



SOUTH AFRICA FROM A GLOBAL INVESTOR'S PERSPECTIVE

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ABOUT THE AUTHOR

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KEY TAKEOUTS



- THE RATE OF CHANGE CAN BE AS IMPORTANT AS THE LEVEL – WE EXPECT SOUTH AFRICA'S ECONOMIC GROWTH GOING FORWARD TO BE BETTER THAN IT HAS BEEN MORE RECENTLY.
- IF A COUNTRY BORROWS TOO MUCH, IT CAN BECOME TRAPPED IN A DEBT SPIRAL WHERE IT DOES NOT HAVE THE GROWTH (AND HENCE THE REVENUE) TO PAY BACK THAT DEBT.
- SOUTH AFRICA NEEDS TO AVOID LARGE DEFICITS AND THIS IS WHY OUR ABILITY TO GROW THE ECONOMY THROUGH GOVERNMENT SPENDING IS SEVERELY CONSTRAINED.
- WE NEED TO ENTICE FOREIGNERS TO INVEST IN OUR HIGHER-YIELDING FIXED INTEREST INSTRUMENTS, TO MITIGATE A POTENTIALLY WEAKER CURRENCY.

SOUTH AFRICA FROM A GLOBAL INVESTOR'S PERSPECTIVE

At MacroSolutions, we often say perspective is important. Having the right perspective can mean the difference between making an informed decision – and a mistake. It's with this in mind, that I thought it would be good to look at South Africa (SA) from the perspective of a global investor. Living here, being absorbed in the day-to-day noise, it's easy to forget that SA does not exist in a vacuum. Like the old saying – it's difficult to see the wood for the trees, especially when you're standing in the middle of the forest.

GROWTH: A BETTER TRAJECTORY ON THE HORIZON

It's no secret that SA has gone through a challenging period in terms of economic growth. Whether comparing us to

emerging markets (traditionally our peers) or developed markets, by comparison our growth has been decidedly lacklustre. Over the 10 years to 2018, the average calendar year real GDP growth of SA has been 1.5%. The only countries with a lower average growth rate than that have been Greece, Russia, Argentina and Brazil – all of whom have been through a major economic crisis in that 10-year period. Even when one leaves out heavyweights like India and China and the fast-growing ASEAN (Association of Southeast Asian Nations) bloc, the more "developed" emerging markets like Taiwan and South Korea managed to achieve growth of around 3% over this period. Clearly, SA has not been a high growth economy. While it may be tempting to have this lead one to despair, it's important to remember that the rate of change can be as important as the level. We expect SA's economic growth going forward to be better than



it has been more recently – and this contributes partially to our thinking on the SA Winds of Change theme you would have heard about from MacroSolutions.

BUDGETARY CONSTRAINTS AND FISCAL POLICY

We have heard ad nauseam in the media, how critical the constraints are on SA's government spending, especially given the risks that state-owned enterprises (SOEs) in general and Eskom in particular have presented. As of 2018, SA's budget deficit stood at 4.5% of GDP. Not many countries in the

emerging markets (EM) space had a worse situation than this, with a key exception being Brazil – which stood at 7.1%. The risk of running large budget deficits is the potentially unsustainable need to borrow in order to fund expenditure. If a country borrows too much, it can become trapped in a debt spiral where it does not have the growth (and hence revenue) to pay back that debt. The result is ever higher borrowing costs for the government, a weaker currency and usually much higher interest rates – all of which lead back to much lower

growth, and so the vicious circle continues. This is why SA needs to avoid large deficits and this is why our ability to grow the economy through government spending is severely constrained.

MONETARY POLICY: IN LINE WITH EMERGING PEERS

In the event that fiscal policy is constrained, monetary policy (in the form of interest rates set by the SA Reserve Bank) is expected to do the heavy lifting. By cutting interest rates, private spending can be stimulated – and so grow the economy. We have had an

interest rate cut of 25 basis points in the last six months. Brazil, Russia and Turkey have cut interest rates by 100, 75 and 750 basis points (bps) respectively – all from much higher levels. Mexico has cut 50bps, India 85bps and the Philippines 75bps. Thailand, South Korea, Malaysia and Peru have also cut 25bps each. So SA does not distinguish itself in terms of the monetary stimulus being applied either.

EXTERNAL VULNERABILITY

There is, of course, good reason why the SA Reserve Bank (SARB) has not embarked on more aggressive interest rate cuts. SA's current account deficit – largely how much more we import than export goods and services – stood at 3.5% of GDP. More importantly, this has remained persistently negative over the

years – which means we have to rely on foreigners to fund our additional spending. This leaves the rand in a precarious spot – especially as it is so openly traded, it is used as a high beta proxy for global risk sentiment. Thus we need to entice foreigners to invest in our higher-yielding fixed interest instruments, to mitigate a potentially much weaker currency. This tight monetary policy is good for investors in SA bonds but less so for SA equity investors. In fact, SA stands out as very cheap relative to other countries from a fixed income and government bond perspective.

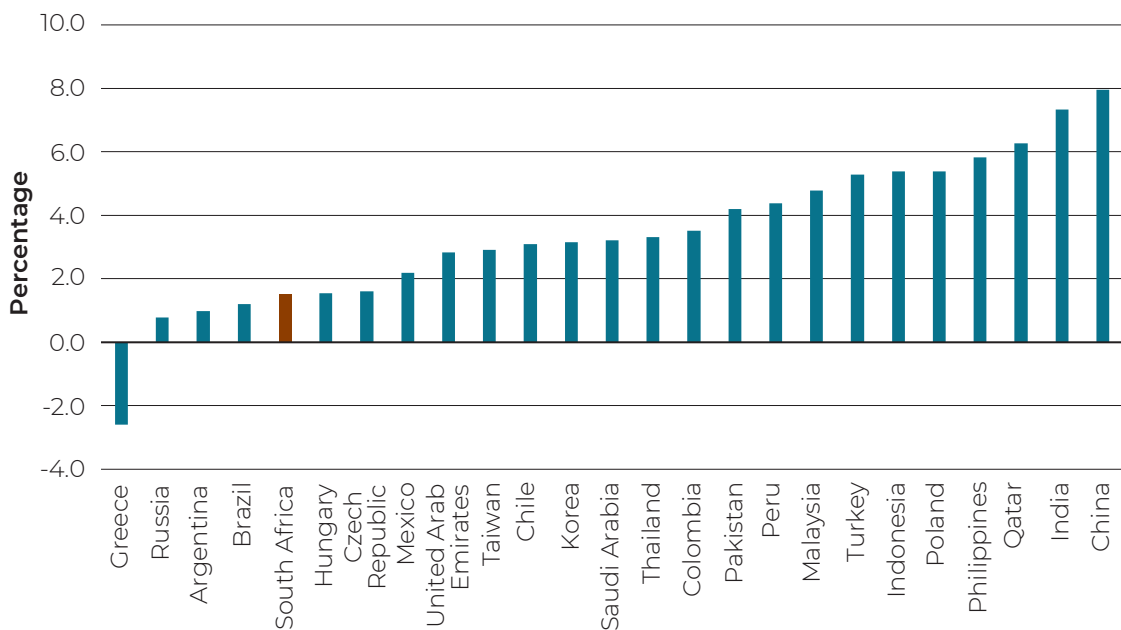
EQUITY MARKET

We therefore have an economic environment that is in no way distinguishing itself from global peers with significant constraints and vulnerabilities. However, economies and markets are

not the same – especially in SA. When we look at the market for SA, it is also important to realise that global investors see SA very differently to how local investors view our own market. This difference in view is typified by two equity indices for SA – the FTSE JSE Capped Shareholder Weighted Index (the index used by local investors) vs the MSCI SA Index (how global investors view the SA equity market).

On a valuation basis, MSCI SA is not in the bottom half of countries on a price-to-book basis and the market produces a return on equity that is lower than the global index average. Over the next 12 months, earnings growth in US dollar terms is forecast to exceed the global index average. However, due to the composition of this growth and the future path of the rand, there remains a lot

AVERAGE CALENDAR YEAR REAL GDP GROWTH OVER THE LAST 10 YEARS



Sources: FactSet, MacroSolutions

of uncertainty attached to this. Admittedly, this talks to aggregate data of many different companies. Nonetheless, it remains difficult to see how these attributes attract global investors.

THE EXAMPLE OF BRAZIL

Brazil has been mentioned earlier in this article. Brazil is an example of an emerging market country that faced very similar challenges to SA a few years ago – spiralling debt, which caused a currency crisis and a very deep recession. Brazil is now emerging from this and is embarking on a reform path that aims to cut its expenditure by making tough social funding choices, implementing labour reforms and privatising state enterprises. While on the same path as SA, it seems like Brazil is a few steps ahead. Combine this with interest rates that are coming down sharply

and a large relatively insulated domestic economy, this paints the picture of why we are overweight to Brazil – rather than SA – in MacroSolutions’ Global Macro Equity Fund.

In SA, on the other hand, we see the probable path of reform as just beginning. While the reforms are necessary to ensure long-term sustainable economic growth for SA, in the short term they are likely painful for growth. We therefore see the Winds of Change theme for SA as much more beneficial for our local fixed income assets than local equity. In fact, SA bonds are one of our most favoured asset classes in our balanced funds.

GLOBAL RISKS

It is also important to realise that SA (being a small economy with a very tradable currency) is often buffeted by the fortunes of the global economy. The

significant slowdown in global manufacturing brought about by the trade war started by President Trump in the US, has heightened the very real risk of a global recession unfolding. In this scenario, it is very unlikely that SA will emerge unscathed.

Although this makes for a challenging environment for SA investors, it's in such times when sticking to long-term investment goals and incorporating appropriate diversification strategies in a portfolio are often the best investment strategies. As you'd expect to hear in a MacroSolutions article, a balanced fund is often the best place to balance risk in one's investments. Here, you are able to navigate choppy waters guided by investment professionals at MacroSolutions.

RETURN ON EQUITY

