Economy
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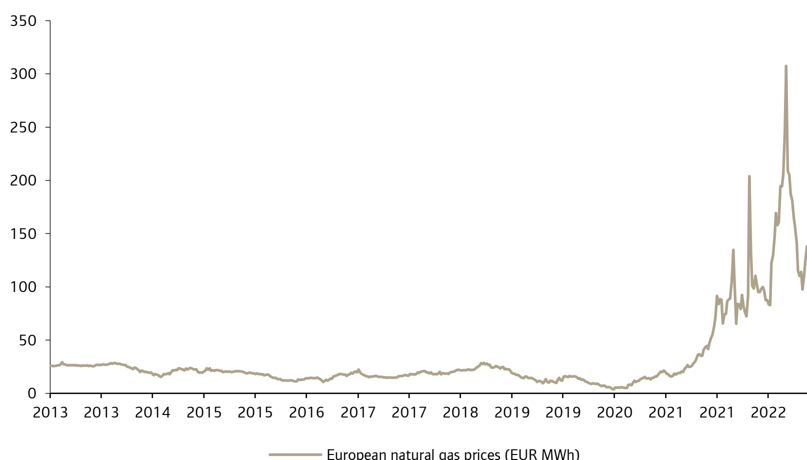
G10 outlook for 2023

Recession risks

G10 countries will be blighted by recessions, or at least a period of very weak growth, in 2023 as the surge in energy and food prices stemming from the conflict in Ukraine continues to weigh on real incomes, while higher interest rates bear down on interest-sensitive sectors, such as housing. It is true that energy prices, particularly natural gas, have fallen but, as Figure 1 shows, they are still considerably above pre-conflict levels. In addition, the supply of gas has been compromised by the conflict. As a result, those countries that were heavily reliant on Russian gas, in Europe in particular, have struggled to source sufficient supplies from elsewhere to make up the deficit. So far, this winter has not seen the power cuts in Europe that many feared, but that's partly a function of warm weather and, even after this winter, there will be question marks about this region's ability to source sufficient gas next winter and beyond. That is a task that could become even harder if China's economic recovery from its zero-Covid policy malaise leads to a significant rise in the country's energy demands.

Figure 1: European gas prices fall, but still well above pre-conflict levels



Source: Bloomberg

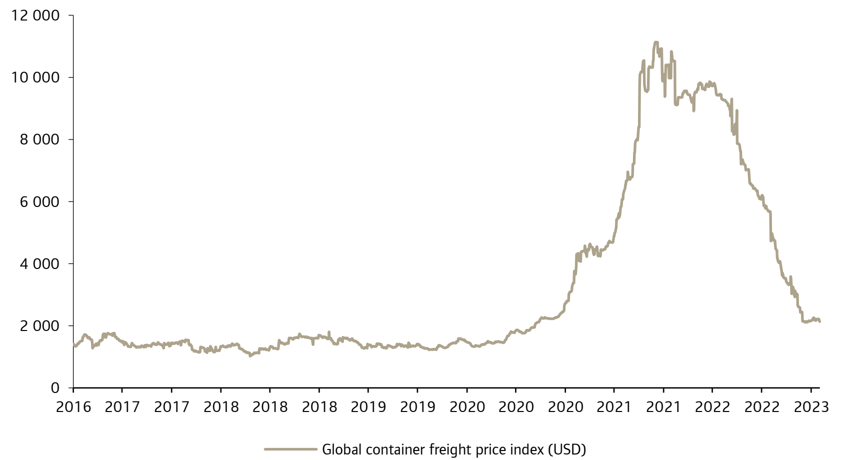
Countries with sufficient energy resources of their own have clearly been spared much of the pain. But significant economic downturns, if not recessions, still seem likely in countries such as the US, Canada and Australia. This is partly a function of slowing growth elsewhere, which weighs on trade, and also because monetary policy has been tightened significantly to deal with the surge in inflation that's resulted, not just from the rise in energy prices, but also from the post-pandemic tightening of global supply chains. Here, too, there is good evidence that supply-chain pressures are easing, which should help to bolster growth. But supply pressures still seem considerably greater than they were before the pandemic struck and the Russia/Ukraine conflict began. This could place something of a speed limit on global growth once demand recovers from the pressure being applied by high interest rates. Labour supply constraints are also a major headache for policymakers in G10 nations. Vacancy levels remain at very high levels, suggesting that, if we do see recessions this year, they will not be accompanied by the usual surge in unemployment rates. Despite solid employment levels, we look for growth in advanced countries to be in the region of 1% in 2023, then picking up to the 1.5%-2.0% range in 2024. Both forecasts are lower than the 2.5% that is likely to be the final outcome for 2022.

Inflation easing

With slowing growth will come lower inflation. Cyclical factors should place significant pressure on inflation to fall but there are several longer-term structural factors that suggest maintaining inflation close to the 2% target, that most advanced-country central

banks have, will be difficult once these cyclical factors have washed out. These cyclical factors are dominated by the weakening of demand created by the tightening of monetary policy. There are also some helpful base effects given how fast inflation rose last year. A third ingredient, which is related to this, is that many of the factors that have inflated prices so much in the past, have reversed. Earlier we showed the sharp fall in European gas prices and, in Figure 2, we can see that global container freight prices have fallen heavily as the log-jam from Covid has cleared and global demand has fallen, particularly in China. But notice also that container freight prices are still above their pre-Covid levels, just as European gas prices are still above their pre-conflict levels. This hints that there could be a degree of permanence, or sustainability, to the price disruptions caused by the pandemic and the conflict in Ukraine.

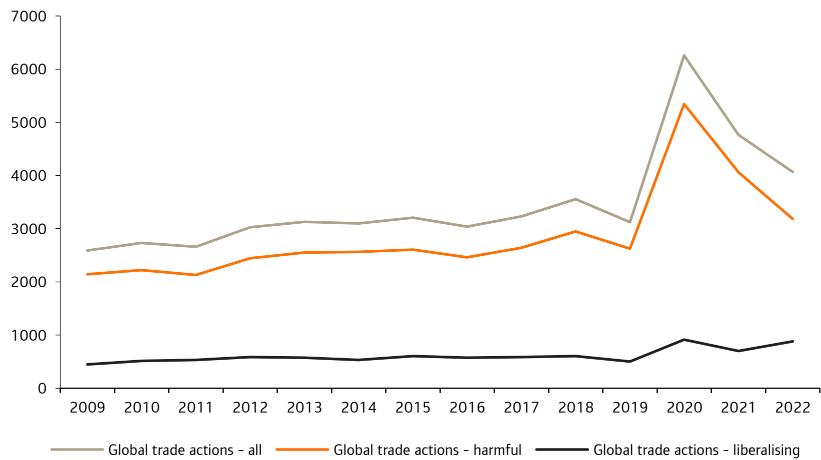
Figure 2: Container freight prices fall but are still above pre-Covid levels



Source: Freightos

But it is not just here where we see evidence of a structural rise in inflation in advanced nations. Two inflationary impulses, deglobalisation and deteriorating demographics, were developing even before the pandemic struck and the conflict in Ukraine began. The pandemic has placed these adverse deglobalisation and demographic effects on steroids, with the result that some of the recent rise in inflation is likely to remain persistent.

Figure 3: Trade tensions remain high



Source: Global Trade Alert

Deglobalisation pressures really started with the trade war between the US and China, which began before Covid under the previous US administration. And far from easing, these strains have been exacerbated by the pandemic, the conflict in Ukraine, and the Biden-led White House's tough trade stance. As a result of this, the number of harmful

trade actions last year, while down from 2020, was still above the pre-Covid average. We don't think that these actions are likely to fall very much as governments fret about the security of supply chains and attempt to re-shore as much as possible, or 'friendshore' as it is called, to try to protect important supply lines. All of these actions seem likely to imply a higher level of structural inflation than existed before the pandemic and the conflict in Ukraine. For it stands to reason that, in the previously highly globalised world, firms sourced supplies from the cheapest place possible, often China. But now, with supply security more important, the re-shoring, or friendshoring, that seems to be taking place looks likely to imply higher prices on a structural basis, not just a cyclical basis.

There is also likely to be structurally higher inflation resulting from demographic factors. Projections of dependency ratios (the ratio of retired people to those in work) suggest a significant increase in coming decades in advanced countries as populations age. In fact, this sharp acceleration has already started in the past decade or so. Hence, even before the pandemic it has seemed reasonable to assume that demand in advanced countries could rise relative to supply and so lift structural inflation. This is because those who have retired contribute only demand to the economy, compared to working-age people who contribute both supply and demand. One way out of this problem is to tap more abundant labour forces overseas but, as we've just mentioned, the trend towards deglobalisation is pushing in the opposite direction. What's more, some countries, such as China, that have been a ready supplier of cheap labour in the past, are running into their own demographic constraints.

Figure 4: Dependency ratio seen rising sharply

Source: OECD

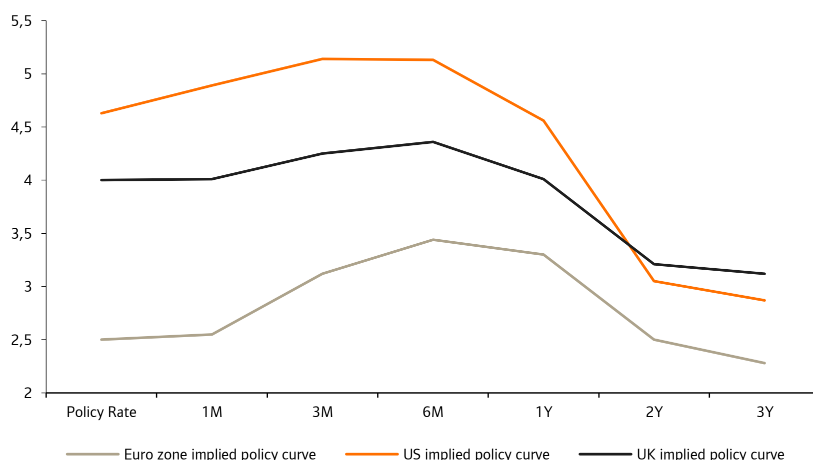
If all this is not problematic enough, the pandemic has led to a very substantial decline in labour participation due to factors such as ill health and those nearing retirement age who are choosing to retire early. The consequence has been a surge in vacancies and, even though the fall in demand in the advanced economies bought on by higher central bank policy rates is bringing down these vacancies, they still remain very high. That's why we said earlier that if countries do experience a recession this year, it will be pretty unique because the unemployment rate is unlikely to rise very much, if at all. This situation gives workers significantly more power to demand higher wages than before. Some of this power is being exercised in a cyclical sense because inflation has soared, real wages have fallen, and workers now want to catch up. Industrial action, such as strikes, has increased very significantly, rising to more than decade highs in the UK, for instance. But what's important to bear in mind here is that even once these cyclical wage demands have ebbed, as actual inflation comes down, there will still be a structural labour supply problem that's likely to keep wages – and prices – higher than they were before the pandemic. In our view, this discussion leaves a number of important questions, particularly about monetary policy. For while demand restriction can, and will, lead to a cyclical decline in inflation, the structural inflation outlook is worse than it was before the pandemic and the conflict in Ukraine. If it is only slightly worse, meaning that major central banks such as the Fed, ECB

and BoJ can consistently hit their 2% inflation targets, rather than undershoot as before, then the outcome will be a positive one. But if, as seems more likely, factors such as deglobalisation and demographics cause a persistent overshooting of 2% inflation targets by some distance, we have to ask whether central banks will be prepared to tighten sufficiently to keep demand permanently lower, or whether they will fold, accept the rise in prices, and cut policy rates.

Monetary policy tussle

Financial markets are betting that major central banks, particularly the Fed, will fold, or 'pivot' before the end of the year and turn rate hikes into rate cuts. The Fed for its part, and other central banks as well, maintains that early rate cuts are out of the question. The answer to who is right on this one could dictate the performance of global asset prices this year, including currencies. It seems understandable that markets have got ahead of central banks in predicting rate cuts. For one thing, peak rates at the end of a tightening cycle are traditionally not held in place for a long period of time, most often between 6 months and a year in the Fed's case. This is because the rate hikes tend to slow the economy, bring down inflation and, in some cases, create recessions. And, for the Fed, which has a goal of maximum employment as well as price stability, there soon comes a point when inflation moves back down towards the target but the unemployment rate rises and jeopardises the full employment goal, so pushing the Fed to cut rates again. This has been the playbook of many a tightening cycle in the US and other countries and the market is basically assuming it will play out again this time, as Figure 5 suggests.

Figure 5: Market sees rates close to a peak and then falling



Source: Bloomberg

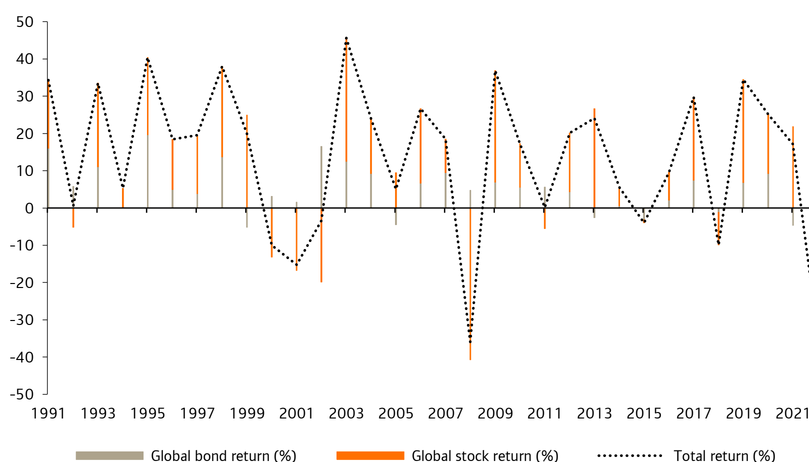
However, there is a saying that 'history is a good guide to the past' and we think that this applies here, and it is the reason why we think central banks are more likely to 'win' this particular battle by keeping policy rates higher for longer than the market expects. The first point is that all prior tightening cycles by major central banks since the 1980s have not involved the sort of rise in inflation we are seeing now. In the past, central banks seemed to act in advance of rising inflation and, in fact, the inflation they feared never materialised. That's why the Fed, in the summer of 2020, changed its monetary policy strategy so that it adjusted policy on the basis of actual inflation data and not its own forecasts. This time is different because inflation has soared and central banks have been left behind. We can also add that central banks started the rate-hike cycle from a point of extremely low rates and extra monetary largesse from all the quantitative easing undertaken since the global financial crisis. These points alone would suggest maintaining higher rates for longer. But there's another factor as well, which is the labour market, as discussed earlier. Central banks usually rely on some rise in unemployment to cool demand whenever they hike rates. Often these increases in unemployment can be large and they help prevent excessive wage growth. Again, this is not happening in the current cycle. In the US, for instance, the unemployment rate is still below the Fed's best guess of the full-

employment rate, which FOMC members put at 4%. Other countries are in a similar situation and hence their fight against sustained inflation is made all the more difficult by the tight labour markets. This too suggests a higher-for-longer strategy. Our view is that the Fed will likely take policy rates up to a peak of 5.5% and won't start to cut until 2024 but, when rates do start to fall, the cuts are likely to be swift, with the fed funds target close to 3% by the end of 2024. Similarly, we expect the ECB to lift the key refinancing rate to 4%, which is above market expectations, and hold peak rates for longer than the markets are pricing right now.

Weakness for asset prices?

Does it follow from this description of monetary policy, particularly from the Fed, that asset prices, meaning stocks and bonds, will have another poor performance like last year and that the dollar will rally as it did through most of 2022? Not necessarily. We feel that even if central banks take rates higher than the markets are pricing and hold them there for longer, it won't prevent a recovery in asset prices this year and weakness in the dollar. However, this is on the basis that central banks hold rates high for longer because they show patience in waiting for clear signs of inflation's defeat and that inflation continues to slowly decelerate. Should rates stay high because inflation starts to rebound again, possibly leading to the re-starting of the rate hike cycle later in the year, then the outlook would be much worse for asset prices and much better for the dollar.

Figure 6: Poor asset returns in 2022



Source: Bloomberg

Last year saw a particularly poor performance from asset prices and a correspondingly good performance from the dollar as its safe-asset allure lifted the currency as asset prices fell. But in Q4 last year, and so far this year, asset prices have rebounded and, while we don't doubt it will be a bumpy ride, we do see bonds and stocks making gains and the dollar falling. This is despite high inflation, possible recessions, and some persistence in high policy rates. This might seem a strange call but we suspect that the market will focus more on the longer-term prospects for lower inflation, rebounding growth, and policy easing later this year and into 2024. A lower dollar, to the tune of some 5%-10% against other developed currencies, should serve to aid the rebound in asset prices, and perhaps even more so in the riskier segments of the asset-price space.

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EM outlook for 2023

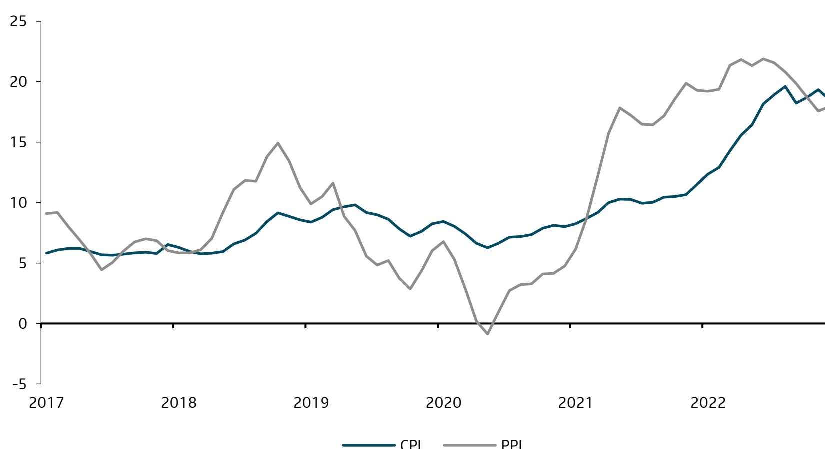
Surprisingly optimistic, but guarded

2022 was a tough grind. Sure, in contrast to the waves of 2020 and 2021, which saw the deepest global downturn on record followed by the strongest rebound, the surf seemed moderate. Global growth came in at around 3.1% - broadly in line with the pre-pandemic five-year trend. Nevertheless, investors will know that paddling out into choppy waters last year was remarkably testing. The global economy was hit by multiple adverse shocks: tightening financial conditions, supply and demand issues spilling into labour markets, record-levels of inflation, whipsawing commodity markets, a steadily rising US dollar, on-going waves of COVID-19, lingering concerns around debt levels is riskier corners, and, of course, Russia's invasion of Ukraine. Assessing the swell this year, despite some pretty dire warnings from lifeguards at the IMF and global central bankers about the difficulties that lie ahead for the global economy, financial markets seem rather upbeat – especially when hitting the beaches in emerging markets in 2023. And at this juncture, we too find ourselves reasonably optimistic. Many of the drivers for emerging markets poor performance last year go into reverse this year, most notably, global inflation is set to fall, easing pressure on central banks, emerging market growth alpha will widen, currencies will be firmer, risk appetite and financial flows will be supportive, attracted by favourable valuations, with the outlook bolstered by the sharp improvement in the outlook for the Chinese economy (around which many emerging markets orbit). Of course, events last year made plain that rising geopolitical tensions loom large, threatening to sweep away forecasts like a tidal wave. The political calendar is rather full (with several pivotal elections in important consequential economies). And, despite lowering our default expectations, several smaller and high-risk countries still face acute debt fragilities.

Global disinflation this year is an important steppingstone for economic resilience

Global inflation has been increasing by its fastest pace in a generation. Sure, we had expected the post pandemic inflationary pressures to continue as supply interruptions to production would continue to push costs higher, and bleed into consumer prices. Russia's invasion of Ukraine compounded matters, leading to an even strong rise to core inflation. With each passing month, despite broad-based tightening of monetary policy, inflation rates printed higher and higher. Weighted by GDP, the inflation rate for the largest 25 emerging market economies nearly doubled from 11.5% in January 2022 to 19.5% in August. Promisingly, the pressures began to fade in October. Most are now on the down-slope of the cyclical peak. In fact, just four of the 25 largest emerging markets – Colombia, Egypt, Philippines, and Saudi Arabia – recorded cyclical highs in December 2022. So, whilst inflationary pressures are still at elevated, they have eased considerably.

Figure 1: Inflationary pressures in large emerging market economies have peaked



Source: CEIC & SBR

Looking ahead, inflation in emerging markets is expected to moderate from around 10% in 2022 to 6.5% in 2023, with sharper disinflation in H2:23. Supply chain disruptions will be far less damaging to global production than in recent years – especially due to China's turning the page on the pandemic. Since December the Baltic Dry Index – a barometer for the price of moving major raw materials by sea – has plunged from USD1,700 in December 2022 to just USD700 in February 2023. As a result, for instance, the cost of a 40-foot shipping container from China to Kenya has dropped to USD3,500 – half of what it was at the height of the pandemic container supply was locked down in Chinese ports. In addition, the impact of the sharp increases in commodity prices in the aftermath of the Russia-Ukraine conflict will start to reverse, meaning base effects in food and energy inflation will rescind some inflationary pressures.

Figure 2: Baltic dry index

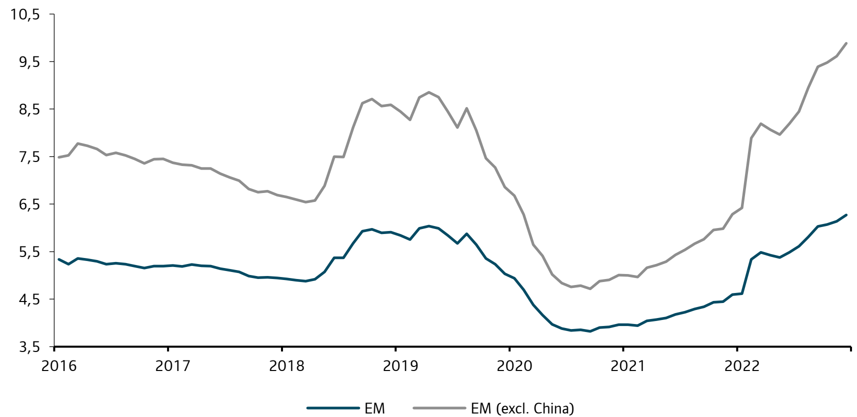
Source: Bloomberg & SBR

More benign inflation suggests that rate hikes in emerging markets have mostly run their course

For the past two years, despite the compelling need to support weak domestic economies, central banks in emerging markets have had no option but to safeguard prices and maintain external stability, tightening policy rates. In fact, a few central banks had proactively started to hike rates back in 2021 – earlier than advanced economies. Across the emerging world we have seen a high degree of monetary synchronization across the emerging market landscape (just China, Russia and Turkey refrained from raising interest rates). Also, the tightening has been the steepest rise in policy rates in over two decades.

Again weighted by GDP, policy rates in the largest 25 emerging markets universe increased by 3.4pps in 2022 alone – twice the magnitude experienced in 2021. Promisingly, now looking at more benign inflation trajectories, virtually the entire group have completed hiking cycles. Currently consensus is that half of the 25 largest economies will be able to ease rates in H2:23. Even though that is likely to turn out to be optimistic, monetary policy across the board should be able to stay on hold in 2023.

Figure 3: Synchronised and large hikes now in the rear-view mirror



Source: CEIC & SBR

US inflation, interest rates and the USD supportive of risk assets in 2023

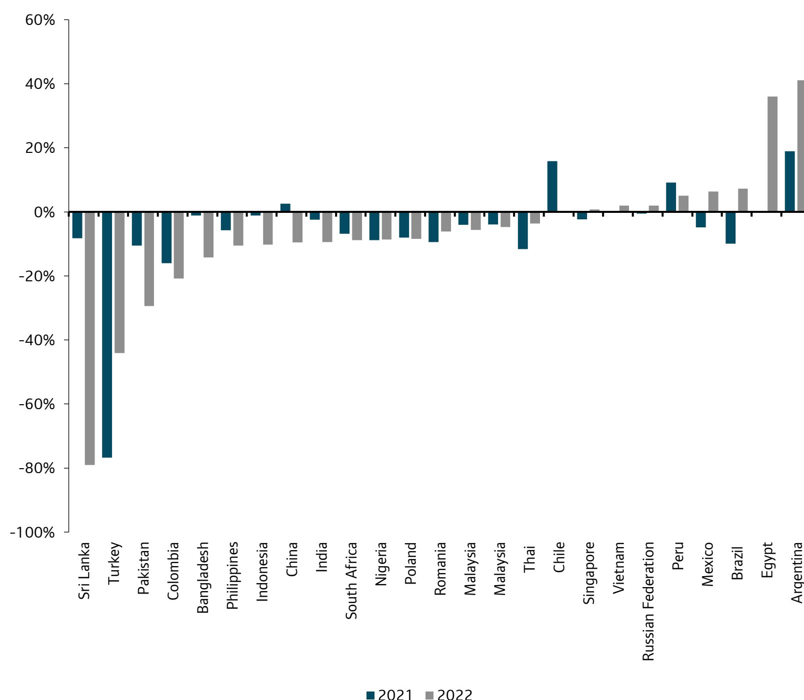
Much is contingent on the path of inflation and interest rates in advanced economies, shaping the decisions made by their respective policymakers. That means investors will have to maintain a sharp focus on the utterances, meeting minutes and communication from members of the FOMC, ECB, BOJ and other key central banks, searching for clues on the relative pace of their respective rate hiking cycles. Last year decisions made in these economies have made international liquidity far less abundant and more expensive, and the USD has strengthened forcefully. From January through October 2022, the USD index appreciated by 16.4%, which is the fastest pace since 2015, rising to the strongest level since 2002.

Figure 4: USD's tear has likely come to an end

Source: Commodity Research Bureau & SBR

On the other side of that coin, emerging market currencies have been on the back foot, threatening additional capital outflows, narrowing domestic policy choices by placing further upside pressure on inflation, and exposing many auxiliary idiosyncratic internal fragilities. Even though emerging market currencies have been depreciating against the USD since 2014 – albeit with some pauses, most notably between Dec 2016 and May 2018 – the pace of depreciation in 2021 was sharp. And in 2022 was even sharper.

Figure 5: EM currencies battered over past two years



Source: CEIC & SBR

Promisingly, for the first time since the pandemic, cost-push pressures and prices in advanced economies will drift lower. Whilst it is quite likely that in the US (and elsewhere) inflation will be more persistent than many expect, central banks are close to ending their respective tightening cycles. And, we believe that the Fed is closest of the bunch to ending its tightening cycle. Overall central banks will probably have to hold rates at higher levels and for longer than most forecast, but as long as the extra wait-time for rate cuts is not too long, asset prices should bounce back after such a rough 2022 and the USD should continue its recent decline.

Advanced versus emerging market growth alpha widening in 2023

Like the path of inflation, less hawkish global central banks and the path of currencies, several external factors, that proved to be drivers for the poor performance of emerging market assets and sovereign credit, will move in the opposite direction in 2023. In addition, economic growth in emerging markets is expected to beat advance economies by the most in nearly a decade, accelerating marginally from 3.7% in 2021 to near 4% in 2023. In contrast, developed economies are expected to slow sharply – perhaps to levels not seen outside the global financial crisis or the pandemic since 1982. The concern is that the US may follow the eurozone and UK into recession. At the very least, construction demand in advanced economies is likely to remain weak this year, and we think that any recovery in global industrial activity is likely to be a 2H23 story. The developed-market growth projections mean that global demand for goods is likely to be soft, and global trade is expected to slow sharply, from 3.5% in 2022 to just 1.0% in 2023.

Figure 6: GDP growth differential between advanced and emerging markets

Source: IMF & SBR

The growth rate of emerging markets is not nearly as lofty as it once was

The largest 25 emerging market economies are expected to expand by an average of 3% in 2023, down from 4.2% in 2022 and well-below the pre-pandemic average trend growth of 4.5% each year. The group is increasingly diversified too. Akin to the varied impact of reverberations during the global pandemic, different speeds of recovery among emerging markets are expected to continue in 2023. In general terms, around half the world's emerging market and developing economies are expected to expand more slowly this year than last year. Around a dozen fewer will also be expanding by above 5%. Latin America is expected to experience the most forceful slowdown, from 3.4% in 2022 to 1.7% in 2023, lagging the other regions. Leading the pack is Asia, which will accelerate from 4.3% in 2022 to 5% in 2023. In the middle is Sub-Sahana Africa, expected to tread water, expanding by the same speed as last year, growing 3.7% in 2023. Also, out of the largest 25 emerging market economies just Bangladesh, China, India and Vietnam are expected to expand near or above 5% in 2023 – fewer than in 2022. In fact, most of the largest emerging market economies are expected to expand by less than 4% over the next three years.

An important reason for optimism towards emerging markets is that we enter the year uncharacteristically optimistic for Chinese growth in 2023

Since mid-2020 the looming question has been how China is planning on eventually unwinding its Covid policy, which had held the economy ransom and drained increasingly scarce fiscal resources. Gradualism had always seemed to be the most likely option, but instead authorities have dramatically changed tact. Discarding the pandemic policy playbook fundamentally changes the outlook for the Chinese economy over the next 12 months. We expect households to finally get back to normal life, supporting consumption and services through the year, feeding into business sentiment. Even though activity may only gradually recover during Q1:23, the robust and supportive base effects – now no longer confined to Q2, instead reverberating throughout the year – combined with the abrupt jettison of the Covid-pandemic policy playbook and a more steadfast pro-growth

policy tilt, suggest that a robust rebound in economic activity will occur in 2023 – sharper than current consensus forecasts predict. In addition, the obvious takeaway from the China Economic Work Conference in December, which sets the economic policy agenda for 2023, is that policymakers are far more focused on delivering growth in 2023 than they have been in recent years, which suggests some support for real estate developers and infrastructure investment, and taking a more constructive stance towards the platform economy is likely, too. However, even though Chinese reopening adds muscle to the emerging market outperformance, the nature of the recovery will be less supportive for emerging markets than yesteryear. In fact, in our reckoning, commodity markets already reflect both peak interest rate expectations and improving Chinese industrial activity. For many then, the subdued growth in developed markets will be a greater offset – especially those open and EU-linked economies. In addition, eventually, the optimism around China's re-opening will fade, and the reality of China's ongoing structural momentum loss will once again matter more. Then, emerging market assets and currencies will need a new catalyst.

Debt levels are elevated, but investment grade credit portfolios remain robust, and even for the riskier markets, debt maturities due in 2023 are limited

Debt vulnerabilities for some economies were compounded in 2022 following the rise in geopolitical tensions and interest rates. Currency depreciation made matters worse as much debt is denominated in US dollars, which is now more expensive. An extended period of higher rates and the recession risk in a few advanced economies suggest that quality credits remain the name of the game. Promisingly, for twin deficit countries we anticipate less acute pressure as commodity prices, which are likely to be range-bound and unlikely to blindly respond to improving data from China as forcefully as before. As it stands, sovereign default risks seem concentrated to a narrow range of smaller and risker countries – many of which are effectively locked out of capital markets. More than half of the 68 low-income countries included in the Debt Sustainability Framework are at high risk of debt distress or are in debt distress. That said, markets are better priced and, fortunately, there is not a lot of debt maturing next year in these at-risk countries.

The political calendar is reasonably full and some pivot elections may have meaningful impacts on risk appetite

Nearly half of the world's largest 25 emerging market economies face elections in 2023. Some will have a greater impact on the economy (Argentina and Thailand), others impact on the prospects for structural reform (Nigeria), but three are potentially pivotal with economic and financial implications, plus reverberations on political and social stability. First, Turks will head to the ballot box in June. President Tayyip Erdogan is facing the biggest political challenge of his two decades in power. Years of unorthodox monetary policy have seen many investors cut exposure, and a change in leadership could mark a turnaround. Second, in October, Pakistan's general election could lead to a major upset. Opposition leader Imran Khan's high popularity, combined with general discontent over the ruling Shehbaz Sharif-led Pakistan Muslim League Nawaz government, is a volatile mix. Third, also in October, a close race is expected in Poland, where the opposition may form a majority government, ousting the country's ruling party, recasting Warsaw's tense relations with Brussels.

Then of course, there is the lingering threat of further breakdown in relations between China and the US

A year ago, the global economy and financial markets were profoundly shaken by Russia's invasion of Ukraine, throwing out of whack all expectations for advanced and emerging market economies alike. True to long-standing historical habits, trade disruptions and soaring commodity prices were felt forcefully by more import-dependent emerging market economies – especially, for instance, the 25 African economies that import more than one-third of their cereal from Russia and Ukraine. The war's evolution in 2023 will

continue to hold global markets hostage – whether that would be a resolution, continuation, or escalation.

Relations between China and the US remain in flux at the political, economic, military, and ideological level. Increasingly, the US and China are talking past each other on a wide arc of issues, and the disconnect is leading to a very unstable new baseline. Mutually hostile substantive policies have become the norm, with both determining engagement in zero sum terms. Eventually, the broader shift towards multipolarity will prove inevitable, but the path ahead is charged, and uncertain, and emerging markets may find themselves caught in the cross-hairs before the new global geopolitical landscape clarifies itself.

Conclusion

For emerging markets much will depend on inflation, policy and economic growth in advanced economies, and the path of the USD and global risk appetite. We do expect attractive yield opportunities in emerging markets and improving growth prospects should continue to encourage market participants to allocate capital toward the emerging markets in 2023. These portfolio and capital flows to emerging markets will support global risk assets claw back a good deal of the poor performance that we saw last year. We have also lowered our default expectations for the broader group, but several smaller and high-risk countries – many in sub-Saharan Africa – face acute debt fragilities. Of course, events last year made plain that rising geopolitical tensions loom large, so interactions between the US and China will be watched closely, and we are watching a number of pivotal elections in large economies that have implications for social, political and economic stability.

Jeremy Stevens[#]

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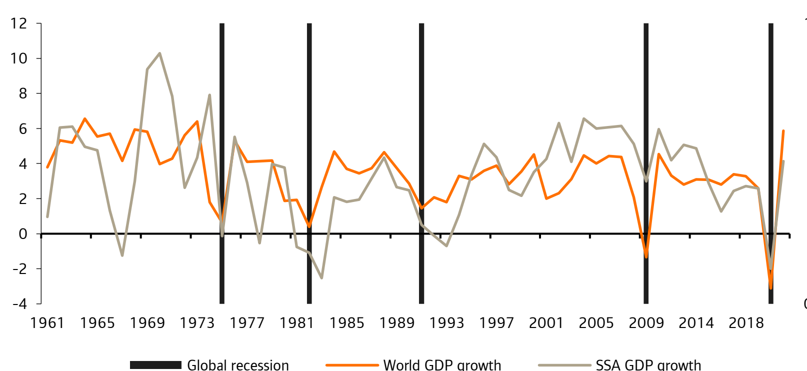
Sub-Saharan Africa

Growth may recover in some markets despite the global slowdown

With a global economic growth slowdown on the horizon, there are naturally now growing concerns around economic growth in Sub-Saharan Africa too. Global growth in 2023 is set to expand at its slowest pace over the last 15-y, barring the recessions of 2009 and 2020. The World Bank expects global growth to ease to 1.7% y/y in 2023. Moreover, in its Oct 22 World Economic Outlook, the IMF also sees global growth falling to 2.7% y/y in 2023, from 3.2% y/y in 2022, although they will probably also revise this forecast downwards too.

As per Figure 1, while GDP growth in SSA tends to broadly mirror the trend of global growth, this is perhaps largely linked to the commodities cycle. Notably, Nigeria and South Africa account for nearly 50% of SSA output, whereas commodity-price shocks tend to accompany global recessions or economic slowdowns. This would inevitably weigh down growth in both Nigeria and South Africa due to their reliance on commodities and, by extension, external demand, dragging lower the overall SSA average.

Figure 1: Global vs Sub-Saharan Africa GDP growth



Source: World Bank

Crucially, while we expect oil prices to remain somewhat volatile in 2023, we expect an upward bias. Moreover, while concerns around moderating global growth may place downward pressure on oil prices initially, the recent reopening of China's economy from its previous zero-Covid policy, combined with the expected tight supply stance from OPEC, underpins our bullish view on oil prices. Furthermore, with the US government having already outlined their intentions to replenish their strategic oil reserves if prices fall to around USD70/bbl, demand for oil will probably bounce higher again — even if prices begin to ease owing to slower global growth concerns.

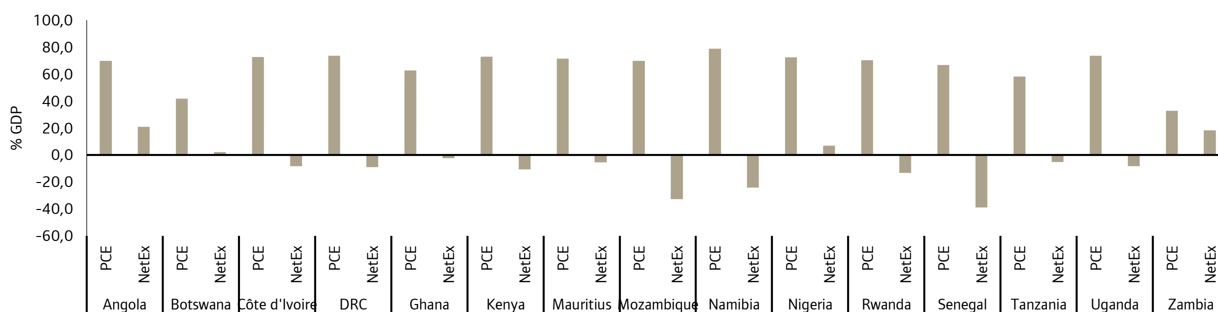
A useful way to assess how detrimental a global slowdown in growth will be for Africa, is by looking at certain components of the GDP by expenditure breakdown, such as private consumption expenditure (PCE) and net exports (Netex). PCE gives one an indication of how reliant growth is on domestic demand, whereas Netex may suggest the reliance on external demand. Admittedly, economies that have a relatively higher share of Netex may be more susceptible to abating economic activity should global growth decline. Alternatively, economies where PCE is the dominant driver of growth may be less exposed, although not totally immune to slower global growth.

For example, economies in East Africa tend to be more resilient during previous periods where global growth has eased. PCE accounted for an average of 75.7% of overall GDP growth between 2015 and 2021 in Kenya, while Netex was an average of negative 9.7%. Similarly, PCE accounts for around 74% in Uganda and 60% in Tanzania, with net exports also in negative territory. The East Africa region is a net importer of oil. Thus, slower

global growth, which tends to ease oil prices, provides some tailwinds for PCE as household incomes are boosted.

However, this doesn't imply that East Africa will be insulated from slower global growth. For instance, Kenya's main export market for horticulture and floriculture goods is Europe, while nearly 60% of diaspora remittances come from North America. Moreover, Tanzania's main export markets are also outside SSA for its cotton, tobacco and cashew nuts. Hence, a waning in external demand may still pose downside risks to growth.

Figure 2: private consumption expenditure (PCE) and net exports (Netex) 2021



Source: Standard Bank Research; Various statistical agencies

Crucially though, we expect the growth outlook in East Africa to be largely dependent on whether drought conditions experienced last year dissipate in 2023. The severe drought was further exacerbated by the rising geopolitical tensions which increased the prices for both wheat and fertiliser imports. That said, our baseline assumption sees an improvement in weather conditions, which should revive agricultural productivity and spur PCE in 2023.

In Kenya, we see GDP growth recovering to 5.5% y/y-5.8% y/y in 2023, from an expected 4.6% y/y-4.9% y/y in 2022. Favourable base effects and better weather conditions should support growth over the coming year. Refreshingly, the new government is keen to revive agricultural productivity, a likely highly positive move for medium-term growth prospects. Concerningly, the authorities still have to deal with a massive arrears stock of over KES500bn. If impending bills rise further over the coming year, this may also subdue private sector economic activity in 2023.

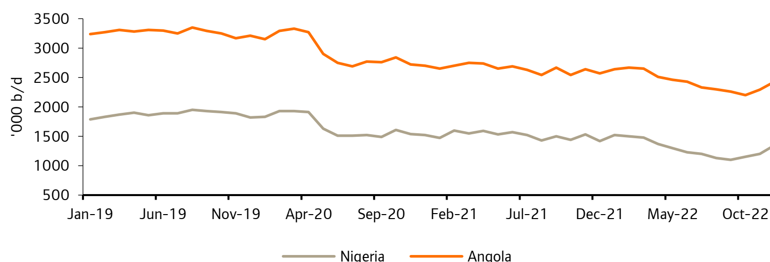
Growth in Uganda is also likely to be robust over the next 2-y. We see GDP growth rising to 6.0% y/y-6.4% y/y in FY2022/23 and 6.5% y/y-6.8% y/y in FY2023/24. The government may need to finalise all the funding for the crude oil pipeline in 2023 for the 2025 first-oil target to be achieved. Environmental concerns have now stalled financing for the construction of the pipeline. Any further delays in funding will likely push out first oil further out, to 2026-2027, and perhaps the surge in growth we currently expect may be more measured. The construction of the crude oil pipeline will underpin growth once it commences, with other ancillary investment linked to the oil sector also likely to meaningfully spur investment. Moreover, a US-based consortium took a final investment decision (FID) in Dec 22 for an oil refinery in Hoima Bay. This USD4.5bn refinery is expected to have a 60k bpd peak-refining capacity when operational.

GDP growth in Tanzania will probably also recover to 5.9% y/y in 2023, from an expected 4.5% y/y in 2022. The government's new pro-business posture is already showing signs of a revival in private sector economic activity, while the possibility of the host government agreement (HGA) being signed in 2023 with gas companies may be the final hurdle before the FID for the nearly 60bn tcf LNG project can be secured.

Growth in Nigeria and Angola is perhaps more susceptible to decline on the back of easing global growth due to the structure of their economies being more skewed towards their oil

sectors. In fact, Netex were positive in Nigeria, averaging 16.2% between 2017 and 2021. However, we don't expect a durable capitulation in oil prices in 2023, so perhaps abating external demand may after all not be that detrimental for growth. In fact, despite a relatively higher share of net exports, PCE roughly still accounts for a lofty 65% and 70% in Nigeria and Angola respectively over the past 5-y.

Figure 3: Oil production



Source: Bloomberg

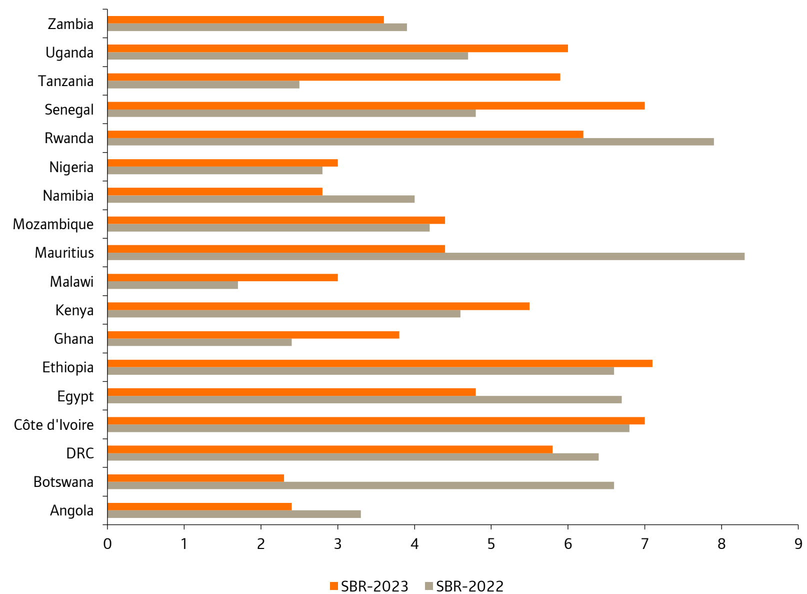
We expect growth in Nigeria to marginally tick up to 3.0% y/y in 2023, from 2.8% y/y in 2022. Growth will still primarily likely be driven by the non-oil sector in 2023. Despite a recovery in Q4:22, oil production has remained weak, declining to an average of1.29m bpd in 2022, from 1.51m bpd in 2021, constrained largely by oil theft and pipeline sabotage. The authorities are attributing the recovery in oil production in Q4:22 to a partnership between the Nigerian National Petroleum Company (NNPC) and a security company owned by Oweizide Ekpemupolo (Tompolo), to tackle offshore oil theft in the Niger Delta region. If this trend from Q4:22 persists, indeed there may be upside risks to oil-sector-driven growth in 2023. Further, per management guidance, the Dangote refinery may begin operations in H2:23. If so, mining sector output and net exports may be boosted over the medium term. The refinery has a peak capacity of 650k bpd. However, current FX liquidity challenges still pose a risk to the industrial sector and may continue to restrain household consumption over the coming year.

Growth in Angola may now decline to 1.8% y/y in 2023, from a preliminary estimate of 2.9% y/y in 2022. Investment in the oil sector remains lacklustre, which may not help revive stagnating oil production (which remained more or less flat at around 1.1m bpd in 2022). However, the government has made efforts, culminating in notable reform, in their quest to diversify the economy away from oil. For instance, the fight to eliminate corruption has been noticeable, which has resulted in Angola being withdrawn from the 'grey list' under the Financial Action Task Force (FATF). Furthermore, VAT for goods at 14% has been introduced to help diversify governmental revenue sources away from oil reliance, with privatisation efforts also noticeable. The government is also looking to create a more conducive environment for oil companies following the formation of the Angola Oil Gas and Biofuels Agency, which separates it from Sonangol. Indeed, this should help foster a more favourable and predictable regulatory framework for the oil sector, which may help underpin waning investment in that sector. Declining inflation will also probably help boost private consumption in 2023, although fuel subsidy reform, which is draining public finances, still needs to be withdrawn.

Moreover, GDP growth in Mozambique will likely modestly rise to 4.2% y/y in 2023, from an expected 4.1% y/y in 2022. Positively, Mozambique officially became an LNG exporter in Q4:22 from the Coral South Floating LNG project (which is a USD10bn investment). The security situation in the areas where gas projects are being developed has improved materially with the presence of regional (SADC) military, including Rwanda since Jul 21. Against this backdrop, we wouldn't rule out Total Energies resuming construction in 2023 during which the project is expected to generate over USD20bn in investment. The third project, led by ExxonMobil for over 15 mtpa of LNG (over USD25bn investment), has been approved by the government, but FID is still pending. It appears that ExxonMobil is waiting for Total Energies to resume construction, which perhaps would be an indication of an ameliorating security environment, before they

progress with their project. Hence, medium-term growth prospects remain highly exciting. However, climate risks continue to pose downside risks to growth given that the agricultural sub-sector accounts for over 20% of economic activity.

Figure 4: 2022 vs 2023 GDP growth forecast



Source: Standard Bank Research

Will tourism recover further in 2023?

With economic growth in advanced economies broadly expected to slow down in 2023, there will be concerns about whether Africa's tourism industry can continue its recovery post-pandemic. As it has been dubbed widely, the era of revenge spending has underpinned both tourist arrivals and earnings since 2020. Based on data from the United Nations World Tourism Organisation (UNWTO), even though around 900m tourists travelled internationally in 2022, which was more than double the number from 2021, this was still around 60% of pre-pandemic levels.

As per Figure 5, there is a clear indication that tourism earnings in Africa tend to decline when global growth slows. Prior to the 2020 pandemic, this was the case between 2008-09, 2011, 2015-16 and 2019.

Figure 5: Global GDP growth vs SSA tourism

Source: World Bank

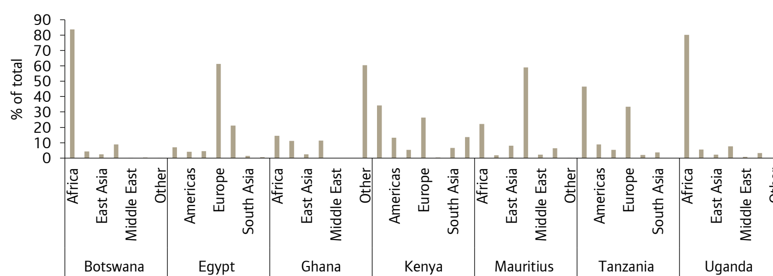
However, given bloated travel expenses due to elevated inflationary pressures relative to a few years back, one may infer that, while tourist arrivals may decrease owing to the likely slowdown in external demand in 2023, tourism earnings may very well continue recovering.

Notably, even in a market such as Egypt where there was a broad expectation for tourism revenue to crash due to Egypt's reliance on Russian and Ukrainian tourists, travel receipts remained resilient, averaging USD2.4bn in H1:22, from USD2.9bn in H2:21.

In Kenya, tourism revenue recovered to USD809.8m in the 9-m to Sep 22, from USD585.9m during the same period in the year before. Similarly, tourism receipts in Tanzania grew to USD1.0bn in H1:22, from USD777.8m in H2:21. Additionally, in the 9-m to Sep 22, travel receipts rose to USD916.3m in Mauritius, from USD61.7m in 2021 during the same period.

Moreover, while some economies in Africa rely more on tourist arrivals from Europe and North America, some rely more on arrivals from the rest of the continent. For instance, arrivals into Uganda and Botswana from other African countries account for around 80%. Also, despite arrivals from Europe and the US accounting for close to 40% combined in Kenya, tourist arrivals from Africa comprised a notable 34%. Similarly, in Tanzania, even though Europe and US accounted for around 42%, Africa arrivals account for a higher 46%. Furthermore, arrivals from North America and Europe accounted for a combined 65% and 62% in Egypt and Mauritius respectively.

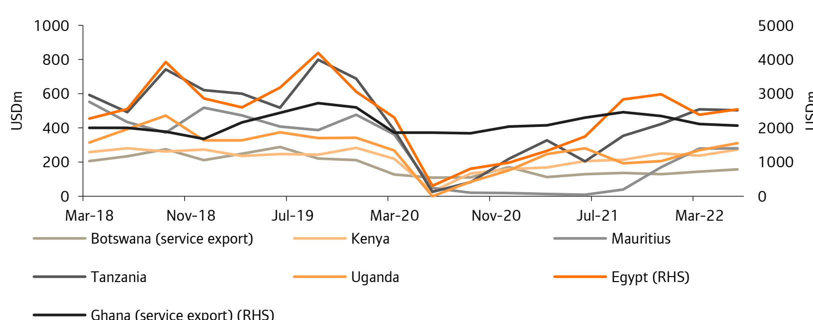
Figure 6: Tourism source markets



Source: UNWTO

Indeed, while there is clearly a risk that markets with a higher reliance on tourists arriving from North America and Europe may see a slight slump in receipts due to weaker global growth in 2023, most economies in Africa won't see a sharp capitulation in tourism earnings, thanks in large part to their large reliance on tourist arrivals from the rest of the continent as well the rise in travel expenses, which may keep tourism revenues and service receipts relatively inflated.

Figure 7: Tourism receipts



Source: Standard Bank; Various central banks and statistical agencies

Debt vulnerabilities may ease for now as access to international capital markets returns

Debt vulnerabilities for some economies were compounded in 2022 following the rise in geopolitical tensions and steep increase in interest rates in advanced economies. The tighter monetary policy conditions, which triggered capital outflows from Africa, not only

resulted in fiscal funding shortfalls but also exacerbated balance of payment (BOP) pressures. Indeed, many African economies had used external funding sources from international capital markets to boost FX reserve buffers over the better part of the last decade. Thus, there was inevitably going to be enhanced external account pressures in 2022.

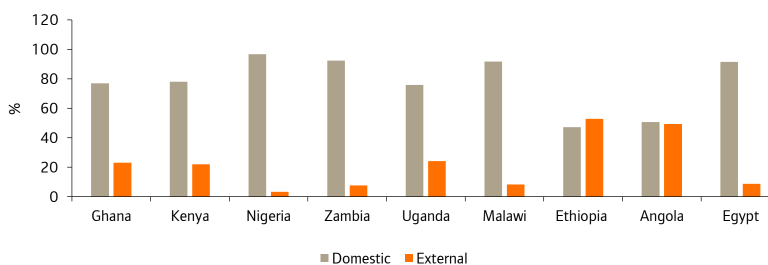
Over the coming year, some African governments may tap international capital markets again from H2:23 or even earlier for some, although the underlying debt vulnerabilities may remain.

Interestingly, due to external funding shortfalls in 2022, fiscal deficits reduced relative to the previous year as expenditure declined. Of course, this was further boosted by higher inflation as tax collections for import duty and VAT were also supported through this avenue.

Just barely a week after the authorities and the IMF reached a Staff-Level Agreement (SLA) for a 3-y USD3.0bn ECF arrangement, Ghana officially suspended repayments for its Eurobonds, other commercial debt and most bilateral debt too on 19 Dec 22. Multilateral creditors have been excluded, for now. The authorities also proposed a voluntary domestic debt restructuring programme for GHS bonds, with an initial deadline of 19 Dec 22, which has now been extended for a fourth time, to 7 Feb 23. The initial proposal on offer looked to exchange existing government bonds into four new bonds that will mature in 2027, 2029, 2032 and 2037. Furthermore, coupons on these new bonds were expected be halted in 2023, before rising to 5% in 2024 and then 10% from 2025 until maturity. But now the government has proposed a coupon of 5% 2023.

Notably, the authorities opted for an extension of maturities and reduction of coupons rather than a haircut on principal to ensure a limited negative impact on the capital positions of the local banking sector. However, much uncertainty remains around local debt restructuring. Firstly, it seems rather clear that external creditors, and perhaps even the IMF, will require a notable amount of local debt to be restructured before they are convinced of debt sustainability being restored. After all, domestic service accounts for around 79% of overall debt service.

Figure 8: Domestic and external debt service % of total

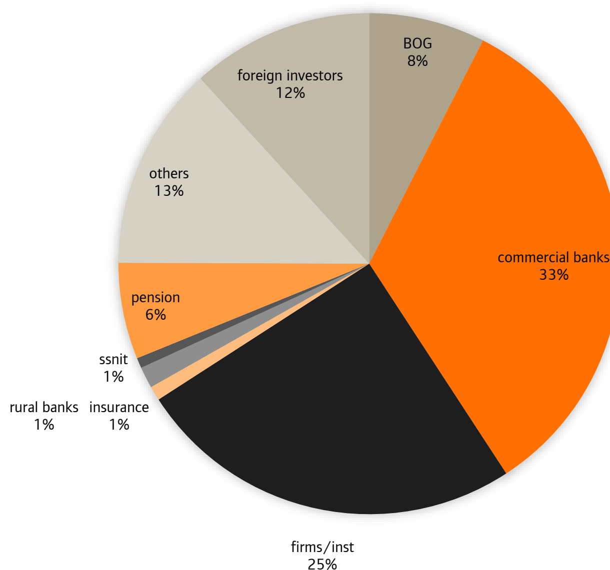


Source: Standard Bank Research; Various central banks and ministry of finance

However, with domestic debt restructuring being voluntary, there are admittedly growing concerns on whether the government can secure an adequate amount of local debt to be restructured to appease the IMF and external creditors but, more importantly, commence the journey towards achieving debt sustainability.

The government had initially excluded pension funds and individual/retail investors from the programme, but the exemption for retail investors was lifted. Domestic debt held by commercial banks, accounts for around 33.0% of the domestic debt stock, Bank of Ghana (c.8%), foreign investors (c.12%), and institutions (c.25%). We estimate that the government would have to restructure at least 50%-60% of local debt.

Figure 9: Ghana domestic debt-holders



Source: Central Securities Depositories

To ensure that the domestic debt restructuring is successful, the authorities are looking to provide incentives for local banks to participate. For example, capital requirement flexibilities will only be accorded to the financial institutions that participate in debt restructuring, but perhaps other incentives too may be needed to embolden a wider participation from the banking sector. Furthermore, the authorities have indicated that they are in talks with the World Bank to potentially arrange a financial sector stabilisation fund of around USD1.0bn, to ensure that financial sector stability is not derailed during the debt-restructuring process.

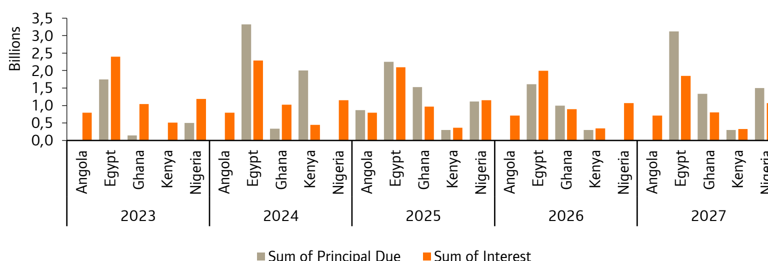
But still, as already seen by the postponement of deadlines over the past month or so, domestic debt restructuring may prove complicated for the government. Admittedly, we suspect that IMF executive board level approval for the USD3.0bn programme will mostly be contingent more on domestic debt restructuring progress than progress on the external side.

However, the government is expected to restructure external debt under the G20 common market framework, which, arguably since inception, has not been swift enough in finalising debt restructuring for countries such as Zambia and Ethiopia (which are still in discussions with external creditors). Yet, some cautious optimism does arise given that, for instance, in Zambia's discussions, there is emerging consensus that China's influence as the single largest bilateral creditor may be delaying negotiations on a debt restructuring deal, which Ghana may not struggle with due to smaller holdings of external debt by China. Still, a successful domestic debt restructuring may be a prerequisite for external debt-restructuring negotiations to progress well and thus for improving the chances of getting IMF executive board level approval sooner in H2:23. Funding under the IMF programme may also prove the catalyst for other multilateral partners to extend budget support to Ghana, similar to what we have seen with other IMF programmes in Africa. Yet, once a staff report from the IMF is published, it may become clearer what level of domestic debt is needed to be restructured and what external debt haircut is expected to restore debt sustainability.

Kenya is another market under the spotlight when it comes to debt sustainability concerns, largely due to the large upcoming USD2.0bn Eurobond maturity in May 24. Of course, a lack of access to international capital markets last year compounded concerns as FX reserves came under pressure.

During a series of recent investor roadshow meetings in Q4 hosted by Standard Bank Research, we increasingly noted comparisons being made between Kenya and Ghana, so much so that Kenya was being labelled as “the next Ghana”.

Figure 10: Eurobond coupon and principal maturities



Source: Bloomberg

There have been a notable number of similarities over the years where both these economies have ramped up infrastructure expenditure, which has bloated fiscal deficits and raised debt to GDP ratios. Also, Kenya, just like Ghana, has increased the uptake of external commercial loans to finance these larger budget deficits over the last decade, as the share of commercial debt as a function of overall external debt grew to around 30% in FY2020/21, from around 7% in FY2011/12. However, Ghana’s appetite for commercial debt spiked to around 51%, from 10.5% in that time.

As a feather in the cap for Kenya, the government has already been on an IMF-funded programme since mid-2021 and is passing reviews under this arrangement. Ghana, on the other hand, seemed slow to approach the IMF in 2022, which worsened both fiscal and external pressures amidst deteriorating global risk which depleted external commercial funding.

One other important differentiating factor between these two markets is their reliance on foreign portfolio investment inflows into their local debt market. While offshore investors held a larger share of local bonds in Ghana of close to 40% in 2019, which has subsequently declined to below 15% now, foreign holding in Kenya’s local debt market has consistently been below 5.0% over the better part of the last 10-y. Even prior to the adverse global risk conditions in 2022, Ghana’s cost of domestic debt service was notably higher than Kenya’s. Bear in mind that the split between debt service is also skewed towards domestic debt service (78%), versus external debt service (22%) in Kenya. However, as seen in Ghana’s case last year, when refinancing and debt restructuring concerns emerge, the cost of domestic debt service can sharply rise in just months.

The new government, since taking over in Sep 22, has been adamant about factoring in debt sustainability risks, and will look to address these issues over the next few years. President Ruto on multiple occasions has stressed that the government was planning to cut up to KES300bn from the budget and lower borrowing needs. He also reiterated that the government was looking to avoid expensive commercial loans in favour of concessional lending from multilateral agencies. And, most fuel subsidies were withdrawn in Q4:22.

These proposed austerity measures were expected to be broadly reflected in a supplementary budget for FY2022/23. Earlier this month, the government released the draft Budget Policy Statement (BPS), which gave an indication of the revised numbers in the supplementary budget. Of course, the supplementary budget still needs parliamentary approval, which may come through at end Jan 23 or early Feb.

The draft BPS shows that the fiscal deficit, excluding grants, with the supplementary budget has been revised lower to 6.0% of GDP for FY2022/23, from the initial budget of 6.4% of GDP. Moreover, while the proposed KES300bn cut in spending wasn’t reflected

in the BPS under the supplementary budget for FY2022/23 in nominal terms, total expenditure declined to 23.3% of GDP, from 24.0% initially.

Net external borrowing for FY2022/23 was also slightly higher in the draft BPS under the supplementary budget, at KES298.4bn, versus KES280.7bn initially. However, for FY2023/24, next external borrowing is slashed to KES198.6bn, with the fiscal deficit excluding grants seen declining to 4.6% of GDP.

External debt principal repayments rise to KES475.6bn in FY2023/24, from KES550.9bn in FY2022/23, largely due to the USD2.0bn Eurobond maturity due in May 24.

But, crucially, much of the fiscal consolidation in FY2022/23 and FY2023/24 is expected via robust revenue collections. In fact, development expenditure is expected to increase to KES796.4bn in FY2023/24, from KES596.6bn in FY2022/23.

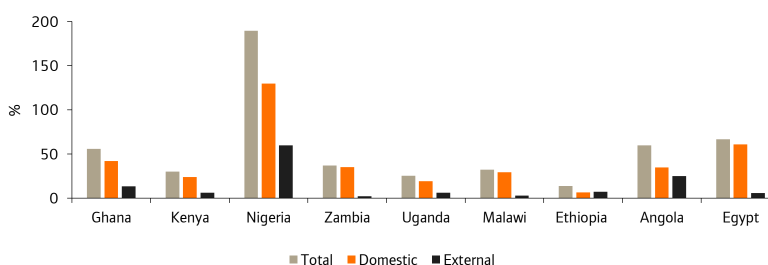
Total revenue is now expected to grow by 14.2% y/y in FY2022/23, from the initial expectation of 11.9% y/y. Moreover, implied growth for revenue is seen at 15.3% y/y in FY2023/24, which is broadly why net external funding has been lowered.

Indeed, these are ambitious revenue targets that may eventually increase the actual fiscal deficit. Still, revenue collections grew by an impressive 22.0% y/y in FY2021/22. However, this was mostly due to Covid-19 tax cut reversals as well as notable improvement in excise tax collection receipts.

More importantly, the revised fiscal numbers in the BPS are closely aligned to the IMF staff report numbers that were published in Dec 22. This may imply limited risk of Kenya failing the next review and losing out on further funding under the programme. However, the biggest risk for debt sustainability this year would be if Kenya failed a review and missed out on funding from the IMF programme.

Based on the numbers from the BPS, the government expects to issue another Eurobond in FY2023/24, perhaps as they hope that global risk conditions could improve from H2:23. However, Kenya's ability to refinance the May 24 Eurobond from another issuance in that market may be contingent on fiscal performance and/or discipline shown before Jun 23. If fiscal restraint is not shown, then refinancing costs may remain exorbitant. Hence, for Kenya we would argue that when it comes to restructuring debt, Kenya has a better fighting chance than Ghana to avoid it but isn't completely out of the woods. An improving global risk environment and better fiscal performance may be the main catalysts to boosting refinancing capability in 2023. For now, we think that the government is seeking to conduct liability management for the May 24 Eurobond from H2:23, rather than leaving it too late in Q1:24.

Figure 11: Debt service % tax revenue

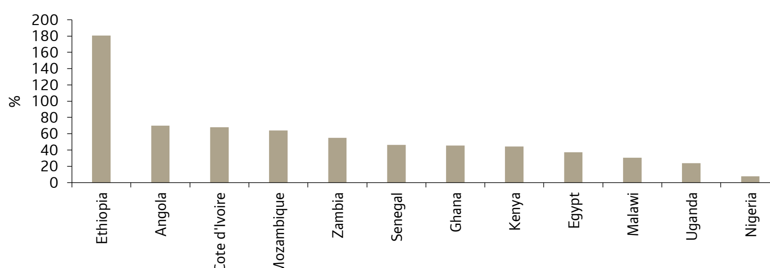


Source: Standard Bank Research; Various central banks and ministry of finance

Despite worsening FX liquidity issues, and a weak tax revenue base, Nigeria's relatively large FX reserves (currently c.37bn) should quell concerns around external debt repayment risks. Per Figure 12, short-term debt service (interest payments and principial repayments in 2023) as a function of FX reserves is 7.8% in Nigeria, compared to Kenya's 44.5% and Angola 69.9%. However, FX reserve accretion has been hindered over the

past year due to subdued oil production and a decline in external commercial debt issuance. Furthermore, there are concerns around how big the CBN's FX swap book is, with some estimating it as large as USD10.0-15.0bn of FX reserves. But still, total debt service as a percentage of tax revenue is around 189%, compared to Kenya's 30.1%, Egypt's 66.4%, and Angola's 59.7%. Domestic debt service accounts for a whopping 97% of total debt service.

Figure 12: Short-term debt service % FX reserves



Source: World Bank; Bloomberg; Standard Bank Research

The Nigerian government plans to securitize about NGN23tr (USD50b) of the CBN's overdraft in 2023. Indeed, the growth in the CBN's overdraft has been at concerning levels over the years, with the total outstanding amount of the overdraft having since breached the regulatory stipulation of 5% of the previous fiscal years' audited revenue.

We believe that the rising level of the CBN's overdraft has supported double-digit growth in money supply (M3) over the years and, consequently, partly driven elevated and sticky inflation. Indeed, headline inflation has been higher than the upper band of the CBN's target (6%-9%) since Jun 15.

Nonetheless, this is a step in the right direction as the recent proposal to convert the long-standing overdraft to long-term securities (a 40-y bond at 9% yield). Once approval of the securitization plan has been received from parliament, it should reduce interest cost on the ways and means overdraft from the current 19.5%, to 9%, which should curb government's high domestic interest costs. Even though securitization is expected to improve transparency around government debt, many would still contest that the risks of inflationary pressures, due to fiscal deficit monetization, may not be totally mitigated by this proposal. Additionally, the total public debt stock will likely increase to about 38% of GDP, from 23% of GDP, with this debt moving onto the government's balance sheet.

Malawi too is concerning from a debt sustainability perspective over the last few years. Malawi's fiscal budget states that the Ministry of Finance is reviewing the country's debt profile with the aim of addressing current concerns about debt sustainability by restructuring debt to lengthen maturities. Domestic debt maturities this year are estimated at MWK989bn, slightly above the planned budget deficit. The government may attempt to roll over the maturing amount. That said, the RBM's net claims to central government (including the ways and means advances and withdrawals of government deposits) may represent another important funding channel. Commercial banks are the largest holders of domestic debt, followed by the RBM and the insurance sector.

In terms of the external debt composition, multilateral creditors account for 64% of Malawi's total external debt, followed by commercial (23.3%) and bilateral (12.7%). Authorities hired a debt advisor back in May 22 and began debt negotiations with commercial and bilateral creditors, according to the IMF. The debt restructuring strategy focuses on commercial debt restructuring and bilateral debt reprofiling. Multilateral debt comprises most of the external debt stock, but foreign commercial debt has shorter maturities, most of which is owed to the Africa Export Import Bank. However, domestic debt service accounts for nearly 92% of overall debt service, implying local debt restructuring if domestic debt liability management proves to be a challenge. Malawi received a 12-m non-funded Staff Monitored Programme (SMP) from the IMF in Nov 22.

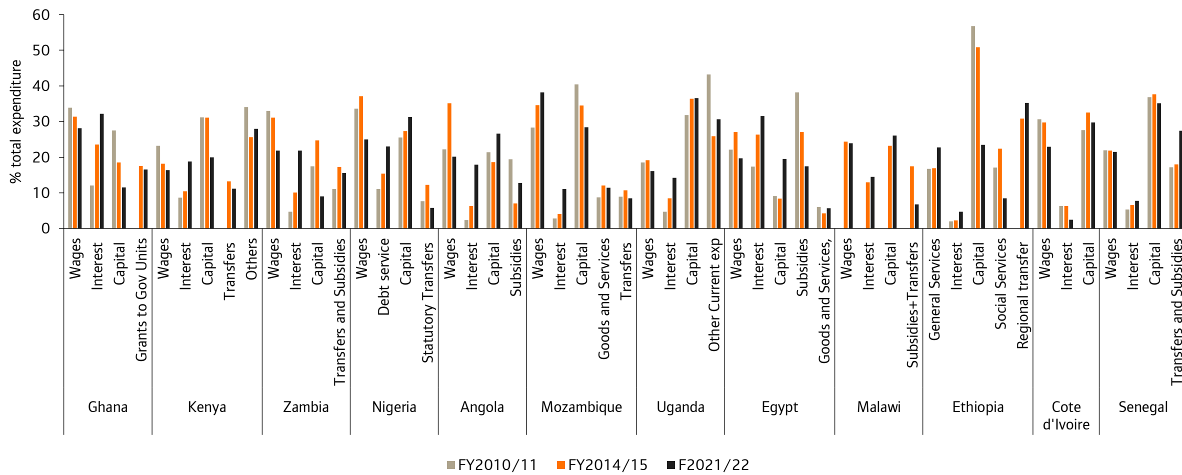
The IMF will perhaps be primarily looking for progress on a comprehensive debt restructuring framework and fiscal consolidation efforts before a funded arrangement is provided.

Meanwhile, Ethiopia's FX reserves have remained persistently low, but steady external debt issuances have assisted improved debt repayment capacity in the past. However, disbursements have dwindled since FY2021. Despite China's debt forgiveness agreements over the past 3-y, we cannot rule out the possibility that the government may default, through the outcome of the G20 Common Framework creditors' committee on debt settlement, or due to increased liquidity pressure from protracted negotiations under the common framework. Eurobond debt accounts for a relatively small share of the overall external debt stock, and it appears that the government intends to default on Eurobond debt repayments as of now. However, the Ministry of Finance reportedly said that the creditor committee could ask holders of commercial debt to defer payment for one to two years, which may trigger further negative rating action by credit rating agencies. Interestingly, despite the common market framework endorsing comparable treatment across all creditors when restructuring debt, there are exceptions under the framework that state that, “when the debt only represents a small proportion of the country's debt burden and when restructuring would unduly interfere with the smooth running of trade”, certain debt can be excluded from a restructuring. Hence, restructuring may still exclude Eurobond debt.

Over the past year in Ethiopia, principal payments have exceeded new disbursements. Crucially, total debt service is estimated at USD2.1bn-USD2.7bn in FY2022/23 and USD3.4bn in FY2024/25 due to a USD1.0bn Eurobond maturity in Dec 24. With FX reserves at estimated at around USD1.5bn at the time of writing, short-term interest and principal repayments accounted for about 180% of FX reserves. But some SOEs are fluid enough to pay their share of the debt-servicing cost, with the large national carrier accounting for the lion’s share of the external debt-servicing costs.

Our base case assumes global risk conditions improving from H2:23, and external and fiscal pressures easing as refinancing capabilities improve for some markets. However, if underlying debt concerns are not addressed through consistent fiscal consolidation efforts, moving away from non-concessional lending to longer-term concessional lending, improving the efficiency of infrastructure spending, and boosting domestic savings, this may be simply a case of kicking the can down the road until the next period where advanced economy will tighten monetary policy again. We’d also expect many African economies to push to receive the IMF’s Resilience and Sustainability Trust (RST) fund this year. Indeed, Rwanda was the first Africa country to receive financing worth USD319m under the RST arrangement in Dec 22, while Malawi was the first to receive USD88.3m under the IMF’s food shock window in Nov 22. However, any country with a funded IMF programme is not eligible to receive funding under the food shock facility. Hence, we’d expect a bigger push towards securing RST funding over the coming year.

Figure 13: government expenditure breakdown



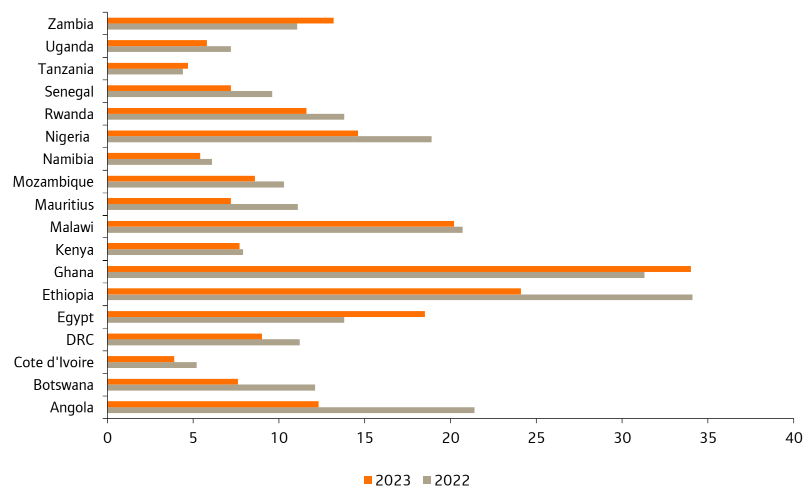
Source: Standard Bank Research; Various ministry of finance

FX and fixed income strategy

Inflationary pressures broadly accelerated in 2022 due to geopolitical tensions causing spikes in food, fuel and fertiliser prices. Also, the stronger USD globally, which exacerbated exchange rate depreciation due to capital outflows, placed further upside pressure on inflation.

However, now, thanks in large part to unwinding base effects, as per Figure 14, on average inflation is likely to ease in most of our markets, perhaps more notably in H2:23. The relative improvement in global supply chains from H2:22 may follow through for the better part in 2023. Already, as reflected by various African market PMIs, supplier delivery times are diminishing in H2:22, with freight charges also dropping.

Figure 14: Inflation forecast



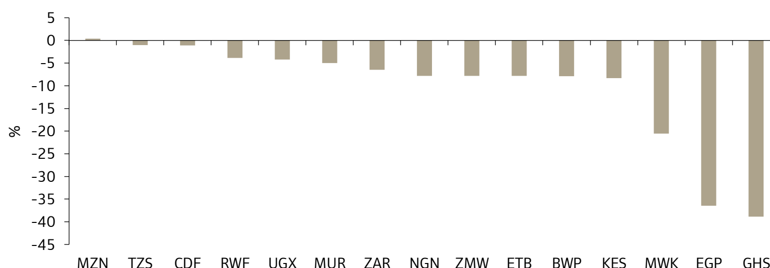
Source: Standard Bank Research

The reopening of China's economy may further underpin the ongoing improvement in supply chains. But that said, the restoration of broken supply chains is perhaps mostly a function of abating demand rather than robust supply. Global demand has been

weakening somewhat from H2:22 and, if demand picked up again in H2:23 and/or H1:24, renewed supply chain pressures may swell inflation again.

Crucially, the risk of geopolitical tensions escalating, both from an increase in aggression from Russia towards Ukraine and China's belligerence towards Taiwan potentially transpiring in a military retaliation, could pose notable risks to the global risk environment and the inflation outlook in 2023.

Figure 15: Currencies movement against dollar 2022

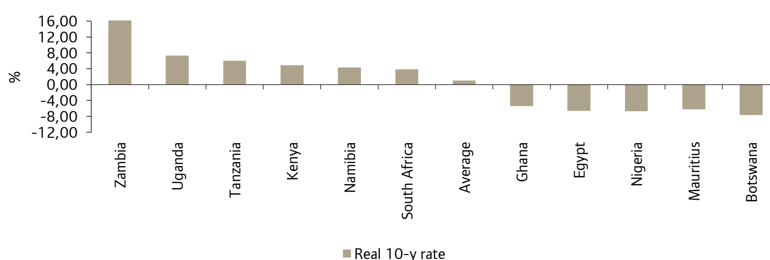


Source: Bloomberg

But still, for the most part of H1:23, bar perhaps Angola and Uganda, most MPCs may maintain a hawkish bias. Thereafter, as inflation will likely begin to moderate from H2:23, there may be an accommodative bias during H2:23-H1:24.

Zambia is one of the few exceptions of the markets under our coverage where inflation will likely rise this year. Indeed, base effects will be somewhat unfavourable as inflation declined last year despite increasing in most other markets. Furthermore, the ZMW may also come under some pressure in H1:22 as portfolio investors begin to take profit on their ZMW government bond trades, while a power tariff adjustment is also likely to place upside pressure on inflation in 2023. This will likely prompt the MPC to begin hiking rates (after maintaining a neutral stance in 2022).

Figure 16: Real 10-y rates



Source: Bloomberg

Therefore, both yield entry and FX levels are likely to improve for ZMW bonds in H1:23, emboldening us to wait before recommending duration in this market again, potentially in H2:23.

The government finally secured an Executive Board Level approval from the IMF in Aug 22 for the USD1.3bn 38-m ECF arrangement, after having reached a Staff-Level Agreement in Dec 21. However, it seems pretty clear that the IMF is looking for further progress mainly with external creditors, before Zambia can pass the upcoming programme reviews in Apr and Oct 23. Hence, if the ongoing delays in agreeing a debt-restructuring deal with external creditors become further protracted, this may also place more upward pressure on both ZMW bonds and USD/ZMW than we currently anticipate.

The previously proposed haircut in the IMF staff report from Aug may not be accepted by both external commercial creditors and bilateral partners, such as China. The Zambian government will be hoping to find a deal with creditors swiftly to ensure that funding

under the IMF programme is not delayed. We think that the earliest the government will reach an agreement with creditors may be in H2:23.

The likelihood of another currency devaluation is now also growing in Malawi. We suspect a 30%-40% devaluation in the MWK against the USD may be on the cards over the coming year or so. Despite the 25% devaluation in the MWK in May 22, FX liquidity challenges have worsened. The RBM is conducting FX auctions from the market to buy USD, although hard currency availability remains scarce. FX reserves fell by 26.7% to USD304m from Jun to Dec 22.

The government is on a non-funded IMF Staff Monitored Programme (SMP) until Nov 23. We suspect that they are keen to get IMF funding, for which we think a devaluation would be required before a funded arrangement can be secured.

However, it appears that the NDF market has already priced in the likelihood of a devaluation. At the time of writing, 6-m and 12-m USD/MWK NDF implied yields were trading at 47.7% and 40.4% respectively.

The possibility of an ETB devaluation is also increasing. We estimate the ETB as nearly 60% overvalued on a real effective exchange rate (REER) basis, as inflation remains elevated and sticky. The Ethiopian government lost access to its funded IMF programme back in 2020, after failing to secure an executive board level approval; for the first review, after receiving the initial disbursement under the arrangement in Q4:19. The IMF hasn't been able to visit Ethiopia to conduct reviews over the past year due to the political tensions in Tigray.

However, any resumption of funding under the programme may require an adjustment in USD/ETB, among other reforms. Such an adjustment could happen either in 2023 or even 2024.

We will open a new trade in our shadow portfolio; buy 24-m USD/ETB at a yield of 20.01%. The previous USD/ETB NDF trade that we had in our shadow portfolio provided a direct return of 17.17% and matured on 6 Aug 22. Initially, there may be more sellers of USD/ETB NDFs, which may take our position to a negative carry, although the probability of an IMF sponsored devaluation cannot be discounted over the next 2-y.

Going long duration in Uganda is becoming tempting again. In fact, long end UGX yields have already declined since late 2022, courtesy of a pickup in foreign portfolio investor interest. We've also seen further interest from offshore investors since early Jan 23.

Inflation will likely begin to ease as improving weather conditions begin to moderate the rise in food prices last year. The MPC may also look to cut rates before the end of Q2:23. However, there is a notably a large bulge in the local debt maturity profile in Apr, which is north of UGX2.0tr UGX. This may prompt the BOU to either conduct a switch auction before or even a private placement similar to May/Jun 22. Hence, we will wait for UGX yields to rise slightly more, and we suspect FX entry levels may also improve over the next few months as we approach the dividend season at the end of Q1:23. But this is a trade that we like, and perhaps even if one was to buy the 10-y bond now at a yield of 15.0%, where it is trading currently, and has a one- to two-year investment horizon, one may not lose money on the trade.

We remain on the side-lines for Kenya duration. Infrastructure bond yields were trading at around 13.9% in the secondary market at the time of writing. However, offshore participation in these bonds has waned due to FX liquidity concerns. In the IMF staff report following the fourth review of the programme in Dec, it was noted that "liquidity in the interbank FX market has dried up and shifted to the bank-client market where forex transactions are executed at a more depreciated rate".

The official USD/KES rate has gradually been moving higher over the past few months, trading at around 124.0 levels, at the time of writing. We see USD/KES rising further to 127.2 by Jun 23, with KES depreciation thereafter in H2:23 likely to be more measured. However, the pent-up USD demand that has built up over the past year may not necessarily be cleared solely by the USD/KES rate moving to 127-128 levels over the coming months. We suspect that a move higher in the USD/KES rate perhaps would also have to be complemented with a notable increase in short-term interest rates. This will then likely embolden USD hoarders to begin buying KES assets. Hence, we'd rather wait for these yield entry levels to potential improve as well as assess the FX liquidity conditions before recommending duration trades in this market again. But we'd prefer to be buyers of USD/KES NDFs going into Jun 23 rather than sellers.

We expect USD/NGN to rise to around 520 by Dec 23. Recall that the CBN had halted FX supply to portfolio investors (since Jun 22) to prioritise meeting FX forward obligations. According to our estimates, the FX forward backlog that is sold and yet to be delivered is around USD300-350m. Additionally, the exchange rates at other FX intervention segments, such as the "SME and invisibles segment" (personal and business travel allowance, school fees, and health), have aligned to the current NAFEX levels, which we see as a gradual step to unification of exchange rates across the various official FX windows.

FX and petrol subsidy reform has been the cornerstone of economic discussions by the key candidates running for president in the upcoming elections in Feb 22. However, as we've noted before, a weaker NGN will only make the petrol subsidy programme more expensive for the government. But the authorities seem to be pinning their optimism on the likelihood of the Dangote refinery commencing in H2:23, something they believe may help expediting the removal of petrol subsidies.

At the time of writing, USD/NGN 6-m NDF yields were trading around 49.9% and 43.0% for 12-m, indicating that the market is perhaps expecting a steeper depreciation in the NGN than we currently envisage. However, selling NDFs into Jun 23 may also prove slightly risky, with the expectation of sharper devaluation in the NGN likely to influence implied yields for the better part of 2023.

We are now recommending an EGP carry trade via the 364-d T-bill. We will open this position in our shadow portfolio at the auction on 24 Jan, with a yield expectation of around 22.0%. Following, what was effectively the third devaluation earlier in Jan 23 over the past year, foreign portfolio investors have already begun investing in EGP fixed income. In fact, according to the Ministry of Finance, there has been inflows north of USD1.0bn since early Jan 23.

The market broadly still seems to expect the USD/EGP to rise over the coming months due to the IMF programme conditionality to have a flexible exchange rate. However, on a REER basis, the EGP is looking relatively cheap now, while the inflow of portfolio investment in the EGP fixed income market may also help FX reserves recovers. But surely, IMF programme conditionality cannot imply that the USD/EGP should only move higher, particularly if the REER hasn't been appreciating. Instead, it may now mean that the CBE will have to begin buying USD from the market to build external buffers to meet IMF programme FX reserve targets.

The IMF programme is expected to catalyse other funding of up to USD14.0bn from multilateral partners, while plans are already underway to sell state-owned enterprise (SOE) assets to further boost FX reserves.

African Eurobonds

Issuance will likely return in 2023, although perhaps not for all markets in our coverage. Going into 2023, the broad investor community were somewhat split on what direction global risk will take in 2023. On the one hand, there is emerging consensus that the Fed

may likely not hike rates after Q1:23, which may then help underpin risk appetite. However, some investors still believe that the growing likelihood of a global recession in 2023 would curb risk appetite.

We tend to agree with the former and thus expect some economies to return to the Eurobond market in 2023 as the search for higher-yielding assets may prove to be too tempting. But that said, due to the expected slowdown in global growth, investors may understandably be more selective about to whom they may lend. Both our SBAFSO index and the EMBI lost 20.6% and 16.5% in 2022 respectively. But the SBAFSO is up 5.4% since the beginning of the year as risk appetite has improved following lower than expected US inflation outcomes over the last few months.

Rwanda has a USD400m Eurobond maturity this year in May. However, the government's liability management has been sound given that they already paid down 85% of this debt back in 2021 when they issued USD620m from the market. The government doesn't expect to return to the market this year as the balance of this Eurobond repayment (USD60.5m) will likely be paid by part of the IMF additional SDR allocation the government received in Aug 21. But, if financing costs in the Eurobond market for Rwanda continue easing, the government may be tempted after all.

In Nigeria, the current guidance coming from the Ministry of Finance indicates that they currently don't have any plans to issue a Eurobond in 2023. Nigeria does have a USD500m Eurobond maturity in Dec 23 and, even if market conditions remain not conducive to refinancing for the government by then, the government should still be able to pay this off via FX reserves. However, despite the guidance, once political risks subside in H2:23, and with our rather bullish view on oil prices during this period, Nigeria may still look to issue if market access is available in H2:23.

Senegal has a lower net external funding target of USD991m in 2023, down from USD1.5bn in 2022. But the government has an outstanding Eurobond maturity of around USD162.9m in 2024, implying that they may still come to the market this year for liability management purposes (if funding costs are favourable).

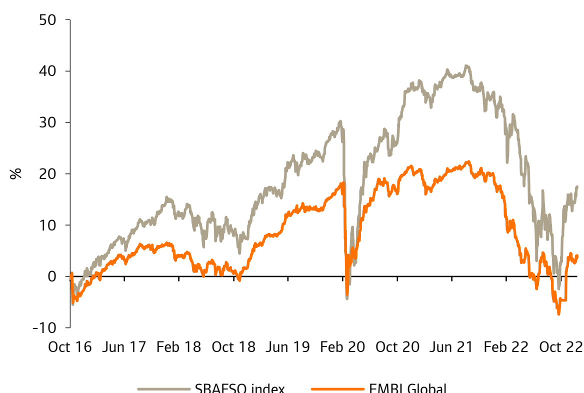
Côte d'Ivoire has budgeted to issue a Eurobond of around USD533m in 2023, but only if external financing costs are favourable. We'd therefore expect them to come to the market this year.

Angola will also likely come to market this year for as much 50% of external funding requirements. Angola's net external borrowing target increased to USD6.55bn in 2023, from 5.37bn in the previous year. The balance of the external borrowing target will likely be funded bilateral partners. Angola may also issue again 2024.

Egypt hasn't pencilled in a Eurobond for FY2022/23 but, similar to most other markets, we can't rule out an issuance for FY2023/24, should market conditions improve. The USD5.0bn financing gap for FY2022/23 is expected to be covered by the World Bank (USD1.1bn), Asian Infrastructure Investment Bank (USD400m), the African Development Bank (USD300m), the Arab Monetary Fund (USD300m), China Development Bank (USD1.0bn) and state-owned enterprises (SOE) asset sales amounting to USD2.0bn

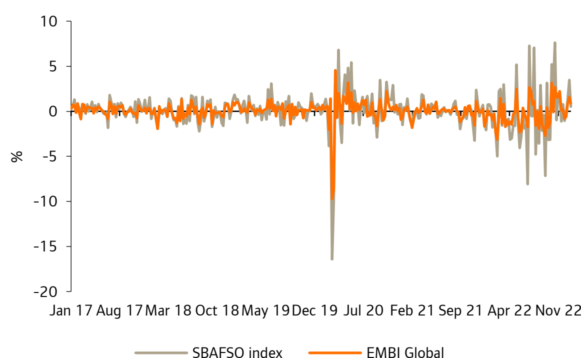
Kenya will also perhaps struggle to come to market in H1:23. However, the government has pencilled in a large commercial borrowing target of around USD2.1bn for FY2023/24, implying that they may come to market from H2:23. In the interim, the government is probably going to issue commercial syndicated loans both in FY2022/23 and FY2023/24 to complement budget funding from the World Bank and the IMF programme. But Kenya's fiscal performance in H1:23 may ultimately be the key indicator, or prerequisite, for the market to assess before they can lend to Kenya again, assuming an improved global risk environment from H2:23. If refinancing from the Eurobond market is not an option in H2:23, investors will understandably get nervous about the May 24 USD2.0bn maturity, as coming to the market in Q1:24 may be "cutting it too close".

Figure 17: Cumulative returns – SBAFSO index vs EMBI



Source: Bloomberg; Standard Bank Research

Figure 18: Weekly return of the EMBI vs SBAFSO index



Source: Bloomberg, Standard Bank Research

Political calendar

Nigeria's 2023 general elections are due on 25 Feb, and may see a tight contest from current indications, and likely paving the way to tackling the long-standing challenges in terms of worsening domestic insecurity, poor infrastructure, and others. The beam of hope comes from knowing that top contenders, in our view, have a business-friendly mindset, which may enhance the implementation of necessary policies to promote economic growth, welfare, and improve investor sentiment.

The top four candidates are expected to be Atiku Abubakar of the People's Democratic Party (PDP), a former vice-president; Bola Ahmed Tinubu from the ruling party- All progressive Congress (APC), also the former Lagos state governor; Peter Obi of the Labour party, the former Anambra state governor and Rabiu Musa Kwankwaso of the New Nigeria Peoples Party (NNPP), the former Kano state governor.

Activity	Date
Publication of official register of voters for the election by the commission.	12th January 2023
Publication of notice of poll by the commission.	30th January 2023
Last day for campaigns by political parties.	Presidential and National Assembly- 23rd February 2023.
	Governorship and state houses of Assembly- 9th March 2023
Date of Election	Presidential and National Assembly- 25th February 2023.
	Governorship and state houses of Assembly- 11th March2023

Digital polls indicate Peter Obi as the leading contender. Understandably, Peter Obi seems to be more popular among the youth and the elites (those that mostly use smartphones and are more active on social media). However, it is likely that penetration of the political party within the low-income class could still be at a lower level, compared to the ruling and the main opposition party.

Given the well-known challenges that the Nigerian economy faces, it is not surprising that the manifestos of the contesting political parties appear similar. Top of which is the escalating insecurity challenges which all the candidates have flagged as a priority. Peter

Obi has stressed power-sector reforms targeted at improving power supply by allowing more private participation in order to improve efficiency.

Atiku Abubakar, who is notable for driving some major sectoral reforms during his term as vice president, has placed emphasis on growth headed by the private sector. Hence, there is an emerging consensus that we are likely to see more reform implementation and growth driving economic policies, should he become the president. Other issues being discussed, with pledges to address them across all political parties, include improving Infrastructure, healthcare and education, and reducing poverty. Meanwhile, Bola Tinubu's manifesto also highlights the introduction of student loans for tertiary institution students to fund their education.

Despite security concerns that usually come with general elections, the last election in Feb 19 was largely peaceful. This can be attributed to increased security efforts to contain security breaches that could occur. There will likely be more efforts in ensuring security during the 2023 election by the government. This should minimize any form of escalation that could result from the outcome of the tight contest.

Post-elections, the president -elect would be sworn into office by May 29, 2023.

The DRC also faces a busy political year in 2023 as the country has general elections for the Presidency, and for the 500 members of the National Assembly (lower house of the legislature), scheduled for the 20 Dec, on direct elections.

According to the elections calendar, there will also be direct elections for the members of provincial assemblies, with the Senate (upper house of legislature) being indirectly elected by members of the provincial assembly.

President Tshisekedi, who was inaugurated on Sep 19, after obtaining 39% of votes in the 2018 election with his party, the Union for Democracy and Social Progress, will run for a second term in Dec. Presidents are limited to two terms by law.

Moïse Katumbi, a former ally of President Tshisekedi, a businessman and Katanga province's former governor, has launched his party ("Together for the Republic") and will be running as a candidate for the presidency.

More candidates will likely run for presidency, including Martin Fayulu, who received 35% of votes in 2018 under the party Dynamic for Congolese Political Opposition.

The elections calendar has been set and already announced by DRC's Independent National Electoral Commission (CENI). Per CENI, despite the ongoing conflict in the eastern part of the country, commitment to the elections calendar remains a constitutional demand and will be honoured. The elections are reportedly expected to cost USD600m. Hence, funding availability challenges could cause some delays on the preparation of these elections.

While insecurity will likely continue to be the dominant discussion ahead of the elections in DRC, ongoing reforms to strengthen its institutions could help see limited election and post-election violence this time around.

Jibran Qureshi[#]

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SA politics in 2023: great expectations

While 2022 ended with a degree of political relief after the outcome of the ANC's national conference, 2023 has begun with deep angst over the extent of the electricity crisis and uncertainty over when this burden will be eased. Indeed, the electricity crisis encompasses the political outlook in a variety of ways. Most clearly: there is an expectation that President Ramaphosa will capitalise on his recent re-election to effect more decisive reform and provide a believable path out of the current crisis. Yet, equally, ongoing failure in this area will diminish confidence in the president's second-term aspirations, and compound the ANC's electoral losses in 2024, introducing the prospect for significant (and potentially turbulent) national coalitions. These expectations – for bolder reform, and, for the opposition, of further ANC loss – will characterise this year's political activity.

With this as a backdrop, three principal questions will frame this year's political outlook, each of which we focus on in this report.

(1) First, will President Ramaphosa see out the year? And what happens if he does not?

The ANC's leadership is now far more firmly aligned to the president's political command and will likely provide robust support for him as various ongoing Phala Phala investigations unfold, and finalise, this year. As such, the risk that the president will be removed, or resign, as a result of these processes has certainly diminished. As has key-person risk, given both the election of Paul Mashatile as ANC deputy president, and the election of Fikile Mbalula as ANC secretary general in December last year. With the president's allies in control of key party functions, the risk of a fundamental shift in party policy should the president be removed from power has considerably decreased. It is therefore probable that President Ramaphosa will survive this year's Phala Phala-induced political theatre and lead the ANC into the 2024 national and provincial elections.

(2) Second, what kind of reform is possible this year?

The electricity and broader energy crises will be apex challenges for government and all other stakeholders throughout this year. Much of the political focus in this regard will rest on the leadership that is appointed to steer the energy conversation in cabinet. Though load shedding will remain a pressing challenge, and notable impediment to growth and sentiment, throughout the year, we expect its severity will begin to ease as some of the more targeted initiatives recently unveiled by NECOM begin to take effect.

Elsewhere, the year promises more progress in rebuilding governance and anti-corruption institutions, which remains President Ramaphosa's most impressive executive achievement thus far. The NPA will seek to convert some of its high-level arrests into successful convictions, while the effort to avert grey listing will bolster the country's capacity to respond to financial crime. And the general structural reform endeavour will be bolstered by the president's ability to channel reform oversight through the Presidency, bolstering initiatives such as Operation Vulindlela in driving change across government departments.

Two other areas of critical concern that were highlighted by the president in the ANC's January 8th statement, and that will need to feature strongly as part of this year's reform effort, will be policing (and law and order generally) and service delivery. To the former point, last year the Global Initiative on Transnational and Organized Crime ranked SA 19th in the world in terms of the threat of criminality. Last year reflected how troubling the rise of organised crime has become for the country, and the impact it is having on the broader economic recovery.

Within the ANC, the push for organisational 'renewal' will be a presiding theme this year, too, particularly in light of the need for the party to polish its image in the build-up to the 2024 elections. A strengthened Luthuli House will aid this drive, though the extent of the ANC's institutional slide will continue to limit the extent of the reform that is possible.

The president will realign his cabinet to effect some of the above changes, and to reflect the ANC's shifting leadership composition, too. The extent of this reshuffle, together with the firmness and detail of the president's SONA pledges, will largely inform the extent to which the coming year will offer more decisive executive steer.

(3) What impact will this year's outlook have on the 2024 elections?

Though the quantum of loss is uncertain, it is clear that the ANC will suffer further national and provincial electoral loss next year. Based on our political expectations for 2023, as well as on credible polling data and the recent trend in by elections across the country, it appears likely that the ANC will lose up to 10ppts nationally next year. This means that the ANC will potentially slide below 50% but would be sufficiently near to this mark to allow it to build a small and ideologically uncomplicated coalition to remain in power for a further five years.

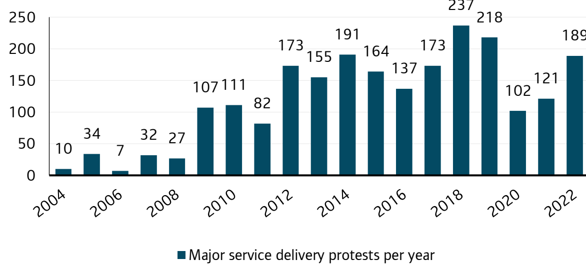
The real test, therefore, will come in key provinces such as Gauteng and KZN, where we expect the ANC's losses will be such that large, multi-party, coalitions may be required for governing majorities to be forged. As such, the key considerations in these provinces in the year ahead will be what types of coalition agreements seem to be building, as well as which outcomes would provide the greatest stability or instability in the coming five years. Ongoing metro-level coalition unease in Johannesburg and Ekurhuleni points to the risks inherent in this outcome, and places even greater pressure on major political parties to imbibe the pragmatism required of them to build agreements that are more durable, and that reflect the predominant will of the local electorate.

There will also be a focus this year on potential new entrants to the political system in 2024. Independent candidates will, for the first time, be able to contest national and provincial elections in 2024, even if the extent of their involvement is less pronounced than the Constitutional Court has demanded. Inevitably, new parties that seek to benefit from ANC and DA electoral losses will form, offering an expanding variety of options for SA's electorate. A key test not just for all political parties contesting the 2024 elections, but for the country's democracy more broadly, will be whether the sliding voter turnout rate is stabilised in 2024.

In other areas:

- **From a fiscal perspective, the three primary political considerations will remain public sector wages, SOE support, and social welfare**. All will be central to this year's outlook, though the principal gaze will fall on the extent of, and conditions attached to, Treasury's support for Eskom, as well as government's ability to maintain its wage containment credibility in the next round of negotiations with public sector unions.
- **Labour relations, protest action, and social stability**. The 2023 outlook will likely mirror 2022's, with an ongoing pickup in strike action and protest action to pre-COVID-19 levels. In 2022 there were 189 major service delivery protests, up from 121 in 2021 (Figure 1). And in all 2,4m workdays were lost to strike action in 2022, compared to 1,5m in 2021. That said, there are no signals that industrial action will return to previous periods of extreme concern, as during the 2007 – 2015 period when an average of 8.5m workdays were lost per year to strike action (Figure 2). And though the tensions underlying the country's social fabric will remain pronounced, we maintain that protest action is unlikely to catalyse at the national level this year – or next.

Figure 1: A return to pre-COVID-19 protest levels



Sources: Municipal IQ; Standard Bank Research

Figure 2: A slight uptick in strike action in 2022

Sources: Andrew Levy Publications; Standard Bank Research

In sum, though we expect progress in key areas this year, driven in large part by the president's firmer hold on party power, in some areas overarching change will remain elusive. This includes change within the ANC and its push for fundamental renewal, as well as across the state more generally – which will continue to lack the capacity to spearhead broader progress. These deficiencies will feed concerns around the 'collapse' or 'failure' of the SA state. While these fears are understandable, we maintain that there are a variety of compelling and comparative strengths that hold SA back from systemic decline. Indeed, this year will likely see ongoing, and mood-lifting, governance reform – with key anti-corruption organisations provided with ongoing air cover by President Ramaphosa. Aside from this, we believe that the state's retreat from the centre of activity in areas such as transport and energy present opportunities for the country's longer-term stabilisation, and progress. These opportunities will be more pronounced in 2023 than they were in 2022, even if the benefits of this shift may only become apparent in the outer years of the medium-term outlook. Linked to this, new political and non-political partnerships will begin to take shape in 2023 that will add more obvious counterweight to the threat of ANC-led decline.

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* Independent Research. 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.

South Africa: global headwinds moderating, but not the idiosyncratic risks

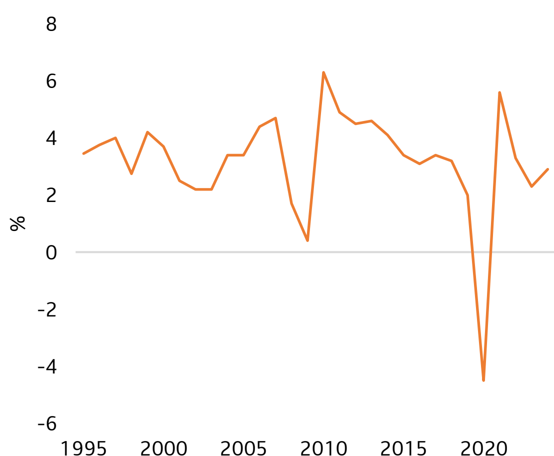
Executive summary

The global economic backdrop is generally expected to turn more benign in the second half of this year. However, geopolitical risks, including the ongoing war in Ukraine, elevated risks around the prognosis for the Chinese economy, the delayed impact of aggressive global monetary policy tightening, and the worldwide aftershocks of the pandemic still present elevated negative global forecast as well as spill-over risks.

There are growing indications that global inflation has peaked and, while a few countries are still expected to continue hiking interest rates early this year, a widespread rate-cutting cycle should be in full swing by 2H23. By then, a gradual, but sub-trend, global growth recovery is forecast to be underway, which should soon provide support for forward-looking financial markets. Global headwinds for the rand and domestic bond market should thus start dying down; this underpins our relatively constructive views for both, notwithstanding SA's idiosyncratic risks, including potential grey-listing by the Financial Action Task Force (FATF) in February 2023.

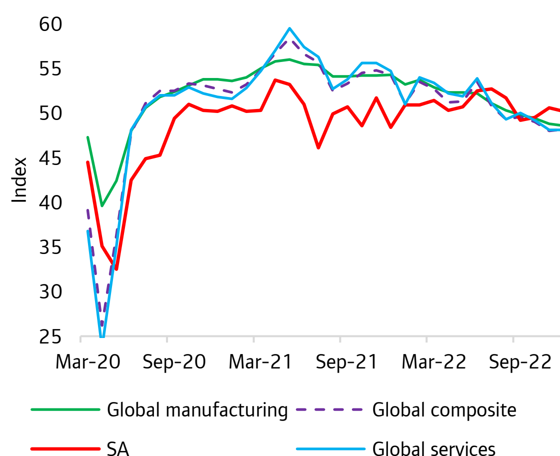
Locally, the electricity and transportation constraints are severely curbing growth, counteracting the gradual traction underway with fiscal and growth reforms (which should now continue uninterruptedly following President Ramaphosa's re-election as ANC leader in December). We don't foresee any particular loosening of fiscal policy ahead of the 2024 general election; however, persistent fiscal and growth risks will likely stave off positive sovereign credit rating action notwithstanding government's commitment to fiscal consolidation and more pragmatic fiscal choices, alongside growing gains from increased SARS efficiencies. A risk-averse SARB might hike the repo rate further beyond its estimated neutral level, even though this is not, in our view, required by the prevailing growth and inflation forecasts. Hikes beyond the neutral rate might be reversed quite quickly, premised on a supportive global backdrop. Recent media reports, that the ANC intends to expand the mandate of the SARB to also include growth support, are somewhat disquieting — although it doesn't seem to be high on the agenda and may, considering that the SARB's constitutional mandate already has "balanced and sustained" growth at its core, not ultimately be impactful.

Figure 1: Slowdown in SA's weighted export destinations should be shallow and short-lived



Source: IMF, UNCTAD, Standard Bank Research, Bloomberg

Figure 2: SA activity indicators, such as the PMI, are reasonably resilient vs global trends, notwithstanding loadshedding

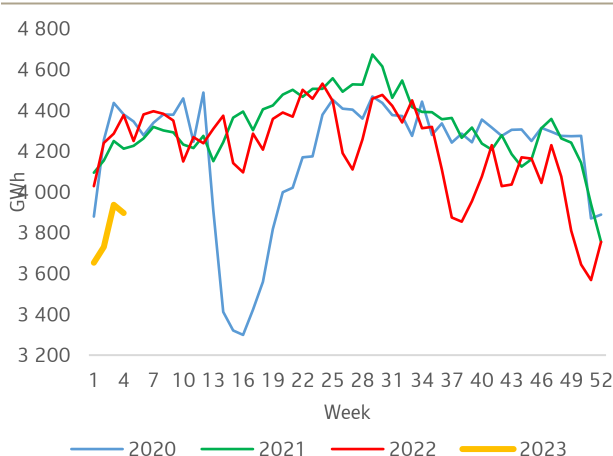


Source: Bloomberg

Growth: moving ahead amid multiple risks

The electricity shortfall – a binding growth constraint –might this year be even worse than last year. The economy's relative resilience is being buffered by growing own-generation and the economy's declining electricity intensity. Still, increasingly frequent bouts of high stages of loadshedding would have a disproportionately negative impact. Similarly, Transnet's railway and port constraints are significantly impacting the goods-producing sectors of the economy. Our detailed analysis in this section of the report highlights the negative impact on fixed investment trends (while the fiscal section of the report unpacks the impact of the expected transfer of a large part of Eskom's debt to the government alongside further transfers to SOEs, including Transnet).

Figure 3: Electricity supply by Eskom has been exceedingly weak since late-2022



Source: Eskom

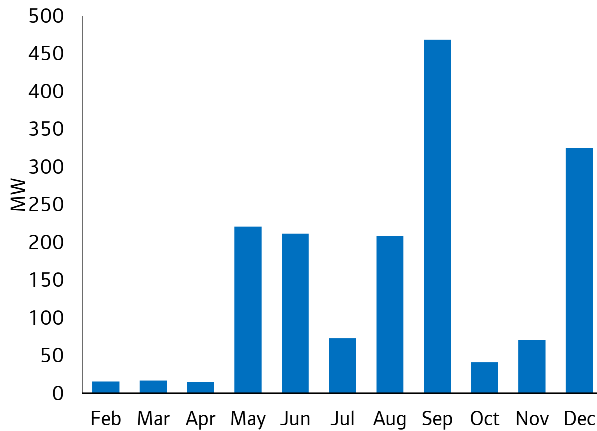
Figure 4: Declining energy intensity of GDP makes the economy more resilient, also supported by growing private electricity generation

Source: Stats SA, Eskom

Softer global growth adds to the headwinds, though at this stage it is expected to be a relatively shallow global growth dip, with an imminent trough foreseen in 1Q23. The imminent recovery should already provide some support for forward-looking financial markets, which are also encouraged by domestic policy continuity due to President Ramaphosa's re-election as ANC leader in December 2022. However, the concerns about weak trend growth and longer-term political risks will persist.

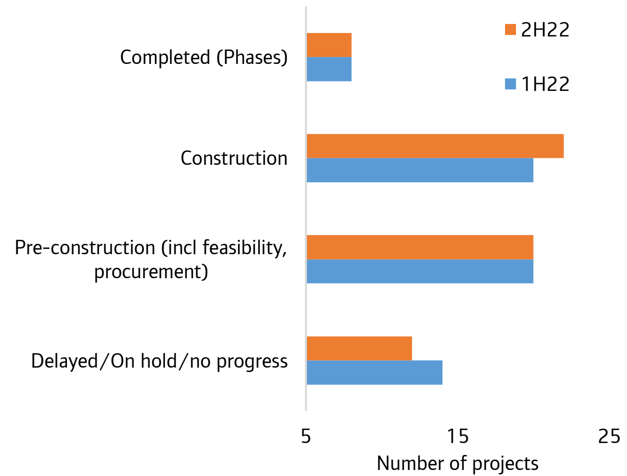
Encouragingly, the expected lagged employment recovery is now underway, consistent with a broad-based improvement in firms' perceptions of the job market. This should provide some support to consumers amid multiple headwinds, though our detailed analysis highlights the unevenness of this recovery across the income groups. Our proprietary consumer spending data implies that spending remained resilient at the end of 2022 and that spending patterns have largely normalised from the initial pandemic/lockdown distortions.

Figure 5: Strong growth in embedded generation projects registered with Nersa



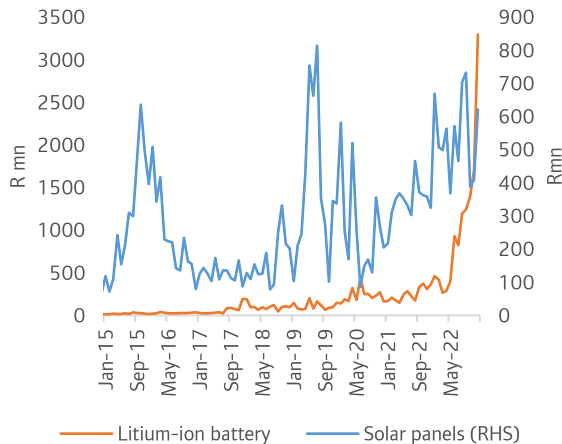
Source: Nersa

Figure 6: Growing traction with government's SIPS investment projects



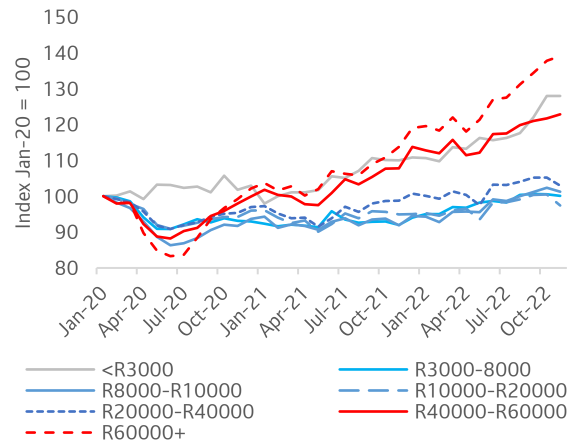
Source: government, Standard Bank Research

Figure 7: Energy-related capex imports put pressure on imports



Source: SARS, Quantec

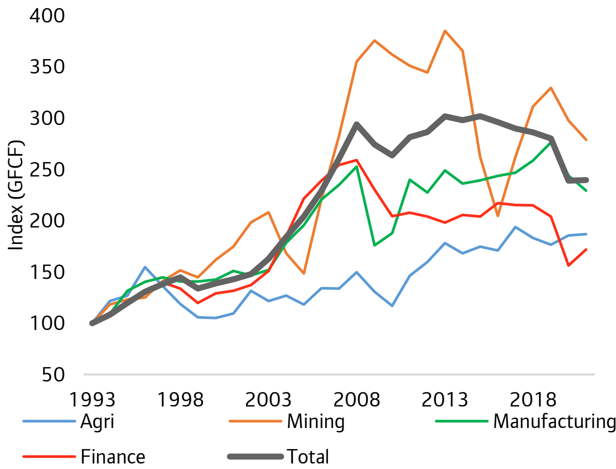
Figure 8: Higher-income consumers still relatively resilient, supporting growth



Source: Standard Bank Research

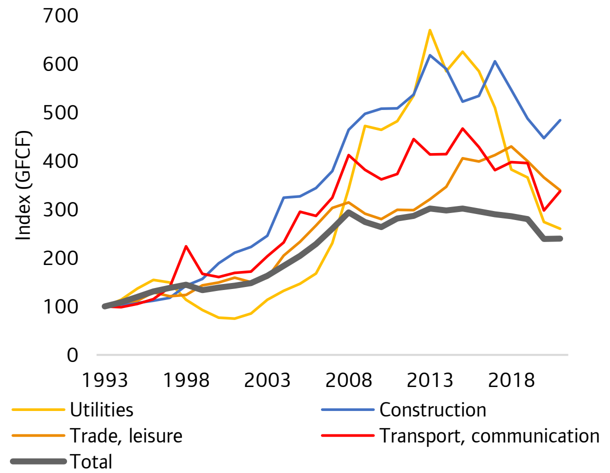
The improvement in fixed investment fundamentals, alongside less bearish business views on fixed investment, supports our expectation for a further recovery in gross fixed capital formation (GFCF), though here, too, a detailed analysis reveals very uneven sectoral trends. We also foresee GDP support from further inventory building, but net exports will likely weigh on the growth trajectory.

Figure 9: Real GFCF trends: sectors with weakest long-term trends



Source: SARB, Quantec, Standard Bank Research

Figure 10: Real GFCF trends: sectors with strongest long-term trends



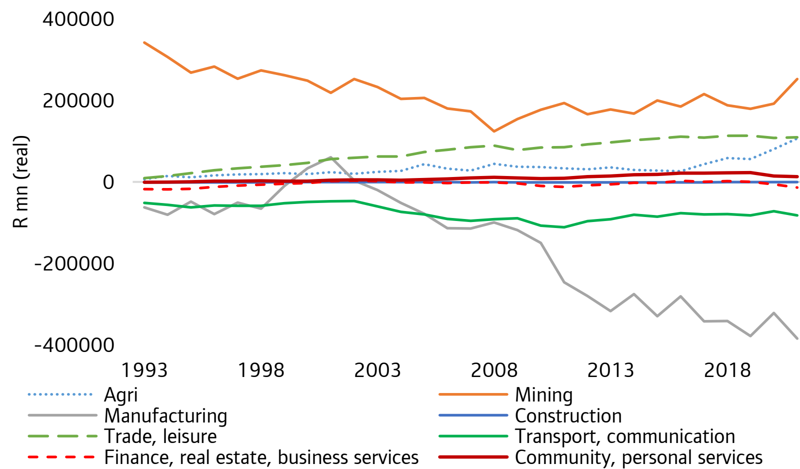
Source: SARB, Quantec, Standard Bank Research

Trade and current account deterioration still contained

The trade and current account balances remain supported by elevated terms of trade still being around 2% to 3% above their 10-year and post-GFC averages. However, this support has waned, with the terms of trade falling to around 15% below the recent peak. At this stage, our mining team's forecasts imply that the terms of trade will likely trend sideways. After initial support from the broad-based spike in energy costs, with coal prices outpacing oil prices, the net trade balance of coal and oil products has deteriorated recently.

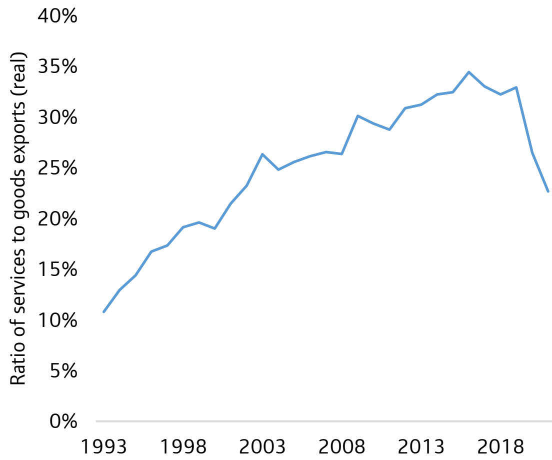
Furthermore, goods imports (volumes) continue to recover and, notwithstanding the import-GDP ratio having recovered to its pre-pandemic trend, there might be some additional upward pressure. At the same time, goods exports are being curbed by electricity and logistical constraints, though we'd expect tourism receipts to recover further, consistent with the resurgence in the confidence of the services sector, and the leisure industry in particular.

Figure 11: Worsening trade deficit in manufacturing weighs on trade and current account balances



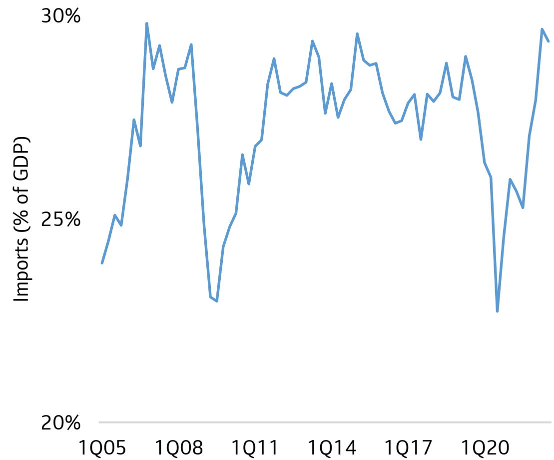
Source: Quantec, SARS, Standard Bank Research

Figure 12: We expect services exports, which has been lagging the goods export recovery, to grow



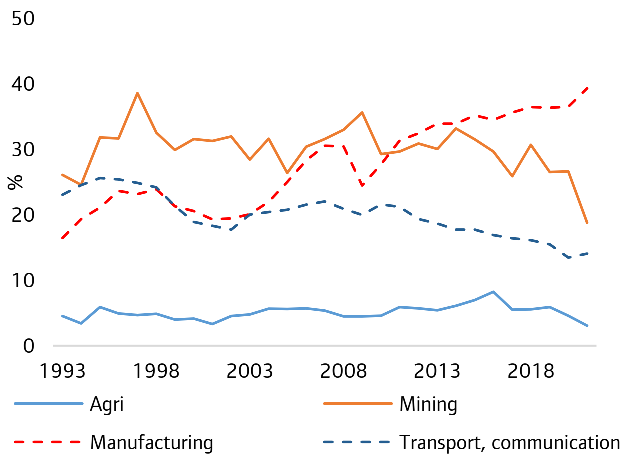
Source: Quantec, SARB, Standard Bank Research

Figure 13: We expect further import growth, notwithstanding the full recovery in the import-GDP ratio



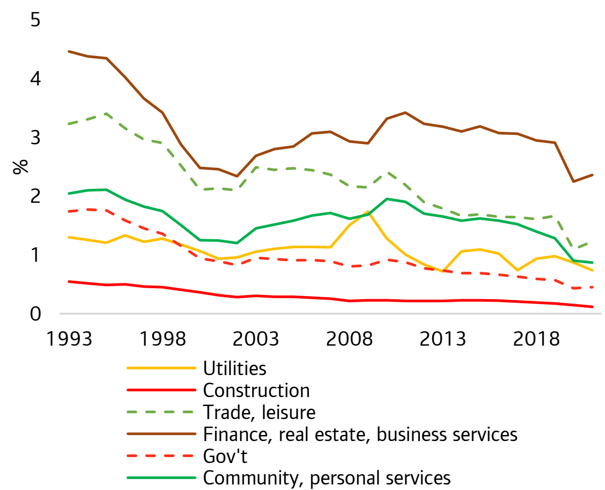
Source: Quantec, SARB, Standard Bank Research

Figure 14: Import penetration rising in manufacturing



Source: Quantec, Standard Bank Research

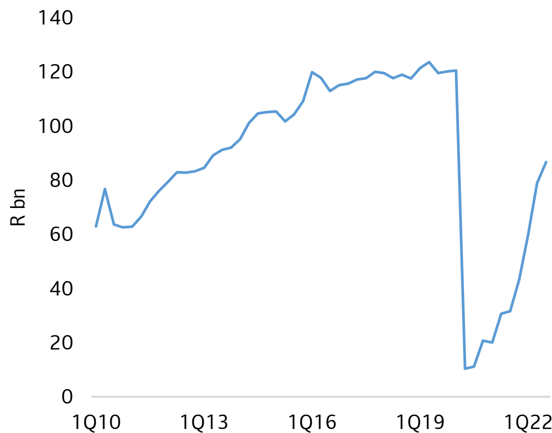
Figure 15: Generally, import penetration lower in services sectors



Source: Quantec, Standard Bank Research

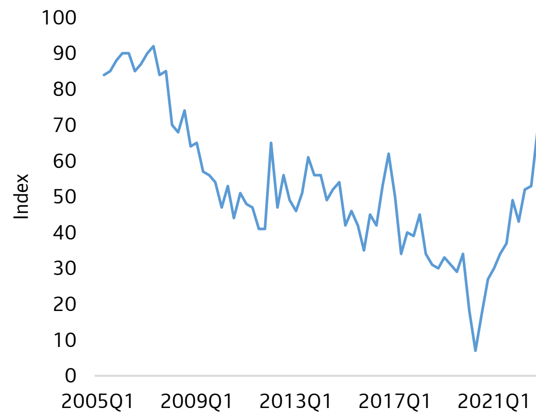
The bottom line is that we foresee a gradual deterioration in the current account, though the twin deficits are forecast to be much smaller than prior to the pandemic/lockdown, and thus less negative for the rand and government bonds.

Figure 16: We expect a further recovery in tourism receipts…



Source: SARB

Figure 17: …consistent with strong(er) confidence in the services sectors

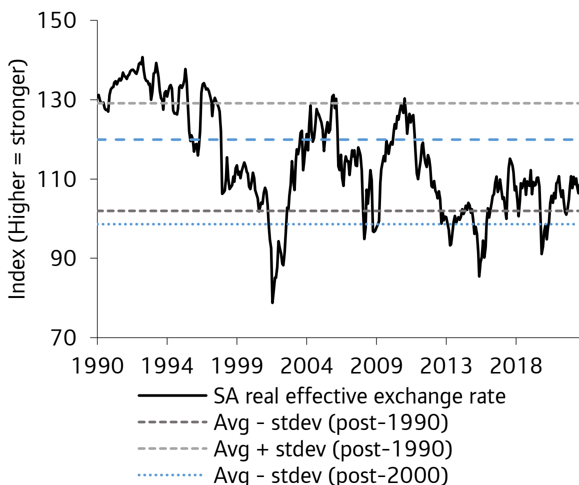


Source: BER

Rand headwinds may fade

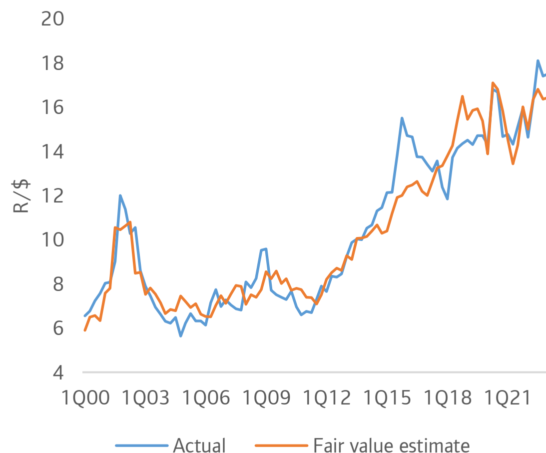
The rand is currently confronting several headwinds, some of which should die down this year. In particular, global growth is forecast to trough early in 2023, and some countries should start to partly unwind 2022's aggressive monetary policy tightening (though our G10 strategist foresees the Fed as only joining the monetary easing cycle next year). Most importantly, our mining team's commodity price forecasts imply that the terms of trade should drift sideways in 2023, below the recent peak, but still very elevated in a historical context. This is a key input into our fair-value assessments.

Figure 18: Real trade-weighted rand seems reasonably valued (data updated end-January)



Source: SARB, Bloomberg, Standard Bank Research

Figure 19: Rand weaker than our fair value estimate against the dollar



Source: Bloomberg, Standard Bank Research

Following President Ramaphosa's re-election as ANC leader, investors are likely relieved about policy-agenda continuity and particularly the commitment to fiscal consolidation. However, concerns about adverse fiscal risks and weak trend growth are persisting. Furthermore, there are near-term concerns about the potential grey-listing by the

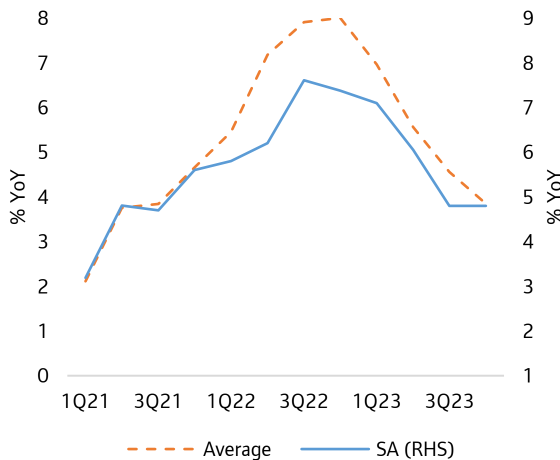
Financial Action Task Force (FATF). The ANC's recent stated intention, to supplement the SARB's mandate with a growth-support component, now puts undue pressure on the country-risk premium.

Our econometric model, peer comparisons and real trade-weighted rand trends imply that the rand exchange rate might be slightly undervalued. Premised on the bearish dollar projections of both our G10 strategist and the consensus, the rand should gain notably, particularly against the greenback. Our fair-value analysis still remains very sensitive to the terms of trade.

Interest rates rising beyond the inflation peak

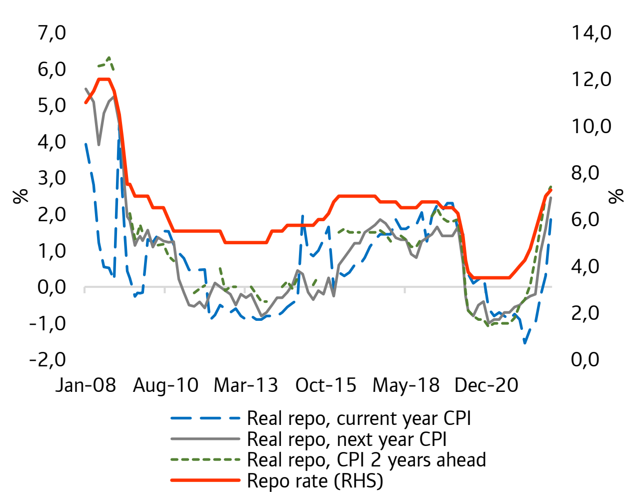
The retreat in global commodity prices (food and oil in particular) as well as moderating global producer and consumer inflation momentum support our expectation for SA consumer inflation to moderate further this year. Consumer inflation likely peaked in July 2022, at 7.8% YoY. Thereafter, the moderation should initially be quite gradual before gaining considerable momentum into year-end. We concur with the SARB that inflation should approach the mid-point of the target range from 2H23.

Figure 20: SA inflation spike more subdued than global norm



Source: Bloomberg, Standard Bank Research

Figure 21: Real forward-looking repo rate higher, at SARB's neutral rate



Source: SARB, Standard Bank Research

For some time now, the SARB has forecast inflation as moderating towards the mid-point of the target range from mid-2023, which, amid the steep series of rate hikes, will push the repo rate towards the bank's estimate of the neutral (policy rate) level. The SARB's baseline forecasts thus don't warrant further rate hikes, although the MPC has so far been reluctant to base its policy decisions on its forecasts, and rather places more focus on the risks because it would want to avoid underestimating the pervasiveness of inflation, as several other central banks have done. The SARB might hike rates once more, as an "insurance premium" against upside inflation risk.

There is some concern about the ANC aiming to broaden the SARB's mandate to place more emphasis on growth, though the SARB's constitutional mandate already puts "balanced and sustainable economic growth" at the heart of the SARB's primary objective. Furthermore, the ANC's stated aim doesn't appear to be high on the agenda, so at this stage we see this as unduly increasing policy uncertainty, while unlikely being impactful.

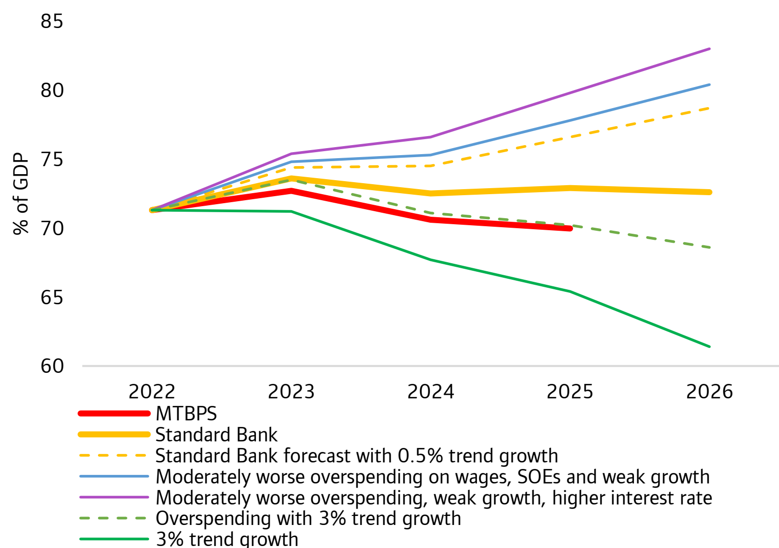
Fiscal decision-making has improved, but some fiscal slippage still seems imminent

In the fiscal year to date, tax revenues have performed broadly in line with Treasury's forecasts for the full fiscal year. This, however, reflects key revenue categories growing faster than Treasury's full-year forecasts, alongside VAT refunds that have also grown faster than Treasury's projections for the full year. At this stage, an extrapolation of year-to-date tax revenue performance implies that Treasury's forecasts in the Medium-Term Budget Policy Statement (MTBPS) should be met. We don't expect any tax hikes this year; however, we'd expect further support from SARS's efficiency gains (which it now quantifies). While Treasury's near-term revenue forecasts seem achievable to us, investors will likely remain cautious until trend growth has been lifted sustainably, notwithstanding clearer indications of government's commitment to fiscal improvement, especially considering the re-election of President Ramaphosa as ANC leader.

The more pertinent risks at this stage, however, are on the expenditure side, with persistent concern about the medium-term risk of unaffordable increases in social grant spending, upward pressure on the wage bill, and ongoing fiscal support required by state-owned enterprises (SOEs). The planned debt relief for Eskom, which should finally be forthcoming in the Budget, will likely entail five annual transfers of R50bn (including the previous equity injections), which should, alongside possible further support for SOEs, elevate the debt-GDP trajectory. We don't expect immediate increases in the wage bill or social grant allocations, but both risks will continue to cloud the medium-term fiscal picture.

The improvement in the fiscal prognosis since the last set of sovereign credit rating downgrades underpins the potential for positive rating action, especially from S&P given its positive rating outlook. However, the elevated fiscal risks will likely prevent any upgrades in the near term.

Figure 22: Government debt trajectory depends on growth and spending decisions



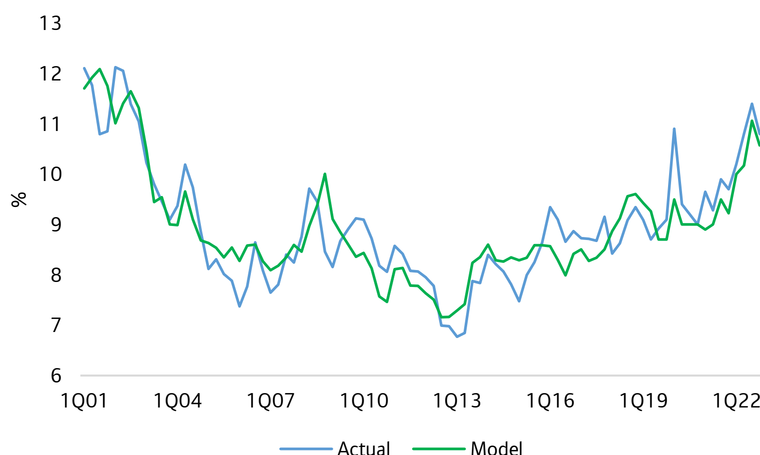
Source: Treasury, Standard Bank Research

Bond prognosis constructive

We remain relatively constructive about the outlook for SA government bonds. Our fair-value model implies that SA government bonds are modestly undervalued relative to the prevailing fundamentals, but the bigger upside arguably stems from the global bond gains forecast by both our G10 strategist and the consensus.

At this stage, we still favour the 10-year area of the yield curve. Apart from our fair-value model's assessment that it is undervalued relative to fundamentals, our yield-spread models also assess this area as cheap, relative to the rest of the curve.

Figure 23: Bonds modestly undervalued



Source: Bloomberg, Standard Bank Research

Forecast summary

Figure 24: Macroeconomic forecast summary

	2022	2023	2024
Gross domestic product (GDP)	2.3	1.3	1.8
Household consumption expenditure (HCE)	2.8	1.3	1.7
Gross fixed capital formation (GFCF)	4.6	3.2	4.1
Current account (% of GDP)	0.1	-1.1	-1.6
R/$ (avg)	16.37	16.61	16.33
R/€ (avg)	17.21	18.55	19.31
R/£ (avg)	20.18	20.58	21.79
CPI (avg)	6.9	5.7	4.7
Repo rate (YE)	7.00	7.25	7.00
10-year generic bond yield (YE)	10.86	10.35	10.25

Source: Bloomberg, SARB, Standard Bank Research

Elna Moolman[#]

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