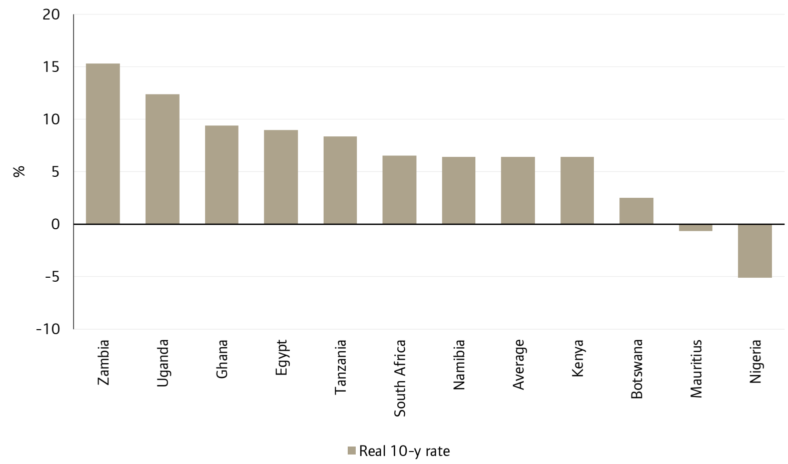
The vaccine rollout may initially boost discretionary imports more than service exports. But even then, we doubt that imports will rise in a manner that would result in economies overheating or central banks getting concerned about tightening policy.

Therefore, while we expect most central banks to keep policy rates neutral in2021, we still see a broad monetary policy easing bias in 2021.

However, there's growing consensus that global risk conditions are likely to remain favourable in 2021. Thus, issuance of hard currency bonds will possibly be re-evaluated again this year, while economies that have open and liquid secondary local bond markets will probably benefit from the improving global risk environment through increased foreign portfolio investment.

Egypt, Uganda, Ghana and Kenya are our local fixed income trade preferences over the coming year. In our Sep publication, we highlighted that perhaps it may be time to look more closely at EGP bonds. In fact, since Sep we have already seen more offshore appetite for longer-dated paper in Egypt. The 12-m USD/EGP NDF that we recommended selling back in May 20 has since returned an impressive 12.3% in our shadow portfolio. We retain our constructive view on the EGP in H1:21 as foreign portfolio investment inflows will probably underpin the currency. For now we are happy to continue holding this EGP carry trade, but given the increased exposure of offshore portfolio investment in EGP local debt, we suspect that there will still be opportunities for better entry levels for EGP bonds over the coming year after our NDF trade matures in May 21, especially as the authorities are looking to increase duration of their EGP liabilities. Of course, it doesn't hurt that the EGP bonds may be included in the JP Morgan EMBI this year in addition to receiving Euroclearability.

Figure 8: Real 10-y T-bond yields



Source: Standard Bank Research, Standard Bank Trading, Various Central Banks, Bloomberg

In Uganda we were perhaps more valiant than others in the market, considering that we recommended lengthening duration back in Nov, a month or so before the Jan 21 election. We opened a 10-y government bond position with an entry yield of 15.5% in our shadow portfolio. At the time we recommended this trade, we acknowledged that yields could still edge higher leading into the Jan 21 election. Indeed, yields rose to slightly above 16.0%. But our trade view for this is more strategic rather than tactical and we are willing to hold this paper for even as long as a year. Still, development expenditure pressures are unlikely to abate after elections given that the government may be keen to boost spending on the ancillary oil related infrastructure. We will reassess this trade closer to the end of FY2020/21 in Jun, as the Ugandan government tends to frontload their domestic borrowing at the beginning of a new fiscal year (which also typically coincides with a higher domestic borrowing target).

In Ghana we opted to wait for political risks to subside. We went long the GHGB Jun 29s in Dec 20 after the election. The position has already returned 5.8% since inception. Despite the risk of slower fiscal consolidation over the next 2-y, an entry yield of 21% provides us with an added cushion that our carry is unlikely to be eroded over the coming year. Admittedly, one may expect that an easing in the monetary policy stance may result in an increase in GHS yields and weakness in the exchange rate as foreigners exit the market, as we saw in early 2019. However, we would argue that that shouldn't be the case in 2021 as the MPC may have scope to ease policy given the weakness in economic growth and also as the rate cut in 2019 by the BOG had caught the market by surprise. Inflation is also expected to fall back into the BOG's target band of 6%-10% this year. After all, foreign portfolio holdings in Ghana have also declined to around 19% as at Nov 20, from around 40% in 2017. But still, should the government struggle to lower its fiscal deficit this year, upside pressure on GHS yields is likely as the market would want a premium.

For Kenya, we opt to take profit on the KENIB 2031 position that we opened in Aug 20. The return on the trade was 3.9%. We have now opened a new position, adding the KENIB 2037 (average life 12.5 years) in our portfolio. We always have a preference to recommend the most recent KENIB as it tends to become the more actively traded paper in the secondary bond market. But despite inflation likely to edge higher in H1:21 driven by base effects and the increase in VAT, we don't think that the MPC will hike rates. Moreover, we opted to open this new KENIB position as the FX entry level has improved too. But also, with the government expected to save around USD690m under the DSSI framework in H1:21, combined with the likelihood of an IMF funded deal during this period which will boost FX reserves, we are constructive on the outlook for the KES.

Notably, these markets that we have highlighted above that are likely to benefit from higher portfolio investment in 2021, are also probably going to benefit more due to portfolio investors being unable to invest in Nigeria. We took profit on our sell USD/NGN 12-m NDF trade in our shadow portfolio at a return of 6.4%. Recall that the trade idea was a contrarian one, but it worked out as we had envisaged. However, into 2021, we acknowledge that Nigeria cannot have ultra-low NGN yields, high and sticky inflation as well as an FX liquidity problem. Something would have to give. Therefore, we expect that the CBN could move the official USD/NGN higher to around 420 by end 2021. Perhaps they would prefer a gradual move higher in the pair, particularly as international prices are likely to recover somewhat in 2021.

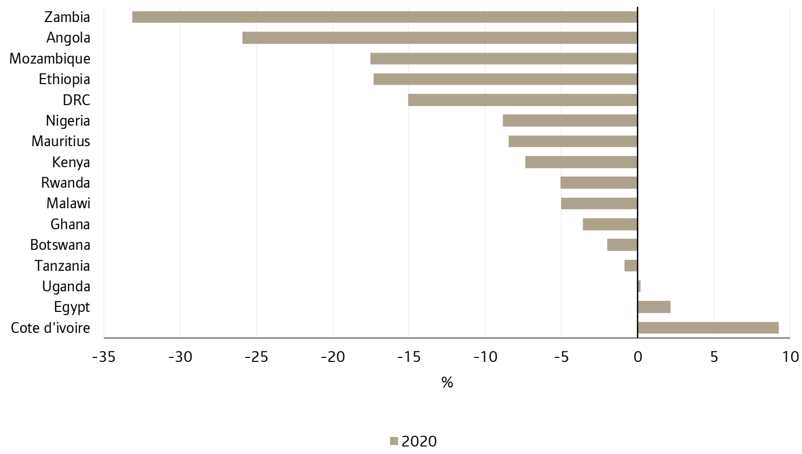
Will that be enough? Probably not, as it won't guarantee an increase in foreign portfolio investment, something we believe is needed to alleviate the existing shortfalls in FX liquidity. NGN bond yields rose by an average 200-250 bps in Dec 20, although offshores typically prefer to invest in OMO bills. Interestingly, yields on these OMO bills were sub-3.0% at the time of writing.

More importantly, with inflation at 15.8% and expected to rise further, it will be hard to embolden foreign portfolio investors to invest in Nigerian fixed income assets given the negative real yields. But then again, due to weaker growth, the CBN may not be particularly keen to allow NGN yields rising dramatically.

Intriguingly, the level of FX reserves (USD36.3bn as at 14 Jan) isn't the chief factor resulting in insufficient FX liquidity. It's the CBN's reluctance to supply this FX to the IEFX window. We reiterate that the CBN is probably concerned that the more FX they supply to the window, the more USD outflows are likely to follow. But the only way to perhaps mitigate this risk is to allow NGN yields to rise to an attractive level, something they'd likely be unwilling to do.

Moreover, we closed the 12-m USD/AOA NDF position at a loss of 7.5% in our shadow portfolio. Recall that we had been sellers of the USD/AOA NDF. However, despite the added pressure of enhanced AOA liquidity arising from the maturing USD-linked AOA bonds in H2:20, the AOA never weakened at the pace we had envisaged. Perhaps the BNA was encouraged by the IMF's assessment of the AOA being undervalued. However, strangely, according to the BNA, there isn't a USD demand backlog. Moreover, upon closer assessment of some of the recent FX auctions, it appears that FX supply has been outstripping demand. But that said, to obtain a merchandise import license has also been a cumbersome process from the Ministry of Commerce given that the government has been closely scrutinizing import documentation in order to curb what they consider illicit trade. But still, while it's hard to believe that there isn't a USD backlog, import demand inevitably should be weak, given that the economy has been in recession since 2016 and unlikely to escape it in 2021.

Figure 9: 2020's FX performance



Source: Standard Bank Research, Bloomberg

Political calendar

President Yoweri Museveni was declared the winner at the Jan 21 election, extending his 35-y rule in Uganda. As with the 2016 election, the main opposition candidate Robert Kyagulanyi, better known as Bobi Wine, rejected the election results, alleging irregularities.

Wine had been arrested by security forces in Q4:20, fuelling further controversy. However, Museveni was categorical that political rallies had been banned due to the outbreak of the Covid-19 pandemic, and that Wine and his entourage had not followed the law by holding public rallies.

Foreign envoys and other human rights groups have lamented the lack of transparency, mistreatment of the media and violence leading up to the Jan elections. Even the internet was shut down as voting began.

Of course, the obvious concern is that should political protests persist over the next few months, economic activity could potentially be disrupted further. Additionally, if external funding partners such as multilateral and bilateral agencies have reservations around the electoral process, budget and project support could also decline.

The Ethiopian elections will now be held in Jun 21, according to the National Electoral Board. Political uncertainty remains rife following the clashes between government forces and the leadership of the Tigray region in Q4:20. The government had accused the Tigray People's Liberation Front (TPLF) of attacking an army base in Mekelle. However, in early Dec 20, the Ethiopian government claimed that they had taken full control of Mekelle, which is the capital of the Northern Tigray region.

Due to media blackouts, it was understandably hard to get a sense of the situation on the ground. But still, international media houses reported that hundreds of people had been killed and many more displaced during the conflict. Given the fragile state of the Ethiopian political economy, risks associated with the election in Jun will most likely be elevated.

Elections in Zambia are expected to be held in Aug 21. Zambia's constitutional court cleared incumbent President Edgar Lungu to run in the upcoming elections. The court ruled that since Lungu only served two years in power following the death of previous President Michael Sata, he can run again. According to the court directive, anything under three years does not constitute a term. Lungu served two years during that stint.

Lungu is seeking re-election at a time when the economy is suffering and the government is scrambling to seek an IMF bailout, amidst an official default on their external debt obligations.

Moreover, while Kenya will only hold an election in 2022, there is a high likelihood that a referendum under the Building Bridges Initiative (BBI) will be held in 2021 to amend the constitution. President Uhuru Kenyatta and former Prime Minister Raila Odinga seem to be spearheading this process. However, Deputy President William Ruto and his close allies have publicly voiced concerns on the BBI proposals. According to Ruto, the government should be focusing on the vaccine, economic revival and education sector in 2021, and not the BBI.

The BBI proposes to introduce a Prime Minister post, along with a Deputy Prime Minister position, to supplement the President and the Deputy President positions. Proposals to introduce an official post for the leader of opposition along with a shadow cabinet are also part of the BBI document, while a judiciary ombudsman position will also be created. Additionally, the BBI is proposing to increase country revenue allocation to 35% from 15% currently.

Should these proposals go through via the referendum, the cost of running the government would increase after 2022. Fiscal consolidation is already going to be hard to implement before the 2022 elections, but even after 2022, these proposals could delay this process further, posing serious concerns around debt sustainability.

Jibran Qureishi[#]

[#] This material is "non-independent research". Non-independent research is a "marketing communication" as defined in the UK FCA Handbook. It has not been prepared in accordance with the full legal requirements designed to promote independence of research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

SA politics in 2021 – better, but bumpy

Introduction

Perhaps it says little after the unprecedented scale of 2020's challenges, but the year ahead will be a better one for SA from a political economy perspective. Two core assumptions anchor our view in this regard:

- First, that government will more lightly intervene (in relation to much of its 2020 approach) to control the spread of Covid-19. Already, it is clear from the relatively limited economic restrictions imposed by government to control an ongoing and intense 'second wave' of the virus that the year ahead will not be characterised by the scale and duration of economic shutdowns that prevailed in 2020. Linked to this, the rollout of vaccines, both globally and locally, will likely limit the intensity of future waves of the virus, thus supporting economic recovery.
- Second, that the macro outlook will be considerably more buoyant (as already outlined in this note, we expect GDP growth of 4.6% after a 7.6% contraction in 2020). From a political perspective this will serve to soften some of the criticism that government has consistently faced as a result of its unimpressive approach towards resolving SA's structural economic disorders.

However, this generalised path of improvement will not be linear, and disruptions to the positive sentiment, that it has the potential to create, will be frequent and substantial. In our view, three primary challenges will continue to hobble the path of progress in the areas outlined above this year: (1) chronically low state capacity, which will continue to hinder the efficacy of government's Covid-19 response, while undermining the fluidity of economic reform and elevating demands on the fiscus; (2) the systemic nature of patronage across the ANC and the political economy more broadly; and (3) a rise in factional dissent within the ANC.

(1) President Ramaphosa's authority

It is clear how much rests on President Ramaphosa's shoulders, and how vital his ongoing political consolidation is for the country's immediate and long-term prospects. Our views in this regard remain relatively constructive: we believe that President Ramaphosa will continue to consolidate his internal ANC and broader national authority this year, ending the year virtually assured of re-election as party president at the December 2022 congress.

This view is based on a variety of internal ANC and broader political economy considerations.

- First, the president enjoys a comfortable majority of support within the ANC NEC, and across the party's structures (provinces, leagues, and alliance partners).
- Second, and linked to the above, the president holds a substantial national popularity advantage over all other prominent political leaders in the ANC and the country more broadly.
- Three, though there are clear tensions emerging as a result of government's stance on public sector wages, we do not believe that COSATU will formally break with the alliance this year.

We regard the president's political fortification as an anchoring component of the political and economic outlook, and will aid some degree of economic policy reform; support fiscal consolidation; provide the political space for ongoing anti-corruption momentum at the national level; and limit the threat of synchronised social unrest.

(2) The prospects for economic reform

We expect a mixed bag of economic reform in 2021. On the upside, some hard-won gains were made on the economic policy and ideological front in 2020 which will enable more fluid progress this year. These include: (a) the articulation of a relatively viable economic recovery plan; (b) the forging of greater space for business to implement key reforms; (c) a less 'radical' tone from the ANC on matters such as SARB nationalisation, land expropriation, and prescribed assets; and (d) a stronger and more central role for the Presidency in guiding some aspects of the reform drive. As such, we are relatively optimistic that some of the targeted reforms in the president's Economic Reconstruction and Recovery Plan will be pursued this year, with a clear emphasis on areas – such as infrastructure; renewable energy; and ICT reform – that allow for (and indeed require) the private sector to take the lead.

However, despite these gains, there will still be substantial economic policy and reform shortcomings in 2021. These will remain hinged on three core impediments to structural reform, namely: patronage, ideology, and state capacity. Further to this, the inertia brought about by the ANC's comfortable incumbency will continue to undermine the urgency necessary for the reform agenda in 2021. Here, the lack of real competition to the ANC under President Ramaphosa has deprived the reform drive of some of the vigour that it requires. We doubt that this will materially shift in 2021.

(3) Political support for fiscal consolidation

Last year National Treasury made meaningful gains in building broader political support for its fiscal consolidation plan. We expect that there will continue to be broad support for NT's approach in this regard in 2021, with the primary focus remaining on government's ability to hold the line on its public sector wage containment ambitions.

Aside from the public sector wage negotiations, political pressures to fiscal consolidation will emanate mostly from:

- **Demands for greater social welfare support.** This will take two broad forms: first, calls for the extension of the Social Relief of Distress (SRD) grant provided to buffer the fallout from last year's lockdown; and, second, discussions around the creation of a basic income grant.
- **SOE support**. No provision was made in the MTBPS for the additional requests for fiscal support that have been put forward by a range of embattled SOEs, such as Land Bank, ACSA, Denel, SA Post Office and the SABC. Though NT has committed to ensuring that further SOE support will be fiscally neutral, this stance will be pressured, considering the implications that budget cuts to key delivery departments will have on ANC support in a local election year.
- **Vaccines**. As we know, government will need to source the funds to pay for the vaccines necessary for the country to reach herd immunity, as well as, perhaps more materially, to support the elaborate logistical operation that will be required to administer them across the country.

What these various pressures outlines is how the fundamental tension within the ANC and government between fiscal and economic policy will remain throughout 2021, and beyond. Yet, again, a holding assumption behind our view on fiscal consolidation is that President Ramaphosa will maintain and further consolidate his political authority in 2021. This will enable him to retain Tito Mboweni as finance minister and ensure that NT enjoys enough political support in the build-up to both the Budget (in February) and the MTBPS (in October).

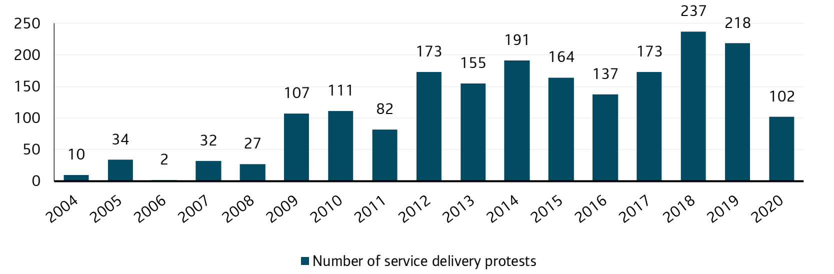
(4) Ongoing anti-corruption and governance reform

Last year President Ramaphosa's Stage One governance reform endeavours bore fruit in a string of high-profile arrests by institutions such as the NPA and the Hawks. Behind the scenes, these processes have been enabled by a dogged and ongoing institutional recalibration of the state's most critical anti-corruption task team institutions. In 2021 this institutional rebuild will continue, with further arrests linked to notable state-capture-linked cases. Another key governance-related theme for the year will be the shift from investigations and arrests to prosecutions. Though this progress will be galvanising of the public mood, it is still likely that final accountability for the wrongdoing being unearthed by the NPA, the Hawks and the SIU, and that is being so publicly ventilated at the State Capture Commission, will take time to more fully manifest.

(5) Social stability and labour relations

Last year was a remarkably calm one in terms of both protest activity (which was suppressed by the lockdown) and labour unrest (due largely to the enormity of the economic contraction, which dulled demands from unions in key negotiations). Notably, there were no recorded strikes in the country between January and September last year, and throughout the year Municipal IQ measures just 102 service delivery protests, down from 218 in 2019 (Figure 1).

Figure 1: A notable decline in protest action in 2020



Sources: Municipal IQ; Standard Bank Research

This year will likely be livelier on both counts.

- Protest action will pick up, particularly in the build-up to the Q3/4 Local Government Elections, which are typically preceded by pronounced local-level jostling for political and factional ascendancy.
- Labour relations will be pricklier, with a threat of industrial action in some of the more historically challenging negotiations. In addition to talks in the public sector, negotiations are due in the gold, coal, local government (SALGA), metals and engineering, and chemicals industry this year (Table 1).

Table 1: Centralised bargaining negotiations scheduled for 2021

Sector	Expiry of current deal	Central coordinating body in the negotiations	Largest unions and/or federations represented
Public sector	31 March 2021	Public Sector Coordinating Bargaining Council (PSCBC)	COSATU (NEHAWU, SADTU) FEDUSA (Public Servants Association)
Local government	30 June 2021	South African Local Government Association (SALGA)	COSATU (SAMWU) Independent Municipal and Allies Trade Union (IMATU)
Gold	30 June 2021	Minerals Council SA	NUM; AMCU; Solidarity; UASA
Metal & Engineering	30 June 2020 (but this agreement was extended to 30 June 2021)	MEIBC (and its various employer parties, including SEIFSA)	SAFTU (NUMSA) COSATU (CEPPWAWU) Solidarity, UASA
Chemical Industry (Petroleum, FMCG, Industrial chemical, Pharmaceutical, Glass)	30 June 2021	National Bargaining Council for the Chemical Industry (NBCCI)	COSATU (CEPPWAWU) NACTU (SACWU)

Sources: Andrew Levy; Standard Bank Research

With that said, we expect that the threat of economically harmful strike action will remain modest in 2021. This is in large part due to the residual precarity of the economic outlook, which will reduce the willingness of union members to endorse the industrial action that their leaders may call for but that could imperil their income or job security.

Conclusion: a brief but bumpy reprieve

2021 should be a better year on two core fronts for SA: (1) the management of Covid-19; and (2) the macro outlook. Further, we believe that President Ramaphosa's ongoing political consolidation will drive incremental gains in economic policy; fiscal consolidation; and governance reform at the state level. However, this generalised y-o-y progress will be interrupted by the structural limitations imposed on SA's reform trajectory by low state capacity, embedded patronage networks, and residual ideological opposition to some prominent reforms (particularly at the SOE level). Further, the timbre of political noise will be amplified in 2021 as the factions most threatened by the president's governance reform initiatives seek ways to rebuild their vastly diminished institutional credibility. Looking through this noise will remain critical, with a focus not on the statements made by individuals (or the impression created by the typically breathless media commentary of ANC events) but by the outcome of the various internal party elections and conferences that are scheduled for the year.

Stepping back, 2021 will provide some degree of balm to the country's nerves after a deeply challenging preceding year. This reprieve will be galvanising, but likely short-lived. Indeed, as the year progresses and the immediate effects of the pandemic hopefully diminish, focus will again draw to SA's structural maladies, some of which have deepened and/or government's ability to progressively respond to them has been diminished as a result of the Covid-19 crisis. As these discussion points emerge from the Covid-19 fog, an important question to ask, is whether the crisis has in any way aided the nation's capacity to more meaningfully address the structural impediments that it has long faced, and that are in many cases rooted in the inequities of the past.

We nevertheless see some cause for cautious optimism: the crisis has reminded the country's social partners of the possibilities that still exist to collectively address a range of critical challenges. It is here – galvanised by the underlying political stability that President Ramaphosa's two-term prospects now suggest, and by the gradual rise in state legitimacy that ongoing governance reforms will allow – that the country's prospects will be increasingly hinged upon.

*Simon Freemantle**

* Analyst certifications and important disclosures are in the disclosure appendix. For other important disclosures, please refer to the disclosure & disclaimer at the end of this document.

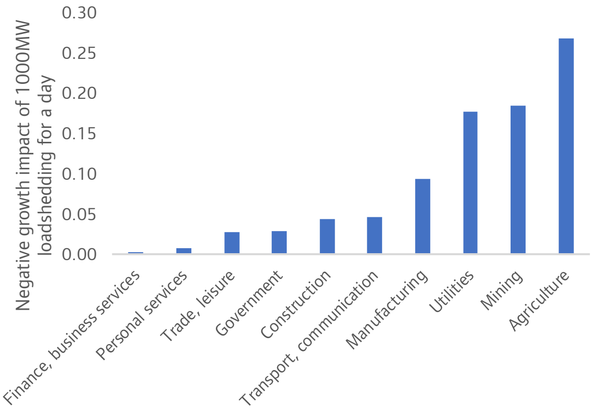
SA economy – Slow but sure gains in 2021

Economic growth: better, but fragile

We pencil in a robust GDP growth rate for 2021 (4.6%) as part of a multi-year recovery to pre-pandemic real levels. Though this is well above the consensus forecast, we are comfortable that the three years of projected recovery to pre-pandemic levels are adequately bearish notwithstanding the unusually destructive impact of the current crisis. **Growth is mainly forecast to come from a consumer rebound and inventory rebuild,** with crucial support from the forecast global recovery. We pencil in modest real growth in private sector fixed investment, supported by a rebound in gross operating surplus (essentially the proxy for profits in the economic data), improved business confidence and the expected recovery in global growth that is also supporting elevated commodity prices. While there is renewed concern about the impact from the resurgence in Covid-19 infections and renewed global lockdowns, the roll-out of vaccines, and indications that they are also effective against new strains of the virus, still support a credible expectation for an economic recovery – the critical assumption underpinning our forecasts.

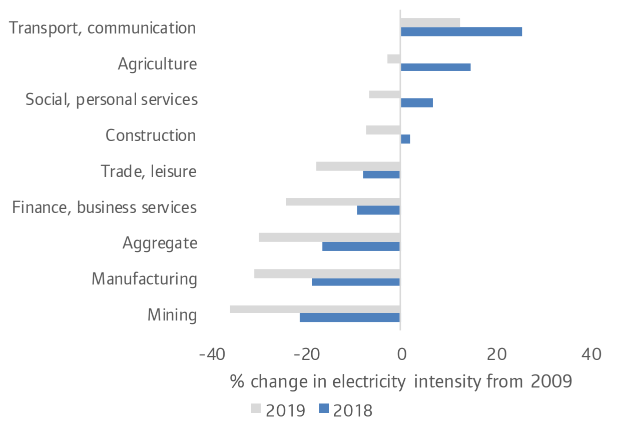
Apart from the pandemic-specific risks, SA's electricity shortfall is the biggest headwind and risk to the growth that we foresee. After shaving about 1ppt off economic growth in 2019 and 2020, **addressing the electricity constraint could lift growth noticeably** ahead of other structural reforms. This risk should fade as capacity expands, though it remains a major growth constraint and risk in the first part of 2021 (with every day of stage one loadshedding lowering economic growth by around 0.015% - see Figure 1)[1].

Figure 1: Loadshedding impact typically worst for goods-producing sectors



Source: SARB

Figure 2: Sectoral energy intensity of production declined in most sectors over the past decade



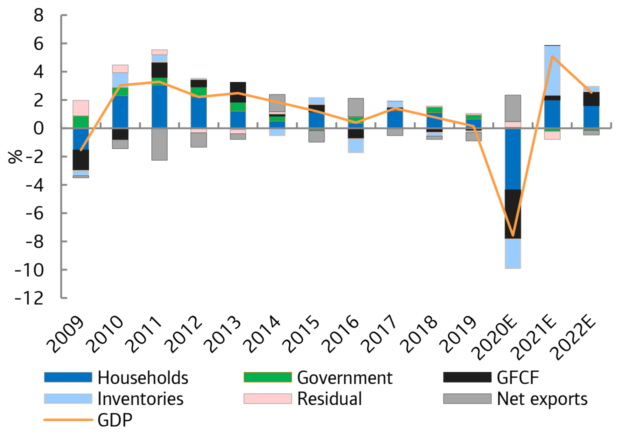
Source: Quantec, Standard Bank Research

Thus far, government's **growth-supportive adjustments have comprised focused, and largely uncontentious, policy steps** – including interventions to make it easier to do business, such as shorter timelines to issue select government licences and the one-stop business registration website, and specific programmes, such as the e-visa regime (see Make doing business in SA easier). In addition, the Infrastructure Fund is one of the first concrete programmes aimed at increasing private sector participation in areas previously monopolised by the state and state-owned enterprises, and energy sector reforms are structurally changing the sector (see our report From the crisis, a rare opportunity for

[1] There are, of course, many caveats and reasons for non-linearity and this is just a back-of-the-envelope estimate; it takes into account the reduced impact of loadshedding due to a broad-based decline in the energy intensity of the economy as well as a decline in the importance of the most energy-intensive sectors.

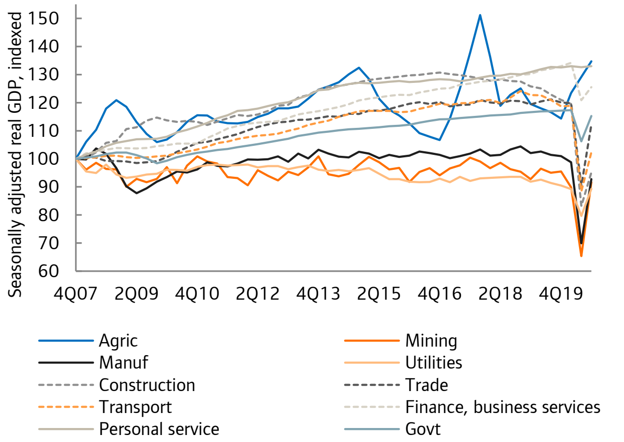
reform). Encouragingly, government seems to be making gradual progress with its short-term growth reform targets set at the end of 2020. These interventions alone, however, cannot adequately lift trend growth, and more decisive traction is required to bolster confidence and growth meaningfully.

Figure 3: Growth boost from consumers and restocking



Source: SARB, Standard Bank Research

Figure 4: Services has lagged the recovery



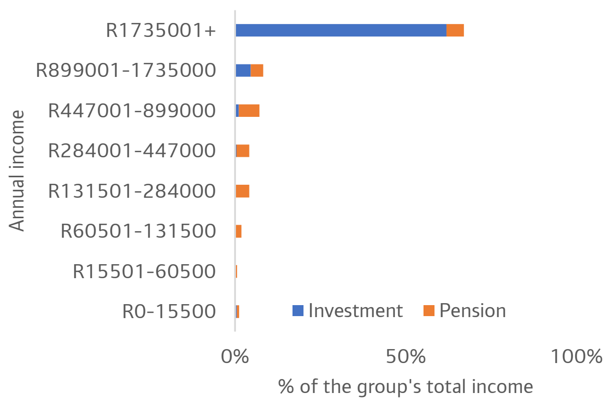
Source: SARB, Standard Bank Research

Consumer spending: an uneven growth prognosis

Disaggregated consumer confidence, overdue debt and spending data confirm the pervasive adverse impact of the crisis, with very few consumer segments left unscathed. However, the crisis affected employer and income segments in varying degrees, and the recovery will likely also be uneven.

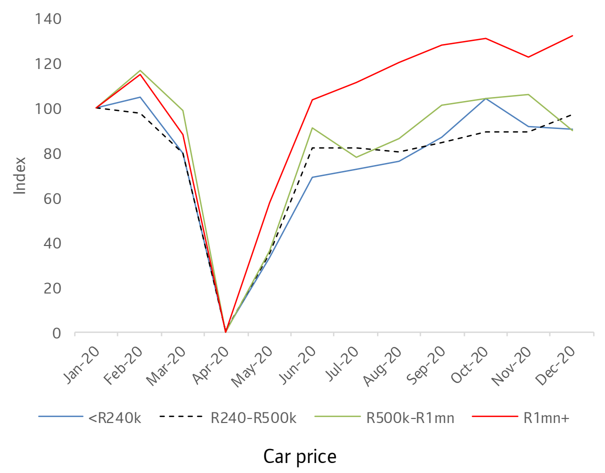
It seems to us that **higher-income groups were the most affected by weakness in non-wage income, including investment income**, quite early in the crisis (see SA consumers: a raft of imbalances). Their spending should be supported by the recovery in asset prices and expected investment returns, as well as relief about the below-average impact on their employment. A recovery in dividend income can be potent despite its concentration in the high-income group (for example, it added a full percentage point to total household income growth in both 2018 and 2019).

Figure 5: Investment income disproportionately important for top income groups



Source: SARB, Standard Bank Research

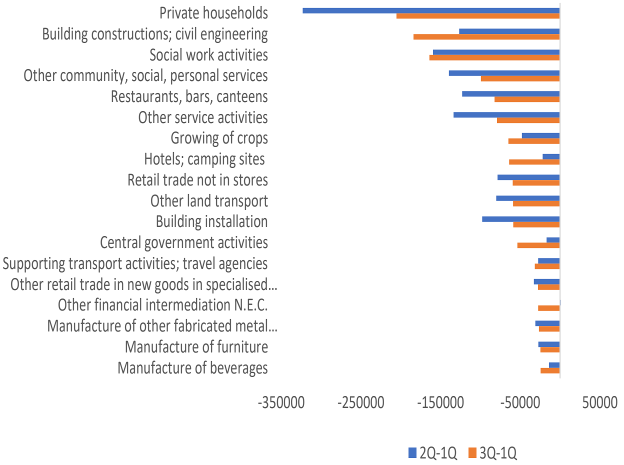
Figure 6: Some improvement in new passenger cars sold to individuals, especially high-end cars



Source: IRESS, Standard Bank Research

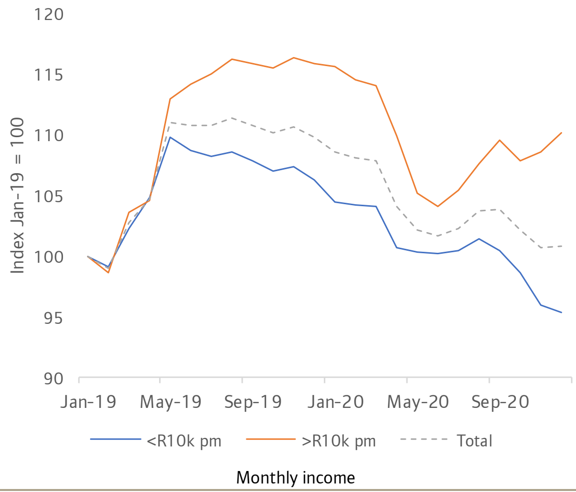
At the other extreme, **the pressure on low-income groups is likely to be more persistent as they bear the brunt of the job losses** (see SA consumers: a raft of imbalances and Figure 7) and as the temporary relief they received from expanded social grants fades[2]. This should only be partly mitigated by the roll-out of the presidential employment programme from which we estimate them to be the main beneficiaries.

Figure 7: Industries that recorded most job losses during the crisis – construction, entertainment, select manufacturing and domestic workers lead the job losses



Source: NIDS-CRAM, Standard Bank Research

Figure 8: Standard Bank jobs proxy relapsed in 4Q20, owing to further pressure on low-income groups



Source: Standard Bank Research

Figure 9: Estimated income distribution of the presidential employment programme: mostly low-income jobs[3]

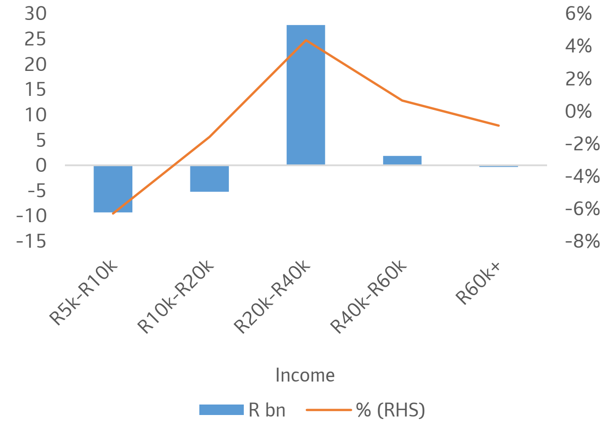
Programmes	Estimated monthly income	% of total income[4]
Muni infrastructure, job retention, social employment fund	≤R3,000 pm	19%
Subsistence farming, service sector development, provincial roads, teaching assistants, graduate programmes	R2,500 - R4,000 pm	57%
Metros, environmental programmes	R4,000 - R10,000 pm	20%
Community health workers, professional services programme	> R10,000pm	4%

Source: Presidency, Standard Bank Research

The picture is murkier in the middle of the income spectrum. The lack of real wage growth for government employees in the next few years should curb the spending power growth of the high-middle to high-income groups. It seems as if **the middle-income groups were mainly responsible for the credit growth during lockdown** (1Q20 to 3Q20, the latest data available, see Figure 10), and **debt in arrears also increased most for the middle-income groups** (see Figure 11)[5]. This credit growth doesn't generally seem to be distressed borrowing, with the uptake concentrated in asset-backed credit types (which are at new record levels) as consumers take advantage of ultra-low interest rates (which we estimate constitute an annual net saving of around R30bn - R40bn per year for households); the SARB estimates that the debt servicing-income ratio declined to 7.9% in 3Q20 from 9.3% - 9.5% in 4Q18-2Q20, the lowest since 3Q06. We suspect the credit trends aptly reflect the range within this income group from solid finances and prospects that support asset purchases to those increasingly financially distressed.

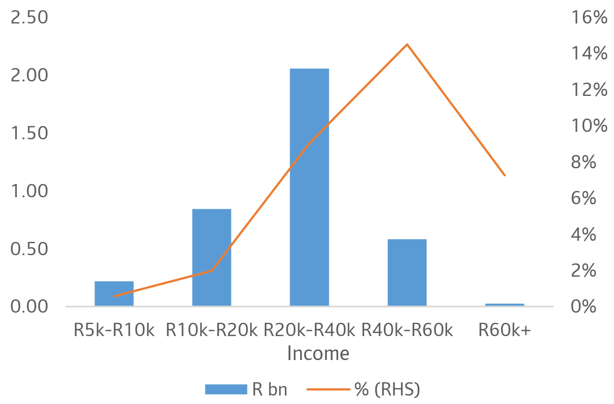
[2] See SA consumers: uneven recovery underway but not without risks for detailed charts on the income distribution of recipients of the new Covid relief of distress grant as well as the increased child grants.
[3] Average salaries presented here are our estimates, assuming that jobs and budgets are for six months. The objective here is mainly to get some sense of the income levels of the jobs that will be created. These calculations imply that around three-quarters of the planned jobs will be at estimated salaries below R4,000 per month, thus to some extent providing relief at the income levels where job losses and the phasing out of expanded social grants are having the biggest impact.
[4] Percentage of total income expected to be paid by the programme.
[5] This data is from one of the credit bureaus and is not as robust as official data, so need to be treated with caution.

Figure 10: Debt grew most for middle-income groups (3Q20-1Q20)



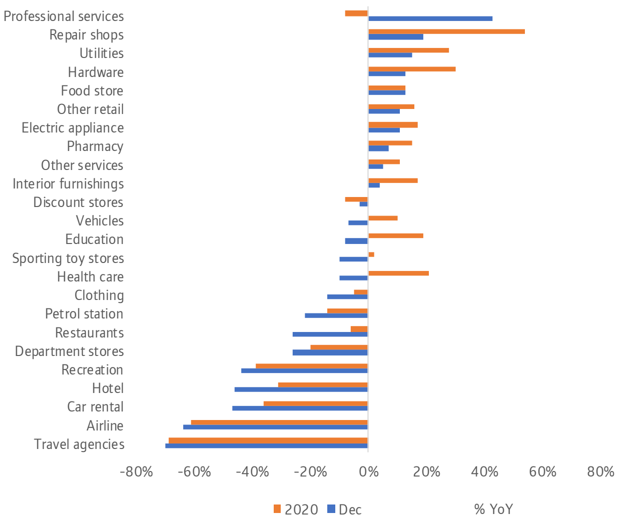
Source: XDS, Eighty20, Standard Bank Research

Figure 11: Arrears increase broad-based (3Q20-1Q20) but worst for middle- to high-middle income groups



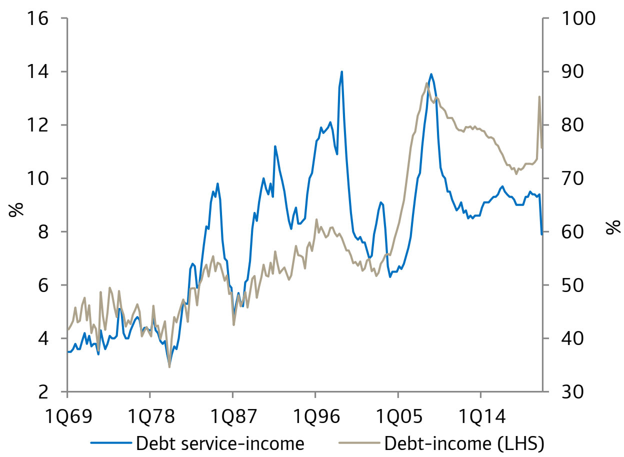
Source: XDS, Eighty20, Standard Bank Research

Figure 12: Our proprietary spending data reflects an uneven recovery; services is generally lagging



Source: Standard Bank Research

Figure 13: Savings from lower debt-servicing cost boosting credit and spending growth



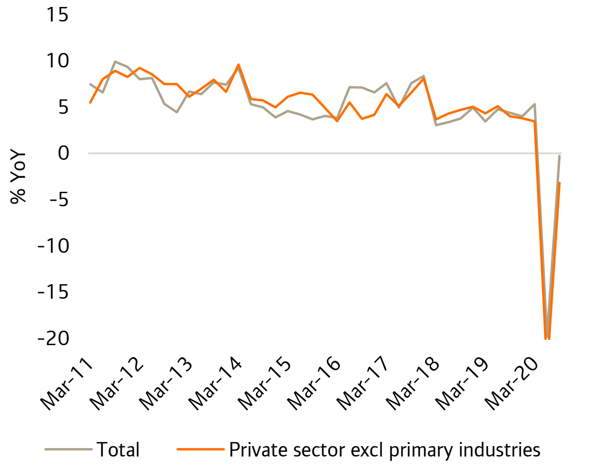
Source: SARB, Standard Bank Research

Fixed investment: weak and fragile for now

We foresee a very modest recovery in real fixed investment in the near term, followed by an acceleration in the medium term. The prevailing electricity constraint as well as persistent uncertainty about inadequate medium-term electricity supply and the general economic outlook are weighing on firms' investment intentions, though there should be an ongoing resumption of activities from suppressed levels during the harshest lockdown levels and, ultimately, support from the roll-out of further private sector energy generation capex. We expect the roll-out of the Risk Mitigation Independent Power Producer Procurement Programme (RMIPP) to boost gross fixed capital formation (GFCF) from 2Q21.

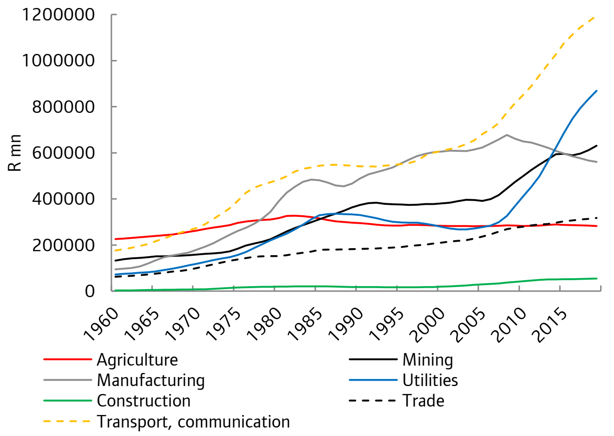
Recent improvements in aggregate profits and business confidence are encouraging (see Figure 14). Until 2019 (the latest data available), **firms in all sectors, except manufacturing, continued investing enough to maintain or expand capital stock levels** (see Figure 15) notwithstanding the aforementioned constraints.

Figure 14: Gross operating surplus (profit proxy) has (partly) recovered



Source: Stats SA, Standard Bank Research

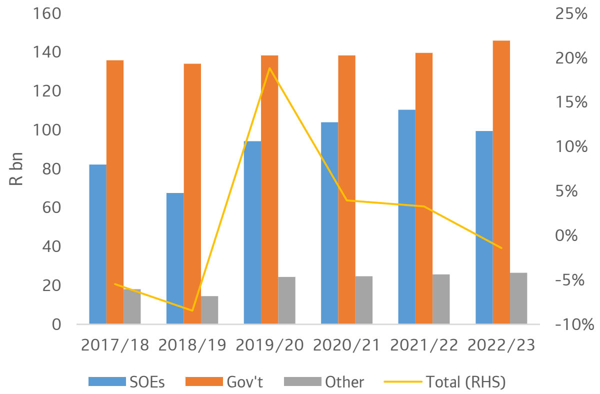
Figure 15: Prior to the pandemic, real capital stock levels continued to rise in all sectors except manufacturing



Source: SARB, Standard Bank Research

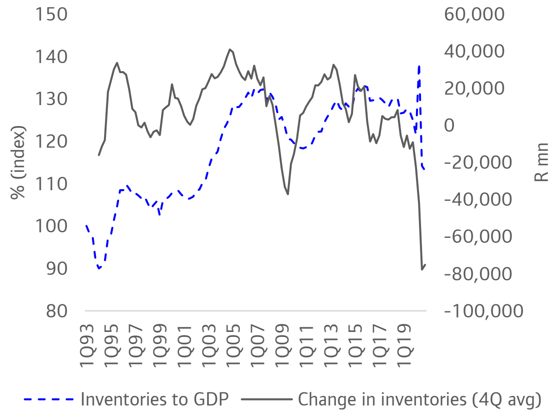
The fiscal crisis weighs on government's capacity to expand infrastructure spending. So far, there are encouraging signs that **government is living up to its promise of protecting capital spending** from the expenditure curbs that form the core of its fiscal consolidation plan: government's real GFCF expanded through the lockdown. We foresee only modest risk of underspending on government's latest capex projections, unlike significant underspending in recent years when government's forecasts implied implausibly high spending growth. The prognosis for real investment by SOEs is the weakest of the three groups given their weak finances.

Figure 16: Gov't investment projected to be steady; SOE investment may slow even more than projected



Source: Treasury, Standard Bank Research

Figure 17: Real inventories plunged; we estimate inventory levels are now very low vs GDP and due for rebound



Source: Treasury, Standard Bank Research

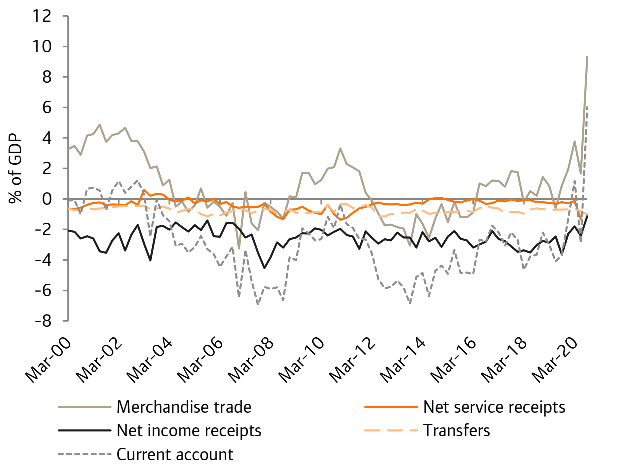
Inventory restocking likely to be a GDP boost

When assessing the level of inventories, and the probability of a change in direction, we focus on the level of real inventories to GDP. According to our estimate of the real ratio, **inventories are now very low relative to the size of the economy, and we expect firms to start rebuilding inventories soon**. Usually, more severe inventory destocking cycles are followed by more intense restocking cycles (see a more comprehensive analysis in A challenging year despite incremental progress). The latest inventory destocking cycle has been extreme relative to previous cycles, and a correspondingly strong restocking cycle is now likely.

Trade and current account surpluses starting to unwind
The trade balance recovery was the key swing factor in the improvement of the current account in 2020; a deterioration in net services (mainly tourism) receipts was offset by a similar improvement in net income (mainly interest and dividends) payments. **The weakness in net services income will probably persist until global tourism recovers** – this looked promising following progress with Covid-19 vaccines towards late-2020 but the resurgence in global infections and virus mutations will likely delay the expected tourism improvement. While **an improvement in net income receipts during the crisis is unsurprising, the sharp recent uptick seems unsustainably strong**.

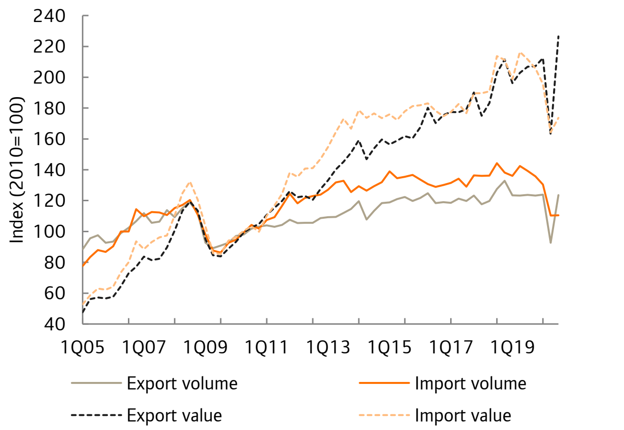
We are reasonably constructive about the outlook for net exports, notwithstanding the gradual recovery underway in imports. This is supported by the robust weighted growth recovery in SA's export destinations implied by the IMF's forecasts (see Figure 19), though the forecast global rebound is vulnerable to setbacks in vaccine effectiveness and/or roll-outs. There is a risk that electricity loadshedding in the first part of the year could inhibit the extent to which SA exports can meet the increase in global demand, though so far SA's exports have generally been able to maintain their global market share despite the electricity constraint, except for basic manufactured goods.

Figure 18: CAD supported by trade improvement, but it is already starting to unwind



Source: SARB

Figure 19: Import volumes likely to catch up with export recovery



Source: World Bank, IMF, UNCTAD, Standard Bank Research

A key forecast risk is the sustainability of support from the record-high terms of trade, which cannot be taken for granted even if the global economic recovery is strong-footed, as some commodity prices are, arguably, unsustainably high. We expect the real trade-weighted rand to remain more competitively valued than it was before the 2020 crisis, which should provide some support for the trade and current account balances. The bottom line is that the current account should remain reasonably small in 2021 (especially once the SACU payments are excluded), but it is very likely to deteriorate after the extraordinary improvement in 2020.

Fiscal stakes sky-high

We view **government's fiscal consolidation strategy as appropriate** – finally addressing excessive and imbalanced spending (see MTBPS 2020: Desired rebalance and consolidation, but high execution risk), though with due consideration to the potential service delivery impact of unduly aggressive cuts. The forecast fiscal consolidation seems by and large feasible, with the new spending trajectory still implying year-on-year growth in total spending and most spending categories (though the allocations are lower than previously anticipated, and there is an apt emphasis on the composition of expenditure (to protect capital allocations). That said, **the required adjustment is sizeable and subject**

to high execution risk, particularly given that wage bill curbs dominate the spending adjustments.

So far, though, **government has demonstrated steadfast commitment to curbing the wage bill**, with the reopening of the FY20/21 wage agreement to lower the 2020 wage increase despite fierce union objection. The economic setting is also conducive to containment of the public sector wage bill given the job security of the public sector amid severe pressure on private sector jobs and income. Furthermore, the freeze follows the strong growth in government wages in recent years (when they outpaced private sector wage growth by nearly 1% per year and inflation by 66% from FY06/07 to FY18/19[6]).

The execution risk will remain high until the next wage agreement has been reached, though the most important consideration is that there has been a step-change in the entire wage debate, from the habitual high-single-digit increases to low, if any, aggregate wage growth. The unions will, particularly after the FY20/21 reopener, likely stage strong resistance to low wage growth, but we expect government to be largely successful in the planned savings. We are only pencilling in modest slippage in the upcoming fiscal year (FY21/22) relative to the proposed wage freeze[7].

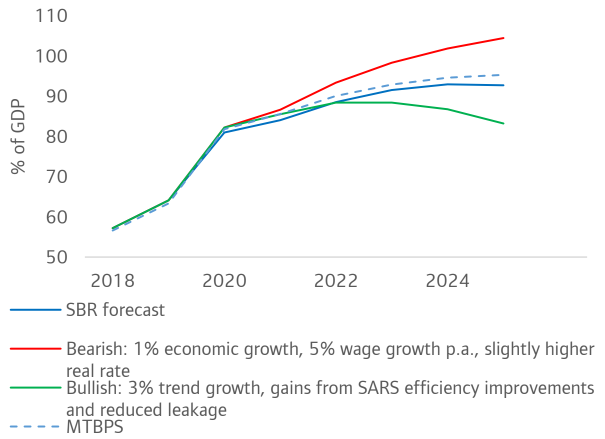
To some extent, we consider the fiscal forecast period in two phases. In the next three years, the fiscal trajectory largely depends on government's ability to curb expenditure, while GDP is merely reverting to pre-pandemic levels and is thus somewhat less reliant on a boost from growth reforms. Thereafter, higher real GDP growth would be essential to ensure debt stabilisation (which, of course, requires imminent traction with growth-supporting reforms to materially boost growth by that time). Given our expectation for fiscal consolidation, even if at a slightly slower pace than Treasury's latest forecasts, **we don't foresee further negative sovereign credit rating action this year.**

At this juncture, **we don't foresee additional capex injections for Eskom** but we do expect moderate further funding support for the other SOEs. Like the government wage bill, this is an area in which there has been some encouraging progress following several years of deeply disappointing slippage (even though this is still not decisive enough, and much more still needs to be done).

[6] According to National Treasury's estimates.

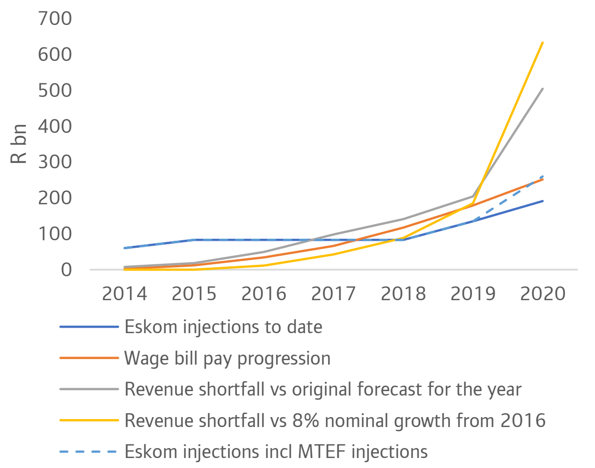
[7] We assume that government will ultimately implement the proposed reduced wage increases in FY20/21 rather than persevere with no wage increases. We are therefore not expecting any savings relative to the latest (MTBPS) forecasts here (though we are awaiting confirmation from Treasury in this regard).

Figure 20: Government debt scenarios



Source: Treasury, Standard Bank Research

Figure 21: Cumulative fiscal pressure from wage bill, SOE cash injections and revenue underperformance is large (until 2019; in 2020 revenue underperformance clearly dominated)



Source: Treasury, Standard Bank Research

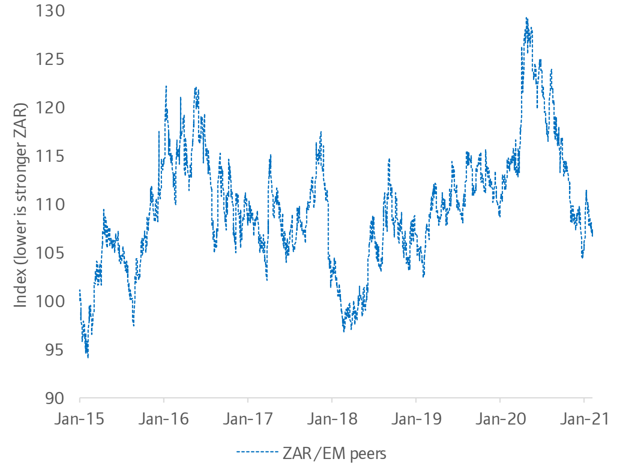
We sense that **government is increasingly reticent to increase taxes following several years of hikes**. In the pre-pandemic February 2020 Budget, government already avoided tax hikes – even fiscal drag – to not pressure an already weak economy. Households' tax burden in particular has reached the highest level in more than two decades, while there are obvious concerns about hikes of any of the other major types of taxes (particularly company income tax and VAT). We still generally expect any future tax hikes to be borne by consumers, with government reluctant to increase taxes on companies given the bearish sentiment of corporates and the president's investment-driven growth agenda. However, we expect a sizeable revenue overrun in FY20/21 relative to government's conservative MTBPS forecasts, which would negate the need for tax hikes now while the economy is still weak and fragile.

Rand ranging around fair value

A few distinct factors will likely drive the rand exchange rate in 2021, mostly centering on the actual and expected strength of the global economy (which will, in turn, influence global capital flows, sentiment and commodity prices) as well as perceptions around the SA government's progress with fiscal, economic and energy reforms. The global economic backdrop should remain rand-supportive, with the ongoing global search for yield, forecast growth rebound, easy financing conditions and possible further dollar weakness.

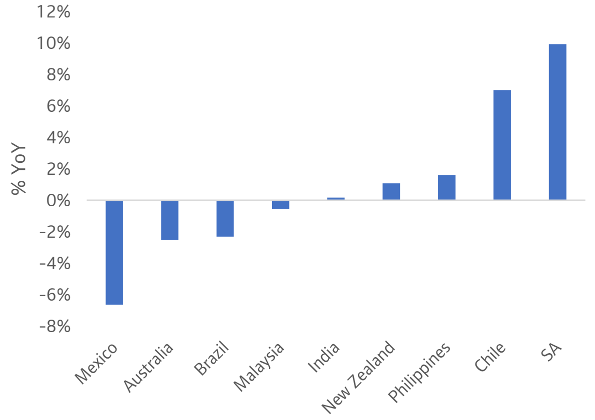
A dominant forecast risk around the rand's trajectory in 2021 will be the resilience of SA's terms of trade, which reached a new record during 2020. **Our econometric model estimates that the rand's strong rally late in 2020 is largely attributable to the elevated terms of trade**. We also attribute the rand's outperformance of peers (see Figure) to the strong increase in SA's terms of trade (in both absolute and relative terms). Our mining team estimates that low stock and strong (actual and/or anticipated) demand have driven many commodity prices beyond cost-curve support. Furthermore, our precious metals equity analyst concurs with the consensus that platinum and palladium prices – a major underpin to the 2020 rise in SA's terms of trade – should retreat in 2H21. While we expect SA's terms of trade to remain elevated, it may very well ease somewhat, which we suspect will reduce the support for the trade-weighted rand.

Figure 22: ZAR outperformed peers in 2H20, supported by strong terms of trade and large current account surplus



Source: Bloomberg, Standard Bank Research

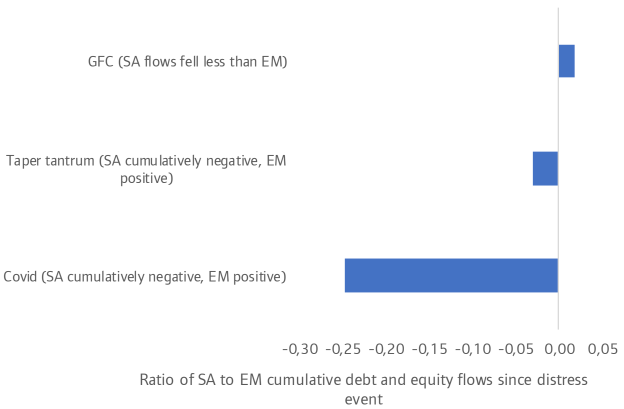
Figure 23: SA terms of trade strengthened more than in many EM and commodity economies (YoY, till mid-2020[8])



Source: Oxford Economics, Standard Bank Research

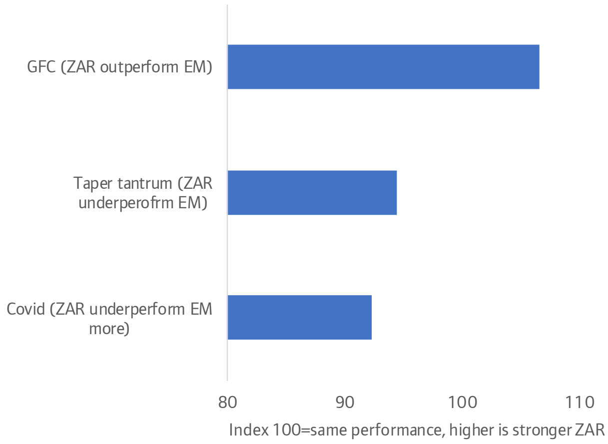
There are a few headwinds that will temper the support for the rand from the generally supportive global backdrop. First, the unwinding of the huge current account surplus in 3Q20 has begun, with export growth tapering off after the strong resurgence in 2H20 while imports are gaining pace as the domestic economy recovers. Perhaps even more pertinently, International Institute of Finance (IIF) data implies that **SA has in every recent consecutive global currency market stress episode received a lesser share of equity and bond inflows into emerging markets** (see Figure 24 and Figure 25), presumably reflective of growing investor unease about weak SA growth and fiscal prognoses[9]. While we remain constructive about progress with growth as well as fiscal reforms, this will likely be gradual and is therefore unlikely to reverse the trend of SA's declining share of global capital inflows into EM any time soon.

Figure 24: SA vs EM cumulative net equity and bond inflows during recent stress episodes for capital flows[10]



Source: IIF, Standard Bank Research

Figure 25: SA vs EM currency performance during recent stress episodes for capital flows



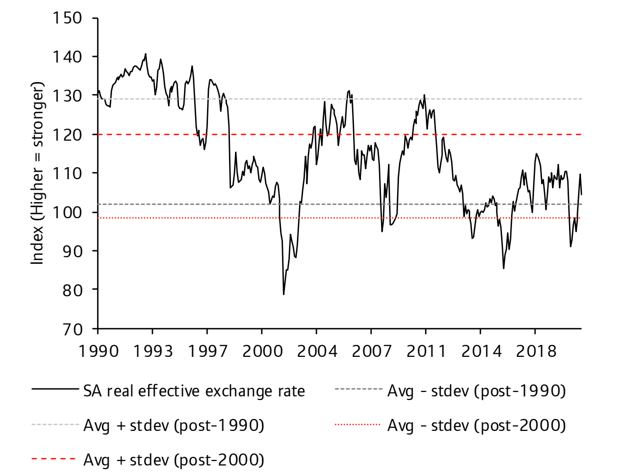
Source: IIF, Standard Bank Research

Quantitative assessments of the value of the rand across our preferred valuation metrics imply that the rand is about fairly valued for the prevailing fundamentals – by implication, the rand is then vulnerable to changes in these fundamentals. Based on comparisons with

[8] *Latest consistent data available.*
[9] *This analysis only compares equity and bond flows during these specific periods, without adjusting for any other factors that influenced SA flows over these periods.*
[10] *The following dates were used in this analysis: global financial crisis (GFC) in August 2008, taper tantrum (TT) in May 2013, China scare in July 2015, and Covid-19 in February 2020.*

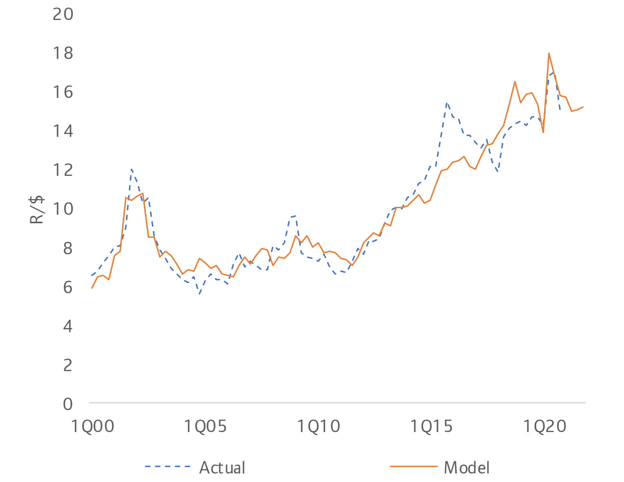
our preferred historical benchmarks, the real trade-weighted rand (which we strongly prefer to PPP estimates) seems fairly valued (see Figure 26). Our preferred **econometric model of the real rand exchange rate that explicitly captures (*inter alia*) SA's fiscal position, terms of trade and growth projections implies that the rand is fairly valued** premised on the prevailing fundamentals (see New econometric model affirms our R/$ view). We estimate a few scenarios for the rand's fair value based on different assumptions for the key fundamentals (see Figure 28) with this econometric model, focusing on the terms of trade given our view that it is a key forecast driver and risk for 2021 (these estimates are in current terms and would need to be adjusted by inflation differentials if projected to future dates).

Figure 26: Real trade-weighted rand implies rand is fairly valued



Source: SARB, Bloomberg, Standard Bank Research

Figure 27: Econometric model implies rand is about fairly valued



Source: Bloomberg, Standard Bank Research

Figure 28: Scenario analysis implies rand aptly discounting weak fundamentals, but vulnerable should recovery disappoint

Scenario	Assumptions			Estimated fair value (R/$)
	Fiscal	**Growth**	**Terms of trade**	
Base case	Improve in line with MTBPS projections	Our growth forecasts (+4.5% 2021)	Moderate decline from 3Q20 (to 1Q20 level)	15.00
Bullish terms of trade	Improve in line with MTBPS projections	Our growth forecasts (+4.5% 2021)	Remains at 3Q20 (near-record) level	14.50
Modestly bearish terms of trade	Improve in line with MTBPS projections	Our growth forecasts (+4.5% 2021)	Revert to 4Q19 level	15.75
More bearish terms of trade	Improve in line with MTBPS projections	Our growth forecasts (+4.5% 2021)	Revert to 1Q19 level	16.50
Very bearish	No improvement	No growth	Fall to early-2019 level	20.50
Very bullish	Deficit 2% of GDP smaller than MTBPS	2ppt higher than base case in 2021	Stay at 3Q20 near-record level	13.40

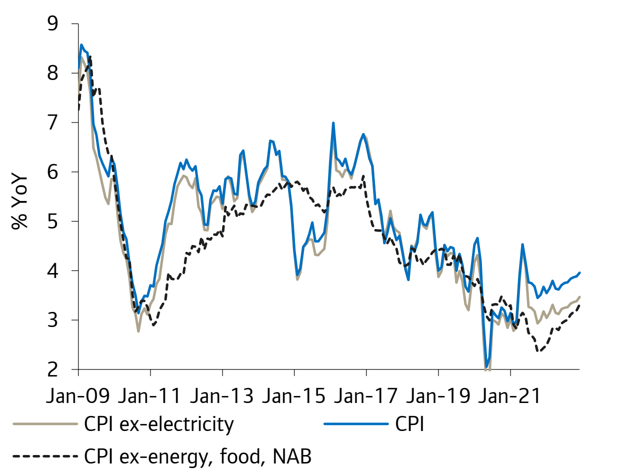
Source: Bloomberg, Standard Bank Research

Our rand forecasts assume a marginal retreat in SA's terms of trade, and the growth and fiscal improvements discussed in the relevant sections of this report. **Our forecasts are more bullish than consensus** though broadly in line with the expectations of the options market. We don't see a high risk that the trade-weighted real rand will be stronger than our forecasts or the prevailing levels on a sustained basis, though it might strengthen against the dollar if the greenback weakens more than we expect.

Inflation and rates: drifting

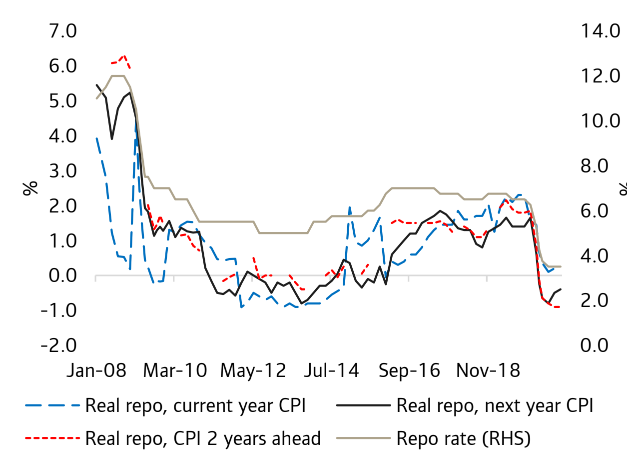
A number of factors, including forceful base effects, higher food and energy inflation, and the potential further (lagged) impact from earlier rand weakness, should conspire to noticeably lift consumer inflation from 2Q21. These pressures are counteracted by subdued pass-through from any rand weakness, our expectation that the rand will remain relatively resilient this year, and subdued inflation in the weighty rental inflation category. Even with the step-change that we foresee from 2Q20, price pressures should remain quite tame, with headline inflation spending the year mostly drifting in the bottom half of the SARB's inflation target range.

Figure 29: Inflation forecasts comfortably in-target



Source: Eskom, Nersa, Stats SA

Figure 30: Negative forward-looking real rates a reason for SARB's reluctance to cut rates further



Source: Stats SA, Standard Bank Research

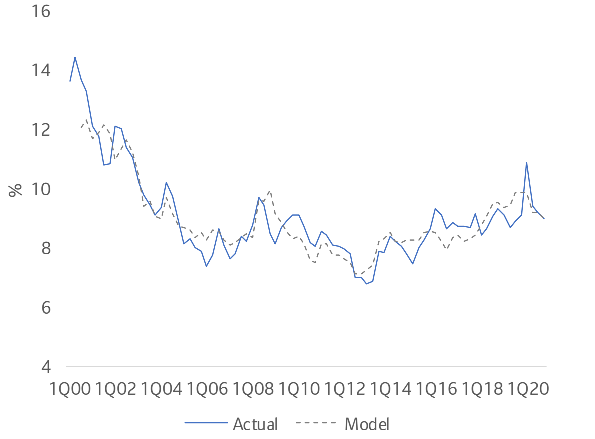
Weak growth and contained inflation keep the possibility of modest further interest rate easing alive but **at this stage we see the odds as biased against another rate cut**. This is mainly because we sense that the SARB would be reluctant to pull the forward-looking real rate further into negative territory, especially since it sees the growth benefit of any further easing – which will likely be only marginal and short-lived – as doubtful, and the bank expects growth and inflation to pick up in the coming months. The bank also remains concerned about the possible rand-negative fiscal risks.

While the previous MPC decision to keep interest rates on hold was quite close, with a 3-2 vote, this doesn't necessarily imply that only a modestly dovish shift in key fundamentals will swing the one vote required to support a rate cut. Our sense is that the three members who preferred to keep rates on hold at the last meeting are focused on factors that won't easily change, including negative forward-looking real rates that the bank deems risky as well as an emphasis on the sustainable level of interest rates, following aggressive, front-loaded rate cuts in 2020. The bank's concerns about possible rand-negative (fiscal) risks are probably also still intact.

Bonds tread warily

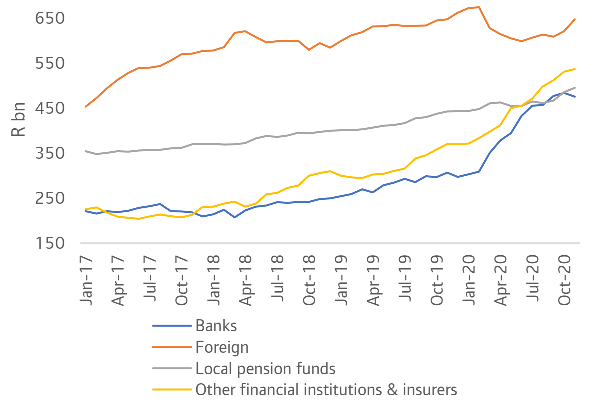
Our econometric model estimates fair value of the 10-year generic yield at around 9% premised on the prevailing global fundamentals and our fiscal forecasts (*ceteris paribus*, see Figure 31 and Bond model: unpacking the drivers). In other words, local bonds are discounting the weak growth and fiscal fundamentals but not discounting any premium for (execution) risk. We show in Figure 33 the impact on the estimated fair value of different government debt and global assumptions.

Figure 31: Econometric model of 10-year generic yield implies it is fairly priced for the prevailing fundamentals



Source: Bloomberg, IRESS, Standard Bank Research

Figure 32: Buying of SA bonds by local bonds and financial institutions counteracted foreign selling



Source: Bloomberg, Standard Bank Research

Figure 33: 10-year generic bond yield fair value scenarios

Scenario		Assumptions		Fair value estimate
	EMBI	US yield	Debt-GDP	10-year yield
Spot	320	0.9	95	9.00
SA fiscal disappointment	320	0.9	110	9.80
SA fiscal outperformance	320	0.9	90	8.80
More supportive global setting	300	0.8	95	8.90
Less supportive global setting	400	1.5	95	9.54

Source: Treasury, Bloomberg, Standard Bank Research

Forecast summary

Figure 34: Forecast summary

% avg	2020	2021	2022	Bias of risks to our forecasts, 2021	Relative to consensus
Household consumption expenditure (HCE)	-7.0	2.8	2.1	Two-sided	N/A
Gross fixed capital formation (GFCF)	-18.1	1.6	6.0	Higher	N/A
GDP	-7.6	4.6	2.2	Two-sided	Higher
Current account (% of GDP)	2.0	-0.4	-1.3	Negative	Better
R/$ (avg)	16.47	14.97	15.15	Stronger	Stronger
R/$ (YE)	14.86	15.00	15.28	Stronger	Stronger
CPI (avg)	3.3	3.8	3.8	Two-sided	Lower
Repo rate (YE)	3.5	3.5	4.0	Lower	Similar
10-year generic bond (YE)	9.1	9.0	9.2	Two-sided	Lower

Source: Bloomberg, SARB, Standard Bank Research

Elna Moolman[#]

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7.4 any other purpose SBR reasonably believe is required to fulfil its obligations in accordance with regulation or this agreement.

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