ECONOMY

An Enigma 2024

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G10 outlook for 2024

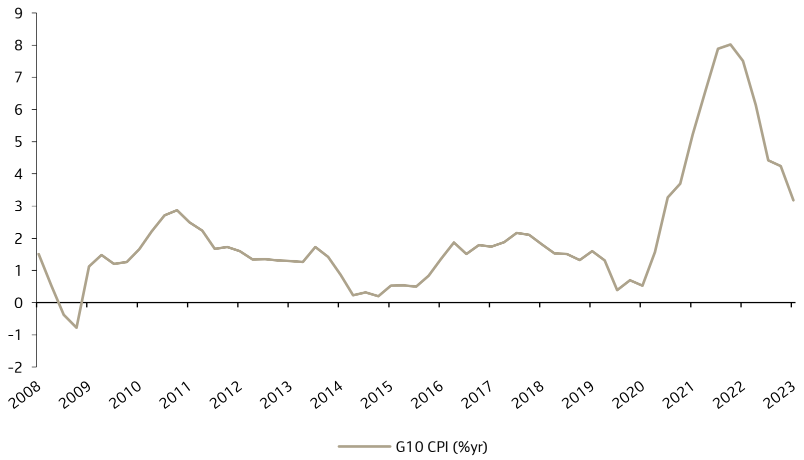
Soft landing, but not much of a bounce

What seemed barely believable a year ago, that G10 countries could achieve a soft landing, now seems to be happening. This is not to say that all countries are avoiding recessions. Winter recessions seem likely in Europe but, even so, the downturns look set to be relatively mild and at limited cost when it comes to higher unemployment rates. In some senses, this is quite a remarkable achievement by policymakers given the extent to which inflation increased and the punitive interest rates that were put in place to try to bring inflation back to target. Of course, inflation is not back to target levels in the vast majority of G10 countries but victory is increasingly being celebrated, at least in terms of the aggressive pricing of central bank rate cuts for this year by the market and the strong performance of assets such as stocks and bonds since the last quarter of 2023. But before any victory is declared, there are a number of questions that remain and could mean that many might find themselves celebrating too early.

The first issue is that the landing might be soft, but any subsequent lift-off looks as if it will be very meagre, particularly in Europe. The outlook is clearly not like the immediate post-Covid period when the end of lockdowns unleashed a wave of strong demand. This time around, the recovery will be slow. The Governor of the Bank of England, Andrew Bailey, said late last year that the bank's forecasts for growth over the next three years were the worst he could ever remember. Many other central banks have similarly poor outlooks. So, while many countries that find themselves in recession should recover through 2024, it will still feel like a recession to many in the population, and that can be dangerous when it comes to social and political strains, particularly in a year when around a half of the world's population is eligible to vote for new leadership.

A second reason why calling a soft-landing victory might be presumptuous relates to the labour markets. The continued tightness of labour markets across G10 countries has undoubtedly contributed to the fact that the slowdown in growth has been limited. But this same tightness risks persistent wage pressure and persistent inflation, even if price growth is quite a lot lower than the peak seen in the third quarter of 2022.

Figure 1: Down, but not back to target



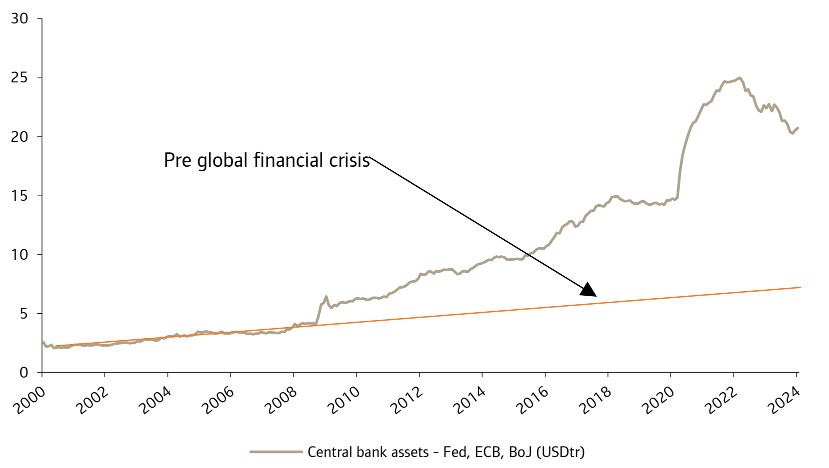
Source: LSEG datastream

Cyclical factors, such as slower growth, and helpful base effects have combined to bring a swift and significant fall in inflation across G10 countries. But structural impediments to lower inflation persist. These not only include the aforementioned labour market tightness but also the continued trend of what's termed deglobalisation. For, as companies continue to prioritise the security of supply over the price of those goods and services, so higher inflation is likely to become entrenched. As an example, a number of years ago we used to talk about China exporting its deflation to the rest of the world. But today, with overseas firms' cutting their investment in China and looking elsewhere to secure supply, we no longer hear so much about China's exporting of deflation, even though both the CPI and PPI in China are below the zero line. What this suggests, is that inflation in G10 countries is most likely to settle at levels that are above target, and this in turn hints that the so-called 'natural' rate of interest, that stokes neither inflation nor deflation, is likely to be higher than it was prior to the pandemic and Russia's attack on Ukraine.

A third concern that comes out of this soft-landing nirvana, is that it might have been 'bought' by injudiciously expansive balance sheet policies of the G10 central banks. Figure 2 shows the growth in assets of the Fed, ECB and BoJ as they all engaged in hefty bond-buying sprees, especially in the wake of the pandemic. Normally, central bank assets grow in line with the public's demand for cash, as was the case before the global financial crisis. But today central bank assets are 2-3x above these levels. This massive cushion of reserves that commercial banks hold may have helped ensure that the economic difficulties created by the recent rise in inflation did not spill over to a much deeper economic meltdown, or worse still, a financial crisis. But there could be a cost as well. One is that this excess liquidity has found its way into assets such as equities, potentially creating a financial bubble. Another issue is that central banks have started to reduce these assets and, as they slowly remove this reserve cushion, so economies could become more vulnerable. Yet another issue concerns the fact that such excess liquidity may have created so-called zombie banks and, in turn, zombie companies as their access to credit has been far more accessible than before global financial crisis period.

In short, high policy rates might have not sifted out the weak companies in the way that they might have done in the past, and now the longevity of such companies will weigh on productivity growth and so contribute to the outlook for the very modest economic growth ahead that we spoke about earlier.

Figure 2: Outsized assets



Source: LSEG datastream

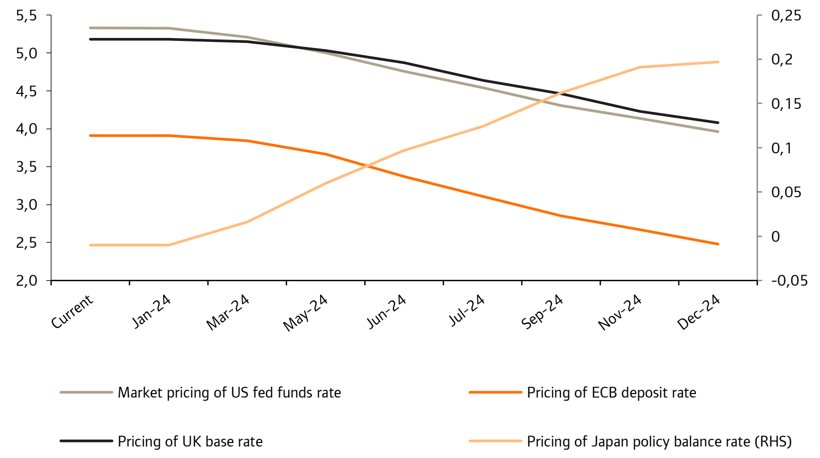
Putting all this together, we expect economic growth in the G10 countries to be in the region of 1.0-1.5% this year, which is lower than the likely 2023 outcome and also lower than the 1.5-2.0% range we foresee for 2025.

Policy easing

Although we remain sceptical that inflation in most G10 countries will fall back to target, which is 2% in most cases, central banks look set to unwind some of the policy tightening that they undertook through 2022 and the first half of 2023. Wage growth is critical in determining both the timing and extent of rate cuts. This is because the goods price inflation associated with the pandemic and supply-chain disturbances has largely disappeared, to be replaced by service sector inflation, much of which is being generated by elevated wage growth. Tight labour markets have helped lift wage pressure but now that inflation is falling, there are hopes that wage awards will slow, particularly bearing in mind that public expectations for inflation in the long haul have not moved significantly above pre-Covid levels, in spite of the sharp spike in inflation.

Provided central banks are content with the outlook for wages, then we'd expect policymakers in the likes of the US, euro zone and UK to start reducing policy rates from the middle of the year. The market is pushing for faster action, but this is usual as we head towards an easing cycle. It is also not uncommon for the market to anticipate more easing than central banks suggest. In the US, for instance, the last median forecast from FOMC members is that the fed funds target will be reduced by 75 bps this year, but the market predicts close to double that amount. Other central banks that predict future policy rates, such as the Swedish Riksbank, are also seeing market pricing that is running well ahead of their own views in terms of both the timing and scale of rate cuts. Our forecasts are for around 100 bps of rate cuts from the major central banks this year; indeed, we'd expect to see cuts across all the advanced-country central banks, except Japan. For, contrary to other central banks, the Bank of Japan is hoping for signs that the spurt in wage awards in 2023 is maintained this year as it wants to see the rise in CPI inflation, to levels above the 2% target, maintained via increased wages. We believe that the signs are good for elevated wage awards in this year's spring wage round – the Shunto – and that should allow the BoJ to increase the policy balance rate which has sat at -0.1% since 2016.

Figure 3: Rate cuts priced for 2024 - except Japan



Source: Bloomberg

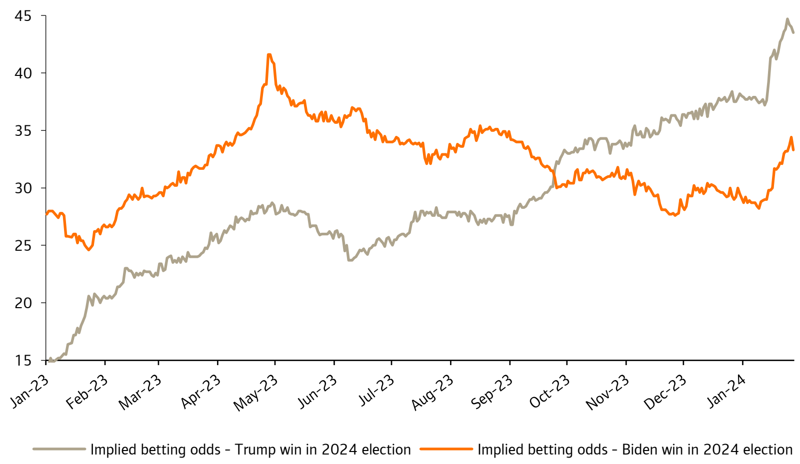
There may be speculation that the BoJ's countertrend tightening of policy this year will lift Japanese bond yields considerably and possibly prevent yields falling elsewhere. For instance, unhedged purchases of US treasuries by Japanese investors will have proven very profitable in recent years given the significant US yield pick-up and the surge in dollar/yen. But if these flows to treasuries – and other bond markets – are swiftly reversed as JGB yields become more attractive, and the yen recovers, an important source of external support for foreign bonds could be removed. This represents one of the headwinds to lower bond yields this year. Another headwind is that central banks take longer to cut policy rates than anticipated and reduce rates by less than that currently priced into the market. Budgetary concerns could prove a further headwind to lower yields. For, the legacy of huge fiscal support through the pandemic and other support initiatives, such as those in Europe during the surge in gas prices related to the war in Ukraine, has been deficit and debt levels that imply considerable bond supply, especially when you also consider that central banks are reducing their own bond holdings via quantitative tightening. But will these headwinds prove sufficient to prevent yields falling if, as expected, central banks are easing policy, growth is weak and inflation still falling? In our view bond yields can still fall, albeit modestly, with 10-year treasury yields expected to fall from current levels in the vicinity of 4% to a 3.0-3.5% range by the end of 2024.

Political uncertainty

The 2024 G10 economic backdrop might appear relatively benign, with modest growth, further falls in inflation, and central-bank easing. But all this could be upset by a febrile political backdrop given the very large number of national elections this year and the ever-present geopolitical threats. Already, we have seen the most recent geopolitical tensions in the Red Sea put renewed upward pressure on shipping costs. But probably the most closely watched issue will be the US presidential election in November. Former president Trump has already threatened some contentious policies, such as an across-the-board 10% tariff on all imported goods and an even higher rate on goods coming from China. This would undoubtedly raise the heat on a trade war that Trump first stoked during his 2017-2021 presidency. But does the prospect of a second term for Trump imperil the global economy and risk asset price destruction in 2024?

The first thing to say is that we can't be sure that Trump will be on the ticket given the various legal cases against him. The second is that elections are typically close in the US and hence it is going to be difficult for the market to pre-judge the outcome and position accordingly. This suggests that if there is any impact from the election this year it is unlikely to be seen until the November 5th result is announced, much as we saw in 2016 when Trump's promised corporate tax cuts spurred a big rise in stocks when his victory was announced. A third point is that the Biden administration has hardly de-escalated the trade war with China, and hence a switch-back to a Republican-led administration might not be the sea change in terms of protectionism that many might imagine. One final point is that Trump's 2017-2021 presidency did not see major financial market upheaval. The dollar, for instance, was broadly stable in trade-weighted terms through the period which was a much better performance for the greenback than we saw during prior Republican presidencies, where the dollar fell quite significantly. Putting all this together, our view is that the possibility of a second term for Trump is likely to make a lot more political noise than it will impel economic and financial market upheaval.

Figure 4: Early betting puts Trump ahead



Source: RealClearPolitics

Currency stability unlikely to persist

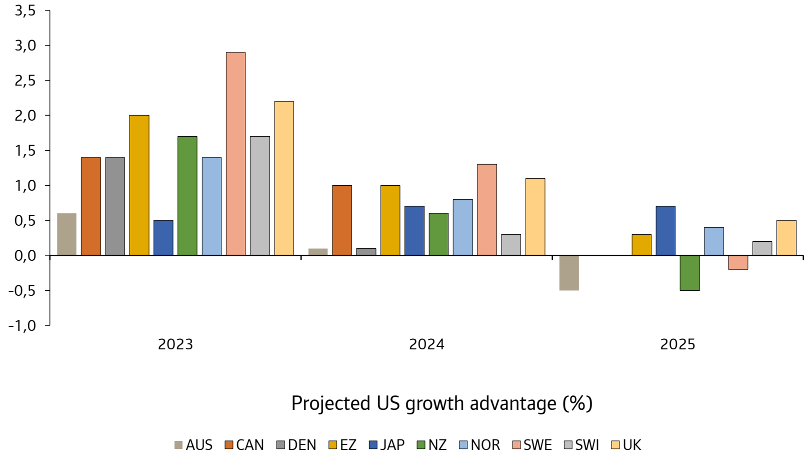
With the exception of the yen, G10 currencies have been very stable over the past year, with euro/dollar, for instance, rarely straying outside of a tiny 1.05-1.10 trading range. This seems all the more extraordinary given the substantial divergence that we've seen between strong US economic performance and the weakness that's not just blighted Europe, but most other G10 nations. It may also appear at odds with the fact that it has been an extraordinarily active time for central banks as they have pushed policy rates up swiftly and aggressively. This year is likely to see monetary policy turn around with central banks slowly reducing policy rates. While this process could have a bearing on currencies, it seems reasonable to assume that if synchronised rate hikes in the past year or so have not created significant currency volatility, policy easing will leave currencies similarly untouched if, it too, is broadly synchronised, as seems likely.

The odd one out is Japan where the lack of policy rate hikes in 2022 and 2023 cost the yen dearly as other central banks lifted rates. The yen was the worst-performing G10 currency last year. This year, with the BoJ likely to hike as others cut, the yen should recover, and we'd expect it to be the best-performing G10 currency as it heads towards 125 against the dollar by the end of the year. For the other G10 currencies, the lack of interest rate divergence, as central banks ease in tandem, seems likely to restrict currency volatility. Still, a lowering of policy rates from the Fed will help ease global financial conditions given that the dollar dominates in terms of international lending. Some 65% of international debt securities and over 50% of international bank loans are denominated in dollar, and hence changes in US rates – and changes in the value of the dollar – tend to drive the global financial cycle. This cycle has been a tightening one in recent years but it should switch to an easing cycle this year. The reduction in risk-free rates, particularly in the US, potentially makes 'riskier' assets such as equities and corporate debt more attractive to investors. If this creates positive momentum in asset prices, it will likely weaken 'safe' currencies. The traditionally 'safe' currencies are the dollar, yen and Swiss franc. But, as we've mentioned, the yen seems unlikely to weaken significantly because the BoJ will likely be lifting policy rates as others cut. In addition, BoJ intervention seems probable again if the yen falls too far. The franc is another currency where the prospect of a steep decline seems to be restricted by the close attentions of the Swiss National Bank, and especially so when inflation is running hot.

In short, this could leave the dollar as the 'safe' currency that's most likely to slide if there is strength in global asset prices bought about by Fed easing and 'safe' currencies are no longer wanted. Of course, this presupposes that asset prices will rally as the Fed and other central banks cut rates, and this is debatable given that we have already seen sharp rallies in asset prices since Q4 last year and many markets, not least US stocks, are still viewed by many as historically very expensive. Another consideration is that the febrile situation in geopolitics around the world could flare up and so produce strong demand for the 'safe' dollar, even as lower Fed policy rates might be pushing it down.

While central bank policy is a key focus for the currency markets, it is clearly inappropriate to think that FX movements are solely determined by interest rates. Broad economic performance is a factor as well and, on this score the US, and hence the dollar, have been the G10 standouts. The US outgrew other G10 countries last year; many by some considerable distance (Figure 5 overleaf). However, consensus forecasts from analysts suggest that this advantage will dwindle in future years, and we suspect that the dollar will follow with a modest 5-10% trade-weighted decline through to the end of 2025.

Figure 5: US growth advantage seen dwindling



Source: Bloomberg

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EM outlook in 2024

Introduction

We expect a decent, but bumpy, year for emerging markets (EM) given the uncertainty over the health of advanced economies and the path of still elevated policy rates, ongoing geopolitical developments, the relative resilience of the USD, and strained fiscal positions for some.

The level of economic growth in EM economies is expected to remain at the same speed as in 2023. As in 2023, the world's largest EM economies are expected to expand by an average of 3.0% in 2024, stuck below the pre-pandemic average of 4.5%. Such sluggishness would be largely due to reduced momentum in the largest economies, particularly China – by far the largest economy in the group – but also even India – the fastest-growing large EM economy. Slowdowns in these economies offset the favourable fact that half of the largest 30 EMs are expected to accelerate in 2024. The issue not only a matter of scale; importantly, only five EMs will grow above 5% – down from 20/30 in 2010 and 10/30 in 2019.

Tailwinds from a broadly easing bias is a slam dunk, but most will have to reduce benchmark policy rates more slowly than many expect. EM central banks need to continue fighting inflation to maintain monetary policy integrity before prioritizing growth. Granted, one-third of EM economies started reducing interest rates in the second half of 2023. It is also true that inflation, for the most part, peaked around Q3:22, and is expected to fall further in 2024. On balance, central banks in Latin America have the most room to cut rates, potentially leading to relatively sharp falls in sovereign yields and spreads. However, many Asian central banks will have to be more conservative due to already low interest rates, negative yields for some, and, therefore, elevated risks of capital outflow and currency depreciation. Emerging markets may become more attractive throughout the year due to a widening growth differential with advanced economies and demand for diversification away from the US, but they will be hamstrung by policy rates in advanced economies probably falling more slowly than what has already been priced in by financial markets.

The global economic backdrop is best described as lukewarm. Global economic growth is expected to slow slightly in 2024, hitting a cyclical low in the first half of 2024, with a potential recovery led by interest rate cuts. EM will benefit from a no-recession scenario, and, with higher starting yields and potential rate cuts, EM assets are likely to become more attractive to investors. To be sure, EMs are showing attractive valuations, creating a favorable entry point during 2024. In general terms, despite pockets of stress and despite relatively high debt service costs, companies in EM economies have been deleveraging. Corporate debt as a share of GDP has fallen from 244% in 2020 to 221% in 2023, and corporate net leverage is at the lower end of the historical range. Logically, investment-grade firms in EM are expected to navigate choppy waters most successfully; however, their bonds are not actually that cheap compared to counterparts in mature economies.

An unstable global political landscape serves as backdrop for huge volume of domestic elections this year. Recent elections in Argentina and Poland highlight the unpredictability of election results. Global investors are concerned about possible changes in financial management, fiscal and monetary policies, and the rise of populist policies in these countries, at a time when the quality of global democracy has been waning over the past five years. Of course, the outcome of these elections is also likely to have a significant impact on the global response to the ongoing conflicts.

Despite decades of multilateralism, geopolitical stability is now more unpredictable. There is a fundamental shift in the geopolitical landscape. It is probable that a persistently elevated level of geopolitical risk that has enveloped the world in recent years will remain the status quo, raising the risk of volatility in the global economy and financial markets.

For the most part, the macro conditions seem to have already been factored into market prices – including commodity markets. However, it is important to note that this scenario assumes a delicate balance between inflation, growth, and monetary policy. **Any unexpected developments in these areas could lead to market volatility and require a reassessment of the economic outlook.**

- An obvious risk is that inflation may prove to be stickier than expected forcing central banks to reduce policy rates by far less than what has already been priced in by financial markets, potentially slowing economic activity, which could cause credit spreads to widen, raising the cost of borrowing for emerging market sovereigns and companies, especially those with lower credit ratings.

- A short and shallow recession in 2024 cannot be ruled out in the US and/or Eurozone. The "no recession" or "soft landing" scenario faces notable downside risks. Consider that US consumer spending may start to wilt under the pressure of high interest rates, fading labour market support, and slowing wage growth. High-frequency data shows companies have become more cautious, housing remains weak, and the fiscal impulse is lessening. Meanwhile, half of Eurozone members already experienced two or more consecutive quarters of negative GDP growth in 2023, and softness in the larger economies – particularly Germany – continue to weigh on the region.

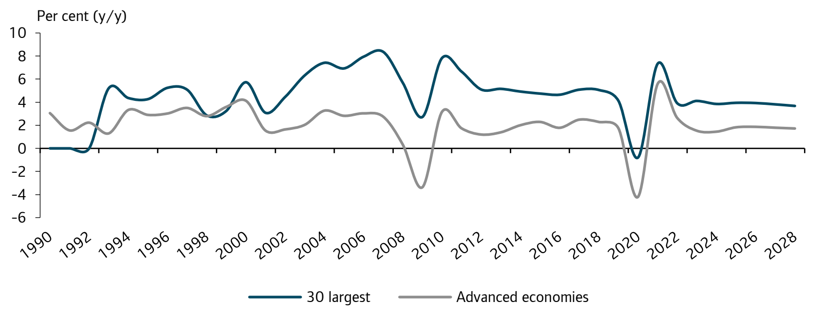
- In China, any stimulus measures authorities pursue throughout the year will be scaled to do just enough to slow or halt momentum loss and boost sentiment. We do not expect a rebound in economic activity and the scope for miscalculation is high. China is at the waning stages of its developmental super cycle, metabolizing peak housing and infrastructure, reigning in local government debt, navigating deflation, maintaining financial stability, and ensuring the recent surge in loans to manufacturing doesn't create a new locus for non-performing loans.

- Other risks confronting EMs in 2024 include the weighty election cycles and ongoing geopolitical conflicts. Indeed, an escalation in tensions in the Middle East and Russia/Ukraine war loom large, which would have meaningful consequences for global risk appetite.

A decent growth profile for emerging markets

The overall economic growth in emerging and developing economies is likely to flatline at 2023 levels. Overall, the largest 20 EM economies are expected to expand by an average of 3.0% in 2024, which is basically unchanged from 2023. The IMF forecasts that emerging market and developing economies will slow from 4.1% in 2023 to 3.9% in 2024. That is well below the pre-pandemic five-year average trend of 4.5% each year. The relatively subdued outlook is largely contingent on the still sombre view of global growth over the medium term. Emerging economies typically have a strong concentration in cyclical sectors and businesses, which heightens their dependency on the trajectory of the global economy.

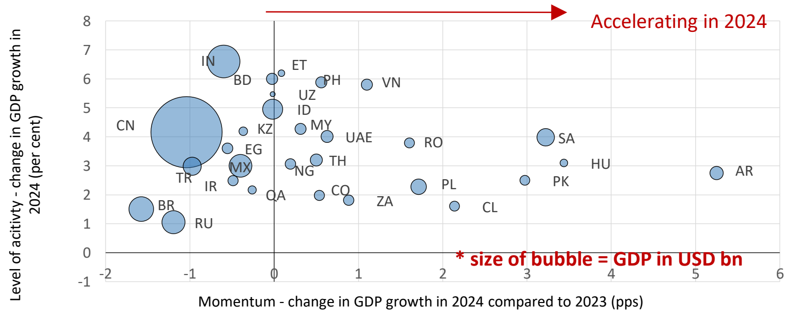
Figure 1: Reasonable growth divergence anticipated between EMs and the rest



Sources: IMF, SBR

Notably, unlike last year when all the world's largest emerging markets – except Russia – decelerated, we expect around half of the world's largest 30 EMs to accelerate in 2024. However, momentum loss in the largest EM economies – particularly Brazil, China, India, and Russia – accounts for the seemingly lacklustre outlook for EMs. Even India, the fastest-growing economy in Asia and the second-largest EM economy, is expected to slow from 7.2% in 2023 to 6-6.5% in 2024. Worse still, fewer and fewer EM economies are expanding at elevated rates to offset the lethargy elsewhere. Only 5/30 largest EM economies will expand by above 5%: Ethiopia, India, Indonesia, Philippines, and Vietnam.

Figure 2: Rate of growth and rate of change across EMs varied



Sources: IMF, SBR

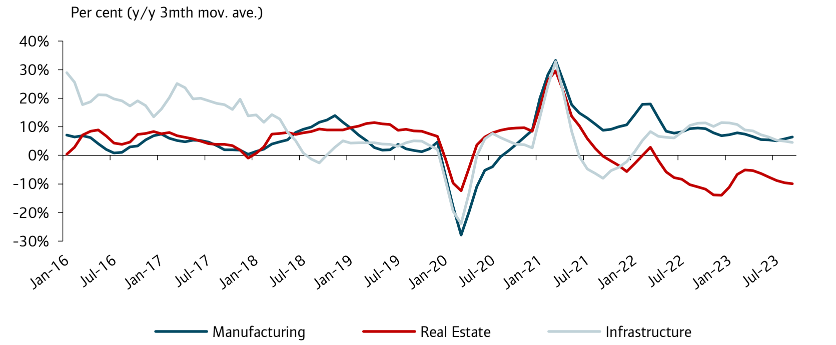
China's ongoing slowdown

Naturally, accounting for 40% of the EM annual economic output, China's trajectory matters a great deal to the group. China's economic momentum is far from resilient and, without the supportive base effects that flattered the data last year, GDP growth will continue to slide. How far, will depend to a large degree on policymakers being willing to defend this year's target (to be announced at the National People's Congress in March). However, a lot would need to go right for Beijing to hit a growth target of, say 4.5%, in 2024.

The weakness in domestic demand is made plain in the GDP deflator – the broadest measure of prices in an economy - turning negative for the first time since 2015. Notably, for only the second time in over 30 years, China reported consumer price deflation in 2023. Consumer price deflation confirms that the consumption "rebound" has been driven by base effects. Granted, household sentiment has improved since re-opening, but it remains near record lows as individuals fret about future income, employment, and wealth. A policy-led silver bullet is unlikely, suggesting that 2024 household consumption should look much as it did in 2023, which, without supportive base effects, will equate to a 2 percentage point contribution to 2024 GDP growth. Headline growth would have to slow if consumption remains the significant driver for this economy.

To plug the property-shaped hole in investment activity, policymakers have incentivized banks, SOEs and the private sector to channel investment into industry and manufacturing, and clean energy. Medium- to long-term loans to manufacturing jumped 37.2% y/y in 2023. Led by autos, machinery and equipment, and special manufacturing, manufacturing investment, the largest component of domestic investment, tallied a whopping CNY28trn in 2023, expanding by 6.5%. Meanwhile, 2023 was a tough year for China's exporters. Total exports for 2023 were down 4.6% from 2022 levels – the first annual decline since 2016. In response, exporters are reducing prices, diversifying to non-core markets, as in Africa, and embedding themselves into global supply chains, exporting intermediate goods to countries such as Mexico and Vietnam.

Figure 3: Growth in investment by sector



Sources: CEIC, NBS, SBR

So, all eyes will now shift to the target for 2024. China could feasibly pursue growth of "around 4.5%", but it would require expanding debt, which expanded at twice the speed of the economy in 2023, pushing bank loans to the private sector to 239% of GDP (up from 171% in Q1:20). Deflation won't help as it causes the real debt burden of an economy to rise dramatically as asset prices fall while the costs of debt liabilities remain fixed. Also, deflation hits corporate earnings and disincentivizes capacity expansion.

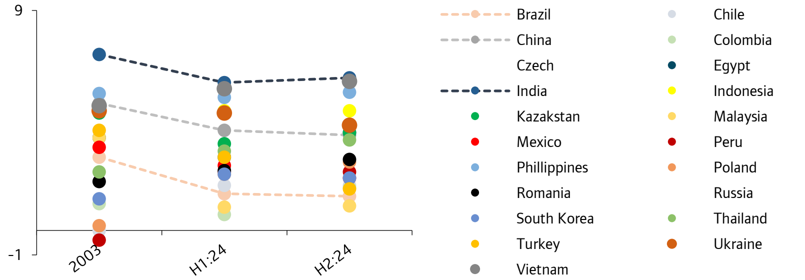
Some pockets of relative strength

Although it's true that these markets often share common vulnerabilities, such as their exposure to ongoing geopolitical tensions and the general inclination towards risk-taking, it's crucial for investors to be aware of the distinct differences that exist.

India will be the fastest-growing economy in Asia, boasting a youthful and expanding populace and, coupled with robust economic expansion, this nation exhibits attractive traits for investment. Robust credit expansion in recent quarters has fueled bets that corporate earnings will grow at a reasonable rate in 2024. Importantly, the composition of India's industrial sectors is varied – the combined contribution of the finance, technology, and energy sectors constitutes roughly half of the standard India stock market index, which last year overtook Hong Kong to become the fourth largest stock market by market capitalization.

India and others, like Mexico and Vietnam, are positioning themselves to gain from the ongoing realignment of international supply chains, with numerous enterprises exploring manufacturing "alternatives" to China. Latin America's second-largest economy, Mexico, is expected to expand by 2.6% this year, but has seen upward revisions in recent months due to positive economic indicators, including strong consumption, remittances, and a favourable investment environment. Vietnam's economy is expected to accelerate from 5.1% in 2023 to 6.0% in 2024 due to fiscal and monetary policies.

Figure 4: GDP growth forecasts in key EMs in H1:24 and H2:24



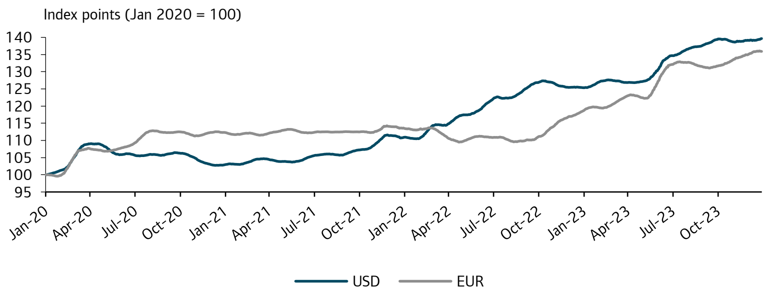
Sources: Bloomberg, SBR

Ultimately, following a period of 20 years marked by outstanding outcomes, the expansion experienced by emerging markets is anticipated to remain lacklustre for the foreseeable future. It's projected that growth will settle at more modest levels, around 4% by 2030, resulting in the gap between emerging market and advanced economic growth continuing to be a rather narrow 2pps - broadly in line with the three-year trend prior to Covid-19 and well below the 4-5 pps enjoyed in the run-up to the financial crisis.

Interest rates and inflation

For the group more generally, elevated inflation has led to rising rates. Overall, central banks in emerging economies collectively increased interest rates by a whopping 5,075 and 7,425 basis points in 2023 and 2022 respectively. Such high policy rates have been a headwind to growth, but measures taken have better safeguarded their economies from abrupt changes in capital movements. As such, currencies from emerging markets have experienced more modest depreciation since 2022 than in typical hiking cycles. Concurrently, currencies from developed economies also witnessed weakening in value versus the USD, often leaving emerging market currencies relatively stable against other trading partners. Indeed, elevating their benchmark interest rates well ahead of (and to higher levels) than the US Fed marked a significant departure from the patterns observed during previous cycles of Fed rate hikes.

Figure 5: Emerging market currency trend versus USD and EUR



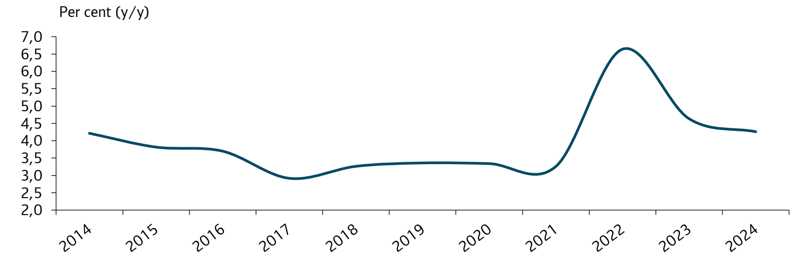
Sources: CEIC, SBR

The outlook for 2024 hinges on rate decisions by key central banks. Indeed, many EM central banks are waiting on the US Fed to pivot, creating space for the pace of interest rate reductions in emerging markets to either start or quicken. Already, around one-third of emerging market economies were able to begin lowering interest rates in H2:23, with five central banks cutting rates by a cumulative 250 bps in December. However, in the coming cycle, the surprise is likely to be that key central banks, like the Fed, start later and cut by less.

Promisingly, most in the emerging market universe are ready to respond. The cyclical peak for inflation in most large emerging economies occurred in Q3:22. Weighted by

GDP, inflationary pressures have eased considerably, from 6.63% in 2022 to 4.63% in 2023, and will continue to trend lower, averaging 4% in 2024.

Figure 6: Inflationary pressures in large emerging market economies have peaked

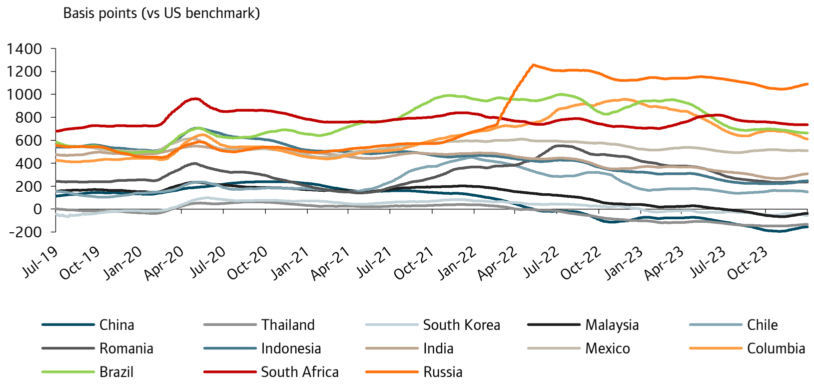


Sources: CEIC, SBR

Also, given how high rates are in many countries – notably in Latin America – central banks do have plenty of room to cut rates in 2024, facilitating a sharp fall in sovereign yields and spreads. Notably though, in contrast, central banks in much of Asia will be more cautious as benchmark rates are much lower. In fact, in a number of countries, most notably China, interest rate spreads not only shrunk sharply in 2022, but turned negative in 2023. Policymakers would loathe a further widening of interest rate differentials, which would put additional pressure on the exchange rate, potentially undermining confidence and encouraging capital outflows.

In general terms, central banks in emerging markets are expected to reduce policy rates in 2024. In 20 large emerging markets, a cumulative 3,870 basis points of cuts are anticipated, predominantly in H2:24, and predominantly by Latin American central banks. That said, to uphold the integrity of their monetary policy, emerging economies must stay alert and proactive in their fight against inflation and tread carefully until lower inflation provides the flexibility to reduce rates and prioritize growth. And they will be hamstrung by the later start and slower path for central banks in key economies.

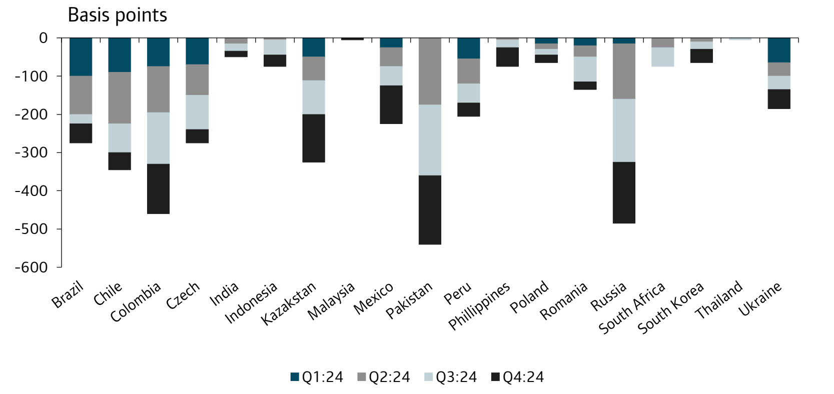
Figure 7: Yield spreads narrowed in 2023 – but from very different starting points



Sources: CEIC, SBR

In general terms, central banks in emerging markets are expected to reduce policy rates in 2024. In 20 large emerging markets, a cumulative 3,870 basis points of cuts are anticipated, predominantly in H2:24, and predominantly by Latin American central banks. That said, to uphold the integrity of their monetary policy, emerging economies must stay alert and proactive in their fight against inflation and tread carefully until lower inflation provides the flexibility to reduce rates and prioritize growth. And they will be hamstrung by the later start and slower path for central banks in key economies.

Figure 8: Expected reductions to benchmark lending rates in 2024



Sources: Bloomberg, SBR

The global backdrop

Global growth is expected to slow a fraction in 2024. Advanced economies' growth is expected to flatline around 1.5%, remaining below trend, with elevated central bank policy rates to fight inflation, a withdrawal of fiscal support amid high debt weighing on economic activity. The Eurozone is expected to accelerate from 0.6% in 2023 to 1.2% in 2024, offsetting some of the momentum loss in the US, which is forecast to slow from 2% in 2023 to 1.5% in 2024. The global economic cycle is expected to bottom out in the first half of the year before interest rate cuts lead to a slight recovery.

2024 is likely to prove to be a pivotal year during which we see if a soft landing is achievable. The “no recession” or “soft landing” scenario, which is generally favourable for market stability and investor confidence, faces notable downside risks. The risk of a US recession or a more significant downturn in the US or Eurozone has not disappeared. Consider that US consumer spending may start to wilt under the pressure of high interest rates, fading labour market support, and slowing wage growth. High-frequency data shows companies have become more cautious, housing remains weak, and the fiscal impulse is lessening. A recession in 2024 – albeit short and shallow – cannot be ruled out. Meanwhile, half of Eurozone members already experienced two or more consecutive quarters of negative GDP growth in 2023, and softness in the larger economies - particularly Germany – continues to weigh on regional growth.

An obvious risk is that inflation may prove to be stickier than expected forcing central banks in advanced and emerging market economies to reduce policy rates by far less than what has already been priced in by financial markets. Given that households have deleveraged in the US, the elevated level of household liquidity as a share of GDP means that cutting rates too forcefully – especially while unemployment is close to historic lows - may keep inflation elevated. If inflation proves to be stickier than expected the US Fed will cut rates by less than the 100 basis points (bps) in cuts markets have priced in.

If the cuts are less than expected:

- We could see a "backup" in interest rates, meaning rates might rise from their current or projected levels, which could increase borrowing costs and potentially slow economic activity.

- A deeper economic slowdown could cause credit spreads to widen, raising the cost of borrowing for companies, especially those with lower credit ratings. This can lead to higher default rates and have a negative impact on corporate profits and investment.

- Lower-than-anticipated rate cuts and a potential economic slowdown could lead to a decline in equity markets as investors reassess the growth and profit outlook for companies.

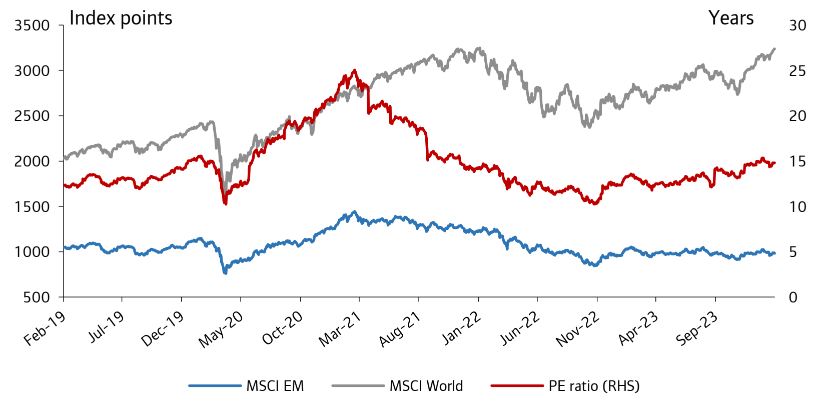
- In a situation where economic conditions worsen, investors might flee to safety, which could drive a rally in core government bonds, such as US Treasuries, as they are considered safe-haven assets.

This year investors will also have to weigh up the potential benefits of soft landings and policy easing on the one side, against heightened political risks on the other. The possibility of a return to the White House for former president Trump will raise angst in some quarters. We expect the primary season and subsequent general election campaign to produce market volatility. However, at this juncture, we do not believe that it would undermine US asset prices.

A no-recession environment would be very positive for EM, especially now that starting yields in EM are higher than in any of the recent rate easing cycles. Already, optimistic sentiment in bond markets, coupled with the possibility of interest rate reductions by the US Federal Reserve, has prompted a shift towards a more risk-tolerant approach concerning the debt of emerging market countries. This development suggests that more developing countries may have the opportunity to refinance their debt through fresh borrowing, avoiding the default scenario witnessed in the aftermath of the Covid-19 pandemic. Also, the tempering pace of expansion within China's economy opens the door for other emerging market economies, such as Brazil, Mexico and India, to satisfy the appetites of investors.

We favour a strategy that positions for asset prices to improve and the dollar to weaken. At this juncture, we see relatively low investor positioning and valuations metrics in emerging markets. Last year the MSCI EM index was basically flat (+2.5%) whilst its global equivalent rose by 25%. That trend has made EM growth stock valuations attractive coming into 2024. The deviation in price-to-earnings ratios between emerging markets and advanced economies is the largest it has been since the global financial crisis. Promisingly too, the forward-looking MSCI earnings per share figures suggest that earnings will expand by twice the speed in emerging markets during 2024 than the rest of the world.

Figure 9: ESCI world vs emerging market, and ESCI EM PE ration



Sources: Bloomberg, SBR

Worryingly, amid the biggest surge in global interest rates in four decades, the largest thirty developing countries spent a record USD330 bn and USD313bn to service external public and publicly guaranteed debt in 2022 and 2023 respectively, shifting scarce resources away from critical needs such as health, education, and the environment. Whilst Brazil, China and Russia reduced their payments materially, Argentina, Mexico, India, and Turkey saw large increases in 2023. Sharply rising government interest expense-to-revenue ratios are raising concerns about potential sovereign liquidity strains, including in Egypt, Pakistan, and Nigeria. Importantly, this year low-income countries face record high external refinancing needs: around USD80 billion in long-term external public debt is due in 2024, of which around USD50 billion is owed to official bilateral and multilateral creditors.

Encouragingly, companies in emerging markets have been deleveraging in recent years, as indicated by lower net leverage ratios. Net leverage increased by just 20 basis points to 2.4% in 2023, largely driven by cyclical pockets of weakness in the high yield segment. As a result, aggregate EM corporate net leverage is at the lower end of its historical range and is entering 2024 from a position of relative strength. We expect investment-grade firms will be better able to cope with higher refinancing costs than noninvestment-grade ones. However, EM investment-grade corporate bonds do not appear particularly cheap relative to US investment-grade credit.

Political backdrop

A pivotal election season is on the horizon for emerging markets. Recent voting outcomes in Argentina and Poland have served as a stark reminder that elections can yield unforeseen results and underscore the tendency for incumbent governments facing elections to increase fiscal spending in a manner that potentially adds fragility to the medium-term prognosis.

This year elections span countries representing more than half the global populace, including almost all the largest EM economies. This includes the US, India and Indonesia, the world’s three largest democracies. Global investors will be watching closely for any potential deviations in each countries financial stewardship, fiscal and monetary policy tilt, and the potential for populist policy shifts. Worryingly, one-third of the 64 countries holding elections in 2024 fall within the two highest risk categories of Verisk Maplecroft's Democratic Governance Index (DGI), which measures factors such as threats to electoral processes, civil and political rights and the independence of institutions. At the same time, data shows that the quality of global democracy has been waning over the past five years.

The backdrop for the election cycle is a fundamental shift in the geopolitical arena. Multiple new players are shaping today's geopolitical scene. Despite the growth of multilateralism over the last three decades, the geopolitical environment had remained relatively stable and predictable. However, this status quo appears to be in flux. The series of uprisings in 2011, known as the Arab Spring, ignited strife in nations such as Libya, Syria, and Yemen. Since, the world has witnessed a succession of significant conflicts: the 2020 clash between Azerbaijan and Armenia, the brutal confrontations in Ethiopia's Tigray region that erupted shortly thereafter, the turmoil ensuing from the 2021 military coup in Myanmar, and the Russian invasion of Ukraine in 2022. Moreover, 2023 saw catastrophic events unfold in Sudan and the Gaza Strip. The surge in combat across the planet in part reflects the current state of international politics. The deterioration of the relationship between the Western nations and Russia, along with the escalating rivalry between the United States and China, bears a significant portion of the responsibility. Nations around the globe, including those in Africa, must contemplate how to adapt to this new landscape of heightened geopolitical rivalry and diplomatic imperatives.

Forces likely to shape the EM universe in the medium-term

Looking further ahead, we expect that GDP growth will remain at this more moderate rate of around 4% through 2030. This temperance is attributed to a confluence of challenges that EMs, including those in Africa, must find ways to adapt to:

- The growth of **capital investment in EMs is falling short** of the robust rates seen in the past two decades. In the early 2000s, robust economic growth, credit expansion, improved terms of trade and improved investment climates encouraged capital to seek out EMs. However, since 2014, deteriorating trade conditions, heightened debt levels, general economic and geopolitical uncertainties, and China's "New Normal", combined with multiple global shocks, have sapped the swagger of EMs.

- **Physical infrastructure bottlenecks** remain a critical impediment to the competitiveness of a wide arc of EMs. Investments in infrastructure projects remain critical to enhance trade, attract foreign direct investment, and create employment opportunities. Those countries that make the best inroads at improving infrastructure, including transportation, energy, and digital connectivity, will outperform.

- **Environmental concerns** will become increasingly important. Rising awareness of environmental impacts in recent years, together with the establishment of Environmental, Social, and Governance (ESG) standards, has led to a pivot towards green energy investments, now outpacing those in traditional fuel sources. This shift will likely accelerate. Adopting clean energy solutions, reducing carbon emissions, and implementing eco-friendly practices will shape trade, investment, and supply chains.

- Emerging markets themselves will experience **demographic shifts**. Some, like China, are likely to get old before they are rich. Governments in the EM landscape will have to focus on addressing the various challenges associated with rapid urban growth, such as housing, healthcare, and education, to ensure inclusive and sustainable development.

- EMs are expected to continue experiencing a broad-based **deceleration in productivity growth**. World Bank estimates show productivity growth in EMs have declined by 0.8pps to 1.6% over the past decade, compared to the previous decade and is heading towards 1% by 2030. Driving this trend are factors such investment weakness, smaller efficiency gains, the deceleration in the growth of the working-age population and educational attainment. Countries that best incentivize investment in physical and human capital, and encourage reallocation of resources toward more productive sectors and enterprises will outperform.

- Emerging markets that **harness technology to drive economic growth** and innovation will rise to the top. Embracing digital transformation, artificial intelligence, and automation will play a vital role in improving productivity and competitiveness, elevating technological capabilities and human progress, to counteract this productivity decline remains highly uncertain.

- **International trade has plateaued** in the past decade amidst a move towards deglobalization, limiting trade's potential to further bolster growth. Tariff reductions, once a catalyst for trade growth, now have limited scope for impact due to their already low average levels.

Additionally, the shift towards service economies will likely lessen the significance of goods trade as a growth engine.

Conclusion

The level of economic growth in emerging and developing economies is expected to remain at the same speed as in 2023, stuck below the pre-pandemic average of 4.5%. Easing bias is a slam dunk but will go ahead more slowly than many expect. Emerging markets may become more attractive throughout the year due to a widening growth differential with advanced economies and demand for diversification away from the US. Our reasonably constructive prognosis for emerging markets is built on the back of a few core assumptions: (i) Inflation has and will continue to ease, which is generally a positive sign as it can lead to reduced pressure on households and firms. (ii) Central banks will have the space to ease policy rates (some are already in the process of doing so). This will support economic growth by making borrowing cheaper, encouraging investment and consumption. (iii) Although global growth is anticipated to slow a fraction, the expectation is that a full-blown recession in key advanced economies is likely to be avoided. The global economic cycle is also expected to bottom out in the first half of the year before interest rate cuts lead to a recovery. (iv) Growth in China will continue to slow, stimulus measures will be calibrated to do just enough to prevent a major step-down in real GDP growth. (v) Tensions between major powers, including the United States and China, will continue to shape international relations, but will not escalate during the course of 2024.

Any unexpected developments in these areas could lead to market volatility and require a reassessment of the economic outlook.

Jeremy Stevens[#]

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

African growth stages a come-back

El Niño weather, debt burdens and geopolitics still pose risks to growth

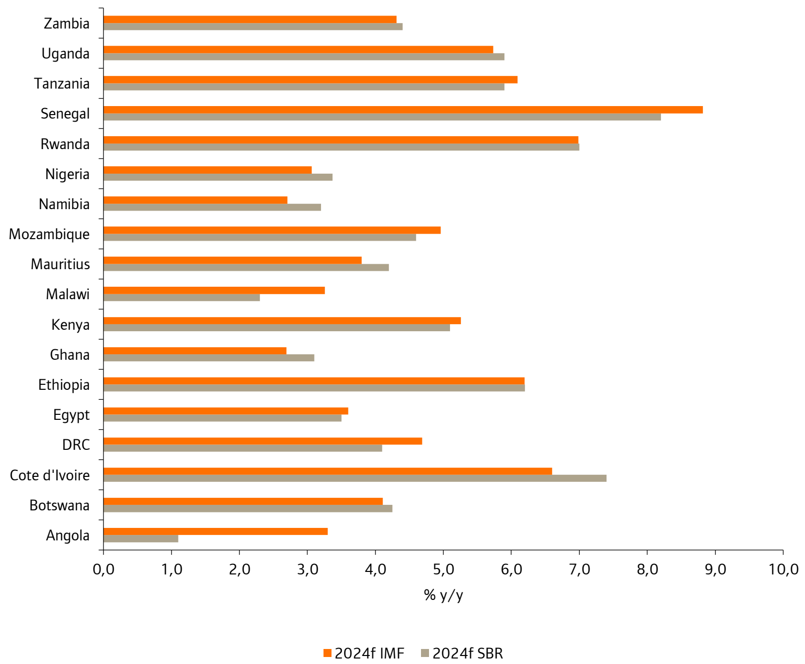
The IMF expects GDP growth in Sub-Saharan Africa (SSA) to rebound to around 4.0% y/y in 2024, from an expected 3.3% y/y in 2023. The growth outlook for both 2023 and 2024 was revised lower by the IMF, from 3.5% y/y and 4.1% y/y respectively, in their mid-year 2023 outlook.

Notably, unfavourable weather concerns, renewed geopolitical risks and ongoing debt sustainability challenges constraining the fiscal capacity to spur growth, are the primary downside risks for economic growth in SSA for 2024.

El Niño will have a varied impact on growth across Africa. Countries in the East Africa region, such as Kenya, Uganda and Tanzania, are expected to experience above-normal rainfall, while countries towards the southern parts, such as Malawi, Zambia and Mozambique, will likely experience drier weather.

El Niño may peak in early 2024, then recede during Q2:24. East African economies already experienced torrential rainfall in Nov and Dec 23, disrupting transport routes for trade. However, El Niño, particularly when associated with heavy rainfall, may either reduce cereal yields and/or production, or increase it – depending on the timing and whether the breadbaskets of the countries in question receive such excessive rainfall. Nonetheless, El Niño portends notable downside risk to economic growth for many of the markets in our coverage in H1:24.

Figure 1: SBR versus IMF GDP forecasts

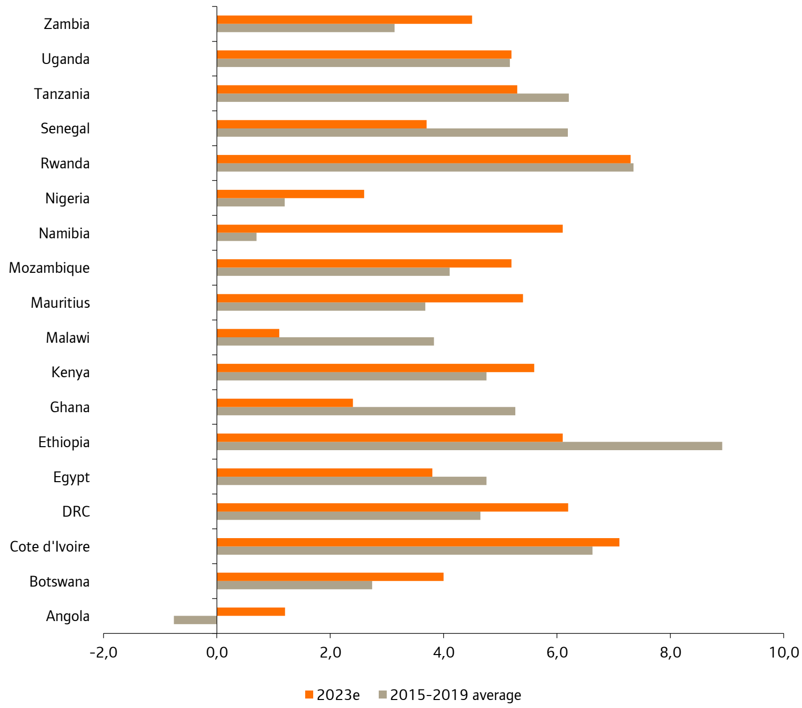


Sources: Standard Bank Research, IMF

The world economy has seemed unable to 'catch a break' since 2020, with multiple shocks that have simultaneously impacted economies in quick succession. SSA GDP growth in 2021 was on the mend somewhat as the removal of public health restrictions, brought about by the pandemic, spurred economic activity in 2021, which of course was further aided by complementary base effects. As economic activity showed promise to expand further in 2022 and normalise from the unusual decline in output from the 2020 pandemic, geopolitical tensions increased after Russia's invasion of Ukraine in Feb 22, which sharply spiked inflation expectations as food, fuel and fertiliser prices rose abruptly.

Concurrently, the US Federal Reserve and other major advanced economies central banks began aggressively tightening monetary policy conditions in H1:22. This exacerbated exchange rate pressures and compounded debt sustainability problems, both weighing on growth across SSA. Still, growth in most African economies is now approaching, or has already breached, pre-pandemic averages, underscoring notable resilience notwithstanding the confluence of recent shocks. Arguably, it may be prudent to compare pre-2020 growth averages to 2023, which would omit the base effect distortion in growth seen in 2021 and 2022.

Figure 2: Historical GDP average versus 2023 estimate



Sources: World Bank, Standard Bank Research

Growth in Kenya likely recovered to 5.6% y/y in 2023, exceeding the 3.6% y/y average GDP growth forecast in the 4-y to 2019. Economic activity was largely spurred by a recovery in the agrarian sector, which was weighed down in 2022 by a severe regional drought, which the authorities claim was the worst in 40-y.

We see GDP growth in Kenya easing to 5.1% y/y in 2024 in large part due to a weaker performance from the agricultural sub-sector in H1:24 due to the ongoing El Niño rains. But, rising domestic arrears, or impending bills, remain a drag on economic activity, which have now reached around KES630.6bn as of Sep 23, from KES439.2bn in Sep 22, and this is just for the national government. When county governments arrears are included, this number is reportedly closer to KES800.0bn. Surprisingly, these are arrears have been accumulated from Jun 2005, whereas county governments were only formed in 2013, when the system of a previously sole central government was devolved into the formation of 47 counties. County government pending bills have shot up to around KES165bn as of Sep 23, from just KES37.6bn in 2015.

These rising pending bills are predominantly due to delays in disbursement of the equitable share of revenue to counties due to government cashflow issues over the past year, exacerbated by delays in issuing supplementary budgets. However, the change of county administrations since Q4:22, when the government also changed, has also contributed to the rise in domestic arrears.

Further, the process to verify pending bills has also taken longer than the authorities expected. Indeed, rising domestic arrears typically weigh down economic activity as private sector credit extension eases due to banking sector non-performing loans (NPLs) growing. However, the government has now formed a pending bills verification committee, with line ministries and county government expected to submit their claims and supporting documents by 2 Feb 24. That said, should arrears rise further, economic activity may falter.

However, positively, with external debt obligations expected to ease from H2:24 and external funding sources also likely to improve, the government may begin to boost investment in infrastructure, which may underpin growth. That's said, the government's affordable housing construction plans may also be disrupted if a court ruling in late Jan 24 upholds its decision to halt employee and employer monthly contributions for the project.

Growth in Uganda will likely recover to 5.9% y/y in FY2023/24, from 5.2% y/y in FY2022/23. This would exceed the 5.2% y/y growth average in the 4-y to 2019. GDP growth will likely be buoyed by the ongoing investment in the oil sector and a stable macroeconomic environment, which should provide tailwinds to private consumption expenditure.

Admittedly, similar to other economies in the East Africa region, the primary downside risk to growth in Uganda in H1:24 is also associated with El Niño rainfall, which already caused flooding in parts of the country in Q4:23. This could also weigh down net exports by way of lower coffee sector productivity.

We nevertheless maintain our medium-term bullish outlook for growth in Uganda, largely owing to increased oil sector investment. We therefore see growth rising to 6.2% y/y in FY2024/25. The government still foresees first oil in 2025. However, this might be delayed towards 2026.

Nonetheless, subdued public investment also poses as a notable downside risk for growth over the next couple of years. Securing full financing for the construction of the crude oil pipeline to Tanga is still pending, although the authorities are confident that the shortfall in financing will likely be filled from Chinese funding partners. A delay in financing for oil related infrastructure could also keep growth lower than we currently envisage in our base case.

A further dent to public investment in infrastructure could also arise if the World Bank doesn't resume project financing from FY2024/25. Recall, following the passing of the anti-homosexuality law, the World Bank announced a suspension of new project financing from FY2024/25. However, the law is being challenged at the Constitutional Court and, if it is scrapped, or perhaps tweaked, with the penalties being made more lenient, the World Bank suspension may be lifted.

Nevertheless, external funding concerns, which could drag down development expenditure further, may persist in H1:24 after the IMF programme fifth review was delayed. The government had expected to receive a cumulative USD250m by Jun 24. This could also curtail economic activity over the coming year.

In Mozambique, we see GDP growth decelerating this year and next year, to 4.6% y/y and 3.8% y/y respectively, from an above 5% y/y growth in 2023, on dissipating favourable base effects, since the ramp-up in LNG production from the Coral South FLNG already expanded output to the 3.4 mtpa of LNG nominal capacity in 2023.

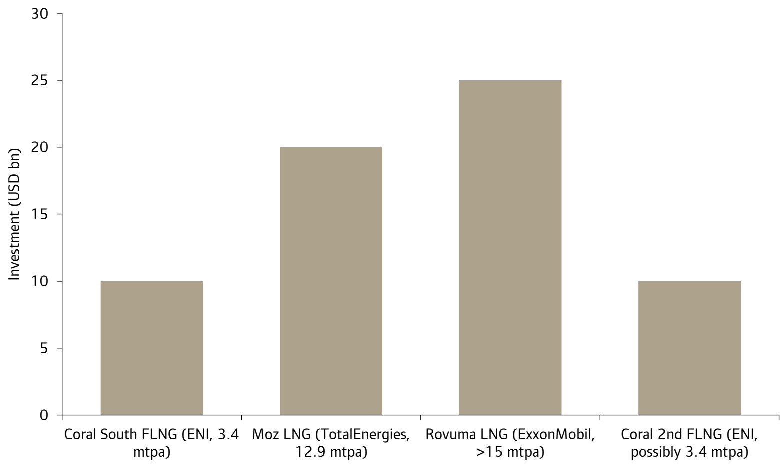
This implies a deceleration in extractive sector GDP growth this year. We also factor in, persisting government domestic debt pressures, which would translate into financing conditions remaining tight, likely subduing non-extractive GDP growth. Of course, drier weather conditions linked to El Niño may also weigh on growth in 2024. Agricultural sub-sector growth had been hampered in 2023 owing to Cyclone Freddy, but for which stronger growth in the LNG sector more than compensated.

Tight financing conditions has seen limited investment outside the resources economy, which further curtails future non-resources growth.

Our expectation for a GDP growth acceleration from 2026 onwards reflects the impact of LNG investment, with LNG output expected to rise again from 2027 onwards.

Needless to say, while Mozambique's LNG story is marked by delays and setbacks, at least one project, the Coral South FLNG, led by ENI, has successfully been completed, and began exports from Nov 22. Positively, being offshore, this project is less vulnerable to security challenges.

Figure 3: LNG investments



Source: Standard Bank Research

Refreshingly, there have been material improvements in the security situation in Cabo Delgado, supported by Rwanda and SADC military on-the-ground support, assisting the Mozambique's Defence and Security Forces (FDS) to restore security.

Improvements in the security situation imply that the Area-1 project, led by TotalEnergies, for 12.9 mtpa of LNG (USD20bn investment), will likely resume onsite construction during H1:24, with production expected by 2027.

The Area-4 project led by ExxonMobil for over15 mtpa of LNG (USD25bn investment) is seen taking final investment decision (FID) in 2025, with production expected by 2029. A second floating LNG project (Coral North, for 3.4 mtpa of LNG or USD10 investment) is also seen taking FID next year, with production expected by 2028.

With that said, there have been reports of an increase in insecurity again early in 2024. For now, it remains uncertain as to what extent continued insurgency may discourage future LNG investments, which could then weigh on growth.

The size of these four LNG projects, implying around USD65bn in FDI, is over 3x the current size of Mozambique's nominal GDP.

We note, though, limited positive spill-over effects from these LNG investments into the rest of the economy, at least during the construction phase, due to limited linkages between the LNG cluster and the rest of the economy (limited local content).

The recently approved Sovereign Wealth Fund (SWF) is seen as an important tool to help manage transparency on the transfer of LNG wealth into the rest of the economy.

After all, taxation will likely become the major element in transferring benefits of the LNG cluster to the rest of the economy. But then again, no major contribution to taxation from the LNG sector is expected before 2028.

GDP growth in Malawi will likely increase to 2.3% y/y, from an expected 1.1% y/y in 2023. Growth in 2023 is lower than the 4.1% y/y average recorded between 2016 and 2019. The agricultural sector in Malawi, similar to Mozambique, accounts for over 20.0% of nominal GDP, implying that El Niño weather could drag economic activity lower. However, while the base effect for 2024 in Mozambique is not favourable, the base effect for growth in Malawi in 2024 is now favourable, underscoring the divergence in the direction of growth forecasts amid weather related risks.

Indeed, El Niño weather patterns are putting Malawi's main export commodities – tobacco and tea – at risk again. Tobacco and tea exports comprise 50-60% of Malawi's total exports. Therefore, Malawi's FX liquidity depends on these two commodities, both of which in turn depend on weather patterns. Further, the country's FX liquidity has long been tight.

For Malawi, El Niño weather patterns typically lead to drier and hotter conditions. Though not necessarily causal, historical data indicates declines in tobacco exports during, or shortly after, an El Niño cycle. Indeed, data from the two El Niño cycles (2002/03 and 2015/16) shows tobacco exports (on average for those two years) contracting by 3% y/y and 7% y/y respectively.

Malawi ended 2023 with an import cover of an estimated 1-m. Should an El Niño cycle prove recurring in 2024, and thereby lead to a contraction in Malawi's main export commodities, FX liquidity may prove tighter still.

However, Malawi is on an IMF program (ECF approved in Nov 23), which has unlocked multiple sources of funding, to be channelled towards supporting external buffers as well as providing budget support, which may underpin growth.

For Zambia, we see growth at 4.4% y/y in 2024 slightly down from 4.5% y/y in 2023. However, this exceeds the 3.2% y/y average growth in the 4-y to 2019. From Q4:20 to Q3:23, Zambia's economy has displayed remarkable resilience, as evidenced by a 6.5% annualized growth in real gross value added (GVA) over that period.

A portion of this growth can be attributed to the low base effects resulting from the pandemic's impact on the economy in 2020. However, what is notable is that the recovery was not driven by either mining (80% of FX earnings) or agriculture (over 50% of formal and informal employed population). Indeed, agriculture's annual real GVA over the period was -1.5% and mining -0.2%. Instead, the recovery has been driven by telecommunications, 2% annualized increase in GVA, education, 1.2%, and transport and logistics, 0.7%.

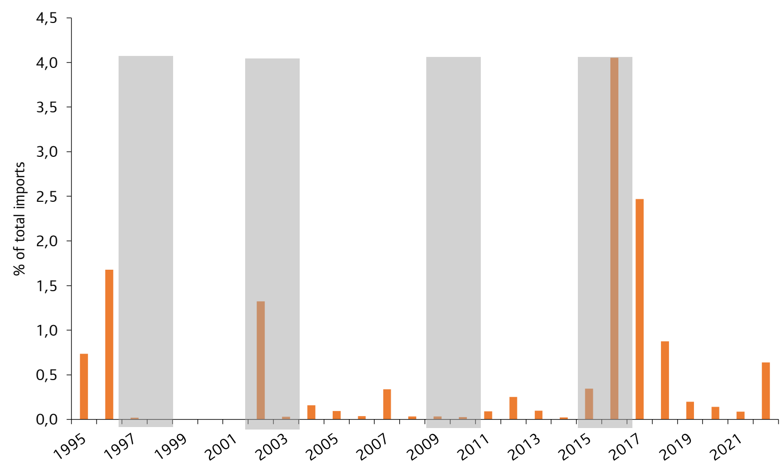
The telecommunications sector has benefited from mobile network operators' continued investment in telephony and digital services, with the government committed to increasing the national network coverage from 78% in 2020, to 92% in 2024, by investing in more than 300 communication towers.

Education comprised 15% of the 6.5% annualized real GVA growth in the post-pandemic period. This is due to the UPND government more than doubling the ZMW amount allocated for education in the budget, from ZMW13.8bn (11% of the budget) in 2021, to ZMW27bn (15% of the budget) in 2023. Tangible achievements in education over the period include a surge in enrolments, 30,000 teachers recruited, addressing critical teacher shortages particularly in rural areas, the completion of 69 out of 115 secondary schools and the commencement of 120 new schools in collaboration with the World Bank. We forecast education being a sustainable growth driver in 2024, immune to the vagaries of the exchange rate due to the commitment shown by the government.

Transport and logistics are the third largest contributor to Zambia’s 6.5% overall real GVA growth since 2020, contributing 0.7% annually. Public-private partnerships in road construction have been key for this sector, with initiatives such as the Lusaka-Ndola dual carriageway, Chingola-Solwezi, Ndola-Mufulira, Chingola-Kasumbalesa, and Lumwana-Kambimba roads. Leveraging private sector investment through PPPs has been instrumental, especially given the limitations in government financing. This model has facilitated the commencement of major projects that enhance road networks within the Zambia-DRC copperbelt region as well as the copperbelt region to the commercial capital, lowering the cost of transportation and fostering trade. These projects are long dated commitments, which we expect will continue to stimulate growth in 2024, regardless of recent kwacha weakness.

However, El Niño is associated with an increased likelihood of drought conditions in Zambia, which could adversely affect rain-fed agriculture. Drought conditions could also impact hydroelectric power generation. Hydro-electric power accounts for 85% of the country's electricity generation. Previous El Niño events, such as in 2016, and non-El Niño related drought conditions between Q4:22 and Q1:23, led to significant drops in dam water levels, causing widespread power outages and elevated importation of electricity, mainly from Mozambique.

Figure 4: El Niño (grey areas) and Zambian Electricity current imports as share of total imports



Sources: ZESCO, Standard Bank Research

The reliance on the Kariba Dam for hydroelectric power makes water levels there a critical factor in determining Zambia's power stability. The improvement in early 2024 relative to 2023 may offer some respite. As of January 8, 2024, the water level at Kariba Dam was 477.30 meters, translating into 12.46% usable storage for power generation. This level marks an improvement from early 2023, when the dam's water level was at a very low level of 0.83% of live storage.

Growth in Nigeria could pick up to 3.4% y/y in 2024 from 2.6% y/y in 2023, largely courtesy of an expected increase in oil production. Crucially, oil production could benefit from the ongoing anti-crude oil theft drive aided by new production streams.

Downside risks to growth remain, with activity in the industrial sector likely to stay subdued due to cost pressures and FX liquidity constraints. However, the commencement of operations at the Dangote Refinery should boost oil refining, a sub-sector within manufacturing.

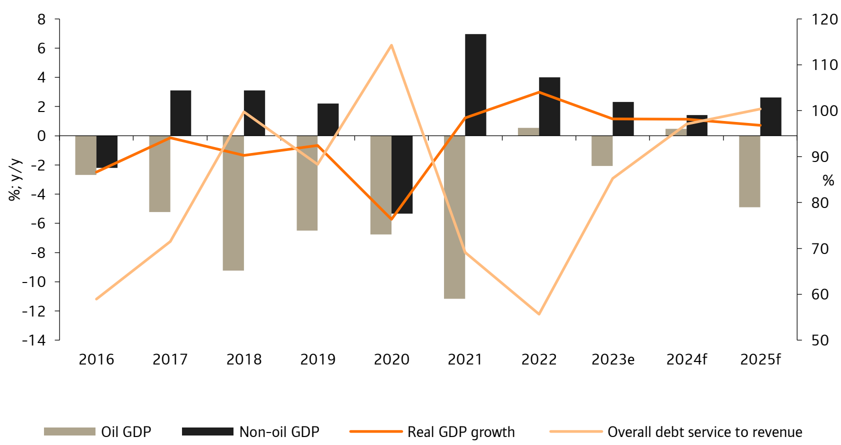
For Angola, the economy remains heavily reliant on the oil sector to grow. Despite economic diversification efforts, the oil sector accounts for over 95% of exports, more than 50% of fiscal revenues and over 25% of GDP. Heavy concentration in the oil sector exposes this economy's GDP growth to oil output and oil price fluctuations.

Declining oil prices, typically implies softer export revenues, fiscal pressures (due to external debt service remaining high) and FX liquidity pressures, which was the case in 2023, when oil prices fell from 2022 highs.

Growth implications of fiscal and FX liquidity pressures are severe. Oil output declining over the past few years too implies that GDP growth in Angola has largely been driven by the non-oil economy.

However, given Angola's large dependency on imports, the non-oil economy requires adequate levels of FX supply to perform. This explains the deceleration on non-oil GDP growth in 2023. Our view of fiscal pressures and FX liquidity persisting informs our forecasts of Angola displaying poor GDP growth prospects, pointing to further deceleration of GDP growth to 1.1% y/y in 2024 and 0.7% y/y in 2025, from an 1.2% y/y estimate for 2023, remaining well below population growth of 3% per annum, but higher than the 1.2% y/y average contraction in GDP growth in the 4-y to 2019.

Figure 5: GDP growth versus debt service



Sources: Banco Nacional de Angola, Ministério da Economia e Finanças, Standard Bank Research

Swift Ghana bondholder deal can redeem dimming faith in G20 common market framework

The formation of the G20 common market framework in 2020 following the implosion of debt sustainability of economies that were already on the cusp prior to the pandemic, was expected to expedite debt restructuring resolution and kickstart the journey to restore debt towards more sustainable positions. Zambia, Ethiopia and Chad were the first economies initially to apply for debt restructuring under this framework, with Ghana following suit in 2022.

Now, nearly four years later, and questions are now arising whether the common market framework needs to be significantly refined or shelved altogether, as scepticism towards it grows. Indeed, as we have noted in our previous research, the broad diversity in creditors that comprise of Africa's external debt has notably pivoted towards a larger share owed to non-Paris Club lenders such as China over the past two decade or so.

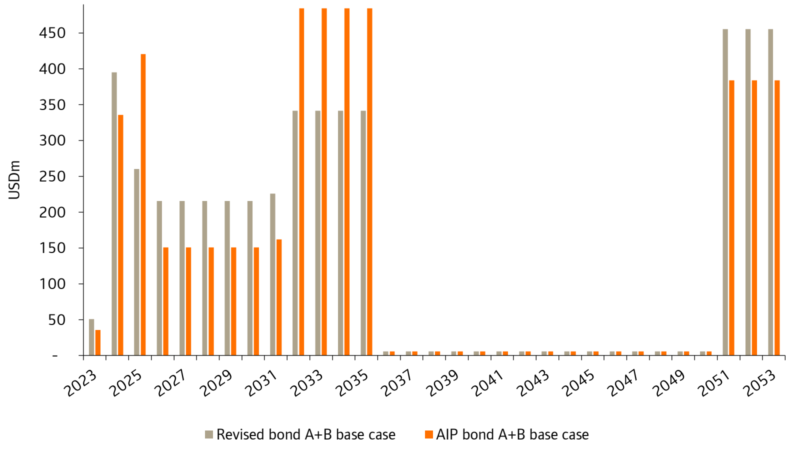
Admittedly, coordination amongst creditors was expected be tedious as debt restructuring modalities under the framework would have to align to both IMF pogramme parameters for debt sustainability (external debt service to revenue ratios, external debt to export ratios, and external funding to close the BOP funding gap during the IMF programme) and the comparability of treatment principle. However, the common market framework was precisely formed to address these concerns and aide in coordination amongst various creditor groups. Bondholders have argued that principal haircuts should also be accounted for when evaluating comparability.

In Jun 23, Zambia achieved a significant milestone by securing a USD6.3bn debt restructuring agreement with its official and bilateral creditors. This culminated in the signing of a Memorandum of Understanding (MOU) on 12 Oct 23, at the IMF Autumn meetings in Marrakesh. Attention then turned to restructuring Zambia's private sector external debt, particularly its Eurobonds. At the time, there was a growing sense that these common market framework concerns may finally be behind us.

However, after the Zambian government also reached an agreement in principle with bondholders on debt restructuring in Oct 23, the IMF vetoed the deal as it failed to align to their guidelines. But even as the IMF and the government ironed out these marginal issues, and were now on the same page, with a revised proposal being submitted, China and the Official Creditor Committee (OCC) expressed their grievances, implying that the deal with bondholders had breached the comparability of treatment principal, with more favourable terms being offered to bondholders. In order to assess the comparability of treatment, the OCC looks at the nominal debt service relief during the initial IMF programme, the elongation of the duration of claims and the lowering of the debt stock in PV terms.

Under the initial agreement in principal (AIP), Zambia would receive cash flow relief of USD1.12bn from 2023 to 2033, assuming a continued low debt carrying capacity as per the IMF and World Bank's Composite Indicator (CI). The debt servicing for the unrestructured Eurobonds of USD3.8bn over a decade until 2033, was reshaped in the AIP to USD4.9bn over 31 years. Notably, 55% of this amount (USD2.7bn) was due in the first ten years. USD792m (16% of the overall USD4.9bn notional) was due before 2025 when the current IMF programme expired.

Figure 6: AIP vs Revised – base case



Sources: London Stock Exchange, Standard Bank Research

The International Monetary Fund (IMF) initially rejected the AIP due to its misalignment with key debt sustainability metrics, notably the elevated debt service to revenue ratio and the substantial present value of debt compared to projected exports. The OCC, led by China and France, too rejected the AIP, arguing that official creditors had more significantly extended their restructuring terms than Eurobond holders, a move they viewed as contrary to the G20's principle of comparability of treatment. Additionally, the OCC criticized the Eurobond restructuring proposal for its inadequate contribution to mitigating Zambia's balance of payments financing gap during the critical period from 2023 to 2025.

While the IMF found the revised proposal satisfactory, the OCC, presumably China, did not agree, maintaining that the revised terms still did not provide comparable treatment on the basis, we believe, of providing cash flow relief to Zambia rather than NPV reduction, particularly in 2024 when the revised offer proposes debt servicing of 1.4% of GDP, putting the 2024 balance of payments financing status in jeopardy. On the issue of closing of the balance of payment financing gap, the bondholders seemed to imply that their concessions in other areas (like greater NPV reductions than the OCC and face value haircuts) should be considered as compensatory measures.

Crucially, the IMF managing director has recently advocated for a proactive application of the IMF's lending-into-arrears policy. This strategy involves the IMF continuing to lend to countries even when they fall behind on debt payments, incentivizing commercial creditors to agree to debt restructuring terms akin to those accepted by other creditors. This principle could be applied to Zambia's current situation and provide assurances to both creditors and debtors.

Indeed, it is natural to expect both creditor groups to seek their pound of flesh in these negotiations but, if an agreement between the OCC and bondholders is not secured in 2024, it will be a huge blow to the common market framework and perhaps may dissuade other economies from contemplating external debt defaults in the absence of a better solution. Official creditors broadly believe that bondholders already benefited from not participating in the 2021 Debt Service Suspension Initiative (DSSI). Under our base case scenario, we see Zambia securing an external debt restructuring deal, that will be acceptable to both creditor groups, in H2:24.

However, Ghana can still save face for the common market framework. The government reached a deal with the OCC in early Jan 23, which unlocked the USD600m second disbursement under the IMF programme and, at the time of writing, had subsequent meetings lined up in Europe to advance debt restructuring negotiations with bondholders. The Ministry of Finance is confident that a deal with bondholders can be reached by the end of Q1:24.

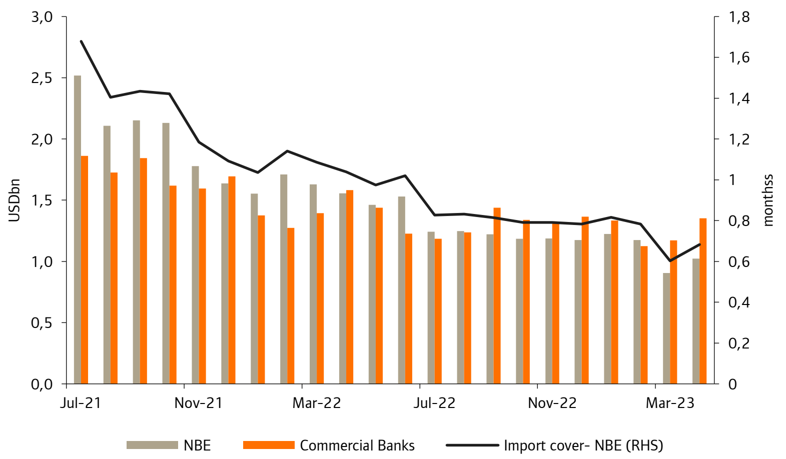
Reportedly, the main issue of contention in the OCC talks initially was the cut-off date, for which loans disbursed after this date, won't be eligible for debt restructuring. Although, they finally agreed to Dec 22 rather than Mar 20. The Ministry of Finance confirmed that the deal with the OCC has a moratorium on debt repayments in place through to 2026. Further, they confirmed that debt service for 2023 and 2024 for bilateral debt will now be extended by 17-y, repayable in two tranches.

In Oct 23 the government had proposed a haircut for bondholders as high as 40% with maturity extensions of 20-y and reduced coupons of 5.0%. However, the Ministry of Finance had already noted back then that the OCC deal would eventually influence the terms of the final bondholder deal.

Admittedly, with the recent case study of Zambia's external debt negotiations, it is obvious that, while the government can reach separate agreements with official creditors and bondholders, the most crucial aspect of the common market framework will be for both these creditor groups to be on the same page and for the proposals to be aligned with the IMF programme debt sustainability parameters and comparability of treatment principles. We see Ghana finalising an external debt restructuring deal in H1:24.

In Ethiopia, attempts over the last 15-y or so to finance large-scale public investment programs, through a combination of substantial external borrowing and domestic financial resources, coupled with subpar project execution, resulted in significant macroeconomic imbalances, including high inflation, FX shortages, and a high risk of debt distress.

Figure 7: FX reserves



Sources: National Bank of Ethiopia, Standard Bank Research

Indeed, debt sustainability risks aren't new to Ethiopia, having reprofiled the USD2.5bn loan from China for the Addis Ababa-Djibouti railway before the 2019 IMF-funded program. Following this, when Ethiopia was on an IMF-funded program, additional debt service reprofiling was part of the program condition aimed at helping Ethiopia in reaching a "moderate" risk of external debt distress, which was expected to occur before 2023. At the time of the most recent DSA in 2020, the PV to GDP ratio of external debt was well within the required threshold; however, PV of external debt to exports exceeded the threshold.

Indeed, FX reserves, which covered 1.9-m of imports by Jun 19, were already deemed by the IMF as below both model-based and rule-of-thumb adequacy metrics. This fell further, covering less than 1-m of imports since Q1:22. Ethiopia stated on Feb 21 its desire to restructure its debt in accordance with the G20 Common Framework, which has not gone smoothly.

Fast forward, the government of Ethiopia's decision to miss the USD33m Eurobond coupon payment in Dec 23 has been a long time coming. Following the breakdown of negotiations with key Eurobond-holders to restructure the USD1.0bn Eurobond that matures in Dec 24, the government failed to make coupon payment. The sovereign was then downgraded to RD by S&P Global and lowered to SD by Fitch. Even though FX reserves are now less than 1-m worth of imports, the USD 33m amount could've been covered from reserves. However, the government stated that the nonpayment was due to a desire to treat Eurobond-holders equally with its official creditors, that had already granted Ethiopia a debt suspension.

Following a debt-suspension agreement with China in Aug 23, Ethiopia and official bilateral creditors agreed to suspend debt service while orderly (G20 Common Framework) restructuring negotiations unfold. Such restructuring would be in line with an economic adjustment program that is supported by the IMF.

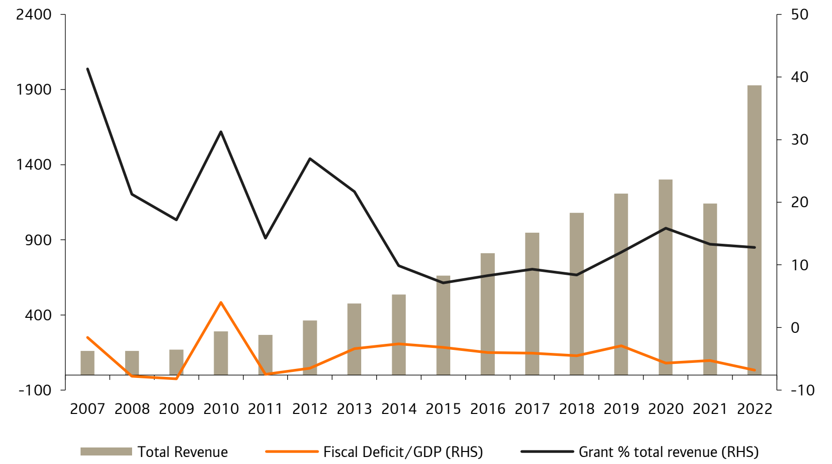
We would anticipate a below average (previous external restructuring in other countries) PV haircut given that Ethiopia is facing a liquidity rather than solvency problem, per the initial DSA from the IMF. According to the NBE estimate, between FY2012/13 and FY2021/22, the share of interest payments in recurrent revenue ranged at 2.4% to 7.1%, while debt service to goods export varied at 18% to 77.8% during the same period. Debt service to FX reserves increased from 15% in 2013, to 77% by 2022. Furthermore, external financing has plummeted, contributing to a significant reduction in FX availability between FY2019/20 and FY2020/21.

As it turns out, the government's proposal to the Eurobond-holders does not call for a principal haircut; rather, it proposes an amortizing structure with eight equal payments spaced out from Jul 28 to Jan 32, along with a lower coupon of 5.5%. The bondholders proposed a coupon rate of 6.625% (in accordance with the original rate) and an amortization period that is significantly faster, from Jul 28 to Jul 29.

All things considered; it seems unlikely that Ethiopian domestic debt will be included for debt restructuring. Crucially, there are no rollover concerns associated with the repayment of domestic debt as outstanding debt is held largely by public sector financial institutions.

Moreover, by 2019, Malawi exhibited a moderate risk of external debt distress and a high overall risk of debt distress, as per the IMF's Nov 19 DSA. Larger primary deficits in FY 2019/20-20/21 led to rising levels of domestic debt, which the IMF noted was a significant cause of the elevated risk of overall debt distress. As a result, it goes without saying that domestic debt has long been an issue, with an average maturity of 2.4 years, compared to 12.8–13.6 years for external debt as of FY2022/23. As a matter of fact, since the 2013 "Cashgate" scandal involving the embezzlement of public funds, budget support and grants reduced quite meaningfully. Thus, a large portion of the funding for the deficit during the last couple of years has come from expensive domestic borrowing with an average interest rate of 15.4%, compared to 1.66% for external debt, as of FY2022/23. Malawi's government debt has increased markedly due to growing domestic financing as well as non-concessional borrowing from regional development banks. Its capacity to service its external debt started to erode in 2021. FX reserves months of import cover fell to 1.7-m in 2021, from 4-m in 2020 and 3.2-m average in the five years prior to 2022. This is coupled with Malawi's severe lack of FX to import essential commodities such as fuel. Further, the Covid-19 shock made macroeconomic imbalances worse.

Figure 8: Fiscal deficit versus grants

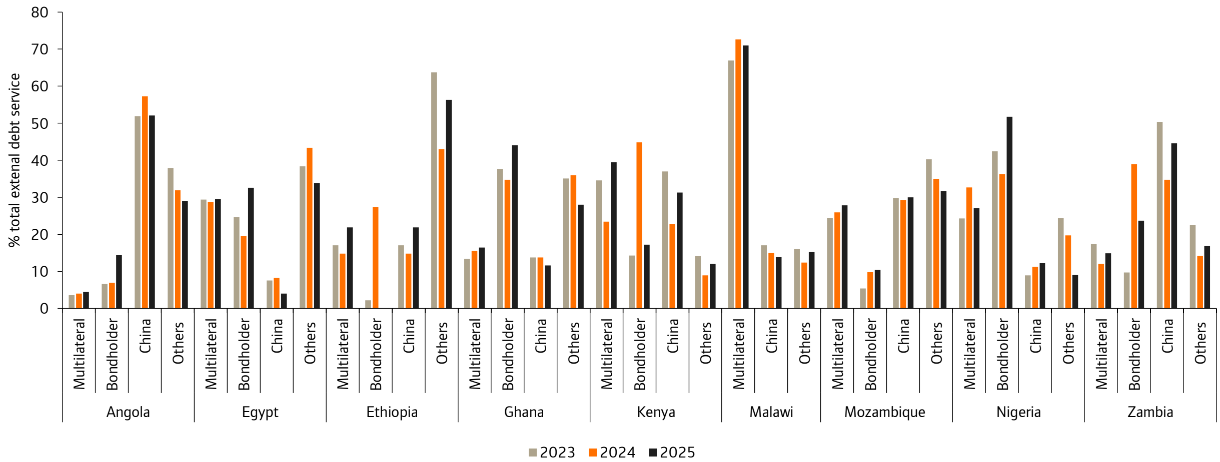


Sources: Malawi Ministry of Finance, Standard Bank Research

With the intention of returning external debt to a moderate risk of debt distress through a combination of policy reforms, external debt restructuring, and maximizing external grant financing from development partners, the government appointed a firm in May 22 to assist with the restructuring of external debt. As per the government's statement, the purpose of external debt restructuring is to provide liquidity relief through maturity extensions. While it continues to negotiate with external commercial creditors, with some of whom Malawi is already in arrears, the government has secured financial assurances from its key official creditors. As a result, Malawi and the IMF completed the Second (and final) Review of the Staff-Monitored Program with Executive Board Involvement (PMB), and a 48-m arrangement under the Extended Credit Facility (ECF) of approximately USD175m, approved in Nov 23.

Although the government and the IMF see debt becoming sustainable with debt treatment or restructuring from bilateral and commercial creditors, multilateral debt service as a percentage of total debt service rises to 72.7% in 2024, then falling to 70.9% in 2025, from 66.9% in 2023. As a result, Malawi may require fresh financial guarantees from multilateral institutions as these funding partners will be exempt from debt restructuring.

Figure 9: Debt services by counterpart



Sources: World Bank* saving from debt restructuring not deducted

Regarding domestic debt, the government stated in the FY2022/23 budget that it was "reviewing domestic debt profiles with a view of restructuring debt towards longer maturity period, to address the current debt sustainability concerns". However, we suspect that reprofiling was the intended word, rather than restructuring. Admittedly, the possibility of domestic debt restructuring has been increasing, probably most notably since last year when local redemptions reached MWK1.18tn. Thus, the rollover risks are relatively substantial. The redemption profile for domestic debt beyond FY2022/23 suggests that maturities will stay elevated until 2027.

According to RBM data, in FY2022/23, the government sourced its domestic funding from net credit from commercial banks which climbed by 30% y/y, while net credit from the RBM soared by 58%y/y (ways and means only accounting for 10% of the rise). 39% of the MWK9.2tn in domestic finance came from commercial banks, 34% from RBM, and 27% from non-banks. The government may need to improve revenue mobilization, expenditure rationalization, and possibly even lower fiscal deficit monetization to avoid having to restructure domestic debt as well because there is no room for fiscal spillage. In FY2022/23, recurrent expenditure was likely 116% of total revenue or 77.4% of overall expenditure, with interest payments accounting for 21% of total expenditure and 32% of total revenue.

We don’t expect Malawi to restructure domestic debt in our base case scenario, but risks are elevated. Surprisingly, in the recent IMF staff report following Executive Board approval of the funded programme, there was no mention of restructuring external debt under the G20 common market framework. Although, if the ongoing separate external debt restructuring talks hit a snag, one cannot rule out the IMF asking the government to move towards the common framework for negotiations. But would this be any smoother, given the evidence so far?

Mozambique also faces relentless domestic debt pressures since the implementation of the government wage bill reform which began in H2:22. Net domestic borrowing spiked in 2022, to MZN50.4bn, or 4.3% of GDP, due to the wage bill rising by 40% y/y that year, to 16.5% of GDP.

The planned fiscal deficit for 2024, of 1% of GDP, implies net domestic borrowing of MZN22.8bn, or 1.5% of GDP in 2024, further exacerbating domestic debt pressures.

It remains uncertain whether the domestic financial system will be capable to support such an increase in governmental domestic borrowing without any meaningful increase in borrowing costs for the government and further crowding-out of private sector credit.

Despite general elections planned for Oct 24, it’s reasonable to expect that the government will, prudently, not accelerate development spending until external funding is available. Otherwise, it would aggravate domestic debt pressures.

Considering the large domestic bond repayments scheduled for 2025 and 2026, which will pressurize debt service, the Ministry of Finance is therefore expected to engage in active debt management for effective liability management.

Table 1: Debt dashboard	IMF Program	Risk of debt distress	Credit ratings (Moody's S&P Fitch)	Reserves (USD bn)	Import cover (months)	External debt service (% of FX reserves) 2023	Debt service (interest) % revenue	External debt service % exports	Current account balance (USD bn) 2023	Domestic debt service split (%)	External debt service split (%)	Eurobond yields (Range)	Eurobond Z-spread (Range)
Angola	-		B3 B- B-	14.70	7.60	78.61	30.99	31.92	4.20	38.39	61.61	10.82-11.8	632-790
Botswana	-		A3 BBB+	4.90	8.10	4.61	3.00	3.10	0.95	67.62	32.38	-	-
Cote d'Ivoire	✓	Moderate	Ba3 BB- BB-	10.00	7.50	31.90	18.42	17.25	-3.50	45.11	54.89	6.16-7.63	76-355
DRC	✓	Moderate	B3 CCC+ CCC+	4.80	1.70	13.06	2.32	2.05	-4.00	88.09	11.91	-	-
Egypt	✓		Caa1 B- B-	35.20	5.10	53.71	52.29	25.48	-4.70	91.42	8.58	11.6-15.14	728.26-1083.57
Ethiopia	Requested-delayed	High	Caa3 RD SD	1.00	0.68	389.04	20.26	36.02	-4.60	83.87	16.13	51.82	5 169.00
Ghana	✓	In debt distress	Caa2 SD C	5.20	2.40	53.71	31.71	16.00	1.30	65.96	34.04	18.43-118.5	1642.88-11397.37
Kenya	✓	High	B3U B B	6.80	3.60	80.26	30.20	73.75	-4.20	29.66	70.34	9.52-10.36	573-647
Malawi	✓	In debt distress	- - -	0.23	0.90	63.62	35.82	12.95	-0.90	96.08	3.92	-	-
Mauritius	-		Baa3 - -	6.60	9.90	8.11	9.94	9.56	-5.80	88.94	11.06	-	-
Mozambique	✓	In debt distress	Caa2 CCC+ CCC+	3.10	4.29	26.63	14.13	8.60	-0.80	73.63	26.37	11.78	844.00
Namibia	-		B1 - BB-	2.70	5.40	4.36	14.98	2.74	-1.70	79.24	20.76	5.90	153.00
Nigeria	-		Caa1 B- B-	32.50	7.20	10.25	36.62	5.61	3.20	81.56	18.44	8.6-10.65	423.4-681.38
Rwanda	RST	Moderate	B2 B+ B+	2.00	4.00	88.97	8.89	71.75	-1.70	66.79	33.21	9.28	549.00
Senegal	✓	Moderate	Ba3 B+ -	5.40	4.40	4.79	9.24	3.70	-4.30	30.48	69.52	6.10	469.00
Tanzania	✓	Moderate	B2u - B+	4.90	3.60	33.32	11.30	12.18	-3.70	67.23	32.77	-	-
Uganda	✓	Moderate	B2u B- B+	3.88	3.40	30.57	18.51	13.18	-3.80	82.12	17.88	-	-
Zambia	✓	In debt distress	Ca SD RD	2.89	3.69	102.48	31.46	24.48	-0.50	85.61	14.39	25.73	2 811.00

Sources: Standard Bank Research, Various ministries of finance
External debt service % FX reserves and % of export does not account for debt restructuring

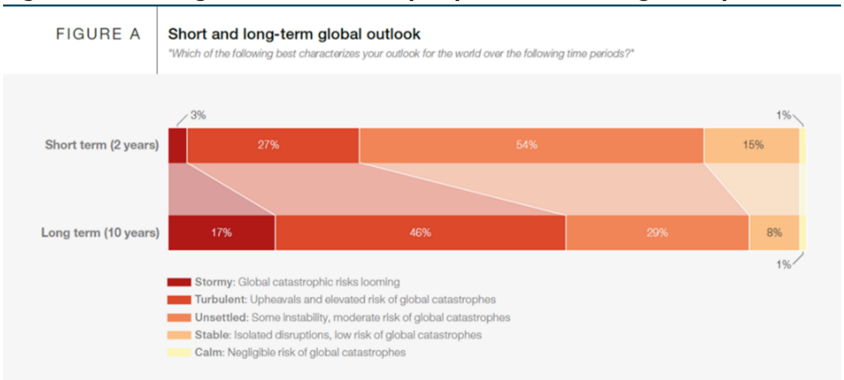
Jibran Qureishi[#]

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

SA politics, 2024: a year of two halves

This year's global political outlook is peppered with perils. 2024 begins with two wars raging, concerns over trade constraints mounting due to the conflict in the Red Sea, and an overarching sense that, with elections scheduled to be held in countries covering half of the world's population this year, the next 12 months will present unparalleled challenges. Delegates surveyed by the WEF in its latest global risk report overwhelmingly expressed the view that the next two years will be marked by upheavals and instability and that the threat of 'catastrophic global risks' will intensify over the longer term (Figure 1).

Figure 1: Mounting anxieties over the prospects for further global upheaval



Source: WEF 2024 Global Risk Report

For SA, politics is again a dominant feature of the outlook. The seventh democratic national and provincial elections will be this year's central political theme, infused by the possibility that the ANC could see its 30-year dominance meaningfully dented, introducing risks around the stability of national coalitions over the next five years. The prominence of the elections, which we expect to be held in late May, is such that they will cleave the year in half.

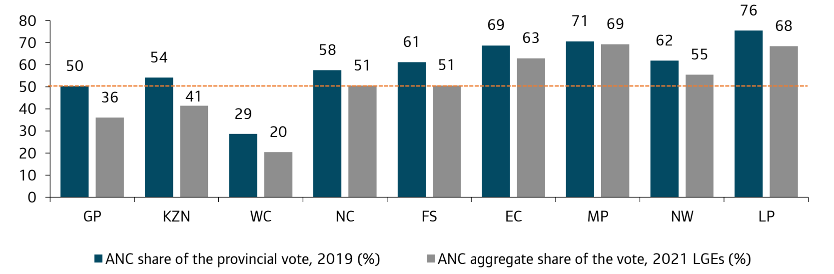
- In H1:24, the focus will rest on each party's election campaign, the IEC's readiness for the polls, and the various potential electoral outcomes and their associated risks and possibilities.
- And, in H2:24, focus will shift to the composition of the new parliament, the coalitions that may be required at the national and provincial levels, the election of a new president (who will have to deliver a new SONA), and the shape of the cabinet that is selected thereafter.

As a result, investors are clearly bracing (in SA and globally) for a tumultuous year. Perhaps most telling of these concerns is that 2024 may well end with Donald Trump back in the White House. In a sense, though, this anticipation should be welcomed: when prepared for change, systems are far more likely to absorb the shocks that these alterations create. To adopt *FT* economics commentator Martin Wolf's approach, it is the 'conceivable, but hard to predict' shocks, such as COVID-19 and Russia's invasion of Ukraine, that really roil the global economy. Now, battered by years of rising geopolitical unease, investors appear to be steeled for the grittiness of the year ahead, potentially ensuring that they will be more able to take the ruptures that will come their way with greater calm. And in SA, the intense noise generated by the election cycle may not translate into commensurately substantial changes to the country's national political landscape. Indeed, perhaps it will be the case that, despite the volatility that the year will offer, it will end by validating French critic Alphonse Karr's much-cited suggestion that 'the more things change, the more they stay the same'.

SA elections

- **Our longstanding base case view is that the ANC will manage to cling to the national majority this year, either alone or via a small party coalition**. As such, we expect that President Ramaphosa will secure a second term as head of state after the elections. Though this outcome does not provide a catalyst for a more positive reconfiguration of government and policy in the coming years, it does reduce the risks associated with unstable or complex national coalitions over this same period of time.
- **It is at the provincial level where we expect the most prolific changes**. Specifically, the ANC is likely to drop well below 50% in both Gauteng and KZN, ushering in a new era of coalition politics in these vital provinces. There is also a chance that the ANC's majority will slip in the Free State and the Northern Cape. In the remaining provinces – Eastern Cape, Mpumalanga, North-West, and Limpopo – the ANC will very likely retain power.

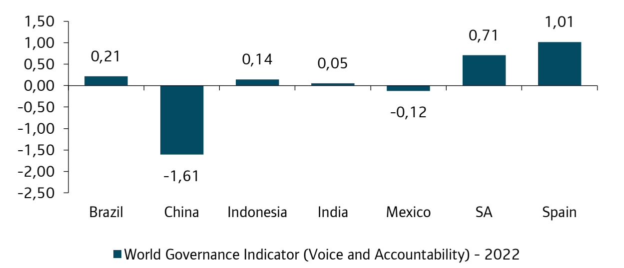
Figure 2: The ANC's sliding provincial fortunes



Sources: IEC, Standard Bank Research

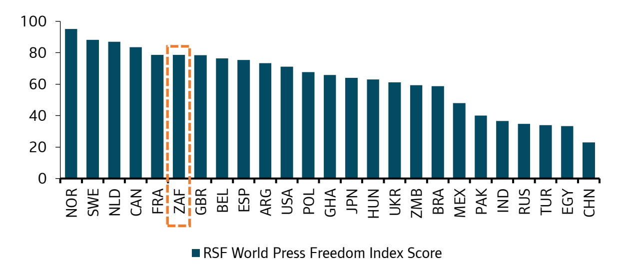
- **Though the elections present novel challenges and complexities for the IEC, we expect that they will be credible and 'free and fair'**. Key strengths for SA in this regard include the relative robustness of the country's democratic standing (Figure 3), the independence of the media (Figure 4), and the IEC's impressive 30-year track record in convening democratic elections in the country (some of which, as we know, have seen the ANC lose power in key areas, such as in the Western Cape in 2009 and across key Gauteng metros in 2016 and 2021).

Figure 3: SA's democratic score is far firmer than EM peers



Sources: World Bank, Standard Bank Research

Figure 4: Press freedom in SA remains a key strength



Sources: Reporters Without Borders, Standard Bank Research

Reform: a mixed bag

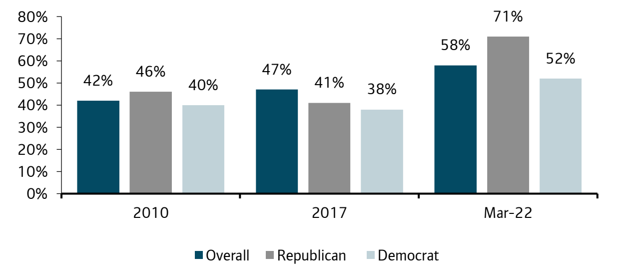
In our view, the structural reform drive will be mixed in 2024.

- In certain areas, such as Operation Vulindlela and the reform being driven by President-private sector workstreams (on energy and logistics), we expect continued, even if gradual, momentum this year, with H2:24 progress hinged on a supportive election outcome. We also anticipate greater focus will be placed this year on SA's ailing water sector, driven by a raft of pending legislative reforms.
- However, outside of these areas our reform expectations are low, with crucial deficiencies remaining in government's response to crime (and particularly organised crime), and local government (though we do at least anticipate that more stable Gauteng metro coalitions will emerge this year, likely after the elections).
- On the governance side, the NPA will be pressed to deliver state capture accountability this year after the disappointments of 2023. Here, the expeditious processing of the NPA Amendment Bill will be vital. From a broader judicial perspective, Chief Justice Raymond Zondo will retire this year and will likely be replaced by Deputy CJ Mandisa Maya.

Foreign policy will remain an apex theme

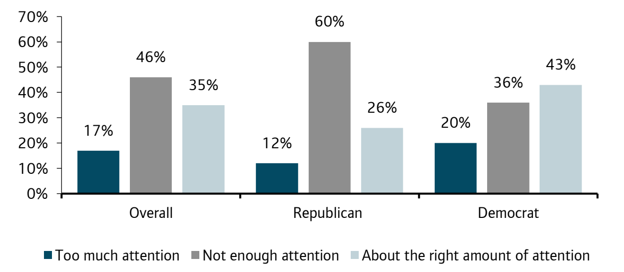
Geopolitical headwinds will remain stern throughout 2024, centred on key flashpoints such as the Russia-Ukraine and Israel-Hamas conflicts, and the underlying realignments being driven by the US-China rivalry. Anti-China sentiment is certain to feature strongly in the US election race, which will routinely underline these suspicions. To this point, in a poll conducted by the Chicago Council on Global Affairs last year, a record high 58% of Americans stated that they regard China's development as a world power as a "critical" threat, and only 19% have "a great deal" or a "fair amount" of confidence that China will "responsibly deal with world problems". These fears are particularly pronounced amongst Republican Party supporters, 60% of whom don't believe that US leaders are paying enough attention to the US-China competition (Figures 5 and 6).

Figure 5: China is a "critical" threat to US interests



Sources: Chicago Council Surveys, Standard Bank Research

Figure 6: US leaders' attention on US-China competition



Sources: Chicago Council Surveys, Standard Bank Research

Navigating the geopolitical and geoeconomic threats presented by these challenges will require the kind of pragmatism and deft that President Ramaphosa displayed in the second half of last year.

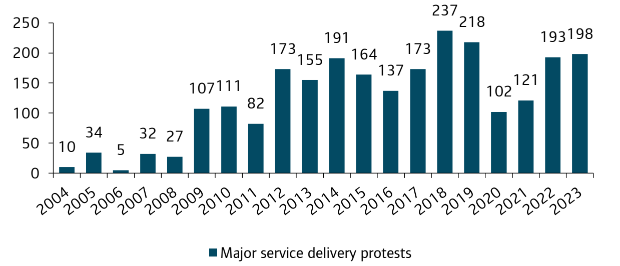
Labour relations, protest action, and social stability

- We do not anticipate a major spike in orchestrated unrest this year, though we remain alive to the threat of political mobilisation and xenophobic populism in the most hotly contested provinces – KZN and Gauteng – in the run-up to the elections.
- That said, service delivery protest action will continue to be a pressing reality across SA, driven increasingly by frustrations over water supply and quality – as well as the general dilapidation of municipal infrastructure. Indicatively, in 2023 there were 198 major service delivery protests, up slightly from 2022, though still somewhat lower than the pre-COVID 19 peaks in 2018 and 2019

(Figure 7). Throughout last year, service delivery protests were predominantly driven by electricity load shedding and water shortages (Figure 8).

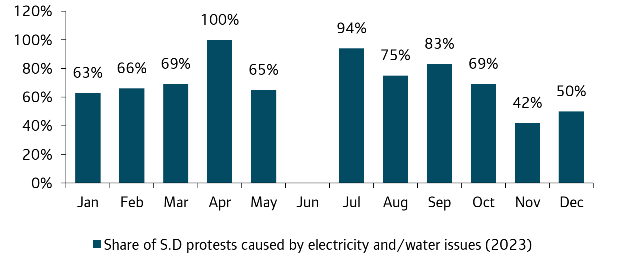
- In terms of labour relations, the two potentially challenging collective negotiations this year cover metals and engineering, where NUMSA remains dominant, and local government (SALGA).

Figure 7: Protests are trending back to pre-COVID highs



Sources: Municipal IQ, Standard Bank Research

Figure 8: Water and electricity shortages driving protests



Sources: Municipal IQ, Standard Bank Research

In closing: 2024 will no doubt be a boisterous year

Within the year ahead lie profound opportunities for change – in and after the elections, on the global stage, and in the important collaborations that were set up last year between government and business to nudge forward the stilted reform agenda.

We believe that SA's outlook will be somewhat brighter by the end of the year than it is now – shaped by some improvements in Cabinet, increased confidence that the worst of the electricity crisis is over, and more momentum towards resolving the crushing logistics and growing water crises.

However, 2024 will not bring catalytic renewal. The ANC will stumble on, with the factional tensions rising after the elections and re-injecting uncertainty into the political and policy outlook. The economy will remain mired in its malaise, compounding fiscal strains. And, we expect only a marginal improvement in President Ramaphosa's executive urgency despite the political authority that he holds now and our expectation that he will secure a second term as head of state – a period where leaders around the democratic world (at least those in country's with term limits such as SA's) tend to become more assertive in driving the reforms that will shape their legacies.

*Simon Freemantle**

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Slowly heading into the right direction

A fragile global economic backdrop, with heightened geopolitical risks, sets a generally unsupportive backdrop for commodities, with SA's terms of trade stagnating. One of the few potential global tailwinds is interest rate relief expected from many of the key central banks from around 2Q24.

Locally, the private sector will to some extent be in limbo ahead of the mid-year general election (due to be held on a still unknown date between May and August), given the uncertainty about both its outcome and impact. Our political analyst's expectation for the ANC to garner around 47/48% of the votes, would negate the need for a coalition arrangement with a sizeable political party and implies policy continuity in monetary and fiscal policy as well as the structural reform trajectory. Under these assumptions, there is scope for modest rand gains – notwithstanding weak domestic fundamentals and the widening current account deficit. Despite the elevated fiscal risks, the expected retreat in global bond yields should support SA bonds. The situation is fluid though and risks to the forecast ANC support are clearly biased to the downside, which would have a significant adverse impact on our macro forecasts.

We expect continuity in structural reform momentum, with Operation Vulindlela removing policy reform impediments systematically, though only gradually. The severe growth impact of electricity loadshedding should ease given the expected increase in Eskom's electricity supply as well as the ongoing expansion of private sector electricity generation, though the unreliable performance of Eskom's existing fleet remains a major risk. The impact of logistical problems, however, will probably ease only modestly, though notably, this year, with the operational benefits of the policy interventions underway likely proving protracted. The persistent structural growth constraints, alongside uncertainty about the outcome, and impact, of the general election mid-year, may curb the recovery underway in private sector fixed investment. Still, there should be some impetus for economic growth from consumer spending, though this remains very uneven across the income groups.

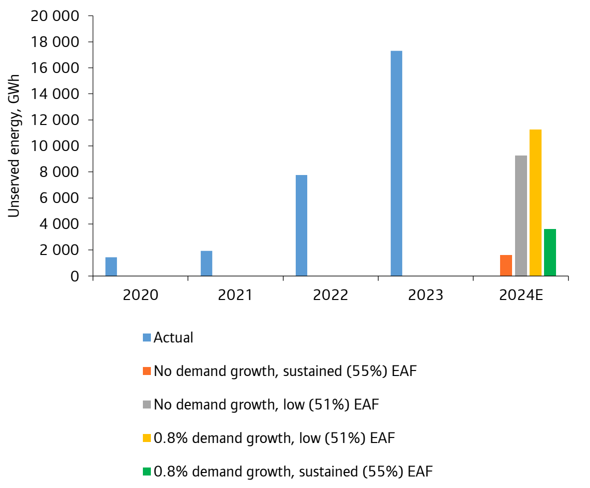
Lopsided growth recovery underway

A meaningful reduction in electricity loadshedding should provide some relief to the economy this year, although progress in the logistical sector will likely be more incremental for now. We sense some urgency to advance Operation Vulindlela's interventions to address the impediments to structural reform prior to the elections, though generally the uncertainty around the outcome and impact of the elections will likely keep businesses and investors in limbo in the first part of this year. This should unwind into the latter part of the year, premised on the ANC gaining near 50% of the votes, as our political analyst foresees, which should then underpin policy and political continuity. From around 2Q24, the economy should also receive relief from monetary policy easing.

We assume ongoing growth in public sector fixed investment, which has so far been shielded from the fiscal consolidation underway (though there might be unforeseen underspending). The recovery in private sector fixed investment is being constrained by weak business confidence, notwithstanding support from investment in electricity self-generation as well as the ongoing, albeit slowing, recovery in company profits.

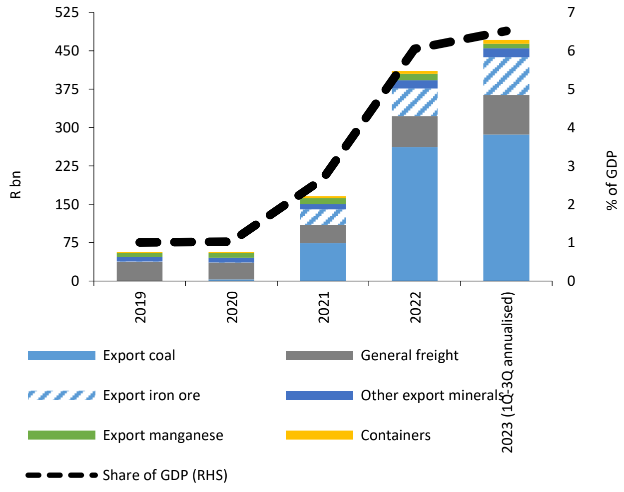
The further recovery in employment in 2H23 should provide some support to consumer spending in 2024, if sustained, as guided by firms' employment perceptions. Consumers should also receive relief from lower inflation and interest rates in 2024, while the proposed implementation of the "two-pot" retirement reform may provide a small boost to consumer spending (though the forecast risk around this unprecedented change is very high). However, these tailwinds may be counteracted by a negative impact from fiscal drag as well as the limited growth in the public sector wage bill. The prognosis remains very uneven across income groups.

Figure 1: Electricity loadshedding should ease meaningfully



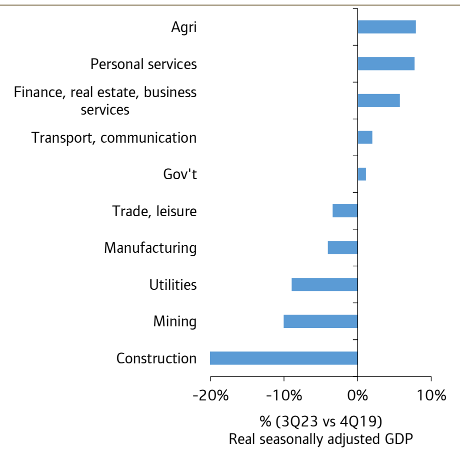
Sources: Eskom, Standard Bank Research

Figure 2: Railway constraints have a meaningful GDP impact



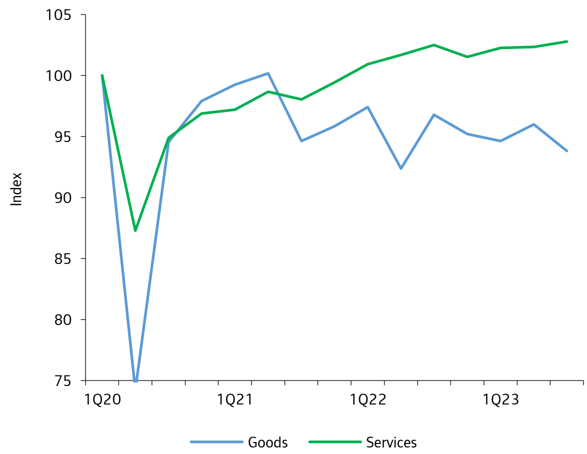
Source: Treasury

Figure 3: Half the sectors haven't yet returned to pre-pandemic GDP levels



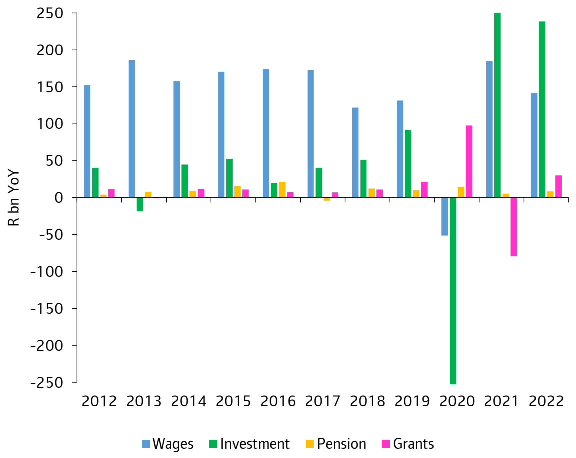
Sources: Stats SA, Standard Bank Research

Figure 4: Goods-producing sectors are more constrained than services by electricity and logistical infrastructure shortcomings



Sources: Stats SA, Standard Bank Research

Figure 5: Sharp swings in investment income in 2021-2022 boosted high-income groups; this support is likely to fade in due course

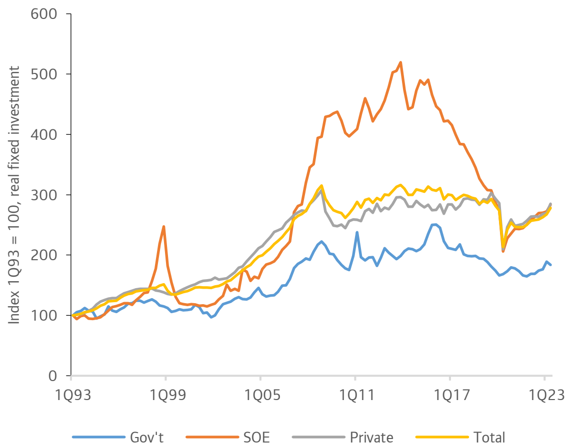


Sources: BMR, Standard Bank Research

Figure 6: Employment recovery also benefited the top end (less skilled workers bearing the brunt of the slow job recovery)

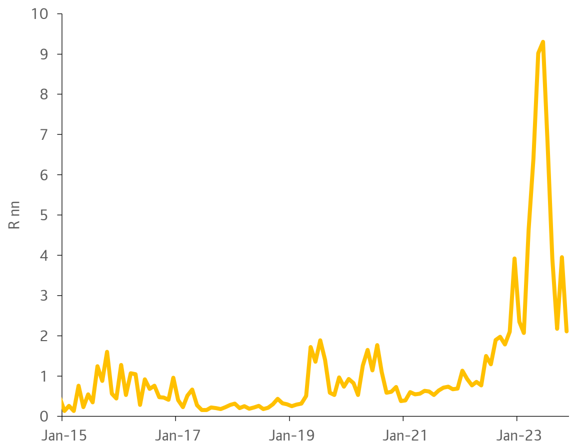
Sources: Stats SA, Standard Bank Research

Figure 7: Fixed investment is recovering, but still weak in a historical context



Sources: Stats SA, Standard Bank Research

Figure 8: Fixed investment is supported by growing private sector purchases of electricity generation and storage equipment

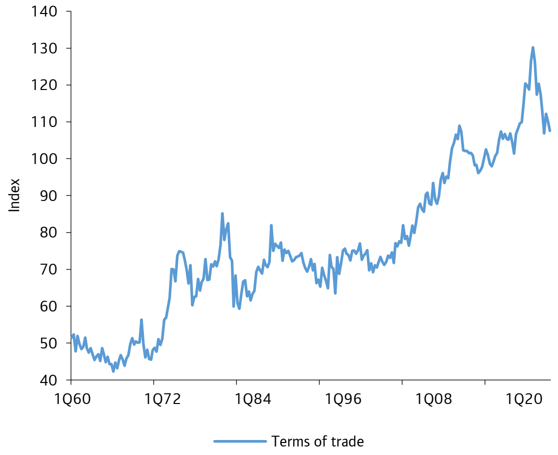


Sources: SARS, Standard Bank Research

Figure 9: Extraordinary high imports of energy-related capex are boosting import volumes, while exports are constrained by infrastructure constraints

Source: SARB

Figure 10: Relative prices (of exports vs imports, or terms of trade) are also less supportive, and weigh on the trade balance



Source: SARB

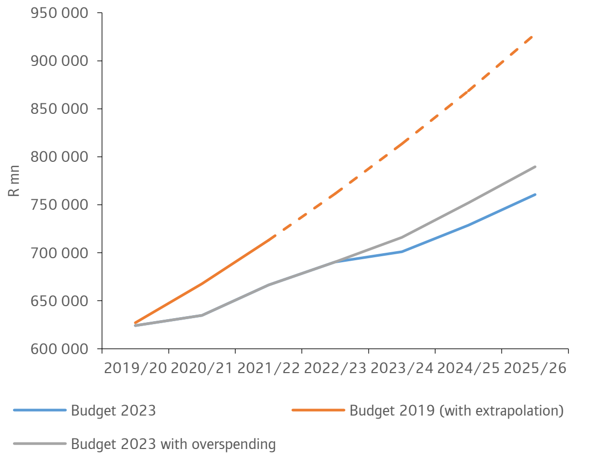
Growing concerns about fiscal sustainability

Year-to-date tax revenues have performed broadly in line with Treasury's latest forecasts for the full fiscal year. We are not particularly concerned about revenue risks in the near term, though the medium-term revenue trajectory requires the higher trend economic growth trajectory that we and Treasury forecast.

In the near term, the fiscal forecast risk stems largely from the expenditure side, where very ambitious spending curbs are required to accommodate the wage bill increase from the FY23/24 wage settlement. The MTBPS spending estimates imply that underlying spending (excluding interest payments, wages and SOE support) hardly grew in FY23/24, with the nominal growth forecast for FY24/25 undershooting inflation (thus implying another real contraction). We're inclined to give Treasury the benefit of the doubt given the relative success in implementing planned curbs in the past - overspending has in the recent past been owing to the introduction (by politicians) of new policies rather than general overspending on the set budgets - and our estimate of seasonally adjusted spending trends have been steady (without growth) in recent months. Meeting the FY23/24 spending targets – which are particularly ambitious – will be critical; thereafter, the targets are generally less onerous.

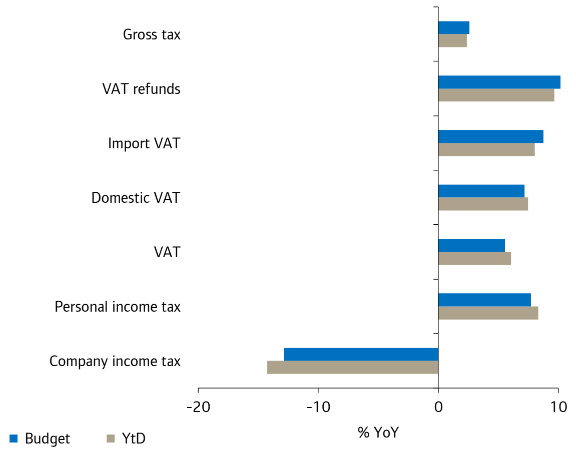
We expect the R15bn of revenue increases planned in the MTBPS for FY24/25 to come from fiscal drag – a notable headwind for consumers. If required to meet its current deficit and debt projections – not our base case at this stage – we suspect that Treasury might increase these planned revenue adjustments (with the additional burden possibly also falling on consumers). The implied reduction in public sector employment will be another headwind to consumer spending. In line with Treasury's forecasts, we foresee the main budget deficit at 4.7% of GDP in FY23/24, with a likely improvement to 4.3% in FY24/25. We expect debt to stabilize at around 78% of GDP.

Figure 11: A step-change in government's wage bill, from firm interventions since 2020, has structurally improved the fiscal prognosis



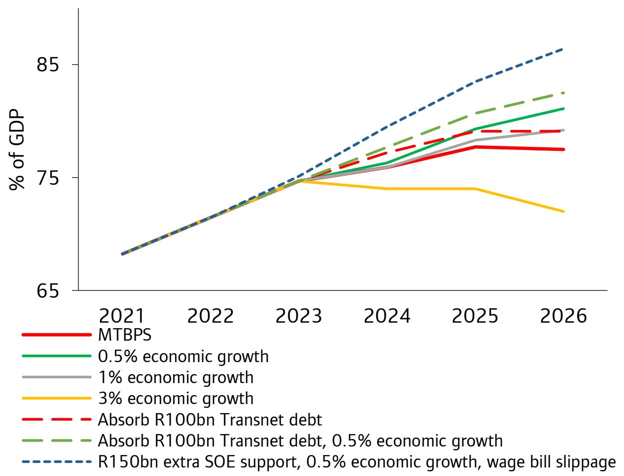
Sources: Treasury, Standard Bank Research

Figure 12: Tax revenues are likely to meet Treasury's latest forecasts



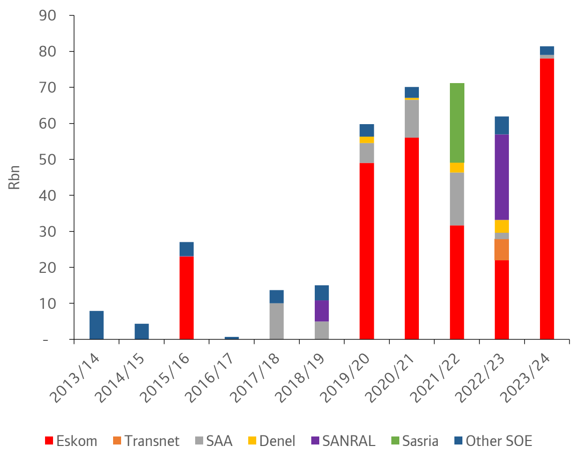
Source: Treasury

Figure 13: Government's debt-GDP ratio should ultimately stabilise, though the negative risks persist



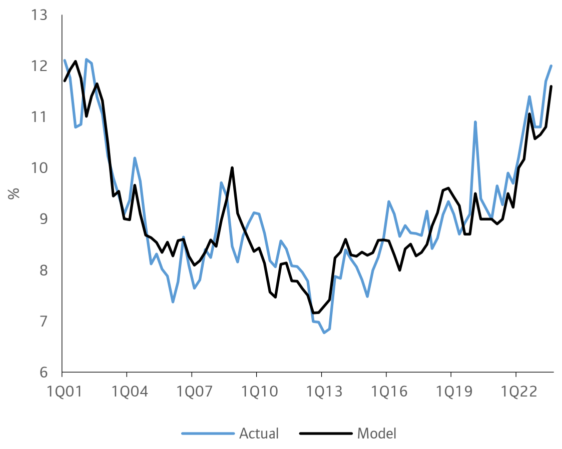
Sources: Treasury, Standard Bank Research

Figure 14: SOE injections have weighed on the fiscus, but we see a plausible turnaround on the horizon



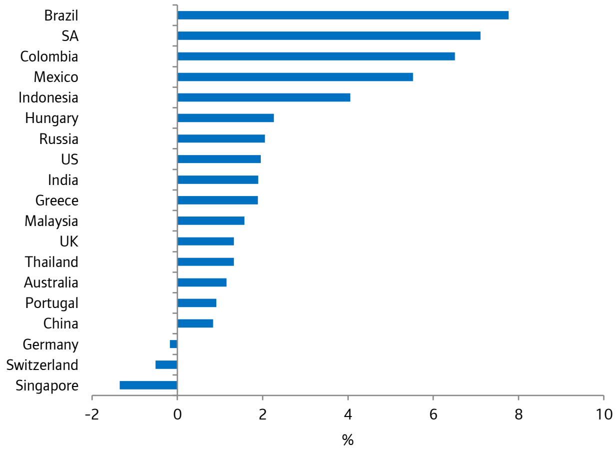
Sources: Treasury, Standard Bank Research

Figure 15: 10-year (generic) bonds slightly undervalued, relative to global fundamentals and our SA forecasts



Sources: Bloomberg, Standard Bank Research

Figure 16: SA real bond yields are high



Sources: Bloomberg, Standard Bank Research

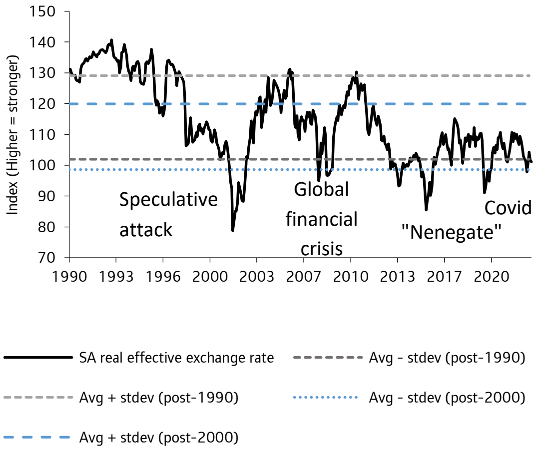
Rand on the back foot amid weak global setting and fundamentals

The rand is currently confronting several headwinds, which are unlikely to improve meaningfully this year. Global growth and commodity prices remain lacklustre. Domestic fundamentals are weak, with persistent concern about fiscal sustainability, inadequate trend growth, and a widening current account deficit. Furthermore, investors are concerned that a particularly weak election outcome for the ANC may ultimately underpin a more populist policy direction.

Our econometric model, peer comparisons and real trade-weighted rand trends imply that the rand exchange rate might be slightly undervalued. In other words, the rand seems to be discounting a modest risk premium after incorporating the relevant (and generally weak) fundamentals. It is unlikely that the modest risk premium being discounted by the rand will compress ahead of the budget and elections given investor concern about potential fiscal slippage as well as concern about the outcome and impact of the election.

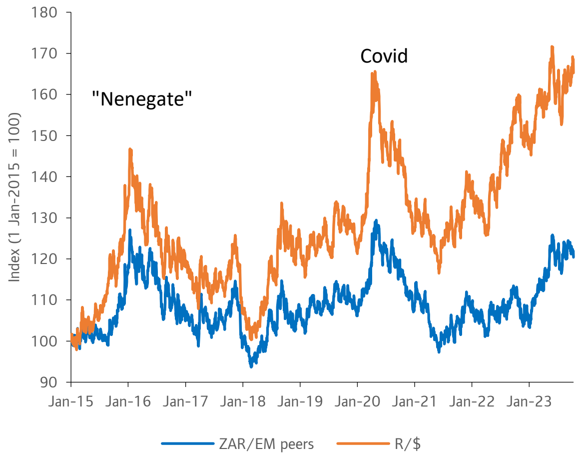
Premised on our current forecasts for the rand’s fundamentals, it might gain modestly later this year as the domestic risk premium compresses. Premised on the bearish dollar projections of both our G10 strategist and the consensus, the rand should gain notably – against the greenback. As usual, our fair value analysis remains very sensitive to the terms of trade.

Figure 17: Real trade-weighted rand is about a standard deviation weaker than its long-term average



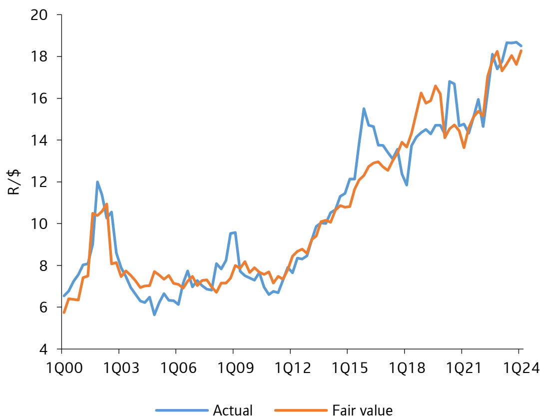
Sources: Bloomberg, Standard Bank Research

Figure 18: ZAR has recovered somewhat from weakest levels against peers, but still reasonably weak



Source: Bloomberg, Standard Bank Research

Figure 19: Rand is slightly undervalued vs our fair value estimates (which incorporate commodity prices, inflation, growth and fiscal and monetary policy)



Sources: Bloomberg, SARB, Standard Bank Research

Figure 20: Fair value scenarios for the rand reveal its sensitivity for key assumptions

	Growth	Terms of trade	Fair value
Base case	1% growth 2024	Similar to 3Q23 levels	18.30
Very bearish	-1%	Fall to 4Q18 level	20.20
Bearish	0% growth	2% lower	19.20
Bullish	2% growth	5% higher	17.20
Very bullish	2% growth	Resurge to 2Q20 level	15.20

Sources: Bloomberg, Standard Bank Research

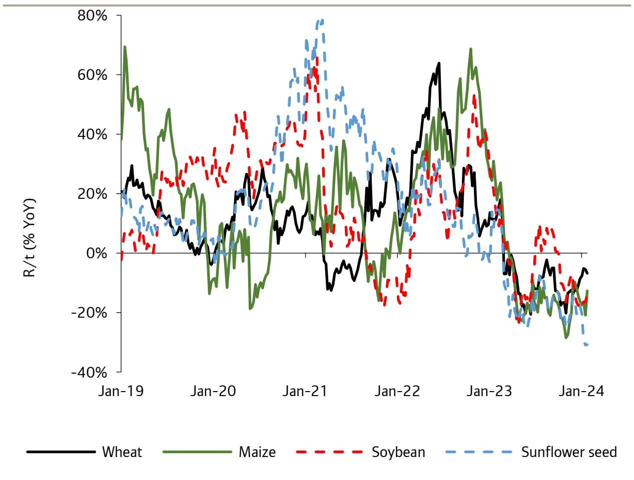
Lower inflation should pave the way for gradual monetary easing

We foresee a gradual retreat in inflation, supported by a lack of demand-driven and wage pressure, favourable base effects (with food and fuel prices in particular likely to slow), and the relatively stable rand exchange rate we pencil in. However, there are clear upside inflation risks, including particularly the persistent negative risks to the rand and the threat to food prices from the El Niño currently underway.

While these inflation risks will likely keep the SARB wary, we see scope for a modest interest rate cutting cycle from around 2Q24, when many of the key central banks are expected to ease policy. The prevailing inflation forecasts are consistent with rate cuts from around 2Q24, with inflation forecast to reach the mid-point of the target range sustainably just two quarters later. By then, the SARB would have more clarity on the fiscal trajectory and the rand's reaction to the (February) Budget. The election, to be held between May and August, may complicate the SARB's decisions (depending on the inflation setting at the time, it might be less influential if inflation is very weak) given that the outcome of the election is uncertain, and the risk of it being rand-negative and thus inflationary. At this stage, we assume that the election will be in 2Q24, with the ANC securing enough support to ensure general policy and political continuity.

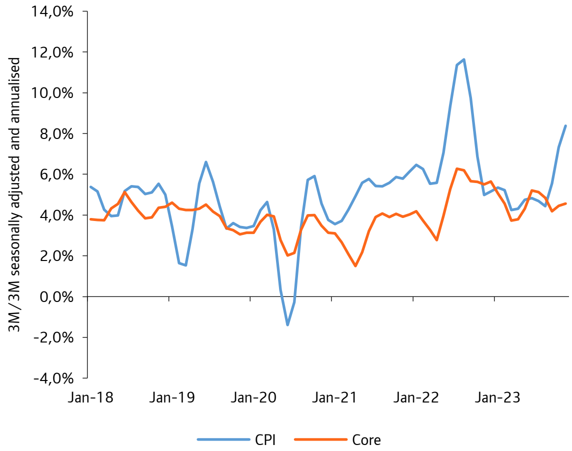
We expect a shallow rate cutting cycle, with the SARB likely to lower the repo rate only to 7-7.25% from 8.25% now. Rate cutting cycles are forecast to be deeper in many other countries, which implies support for SA's interest rate differentials.

Figure 21: Agricultural food price trend is quite benign



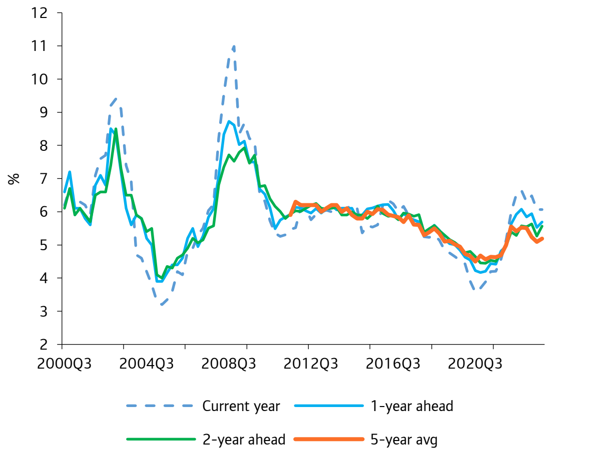
Sources: Bloomberg, Standard Bank Research

Figure 22: Any new inflation pressure gets added to a low base (momentum in inflation is weak)



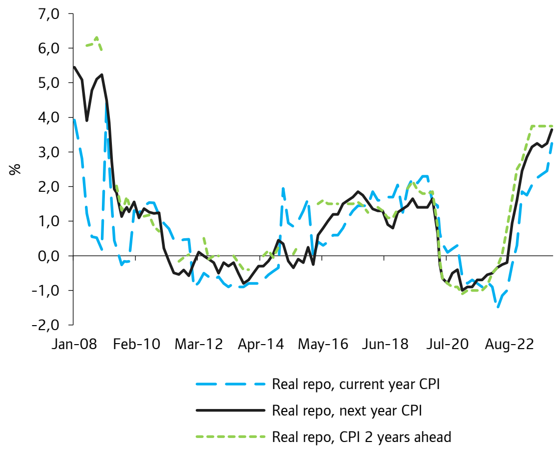
Sources: Stats SA, Standard Bank Research

Figure 23: A decline in surveyed inflation expectations also eases concern about second-round inflation pressure



Source: BER

Figure 24: Real rates have increased significantly and exceed the SARB's estimate of the neutral level (i.e. it is restrictive)



Source: SARB

Elna Moolman[#]

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