RESET ECONOMY 2022

Steve Barrow#
Jeremy Stevens#
Jibran Qureishi#
Simon Freemantle*
Elna Moolman#

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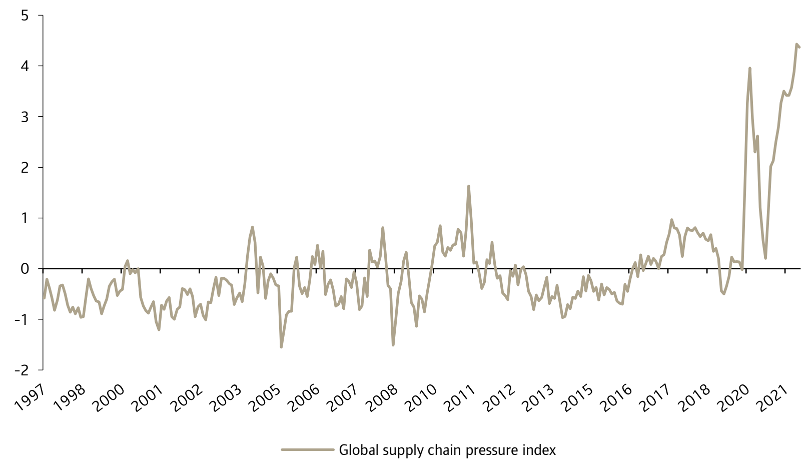
The global economy is likely to record another year of solid growth in 2022, provided that policymakers do not have to slam on the monetary brakes to rid economies of surging inflation. For this appears to be the biggest threat to global growth right now given that the Omicron variant's less deadly prescription may be a sign that the economic disturbance from the pandemic is waning significantly. On the assumption that many Omicron-related restrictions can be removed early in 2022, we'd expect the global economy to grow by close to 5%. That's a percentage point lower than the likely 2021 outcome but it does appear that successive releases from Covid-related lockdowns are producing more limited economic recoveries, and hence the 2022 rebound may be more modest than those we have seen before. While more modest growth this year might seem a negative development, it is important to weigh up the large demand and supply imbalances that have developed since the pandemic struck in 2020.

In short, if global demand does accelerate far more rapidly, lifting growth above last year's pace, it could come at a cost of even more inflation if supply-chain pressures are slow to disappear. One measure of supply-chain pressure, from the NY Fed, is showing few signs that strains have eased materially at a global level, while individual-country survey data, such as PMI surveys, also suggests that pressures remain quite intense.

Figure 1: Supply-chain pressures are still elevated



Source: NY Fed

It seems likely that there will be some easing of supply chain pressures this year, and hence the prices of certain products that have been particularly inflated by this issue, such as used car prices, seem likely to moderate. But while this factor, and the unwinding of high base effects, should cause inflation in G10 countries to fall, we believe that price moderation won't be as significant and rapid as many might hope. For a start, new and more dangerous price pressures are increasingly related to wages, house prices, and more.

Price pressures will remain persistent even as annual inflation rates come down

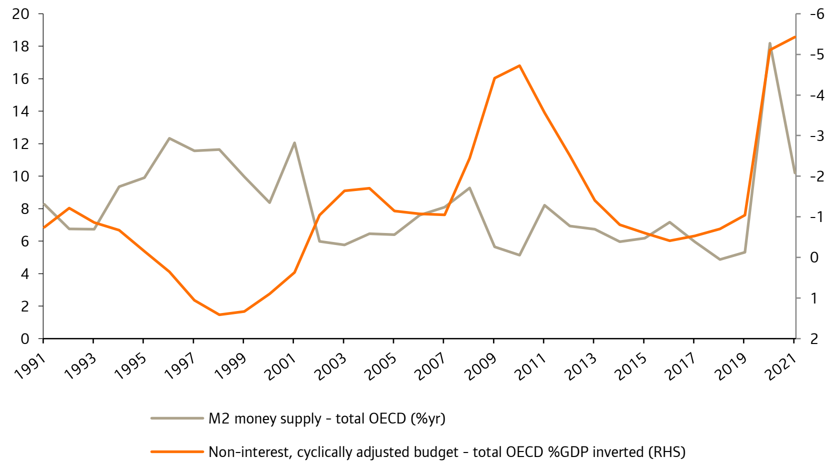
These factors suggest to us that price pressures will remain persistent even as annual inflation rates come down. The Fed presents a median forecast of 2.6% for PCE prices this year; less than half of the expected 2021 outcome. In the euro zone, the ECB anticipates that inflation will be back under the 2% target next year. We believe that these inflation forecasts are too low, and that the price pressure will remain a more intractable problem than policymakers – and the market – anticipate.

Too much easing

While it is fiendishly difficult to calibrate the right setting of fiscal and monetary policy amidst a once-in-a-century pandemic, it does seem as if G10 policymakers have eased policy too much. This is probably because they focused on the demand-sapping properties of the pandemic in its early stages and underappreciated the fact that a pandemic is a negative supply shock that results in lower output and higher inflation. Policymakers have become used to dealing with adverse demand shocks, such as the 2008 global financial crisis (GFC), but an adverse supply crisis of this magnitude has not been experienced since at least the 1970s when oil prices surged.

On the fiscal side, countries devoted huge resources – as much as 25% of GDP in the US's case – to combating the pandemic. In addition to this, monetary easing caused monetary aggregates to soar, to well over 20% in annual terms in the US. The consequence is that demand has rebounded too fast relative to supply, and the only release valve is higher inflation.

Figure 2: Policy is too loose



Source: OECD

2022 will be a year where many policy excesses will be reined in

2022 will be a year where many of these policy excesses will be reined in. Some of this will happen naturally as emergency fiscal and monetary measures come to an end. On the monetary side, asset purchase schemes from the likes of the Fed, ECB and Bank of England have all ended, or will end this year. On the fiscal side, support programs have elapsed and some, such as the UK, are taking the first tentative steps to claw back some of the spending made during the height of the pandemic.

But policymakers are still likely to be somewhat torn. For while surging inflation indicates the need for an aggressive policy reaction, particularly on the monetary side, policymakers also know that the weak post-GFC recovery led to accusations that they had tightened too quickly, particularly on the fiscal side. Policymakers will be wary of making the same mistake as Covid disappears into the rear-view mirror. The upshot of this is likely to be that central banks will prove themselves somewhat more hawkish through 2022 and lift policy rates quite rapidly even as headline inflation falls. But, on the fiscal side, it seems unlikely that there will be much momentum towards budgetary consolidation and, with debt levels already very elevated, this clearly creates the possibility of tensions, especially as higher interest rates increase governments' debt service costs.

Utilising the balance sheet

For most G10 central banks, 2022 and 2023 will be marked by an unwinding of Covid-related easing. This is valid not just because growth has bounced back swiftly after the initial dislocation caused by the pandemic, but also because major supply/demand imbalances have occurred that have pushed inflation up to levels that no policymaker – and probably no investor – foresaw. Arguments that the rise in inflation was temporary have been shown to be incorrect as rising inflation, initially borne of tight supply in certain sectors of the economy has been replaced by broader pressures.

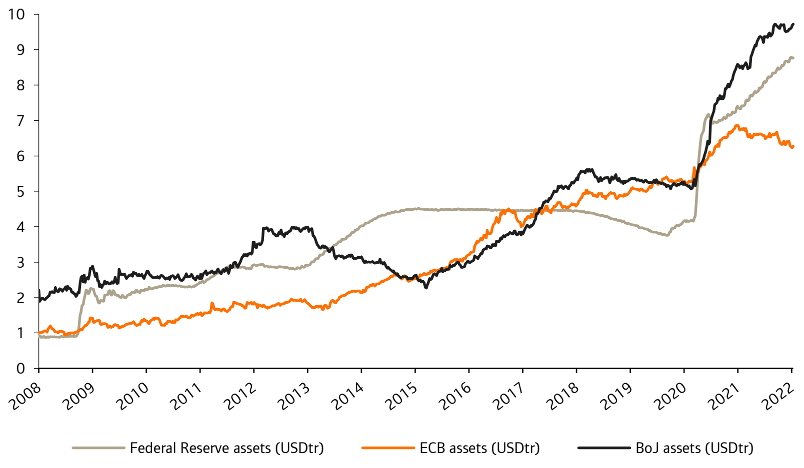
Inflation has taken on a life of its own, and policymakers need to kill it off

In short, inflation has taken on a life of its own, and policymakers need to kill it off. Central banks at the forefront of this fight, such as the Federal Reserve and Bank of England, are likely to embark on a path of quarterly rate hikes of 25 bps a time through 2022. But this pace could easily speed up, and/or the increases become larger should inflation prove intractable. Central banks can supplement rate hikes with balance sheet policy. The Federal Reserve will soon stop buying bonds, and only undertake reinvestments that occur as maturing bonds fall due. But even these reinvestments look set to end this year or next as the Bank enters a quantitative tightening mode to shed some of the USD8tr-plus of securities that it currently owns.

Balance sheet policy could be particularly important through the monetary tightening cycle as the Fed will be keen to avoid an inversion of the yield curve, which would be very possible if the weight of monetary tightening is all laid at the door of higher policy rates. By using balance sheet rundown and later active treasury sales, the Fed will hope to effect a more even distribution of rate increases throughout the yield curve and so avoid the curve inversion that is so often associated with recession. But even this could be touch and go.

In our view, the fed funds target will have to rise above the Fed's definition of the 'neutral' rate in this cycle, which it puts at 2.5% and, while longer-term yields, such as 10-year treasuries are likely to increase, it may be difficult to see yields here rising much above 2.5%, particularly if the peak of inflation is to be passed quite soon. Balance sheet policy will have a role to play as well for other major central banks. The Bank of England has stopped buying gilts on a net basis, and the ECB will slow its purchases from the spring. It may still be some time before the ECB looks to reduce its balance sheet, but the Bank of England could have to act quite soon, such is the difficulty of the inflation problem that it seems to be facing.

Figure 3: Significant amounts of balance sheet expansion to unwind



Source: Refinitiv datastream

Excessive focus on rates

The path of monetary policy seems to be widely cited as being the key driver of currencies this year and, with the Fed tightening faster than the likes of the ECB and BoJ, the corollary is that the dollar will appreciate. But we do not think it is as simple as this, and history tends to bear that out.

For instance, in the last Fed rate-hike cycle between December 2015 and December 2018, the Fed increased rates 225 bps, with no rate hikes in this period from the likes of the ECB, BoJ, BoE nor, indeed, the vast majority of other central banks. And yet, over this period the dollar weakened, ending the period 2% lower on a trade-weighted index than when it started. We think that's partly because a rate hike cycle from the Fed involves an important 'information' effect. In short, the 'information' a Fed tightening cycle conveys is that the US economy is strengthening – and that's something that's positive for the global economy and arguably positive for asset prices. Hence rate hikes, once they start, can produce a risk-on mentality among investors and so weigh on 'safe' assets such as the dollar.

Instead, it tends to be the period before rates start to rise, as rate-hike expectations develop, that risk aversion can rise and the dollar strengthen. If the same logic applies to the coming rate-hike cycle from the Fed, it looks as if we might have just about got through the period of heightened trepidation and risk aversion and, once the Fed gets going with rate hikes, probably from March, the dollar will start to give ground. But much here depends on inflation. For this rate cycle is more about taming current inflation, than it is restraining growth which has characterised every tightening cycle from the Fed since the 1980s. If the Fed is unable to tame inflation now, there is a danger that this 'information' effect for the global economy and global asset prices is a negative one, not a positive one, and hence one that propels the dollar much higher as global risk aversion rises and 'safe' assets such as the dollar appreciate.

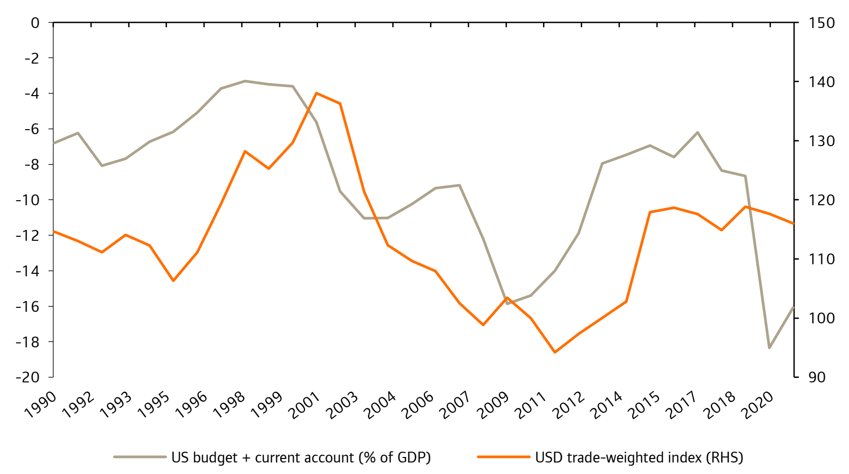
Any further dollar strength may not last beyond the next few months

Our bias is to lean towards the former interpretation and hence to think that any further dollar strength may not last beyond the next few months. We target euro/dollar to slide into a 1.05-1.10 range by the spring, but to rebound to 1.20, or more, by the end of 2022. But it is not just the fact that the interest rate argument for a stronger dollar may fail to meet the expectations of many investors. Interest rates are certainly not the only influence on currencies.

For instance, we still have to bear in mind that the dollar is somewhat overvalued, especially based on its current account position. The IMF's external sector report, for instance, put the dollar's overvaluation at around 8% in 2020, and it seems unlikely to us that this would have narrowed through 2021; quite the reverse. The enormous expansion of the budget deficit thanks to Covid and the US's particularly vigorous fiscal response contributes, along with the much wider current account deficit, to a substantial twin deficit. And, as the graph below suggests, bouts of significant deterioration in the twin deficit tend to be associated with periods of dollar weakness.

The bottom line, in our view is that, even if rising US rates produce a bout of dollar strength, the longer-term argument for persistent dollar appreciation against other G10 currencies is a weak one. We expect euro/dollar to rise to the 1.30-1.40 range over the next 1-2 years, with sterling/dollar climbing to 1.50-plus.

Figure 4: Twin deficits suggest a weaker dollar



Source: Refinitiv datastream

A tougher investment climate

The substantial rally in asset prices, such as equities, in the past 18 months shows, once again, the power of policy support, particularly monetary support. But this support is unwinding. The global economy should prove robust enough to cope, provided inflation starts to moderate and central banks don't have to go in for the monetary kill.

The scope for policy mistakes is substantial. Indeed, it looks as if many have been made already

But it is a difficult balancing act, with many G10 central banks engaged in an inflation fight not seen since the 1970s. The scope for policy mistakes is substantial. Indeed, it looks as if many have been made already. So far investors have tolerated this; equities have held firm and the rise in bond yields has been modest. But we cannot necessarily expect this to continue, and we may have already seen signs of cracks at the start of this year. We therefore anticipate that this could be a more difficult year, with yields rising further and G10 stocks struggling to make headway.

Steven Barrow[#]

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EM outlook in 2022

A tough grind for the once seemingly unrelenting

Going into 2022, emerging markets are certainly better prepared to deal with the pandemic than a year ago. The rate of vaccinations has accelerated. Naturally, there is the risk of new variants capable of evading vaccines. More certain, though, economic momentum is slowing after the post-pandemic bounce. Some emerging markets have already adjusted monetary policy and are preparing to scale back fiscal support to address rising debt and inflation.

2022 poses a difficult choice for emerging markets: they trade off supporting a weak domestic economy with safeguarding price and external stability

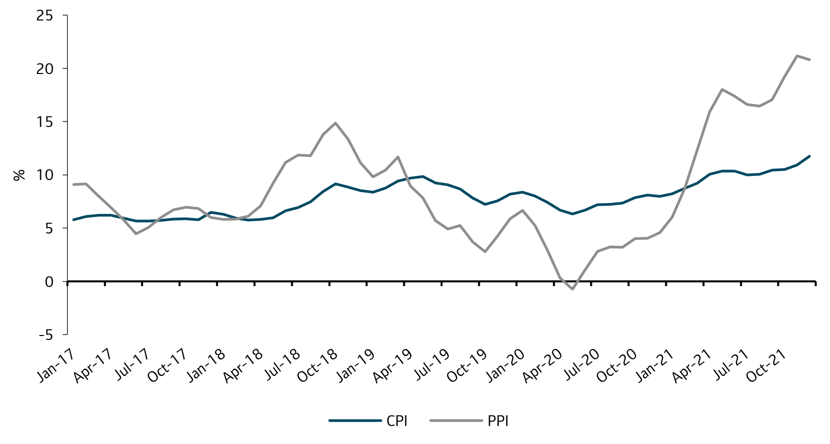
2022 poses a difficult choice for emerging markets: they trade off supporting a weak domestic economy with safeguarding price and external stability. Making matters worse, this year agile policymakers will be further tested by rising interest rates in key advanced economies, along with bond-tapering, which have already triggered flashbacks from the 2013 taper tantrum. Another item to watch closely this year is commodity prices. Even though commodity prices have increased dramatically since early 2020, they are likely to remain reasonably elevated because of continued supply chain disruptions, amongst other factors. And perhaps, for one last time, China's unavoidable pivot towards greater fiscal outlays in 2022 to prevent momentum slipping too far.

This year, other key risks include growing geopolitical tensions, a scenario in which inflation does not prove transitory, and the ongoing growth slowdown in China – not to mention the less obvious regulatory environment. Chinese growth has been the engine for emerging and developing economies (EMDE) for the past three decades. Most remain sensitive to its out-of-favour credit-fuelled investment-led growth model. Absent that engine, most in the group face headwinds.

Unwinding of stimulative policy anticipated

We had expected inflationary pressures to materialise. The rebound in demand, but more importantly, hamstrung supply unable to respond sufficiently, combined to push costs higher. However, last year logistical challenges created an even greater scarcity of goods than anticipated. Delays perpetuated more delays, magnified production issues, causing input prices and the cost of producing almost everything to rise. Across the globe, over the course of the past year, prices at the factory gate nearly tripled, gradually feeding into prices of goods. Weighted by GDP, the inflation rate for the largest 25 EMDE has more than doubled since the start of last year. In addition, in 15 (out of the largest 25 EMDE economies), consumer prices continued to increase to a cyclical high in December 2021.

Figure 1: Elevated costs feeding into inflation



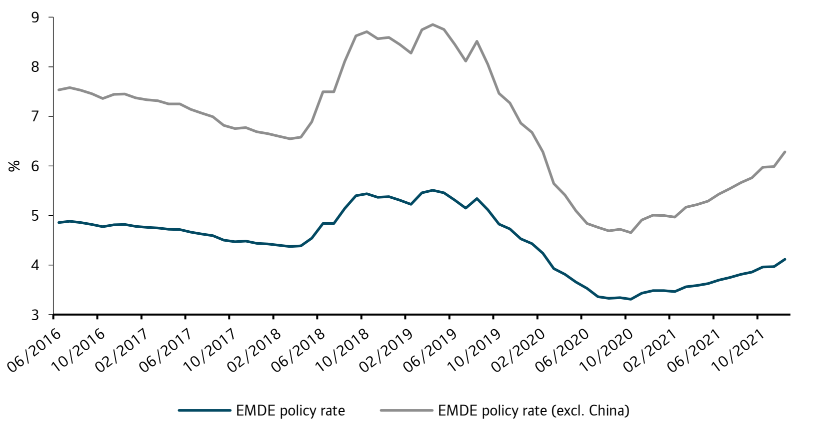
Source: CEIC & SBR

Most emerging market economies have either only increased rates marginally or are yet to respond to rising price pressures, meaning much of the heavy lifting still confronts them and the outlook for investment in risk assets has deteriorated

Even though the Fed, the ECB and other central banks from advanced economies were in no rush to tighten monetary policy – even as inflation proved more pronounced and the transitory narrative lost steam – around half the central banks in emerging markets tightened policy in 2021. Overall, policy rates in the emerging market universe, again when weighted by GDP, have increased since bottoming at 4.55% in September 2020, to 6.28% currently. Therefore, for countries that made more forceful adjustments, such as Brazil (+7.25pps) and Russia (4.25pps), pre-emptive moves have had a moderating impact on inflation, which is favourable for real returns of assets, especially stocks and local-currency bonds. However, most emerging market economies have either only increased rates marginally or are yet to respond to rising price pressures, meaning much of the heavy lifting still confronts them and the outlook for investment in risk assets has deteriorated.

2022 poses a difficult choice for emerging markets: they trade off supporting a weak domestic economy with safeguarding price and external stability. Promisingly, over the course of 2022, we expect virtually the entire group to have completed hiking cycles and be left with real interest rates well above their developed counterparts, perhaps with rate-cutting cycles coming into view. Nevertheless, it is plain to see that this year tighter monetary will increasingly weigh on growth and, even for those that have already increased rates, the headwind remains as higher rates typically weigh on activity with a lag of six to nine months.

Figure 2: Policy rates in emerging markets rising



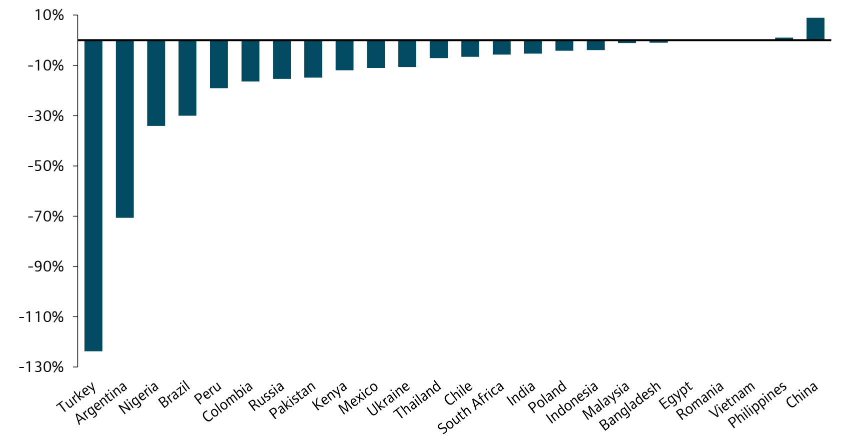
Source: CEIC & SBR

Conversely, tepid responses that extend support to businesses beyond existing measures may increase credit risks and weaken the longer-term health of financial institutions by delaying the recognition of losses. Promisingly, the withdrawal of stimulus and fading pent-up demand may see inflation pressures ease, calming stagflation fears. That may ultimately mean that some emerging market central banks are liberated from delivering the tightening that is priced into markets at this juncture – especially for those central banks, such as Russia and Mexico, that have a decent track record in containing inflation.

Responses should include letting currencies depreciate

All the while, responses should include letting currencies depreciate. Interestingly, since the pandemic, the CNY/USD has been the only EM currency to strengthen against the USD, appreciating by nearly 10%. In just the past 12 months, eight of the largest EMDE have seen their currencies weaken by more than 10% versus the USD. More broadly, EMDE currencies have been depreciating against the USD since 2014 – albeit with some pauses, most notably between Dec 2016 and May 2018. In short, emerging markets are in for another rough year, and it would be wise to pay close attention to those with rising auxiliary idiosyncratic internal fragilities.

Figure 3: EM currencies expected to remain on the back foot in 2022



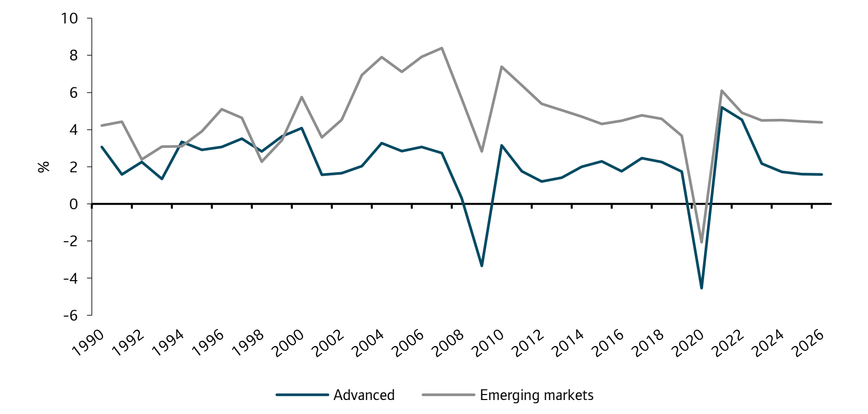
Source: CEIC & SBR

Uneven growth — but uniformly sluggish

Policymakers in emerging markets will be aware that rolling back support measures could further tighten financial conditions, further weakening the growth outlook. Many economies have already recovered to pre-pandemic levels. The recovery of economic growth in 2021, from a contraction of 2% y/y in 2020 – the sharpest contraction in generations – was certainly welcome.

However, this naturally makes it harder to sustain above-trend rates of growth. Specifically, in 2021, growth has been flattered by the low-base comparison in 2020. This statistical tailwind has dissipated, virtually guaranteeing slower rates of expansion in 2022. Growth is expected to slip from 6.1% in 2021 to 4.9% in 2022 and 4.5% in 2023. What is equally clear is the pandemic's economic damage remains serious for many, including the rise in unemployment, poverty and inequality, and the fall in consumption and deferment of investment decisions, which have not yet been ameliorated by last year's rebound in GDP growth.

Figure 4: Growth momentum in emerging markets reasonably resilient



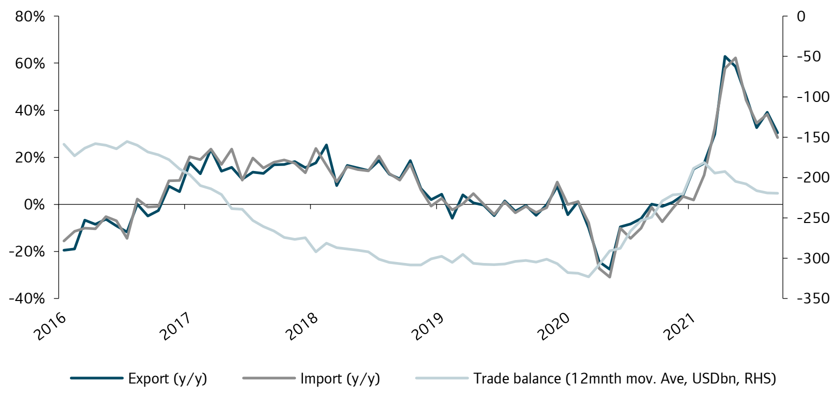
Source: SBG, CEIC

Some seem to contend that this year will see EMDE outperforming developed economies materially. Such more optimistic views for the relative performance of EMDE hinge on the Fed making a hawkish pivot (currently signalling three or four rate increases in 2022), which would reduce US economic growth, which, coupled with an easing policy bias in China, is expected to revive economic activity in China and therefore emerging markets, widening the growth differential again.

The good news is that for most emerging markets, trade deficits are below their pre-pandemic levels

More likely though are that downgrades to developed-market growth projections also mean that demand for manufactured goods is likely to soften in 2022. Recall that after seeing exports collapse in H1:20, emerging economies were able to navigate the pandemic with a strong rebound in exports, and reasonably loose international credit conditions. The good news is that for most emerging markets, trade deficits are below their pre-pandemic levels. In some respects, favourable external balances were the flipside of the sharp slowdown in domestic economic activity, reducing import demand. Then, from H2:20 through to early 2021, the swift recovery in EMDE exports caused the trade deficit to narrow materially as elevated commodity prices lifted exports, offsetting the recovery in imports. Granted, imports too are exceeding pre-pandemic levels relative to gross domestic product, but strong exports have diminished the degree of the imbalance compared to pre-pandemic levels.

Figure 5: External demand has been supportive but likely to slow



Source: CEIC & SBR

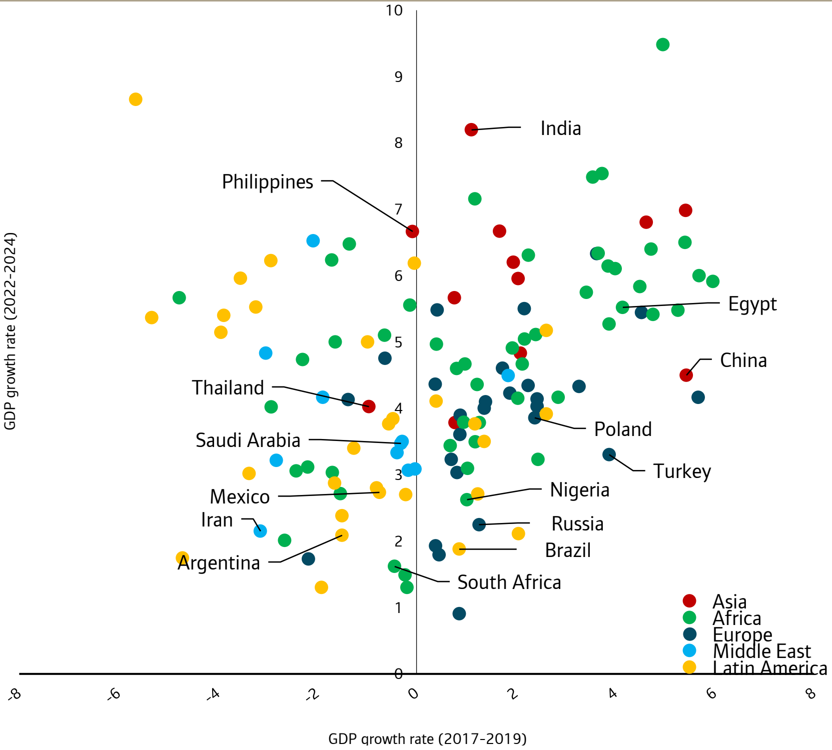
Already, even large emerging markets with reasonably sizable trade surpluses, such as China, Russia and Brazil, have seen their surpluses reduced in 2022. Worse still, so have the surpluses of countries which tended to run slightly smaller trade surpluses, such as Saudi Arabia, Indonesia, Thailand, and Malaysia. Meanwhile, those tending to run trade deficits have seen a more mixed picture emerge since the pandemic: India, Turkey, Poland and Kenya continue to run trade deficits, but they too have narrowed; in contrast, Mexico, Vietnam and Columbia have seen their trade deficits rise in USD terms and relative to GDP. And, Nigeria and United Arab Emirates have seen their trade balances shift from small surpluses to deficits. Nevertheless, given that the recovery in global trade has been an important driver of emerging market growth, less supportive external demand will be a headwind – particularly for small, open EM economies across Asia, Africa and Latin America, but also for the largest, China.

Different speeds of recovery among emerging markets are expected

Akin to the varied impact of reverberations during the global pandemic, different speeds of recovery among emerging markets are expected. Differences across emerging market countries in terms of initial conditions, commodity reliance and sensitivity to US rates and dollar moves, mean that, once again, divergence in economic outcomes will continue in 2022. That said, in general terms Latin America is likely to lag, and Africa and Asia are likely to lead. Nevertheless, the build-up of headwinds has accumulated, revealing broader socio-economic challenges that will not be quickly reversed.

Therefore, the momentum loss is rather generalised: two-thirds of the world's emerging markets are expected to expand more slowly this year than last year. In addition, most of the largest emerging market economies are expected to expand by less than 4% over the next three years, including South Africa, Brazil, Russia, Mexico. Indeed, out of these larger emerging market economies, only India and the Philippines are expected to expand above 6% in 2022. Put together, GDP growth in emerging markets is expected to remain in the 4-5% range for the next three years, resulting in the gap between emerging market and advanced economic growth continuing to be a rather narrow 2pps – broadly in line with the three-year pre-pandemic trend but well below the 4-5pps enjoyed in the run-up to the financial crisis.

Figure 6: Divergence in economic growth rates



Source: CEIC & SBG

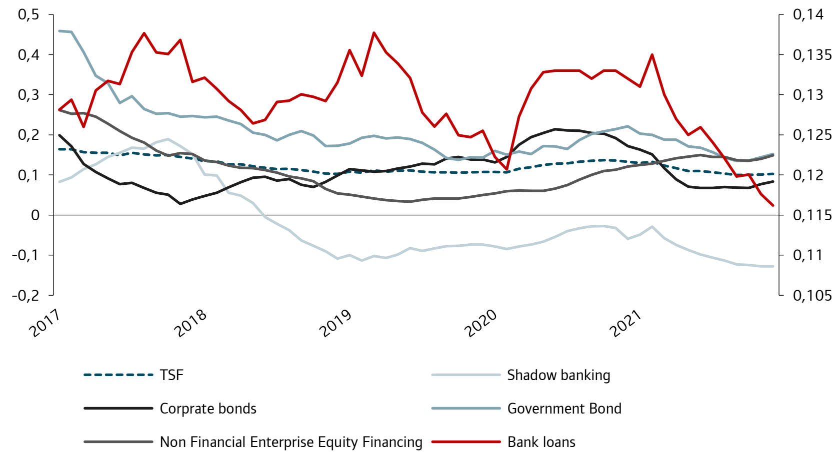
China certainly soft despite policy easing

Turning to the prognosis for the most consequential emerging market economy, China, as expected economic growth has slowed rapidly since Q1:21. Headwinds to the real estate sector, along with electricity shortages and pandemic-related interruptions, dragged the broader economy lower. Making matters worse, "zero-COVID" looks likely to remain in place until the virus poses a threat similar to that of regular flu. Unlike policymakers in the broader emerging market universe, since October policymakers have become increasingly concerned about the level of economic activity, gradually tilting the dials of both monetary and fiscal policy to supporting growth. That said, evidence of easing in the credit data is yet to clearly manifest.

Hitting even this lowered growth target would require policymakers to offer fresh economic support measures in the coming months

Nevertheless, this year, more important than the exact calibration of monetary and fiscal policy, will be the approach to regulation and policy in the property sector and infrastructure. The growth target for 2022 is expected, as usual, at the National People's Congress in March. The government is unlikely to allow growth to drift too far below 5% in 2022. However, such a goal would set China's economy up for the slowest non-pandemic-year official growth rate in over 30 years. And, hitting even this lowered growth target would require policymakers to offer fresh economic support measures in the coming months.

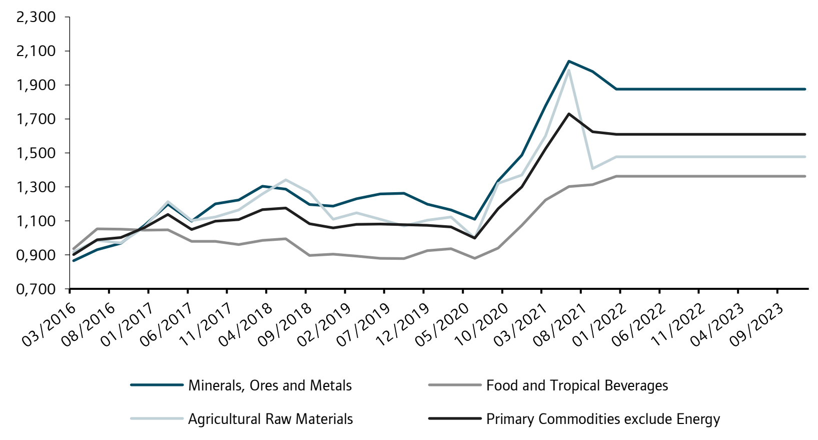
Figure 7: China's much watched credit data yet to really turnaround



Source: NBS & SBR

China's policy has started on the road of reverting to the pre-pandemic playbook in which there is still a lot of what Xi Jinping now describes as "inflated" growth. Herein is a sharp contrast to last year: in 2021 China could comfortably achieve its full-year GDP growth target of above 6%, whilst policymakers pushed ahead with growth-unfriendly polices; this year, even hitting this lowered growth target would require policymakers to offer rather robust economic support measures in the coming months, aiding commodity demand – at least in the near term. Even though commodity prices have increased dramatically over the past 18 months, they are likely to remain reasonably elevated (and volatile). Further support comes from growing geopolitical tensions between Europe and Russia, and US and China, the inevitable issues of further supply chain disruptions, and the transition challenges from disinvestment in fossil fuel reserves.

Figure 8: Commodity prices expected to remain reasonably resilient



Source: CEIC & SBR

China's economic growth is in an ongoing structural decline

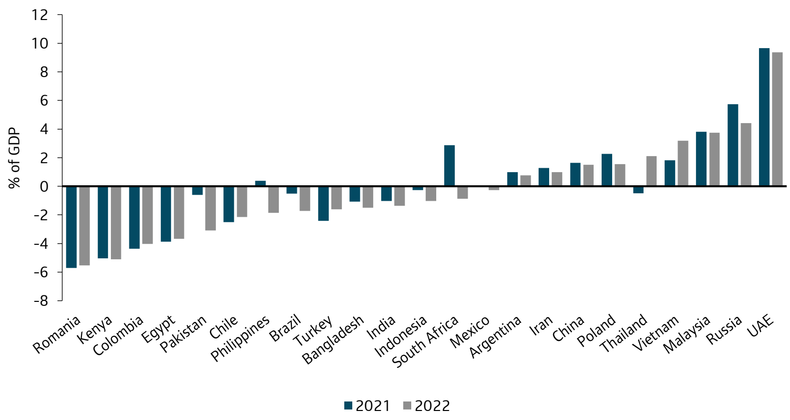
Importantly, China's economic growth is in an ongoing structural decline, down to 5.3% in 2022 and 4.7% in 2023. This means that EMDE are entering a period where rapid economic momentum will need to come from other emerging market economies. Adjusting to this new normal of China's economy expanding by slower than the EMDE average (which hasn't happened since 1990) will not be straightforward. First, China's economy is five times bigger than the second-largest EM economy, India, and bigger than the top 20 combined. Therefore, the pressure on smaller economies to do the group's heavy lifting cannot be overstated. Second, most are reliant on China's growth, and specifically its credit-fuelled investment-led growth model. Recall that a one percentage point decrease in China's domestic investment growth, for instance, is associated with an average 0.6 percentage point decrease in Africa's export growth. Third, with the exception of India and the Philippines, most large emerging markets are expected to expand by less than 4% over the next three years.

External demand and current account balances

Current account deficits in emerging market economies are expected to widen for most this year

Current account deficits in emerging market economies are expected to widen for most of this year. The increase will be most pronounced for Brazil, Indonesia, Pakistan, Philippines, Poland, Russia and South Africa. The latter is expected to slip back into deficit in 2022. Overall, current account deficits are expected to be the largest in Egypt, Columbia, Pakistan, Romania and Turkey. However, for the time being, the deterioration in current account balances is not expected to become a systemic issue, barring severe drops in commodity prices. Should however commodity prices remain inside current consensus forecasts, then the widening of EM current account deficits should be manageable for most.

Figure 9: Current account balances to widen



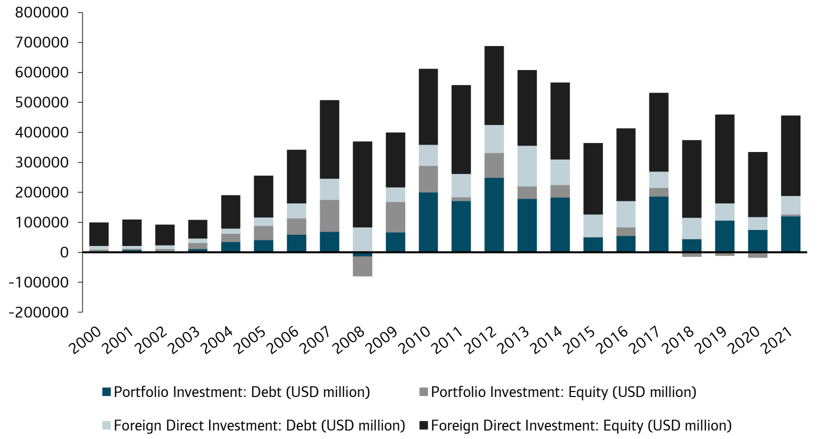
Source: IMF, CEIC & SBR

Keep an eye on external financing needs

This year will be decidedly different: a resolute shift in tone has emerged, signalling that tightening monetary policy is imminent

Notwithstanding, throughout last year those central banks cast in a global role – particularly the US Federal Reserve – shared a sense that they were not in any rush to tighten monetary policy. This year will be decidedly different: a resolute shift in tone has emerged, signalling that tightening monetary policy is imminent. Obviously, unlike during times of strong global growth and low investor risk aversion, international liquidity is expected to be less abundant and more expensive in 2022. Front of mind then is the potential for a credit crunch, which, combined with the variety of burdens already weighing on many emerging market economies as a result of the pandemic and those that predated the pandemic, could further complicate the outlook. For the most part, total external financing needs are reasonably manageable relative to FX reserves, averaging around 10 months for the larger EMDE. In fact, out of the larger EMDE, only Turkey, Poland, Mexico and Hungary have reserves less than 5 months of import cover. Therefore, if faced with disorderly conditions in foreign exchange markets, central banks with sufficient reserves could intervene. That said, much will depend then on the ability of emerging markets to attract capital flows in 2022. Last year portfolio inflows – both debt and equity – into the 25 largest emerging markets increased by their most since 2017. In terms of debt, the market was supported by a higher primary issuance volume in India (USD20bn), the UAE (USD19bn), Egypt (USD18bn), Brazil (USD15bn) and Malaysia (USD12bn). Foreign direct investment taking equity stakes also actually recorded a fourth-best year on record, led by sizable inflows into India (USD61bn), Brazil (USD47bn), Mexico (USD26bn), Indonesia (USD23bn), Thailand (USD12bn) and Vietnam (USD10bn).

Figure 10: Non-resident capital inflows recovered in 2021



Source: IIF & SBR

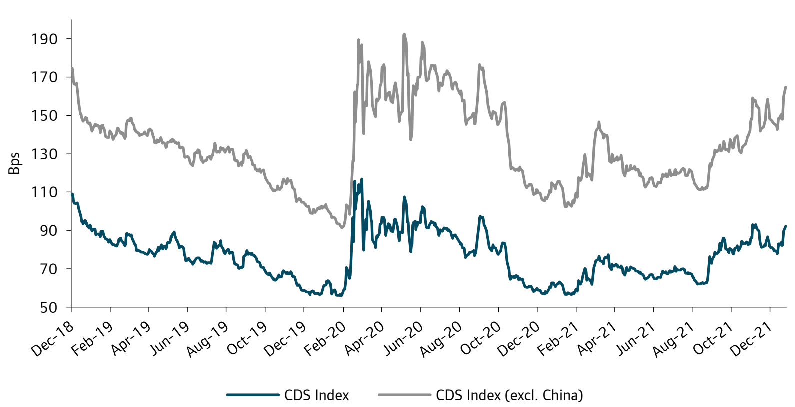
Interestingly, portfolio inflows into stocks, whilst an improvement on the net outflows experienced over the previous three years, were still muted compared to previous years. Part of the explanation is that valuations are not particularly favourable at this juncture. Price-to-earnings ratios are running well above the five-year average. As such, since rallying sharply in 2020, the gains in equity prices have petered out, having moved sideways since July 2021. In fact, excluding China, inflows into emerging market stocks and bonds came to an abrupt standstill at the tail-end of last year. In sum, capital inflow has been less hot than in 2013, with relatively more debt financing than equity, and the yields on EM local debt are relatively attractive.

Exacerbated by currency weakness and moderating risk appetite

Demand for protection from growing credit risks in emerging markets has also increased dramatically – especially in the past six months. CDS, considered a good proxy of credit risk, measuring the probability of default, have increased

Now, risks are elevated – especially as global liquidity conditions have weakened, and credit ratings have deteriorated. Worryingly, the last two years has eroded the resilience of the economies of emerging markets. As such, demand for protection from growing credit risks in emerging markets has also increased dramatically – especially in the past six months. CDS, considered a good proxy of credit risk, measuring the probability of default, have increased. True across the emerging market landscape, but particularly pronounced in Argentina, Russia and Ukraine, Columbia, Turkey, and Brazil, CDS spreads have widened steadily since September 2021, pushing the weighted average of CDS back towards levels experienced in the early part of 2020. It may now be that investors are in the process of hedging the risk of an emerging market sell-off.

Figure 11: CDS spreads confirm rising perceptions of vulnerability



Source: CEIC & SBR

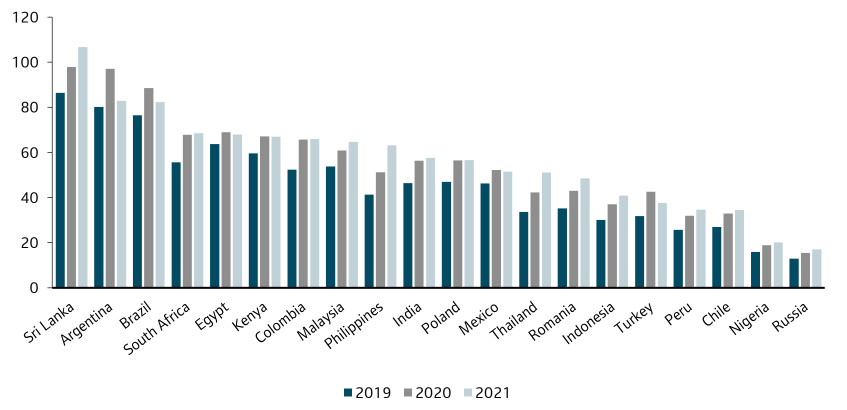
The challenge of public and private debt

The challenging landscape will be particularly tough for countries with high levels of debt. In general terms, the most systemic issue facing emerging markets is that over the seven years ending in 2014, an "all hands on deck" attitude to placing a floor under economic activity has coincided with an explosive growth in debt. More recently, to limit the impact of the pandemic, governments reacted with large stimulus packages in 2020. For the largest 20 EMDE, the public debt measured as a share of GDP increased by an average of 10pps in 2020. A number of countries, such as South Africa and Brazil, with already large stocks of public debt, had to increase their public debt further as a result of fiscal deficits. And, for some, like Columbia, Poland and Turkey, (and even Argentina, Brazil and South Africa), the jump was significantly higher than 10pps. For some, the rebound in growth in GDP during 2021 has manifested in a reduction their level of indebtedness, but many still remain on the elevated end of the spectrum. Worse still, most EMDE still continued to see government debt rise as a share of GDP in 2021.

High debt levels are a constraint to future economic growth

Going forward, high debt levels are a constraint to future economic growth. Heavily indebted countries (i) need to start fiscal adjustment sooner, (ii) use future fiscal spending to make debt repayments, and (iii) pay higher interest rates on future debt due to elevated default risks. A panel study by the International Monetary Fund estimates that a rise in real bond yields of 100 basis points in the US translates into an average increase of about 50 basis points in the average real effective interest rate paid by emerging market economies on their sovereign debt.

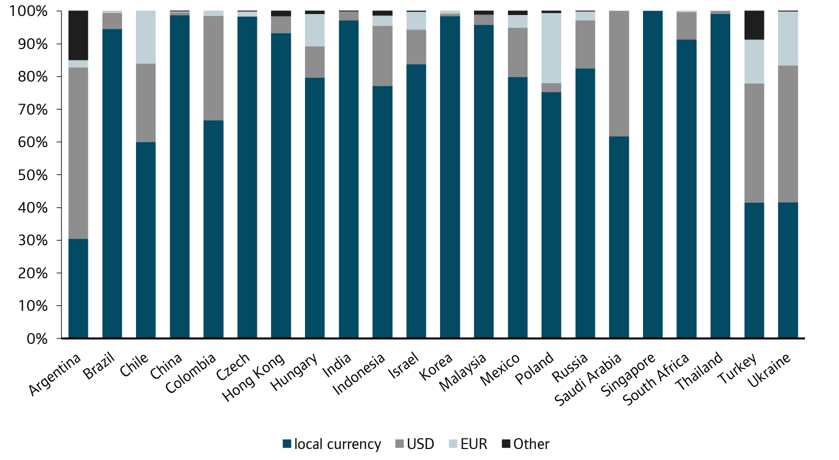
Figure 12: Public debt continued to rise but slower than in 2020



Source: IMF, CEIC & SBR

Many countries with high levels of debt denominated in foreign currencies are therefore more vulnerable to the expected appreciation of the USD. These emerging markets will experience a rise in the relative value of their debt stock. Argentina, Chile, Columbia, Turkey, Ukraine and Indonesia have the largest share of their debt denominated in foreign currency. This dependence on foreign capital constrains the set of monetary or fiscal mechanisms that can be used to stimulate the economy.

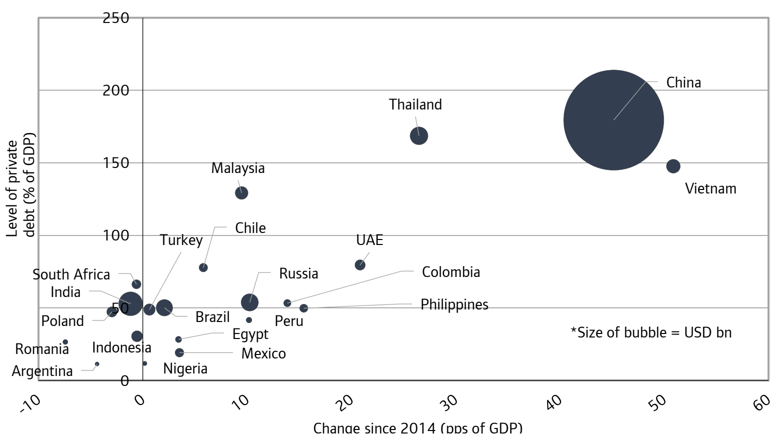
Figure 13: Composition of debt revels potential stress point for many



Source: IIF & SBR

For most emerging markets, private sector credit has increased faster than public sector debt. In just the 25 largest EMDE economies, private credit has doubled to USD35tr since 2014, reaching 120% of GDP. Although the debt helped to insulate some of these economies from a more significant economic slowdown, it is an increasing concern – especially given the potential sluggishness of nominal growth. Therefore, for countries where corporate debt and bad loans were high even before the pandemic, some weaker banks and nonbank lenders may face solvency concerns if financing becomes difficult. Similarly, those corporates in emerging markets that have increased their level of US dollar-denominated debt will see their balance sheets compromised, which implies slowing profitability growth, rating downgrades, and refinancing problems.

Figure 14: The majority have seen modest increases in debt



Source: IIF, BIS & SBR

Conclusion

Will emerging market economies be caught off-guard by rising rates, again?

The crucial question for 2022: will emerging market economies be caught off-guard by rising rates, again? Fortunately, sovereign indebtedness has grown modestly for most, allaying some worries over an external sovereign debt crisis. That said, the unwinding of monetary policy support in advanced economies will have a material impact on emerging markets. Meanwhile, dollar appreciation will continue to dull the shine of non-US dollar assets, making it harder to attract flows into local debt and equity markets, and increase the borrowing costs for sovereigns. At the same time, the group of countries need to start metabolising the structural downtrend of economic growth in China, and its concomitant ongoing transformation.

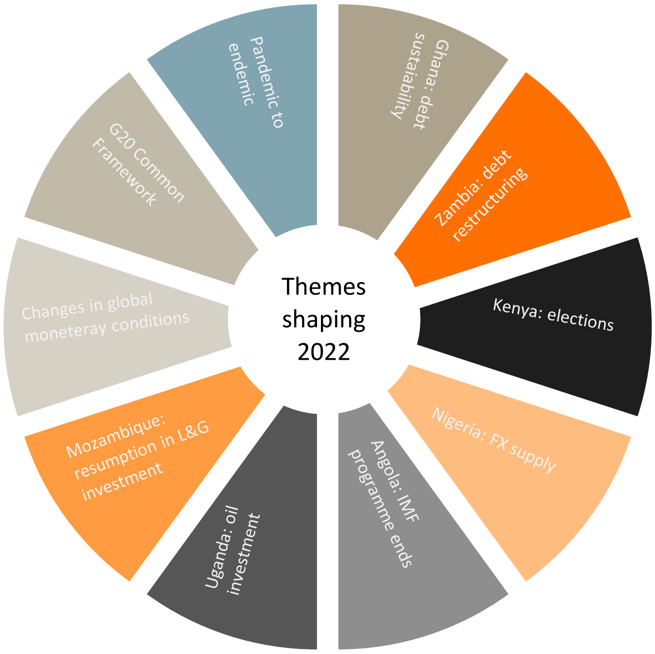
The reality is that the growth outlook and the group's economic trajectory will be undermined for some years. In the past, the negative performance of commodities has exposed many emerging market economies – specifically those with large trade balances with China, such as Brazil. This vulnerability remains. Meanwhile, worrying developments elsewhere, ranging from political uncertainty in Turkey, and weakening economic fundamentals in Brazil, Mexico, South Africa and elsewhere, have kept emerging markets on the front pages of newspapers, but for all the wrong reasons.

This year, pivotal elections, referendums, reforms and geopolitical tensions could shape the economic trajectory across emerging markets. Landmark elections may lead to a shift away from austerity policies in several high-profile EM nations, such as Brazil and Columbia, which could spark concerns about public debt. Political events in several other countries may also affect progress on key economic reforms, such as South Africa, Chile, China and India.

Jeremy Stevens

Sub-Saharan Africa
Themes likely to determine the shape of 2022

Figure 1: Themes shaping 2022



Source: Standard Bank Research

African economies' resilience not to be overlooked

We are approaching the 2-y anniversary of the pandemic in just months. In assessing the rear-view during this difficult period, there always tends to be a negative or pessimism bias towards Africa, especially amidst such a shock being characterized as a one in a 100-year event. This bias was seen too during the Ebola outbreak, various politically related disruptions, and other commodity- and/or weather-induced shocks in past decades.

Indeed, a handful of the economies globally that escaped recession during 2020 were in Africa

Yet, it is clear that broadly most economies fared much better than many had anticipated, both during 2020 as well as during the recovery in 2021. Indeed, a handful of the economies globally that escaped recession during 2020 were in Africa. In fact, about 40% of the global economies that posted positive GDP growth in 2020 were from the continent, as many Africans resorted to the mainstay of their economies – say, the agricultural sector for subsistence at a time when growth in services sectors was contracting.

Furthermore, despite comparatively underdeveloped health systems, fatalities from the pandemic on the continent have been lower than expected – which medical experts have attributed primarily to Africa's youthful demographics, in addition to African authorities' experiences in dealing with outbreaks such as Ebola. This resilience and endurance will likely persist as economies continue to recover and rehabilitate in 2022.

Growth outlook: recovery to continue in 2022

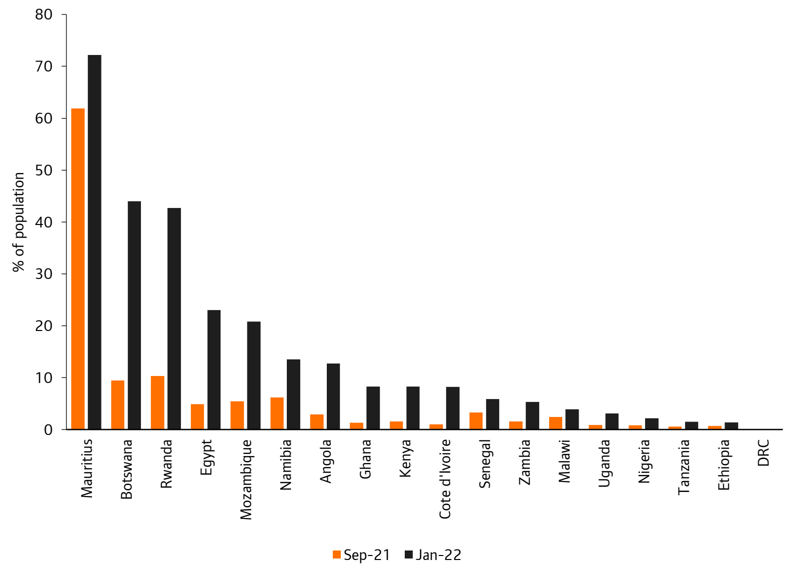
According to the IMF, growth in Sub-Saharan Africa could rise to 3.8% y/y in 2022, from an expected 3.7% y/y in 2021. Admittedly, prior to Dec 21, before the emergence of Omicron, there was a sense of catharsis across the globe as some element of normalcy was gradually being restored. Indeed, the elevated transmissibility of Omicron has, unsurprisingly, resulted in notable rises in new cases across many countries in Africa and the globe since early Dec 21. However, most African governments have declined further stringent public health restrictions, rather focusing on vaccinating, and now even booster shots.

Thankfully, the Omicron variant has proven to be milder, particularly for the vaccinated – probably underscoring why governments have been reluctant to re-impose restrictions. In fact, unlike when the pandemic began nearly 2-y ago, when many would focus on new cases, now, hospitalisations and perhaps fatalities better indicate the progression of this pandemic.

African governments are taking a hard-line stance to ensure full vaccination

As we had highlighted in past AMR (African Markets Revealed) publications from May and Sep 21, vaccine roll-out would inevitably have had to gain impetus as supplies improved and hesitancy eased off. Even if vaccine apathy has not waned, African governments are taking a hard-line stance to ensure full vaccination.

Figure 2: Vaccination rates Sep 21 vs Jan 22

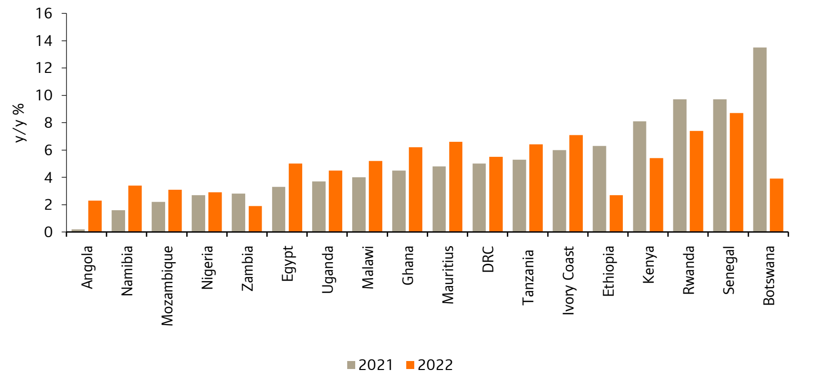


Source: OurWorldInData

For instance, while the Ministry of Health in Ghana has not made it mandatory to get vaccinated, they will block the unvaccinated from accessing government services. This would include public schools, too. A similar approach has been taken by Kenya's Ministry of Health, barring the unvaccinated from government services. In Rwanda, too, vaccination proof is now required for leisure and recreational activities such as restaurants and bars.

Refreshingly, Ghana and Kenya have now fully vaccinated just over 8.0% of their total population as at Jan 22, compared to under 2.0% back in Sep 21. Of course, when accounting for the adult population, Kenya had vaccinated 17.5% of all adults at the time of writing. Furthermore, Mauritius had fully vaccinated 72.2% of its population by Jan 22, from 61.8% in Sep 21, while positive progress has been made in Mozambique, at 20.8%, from 5.4% in Sep. Angola too has fully vaccinated 12.7% of its population, from just 2.9% in Sep, while Côte d'Ivoire has advanced to 8.2%, from 1.0% during that time.

Figure 3: 2021 vs 2022 GDP growth forecasts



Source: Standard Bank Research

However, economies such as Nigeria, Ethiopia, Tanzania and Uganda lag, with less than 5.0% vaccinated as of Jan 22. Nonetheless, with booster shots becoming more paramount amidst new variants, countries behind on vaccination may be forced to reimpose stringent restrictions in 2022, which would weigh on growth.

We forecast Africa's GDP growth to broadly recover further in 2022

We forecast GDP growth to broadly recover further in 2022. Of course, unwinding base effects underpinned economic growth in 2021. Hence, one can presume, at least at the outset, that GDP growth will numerically decline in 2022 for many economies that had benefited from favourable base effects in 2021. In some cases, such as Botswana, Rwanda, Kenya and Zambia, this seems likely.

Some economies may still post lower growth in 2022 primarily as a function of unfavourable base effects but largely not; of course, there may be a few exceptions as idiosyncratic factors come into play. In fact, despite the notable recovery in GDP growth on a y/y basis in Q2:21, which boosted calendar year growth figures, q/q growth recorded then for some countries was still below historical averages. Therefore, underlying growth still could recover further in 2022. In other words, when comparing base effects to 2021, it is easy to conclude that growth might abate in 2022. However, we'd advise comparing base effects from pre-pandemic levels as economic activity continues to normalise.

Take for instance Botswana where GDP growth recovered to 37.3% y/y in Q2:21, from 1.0% y/y in Q1:21. Interestingly, q/q growth for Q2:21 was a contraction of 0.07%. However, average q/q growth was 1.99% for Q2 between 2014 and 2019. Similarly, in Nigeria, while y/y growth improved to 5.3% in Q2:21, from 2.2% in Q1:21, q/q growth for Q2:21 contracted by 0.8%, compared to the 3.0% average for Q2 between 2014 and 2019. Based on this vector, therefore, growth may continue recovering to pre-pandemic levels.

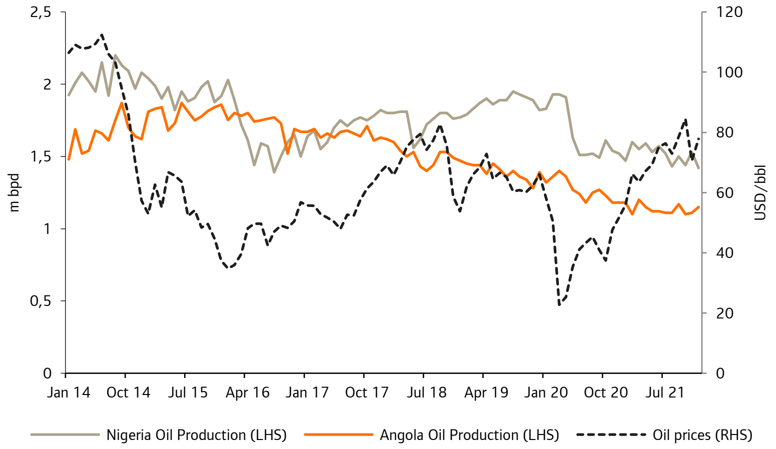
Some notable downside risks

That said, we still see GDP growth easing in Botswana to 3.9% y/y in 2022, from an expected 13.5% y/y in 2021, largely due to unfavourable numerical base effects. GDP growth in Nigeria will probably decline to 2.7% y/y in 2022, from an expected 2.9% y/y 2021. Growth in Nigeria is likely to be supported by higher public capital spending, as 2022 is a pre-election year. Also, the re-opening of the borders should boost activity in the trade sector. However, there are notable downside risks to this outlook. First, the ongoing rationing of FX; should this persist or worsen, GDP growth could undershoot our current forecasts. Second, the ongoing insecurity challenges in the northern parts where farmers and herdsmen have been clashing could further restrain growth in the agricultural sector. However, growth here has been surprisingly resilient since Q4:20.

Higher oil prices, which are likely to hold in 2022, had a limited impact on growth due to waning productive capacity. Furthermore, owing to ageing infrastructure, elevated insecurity, policy uncertainty associated with the passage of the Petroleum Industry Act

(PIA), the Nigerian oil sector has been in contraction since Q2:20. In the 9-m to Sep 21, oil production averaged 1.63m bpd, from 1.66m bpd in 2020 and 1.81m bpd between 2018 and 2019. Looking ahead, as maintenance of key oil fields ends, oil production may average 1.70-1.80m bpd in 2022, from an expected 1.6m bpd in 2021.

Figure 4: Angola and Nigeria oil production



Source: Standard Bank Research

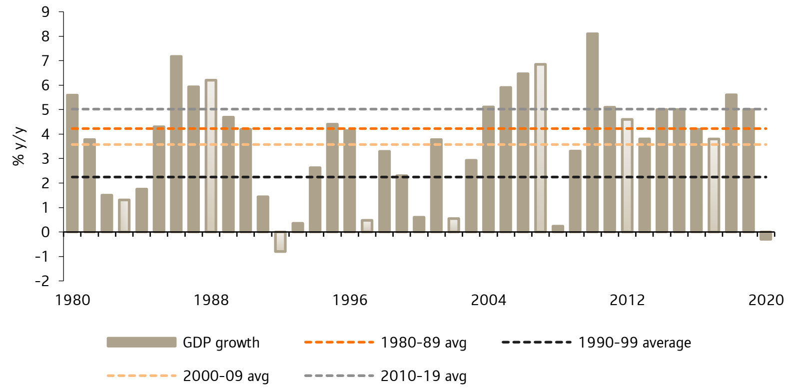
Similarly, in Angola, per-capita income growth is likely to remain negative in 2022, even as we see this economy expanding by 2.3% y/y, from an estimated 0.2% y/y in 2021. 2022 is an election year, with likely higher capital expenditure reflected by the transition away from a fiscal surplus towards a balanced budget, which could support capital formation in this economy this year. However, oil production remains lacklustre. Production declined to an average 1.13m bpd in 2022, from 1.27m bpd in 2020 and 1.45m bpd between 2018 and 2019. A combination of unwinding base effects and a recovery momentum from the non-oil sector assisted the economy exiting its recession (which had started in 2016).

We see oil production rising modestly to 1.25m bpd in 2022. But risks to subdued production will persist, as investment within the sector has been lagging since the 2014 oil price shock. Maturing oil fields hasn't boded well for higher investment either, and even despite an improvement in the regulatory framework back in 2020 when the Angola National Oil and Gas Agency (ANPG) was formed, the pandemic has thwarted investment, further bringing about operational difficulties for oil firms that require equipment to be imported.

In some countries, pent-up demand from 2020 spurred GDP growth between Q1 and Q3:2021, notably above the q/q historical pre-pandemic growth average. For example, in Kenya, GDP growth recovered sharply, to 11.9% y/y and 9.9% y/y in Q2:21 and Q3:21 respectively – the highest in over 10-y. During this period, q/q growth was 2.1% for Q2:21 and 1.7% for Q3:21. Interestingly, q/q growth averaged lower, at 1.8% and 0.1% for Q2 and Q3 respectively between 2014 and 2019.

We see GDP growth in Kenya declining to 5.4% y/y in 2022, from a revised expectation of 8.1% y/y in 2021. Aside from unfavourable base effects potentially dragging 2022 growth lower, the Aug 22 elections are also likely to weigh down private consumption and investment. It isn't unique for growth to ease during election years in Kenya – something that can be proven empirically since the inception of multi-party politics in the early 90s (see election year GDP growth highlighted in the graph below).

Figure 5: Kenya GDP growth trends



Source: Standard Bank Research

But also, it may be important to note that during the 2017 election year, there was a severe drought in H1 which held back agricultural productivity. And, worryingly, Kenya has been experiencing a drought in parts of the country since Q4:21. Furthermore, according to the Kenya meteorological department, the short rains season in Q4:21 was both delayed and inadequate. Nonetheless, the current drought hasn't much affected the food-growing areas in counties located within the Rift Valley region.

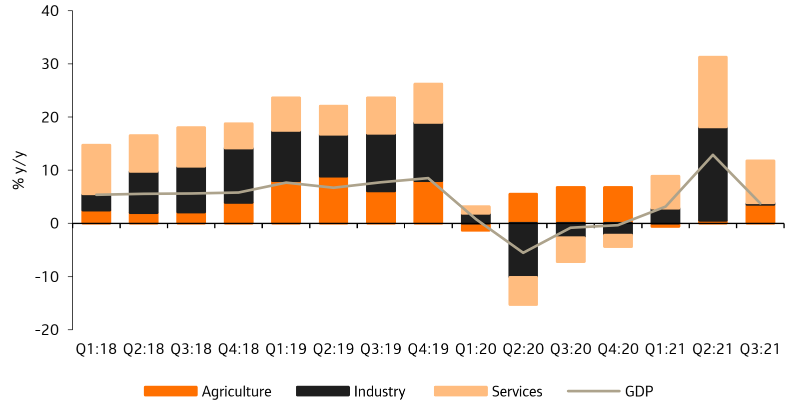
However, in addition to the well diversified structure of the Kenyan economy that is likely to underpin some resilience despite heightened political risks, public investment spending on infrastructure projects, such as the Nairobi expressway ahead of the Aug 22 elections, should support growth in 2022.

Major droughts tend to be a regional event in East Africa

Major droughts tend to be a regional event in East Africa, and this remains a risk to growth in 2022 for Uganda, too. Reports of adverse weather conditions in the northern parts of the country had been reported back in Jul 21. Although growth in the agriculture sub-sector recovered to 3.6% y/y in Q3:21, from flat growth in H1:21.

We expect GDP growth in Uganda to recover to 4.5%-4.8% y/y in FY2021/22 and 6.0%-6.3% y/y in FY2022/23. Economic activity will inevitably be boosted after the government fully re-opened the economy in Jan 22, following restrictions that were imposed back in Jun 21. Moreover, despite the recent spike in Covid-19 infections, the government has maintained that the lifting of restrictions will hold, unless there is a notable rise in Covid-19-linked hospitalisations. Schools are also re-opening after being closed since Mar 21. This should help support growth in the education sector as well as other sectors that rely on it. But, more notably, growth will be spurred by the expected pick-up in oil-related investment spending over the next few years.

Figure 6: Uganda GDP growth trends



Source: Standard Bank Research, Uganda Bureau of Statistics

The authorities have made noteworthy progress on the Final Investment Decision (FID) for the oil sector. Previously, there were concerns that certain conditions were not being met by authorities to enable the completion of the FID. However, the government has now constructed a 220kv high voltage power line, which helped secure the FID at the Kingfisher field in Nov 21. First oil is still expected in 2025, with production at this field estimated at 40k bpd.

However, FID at the Tilenga field, which is expected to produce 190k bpd, still hasn't been finalised. We expect this to be done in H1:22, especially after parliament passed the East Africa Crude Oil Pipeline (EACOP) bill into law in Dec 21, pending presidential assent – which now paves the way for the construction of the oil pipeline to Tanga, Tanzania.

We also expect GDP growth in Ghana to recover to 6.2% y/y in 2022, from 4.5% y/y in 2021, and foresee a notable pick-up in gold production in 2022 after output had been halted at major mines in H1:21. Growth in the mining and quarrying sub-sector contracted 11.2% in Q3:21, from an average contraction of 15.1% y/y in the preceding two quarters. However, gold production from underground ore sources is expected to commence from Jan 22 at the Obuasi mine which had stopped production from H1:21. This should support the ongoing recovery in GDP growth which rose to 6.6% y/y in Q3:21, from a revised 4.2% y/y and 5.1% y/y in Q1:21 and Q2:21 respectively.

Notable downside risks for Ghana in 2022 remain, particularly with the government now facing daunting refinancing risks. It appears that access to the Eurobond market won't be possible in 2022 given the rise in Ghana's Eurobond yields to over double digits. Hence, if the government cannot secure alternative funding options for 2022, growth will inevitably suffer as public investment may have to be rationalised. Furthermore, the government would probably have to resort to borrowing more from the local market, which is likely to stunt growth in private sector credit and perhaps also private investment.

Near-term impediments to the tourism sector

The pandemic crisis has decimated growth in most sectors. However, tourism sectors' recovery was expected as the most precarious

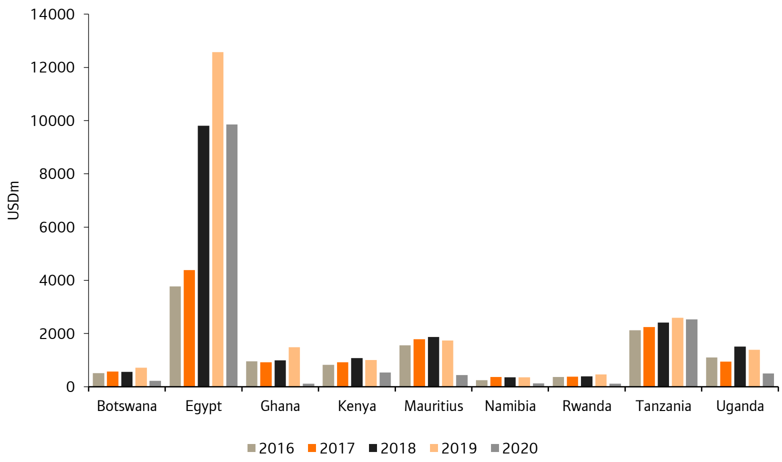
The pandemic crisis has decimated growth in most sectors. However, tourism sectors' recovery was expected as the most precarious. According to the IMF and World Bank, tourism on average accounts for 10%-15% of GDP for most economies in Africa.

But it is quite possible that this contribution is much higher in some markets such as Kenya, Uganda, Tanzania, Rwanda and Mauritius. Also, tourism sectors have wider service value chains depending on these sectors. The transport, telecommunications, financial services and leisure sectors rely on tourism thriving in some form or another.

Even though tourism has broadly been recovering in 2021, there could be temporary disruptions in Q1:22 or even H1:22 – depending on how long recently imposed travel bans and other restrictions remain in place.

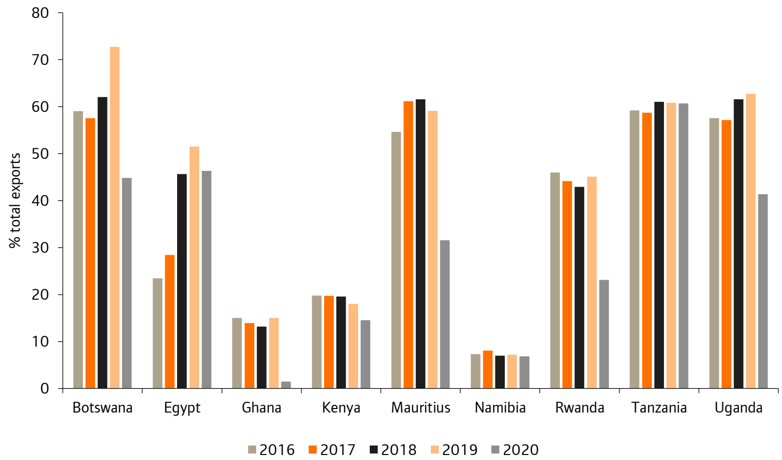
Tourism earnings in Kenya recovered to USD588.9m between Jan and Sep 21, which is already higher than the USD541.0m in receipts received in 2020. However, earnings had declined by 46% y/y in 2020. Similarly, in Botswana receipts rose to USD263.0m in H1:21, already higher than earnings of USD223.2m in 2020. But again, notably, tourism earnings eased by 68.8% y/y in 2020.

Figure 7: Tourism earnings 2016-2020



Source: Various central banks

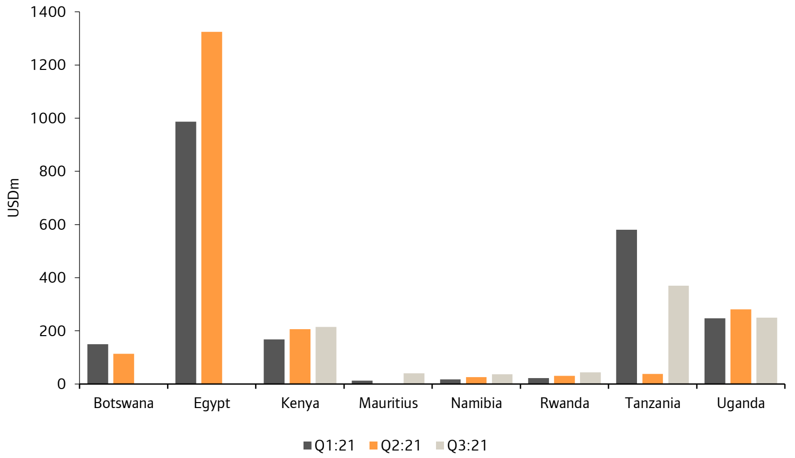
Figure 8: Tourism earnings (% of total exports)



Source: Various central banks

In Uganda too, notwithstanding the 63.6% y/y drop in tourism earnings in 2020, there was a recovery to USD777.1m in the 9-m to Sep 21, exceeding the USD503.5m recorded in 2020. However, the recovery for Egypt, Mauritius, Namibia and Rwanda has been rather sluggish, despite the low base set in 2020 (see graph below).

Figure 9: Tourism earnings 2021



Source: Various central banks

Tourism will probably recover to pre-pandemic levels at the earliest between end 2023 and 2024, assuming that potential mutations of new variants remain mild

Tourism will probably recover to pre-pandemic levels at the earliest between end 2023 and 2024, assuming that potential mutations of new variants remain mild. Indeed, it would be an understatement to say that traveling in a pandemic has become quite stressful, especially as some African countries have further toughened their stance on travel since Q4:21.

At the time of writing, foreign tourists entering Kenya, with the exception of those below the age of 18 years, need to present a Covid vaccination certificate in addition to a negative PCR test taken between 48 and 72 hours prior to travel.

In Mauritius, unvaccinated tourists are required to quarantine for 14 nights in a hotel room as well having taken a PCR test prior to travel. Meanwhile, fully vaccinated tourists will not be constrained to a hotel room, but will have to isolate at the resort they have travelled to for 14-d.

Travellers visiting Egypt must show a negative PCR at least 72 to 96 hours prior to arrival – depending on where they travel from. However, for tourists with a vaccination certificate that has a recognized QR code, prior testing is not required.

For Rwanda, a negative PCR test within 72 hours of arrival is needed. Thereafter, another test is mandatory upon arrival at the airport and then another test on day 3. Moreover, in Ethiopia tourists are required to present a negative PCR test prior to travel in addition to a 7-night mandatory quarantine after landing in Ethiopia.

Given such requirements, it is probably difficult to see the tourism sector reverting to pre-pandemic earnings any time soon, even as a recovery commences from H2:22. But more importantly, while a weaker tourism sector probably may have more impact on GDP growth rather than the overall balance of payments, big tourism economies tend to be those that are relatively more diversified, such as Kenya, Uganda, Tanzania, Egypt and even Rwanda. However, on the flipside, less diversified economies, such as Mauritius and Botswana, could face more pronounced negatives effects on underlying growth.

A closer look at debt sustainability risks

There are five particular markets within our coverage that we think require a closer assessment with regard to debt sustainability over the next 2-y. These are Ghana, Kenya, Angola, Ethiopia and Zambia.

Of course, Zambia has already defaulted since Q4:20, while Ethiopia is probably on the brink too. The Zambian government and the IMF reached a staff-level agreement in Dec 21 for an arrangement worth USD1.4bn under the Extended Credit Facility (ECF) for 2022 to 2025. This arrangement is subject to approval from the IMF Executive Board and progress on a comprehensive debt treatment under the G20 Common Framework.

Indeed, while an IMF programme is clearly the anchor the market was looking for to restore debt sustainability, a successful debt restructuring under the G20 Common Framework is still precarious. So far, only Chad, Zambia and Ethiopia have applied for debt restructuring under the framework. However, implementation of this initiative has been rather slow. These delays have instilled more uncertainty around these markets, with Ethiopia's credit rating being downgraded by multiple rating agencies in 2021, partially owing to this.

Table 1: Evolution of external debt – by composition (%)

		FY 2011/12	FY2014/15	FY2020/21
Angola	Bilateral	29.6	21.8	11.5
	Multilateral	7.8	4.8	11.4
	Commercial	62.5	73.4	77.1
Ethiopia	Bilateral	25.2	30.9	28.7
	Multilateral	45.2	34.0	50.8
	Commercial	29.6	35.1	20.5
	Bond and Notes Holders (Eurobond)	-	5.2	3.4
Ghana	Bilateral	10.4	8.1	5.2
	Multilateral	47.4	36.0	33.5
	Export Credit Agencies	11.3	8.4	3.9
	Other Concessional	12.3	13.6	6.2
	Commercial Creditors	10.5	16.4	51.1
	o/w International Capital Market (ICM)	8.2	18.2	41.3
Kenya	Bilateral	32.2	29.4	27.7
	Multilateral	59.2	49.3	43.2
	Commercial Banks	6.6	20.1	28.8
Zambia	Bilateral	12.7	4.2	2.1
	Multilateral	64.7	31.6	19.8
	Suppliers/Banks (Commercial)	22.7	64.2	78.1

Source: Various central banks and ministries of finance

Crucially, the G20 and the Paris Club probably need to refine the Common Framework further to ensure its implementation and uptake improves. Recall, while the World Bank's Debt Service Suspension Initiative (DSSI) was simply a transitory deferment of debt service costs, on a neutral net present value structure, the Common Framework was expected to address debt restructuring, insolvency, and protracted liquidity issues.

However, most African countries were initially quite hesitant to take up the framework owing to concerns that restructuring commercial debt could result in rating downgrades. Furthermore, a lack of coordination amongst creditors within the framework has disrupted the implementation of the arrangement. Over the last decade or so, China has overtaken the Paris Club as the largest bilateral creditor in Africa. However, Chinese authorities have maintained that their loans extended are a blend between commercial, multilateral and bilateral lending. The IMF is pushing both public and private creditors to align by Mar 22 in order to ensure that the implementation of the framework commences.

That said, it remains highly uncertain on whether commercial creditors will agree to the terms under the framework by Mar 22. Furthermore, it's also unclear whether there will be better coordination between China and other creditors under this initiative.

Yet more importantly, amidst the expected tightening of global financing conditions in 2022, combined with the DSSI expiring in Dec 21, the Paris Club and G20 will probably either have to ensure that the issues within the common framework are ironed out swiftly to enable uptake or else perhaps look to extend the DSSI further. As things stand, there is an expectation that the DSSI won't be brought back in 2022.

At the IMF meetings in Apr 22, there should be further clarity on the alignment of creditors for the common framework

At the IMF meetings in Apr 22, there should be further clarity on the alignment of creditors for the common framework. But two other key things to perhaps look out for from these meetings would be whether the DSSI would be extended after all, and whether there would be a further round of additional IMF SDR allocation. Back in Aug 21, African countries received a total of USD33.0bn in extra SDR allocation, which notably boosted external account positions. While these funds in Aug could be used for both balance of payment and budget support, the next round of SDR allocations may be more condition based and even perhaps linked to conventional IMF programmes. The IMF recently suggested that a resilience and sustainably trust could be created to accommodate this.

Nevertheless, if the functioning of the common framework doesn't improve, to avoid further debt issues, especially amid Omicron, either the DSSI would need to be extended or further SDR allocations would have to be provided.

For Zambia, we remain uncertain on whether the application of the common framework will expedite, or further stall, the IMF programme. After all, China is their largest external creditor accounting for around 51.0% of external debt excluding government guaranteed debt. FX reserves eased to USD2.6bn in Oct 21, from USD3.0bn in Aug 21. However, reserves rose from USD1.2bn in Mar 21, after the USD1.1bn IMF SDR allocation boost in Aug 21.

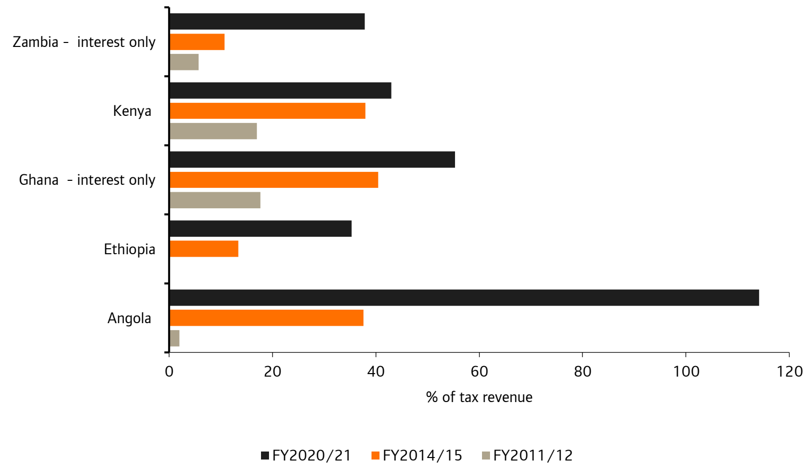
Unsurprisingly, following the rise to above double digits in Ghana's Eurobond yields, it appears that the government will probably not have access to financing from the Eurobond market in 2022. The Ministry of Finance has lamented the widening of Ghana's risk premium by noting that this doesn't reflect the strong fundamentals of the Ghanaian economy.

Chinese authorities suggested that they could adopt a more cautious approach towards lending to Africa following debt sustainability concerns

The recent worsening of global risk conditions combined with the market's concerns around Ghana's deteriorating fiscal position has largely led to this rise in Eurobond yields. The government have recently hinted that they could explore alternative funding options in 2022, with particular mention of China. Yet, as at Q2:21, bilateral loans had accounted for just 4.4% of total external debt, while multilateral and commercial loans accounted for 29.6% and 56.5% respectively. In fact, at the recent FOCAC meeting, Chinese authorities suggested that they could adopt a more cautious approach towards lending to Africa following debt sustainability concerns.

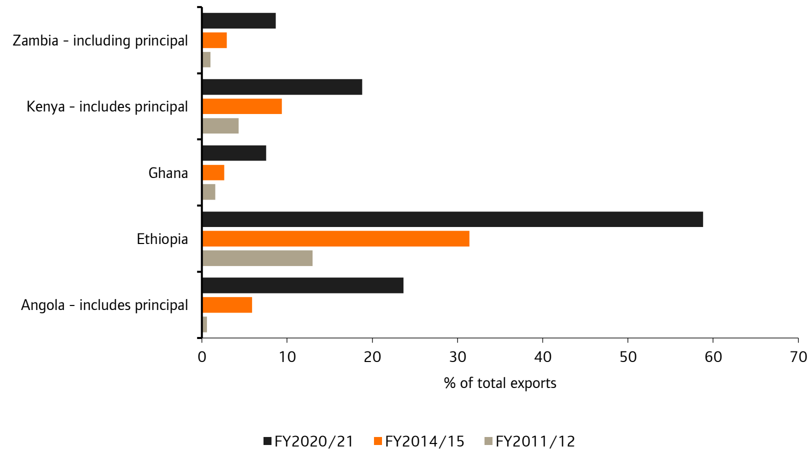
It seems quite likely that Ghana would probably need to secure some sort of arrangement with the IMF to restore investor confidence. If this doesn't transpire, the government would have to rely on an improving fiscal position which may be difficult to achieve in 2022 given overly ambitious tax revenue expectations. The government expects tax revenue to grow by a whopping 45% in FY2022 despite revenue only growing by an average 17.5% between 2015 and 2019. The Ministry of Finance has recently suggested that they may reduce FY2022 expenditure by 20.0%. However, fiscal consolidation in 2022 could face further hurdles, as public wages and debt service costs account for 54.2% of overall expenditure in FY2022.

Figure 10: Total debt service (% of tax revenues)



Source: Various ministries of finance and central banks

Figure 11: External debt service (% of total exports)



Source: Various ministries of finance and central banks

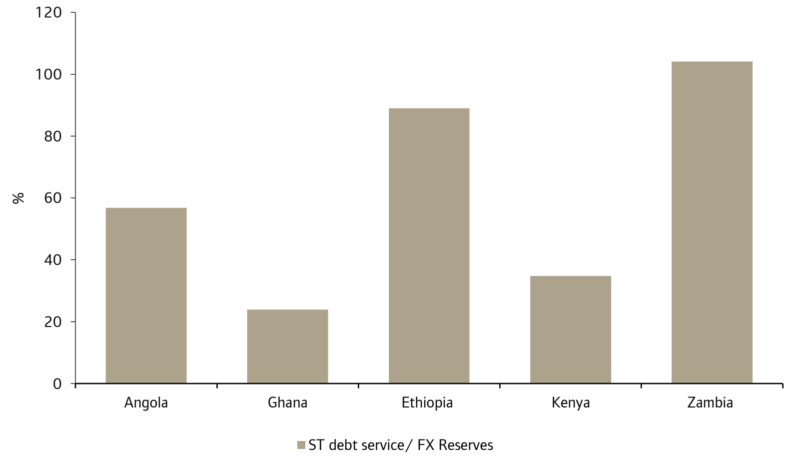
Moreover, while Ethiopia's debt is deemed as sustainable, we remain concerned about FX liquidity shortages which were exacerbated by both the pandemic and political instability. Crucially, it is now pivotal for Ethiopia to reprofile its debt, if default is to be avoided in 2022. Net external debt resource flows are likely to grow negative partly due to the take-up of the G20 Common Framework, in an environment where FX reserves are already quite low, last reported at USD2.3bn in May 21. Also, disbursements under the current IMF programme which expires in Dec 22, have been halted since 2020. The government is expected to make progress under the Common Framework before these disbursements will be released. Commercial debt accounts for 23.9% of the overall external debt stock, with Eurobonds comprising 3.4%.

Angola was the largest beneficiary of the DSSI, saving USD2.9bn in 2021. Disbursements under their IMF programme, higher international oil prices and bilateral debt reprofiling worth some USD5-7bn, all supported the external position in 2021. However, with the IMF programme expiring in Dec 21, uncertainty on further bilateral debt re-profiling and DSSI coming to an end, we ought to be slightly more cautious on Angola in 2022. Indeed, notwithstanding higher oil prices expected to persist in 2022, weak investment in the oil sector could continue to restrain oil production. Angola’s 2022 overall debt service as a function of FX reserves is 56.83%. This is compared to 88.98% and 104.09% for

Ethiopia and Zambia respectively. But still, if things fall into place, Angola and perhaps along with Zambia remain prime candidates for rating upgrades in 2022.

In Kenya, 2022 total debt service as a percentage of FX reserves stands at 34.80% which is even higher than Ghana's 23.93%. On the other hand, overall debt service as a percentage of tax revenue for FY2020/21 is higher in Ghana at 55.3%, compared to 43.0% for Kenya. Both economies have seen their commercial debt as a function of overall external debt rise notably over the years. For Kenya, this rose to 28.8% in 2021, from 6.6% nearly a decade ago. In this same time in Ghana, commercial debt increased sharply, to 51.1% from 10.5%.

Figure 12: Short-term external debt service (% of FX reserves)



Source: World Bank, Bloomberg, Various ministries of finance and central banks

Both the Kenya and Ghanaian economy have well diversified structures. And, admittedly, both have struggled to consistently consolidate public finances over the past 5-y or so. However, the IMF program that Kenya secured in 2021, is now probably a major differentiator when assessing debt sustainability.

Furthermore, Kenya still has the ability to re-finance debt and issue new debt from the international capital markets – something Ghana may struggle to do in 2022. Kenya also relies less on foreign portfolio investors for its domestic market compared to Ghana. But still, Ghana's domestic debt service costs are higher than Kenya, with significantly more attractive real yields. Nevertheless, elevated political risks could delay fiscal consolidation for Kenya in 2022, but the IMF anchor does help instil some comfort that consolidation will ensue thereafter.

Broadly hawkish bias for monetary policy

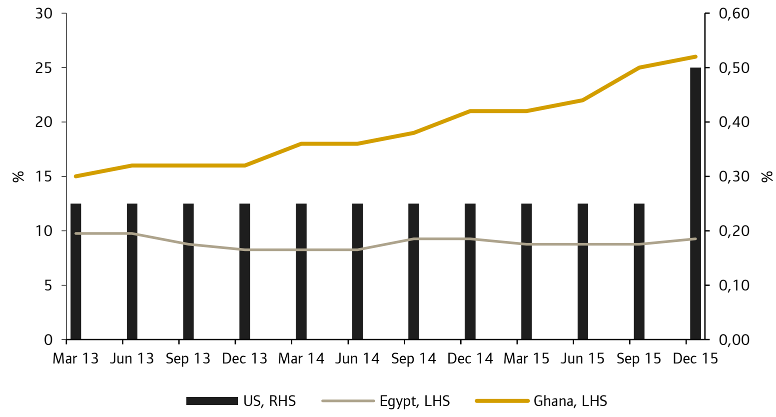
Since the onset of the pandemic, most MPC's in Africa have been cutting their key policy rates to support economic recovery by ensuring that banking systems remain liquid. However, with global financing conditions expected to tighten over the coming year, we now suspect that this easing bias will shift to a hawkish bias.

Upon a closer assessment of the previous two US Federal reserve rate hiking cycles, a large number of MPCs of countries within our coverage, began to hike rates in 2015.

Back then, the Fed hiked, after nearly a decade, by 50 bps in Dec 15. The forward guidance for this hike was provided as early as 2013-14 – when the Fed announced and began tapering asset purchases. Interestingly, initially some MPCs continued easing their policy stance, although this was soon reversed closer to the Fed's rate hike in Dec 15.

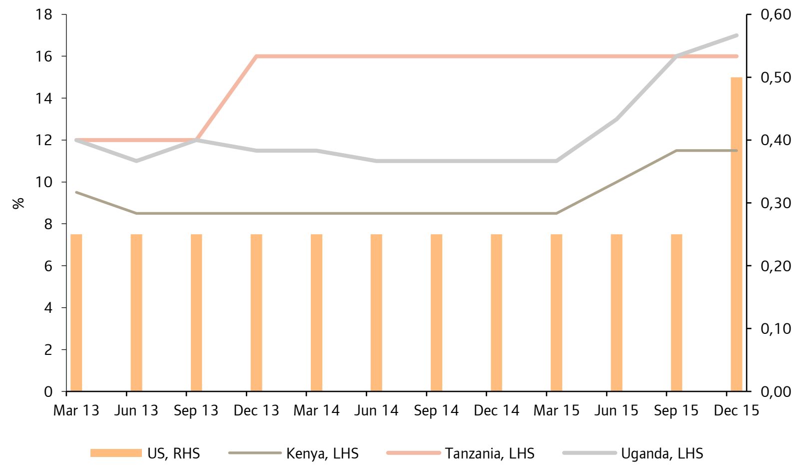
For instance, the MPC in Angola initially cut rates by 125 bps between Mar 13 and Sep 14, before raising by 225 bps between Dec 14 and Dec 15. Similarly, in Egypt, the MPC lowered the policy rate to 8.25% in Jun 14 from 9.75% in Mar 13. However, they then hiked rates in Sep 14 to 9.25% and then eased again to 8.75% in Mar 15 before reversing this cut and raising the rate again to 9.25% in Dec 15. It seems clear that these initial rate cuts could now in hindsight be viewed as policy errors at the time, which needed to be reversed.

Figure 13: Egypt, Ghana, US policy rates 2013-15



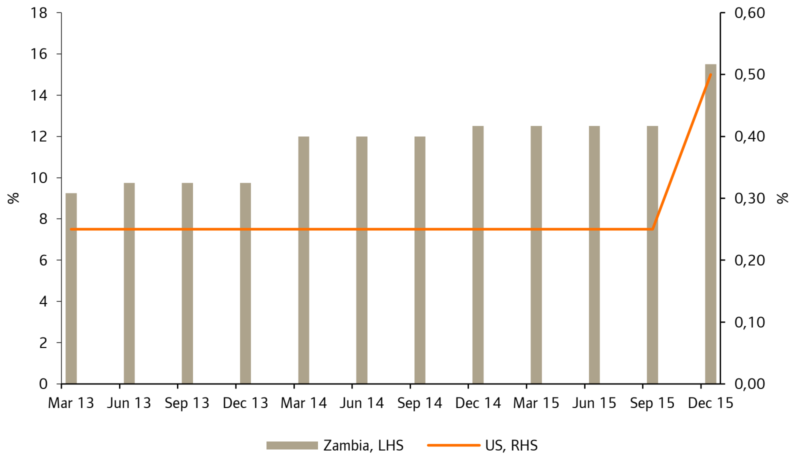
Source: Bloomberg

Figure 14: Kenya, Tanzania, Uganda, US policy rates 2013-15



Source: Bloomberg

Figure 15: Zambia, US policy rates 2013-15



Source: Bloomberg

Other MPCs such as those in Kenya, Ghana, Namibia, and Uganda raised their key benchmark rate by 300 bps, 500 bps, 25bps, and 600 bps respectively in 2015.

Economies that have more liberal capital accounts, with a higher exposure to foreign portfolio investors holding their domestic debt, are likely to be more sensitive to a tightening in global financing conditions

Admittedly, economies that have more liberal capital accounts, with a higher exposure to foreign portfolio investors holding their domestic debt, are likely to be more sensitive to a tightening in global financing conditions. That's why we have high conviction that Ghana, Zambia and Egypt's MPC will probably raise rates this year. Uganda is also another market with notable foreign investment in their local debt. However, inflation is too low, and growth is only gradually recovering from the reinstatement of public health restrictions in H2:21. Namibia too is likely to follow the SARB in tightening while Botswana and Mauritius could also raise policy rates this year.

The more recent Fed tightening cycle between 2018/19 when rates were raised by 75 bps between Mar 18 and Jun 19, was rather different for African MPC's compared to 2014/15.

Interestingly, during this period, the MPC's of Angola, Egypt, Ghana, and Kenya cut rates by 250 bps, 100 bps, 200 bps and 50 bps respectively. Only Zambia and Uganda of the countries in our coverage hiked rates by 100 bps and 50 bps respectively.

Arguably, the 2015 Fed rate hiking cycle was not as well telegraphed as perhaps the 2018/19 or even 2022. Additionally, most monetary policy stances were already tightened meaningfully between 2015 and 2016. Thus, aggressive tightening was probably not necessary at the time.

Our G10 analyst expects the Fed to raise rates by 100 bps in 2022. While one can argue that this move is better communicated than the 2015 cycle, we also ought to acknowledge that economic growth is still mostly below potential for many African economies.

Hence, while we expect monetary policy tightening in Egypt, Ghana, Zambia, Namibia, Mauritius, Botswana and possibly even Angola, it is quite likely that the magnitude of tightening won't be as aggressive as the 2015 cycle.

FX and fixed income strategy: shortening duration for now

With global risk sentiment expected to be volatile in H1:22, we are opting to remain cautious on recommending long duration trades. Although, as FX and yield entry levels potentially improve towards H2:22, we expect multiple opportunities to transpire.

Table 2: Open trades

Positions	Entry Date	Entry yield, %	Entry FX	Latest yield, %	Latest FX	Total Return, %
Egypt: buy Egypt '27	23-Nov-17	15.88	17.69	14.72	15.70	103.9
Ethiopia: buy USD/ETB 24-m NDF	06-Aug-20	12.10	35.42	23.95	48.48	20.7

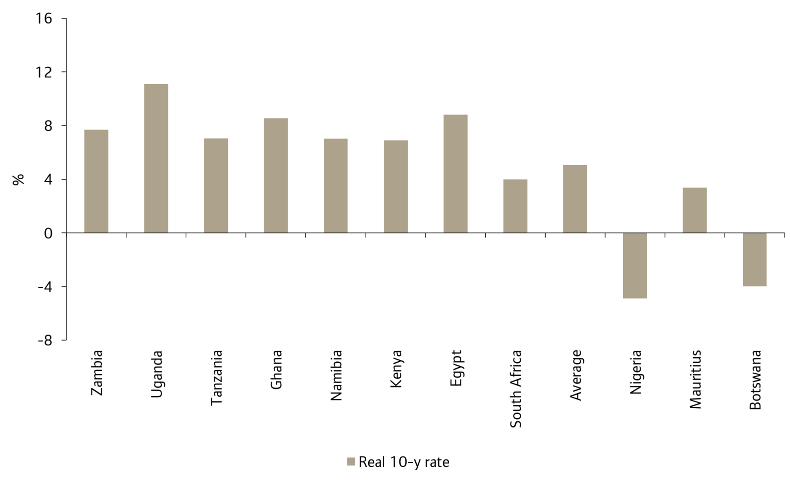
Source: Bloomberg, Standard Bank Research

We took profit on the Ghana 29s government bond position we were holding in our shadow portfolio. The trade returned 11.3% since we opened it in Dec 20. However, with global risk conditions likely to turn unfavourable in H1:22, GHS bond yields could rise by a further 100-150 bps. Foreign holdings of Ghana's local bonds already declined to 17.4% in Dec 21 from 19.2% in Sep 21. Additionally, with access to Eurobond financing looking like a challenge in 2022, the government will inevitably have to borrow more from the domestic market placing further upside pressure on GHS yields.

We would prefer to assess re-entering the duration trade sometime in H2:22, as FX entry levels may have potentially improved while there is likely to be more clarity by then on the government's alternative funding plans and fiscal progress.

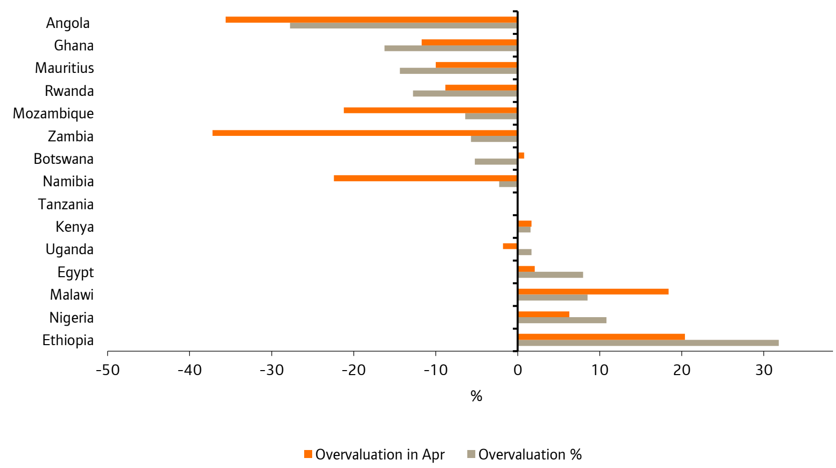
We also took profit on the Zambia 3-y government bond in Dec 21 which returned 43.1% in USD terms. Given how much the bond rallied and with real yields shrinking, we suspect foreign portfolio investment which has pushed yields lower since end of H1:21, could abate somewhat. Furthermore, the government's plans to increase the supply of bonds may present upside risks to yields in the near term. From Jan 21, T-bills and bond auction sizes are expected to increase 30% q/q and 42% q/q respectively.

Figure 16: Real 10-y bond yields



Source: Bloomberg, Standard Bank Research

Figure 17: SBR's REER valuation



Source: Bloomberg; UN Comtrade; Standard Bank Research

We will watch progress from the IMF program which of course is dependent on progress of the G20 common framework before we decide to re-enter the trade.

We also opted to close out our position in the KENIB 22 in Dec 21 in our shadow portfolio due to the weaker KES and high likelihood of a supplementary budget for FY2021/22. Our position returned 2.8% in USD terms since Apr 21, with FX losses weighing on this trade's performance. We suspect that there may be another infrastructure bond issuance in early 2022, and our exit in Dec 21 was tactical to avoid adverse movements in yields ahead of that potential auction as investors exit positions to participate in that on-the-run issue. We will consider re-entering the new KENIB issuance in H1:22. However, this would largely depend on the FX and political situation.

Given Uganda's higher domestic borrowing requirements for FY2021/22, and the government's strategy to lengthen the duration of their liabilities by switching to longer-dated bond tenors, it is likely that UGX bond yields still retain an upside bias over the next few months, especially as global risk conditions remain volatile. However, at recent auctions, the government seems unwilling to allow the 10-y bond yield to exceed 15.0%. As yields edge up closer to this level in H1:22, this might provide an attractive entry level for our shadow portfolio.

In Egypt, despite the inclusion of local bonds in the JP Morgan GBI-EM from end Jan 21, we are opting to remain cautious here. Indeed, despite the notable uptick in foreign holdings of EGP T-bills and bonds in 2021, the EGP has somewhat bucked the trend when other high beta currencies such as the GHS and UGX came under pressure during the recent bout of global risk aversion in Q4:21. This stability has made us somewhat nervous, and we'd prefer to re-assess entering the EGP fixed income market once the global risk environment settles. Foreign holdings of T-bills rose to 24.9% in Sep 21, from 19.3% in Jan 21 and 7.8% in Jun 20.

We had been awaiting a move higher in USD/NGN before we looked to recommend selling the USD/NGN NDFs again. However, despite a move higher to 435 levels at end of 2021, the pair moved back lower to c.414 levels at the time of writing. We still expect the CBN to favour a gradual move higher to 440-460 levels by year-end. We estimate the current FX backlog at USD1.0-1.5bn for foreign portfolio investors and around USD2.0bn for corporates. The backlog for portfolio investors was around USD1.6-1.7bn in Sep 21 while the corporate backlog was around USD2.0-3.0bn. As we don't expect real yields to turn positive in 2022, with inflation expected to remain sticky, foreign portfolio investment in the NGN fixed income market could lag. We would wait for some adjustment on the USD/NGN rate above the 430 levels before contemplating whether to sell USD/NGN NDFs.

Jibran Qureishi#

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SA politics in 2022: a year of ANC unease

This year's political calendar will be dominated by the ruling ANC's December elective conference

This year's political calendar will be dominated by the ruling ANC's December elective conference. While it remains highly probable that President Ramaphosa will secure a second term at the helm of the ANC at this event, a likely challenge from groupings within the ruling party that are threatened by his political consolidation is likely to generate substantial discussion – and potentially investor unease – as the year unfolds. Complicating the outlook in this regard is the intense schedule of internal provincial and league conferences that the ANC aims to run this year before it convenes in December (Table 1). Further to this, the ANC will host its five-yearly Policy Conference in June/July (an official date has yet to be set), at which point differing factions will jostle over the content of party policy in the coming five years.

Table 1: A heady build-up to the ANC's national elective gathering

Province/league	Current ANC chairperson	Next election?
ANC Women's League	Bathabile Dlamini	**Overdue** (should have been in 2020)
ANC Youth League	None (led by a NEC-appointed task team)	**Overdue** (previous leadership disbanded in 2018)
ANC Veterans League	Snuki Zikalala	**2022**
Gauteng	David Makhura	2023
KZN	Sihle Zikalala	**2022 (scheduled for July)**
Eastern Cape	Oscar Mabuyane	**2022 (scheduled for the end of March)**
Mpumalanga	Mandla Ndlovu (Acting)	**Overdue** (no official replacement has been elected to replace former chairperson David Mabuza since he shifted to the national DP role in 2018)
Limpopo	Stan Mathabatha	2023
North West	None (led by ANC task team)	**Overdue** (no elections have been held since the former provincial executive committee was disbanded in 2018)
Free State	None (led by ANC task team)	**Overdue** (the previous PEC was disbanded in 2021)
Northern Cape	Zamani Saul	2026 (**bold?**)
Western Cape	None (led by task team)	**Overdue** (the previous PEC was dissolved in 2019)

Sources: Various news sources; Standard Bank Research

Two other core political themes will attach themselves to the ANC's unfolding succession process this year.

- **National security threats.** Emerging from its most recent National Executive Committee (NEC) meeting the ANC stated that there is an active "counterrevolution" against the current administration, as well as the country's democratic institutions. In part, these assaults refer to the ANC's internal battle for power, meaning that the risk exists that they will continue – or even intensify – in the year ahead. As such, a key challenge for President Ramaphosa this year will be to strengthen the state's security architecture to better interpret and respond to attacks such as the July 2021 'insurrection' and, more recently, the fire in parliament.

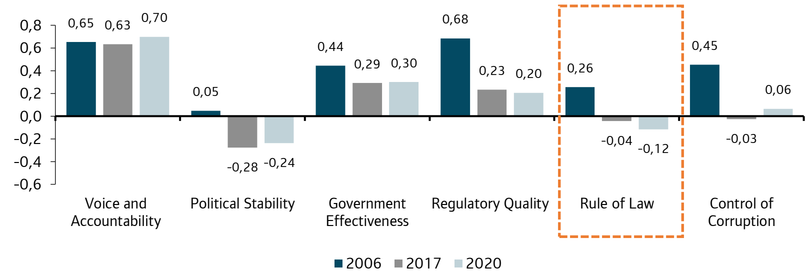
After four years of exhaustive work, the Judicial Commission of Inquiry into State Capture has concluded its work, and is in the process of delivering its findings and recommendations to President Ramaphosa, who has, in turn, vowed to make them public as soon as he receives them

- **Governance reform**. After four years of exhaustive work, the Judicial Commission of Inquiry into State Capture has concluded its work and is in the process of delivering its findings and recommendations to President Ramaphosa, who has, in turn, vowed to make them public as soon as he receives them. The president has appointed a task team of senior ANC members to guide him and the party on how to implement the Commission's findings, and has, separately, committed to producing a report outlining his intentions in this regard by the end of June this year. While the SA government has had a poor record in implementing the findings of past Commissions, public pressure on the president to announce material changes in response to the State Capture Commission's outcomes will be a consistent theme of the political discussion this year, and in the years ahead too. Separately, this year's governance discussion will rest on (a) the ongoing (even if too gradual) institutional reboot at the NPA in order for progress to be made on high-level prosecutions; (b) reform of the SAPS, which may begin with the suspension of National Police Commissioner Khehla Sithole; and (c) the filling of the (five) vacancies at the Constitutional Court, including in the Chief Justice position.

Stepping back, we maintain that President Ramaphosa has performed well in boosting SA's institutional and governance capabilities since coming to power four years ago

Stepping back, we maintain that President Ramaphosa has performed well in boosting SA's institutional and governance capabilities since coming to power four years ago. These reforms are evidenced in the country's stabilisation, and in some instance material improvement, in five of the six World Governance Indicators measured by the World Bank (Figure 1). However, the one notable outlier in the WGI's post-2017 assessment is in the category of the Rule of Law, where SA's score has continued to decline over the past four years. Arresting this slide will be a crucial component of the outlook this year, and will, equally, be one of the most compelling indicators of the president's success in his likely second term in office as ANC leader.

Figure 1: SA's Ramaphosa-era institutional firming, except for the rule of law



Sources: World Bank; Standard Bank Research

Elsewhere, focus this year will rest on government's ongoing response to Covid-19; on the political pressures that will continue to face National Treasury's fiscal consolidation endeavour; on the outlook for labour relations; and on the performance of opposition parties in leading the broad and potentially chaotic coalitions that were ushered in across all three Gauteng metropolitan municipalities after last year's Local Government Elections (LGEs).

This year, the pandemic's effect on the macro and political outlook will be substantially more modest than it was in 2021, and of course 2020

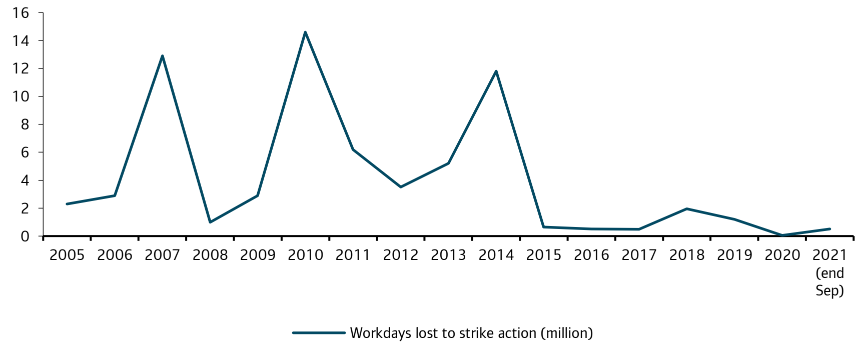
- **COVID-19**. This year, the pandemic's effect on the macro and political outlook will be substantially more modest than it was in 2021, and of course 2020. From a political perspective, discussion will centre on calls for government to bring an end to the National State of Disaster that has been in place since Mar:20; as well as on how the state moves to elevate the country's vaccination rate to provide deeper shielding against potential new variants of the virus. More broadly, however, the political focus on managing Covid-19 will shift more squarely towards an engagement of its deeper and more lasting socio-economic effects. Indeed, the effect of the pandemic and the lockdowns initiated to control it has been disproportionately severe for the country's low-income households, while education outcomes have been profoundly skewed between the public and private spheres too.

This year there will continue to be three broad political points of resistance to deeper fiscal consolidation: (1) SOEs; (2) public sector wages; and (3) social welfare

- **Fiscal consolidation**. This year there will continue to be three broad political points of resistance to deeper fiscal consolidation: (1) SOEs; (2) public sector wages; and (3) social welfare. We expect that SOE fiscal risks will be contained, and that government will manage to secure a new one-year wage agreement that mirrors the agreement struck for the current year (such an arrangement has already been budgeted for by NT). On the grants side, we do not expect a broader basic income grant (BIG) to be implemented this year, though the current Social Relief of Distress Grant will invariably be rolled over beyond its current 31 Mar:22 deadline, which will have an obvious fiscal impact. In time, the SRD Grant will, we expect, become the basis for a limited BIG that targets unemployed citizens between the ages of 18 (at which point eligibility expires for the Child Support Grant) and 60 (at which point eligibility for the Old Age Grant begins).

- **Labour relations.** There has been a deep and potentially structural decline in strike action across SA over the past six years (Figure 2). This speaks to the weakness of the economy (which has narrowed worker appetite for prolonged strike action); the tightening of labour laws pertaining to industrial action; and the political weakening of organised labour in general, and COSATU in particular. We do not expect this trend to be shaken this year. The two most potentially robust collective bargaining processes in 2022 will be in the public sector (where some unions will threaten strike action but, like in 2021, largely baulk at following through with these threats), and in the automotive sector (where we anticipate some strike action, but doubt the duration to exceed 2-3 weeks).

Figure 2: A dramatic decline in prolonged strike activity since 2015



Sources: Andrew Levy Publications; Standard Bank Research

- **Metros.** As the country's political space opens (considering the ANC's ongoing electoral losses), attention will increasingly move to the shape of the coalitions that may viably emerge to reconstitute the country's longer-term outlook. This year primary focus in this regard will rest on the Democratic Alliance's ability to hold together broad and potentially unstable coalitions in Johannesburg, Ekurhuleni and Tshwane, and deliver some improvements to residents in these critical areas. Outside of this, former Johannesburg mayor Herman Mashaba's Action SA will be challenged to build on its impressive LGE performance last year to present itself as a viable alternative to the ANC and DA in the 2024 national and provincial elections.

In all, this year will reflect, perhaps in equal measure, both the ANC's ongoing political dominance in SA (as a function of the attention that rests on its succession debate), as well as its ongoing institutional and electoral slide (as reflected by the party's structural inertia, and the progressive development of alternative governing arrangements in the country's economic centres). At least, this transition will likely be smoothed by President Ramaphosa's re-election, which has the potential to carry compounded (even if incremental) gains in terms of economic policy, fiscal reform, and governance and accountability progress across the state.

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.

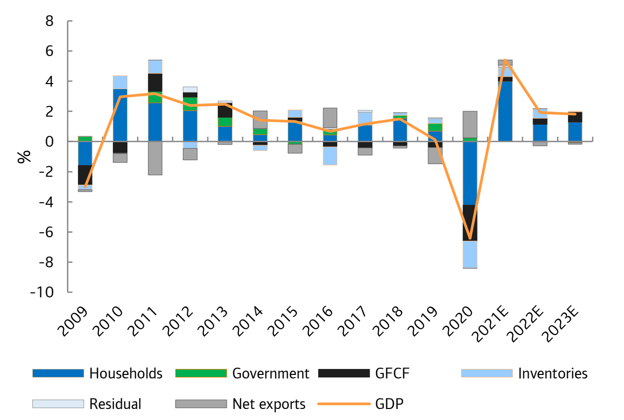
SA 2022 economic outlook

A slowing GDP rebound mired in risks

We forecast growth to slow to around 2% in 2022 from 4.7% in 2021

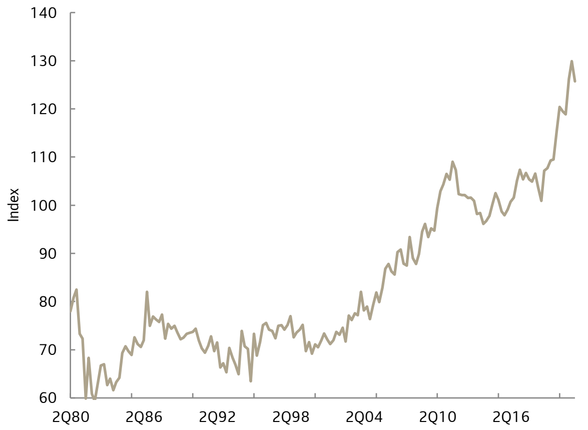
We still expect real GDP to reclaim its pre-pandemic peak by 3Q22, underpinned by ongoing support from the global economy in the form of elevated, even if slightly lower, global growth and commodity prices (see Terms-of-trade windfall quantified[1]) along with domestic monetary policy that is still accommodative, albeit less than before. In short, the GDP recovery continues — but key tailwinds have been fading, and there are abundant and widespread risks (see a more comprehensive discussion in Real strength laid bare as support fades).

Figure 1: GDP expansion turning tougher



Source: SARB, Standard Bank Research

Figure 2: Terms of trade lower but still elevated



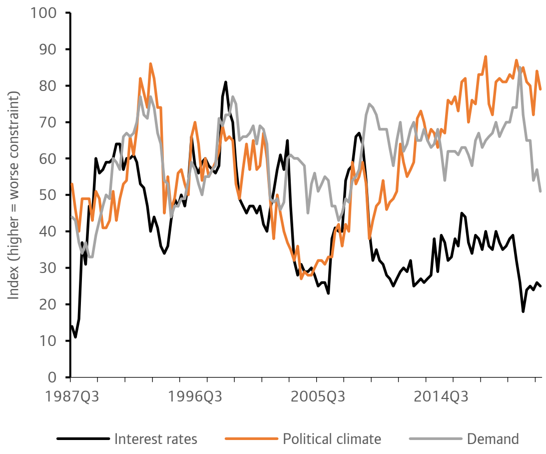
Source: SARB, Standard Bank Research

Traction thus far with policy reform to lift trend growth remains uninspiring

Notwithstanding these cyclical tailwinds and the initial rebound from the pandemic- and lockdown-induced contraction in 2020, SA's trend growth hinges critically on domestic policy reforms. Here, progress has been mixed, with major achievements on the electricity front in 2021, encouraging steps in the transport sector, yet only patchy progress in infrastructure projects and, so far, disheartening delays with the long-awaited spectrum auction. T**he extent to which firms perceive the political climate** – which presumably incorporates the impact of policy and bureaucracy – **to be a growth constraint has improved**, but it remains very elevated as well as a more binding constraint than the weakness in demand (see Figure).

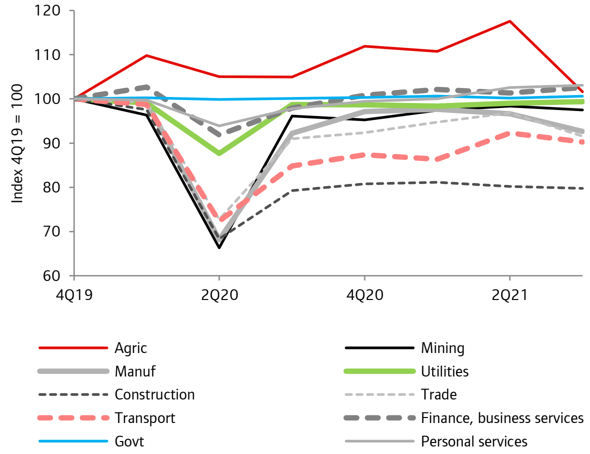
[1] *See report for a comprehensive analysis of the typical impact of such a strong terms-of-trade impulse on the SA economy.*

Figure 3: Companies' perceptions of growth constraints



Source: BER

Figure 4: Some sectors still below pre-pandemic peak



Source: SARB, Standard Bank Research

The electricity shortfall should narrow this year, but further loadshedding is still a key growth risk

Notwithstanding the steps taken to ultimately improve the electricity prognosis, **the electricity shortfall remains a key near-term growth risk**. After shaving an estimated 1ppt off economic growth on average in 2019-2021, addressing the electricity constraint could lift growth noticeably. This year, the fourth unit of Kusile power station becoming commercially operational as well as additional supply expected from the first four bid windows of the renewable energy independent power producer procurement (REIPPP) programme should meaningfully reduce the electricity shortfall

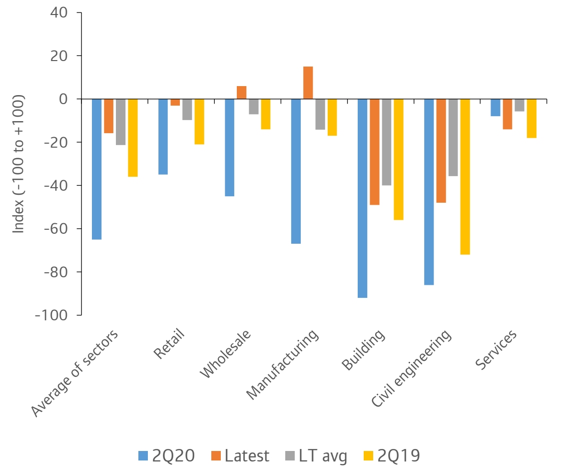
The consumer recovery may slow but also become less uneven

Consumer demand recovery persistent but very uneven

We expect a further recovery in consumer spending, supported by the lagged recovery in employment amid ongoing pro-poor fiscal support and wage growth. There has been no recovery in full-time private sector employment yet[2] after the 2Q20 plunge. There have only been partial recoveries in part-time private sector jobs in the formal sector, in the informal sector, and in the government sector[3]. Employment is now quite low relative to output in most sectors (see charts below), which supports our expectation that the ongoing growth recovery should eventually spur an employment recovery. **This is supported by the general improvement in firms' employment expectations,** with the 4Q21 average exceeding the long-term trend.

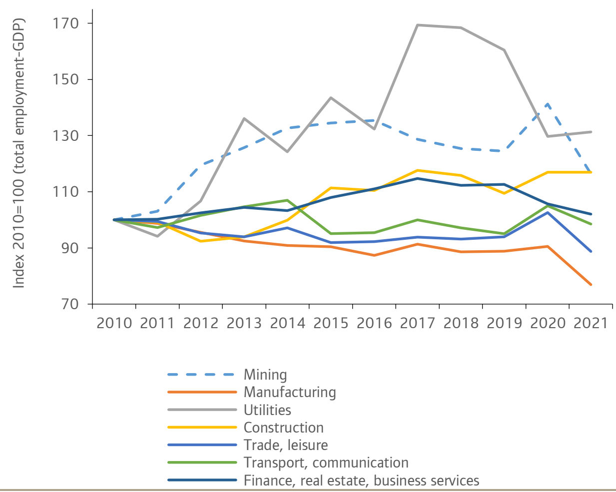
[2] *As captured in the large business-based Quarterly Employment Statistics.*
[3] *Corresponding with the presidential employment programme rolled out from late-2020 in response to the pandemic.*

Figure 5: Firms' average employment expectations improved to above pre-pandemic level



Source: Standard Bank Research, BER

Figure 6: Employment dipped vs GDP in most sectors in 2021



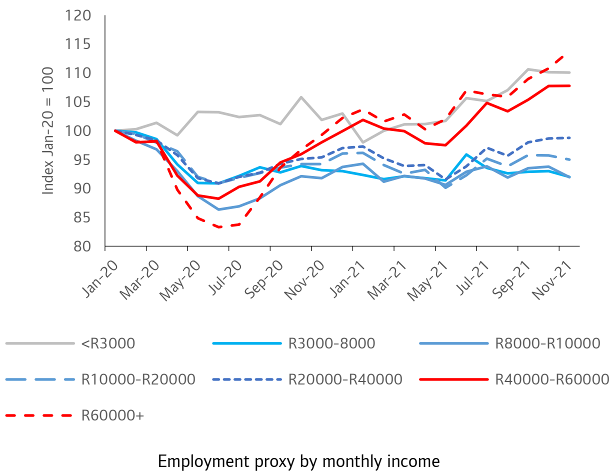
Source: Stats SA, Standard Bank Research

High-income consumers have generally led the recovery so far

While virtually **no consumer group seems to have been entirely unscathed** by the economic weakness in 2020-2021, **the recovery remains uneven**. A number of data sources imply that the high-income groups have recovered reasonably briskly, supported by a full- or near-full employment recovery and a positive wealth effect from the equity market and dividend income recovery. 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 in 2018 and 2019, and dividends have recently grown even faster). Our proprietary income and employment proxies imply that the recovery in the top income groups' income is adequate to drive moderate growth in total income notwithstanding the weakness in the middle-income groups' employment.

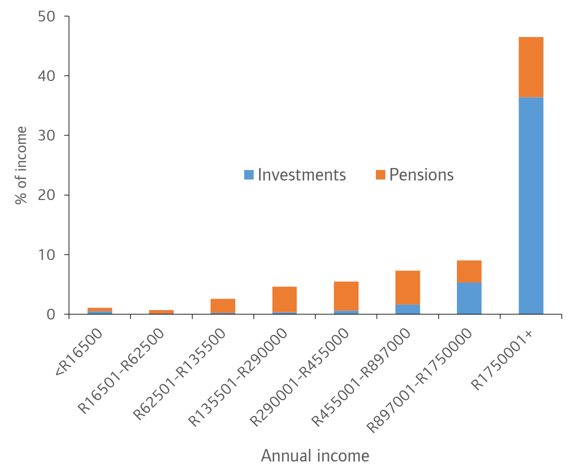
The high-middle income groups are the key drivers of the recent household credit growth – their low, and falling, debt in arrears implies that this is prudent (not distressed) borrowing (see Consumer recovery still only partial). Their income growth should, however, be curtailed by the absence of (or at most very limited) wage growth in the government sector. Meanwhile, fiscal relief (including the Social Relief of Distress grant and the ongoing Expanded Public Works Programme) is supporting the lower-income groups. However, the most financial pressure is being felt among parts of the middle-income groups (see charts below).

Figure 7: Top-end employment seems to have recovered



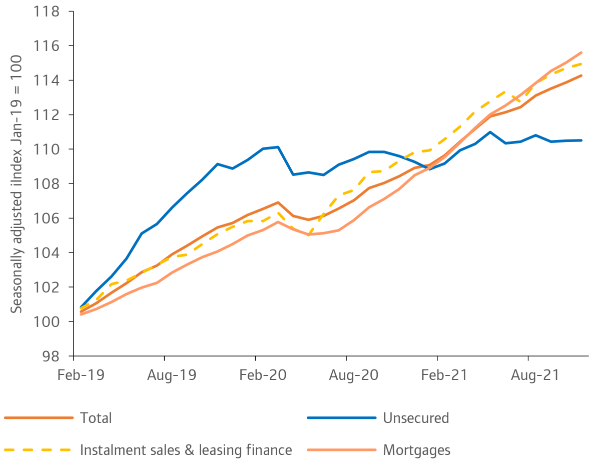
Source: Standard Bank Research

Figure 8: Investment income important to high end



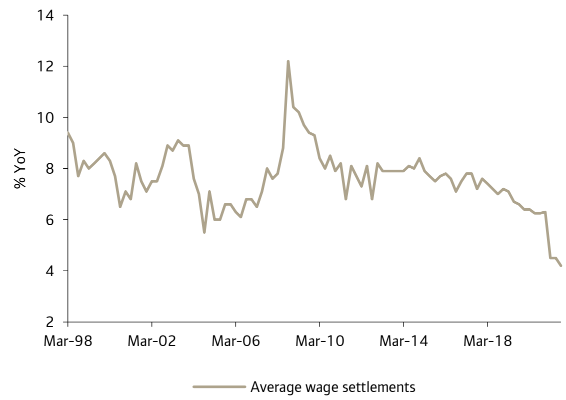
Source: Standard Bank Research

Figure 9: Household credit continues to grow



Source: XDS, Eighty20, Standard Bank Research

Figure 10: Wage increases contained



Source: Stats SA, Standard Bank Research

Inflation in essential items is estimated at more than 1ppt above headline inflation

Our proprietary aggregate income proxy, as well as total personal income tax and total compensation of employees, are all above their respective pre-pandemic peaks. Still, total compensation is lagging the nominal GDP recovery in most sectors at this stage, which should support the employment recovery that we foresee. Credit growth should also provide ongoing support to household spending power notwithstanding higher interest rates. However, **headwinds from a sharp increase in the costs of non-discretionary spending items should not be underestimated** – we estimate that this inflation rate might be more than 1ppt above headline inflation.

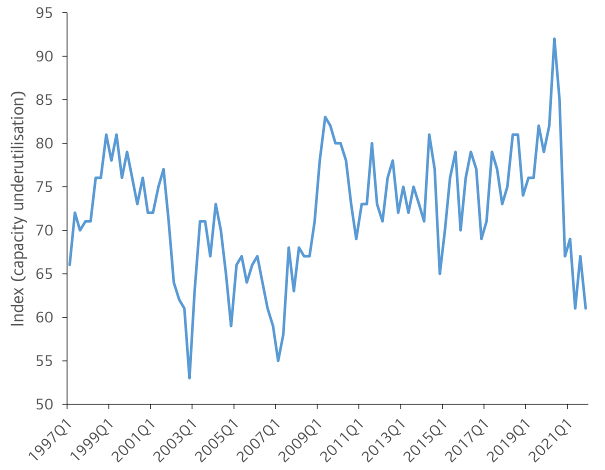
Fixed investment should recover gradually

Real fixed investment should recover somewhat in 2022

There should also be some improvement in private sector gross fixed capital formation (GFCF) as **firms catch up on delayed capex following the recoveries in their profitability and capacity utilisation**. Encouragingly, **surveyed firms'[4] fixed investment perceptions and intentions improved significantly** at the end of 2021, which should signal improvement. The private sector fixed investment growth we pencil in for 2022 would still only reverse the contraction in capital stock during the pandemic – this was the first contraction since 1962 and a mere reversal is, in our view, not a bullish assumption, especially as this also incorporates the expected private sector energy-related capex. Furthermore, government now seems more likely to support increased private sector participation in infrastructure, per our long-standing expectation, although the related impact on gross fixed capital formation (GFCF) estimates may be gradual beyond the expected increase in electricity-related capex.

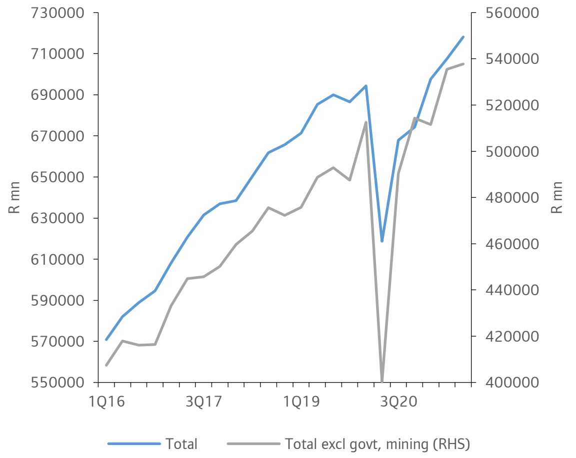
While a rebound in GFCF should be obvious after the deep contraction in 2020, given that the abovementioned fundamentals are supportive of a recovery, the electricity shortfall curbs any expansion investment, and we remain concerned about the protracted impact the July 2021 unrest may have on firms' fixed investment and/or expansion plans. This is notwithstanding most available data seemingly implying that the impact of the unrest so far has largely been on the directly affected areas, with limited indirect impact on the rest of the country.[5]

Figure 11: Firms' capacity underutilisation has declined (i.e. capacity utilisation has improved)



Source: BER

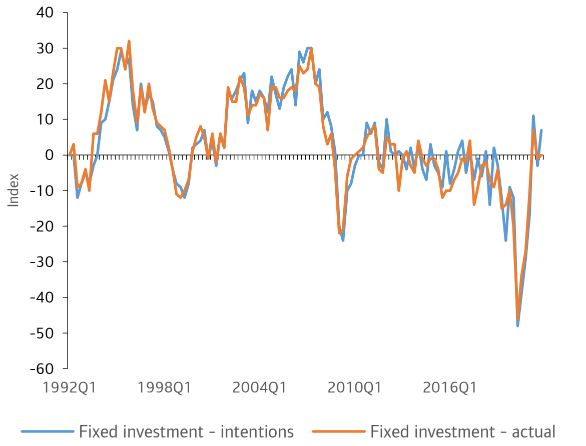
Figure 12: Gross operating surplus (profit proxy) has resurged



Source: Stats SA, Standard Bank Research

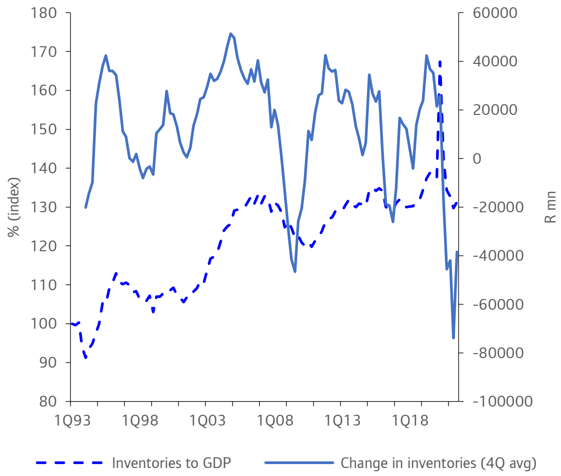
[4] *This question is only included in the manufacturing sector's survey.*
[5] *For example, KwaZulu-Natal and Gauteng dominated the job losses reported in 3Q21, and the BER's manufacturing survey shows that confidence, sales and fixed investment intentions plunged in KwaZulu-Natal but remained relatively resilient elsewhere.*

Figure 13: Companies' fixed investment expectations now exceeding those preceding the pandemic



Source: SARB, Standard Bank Research

Figure 14: Inventories are low vs GDP, and should recover



Source: BER

The ratio of inventory levels to GDP is at the trough of the previous cycle

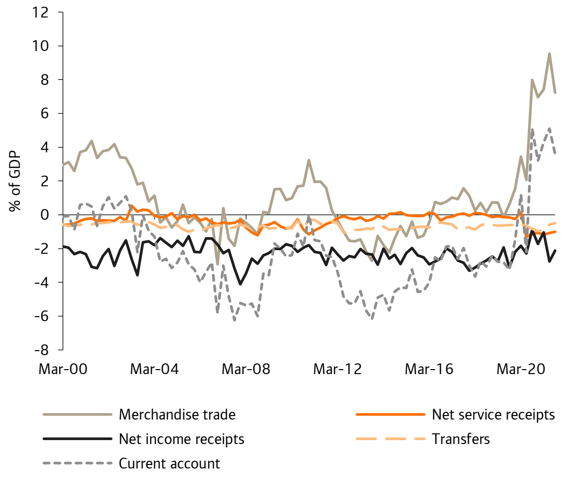
Inventory restocking likely to boost GDP

When assessing the level of inventories, and the probability of a change in direction, we focus on the level of real inventories to GDP (rather than the ratio of nominal commercial and industrial inventories to GDP published by the SARB). According to our estimate of the real ratio, inventories are not extremely low relative to the size of the economy, notwithstanding the sizeable destocking in 2020-2021, but **the ratio of real inventories to GDP is close to where it was in early-2018 at the start of the previous inventory building cycle**.

Trade and current account surpluses unwinding

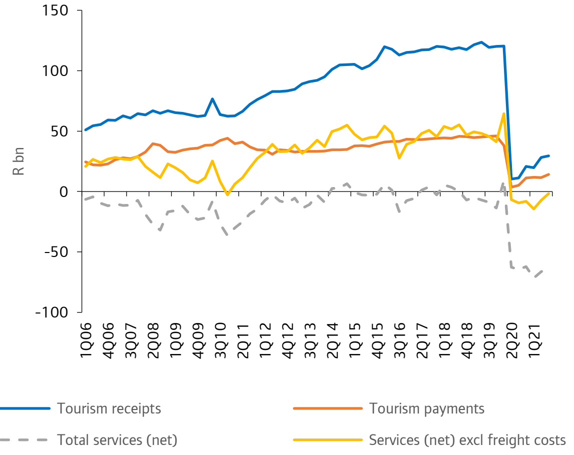
The trade balance recovery was the key swing factor in the improvement of the current account during the pandemic; net service (mainly tourism) receipts declined, while net income (mainly interest and dividends) payments improved modestly. From 2019 to 2021, the trade balance improved by an estimated 6.4% of GDP, net service receipts declined by 0.9% of GDP, and net income receipts improved by 0.6% of GDP. The weakness in net services income will probably persist until global tourism recovers, which looked promising following progress with Covid-19 vaccines but renewed international border closures – and presumably increased caution of travellers – in response to the outbreak of the Covid variant Omicron implies that any recovery is likely further delayed (see Thoughts on Omicron's SA economic impact).

Figure 15: Trade boosted current account in pandemic



Source: SARB, Standard Bank Research

Figure 16: Slump in tourism weighs on current account[6]



Source: SARS, Standard Bank Research

Net exports should weaken in nominal and real terms in 2022, as the terms of trade may prove less supportive than in 2021, while a material improvement is expected in import volumes, which still appear low relative to domestic demand[7] after plunging in 2020 and recovering only partly in 2021. Exports should still be supported by the ongoing growth in global demand, as well as the elevated, albeit in some cases slightly lower, prices of key SA export commodities.

Fiscal forecasts firmer but risks elevated

We perceive credible political will to drive fiscal consolidation, though the execution risks remain high given that it requires extraordinary restraint of the public sector wage bill and social grants. Fitch's recent upgrade of the outlook on SA's sovereign credit rating to stable from negative is an apt reflection of the improvement of key fiscal metrics[8]. Notwithstanding these improvements in the key metrics and Finance Minister Enoch Godongwana's message that government is committed to fiscal consolidation, investor concern about debt stabilisation persists. Despite the increased traction with growth reforms as a result of interventions by Operation Vulindlela[9], investors remain sceptical about adequate traction with policy reform sufficiently lifting trend growth to ensure debt stabilisation amid elevated social spending needs and a precarious fiscal position. Nevertheless, a likely revenue overshoot should again counteract the expenditure increases that we foresee. Most importantly, we believe that policy has finally turned the corner. We therefore don't foresee any further sovereign credit rating downgrades this year, though the risks remain elevated until more decisive improvements transpire.

The 2H21 overspending on public sector wages and social grants was easily absorbed by the coinciding revenue overshoot but overspending on these two sizeable items underscores the persistent risk of further overspending. The increased wage bill spending in FY21/22 was particularly disconcerting, considering the preceding year's resolve to curb the wage bill with a mooted unprecedented reopening of an existing multi-year wage agreement. **We assume that the temporary social grant increase implemented after the July 2021 unrest will turn permanent**, even if there are adjustments to its exact coverage. A basic income grant is, in our view, still unlikely, though. As discussed below,

[6] *Data is seasonally adjusted and annualised.*
[7] *This is also valid when exports are added to domestic demand.*
[8] *Supported by the upward revision of GDP estimates during Stats SA's 2021 benchmarking and revisions of the national accounts data.*
[9] *The joint Treasury and Presidency policy implementation unit.*

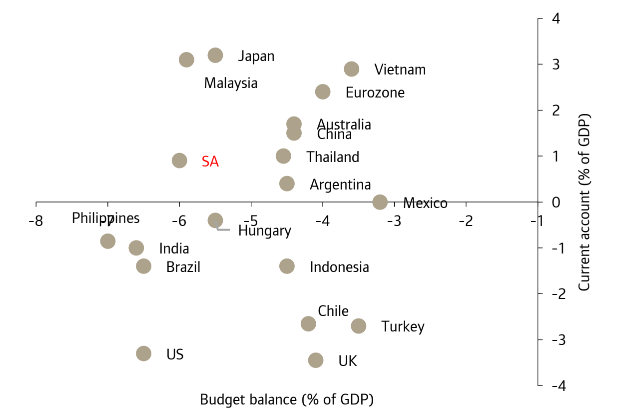
we expect the revenue overshoot in FY21/22 to be adequate to cover the increased social grants spending if the unallocated spending (per the 2021 MTBPS) is used to partly pay for the increase in social grants.

Treasury's forecast fiscal consolidation seems feasible, with the new spending trajectory still implying year-on-year growth in the main spending categories, except for the reduction in Covid-related spending. That said, it is undoubtedly a tough ask to rein in spending growth to this extent; the fiscal consolidation plan is thus subject to very high execution risk, with wages and social grants remaining key risks.

The improvement in key fiscal metrics in 2021 was enough to avoid further negative sovereign credit rating action

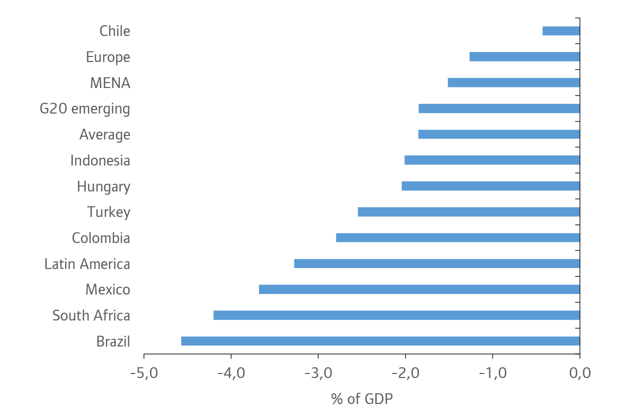
The improvement in the key fiscal metrics in 2021 was, as we expected, enough to avoid credit rating downgrades after the 2021 MTBPS, notwithstanding two of the three major rating agencies having a negative outlook on SA's rating at the time. Ultimately, the risk of further negative rating action can only be negated by sufficient policy reforms to sustainably lift the growth trajectory. Fitch changing the rating outlook to stable from negative at the end of 2021 clearly signalled that it is unlikely to take negative rating action in the foreseeable future. Both Moody's and S&P decided not to take negative rating action at their scheduled rating reviews after the MTBPS, though we remain concerned about the downside risk to the Moody's rating in particular, given that it has a negative outlook on SA's sovereign rating and clearly stipulated that adequate growth reforms are required to preserve the current rating. While there has been encouraging steps in this regard, it hasn't yet been enough to lift trend growth, and further reforms are required. Our base-case forecast is for no negative rating action, though this critically depends on key choices – including those pertaining to social grants and public sector wages – in 2022, for the Moody's rating in particular. Should Moody's downgrade SA again, we'd expect a change in the rating outlook to stable.

Figure17: SA current/fiscal balances compare better



Source: Bloomberg, Standard Bank Research

Figure 18: SA debt servicing cost alarmingly high vs peers



Source: IMF, Standard Bank Research

The fiscal forecast risk will remain particularly 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. We pencil in only modest slippage in the upcoming fiscal year (FY21/22) relative to the proposed wage freeze.

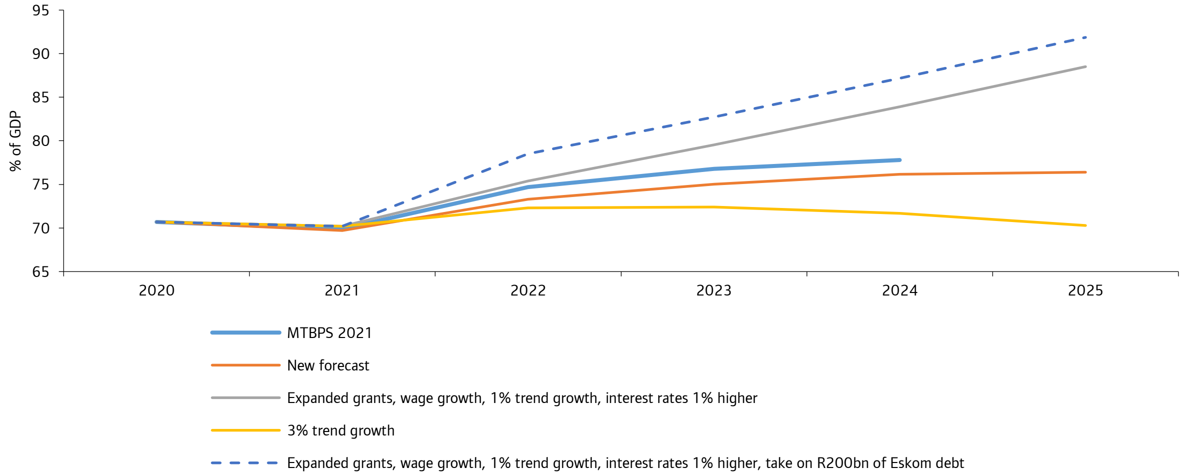
We expect there to ultimately be some savings from the planned zero-based budgeting[10] that will be phased in. Furthermore, **it seems as if gains are finally underway from the improvements taking place in SARS's capacity**. Treasury has repeatedly indicated these

[10] Some of Treasury's savings proposals about which it seems quite confident include: suspend implementation of new transport networks in planning stage for over a decade without roll-out of services to residents; consolidate entities and regulatory agencies; dispose of unused land and other assets; and manage benefits received by political office bearers through Ministerial Handbook reforms.

gains as likely sizeable, although it is difficult to predict the timing, and Treasury hasn't yet factored this into its forecasts.[11]

At this juncture, **we don't foresee additional capex injections for Eskom in the budget**, but we do expect moderate further funding support for some of the smaller 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). Even should Eskom not require further cash injections in the near term, its debt burden remains a major medium-term fiscal risk. Further bailouts of SOEs, the potential liabilities of the Road Accident Fund (RAF), and the elevated unpaid bills and accruals of provincial and local government also add to the fiscal risks. The fiscal risk from the planned roll-out of the National Health Insurance (NHI) seems to have been delayed by the pandemic.

Figure 19: Government debt scenarios underscore the elevated risks



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 increases – even fiscal drag – to not pressure an already-weak economy. Households' tax burden in particular is high in a historical context, while there are obvious concerns about hikes in any of the other major types of taxes (particularly company income tax and VAT). We still generally expect any tax hikes to be borne by consumers, with government reluctant to increase taxes on companies given corporates' bearish sentiment and the president's investment-driven growth agenda.

Fiscal drag (not adjusting tax brackets for inflation) seems possible in 2022 (and thereafter) – at least for high-income groups – though it obviously yields less extra revenue than usual if income growth is weak. We strongly suspect **that government is also reviewing a wide range of tax hike options**, including a wealth-related tax[12] and/or one-off solidarity tax (as was imposed in the mid-1990s as a transition levy to democracy).

We expect a sizeable fiscal revenue overshoot again in FY21/22

While we don't foresee further sovereign credit rating downgrades in 2022, the risks are non-negligible. Comparisons with similarly rated countries underscore the growth-interest rate gap as a factor on which SA compares particularly poorly. However, as reiterated by all three major rating agencies in their latest rating assessments, this is counteracted by institutional strengths, such as low foreign currency debt and a deep and liquid local bond market; also, this is already discounted by the current credit ratings.

[11] Judge Dennis Davis, who headed the Tax Review Commission, recently said that a "significant closure of the tax gap" is on the cards, which he "didn't [previously] think was possible". SARS Commissioner Edward Kieswetter attributed some of the revenue overshoot in the current fiscal year to SARS's improved efficacy.
[12] Also see Fiscal options: can a wealth tax help?.

Below is a succinct summary of global experiences of countries that have, like SA, lost their investment-grade ratings. Our analysis of countries that lost their investment-grade ratings implies that **decisive government action is typically required to regain investment-grade status** (see Global turnarounds). Only half of the countries in our analysis that lost their investment-grade ratings have regained them. Of the countries that regained investment grade, around half of the reversals were quick – less than 4 years – whereas the other recoveries took between 5 and 19 years.

Figure 20: Regaining investment grade – summary of international experiences

Quick recovery		Medium recovery		Slow recovery	
Country	**Recovery time (years)**	**Country**	**Recovery time[13] (years)**	**Country**	**Recovery time[14] (years)**
Korea	1.1	Slovakia	3.1 - 3.6	Hungary	4.7 - 5
Slovenia	1.7	Russia	3.1 – 4	Portugal	5.7 - 7.3
Thailand	2.5	Latvia	3.2	Croatia	6.3
Ireland	2.5			Cyprus	6.7
Bulgaria	3			Colombia	11.5 - 11.8
				Indonesia	14.11 - 19.4
				Turkey	19.4

Source: Bloomberg, Standard Bank Research

SA no longer shares the characteristics of countries that regained investment grade quickly – it has lost its investment grade by all of the major rating agencies, and its downgrades below investment grade have been deep[15]. Many of the interventions by countries that regained their investment grade status – such as privatisation – are politically unpalatable in SA, which limits the government's range of options, although the recent commitment to savings on the government wage bill is very encouraging.

Reduced, but enduring, ZAR support

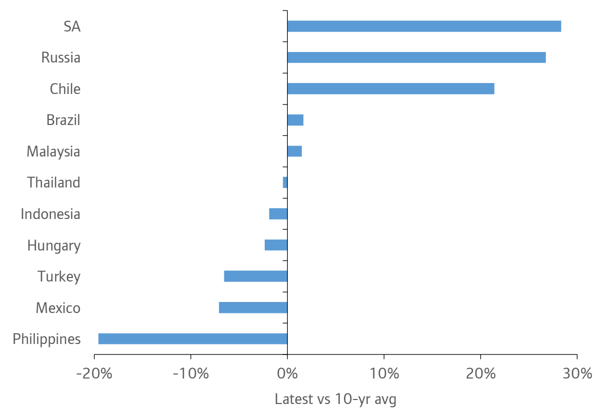
The rand is close to our fair value estimate; we expect the real trade-weighted rand to drift sideways over the medium term

A few distinct factors will likely drive the rand exchange rate in 2022, mostly centring on the strength of the global economy, global capital flows, sentiment, commodity prices and perceptions around the SA government's progress with fiscal, economic and energy reforms. The global economic backdrop should remain relatively rand-supportive with the ongoing global search for yield, still reasonably strong forecast growth, still relatively easy financing conditions, and possible dollar weakness. That said, **most ZAR tailwinds have been dissipating, and a fair amount of volatility is to be expected** given the influence that fluid Covid-related developments and the tapering of exceedingly strong monetary stimulus will have on capital flows and sentiment.

A dominant forecast risk around the rand's trajectory in 2022 will be the resilience of SA's terms of trade, which reached a new record during 2021. Our econometric models estimate that the rand's relative strength vs peers at times during the pandemic is largely attributable to SA's elevated terms of trade. Our mining team's commodity price forecasts imply that the terms of trade should recover slightly in 2022 from their 2H21 dip, and should remain elevated in a historical context.

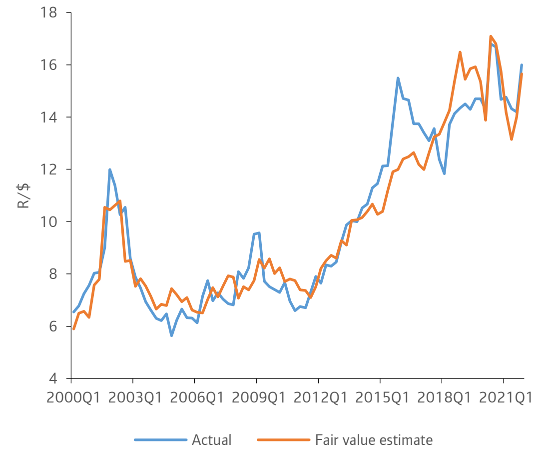
[13] Two numbers represent different recovery times for S&P and Moody's (one number is given if only one rating fell below sub-investment grade and then recovered).
[14] Two numbers represent different recovery times for S&P and Moody's (one number is given if only one rating fell below sub-investment grade and then recovered).
[15] Generally, countries that preserved at least one investment-grade rating, and had only shallow downgrades below the investment threshold, recovered their investment-grade status quicker.

Figure 21: SA's terms of trade strengthened more than for many peers



Source: SARB, Oxford Economics, Standard Bank Research

Figure 22: Rand now close to fairly valued for the prevailing conditions, according to our econometric model



Source: Bloomberg, Standard Bank Research

The real trade-weighted rand is about a standard deviation weaker than its long-term average despite the terms of trade being about 18% stronger than the 10-year average, and 31% stronger than the 20-year average. Our econometric fair value R/$ model, which estimates the fair value of the rand based on inflation, monetary and fiscal policy, growth and terms of trade differentials, deems the rand as about fairly valued (see Figure 22). Also, the risk premium discounted at the beginning of the year has compressed.

Figure 23: Scenarios for R/$ fair value imply it discounts weak fundamentals as well as a risk premium

Scenario	Assumptions			Fair value
	Fiscal	Growth	Terms of trade	
Base case	Wage bill contained, limited grants increase, revenue overshoot.	Trend growth around 2%.	Similar to 3Q21 levels	15.50
Very bearish	No improvement	No growth	Fall to early 2019 level	22.00
Bearish	Deficit 1% of GDP wider than base case	1% growth p.a.	Fall to 1Q20 level	18.95
Very bullish	Deficit 2% of GDP smaller than base case	2ppt higher in 2021 than base case	Reclaim 2Q21 record level	13.50
Bullish	Deficit 1% of GDP smaller than base case	1ppt higher in 2022 than base case	Resurge to between 2Q21 and 3Q21.	15.10

Source: Bloomberg, Standard Bank Research

Our rand forecasts assume that SA's terms of trade will remain around the 3Q21 level, and factor in the growth and fiscal improvements discussed in the relevant sections of this report. **Our forecasts** (at R15.00/$ and R15.15/$ for end-2022 and end-2023 respectively) **are more bullish than consensus**. This is influenced by our G10 strategist's expectation for more dollar weakness in 2H22 than foreseen by the consensus (see The dollar in 2022). Most importantly, on a trade-weighted basis our forecasts imply very little change in real trade-weighted terms in the annual average from last year. We therefore see the risks to our forecasts as symmetric.

Inflation and rates higher but subdued

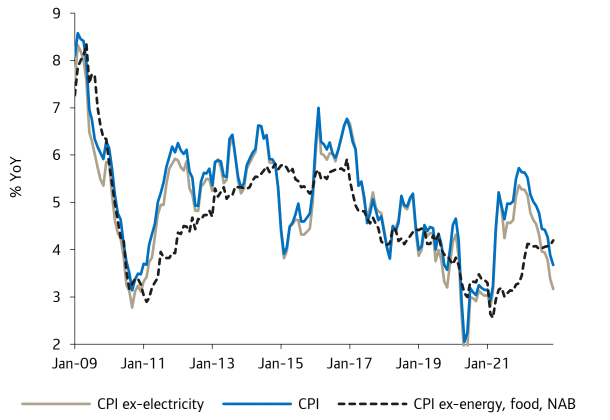
We expect headline inflation to spike towards the target ceiling in the near term, and then retreat to average 5% in 2022 and 4.4% in 2023

We still expect relatively contained consumer inflation in 2022[16], with SA's slow return to pre-pandemic GDP relative to the global norm, as well as a relatively resilient rand vs peers, limiting the rise in SA inflation relative to sharper increases in global inflation. Steep increases in food and fuel prices in 2021 should also eventually underpin

[16] *Our forecasts don't make any specific adjustment for the reweighting that will be implemented from the January CPI data (due in February 2022).*

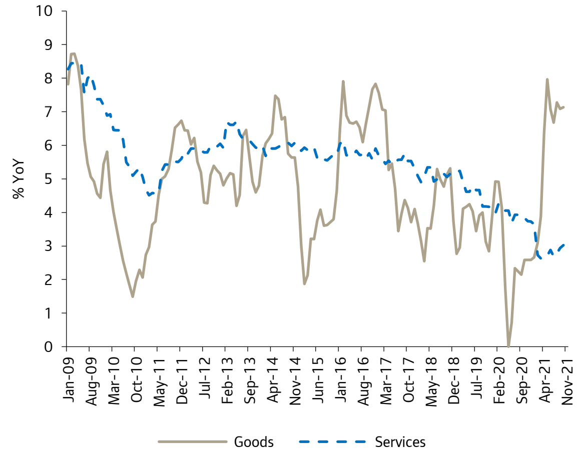
a more favourable base effect, although another double-digit electricity tariff increase is expected to add unique pressure.

Figure 24: Retail food prices should continue to rise, but inflation should moderate



Source: Stats SA, Standard Bank Research

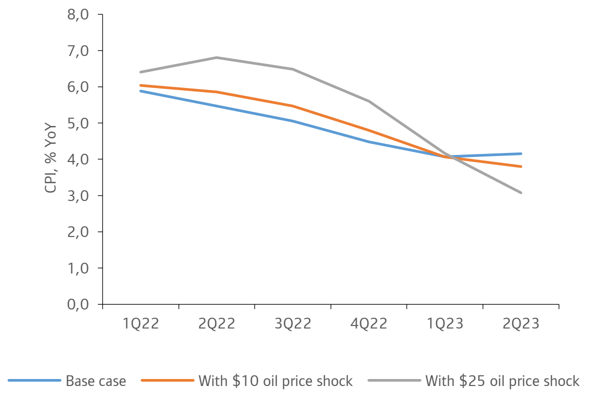
Figure 25: Food and fuel underpin higher goods inflation; services inflation still contained but due to rise



Source: Stats SA, Standard Bank Research

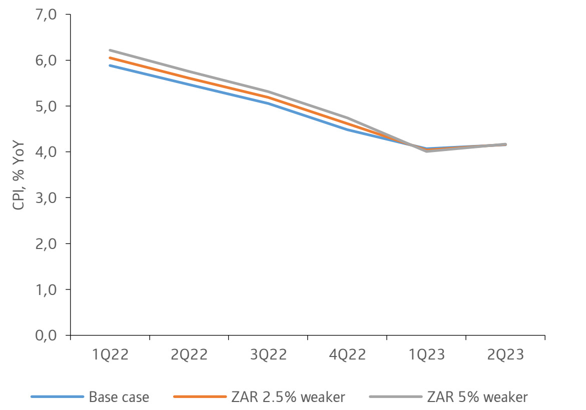
While underlying inflation is still contained and there is no evidence of demand-pull or second-round inflation pressure, the momentum in underlying CPI and PPI inflation has increased, and the next few consumer inflation data prints might be perilously close to the ceiling of the SARB's inflation target range. Furthermore, global inflation risks have increased significantly.

Figure 26: Higher oil prices should *ceteris paribus* only temporarily boost inflation [17]



Source: Oxford Economics, Standard Bank Research

Figure 27: Modest but persistent inflation lift from weaker ZAR assumption[18]



Source: Oxford Economics, Standard Bank Research

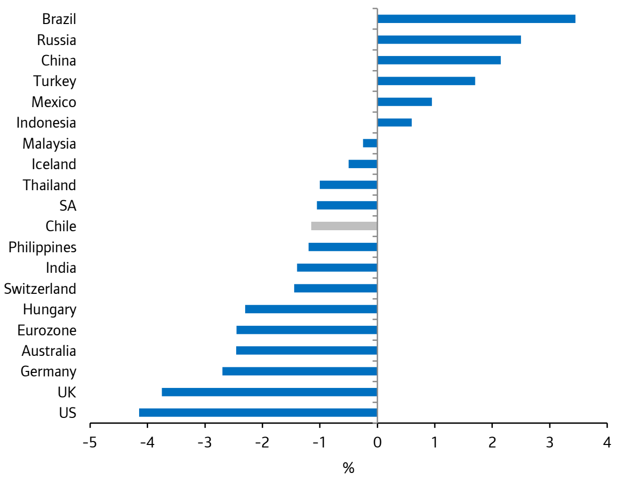
In addition to the SARB's likely unease with inflation spiking towards the target ceiling (albeit temporarily) and the likely rise in core inflation, **SA's real policy interest rate remains somewhat low vs peers** notwithstanding many advanced economies still having

[17] We assume that oil prices overshoot our forecasts by the stipulated margin throughout the forecast period. All the typical second-round impacts of an oil price shock are included.
[18] These are the first scenarios, on which we'll expand in due course. Here, the rand weakness stems from faster US rate hikes and a modest, but fading, increase in the emerging market risk premium. It incorporates a typical domestic monetary policy response.

negative real rates. This is typically not a swing factor in the SARB's decisions but may at the margin tilt the odds towards front-loading of the relatively gradual rate hikes that we foresee.

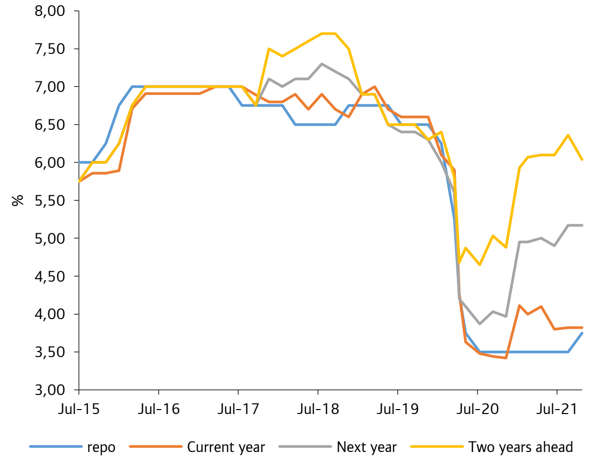
The 75-100 bps of rate hikes that we pencil in for this year would take the forward-looking real repo rate to around zero (or slightly positive), which we would see as an important milestone in the process of interest rate normalisation, especially with the output gap still negative and second-round inflation pressure absent. We expect this cycle to be front-loaded, with hikes at the first 2-3 meetings this year at least before potential pauses in between further hikes. The MPC has stressed that a key reason for the relatively early onset of the rate hike cycle – while inflation expectations and wage growth were still subdued, the inflation forecasts were around the mid-point of the target range and the output gap negative – was to ensure that the rate hike cycle would be gradual. The MPC believes that this would be adequate to contain inflation expectations.

Figure 28: SA real policy rate somewhat low vs EM peers



Source: Bloomberg, Standard Bank Research

Figure 29: SARB's historical decisions deviated from QPM projections



Source: SARB, Standard Bank Research

Elna Moolman#

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